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The ESG Catch-22 For Investment Consultants

What if investment consultants were found liable for the asset managers they *did not* recommend to clients?

Industry experts are posing just that question, suggesting that plan sponsors and their consultants should be deemed legally responsible for not putting forth an effort to incorporate environmental, social and governance (ESG) screens into the vetting process when seeking out investment managers for clients, according to a report from the **United Nations Environment Program**.

"(The report) suggests that investment advisors may be subject to suits for negligence in failing to incorporate environmental, social and governance issues in the investment selection process," said Attorney **William Funk**, who works with nonprofit organizations on various tax and legal issues. "It is hazy, however, on how investment advisors should comply with this requirement. An investment advisor may say 'Okay, so I've thought about the issues. How do I know when I've thought enough about these issues?'"

The 120 page report (http://www.unepfi.org/fileadmin/documents/fiduciaryII.pdf), published in July, says that in the near future, investment advisors may have a far greater legal obligation to incorporate ESG issues into their investment services or face "a very real risk that they will be sued for negligence" if they do not.

In addition, the report stated that pension funds, which have arguably led the way in investment policy changes for other institutional investors such as nonprofits, should be on the path to include ESG requirements into policies if they have not done so already.

"It is an obligation on pension fund trustees, not simply a right or option, to state in their Statement of Investment Principles what the fund's guidelines are on responsible investment and to what extent social, environmental or ethical considerations are taken into account," the report says.

Investment advisors, even those that are leading efforts to identify managers with an ESG focus on a global basis, are skeptical that the report could hold much water due to the lack of legal precedent to shed some light on the potential issue.

"The report encourages debate which we believe is useful," said **Jane Goodland**, a UK-based investment consultant at **Watson Wyatt**. "However, some of the sound bites have suggested that investment consultants could be found liable for negligence if they don't proactively bring this up with clients, but we're not aware of any legislation requiring this or any case law which sets this precedent. What we do is make sure clients are aware of the issues and raise these with them when it's prudent to do so, but the notion that we'll become legally negligent remains untested in law."

Funk agrees with the significance of a legal precedent and said the report also is unclear on providing any sort of recommendation that a legal safe harbor be created for investment advisors to exclude bad actors from the research universe even at the risk of foregoing some returns.

"It is understandable that they shied away from this controversy, but missed an opportunity to have a frank discussion of costs and benefits to investors and society at large," he said.

Putting legal responsibility on advisors often tends to get a bit muddled when it comes to manager-consultant compensation relationships and the ability for new managers or those that have ESG products to get on their platforms. But even those consultants who can boast independent advice have contested that hurdles in access, availability and quality of products that incorporate ESG issues are significant factors impeding the progress of ESG into more portfolios.

"There are existing managers with long-term performance history that can demonstrate experience and quality in SRI, but access is a key issue," said **Mary Jane McQuillen**, director & portfolio manager with the Socially Aware Investment (SAI) Program at **ClearBridge Advisors**. "While ClearBridge has a long track record in sustainable investing, if the products are not yet on the broker-dealer's or consultant's platforms, then it becomes a challenge for the advisor to recommend SRI if they can't access the product."

Other experts have suggested that the top-flight managers have essentially incorporated ESG into their portfolios for years, but had never felt it necessary to market their products to such a niche sector. As larger institutional investors such as **CalPERS** and **CalSTRS** dedicated investments in the socially responsible investment sector, managers took notice and slowly began to market products to similarly interested investors.

"Rather than a situation of 'they will build it and they will come,' asset managers will come on board and develop products when there is sustainable investment demand," said **Sarah Cleveland**, a senior consultant who has spearheaded a great deal of SRI efforts at Watson Wyatt in the U.S.

Aside from public pension funds, community foundations are among the early adopters of socially-responsible portfolios. The **Vermont Community Foundation**, for example, dedicates a portion of its $117 million portfolio to managers that integrate numerous types of ESG screens into their portfolios. The SRI portfolio, consisting of seven total equity and fixed-income managers, has stayed fairly close to its indexes for the past quarter, according to recent numbers.

For the quarter ending June 30, VCF's SRI pool was up 13.8% compared to its blended 35% S&P 500/10% Russell 2000/25% MSCI EAFE/30% Barclays Capital Aggregate benchmark, which was up 14.4%. The pool did beat the blended 60% S&P 500/40% Barclays Capital Aggregate benchmark, which returned 10.2% for the same period, but fell below the S&P 500, which returned 15.9%. Over the calendar year-to-date though, the fund has outperformed all three benchmarks, returning 7.7% compared to 4.4%, 3.1% and 3.2%, respectively.

McQuillen said that since the level of scrutiny on long-term sustainable investing has increased quite a bit over the years, with more tracking on areas such as climate change and generally, there are now more resources available to track sustainability issues and how they affect portfolios, adding to the argument that constructing products with ESG issues in mind will not be much of a stretch down the line.

Asset managers such as ClearBridge Advisors, which offer sustainable portfolios, feel that the crux of the issue could be that some of their peers have not built awareness to a lot of the progress and information out there about sustainable investments.

"Unfortunately there is still this thinking among many in the investing population" that above-benchmark returns are not possible through ESG investments, McQuillen said. "…there shouldn't be any special allowances because of SRI, if you're allocating $10 million to a socially aware large-cap core manager (the diligence process) shouldn't be any less rigorous."