Fiduciary ESG Investing: Navigating the New Frontier

Bernstein Wealth Strategy Research

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Bernstein Private Wealth Management
Wealth Strategy Group

Bernstein Private Wealth Management advises high-net-worth clients on planning for—and living with—the complexities that come with wealth. We specialize in addressing challenges that extend well beyond wealth management by offering a vast network of resources customized to clients' values and needs. Bernstein Private Wealth Management is distinguished among major wealth managers by its holistic approach, flexible process, innovative research, sophisticated modeling, and cutting-edge investment solutions.

The authors of this paper are members of Bernstein's Wealth Strategies Research Team: a multi-disciplinary group of professionals with experience helping individuals and families navigate the intersections of wealth, investment planning, and family governance. This paper is one in a series on issues of particular significance to families and individuals of means and their professional advisors.

Special thanks to Bernstein's Investment Strategy Team for their insights on the origins and evolution of the ESG investing universe and in-depth descriptions of ESG integration and ESG-focused strategies.

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Introduction

Your Uncle Leonard, a world-renowned physician and explorer, recently passed away and named you as trustee of the trust for his children. While you didn't spend much time with your uncle due to his work-related travel, you're fond of his children and agreed to administer the trust. As you decide how to invest the trust's assets, you find yourself drawn to an "Enterprise Fund" that seeks to generate index-like returns while supporting positive social and environmental goals worldwide. The strategy's focus on companies expanding healthcare access to underserved communities seems particularly appealing. Promoting healthcare in under-resourced populations feels like something Uncle Leonard would applaud, though he never discussed his investing preferences with you. In fact, he typically responded to questions about the stock market by saying, "I'm a doctor, not a financial advisor!"

Can you invest in a fund that seeks both financial and nonfinancial goals without violating your fiduciary duties? You know you're required to invest the trust funds solely in the interests of the beneficiaries and with reasonable care in the context of the trust's purpose and terms. You'll also be held personally liable for any damages from a breach of trust. Unfortunately, the trust agreement doesn't overtly address the issue, which adds to your uncertainty.

This piece addresses these concerns and provides a road map for fiduciaries looking to evaluate and engage with investment strategies that incorporate environmental, social, and governance ("ESG") considerations. Part I summarizes the origins and evolution of the ESG investing universe, including an in-depth description of:

- ESG integration (a practice that integrates ESG considerations alongside traditional financial metrics to achieve a greater risk-adjusted return), and
- ESG-focused strategies (those that incorporate ESG considerations into both their mandates and implementation to support financial and nonfinancial goals).

Part II describes a fiduciary's duty of loyalty and how and when fiduciaries may consider an investment's collateral impacts—including ESG investing goals—while satisfying this duty. Part III describes a fiduciary's duty of care[1] and how it informs the evaluation and selection of an investment strategy. Finally, Part IV suggests ways for a trust's interested parties or a charitable nonprofit's decision-makers to bolster and broaden fiduciary use of ESG investing strategies through express authorization in an applicable governing document and/or beneficiary involvement.

Before we begin, we must first establish certain parameters. Commentators have long discussed the pros and cons of active versus passive management, and the market currently offers both forms of ESG-related investing. As a summary of this debate exceeds the reasonable scope of this piece, we will limit our focus to ESG-related investing in the world of active management. More specifically, we will address ESG-related investing only in the context of public equities and fixed income. While many of the principles discussed herein apply to ESG-related investing in other asset classes, these strategies tend to take too idiosyncratic of an approach to risk and return to sufficiently address within this piece. Lastly, we will confine our conversation to the fiduciary duties of loyalty and care. However, we acknowledge that other duties—including that of impartiality—may also play a role in a fiduciary's analysis of ESG-related investing.

Part I—ESG Investing

Responsible Investing Beginnings

The responsible investing ("RI") movement, which includes modern-day ESG investing, originated with faith-based investing by groups such as Muslims, Quakers, and Methodists. While Muslims sought to invest in compliance with Islamic law, Methodists and Quakers avoided businesses that dealt in alcohol, tobacco, gambling, and the slave trade.[2] In the 1970s, RI gained a secular edge as investors sought to rule out companies contributing to the Vietnam War.[3] This included Pax World's launch of the first sustainable mutual fund for religious investors looking to avoid Agent Orange supply chains.[4] The 1980s saw RI further broaden its scope as the anti-apartheid movement led some funds to exclude companies doing business in South Africa as part of a larger call for divestiture.[5]

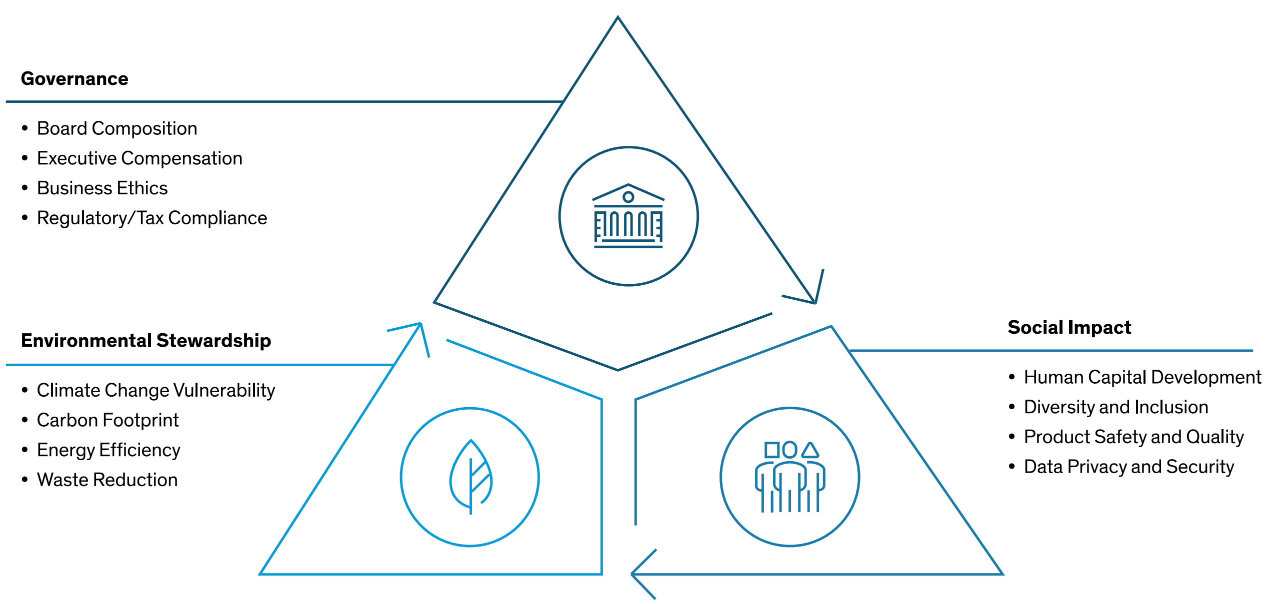
These early RI efforts relied solely on negative and positive screening to support their investment mandates.[6] In the context of RI, negative screening focuses on excluding objectionable assets or industries, while positive screening focuses on the inclusion of companies achieving investors' social or environmental goals.[7] Although screening is commonplace in the investment world, early RI strategies were unique in employing screens for nonfinancial purposes and without regard to the screen's impact on return and volatility.[8] Thus, investors in such strategies had to subordinate their financial goals to the strategy's social or environmental objectives, making the funds "concessionary" in nature.

ESG Investing Strategies

In contrast to the limited offerings of the past, modern ESG investors face an ever-expanding array of investment options aimed at key themes (**Display 1**). For those simply seeking an improved risk-adjusted return, ESG integration uses financially material ESG considerations to better assess a security's future performance and highlight market inefficiencies. ESG-focused strategies, on the other hand, offer investors a means of promoting social and/or environmental change while simultaneously pursuing financial return. In addition to this diversity of investment mandates, the means of implementing an ESG integration or ESG-focused strategy also vary across managers. With so many options, investors may feel overwhelmed and unsure how to evaluate a potential strategy's objectives and performance. To shed some light on this topic, let's dig a little deeper into ESG integration and ESG-focused strategies.

DISPLAY 1: ESG INVESTING IN TODAY'S WORLD

A Modern Approach to RI



Source: AB

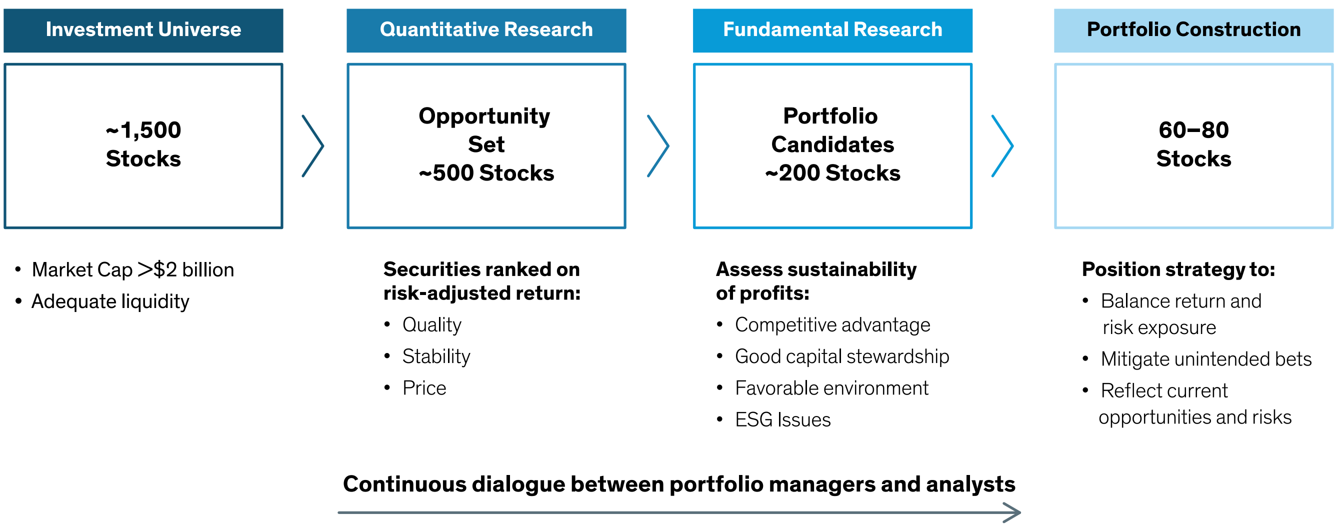
ESG Integration in Active Management

As mentioned above, ESG integration refers to a manager's use of material ESG considerations to better gauge an investment's future financial performance and thus enhance risk-adjusted returns. Put more simply, a manager employing ESG integration evaluates the ways in which a company engages with an ESG issue material to the company's processes or products. If the company fails to appropriately address the issue, that oversight may highlight a future financial risk (e.g., a fine or lawsuit). If the company outperforms its peers in managing the issue, it may be at a financial advantage (e.g., if the company invests in new technology or industry-leading practices). Importantly, the manager evaluates a company's ESG-related performance alongside and in conjunction with more traditional financial metrics to determine whether including a specific security will bolster the overall portfolio's financial performance. Unlike earlier RI strategies, ESG integration does not label investments in a binary manner as "good" or "bad"—or prohibit ownership of companies in any industry. The goal is not exclusion based on a nonfinancial motive but better-informed, financial decision-making.

For example, an active manager creating a portfolio focused on the healthcare industry may begin with a broad potential investment pool based on sector, revenue, and market capitalization. The manager then will narrow this pool through a mix of quantitative analysis—mathematically ranking stocks based on objective financial metrics—and qualitative analysis, assessing the strength of subjective factors like a company's competitive advantage, management strength, and financial health (**Display 2**).

