MSCI

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Mr Fred Wong
Acting Chief
Division of Regulations
Office of Regulations and Interpretations
Employee Benefits Security Administration
Department of Labor

Submitted via electronic filing: www.regulations.gov

**Proposed rule on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights (RIN 1210-AC03) ("Proposed Rule")**

Dear Mr Wong,

MSCI welcomes the proposal to clarify certain aspects of the current rule as to whether a fiduciary under the Employee Retirement Income Security Act of 1974, as amended, ("ERISA") may consider climate change and other environmental, social and governance ("ESG") factors in making investment and proxy voting decisions. The current rule raised doubts among ERISA plan investors regarding their ability to freely integrate ESG factors in their investment decisions, a limitation not faced by their global counterparts.

Global ESG assets under management have grown from $6 billion in 2015 to $150 billion in 2020, and throughout 2020, investors allocated over three times as many assets into ESG ETFs as in 2019. A survey of institutional investors found that most investors had financial motives for integrating ESG into their portfolios, i.e., they were "seeking better risk-adjusted returns over the long term without upsetting the investment strategy and factor allocation of their existing portfolios."[1]

**Suitability of ESG integration as financial factor**

There is a growing body of evidence and research supporting the suitability of ESG integration in the investment process as a financial or pecuniary factor, as set out in the 2020 MSCI comment[2] to a proposed rule by the DOL.[3] MSCI examined how ESG information embedded within companies is transmitted to the equity market. [4] We found that high ESG-rated companies tended to show higher profitability, higher dividend yield and lower idiosyncratic tail risks.[5] We also found that high ESG-rated companies tended to show less systematic volatility, and higher valuations.

[1] Guise, G. et al, May 2018. Foundations of ESG Investing Part 3: Integrating ESG into Passive Institutional Portfolios.
[2] Regulations.gov MSCI Comment RIN1210 AB95.
[3] Proposed Rule Financial Factors in Selecting Plan Investments.
[4] Guise, G. et al, July 2019. Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk and Performance.
[5] This relates to the two idiosyncratic transmission channels cited in this study. Our research relied on existing corporate finance models in establishing the transmission channels of ESG to the financial world.

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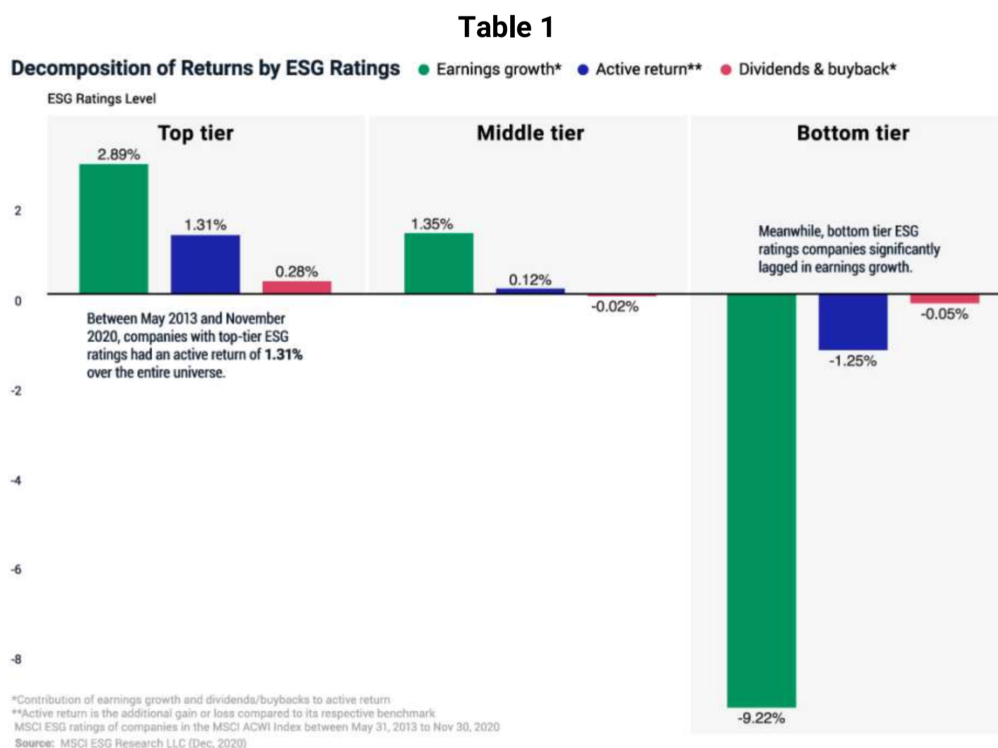
Worldwide, ESG-focused constituents of the MSCI ACWI Index have not only seen higher returns, but stronger earnings growth and dividends. Between May 2013 and November 2020, companies with top-tier ESG ratings had an active return of 1.3% over the entire universe, while bottom-tier ESG ratings constituents significantly lagged in earnings growth (as illustrated in Table 1 below).[6]

