WHY PLAN SPONSORS INCORPORATE SUSTAINABLE INVESTING IN DC MENUS

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Adoption of Sustainable Investing (SI) strategies, or those that integrate Environmental, Social and Governance (ESG) goals, has seen considerable growth in defined contribution (DC) plans. This growth has been primarily fueled by an increased appetite from participants, interest from plan sponsors to align DC menus with their corporate values, and a growing set of investment capabilities that fit the performance needs and values of investors.

ENGAGING YOUR WORKFORCE THROUGH SUSTAINABLE INVESTING

A potential benefit of adding a SI option to a DC menu may be the increased engagement of participants in their DC plans, which we believe can potentially lead to higher savings. With millennials poised to become the largest age cohort in the workforce, plan sponsors have been looking for ways to increase engagement and motivate millennials to save more for retirement. In a 2017 study conducted by Northern Trust Asset Management, we found that more than half of existing DC participants believe SI options should be available in their 401(k) plans.

To dig into that finding a bit deeper, our team conducted two recent case studies to illustrate the drivers behind SI strategies in DC plans and the growth experienced based on participant contributions. In each case, the plans were looking for a broadly diversified SI strategy that was cost effective and fit within the overall design of the DC menu.

In the first case, the sponsor elected to add both an active and passive SI equity option. In the other instance, the sponsor selected a passive SI equity and fixed income strategy. In both instances, electing to add the strategies was desirable because:

1) It provided a cost effective solution to participants

2) It covered a wide variety of ESG factors that appeal to an expansive set of participants

3) It minimized volatility of the solution relative to an index, thereby providing participants with an option that is easier to understand

In both case studies, there was immediate adoption of the SI option with over $20 million[1] invested within the first year of implementation. This demonstrates that DC participant demand indeed exists and that people are taking action to invest in sustainable strategies when given access to them. This suggests that adding SI options, even while the trend is to streamline menu design, can improve the level of engagement with DC participants.

	Case Study #1	**Case Study #2**
Company	Large Financial Firm	Large Accounting Firm
Demand Driver	Millenials	Senior Management
Implementation	Offered two SI options: an active global equity SI option and a passive global equity SI option	Offered one global balanced SI option: combined passive global equity with global fixed SI option

ALIGNMENT OF VALUES WITH INVESTMENT MENU

In the first case, adoption was driven by demand from the millennial employee base. However, in the second case, senior management drove implementation because SI strategies closely aligned with their overall corporate mission and values. It appears from the rapid shift into SI strategies that DC participants shared similar values and aligned their investments with those beliefs.

SI strategies have evolved significantly in the past ten years. The industry has developed many more tools to apply in the investment process that targets risk mitigation alongside alignment of values. Increasingly, corporate and individual values are prioritizing the principle of sustainability. In our experience, plan sponsors are implementing strategies that allocate based on how well companies do managing environmental, social or governance factors versus their peers, this is commonly referred to as a best in class or ESG integration approach.

[1] Northern Trust Asset Management Retirement Solutions Team

THE UPSIDE POTENTIAL OF SUSTAINABLE INVESTING

The most frequent question plan sponsors ask is whether SI strategies can perform well relative to non-SI strategies. The answer is it depends on the strategy selected. However, there are many reasons to believe SI strategies can meet the performance needs of DC participants.

It is important to note that from a fiduciary perspective, the Department of Labor (DOL) made it clear that SI options are acceptable in a DC plan “so long as the investment is appropriate for the plan and economically and financially equivalent with respect to the plan's investment objectives, return, risk and other financial attributes as competing investment.” In April 2018, additional guidance was issued providing more clarity on adding ESG investment alternatives on 401(k) platforms, explaining that levels of shareholder engagement should be balanced with the expected economic benefits. This guidance confirmed that the fiduciary standard for evaluating SI strategies is no different than selecting other non-SI investments. However, the guidance did acknowledge that the plan sponsor should consider how ESG factors, which are non-financial, might affect returns positively or negatively as part of their decision to incorporate a SI option.

To explore the interaction of SI on portfolio performance, we should first establish the different approaches to this investment philosophy.

EXHIBIT 1: CURRENT DC FOCUS: SOPHISTICATION OF STRATEGY

NOTE: Best-in-class: Best-in-class ESG is industry terminology referring to an investment approach that selects companies that are leaders in implementing ESG.

On the left side of the spectrum, negative or norms-based screens represent an exclusionary approach, meaning companies are removed from consideration due to ethical or values oriented concerns. Studies suggest that exclusionary approaches alone have a neutral or negative impact on portfolio performance[2,3].

As the depth and breadth of data and ratings assessing ESG risks and opportunities for integration approaches has improved in recent years, investors have been able to harness this data to create more sophisticated analyses to complement the portfolio construction process. Investors can use this data in a more forward-looking sense by leveraging and integrating ESG analytics from a risk and opportunity perspective into fundamental or quantitative analysis. Best in class and ESG integration strategies lend themselves to the needs of DC plans. Companies with strong ESG ratings typically have better risk control and compliance standards. With stronger risk-controls, those firms typically experience less adverse effects such as corruption or litigation, which could impact firm value over time[4].

A company's ability to identify and respond to material ESG issues may impact their ability to operate in a given community or potential to deliver products and services competitively. According to MSCI ESG Research, an investment approach tilting an index towards constituents with stronger ESG profiles assumes ESG scores are linked to future stock performance; companies that integrate ESG considerations into their operations are able to avoid some financial losses related to ESG issues… [and] are also able to more quickly take advantage of new ESG-related opportunities."[5] Another study indicated that companies with higher ESG ratings demonstrated lower levels of risk and higher valuations.[6] Other studies back up these findings; research published in 2016 analyzed the premise of materiality for ESG metrics, which identified that companies demonstrating strong performance on material ESG issues had significant outperformance compared to companies that lagged in management of those material factors.[7]

This growing body of analysis points to the potential for ESG data and analytics to complement traditional methods, rather than detract from it. Another study aggregated the results of 2,250 academic reviews, conducted between 1970-2014, analyzed the impacts of ESG on performance. The study indicated that the integration of ESG data had a

[2] Meir Statman and Denys Glushkov, "The Wages of Social Responsibility," Financial Analysts Journal 65.4 (2009): 33-46
[3] Marcin Kacperczyk and Harrison Hong, "The Price of Sin: The Effects of Social Norms on Markets," Journal of Financial Economics 93.1 (2009): 15-36
[4] Foundations of ESG Investing MSCI 2017
[5] Can ESG Add Alpha MSCI ESG Research 2015
[6] Foundations of ESG Investing, MSCI ESG Research November 2015
[7] Khan, Mozaffar, George Serafeim, and Aaron Yoon. "Corporate Sustainability: First Evidence on Materiality."The Accounting Review. 2016

neutral or positive impact on portfolio performance in the majority of studies.[8]

Our belief is that sustainable companies can perform competitively and that the integration of this analytical framework may identify risks that traditional financial data does not. This underscores our firm belief that DC investors can benefit from seeking SI strategies without foregoing performance over the long term.

CONCLUSION

Plan sponsors are incorporating SI strategies in their DC menus and we see this trend continuing. Our case studies demonstrate that participants are engaged when provided access to SI options. SI strategies can complement the existing DC menu with the potential to mitigate risks and capture new opportunities for long-term investors. We find that SI options are gaining traction as plan sponsors work to increase engagement and align DC menus with participant demand and institutional values, while being conscious of their fiduciary responsibilities.

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*Assets under management as of March 31, 2018.

[8] Friede, Busch and Bassen *ESG and Financial Performance: Mapping the Global Landscape* 2015