As part of the assessment process, a manager engaging in ESG integration will identify material ESG issues for each security under consideration. In the healthcare industry example, such issues might include product safety standards, access to healthcare, and privacy protocols, among others. The manager then will assess how the company addresses the ESG issue and whether such performance impacts the company's current value. For instance, assume that a healthcare facility institutes aggressive productivity quotas that result in greater earnings for the company but also lead to haphazard data management practices.[9] That is, employees don't take the time to implement data protection measures because they are under severe, quota-driven time constraints. Traditional investors might value the company based on the promise of increased earnings and positive future performance. However, after analyzing the ESG considerations underpinning the earnings increase, an ESG-aware manager might discount the increased profits. For such a manager, the corresponding erosion of data protection standards and the financial impact of a potential data breach's consequent legal costs and damage to

DISPLAY 2: FUNDAMENTAL ANALYSIS INCLUDES EVALUATING ESG CONSIDERATIONS



Numbers represent approximate number of stocks at that stage of the process.
Source: AB

patient relationships highlight an increased risk that detracts from the company's present earnings. In this way, ESG integration allows portfolio managers to be more forward looking, rather than relying solely on historical performance.

Additionally, material ESG considerations may signal compelling opportunities for active managers to exploit market inefficiencies, as such considerations may be especially vulnerable to the broader market's mispricing. For example, recent research indicates that a company's history of ESG risk incidents correlates with a higher rate of future incidents and underperformance in terms of profitability and risk-adjusted returns (meaning the company's ESG risks were underappreciated by the market).[10] Indeed, the study reported that a portfolio with a high rate of adverse ESG incidents generated anomalous stock returns of -3.5% per year in the United States and -2.5% per year in Europe, even when controlling for risk factors, industries, and firm characteristics.[11] The report suggests that traditional investors fail to accurately assess a risk incident's long-term implications for a company's value—due in large part to inconsistency in ESG measurements, weighting, and reporting, the long-term nature of ESG, and corporate "greenwashing."[12] But this was not true for all investors. Rather, investors focused on ESG issues (i.e., investors who are more likely to incorporate ESG information that is material but hard to quantify) built portfolios with lower risk incident exposure and better performance than their peers.[13] Thus, a sophisticated approach to ESG considerations allowed certain investors to capitalize on the current ambiguity surrounding the relationship between ESG issues and financial performance.

While ESG integration may lead to greater returns over time, its effectiveness depends heavily on the selection of material ESG issues. Here, managers differ in their approach, with varying levels of success. Some managers rely on one or more third-party ESG ratings to rank a company's ESG performance in relation to its peers. Such rating agencies collect data from various sources—including annual reports, websites, and direct contact with companies on ESG-related issues—and then assign a weight to this data based on its materiality to the company's core purpose. Returning to our previous example, a rating agency would likely give a healthcare provider's environmental attributes (e.g., its waste management protocols) less weight than its employee and patient safety standards.

However, third-party ratings suffer from certain limitations. They offer a static look at a company's ESG-related attributes based on current conditions and the recent past.[14] Plus, different agencies frequently disagree on a single company's material ESG issues and rating. To address these concerns (and, in some cases, in place of using third-party ratings), managers may engage in fundamental research with respect to a material ESG issue. This allows the manager to project how the ESG consideration might evolve in the future (for example, a company's cutting-edge technology practices may provide less of a financial benefit as they become industry standard).

ESG integration allows portfolio managers to be more forward looking, rather than relying solely on historical performance.

Additionally, hands-on research allows a manager to evaluate whether attributes underlying a company's ESG score are material to the company's financial performance. For example, a manager may downgrade an ESG score that initially benefited from the adoption of a diversity and inclusion policy if the company fails to appropriately implement the policy, thereby undermining its impact on employee recruitment and retention.

DISPLAY 3: FUNDAMENTAL RESEARCH CAN UNCOVER COMPANIES THAT SUPPORT FINANCIAL AND ESG GOALS

ESG Characteristics

Define Purchase Universe

- Narrow investment universe to potential companies that meet both the ESG goals/themes while offering a potentially attractive financial investment
- Seek companies that are outperforming on positive ESG attributes
- Use multiple internal and external data sources, not third-party ratings

Financial Indicators

Identify High-Potential Investment Ideas

- Seek exposure that meets both the ESG characteristics and attractive financial attributes you are striving for
- Focus on industries with attractive competitive dynamics and sustainable returns on invested capital

Due Diligence

Conduct Fundamental Research

- Evaluate stocks on forward-looking basis:
  - Attractive return potential
  - Best-in-class or improving ESG performance
  - Strong competitive positioning
- Evaluate performance under multiple scenarios

Monitoring

Build and Rebalance Portfolio

- Rebalance to maintain exposure to high-conviction ideas
- Actively vote proxies and engage with management teams
- Monitor portfolio and stock-level risks at regular intervals to flag areas of concern

Source: AB

ESG-Focused Strategies in Active Management

While managers utilize ESG integration as a security selection tool without regard to a strategy's underlying mandate (i.e., the overall strategy does not need to pursue a social or environmental objective), an ESG-focused strategy pursues financial and ESG-related collateral benefits. This does not mean that the strategy necessarily elevates its ESG-related mandate above its financial goals, as some commentators suggest.[15] Indeed, we will focus exclusively on strategies designed to deliver financial performance comparable to their non-ESG peers (i.e., non-concessionary strategies) while supporting an additional ESG-related objective.

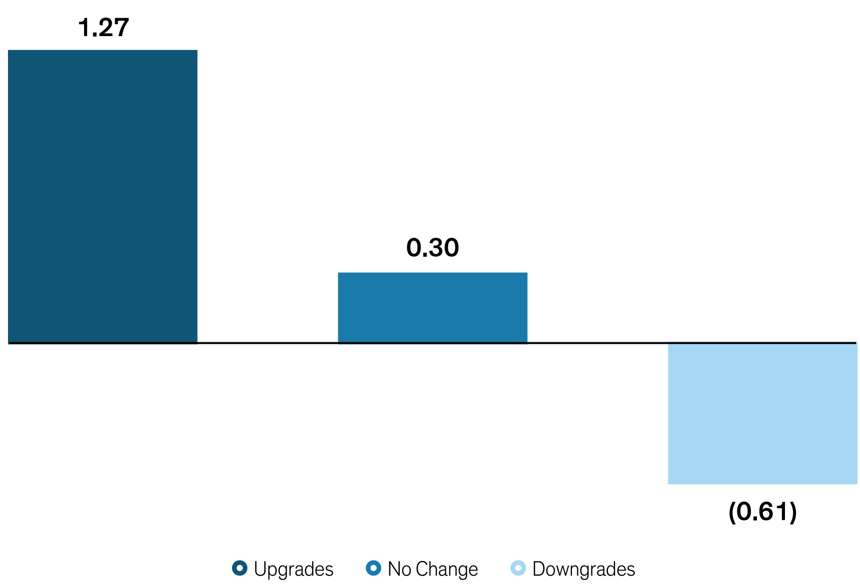
A manager building an ESG-focused portfolio will begin by selecting an initial pool of investment opportunities based on an ESG-related theme or objective. For example, a portfolio's underlying strategy may revolve around industries impacted by one or more of the United Nations Sustainable Development Goals ("SDGs").[16] After identifying the targeted industries, the manager can select companies within each industry that produce profitable products (e.g., sources of renewable energy) through a combination of quantitative and qualitative analyses. In this way, the manager creates a potential investment pool connected to the ESG-related goal and capable of producing a desired level of return (**Display 3**).

Fundamental research can then help identify companies within the narrowed opportunity set that are most likely to deliver the desired ESG-related impact without sacrificing return or increasing risk. For instance, our research shows that changes in a company's ESG rating over time (sometimes referred to as its "ESG momentum") can provide insight into the company's future financial performance.[17] In one study, we found that the average forward return for stocks with positive ESG momentum (i.e., an ESG-rating upgrade from the same rating provider) generally exceeded global equity peers on a relative basis (as measured by the MSCI ACWI Index). Meanwhile, the performance of stocks that had been downgraded lagged (**Display 4**).

To put this into context, let's return to our previous example of a strategy favoring industries impacted by one or more SDGs. Having identified certain target industries and profitable companies within them, a manager may then evaluate the ESG momentum of these potential investments with respect to a relevant SDG. In other words, how do the company's efforts to improve its material ESG processes support the SDG? While exploring this question, the manager may uncover companies that are better positioned to support the strategy's desired social or environmental objective and generate a superior return (sometimes referred to as a "double bottom line").

DISPLAY 4: RECOGNITION OF ESG IMPROVEMENT DRIVES EXCESS RETURNS

Full Period Data: Average Forward Return vs. MSCI ACWI (Percent)



Past performance and historical analysis do not guarantee future results.

Forward returns for the following 12-month period; analysis period since January 1, 2008.

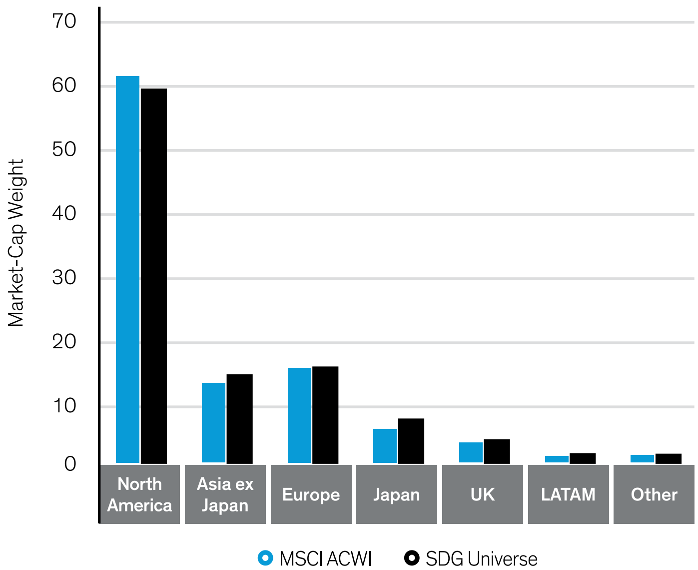
Based on companies in the MSCI ACWI for fullness of data.

As of December 31, 2021 | **Source:** MSCI and AB

DISPLAY 5: ESG-RELATED THEMES STILL ALLOW FOR DIVERSIFICATION

Regional Exposures

SDG Universe and MSCI ACWI (Cap-Weighted, Percent)



Sector Exposures

SDG Universe and MSCI ACWI (Cap-Weighted, Percent)

Sectors	SDG-Aligned Universe	MSCI ACWI Index
Information Technology	23.2	22.1
Healthcare	19.1	12.0
Financials	12.4	13.2
Communication Services	11.7	9.4
Consumer Discretionary	10.6	13.3
Industrials	10.4	9.5
Consumer Staples	4.8	7.0
Utilities	2.7	2.9
Materials	2.4	4.9
Energy	1.9	3.1
Real Estate	1.0	2.5
Total	**100**	**100**

For illustrative purposes only.
As of December 31, 2020
Source: Bloomberg, MSCI, and AB

Commentators have sometimes painted the additional restrictions applied by ESG-focused strategies in a negative light. However, such strategies may benefit from a narrower focus in the same manner as non-ESG active counterparts.[18] Consider a climate-focused approach that devotes attention to areas indirectly impacted by the transition away from fossil fuels (e.g., utility companies that will benefit from infrastructure spending to support a greater reliance on electricity). The manager's in-depth understanding of energy consumption's evolution will provide insight into certain industries overlooked by an investor relying on historical data—allowing the manager to create a more focused, leaner initial investment pool. With a smaller pool of candidates, the manager will be well positioned to apply fundamental research to the remaining securities to unearth opportunities that might otherwise be missed.

