Bracing for Impact: How to Prepare for the Next Generation of Defined Contribution Plans

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Abstract

As defined benefit plans continue to grapple with funding issues, defined contribution plans have emerged as the primary vehicle for retirement savings. In recent years we have seen increased adoption of features that encourage participation in such plans, such as automatic enrollment, as well as the emergence of options that better prepare participants for retirement, such as target date funds. Consideration of ESG issues—that's *environmental, social*, and *governance*—within the participant-directed, defined contribution plan structure has also gained momentum as a way for plan sponsors to engage with their participants and mitigate risks for the investor. Plan sponsors are now tasked with the challenge of determining whether and how to best incorporate ESG considerations into the stewardship of defined contribution plans.

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What Are We Talking About?

The recent surge of interest in ESG investing has generated a disarming set of vocabulary with terms like "SRI," "ESG," and "Impact Investing" being used by plan sponsors and investment professionals to describe socially conscious or mission-related investing strategies. As depicted in the table below, the non-financial criteria under consideration for all of these strategies can reasonably fall into the categories of environmental, social, or governance issues. These strategies also utilize similar structures in terms of implementation, including negative and positive screening and shareholder activism. Since all of these strategies share similar meaning with regard to the investment goals and methods utilized, we will refer to this category of investment strategies as "ESG" for purposes of this discussion.

Exhibit 1: Breakdown of ESG Issues

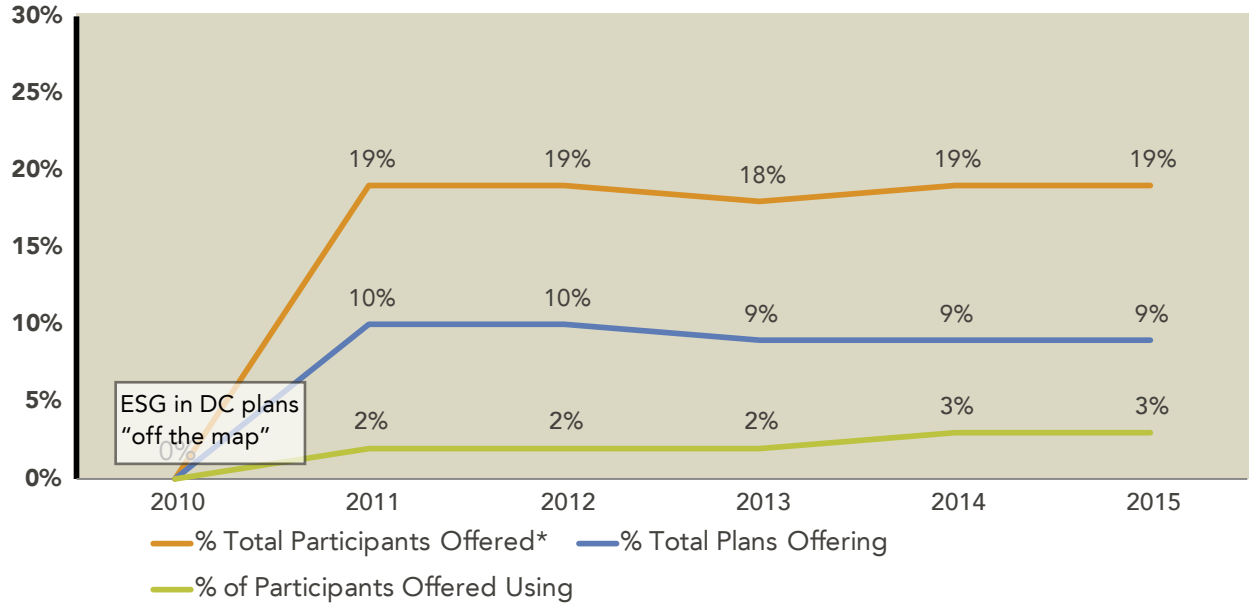
Environmental	Social	Governance
Climate change and carbon emissions	Human rights infringement	Workplace health and safety
Air and water pollution	Consumer health and safety	Executive pay
Water scarcity	Community relations	Conflicts of interest
Sustainable transportation	Fair marketing and advertising	Board diversity
Waste management	Labor relations and supply chain management	Audit committee structure
Supply chain management	Data protection and privacy	Bribery and corruption
Risk of environmental litigation	Employee engagement and satisfaction	Lobbying and political contributions
Biodiversity harm		Whistleblower protection
Energy efficient facilities		

ESG investing can take many shapes, but it is ultimately an investment strategy that can achieve positive ESG impacts alongside a financial return. Nonprofit, religious, and labor groups have embraced ESG investing for decades as a complement to their mission-driven work. However, as the regulatory landscape and investor profile continue to evolve and research uncovers the financial merits of the sustainable business model, more and more investors are expressing interest in this topic.

Why Are We Talking About It?

Both the demand for and supply of ESG investment opportunities have surged over the past several years. From the demand side, signatories to the Principles for Responsible Investment, a set of investment principles that enable incorporation of ESG considerations into investment practices, grew in combined assets from less than $6 trillion in 2006 to nearly $60 trillion by the end of April 2015. Similarly, according to the *How America Saves* study published by Vanguard last year, 9% of Vanguard defined contribution plans offered an ESG option in 2015, a stark contrast from the 2010 study, which bears no mention of ESG. The chart below illustrates the increase in the percentage of participants offered and subsequently using ESG strategies as investment options over time.

