HELP Subcommittee Hearing
"Investing for the Future: Honoring ERISA's Promise to Investors"
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My name is Ike Brannon. I am an economist and a senior fellow at the Jack Kemp Foundation as well as president of Capital Policy Analytics, a consulting firm in Washington DC. I am also a former staff economist for the House Energy and Commerce Committee.

Over the last decade there has been a marked increase in the number of investment funds that purport to offer the chance for people to invest their money into funds that invest only in the stock of companies that their investment managers have determined comport with social and environmental standards and also hew to good corporate governance standards, or what we commonly refer to as ESG. In some cases, the emphasis of these funds is to produce an impact for some social or environmental cause.

There is nothing inherently wrong with people choosing to put their own savings in such a fund. When it comes to tax-advantaged retirement savings, however, the tax deferral amounts to a government subsidy at the expense of taxpayers and this tax deferral is for one purpose – to subsidize a secure retirement. Over the last few years some retirement fund managers have tried to expand ESG funds to encourage more people to put their assets in them, such as by making ESG part of a default option for new participants in a group retirement plan. Some elected officials have taken steps to abet these efforts.

These fund managers have touted what seemed to be an unbeatable deal to investors: By investing their retirement savings in funds that eschew problematic companies or industries--such as those that mine coal or critical minerals, or produce oil, or that have refused to join other companies in adopting a progressive agenda via their board of directors--they can do just as well or even better than the index funds that attempt to track the performance of the broader market.

However, the evidence clearly shows that ESG funds tend to lag the broader market, and the long-term ramifications of accepting even a small reduction in the returns to one's retirement savings are significant. There are two reasons that ESG funds lag the typical stock market index fund: The first is called negative screening or exclusionary investing. Negative screening is an investment strategy that constrains a portfolio to leave out a sizable class of stocks with the result that it will be less likely to match the performance of the stock market as a whole. This is especially true if we were to eliminate gas and oil producing companies from a portfolio. Since these stocks tend to be less volatile and pay a significant and predictable dividend--even when demand has been declining and supply is growing, as is the case today--it means that removing such low-volatility stocks results in a more volatile portfolio without an increase in returns. That is, they're accepting more risk without more reward.

The second problem is that the management fees for such investment vehicles tend to be higher than index funds, since there need to be conscious choices made as to what, precisely, should belong in the fund. There is no commonly accepted metric for determining what companies' stock merits inclusion in an ESG fund, and different companies have different approaches: For instance, Bloomberg columnist Matt Levine has noted that while some ESG funds completely eschew oil and gas stocks, others will include those that they determine have made a determined effort to limit carbon emissions and other negative environmental impacts.

Because there is no standard criterion, companies must invest time and effort in determining which companies merit inclusion in their ESG fund, and revisit the portfolio on a regular basis to determine which companies may need to be taken out of its ESG fund and which new companies should be added.

As a result, the management fees of ESG funds are higher than index funds, even if they are passively managed. A Morningstar report suggests that ESG funds have a fee about .1 percent higher than non-ESG stock index funds. My own analysis of the offerings of the five biggest management companies found the difference to be .15 percent. There are also non-passive ESG funds with higher management fees.

Small differences in returns can have a big impact over the long run, thanks to the miracle of compound interest. A 2015 study by the Obama Administration's Council of Economic Advisors, authored by Jason Furman, a well-respected economist and a friend, noted that a one quarter percentage point reduction in net earnings for someone who makes regular contributions into their retirement account over their entire career will reduce the size of their assets by nearly ten percent at retirement.

An investor who is concerned about the environment, or about broader social justice issues or the corporate governance matters at a particular firm, has the means and ability to express himself if he or she so chooses to do, whether it be by donating money to charities that engage in such issues, voting for politicians who espouse such perspectives, or consciously investing some of his wealth in such a way so that it furthers his non-pecuniary goals. But doing it on his behalf, and insisting that he benefits from that, is simply disingenuous and represents an act done for the pecuniary and non-pecuniary interests of the fund manager, contradicting his fiduciary responsibilities. The government should not acquiesce in such behavior.