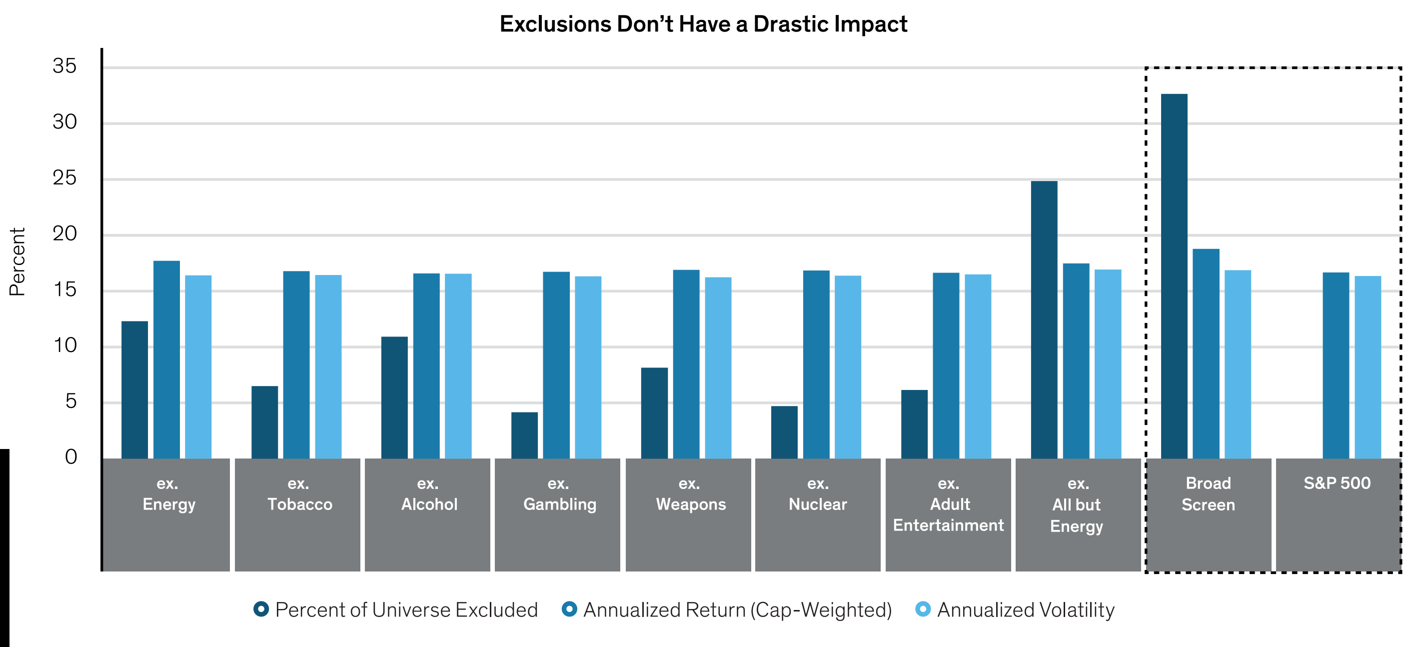
Additionally, managers can select and implement ESG-related themes in a manner that limits impact on portfolio diversification and volatility. In the early days of RI, commentators raised concerns that the application of positive or negative ESG-related screens would decrease or eliminate exposure to certain market industries or sectors to a portfolio's disadvantage when compared to the stock market as a whole.[19] For example, if an excluded industry or sector experienced a period of outperformance, the portfolio could struggle when compared with non-exclusionary peers. Alternatively, the portfolio might suffer if the exclusion resulted in a heavier reliance on an industry or sector that underperformed. However, our research demonstrates that such negative impacts are far from certain.

For instance, a strategy seeking to identify SDGs-aligned investments may still include a wide range of industries and countries (**Display 5**). This allows managers implementing the ESG-related theme to choose assets that will react differently to certain market conditions (i.e., diversify the portfolio), thereby limiting the downside of market volatility while still supporting the strategy's ESG-related objective.

Further, our research shows that limiting the investment universe through ESG-related screening may only modestly impact a portfolio's total return. For example, we built seven different portfolios, applying a different ESG-related exclusion to the S&P 500 in each case. Upon tracking the portfolios over a 10-year period, we found that six out of the seven performed within 0.2% of the S&P 500—with three of the six portfolios outperforming the S&P 500 and one matching it (**Display 6**). Additionally, five of the seven portfolios produced annualized volatility equal to or less than the S&P 500 (the remaining portfolios showed an increase of 0.2% or less). Even more surprising, when we applied all seven exclusions to the same portfolio—thereby excluding one-third of the companies in the S&P 500—the portfolio bested the S&P 500 by more than 2% with only a 0.4% increase in volatility. Does this mean that exclusions ensure a better risk-adjusted return? Certainly not. Rather, our results demonstrate that an ESG-related exclusion on its own does not necessarily generate the decreased returns and spike in volatility previously suggested.

A portfolio manager may further reduce any potential impact from an ESG-related exclusion—whether positive or negative—by employing a materiality threshold. Returning to our previous example, if you were to apply a 5% revenue threshold to the non-energy exclusions and focus the energy exclusion on the highest emitters in the potential investment pool, the resulting portfolio would exclude only 11% of the S&P 500, rather than 33%. Thus, a more nuanced approach to negative screening can weed out many objectionable investments without hindering a portfolio's ability to track its designated index.

DISPLAY 6: RESEARCH CAN HELP TARGET SCREENING



Past performance is not necessarily indicative of future results.

An investor cannot invest in an index. These figures do not reflect the deduction of management fees and other expenses an investor would incur when investing in a fund or separately managed portfolio.

Exclusions are applied by removing companies with revenue exposure to each of the seven areas above (tobacco, alcohol, gambling, weapons, nuclear, adult entertainment, and energy) from the S&P 500 index. Returns and risk are calculated from 1/1/2012 to 12/31/2021. If you applied a 5% revenue threshold and only excluded above-median carbon emitters among energy companies, that excludes 11% of the S&P 500 constituents resulting in annualized returns of 17.4% and annualized volatility of 16.4%. | **Source**: Bloomberg, MSCI, AB analysis

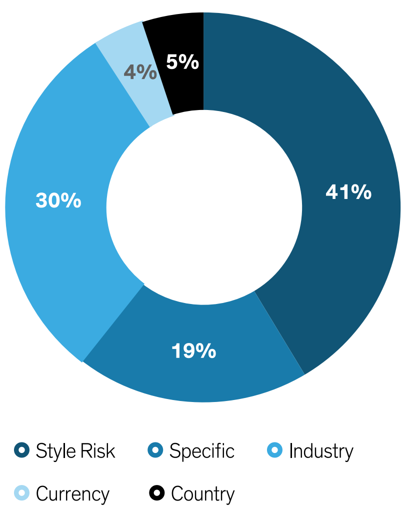
Nonetheless, our research shows that historically, ESG-focused strategies have a higher likelihood of tilting toward certain factors and sectors (**Display 7**). For example, these approaches may favor growth and quality factors (e.g., profitability) rather than value (i.e., cheapness).[20] Additionally, they tend to tilt toward the technology and healthcare sectors, and away from financials and basic materials. Thus, a fiduciary considering an ESG-focused strategy will need to weigh how any existing tilt interacts with the rest of the fiduciary's portfolio as well as the investing entity's ultimate needs.

Additionally, we should note that ESG-focused investment strategies may not be appropriate for investors with a shorter time horizon. The latent risks and returns uncovered by an ESG analysis may be likelier to unfold slowly as failures or inefficiencies in a sector or industry become clearer and the market reacts to them over time.[21] For this reason, ESG-focused investing—much like equity investing in general—is typically regarded as a more suitable approach for long-term investors.

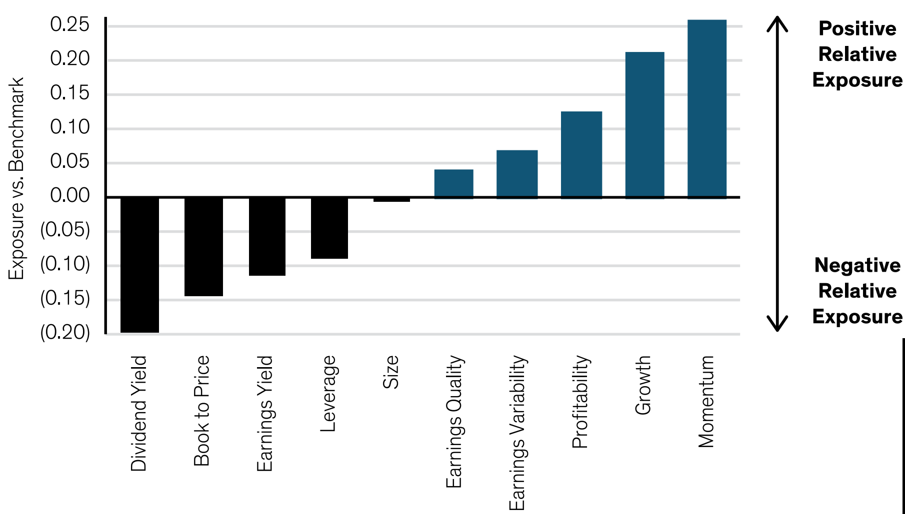
Lastly, in the same manner that an investment strategy cannot guarantee desired financial performance, ESG-focused strategies may fall short of their ESG-related objectives. In fact, the more ill-defined a social or environmental goal, the harder it may be to measure a strategy's impact and nonfinancial performance. For this reason, fiduciaries should seek out ESG-focused strategies with clear and measurable nonfinancial objectives.

DISPLAY 7: ESG-FOCUSED STRATEGIES HAVE A TENDENCY TO TILT

Sources of Tracking Error
SDG Universe vs. MSCI ACWI*



Factor Exposures
SDG Universe vs. MSCI ACWI



For illustrative purposes only.
*Numbers may not sum to 100 due to rounding.
As of December 31, 2020
Source: MSCI and AB

A Word About Conflicting Research

Thus far, large-scale studies of ESG's impact on financial performance have produced conflicting results. Take two recent meta-studies exploring the connection between ESG and financial performance based on research papers published between 2015–2020.[22] In one, researchers found that 59% of investment studies focused on risk-adjusted attributes showed a positive or neutral correlation between ESG and financial performance when compared to conventional strategies, while 14% showed a negative correlation.[23] In a meta-study released a year later, these same researchers noted that 12 of the 13 meta-analyses reviewed found a positive association between aspects of sustainability and company-level financial performance.[24] However, when averaged across strategies in aggregate, returns from ESG investing appeared no better than those from conventional investment strategies.[25] In other words, the anecdotal evidence from active managers about the benefits of ESG bore out at the individual company level but did not translate into overall portfolio performance across managers. In explaining the conflicting results in both studies, the research team noted struggles with inconsistencies in terminology, data reporting, and measures of materiality, along with confusion and/or conflation of various ESG investment strategies.[26] At a minimum, large-scale studies of ESG's impact on financial performance seem to suffer from hurdles in aggregating and standardizing data and may lag behind the diverse offerings of a rapidly developing industry.

The rating agencies many investors rely on to quantify ESG data seem to face similar struggles. As mentioned previously, ESG rating agencies frequently conflict with respect to the factors used, and the weight assigned to them. In addition, efforts by rating agencies to quantify material ESG attributes may unintentionally overlap with more traditional investment metrics. Consider the researchers at Scientific Beta who reconstructed long-short ESG-related strategies from prior studies. They found that positive performance and risk protection previously attributed to the use of ESG ratings disappeared when they accounted for exposure to standard factors—especially quality.[27]

> At a minimum, large-scale studies of ESG's impact on financial performance seem to suffer from hurdles in aggregating and standardizing data.

