Conservative Group Seeks to Block State Pensions from ESG Efforts

Model legislation from a conservative association of state legislators seeks to restrict ESG-related investments and proxy voting.

By Bridget Hickey|April 13, 2022

A conservative association of state legislators has launched a new effort to restrict pensions' consideration of environmental and social issues.

The **American Legislative Exchange Council**, or ALEC, last week released new **model legislation** meant as an outline for state lawmakers seeking to bar plan fiduciaries from sacrificing returns or taking on additional investment risk to promote "non-pecuniary or non-financial social, political or other benefits or goals." The model policies also restrict state pensions from casting proxy votes to further such objectives.

The association writes ready-made legislation to be adopted by state legislators. Between 2010 and 2018, its model bills were introduced 2,900 times across all 50 states and in Congress and had a 21% pass rate, according to ALEC, citing an investigation by **USA Today**, the Arizona Republic, and the Center for Public Integrity.

Countering ESG investing by state pension funds is a driving factor behind the new proposal, the association's chief economist told the **Wall Street Journal**. He argued that state pensions should be banned from "politically driven" investment strategies. ALEC did not respond to an interview request from FundFire.

The new template does not explicitly bar environmental, social, and governance, or ESG, investing, but states that "environmental, social, corporate governance, or other similarly oriented considerations are pecuniary factors only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories."

The move comes at a time when many state pension boards are grappling with the material risks posed to their portfolios by environmental and social issues. The **California Public Employees' Retirement System**, for example, has calculated that about 20% of its holdings are exposed to physical or transition risk from climate change. The **New York State Common Retirement Fund** is divesting from many of its fossil fuel holdings, citing risks to the financial performance of these investments as the world transitions to a low-carbon economy.

Pensions are also flexing their shareholder muscles on these issues. The **California State Teachers' Retirement System** is pushing companies for better disclosure of key climate metrics and for greater board diversity, as **reported**.

Maine, in June, became the first U.S. state to require its pension to divest from fossil fuels.

In contrast, some Republican-leaning states that have made moves to punish managers that eschew oil and gas investments, as **reported**.

Texas passed a law last year to force all state investment funds, including the **Teacher Retirement System of Texas** and the **Texas Permanent School Fund**, to divest from companies that shun fossil fuel investments, as **reported**.

The challenge for states that pass these types of "anti-ESG" laws is that the ESG has become more and more integrated into the investment universe, said **Josh Lichtenstein**, an ERISA partner at the law firm **Ropes & Gray**.

Long term, if more states adopt these laws, asset managers will either determine that they want to manage that pool of money by launching standalone products or using separately managed accounts, or some state plans will not have access to the full range of investments available to their peers, he said.

"The biggest question is, are these states going to continue to have access to investments or not?"

ALEC's legislative template shares some common language with a rule from the Trump Administration's **Department of Labor** that bound retirement plan fiduciaries to a "**pecuniary**" standard when making investment decisions.

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When first announced, the DOL said the rule would explicitly bar ESG investing for plans sponsors governed by the **Employee Retirement Income Security Act**, also known as ERISA, which includes corporate pensions. However, the DOL appeared to walk back these plans following industry outcry, and the text of the final rule did not prohibit fiduciaries from considering environmental impact and workplace practices when relevant to the financial analysis, as **reported**.

The Biden administration **stopped enforcing** the Trump-era rule and proposed a new rule that would make it easier for corporate pensions to include climate change and other environmental, social and governance factors in their investment lineups and to exercise their shareholder rights "seriously," as **reported.** The October proposal calls for ERISA fiduciaries to consider climate change and ESG factors as part of their investment evaluations.

The Trump administration's ESG rule caused "real concern" in the industry that U.S. corporate pensions could miss out on the full range of investment products available to international and, particularly, European peers, who demand more ESG exposure, Lichtenstein said.

"I do not believe that we have the tools to cleanly identify and separate out which investments are "politically motivated," and which are not," said **Olivia Mitchell**, an economist at the Wharton School of the **University of Pennsylvania**, who leads the school's pension research council, in an email.

"My research shows that some conclude that taking [ESG] into account enhances investment performance; others argue that it adds alpha potential; and still others argue that it can mitigate portfolio risk. In the case of pension funds, many struggle to find a clear balance between social responsibility and the fiduciary duty to act to maximize return on behalf of their participants," she said.

Investment industry professionals have **been divided** on the merits of ESG, with some arguing that the approach adds value, some raising concerns about products that promise more than they deliver, and still others questioning the entire premise. A **poll** of FundFire readers last year found that 31% thought ESG strategies were largely delivering what they promised, while 69% said that many offerings on the market today just use ESG as a marketing gimmick.

Jason Hsu, the founder and chief investment officer of China-focused investment boutique **Rayliant Global Advisors**, said by email that he sees "research merit" behind the legislation.

"There is little empirical support that ESG investing would enhance investment return," he said. "There are a lot of theoretical reasons why ESG investing could negatively impact investment efficiency."

Some argue that the jury is still out.

"I don't think there's enough evidence out there right now to say whether screening for ESG factors has added value, produced the same or detracted value," said **Russ Kamp**, a managing director at **Ryan ALM**, a fixed income manager that works mostly with defined benefit pensions.

Until there are some specifics, “I think it's tough to make an assessment as to whether or not this legislation is even warranted," he said.

"I think pension America has bigger problems to face as we see this interest rate environment change dramatically from what we've enjoyed over the last 40 years," Kamp added