**Table 1**




Additionally, when considering the impact of the COVID-19 pandemic on equities, ESG indexes tended to outperform particularly due to positive contribution of stocks with high MSCI ESG ratings. While all MSCI ACWI ESG indexes finished 2020 at least as well as their parent, most of them outperformed during both the 2020 slump (from January 1, 2020 though to March 23, 2020) and rally (from March 24, 2020 through to the end of the second week of 2021). ESG characteristics played a leading role in outperformance during the slump, rally, and the whole year.[7]

**Suitability of climate change as financial factor**

We note the statement that "[t]aking climate change into account, such as by assessing the financial risks of investments for which government climate policies will affect performance and account for the risk of companies that are unprepared for the transition, can have a beneficial effect on portfolios by reducing volatility and mitigating the longer-term economic risks to plans' assets".[8] In our report, *Foundations of Climate Investing: How Equity Markets Have Priced Climate Transition Risks*,[9] we studied the financial impact of climate transition risk in global equity

[6] MSCI, 2021. Fact Check: The Truth Behind 5 ESG Myths.
[7] Ferenc, Y.P., March 2021. ESG Indexes Through the Slump and Rally of 2020.
[8] Proposed Rule on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights p. 57277.
[9] Guise, G. et al, September 2021. Foundations of Climate Investing: How Equity Markets Have Priced Climate Transition Risks.

markets. We identified economic transmission channels within a standard discounted cash flow model showing how regulatory policies and green technology influence financial markets. In developed markets outside the U.S., more carbon-efficient companies experienced stronger stock-price performance over a seven-year study period and, in the U.S., more carbon-efficient companies showed slightly better performance over this period.

After comparing companies' climate transition risk profiles to their valuation levels, we found that carbon-intensive companies experienced greater declining valuations in terms of price-to-book ratios than did their less-carbon-intensive sector peers, suggesting that markets have discounted the book value of carbon-intensive companies. In contrast, companies with significant green revenue saw their price-to-earnings ratios increase relative to their sector peers.[10]

Furthermore, we found that companies' earnings growth and stock performance were directly related to their greenhouse gas (GHG) emissions. Using five MSCI Low Carbon Transition (LCT) categories, the riskiest category (stranded assets) had the weakest performance, and the solutions category had the strongest. While most performance differences were explained by the industry factor, there was a significant stock-specific return that showed a strong correlation to companies' climate transition risk profile. When we included LCT Scores in a standard risk model, we saw a positive return attached to the climate transition risk profile, which has accelerated over the past two years.[11]

**Conclusion**

MSCI believes that a convergence of factors (climate change, social attitudes, institutional governance, technological innovation) will significantly impact the pricing of financial assets and the risk and return of investments and lead to a large-scale re-allocation of capital over the next decades. ESG integration[12] is a transitional step to full incorporation of ESG considerations embedded as a core component of standard security selection, portfolio construction and risk management practices. This is a permanent change to how investment strategies will be constructed and how investments will be allocated and managed. It will also impact how fiduciaries will carry out their duties in voting proxies and exercising shareholder rights for the benefit of beneficiaries and plan participants.

MSCI supports the Proposed Rule to help clarify that ERISA does not prohibit fiduciaries from making investment or proxy voting decisions that reflect material ESG considerations.

Please do not hesitate to contact us to discuss our submission.

Yours sincerely,

**/s/**
**Neil Acres**
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**MSCI ESG Research LLC**

[10] Guise, G. et al, September 2021. Foundations of Climate Investing: How Equity Markets Have Priced Climate Transition Risks.
[11] Guise, G. et al, September 2021. Foundations of Climate Investing: How Equity Markets Have Priced Climate Transition Risks.
[12] The MSCI Principles of Sustainable Investing.