And yet, we cannot ignore the distinct connection between ESG considerations and company-level performance shown by existing research. Large-scale research studies' inability to demonstrate this connection at the portfolio level does not negate the anecdotal evidence of individual managers utilizing ESG considerations to deliver on the promised double bottom line. Instead, the disconnect between larger studies and individual case studies highlights what has always been true for active investing—research, skill, and a repeatable process remain key to a strategy's success. Active management strategies have long been impacted by the skill and approach of the manager at the helm. Not surprisingly, ESG-related strategies are no different.

Part II—Duty of Loyalty

Now, let's discuss the duty of loyalty as it applies to fiduciaries managing trusts, private retirement plans, and charitable nonprofits.

Description of Duty of Loyalty

Trusts

Often called a trustee's most fundamental duty, the duty of loyalty can be summarized as a directive to act solely in the interests of the trust's beneficiaries without interference from the trustee's own interests or those of third parties, unless the trust terms provide otherwise.[28] This duty arose under common law to prevent a trustee from favoring a conflicting interest—whether consciously or unconsciously—over that of the beneficiaries.[29] Indeed, concerns about a trustee's ability to navigate competing interests in the same transaction were so great as to lead to the creation of a "no-further-inquiry rule" that renders certain transactions voidable under the duty of loyalty based on the parties involved, rather than their underlying motives or impacts.[30] More specifically, this rule permits a beneficiary to void any transaction involving (i) a trustee's self-dealing or (ii) an existing or potential conflict between the trustee's fiduciary duties and personal interests, regardless of whether the transaction benefits the beneficiary.[31]

On its face, this duty seems easy to understand and apply in the context of investing trust assets. A trustee may not elevate the trustee's personal beliefs or goals above the beneficiaries' interests. For example, the trustee may not invest in a concessionary strategy that sacrifices return to advance the interests of non-beneficiaries. But what if you are deciding between two investment strategies bearing similar risk and return profiles and one of them supports an additional social or environmental objective? Could you consider the collateral impacts of each strategy under these circumstances? You are not sacrificing return or increasing risk and thus elevating the social or environmental objective above the beneficiaries' interests. But would this qualify as a conflict of interest to which the no-further-inquiry rule would apply, thereby rendering the strategy's financial impacts irrelevant?[32]

To answer these questions, let's examine the duty of loyalty's application and limitations under both common and statutory law, starting with the former.[33] As noted above, current articulations of the common law duty of loyalty apply the no-further-inquiry rule to cases of self-dealing or a conflict of interest—not all transactions.[34] Additionally, common law acknowledges certain exceptional situations where, despite the presence of self-dealing or a conflict of interest, considerations of efficiency and beneficiary interest—as well as a minimal or manageable degree of risk—require an easing of the no-further-inquiry rule.[35] In situations where the duty of loyalty does not impose the no-further-inquiry rule, a trustee must continue to act fairly, in good faith, and in the interests of the beneficiaries.[36]

> What if you are deciding between two strategies…and one supports an additional social or environmental objective?

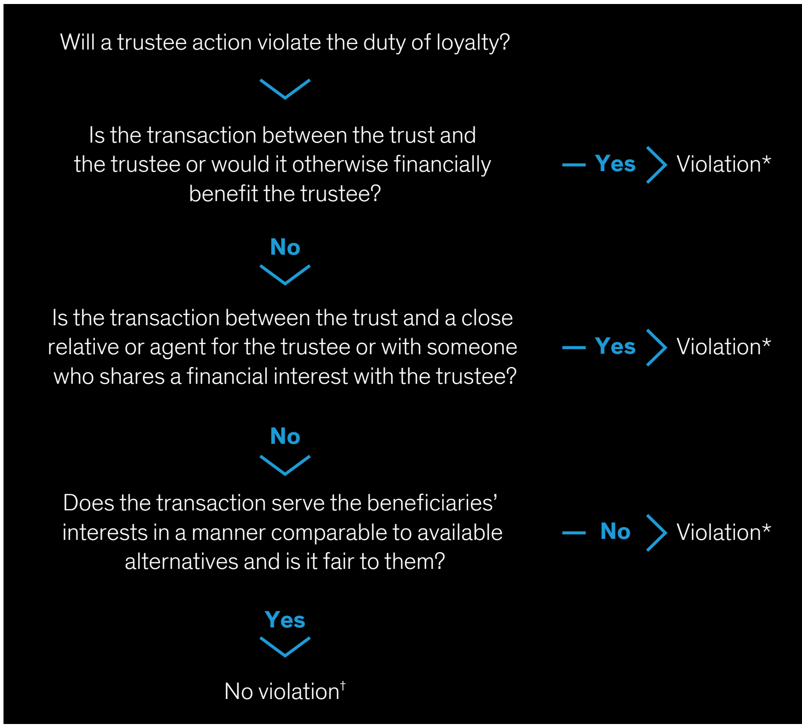
What then constitutes an act of self-dealing or a conflict of interest to which the duty of loyalty applies the no-further-inquiry rule? Let's begin by defining self-dealing. Common law describes self-dealing as the trustee's engagement on behalf of the trust with the trustee, a third party acting as a conduit for the trustee, or an entity in which the trustee owns a substantial financial interest, among other examples.[37] Interestingly, authorities conflict on whether an action motivated by the beneficiaries' best interests—but which produces an "incidental benefit" to the trustee—constitutes self-dealing for purposes of the no-further-inquiry rule.[38]

Next, let's consider what constitutes a conflict of interest. Common law defines a conflict of interest as a situation in which the trustee interacts on behalf of the trust with a person or entity closely related to or associated with the trustee ("related parties").[39] For example, the duty of loyalty prohibits transactions between the trustee and the trustee's spouse, parents, descendants, personal agent, or attorney.[40] Common law does not apply the no-further-inquiry rule to transactions involving a trustee's more remote relatives or personal or business acquaintances.[41] In those situations, the trustee is not presumed to have a conflict of interest and a beneficiary must prove a breach of trust by demonstrating that third-party interests improperly influenced the trustee in a manner disadvantageous to the beneficiaries' interests.[42]

> Common law does not apply the no-further-inquiry rule to transactions involving a trustee's more remote relatives or personal or business acquaintances.

To put this in a familiar investment context, imagine that the no-further-inquiry rule functions as a negative screen for a trustee's possible investment opportunities. In other words, the trustee eliminates those opportunities that involve self-dealing or a conflict of interest from consideration up front. The trustee is then responsible for analyzing the remaining strategies to determine which meet the needs of the beneficiaries. As part of this analysis, the trustee may consider a strategy's collateral impacts to decide among approaches with comparable financial returns (**Display 8**).

DISPLAY 8: A DECISION TREE FOR FIDUCIARIES



*A violation may be avoided by authorization under the trust agreement or beneficiary consent.
†The trustee must also satisfy the duty of care.
Source: AB

Moving on to statutory law, the Uniform Trust Code (the "UTC") provides the duty of loyalty's most commonly codified form.[43] The UTC adopts the general standard that a trustee must act in the sole interests of the beneficiaries and applies the no-further-inquiry rule to self-dealing in the same manner as common law.[44] However, the UTC deviates from common law in applying the duty of loyalty to conflicts of interests, despite identifying many of the same related parties as creating the potential for conflict.[45] More specifically, the UTC provides that a trustee's transactions with related parties are voidable only if affected by a conflict of interest.[46] This means the trustee may defend an action by showing that, even if a conflict existed, it did not impact the transaction. Thus, like those situations where the common law duty of loyalty applies but the no-further-inquiry rule does not, a trustee may defend an action with related parties by establishing the transaction's fairness and similarity to transactions made with an independent party.[47]

Now, let's return to our original example of a trustee deciding between two investment strategies with similar financial profiles but dissimilar collateral impacts. Assuming the trustee does not profit from either strategy directly or indirectly, the no-further-inquiry rule should not arise from self-dealing. Additionally, assuming each strategy's collateral impacts affect strangers (as would most often be the case with a larger social or environmental objective), this situation does not constitute a conflict of interest as defined under common or statutory law. This strategy selection then falls outside the reach of the no-further-inquiry rule—leaving the trustee with the ability to defend an investment choice involving consideration of collateral impacts by showing that the selected strategy supports the beneficiaries' financial interests in the same approximate manner as other alternatives.

> Courts have previously upheld plan investments that produce an incidental third-party benefit, provided it does not come at the expense of participants and beneficiaries.

While case law has yet to address this same scenario in the larger context of ESG-related investing, courts have previously interpreted the duty of loyalty (as explained above) in reviewing a fiduciary's decision to sell or otherwise avoid investments due to ESG considerations. For instance, in *Board of Trustees of the Employees' Retirement System of the City of Baltimore v. Mayor and City Council of Baltimore City*, the Maryland Court of Appeals upheld city ordinances requiring city pension funds' divesture from companies doing business in South Africa as part of an anti-apartheid movement—despite such ordinances' indirect requirement that the funds' trustees consider the interests of impacted South Africans.[48] In doing so, the Court of Appeals noted that, while the common law duty of loyalty bars a trustee from acting in the interest of third parties at the expense of the beneficiaries, it does not strictly prohibit a trustee from considering the social consequences of investment decisions when the costs of such consideration are negligible.[49] Put more simply, the trustees' consideration of strangers' interests did not trigger a violation of the duty of loyalty where such consideration did not result in an unfair transaction.[50]

Retirement Plans

Moving to private retirement plans, the Employee Retirement Income Security Act of 1974 ("ERISA") requires that plan administrators serve as fiduciaries subject to a duty of loyalty like that imposed under common law. More specifically, these fiduciaries must administer the plan (i) solely in the interest of the plan's participants and beneficiaries, and (ii) for the exclusive purpose of providing benefits to such individuals, while defraying reasonable administrative expenses.[51] However, unlike the fiduciary duties imposed under a trust, a plan may not modify an administrator's duty of loyalty.[52]

As ERISA's duty of loyalty stems from the related common law duty,[53] the above analysis suggests that ERISA's references to actions taken "solely in the interest of" and for the "exclusive purpose of providing benefits to" plan participants and beneficiaries should not broadly prohibit consideration of an investment strategy's collateral impacts in the absence of self-dealing or a conflict of interest. Indeed, courts have previously upheld plan investments that produce an incidental benefit to a third party, provided that such benefit does not come at the expense of plan participants and beneficiaries. For example, in *Donovan v. Walton*, the U.S. District Court for the Southern District of Florida held that pension plan trustees did not violate ERISA's exclusive purpose standard by financing construction of an office building on fund property and leasing the building to one of the plan's participating employee organizations.[54] In reaching this conclusion, the court noted that the arrangement benefited both parties and the exclusive purpose standard "does not prohibit a party other than a plan's participants and beneficiaries from benefiting in some measure from a prudent transaction with the plan."[55]

Additionally, the Department of Labor (the "DOL") has described ERISA's duty of loyalty as a bar against harm to the financial interests of the plan's participants and beneficiaries. In rules issued in late 2020 and 2021,[56] the DOL addressed the elements of the duty of loyalty by stating that a plan administrator "may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives and may not sacrifice investment return or take on additional investment risk" as compared to reasonably available alternatives. Thus, ERISA's duty of loyalty prohibits an administrator from prioritizing the interests of third parties over those of the plan participants and beneficiaries but does not similarly prohibit consideration of an investment's collateral impacts.[57] In fact, both rules expressly authorize plan administrators to consider collateral benefits in deciding between two comparable investment strategies.[58]

Nonprofits

The duty of loyalty applicable to individuals exercising authority over a charitable entity varies depending on the entity's structure. For a charitable trust, the duty of loyalty requires that the trustee administer the trust solely to further its charitable purpose.[59] The trust terms will define this purpose, including its scope.

An even more relaxed duty of loyalty applies to charitable nonprofits structured as corporations, associations, or limited liability companies. More specifically, such entities impose a "best interest" standard that requires fiduciaries to act in good faith, with reasonable care, and in the best interests of the entity's charitable purpose based on all relevant circumstances.[60] In effect, this standard matches the duty of loyalty as applied to a trustee's actions in the absence of the no-further-inquiry rule.

Application of Duty to ESG Integration and ESG-Focused Strategies

ESG Integration

When applied appropriately, ESG integration satisfies the duty of loyalty on its face by relying on material ESG considerations to predict an investment's future financial performance—rather than to inform a strategy's overall objective or to promote the interests of the fiduciary or third parties. Additionally, it should not trigger an application of the no-further-inquiry rule in that (i) it does not financially benefit the fiduciary or a related party and (ii) it does not advance the interests of third parties at the expense of the relevant beneficiaries' interests. In fact, the use of an ESG integration strategy may lead to a more thorough evaluation of a potential investment's suitability to the beneficiaries' needs.

However, we should reiterate that the foregoing analysis depends upon proper implementation. A manager must analyze ESG considerations for their ability to predict potential risks and returns. Additionally, a fiduciary should examine how a manager quantifies a company's ESG performance and whether such performance is indeed material to the company's long-term value. For example, a fiduciary may ask whether the manager relies on third-party ESG ratings, and if so, how the manager utilizes fundamental research to contextualize ESG considerations.

ESG-Focused Strategies

Assuming an ESG-focused strategy does not financially benefit the fiduciary or a related party, the fiduciary of a trust, private retirement plan, or charitable nonprofit may consider use of an ESG-focused strategy. As a first step in analyzing such strategy, the fiduciary must determine whether the ESG-focused strategy serves the beneficiaries' interests in the same manner as available alternatives—both with respect to return and cost and the beneficiaries' specific needs (e.g., capital appreciation versus income production).[61] If a fiduciary of a noncharitable trust or a private retirement plan determines that an ESG-focused strategy is designed to generate comparable returns and costs, the fiduciary may then consider collateral impacts to distinguish between investment options.

A fiduciary should examine how a manager quantifies a company's ESG performance and whether such performance is indeed material to the company's long-term value.

As a threshold issue and a point of distinction between charitable and noncharitable entities, the duty of loyalty would likely restrict a fiduciary of a noncharitable trust or private retirement plan from investing in a concessionary ESG-focused strategy. That is, the fiduciary's use of such a strategy would necessarily violate the duty of loyalty by subordinating the beneficiaries' financial interests to the strategy's nonfinancial objectives. The fiduciary of a charitable nonprofit, on the other hand, is bound by the duty of loyalty to serve the entity's charitable purpose. This means the fiduciary of a charity may utilize a concessionary strategy if the investment's nonfinancial value to the charity's mission outweighs the investment's potential financial consequences.

Part III—Duty of Care

Description of Duty of Care

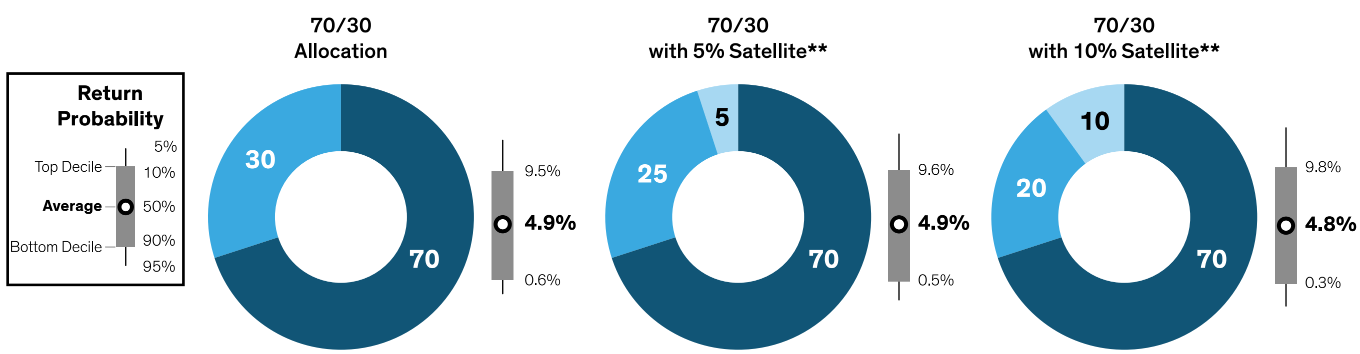
The common law duty of care applies in approximately the same manner to trusts, private retirement plans, and charitable nonprofits, although a trust's terms may modify this duty.[62] More specifically, it imposes a "prudent investor rule" under which a fiduciary must invest and manage an overall portfolio as a prudent investor by considering the investing entity's purposes, terms, distribution requirements, and other circumstances.[63] This includes adopting appropriate risk and return objectives to meet the entity's need for liquidity, income, and capital appreciation in light of all relevant distribution time horizons.[64]

A charitable nonprofit's investment analysis may be even more nuanced, in that the prudent investor rule allows such institutions to give weight to an investment's support of the nonprofit's charitable purpose in addition to its financial return.[65] Additionally, the rule requires a fiduciary to diversify the investing entity's overall portfolio, unless the fiduciary determines that diversification does not serve the entity's best interests due to special circumstances.[66] Now, let's take a closer look at the various components of this rule.

First, it's important to recognize that—in a break from earlier law—the prudent investor rule requires an investing fiduciary to evaluate individual investments in the context of the larger portfolio.[67] This means that a fiduciary may select an investment with exposure to unique investment factors or sectors, provided the fiduciary appropriately adjusts the strategy's proportion relative to the remainder of the portfolio and invests such remainder to balance out any under- or overexposure to certain market sectors, etc. For instance, our research indicates that limiting a more volatile position to 5%–10% or less of the overall portfolio prevents any meaningful increase in such portfolio's risk profile (**Display 9**).

DISPLAY 9: LIMITING A VOLATILE POSITION HELPS MANAGE OVERALL RISK

Range of Compound Growth Rates*



	Scenario A	Scenario B	Scenario C
Probability of Loss of 20%†	33%	36%	40%

As of December 31, 2021

*Represents projected pretax compound annual growth rates over the next 10 years. First-year volatility of the portfolios: Scenario A = 11.5%, Scenario B = 11.8%, Scenario C = 12.2%. Annual equivalent volatility of the portfolios: Scenario A = 10.5%, Scenario B = 10.8%, Scenario C = 11.2%. Annual equivalent volatility differs from the first-year volatility because the expectation and distribution of asset class returns change over time. If the allocation targets change over time, this will also affect the annual equivalent volatility of the portfolio, but will not be reflected in the one-year volatility.

**Concentrated position ("Satellite") assumed to have a 30% volatility and no yield.

†Projections indicate the probability of a peak-to-trough decline in pre-cash-flow cumulative returns of 20% over the next 10 years. Because the Bernstein Wealth Forecasting System uses annual capital market returns, the probability of peak-to-trough losses measured on a more frequent basis (such as daily or monthly) may be understated. The probabilities depicted above include an upward adjustment intended to account for the incidence of peak-to-trough losses that do not last an exact number of years.

Based on AB's estimates of the range of returns for the applicable capital markets over the next 10 years. Data do not represent past performance and are not a promise of actual future results or range of future results. See "Notes on the Bernstein Wealth Forecasting System" for further details.

Speaking of risk, the prudent investor rule allows risk to play a more active role than previous iterations of the duty of care. Where prior law emphasized a fiduciary's duty to preserve capital and generate consistent income—and labeled investments such as growth stocks and discounted bonds as speculative and improper—the prudent investor rule recognizes that compensated risk (i.e., investments that provide greater return in exchange for increased risk) may benefit an overall portfolio.[68] This holds especially true as one considers the impacts of inflation on traditionally less-risky investments (e.g., Treasury bonds) over time.[69]

> The prudent investor rule does not bar the use of any particular approach, provided the fiduciary selects the investment after appropriate analysis.

Lastly, the prudent investor rule requires diversification to reduce the impact of uncompensated risk (i.e., risk that is not company-specific and thus unlikely to be offset by greater return).[70] Put differently, the prudent investor rule requires that a fiduciary invest in a range of investments likely to respond differently to the same market stimuli.[71] For example, if certain investments in a portfolio suffer due to rising interest rates or supply chain concerns, the prudent investor rule requires that the portfolio include investments likely to react neutrally or even positively to such circumstances, thereby potentially reducing the greater portfolio's volatility and buoying its overall performance.

As described above, the prudent investor rule focuses on the mechanics of the investment process, not its end result. Applicable law judges a fiduciary under this rule based on the fiduciary's knowledge and conduct at the time of an investment decision.[72] This is true both at the time of an initial investment and in conducting ongoing due diligence to ensure an existing strategy's continuing suitability. Additionally, the duty does not bar the use of any particular approach, provided the fiduciary selects the investment after appropriate analysis.[73] This allows a fiduciary to engage with new market products and strategies on a case-by-case basis. For example, asset-backed securities have a long history of being characterized as "imprudent" investments for fiduciaries. Rather than rely on such characterization, however, the duty of care encourages a fiduciary to determine whether asset-backed securities fit within the context of a particular investing entity's portfolio based on opportunities, challenges, transaction costs, the value and seniority of the security, etc.[74]

Application of Duty to ESG Integration and ESG-Focused Strategies

ESG Integration

A fiduciary's duty of care requires careful analysis of a potential investment's risk and return profile in the context of an overall portfolio. In ESG integration, managers use material ESG considerations solely to provide insight into both risk and return and thus enhance the care of a fiduciary's investment analysis. Additionally, ESG integration does not impose a narrowing of the investment universe that could hinder diversification. As such, ESG integration should be compliant with the duty of care. Again, however, a fiduciary should conduct sufficient due diligence to ensure a manager's ESG integration methods are properly implemented.

ESG-Focused Strategies

Under the duty of care, a fiduciary should analyze whether an ESG-focused strategy's potential impact on the overall portfolio's financial performance aligns with the relevant beneficiaries' needs and goals. To do so, a fiduciary should look to the strategy's historical performance compared to its selected benchmark and that of available alternatives. Further, the fiduciary should consider the role the investment plays in the overall portfolio when selecting available alternatives for comparison. To that end, if a strategy assumes increased risk but offers greater return potential, it should be compared to non-ESG peers designed to fulfill the same overall objective (i.e., to elevate returns) and in the context of the portfolio's risk-mitigating investments.

The fiduciary should also pay special attention to the limitations the strategy places on its potential investment pool. As explained above, relying on strategies that broadly limit exposure to large market sectors or industries may imprudently raise a portfolio's level of risk and decrease returns, especially if a fiduciary imposes such exclusions without considering their impact on diversification. However, the use of broad themes and materiality thresholds may allow for a fully diversified portfolio and thereby limit the restrictions' negative impact.

Last, but not least, a fiduciary must exercise ongoing due diligence and adjust the overall portfolio as needed to ensure that the strategies selected—including any ESG-focused strategy—continue to serve the beneficiaries' financial interests in the context of their investment time horizon. This does not mean that any negative change in performance requires the abandonment of a particular strategy. Rather, meaningful change merely warrants a fresh analysis of the fiduciary's expectations for the investment's total return and how this return impacts the portfolio's ability to meet the beneficiaries' needs.

Part IV—Ways to Expand or Ensure Permissible ESG Investment

As previously discussed, the duties of loyalty and care do not prohibit fiduciaries from utilizing ESG-related strategies in many circumstances. However, as authorities conflict on this issue and little on-point case law exists, a fiduciary of a trust or charitable nonprofit may wish to gain additional assurance and protection from a governing instrument, or the beneficiaries themselves.[75] Additionally, the creator of a trust or charitable nonprofit may wish to authorize ESG-related investments that do not carry the same risk and return profile as their non-ESG peers—an approach disallowed under a traditional fiduciary duty analysis. We now summarize these methods of bolstering and broadening fiduciary engagement with ESG-related investment strategies.

> Creators of charitable nonprofits should consider addressing the role of ESG-related investment strategies in their mission statements.

Governing Documents

Trusts

If a trust's settlor would like to authorize or require the use of ESG-related investing, the settlor should consider memorializing this intent in the trust agreement. This may take the form of an introductory passage describing the settlor's purposes in creating the trust and wishes for its future administration. Alternatively, the settlor could simply waive application of the no-further-inquiry rule—leaving behind a best-interest standard—and the prudent investor rule's diversification requirement. The settlor may also expressly address and incorporate into the trust agreement an applicable "ESG-friendly" state statute that allows a trustee to consider the settlor's or the beneficiaries' social, environmental, and governance beliefs in making investment decisions. For example, Delaware Code § 3303 provides that the terms of a governing instrument may expand, eliminate, or otherwise modify in any way laws pertaining to "the manner in which a fiduciary should invest assets, including whether to engage in one or more sustainable or responsible investment strategies, in addition to, or in place of, other investment strategies, with or without regard to investment performance."[76] Additionally, several states have explicitly authorized a trustee to consider the values and beliefs of the trust's settlor and/or beneficiaries with respect to sustainable or responsible investing strategies in acting as a prudent investor.[77] If a settlor wishes to rely on this type of statute, it may be beneficial to require under the trust agreement that the relevant parties provide the trustee with a written summary of their views on ESG investing at regular intervals.

However, interested parties should also consider the extent to which a settlor may curtail the beneficiaries' interests and to whom the trustee should ultimately be beholden. Under common law, a settlor may only create a noncharitable trust for the benefit of beneficiaries who are identifiable or ascertainable at the trust's creation.[78] If, however, a settlor gives a trustee the ability to invest in concessionary ESG-related strategies to the detriment of the trust's identified beneficiaries, an argument may be made that the trust's true beneficiaries are those third parties benefited by the authorized investment strategies, with such third parties being unidentifiable and unascertainable.[79] This would then void the trust. As such, a settlor wishing to authorize a trust's ESG-related investments and the trustee of such trust should bear in mind that a trust's terms can lessen the trustee's fiduciary burden but not completely divorce the trustee's investment decisions from the beneficiaries' best interests.

Charitable Nonprofits

A statement defining and informing a nonprofit's charitable purpose should be included in the nonprofit's governing document (e.g., the trust agreement for a charitable trust, the bylaws for a corporation, etc.). For those wishing to authorize the use of ESG-related investing, creators of a charitable nonprofit should consider addressing the role of such investment strategies in the nonprofit's mission statement. For example, a charitable nonprofit created to expand access to healthcare could describe in this statement an intent to support the mission both through investing its endowment in ESG-focused strategies that favor this theme and by using the return from such strategies to underwrite grants to additional healthcare providers.

In addition, those administering a charitable nonprofit may consider adopting an investment policy statement (an "IPS") that defines the standard of conduct for fiduciaries and their agents authorized to manage or invest the nonprofit's assets. The IPS should outline the benchmarks tied to performance standards as well as income production and/or capital appreciation goals to fund the charitable nonprofit's operations over different time horizons. It could also include disclosure of financial interests among those responsible for the charitable nonprofit's investment decisions to avoid self-dealing or a conflict of interest that could trigger the imposition of the no-further-inquiry rule in the context of a charitable trust.

Beneficiary Involvement

But what of a trustee who is pushed by current beneficiaries to engage in ESG integration or an ESG-focused investment approach but who is administering a trust that is silent with respect to ESG-related investing? The trustee may worry about future discord among the beneficiaries on this issue. In response to these concerns, a cautious trustee may wish to pursue beneficiary approval, either before or after investment.

A trustee may seek this approval through a prior written consent, under which the beneficiaries agree to, release the trustee from liability for, and/or ratify an investment. UTC § 1009 provides a safe harbor from a breach of trust claim if a trustee procures this type of consent, provided the trustee does not exercise undue influence in obtaining it and the beneficiary is aware of all relevant rights and material facts. Alternatively, the trustee could consider seeking approval or ratification after the fact, when the trustee may present a history of positive performance for the beneficiaries' consideration. UTC § 1005 provides that a beneficiary may not sue a trustee for breach of trust more than one year after receiving adequate disclosure of the facts underlying such claim and notice of such statute of limitations (commonly referred to as an "accounting").

However, in each case, obtaining the consent or approval of all beneficiaries may be practically impossible, especially if the trust includes beneficiaries who are not yet born. As a workaround, a trustee may seek to make use of the UTC's representation statutes. More specifically, UTC §§ 301-304 provide that—in the absence of a conflict of interest—the following individuals may represent and bind certain other beneficiaries:

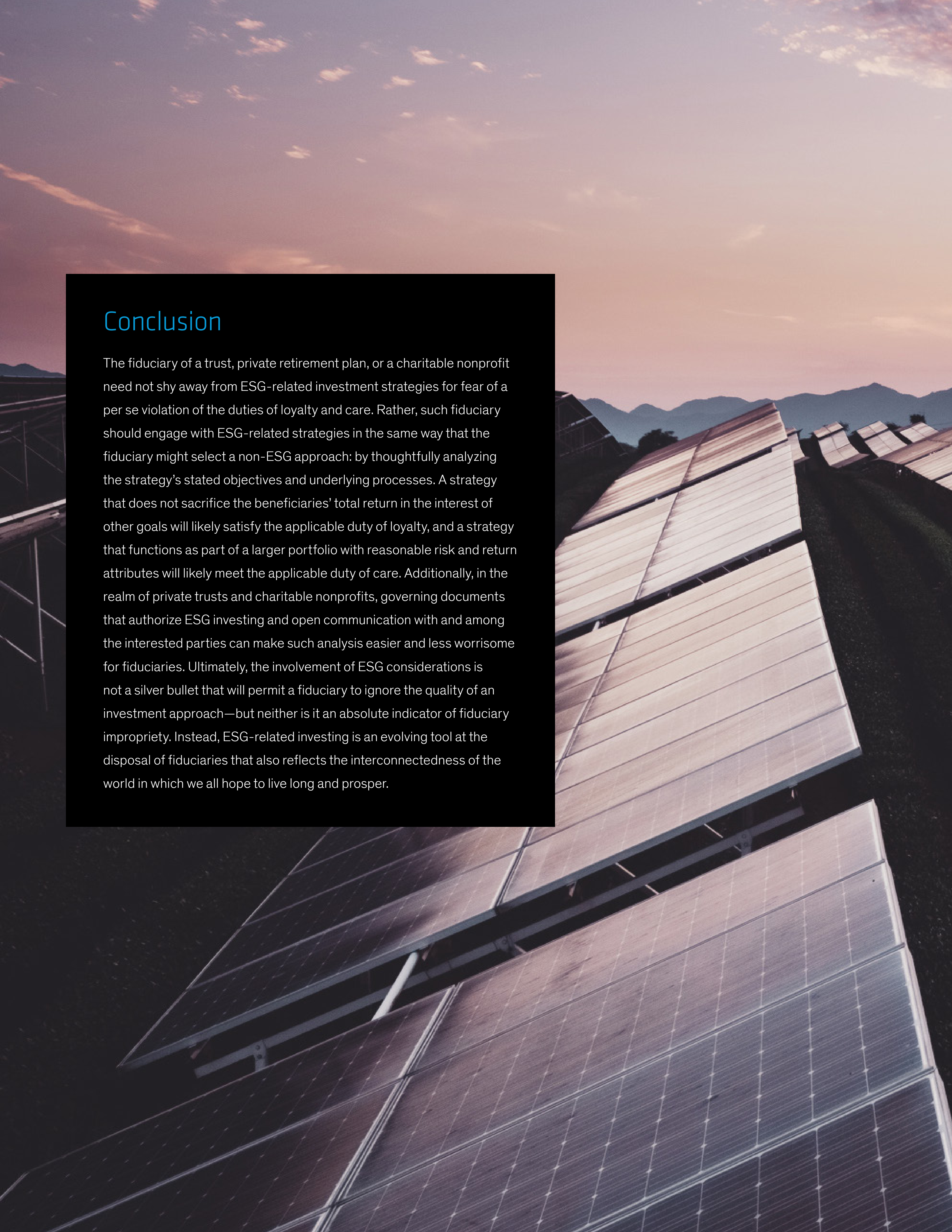
- The holder of a general power of appointment may represent and bind all permissible appointees under such power.
- The parent of a minor or unborn child may represent and bind such child, provided that no other representative had been previously appointed.
- A beneficiary with a substantially identical interest may represent and bind a minor, incapacitated, or unborn individual, or a person whose identity or location is unknown and not reasonably ascertainable, provided that no other representative had been previously appointed.

Hence, yet again, we need to define what constitutes a conflict of interest. To better understand how a conflict of interest might arise in this context, let us consider a case in which a trust currently provides for the parent of a minor child and will distribute property to such minor child in the future. Let's further assume the parent wishes to authorize an investment that might hinder return but would support a social cause dear to the parent's heart. In such case, the investment might reduce the amount of trust property that will ultimately become available for the child's use, thereby creating a conflict between the two beneficiaries. This conflict of interest would prohibit the parent from consenting to the investment on the child's behalf, despite the parent's role as the child's natural guardian. Of course, if the parties anticipated a similar benefit to both the current and remainder beneficiaries (i.e., if the strategy both supported the parent's pet cause and delivered a strong total return), the parent would be able to represent and bind the minor child without conflict.

> A trustee may seek ongoing beneficiary involvement to ensure that the investment decisions made match the beneficiaries' expectations and needs.

Moving away from the UTC's potential solutions, the trustee could rely on contract law by providing the trust's current beneficiaries with a description of the action taken and asking the beneficiaries to ratify such action, release the trustee from any related claim, and indemnify the trustee from any resulting harm or loss. Such a contract may even include a request for indemnification from claims brought against the trustee by beneficiaries who do not execute the agreement. As such, this strategy may provide the greatest coverage of all but would require the most beneficiary involvement to do so.

Perhaps most importantly, a trustee may seek ongoing beneficiary involvement to ensure that the investment decisions that are made match the beneficiaries' expectations and needs. For instance, a trustee may organize a yearly meeting with the beneficiaries. Additionally, the trustee may facilitate the development of a trust IPS to address, among other things: (i) the impact of the trust's time horizon and distribution requirements on potential investments, (ii) the beneficiaries' risk tolerance, (iii) desired monitoring and reporting requirements, (iv) guidelines regarding concentrated positions and diversification, (v) rebalancing requirements, and (vi) the role of ESG-related strategies in the trust's overall portfolio.



Conclusion

The fiduciary of a trust, private retirement plan, or a charitable nonprofit need not shy away from ESG-related investment strategies for fear of a per se violation of the duties of loyalty and care. Rather, such fiduciary should engage with ESG-related strategies in the same way that the fiduciary might select a non-ESG approach: by thoughtfully analyzing the strategy's stated objectives and underlying processes. A strategy that does not sacrifice the beneficiaries' total return in the interest of other goals will likely satisfy the applicable duty of loyalty, and a strategy that functions as part of a larger portfolio with reasonable risk and return attributes will likely meet the applicable duty of care. Additionally, in the realm of private trusts and charitable nonprofits, governing documents that authorize ESG investing and open communication with and among the interested parties can make such analysis easier and less worrisome for fiduciaries. Ultimately, the involvement of ESG considerations is not a silver bullet that will permit a fiduciary to ignore the quality of an investment approach—but neither is it an absolute indicator of fiduciary impropriety. Instead, ESG-related investing is an evolving tool at the disposal of fiduciaries that also reflects the interconnectedness of the world in which we all hope to live long and prosper.

Notes on the Bernstein Wealth Forecasting System

1. Purpose and Description of the Bernstein Wealth Forecasting System

Bernstein's Wealth Forecasting Analysis is designed to assist investors in making their long-term investment decisions as to their allocation of investments among categories of financial assets. Our planning tool consists of a four-step process: (1) Client-Profile Input: the client's asset allocation, income, expenses, cash withdrawals, tax rate, risk-tolerance level, goals and other factors; (2) Client Scenarios: in effect, questions the client would like our guidance on, which may touch on issues such as when to retire, what his/her cash-flow stream is likely to be, whether his/her portfolio can beat inflation long-term, and how different asset allocations might impact his/her long-term security; (3) The Capital-Markets Engine: our proprietary model that uses our research and historical data to create a vast range of hypothetical market returns, which takes into account the linkages within and among the capital markets, as well as their unpredictability; and finally (4) A Probability Distribution of Outcomes: based on the assets invested pursuant to the stated asset allocation, 90% of the estimated ranges of probable returns and asset values the client could experience are represented within the range established by the 5th and 95th percentiles on "box-and-whiskers" graphs. However, outcomes outside this range are expected to occur 10% of the time; thus, the range does not guarantee results or establish the boundaries for all outcomes. Estimated market returns on bonds are derived taking into account yield and other criteria. An important assumption is that stocks will, over time, outperform long bonds by a reasonable amount, although this is in no way a certainty. Moreover, actual future results may not meet AB's estimates of the range of market returns, as these results are subject to a variety of economic, market and other variables. Accordingly, the analysis should not be construed as a promise of actual future results, the actual range of future results or the actual probability that these results will be realized. The information provided here is not intended for public use or distribution beyond our private meeting. Of course, no investment strategy or allocation can eliminate risk or guarantee returns.

2. Rebalancing

Another important planning assumption is how the asset allocation varies over time. We attempt to model how the portfolio would actually be managed. Cash flows and cash generated from portfolio turnover are used to maintain the selected asset allocation between cash, bonds, stocks, REITs and hedge funds over the period of the analysis. Where this is not sufficient, an optimization program is run to trade off the mismatch between the actual allocation and targets against the cost of trading to rebalance. In general, the portfolio allocation will be maintained reasonably close to its target. In addition, in later years, there may be contention between the total relationship's allocation and those of the separate portfolios. For example, suppose an investor (in the top marginal federal tax bracket) begins with an asset mix consisting entirely of municipal bonds in his/her personal portfolio and entirely of stocks in his/her retirement portfolio. If personal assets are spent, the mix between stocks and bonds will be pulled away from targets. We put primary weight on maintaining the overall allocation near target, which may result in an allocation to taxable bonds in the retirement portfolio as the personal assets decrease in value relative to the retirement portfolio's value.

3. Modeled Asset Classes

The following assets or indexes were used in this analysis to represent the various model classes:

Asset Class	Modeled as:	Annual Turnover Rate
Intermediate-Term Diversified Municipals	AA-rated diversified municipal bonds of 7-year maturity	30%
US Diversified	S&P 500 Index	15%
US Value	S&P/Barra Value Index	15%
US Growth	S&P/Barra Growth Index	15%
US Low Vol Equity	MSCI US Minimum Volatility Index	15%
Developed International	MSCI EAFE Unhedged	15%
Emerging Markets	MSCI Emerging Markets Index	20%
US SMID	Russell 2500	15%
Concentrated Position	30% Volatility, No Yield	0%
High-Risk Intl	Country Fund	15%

4. Volatility

Volatility is a measure of dispersion of expected returns around the average. The greater the volatility, the more likely it is that returns in any one period will be substantially above or below the expected result. The volatility for each asset class used in this analysis is listed on the Capital-Market Projections page at the end of these Notes. In general, two-thirds of the returns will be approximately within one standard deviation. For example, assuming that stocks are expected to return 8.0% on a compounded basis and the volatility of returns on stocks is 17.0%, in any one year it is likely that two-thirds of the projected returns will typically be between (8.9)% and 28.8%. With intermediate government bonds, if the expected compound return is assumed to be 5.0% and the volatility is assumed to be 6.0%, two-thirds of the outcomes will typically be between (1.1)% and 11.5%. AB's forecast of volatility is based on historical data and incorporates AB's judgment that the volatility of fixed-income assets is different for different time periods.

5. Technical Assumptions

AB's Wealth Forecasting System is based on a number of technical assumptions regarding the future behavior of financial markets. AB's Capital Markets Engine is the module responsible for creating simulations of returns in the capital markets. These simulations are based on inputs that summarize the current condition of the capital markets as of December 31, 2020. Therefore, the first 12-month period of simulated returns represents the period from December 31, 2020 through December 31, 2021, and not necessarily the calendar year of 2020. A description of these technical assumptions is available on request.

Endnotes

1 Also known as the "duty of prudence."

2 Jess Liu, "ESG Investing Comes of Age," *Morningstar*, https://www.morningstar.com/features/esg-investing-history (Feb. 11, 2020; updated Mar. 2021).

3 Blaine Townsend, "From SRI to ESG: The Origins of Socially Responsible and Sustainable Investing," *J. Impact & ESG Inv.*, Fall 2020, https://www.bailard.com/history-socially-responsible-investing-esg-investing.

4 Id.

5 Liu, supra note 2.

6 Susan N. Gary, "Best Interests in the Long Term: Fiduciary Duties and ESG Integration," 90 *U. Colo. L. Rev.* 731, 737-741 (Summer 2019).

7 Id.

8 Id.

9 For a real-life example, one might consider the BP Gulf of Mexico spill. The report from the National Commission on the BP Deepwater Horizon and Offshore Drilling found that cost-cutting measures helped drive BP's weak safety culture, while at least one sell-side research firm used such intensive focus on costs as a justification to buy BP stock just before the event. Raj Thamotheram & Maxime Le Floc'h, "The BP Crisis as a 'Preventable Surprise': Lessons for Institutional Investors," *Rotman Int'l J. Pension Mgmt*, (Spring 2012), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2064738.

10 Simon Glossner, "Repeat Offenders: ESG Incident Recidivism and Investor Underreaction," 1, 32 (Oct. 11, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3004689.

11 Id.

12 Id. at 4.

13 Id. at 5.

14 Id. at 3.

15 For example, see Max M. Schanzenbach & Robert H. Sitkoff, "Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee," 72 *Stan. L. Rev.* 381, 400-401 (2020) (dividing ESG-related investing into two camps—risk-return ESG (i.e., ESG integration) and collateral benefits ESG (i.e., concessionary RI)—but failing to address strategies that deliver an index-like return and collateral benefits).

16 The SDGs are 17 global goals identified by the United Nations General Assembly to address areas of critical importance, including eliminating poverty and hunger, addressing the impact of climate change, etc. United Nations, Department of Economic and Social Affairs, Sustainable Development, https://sdgs.un.org/goals.

17 See also Casey Clark & Harshad Lalit, "ESG Improvers: An Alpha Enhancing Factor," *Rockefeller Capital Management* (Oct. 8, 2021), https://rcm.rockco.com/insights_item/esg-improvers-an-alpha-enhancing-factor/.

18 For example, consider a strategy focusing on small-cap companies (i.e., companies with a market value of less than $2 billion). Traditionally, small-cap companies receive less attention from research analysts. The lack of research on these companies creates market inefficiencies that may be exploited by active managers focused on this sector.

19 Richard A. Posner & John H. Langbein, "Social Investing and the Law of Trusts," 79 *Mich. L. Rev.* 72, 85 (1980).

20 As the universe of ESG-focused strategies continues to grow, investors will have access to strategies featuring a variety of tilts—including those to value stocks.

21 Linda-Eling Lee, Guido Giese, & Zoltan Nagy, "Is ESG All About the 'G'? That Depends on Your Time Horizon" (June 15, 2020), https://www.msci.com/w/blog-posts/is-esg-all-about-the-g-that/01920981576.

22 Tensie Whelan, Ulrich Atz, Tracy Von Holt, & Casey Clark, "ESG and Financial Performance: Uncovering the Relationship by Aggregating Evidence from 1,000 Plus Studies Published between 2015-2020" (Feb. 10, 2021), https://www.stern.nyu.edu/sites/default/files/assets/documents/ESG%20Paper%20Aug%202021.pdf; Ulrich Atz, Zongyuan (Zoe) Liu, Christopher C. Bruno, & Tracy Van Holt, "Does Sustainability Generate Better Financial Performance? Review, Meta-analysis, and Propositions," *J. Sustainable Fin. & Inv.* (July 22, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3708495.

23 Whelan, Atz, Holt, & Clark, supra note 22.

24 Atz, Liu, Bruno, & Holt, supra note 22.

25 Id.

26 Id.; Whelan, Atz, Holt & Clark, supra note 22.

27 Giovanni Bruno, Mikheil Esakia, & Felix Goltz, "(Honey, I Shrunk the ESG Alpha): Risk-Adjusting ESG Portfolio Returns," *Scientific Beta* (Apr. 2021), https://cdn.ihsmarkit.com/www/pdf/0521/Honey-I-Shrunk-the-ESG-Alpha.pdf.

28 Susan Gary, George Gleason Bogert, George Taylor Bogert, & Amy Morris Hess, *Bogert's Law Of Trusts and Trustees* § 543 (2022); *Restatement (Third) of Trusts* § 78 (Am. Law Inst. 2007).

29 Gary Bogert, Bogert, & Hess, supra note 28, § 543.

Endnotes

30 Id.

31 *Restatement (Third) of Trusts* § 78(2) (Am. Law Inst. 2007).

32 Past commentators have raised concerns that a trustee's consideration of an investment's impact on anyone or anything other than the beneficiaries qualifies as evidence of "mixed motives" that triggers the no-further-inquiry rule's irrebuttable presumption of disloyalty. For example, see Schanzenbach & Sitkoff, supra note 15.

33 We will rely on the *Restatement of Trusts* to summarize current fiduciary common law, in keeping with the practices of state courts, relevant treatises, and other commentators. See, e.g., *Kealoha v. Machado*, 315 P.3d 213 (Haw. 2013), Gary, Bogert, Bogert, & Hess, supra note 28, § 543, and Schanzenbach & Sitkoff, supra note 15.

34 John H. Langbein & Daniel R. Fischel, "ERISA's Fundamental Contradiction: The Exclusive Benefit Rule," 55 *U. Chi. L. Rev.* 1105, 1114-1115 (1988) ("The idea is to prevent misbehavior by erecting an irrebuttable presumption of wrongdoing whenever the trustee engages in *conflict tainted* transactions.") (emphasis added).

35 *Restatement (Third) of Trusts* § 78 cmt. c(4)-c(8) (Am. Law Inst. 2007).

36 Id. at cmt. c.

37 Id. at cmt. d-d(1). Examples of self-dealing provided by the *Restatement (Third) of Trusts* are all financial in nature. The authors are unaware of any proven case of self-dealing in which the trustee (or any involved close relative or business associate of the trustee) received only an emotional, not financial, benefit from the transaction.

38 Compare *Restatement (Third) of Trusts* § 78, Comment d(1) (Am. Law Inst. 2007) ("a trustee's action or decision that is motivated by and taken in the best interest of the beneficiaries does not violate the [duty of loyalty] merely because there may be an incidental benefit to the trustee"), Gary, Bogert, Bogert, & Hess, supra note 28, § 543(Q) (noting that a trustee who accepts an opportunity for the trustee "to profit personally and still carry through the transaction on behalf of the trust" would be considered disloyal but that courts have not found disloyalty in all such cases), and Schanzenbach & Sitkoff, supra note 15 at 413 ("But the sole interest rule does not allow for a de minimis exception. The rule does not allow consideration of other interests even if the beneficiary's interest is not subordinated or there is no concession in returns.").

39 *Restatement (Third) of Trusts* § 78, cmt. e (Am. Law Inst. 2007); Gary, Bogert, Bogert, & Hess, supra note 28, § 543(T).

40 *Restatement (Third) of Trusts* § 78, cmt. e (Am. Law Inst. 2007).

41 *Restatement (Third) of Trusts* § 78, cmt. e (Am. Law Inst. 2007).

42 The *Restatement (Third) of Trusts* describes such improper influence as a trustee's consideration of third-party interests in opposition to (not merely in conjunction with) the beneficiaries' interests. § 78, cmt. f (Am. Law Inst. 2007) ("Thus, it is improper for the trustee to sell property of the trust or purchase property for the trust, or to engage an agent or advisor for the trust, either for the purpose of benefiting a third person (whether or not a party to the transaction) *rather than* the trust estate or for the purpose of advancing an objective *other than* the purposes of the trust.") (emphasis added). See also *Ahuna v. Dept. of Hawaiian Home Lands*, 64 Haw. 327 (1982) (consideration of the interests of the State and its taxpayers, which included non-beneficiaries, did not cause a per se violation of a Commission's fiduciary duty of loyalty, but rather such breach resulted from the Commission's elevation of non-beneficiary interests above those of the beneficiaries in its decision-making process) and *Kealoha v. Machado*, supra note 33 (holding that an expenditure from a public land trust created for the benefit of native Hawaiians did not violate the trustees' duty of loyalty by simultaneously benefiting native Hawaiians and non-native Hawaiians as such expenditure did not conflict with the native Hawaiians' interests).

43 Currently, 35 states and the District of Columbia have codified the duty of loyalty in the same or approximately the same manner as the UTC. Links to all enacted legislation can be found at https://www.uniformlaws.org/committees/community-home?CommunityKey=193ff839-7955-4846-8f3c-ce74ac23938d.

44 Unif. Trust Code §§ 802(a)-(b) (Unif. Law Comm'n 2010). The UTC references transactions "for the trustee's own personal account" or "from which the trustee obtains an advantage" without providing further clarification regarding the definition of self-dealing. Id. at §§802(b) and (d).

45 Id. at §§ 802(b) and (c). The UTC provides that transactions involving the trustee's spouse, descendants, siblings, parents, agent, attorney, and individuals and entities who or which share material financial interests with the trustee are presumptively affected by a conflict of interest.

46 Id. at §§ 802(b)-(c), cmt. to § 802.

47 Id.

48 317 Md. 72 (1989).

49 Id. at 109-110.

50 Past commentators reached similar conclusions in the context of South African divesture. See Robert H. Jerry, II & O. Maurice Joy, "Social Investing and the Lessons of South Africa Divestment: Rethinking the Limitations on Fiduciary Discretion," 66 *Or. L. Rev.* 685, 704 (1987) ("Plainly, the wishes of third parties regarding trust administration ought not to take precedence over the beneficiary's interest. Yet, it is far from clear that the duty of loyalty prevents a trustee from considering collateral factors in circumstances where there is no possibility the beneficiary's interests will be compromised.").

51 29 U.S. Code § 1104. This duty applies to the administration of the plan, including an effort to defray reasonable expenses of administering the plan overall. Such wording suggests that observance of the duty as applied to investment decisions should be assessed based on the plan's overall portfolio.

52 *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409, 422 (2014) (holding that a congressionally approved plan objective of encouraging employee stock ownership could not override the plan administrator's duty to provide employees financial benefits).

53 Langbein & Fischel, supra note 34, at 1108 ("ERISA's exclusive benefit rule … imports into pension fiduciary law one of the most fundamental and distinctive principles of trust law, the duty of loyalty.").

Endnotes

54 609 F. Supp. 1221, 1245 (S.D. Fl. 1985).

55 Id. See also *Luitgaren v. Sun Life Assur. Co. of Canada*, 765 F.3d 59 (1st Cir. 2014) ("ERISA section 404(a) does not require a fiduciary to don the commercial equivalent of sackcloth and ashes. What it does require is that the fiduciary not place its own interests ahead of those of the Plan beneficiary. An example may help to illustrate the point. Suppose the Plan specifies that the death benefit may be paid other than in American dollars. If, in a particular case, it makes no practical difference to the beneficiary whether she receives her promised benefit in dollars or euros, but it is to the fiduciary's advantage to pay in euros, it could not rationally be argued that payment in euros was a breach of the fiduciary's duty under section 404(a). When the fiduciary's payment of a benefit does not unfairly diminish, impair, restrict, or burden the beneficiary's rights, section 404(a) is not transgressed."); and *Trenton v. Scott Paper Co.*, 832 F.2d 806 (3rd Cir. 1987) ("although a fiduciary has a duty to act for the exclusive benefit of trust beneficiaries, the fact that a fiduciary's action incidentally benefits an employer does not necessarily mean that the fiduciary has breached his duty.").

56 The DOL issued a final rule regarding investment duties in the context of ERISA in late 2020 (the "2020 rule"). President Joe Biden issued an executive order shortly thereafter in which he directed federal agencies to reassess existing regulations to consider certain national policies pertaining to the environment, public health, and unions. In response, the DOL issued a proposed rule in 2021 (the "2021 rule") that more directly addressed the role of ESG considerations in pension fund investing. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846 (to be codified at 29 C.F.R. § § 2509, 2550) (Nov. 13, 2020, eff. Jan. 12, 2021); Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. 57272 (Oct. 14, 2021).

57 As a limited exception to the above interpretation, the 2020 rule includes an express prohibition against selecting a qualified default investment alternative if its investment objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors. However, the 2021 rule eliminates this prohibition.

58 The 2020 rule's "tie breaker" provisions are substantially narrower than those of the 2021 rule, in that they only apply when a fiduciary cannot decide between two investments based on pecuniary factors alone and carry a stringent documentation requirement. The 2021 rule, on the other hand, authorizes use of the tie breaker approach when competing interests "equally serve the financial interests of the plan over the appropriate time horizon" and eliminates the documentation requirement.

59 *Restatement (Third) of Trusts* § 78(1) (Am. Law Inst. 2007).

60 Revised Model Nonprofit Corp. Act § 8.30(A) (ABA 2021); Unif. Uninc. Nonprofit Ass'n Act § 22(A), (B) (Unif. Law Comm'n 2011); Unif. LTD. Liab. Co. Act § 409(A)-(D) (Unif. Law Comm'n 2013).

61 As described more fully in our discussion of the duty of care, the way in which an individual strategy may meet beneficiaries' needs will depend on the role it plays in the larger portfolio. For example, a strategy with increased risk but the potential for greater return may be appropriate as a small portion of an overall portfolio and should be compared to other strategies with the same risk and return profile for purposes of the duty of loyalty.

62 *Restatement (Third) of Trusts* § 90, 29 U.S. Code § 1104(a)(1) imposes the prudent investor rule on retirement plans subject to ERISA ("a fiduciary shall discharge his duties with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims"). Similarly, the Uniform Prudent Management of Institutional Funds Act § 3(b) codifies the prudent investor rule for nonprofits organized as corporations ("each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances"). As the prudent investor rule stems from the common law duty of care, the duty of care's impact and restrictions under common law may be extrapolated in most cases to the rule as it applies in other contexts.

63 The Uniform Prudent Investor Act codified the prudent investor rule and has now been adopted in 44 states and the District of Columbia. Links to all enacted legislation can be found at https://www.uniformlaws.org/committees/community-home?communitykey=58f87d0a-3617-4635-a2af-9a4d02d119c9#LegBillTrackingAnchor.

64 Unif. Prudent Inv'r Act § 2(c) (Unif. Law Comm'n 1994); Uni. Prudent Mgmt. of Institutional Funds Act § 3(e) (Unif. Law Comm'n 2006).

65 See Susan N. Gary, "Is It Prudent to Be Responsible? The Legal Rules for Charities That Engage in Responsible Investing and Mission Investing," 6 *NW. J. L. & Soc. Pol'y*. 106 (2011).

66 *Restatement (Third) of Trusts* § 90(b) (Am. Law Inst. 2007).

67 Philip J. Ruce, "The Trustee and the Prudent Investor: The Emerging Acceptance of Alternative Investments as the New Fiduciary Standard," 53 *S. Tex. L. Rev.* 653, 671-673 (2012).

68 Id. at 662, 674-675.

69 Id. at 671-672.

70 Id. at 674-675.

71 Comment to Section 3, Unif. Prudent Inv'r Act (Unif. Law Comm'n 1994).

72 *Restatement (Third) of Trusts* § 90, Comment b (Am. Law Inst. 2007).

73 *Restatement (Third) of Trusts* § 90, Comment e(1), k (Am. Law Inst. 2007) ("The rule recognizes that what may be underproductive of trust accounting income or risky—or even characterized as speculative—in isolation, or in a different context, may play a role in an investment strategy that contributes to the trustee's compliance with the requirement of caution."); Comment to Section 2, Unif. Prudent Inv'r Act (Unif. Law Comm'n 1994) ("An investment that might be imprudent standing alone can become prudent if undertaken in sensible relation to other trust assets, or to other nontrust assets.").

74 *Restatement (Third) of Trusts* § 90, Comment n (Am. Law Inst. 2007).

75 As mentioned above, ERISA does not allow a plan to modify an administrator's duties.

76 To date, Delaware courts have yet to decide a relevant case pursuant to this section of the statute.

Endnotes

77 12 Del. C. § 3302(a) (2018) ("…when considering the needs of the beneficiaries, the fiduciary may take into account the financial needs of the beneficiaries as well as the beneficiaries' personal values, including the beneficiaries' desire to engage in sustainable investing strategies that align with the beneficiaries' social, environmental, governance or other values or beliefs of the beneficiaries."); Ga. Code Ann., § 53-12-340(d) (2021) ("In investing and managing trust assets, the trustee may consider the personal values of the beneficiaries, including but not limited to a desire to engage in investing strategies that align with social, political, religious, philosophical, environmental, governance, or other values or beliefs of the beneficiaries."); 760 Ill. Comp. Stat. 3/902(c)(7)(2020) ("The circumstances that a trustee may consider in making investment decisions include ... environmental and social considerations"); N.H. Rev. Stat. § 564-B:9-902(c) (2021) ("Among circumstances that a trustee shall consider in investing and managing trust assets are … the expressed wishes of the interested persons of the trust … as reflected in a nonjudicial settlement agreement … to have the trustee, trust advisor, or trust protector engage in investing strategies that align with the interested persons' social, environmental, or governance objectives or other values or beliefs of the interested persons, regardless of investment performance."); and O.R.S. § 130.755 (2020) ("A trustee shall consider all relevant circumstances in investing and managing trust assets, including any of the following that are relevant to the trust or the beneficiaries of the trust … (i) [t]he intent, desire and personal values of the settlor, including the settlor's desire to engage in sustainable or responsible investment strategies that align with the settlor's social, environmental, governance or other values or beliefs to the extent known by the trustee; and (j) [t]he needs of the beneficiaries, including but not limited to the beneficiaries' personal values and desire that the trustee engage in sustainable or responsible investing strategies that align with the beneficiaries' social, environmental, governance or other values or beliefs, as well as the financial needs of the beneficiaries.").

78 *Restatement (Third) of Trusts* § 27(2) (Am. Law Inst. 2007); Unif. Trust Code § 402 (Unif. Law Comm'n 2010); Schanzenbach & Sitkoff, supra note 15, at 415.

79 Schanzenbach & Sitkoff, supra note 15, at 416.

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