Exhibit 2: Plans Offering ESG Options[1]

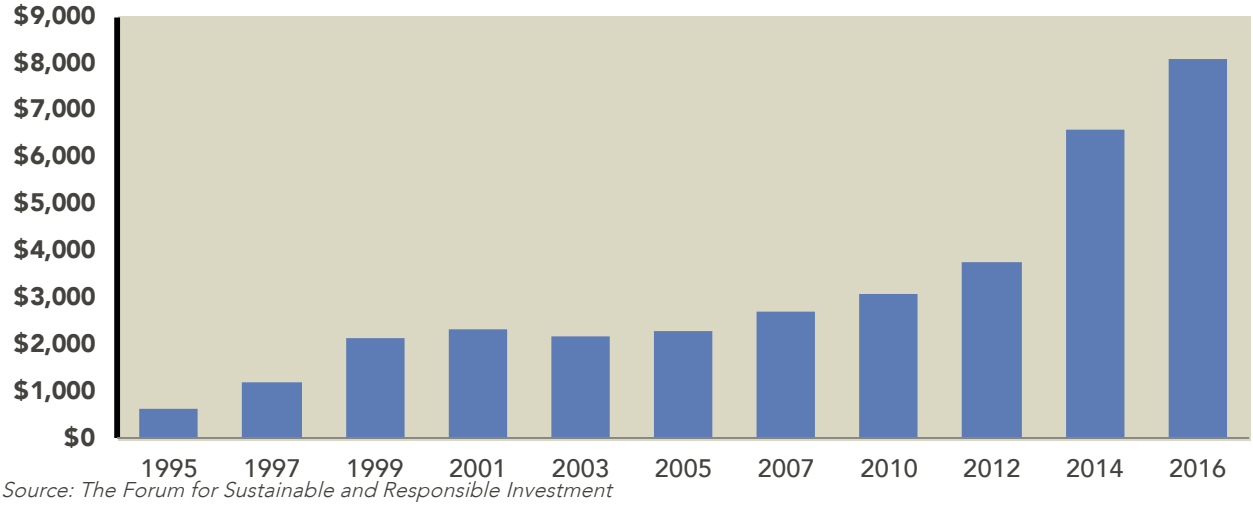


*"Total Participants Offered" refers to the percentage of all participants across all plans surveyed by Vanguard

Source: Vanguard

Similarly, the supply of ESG strategies in the market continues to increase as well, with investment firms offering ESG products in both the traditional and alternative asset classes. The chart below depicts the rise in institutional ESG assets. The value of sustainable, responsible and impact investing assets in the United States rose by an unprecedented 116% between 2012 and 2016 according to the Forum of Sustainable and Responsible Investment.[2]

Exhibit 3: Sustainable, Responsible and Impact Investing in the United States ($B)



Source: The Forum for Sustainable and Responsible Investment

[1] Vanguard, "How America Saves 2016: Vanguard 2015 Defined Contribution Plan Data" (June 2016).

[2] The Forum for Sustainable and Responsible Investment, "US Sustainable, Responsible and Impact Investing Trends 2016." (Released November 2016).

The growing interest in ESG investment opportunities within the defined contribution community can be attributed to several factors, including recent guidance from the Department of Labor ("DOL"), increasing evidence of ESG factor materiality, and the emergence of the millennial investor.

Clarification on Fiduciary Obligations

Given the litigious nature of the defined contribution industry, plan sponsors are particularly mindful of their fiduciary obligations in selecting investment options for their respective plans. To address these concerns, most plans look to the DOL, which has issued guidance on how best to approach investment decisions in compliance with the fiduciary obligations set by the Employee Retirement Security Act of 1974, as amended ("ERISA"). Historically, much of the discussion around ESG investing has focused on how the specific non-investment performance goals of these targeted investments complied with ERISA's fiduciary duty of loyalty, requiring fiduciaries to act solely in the interest of the underlying plan participants and beneficiaries.[3]

In an attempt to unite ESG considerations with fiduciary duties, the DOL, in 1994, issued interpretive guidance on the subject; the DOL conveyed that—assuming all other fiduciary considerations are met—ERISA fiduciaries could seek the collateral benefits of ESG strategies if the expected returns were consistent with alternative investments of comparable risk.[4] This became known as the "all things being equal" test; ESG could be considered so long as the plan wasn't taking on additional risk or accepting lower expected returns in exchange. In 2008, the DOL revisited the ESG consideration by issuing interpretative guidance which modified and superseded the guidance from 1994. The 2008 guidance declared that consideration of non-economic factors by fiduciaries in selecting plan investments should be a "rare" occurrence and any such consideration must be accompanied by documentation that demonstrated compliance with ERISA's "rigorous" fiduciary standards.[5] The tone of this later guidance and added compliance component deterred many ERISA plans from incorporating ESG into their investment processes; instead, plans reverted to focusing on standard, financial-based factors—such as returns—when making investment decisions.

In an attempt to reverse this trend, the DOL issued new guidance late 2015 that withdrew the 2008 guidance and effectively reinstated the "all things being equal test."[6] Not only does the most recent guidance disarm the previous misconceptions surrounding ESG strategies and fiduciary obligation by removing the added layer of scrutiny, it goes a step further by acknowledging that ESG factors may be directly related to the economic and financial value of an investment. Also of importance is that, under this new guidance, fiduciaries are no longer required to produce special compliance documentation when selecting an ESG investment option.

[3] ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1).

[4] Interpretive Bulletin 94-1, 29 CFR § 2509.94-1, 59 FR 32607 (June 23, 1994).

[5] Interpretive Bulletin 2008-1, 26 CFR § 2509.2008-1, 73 FR 61734 (October 17, 2008).

[6] Interpretive Bulletin 2015-01, 29 CFR § 2509.2015-1, 80 FR 65135 (October 26, 2015).

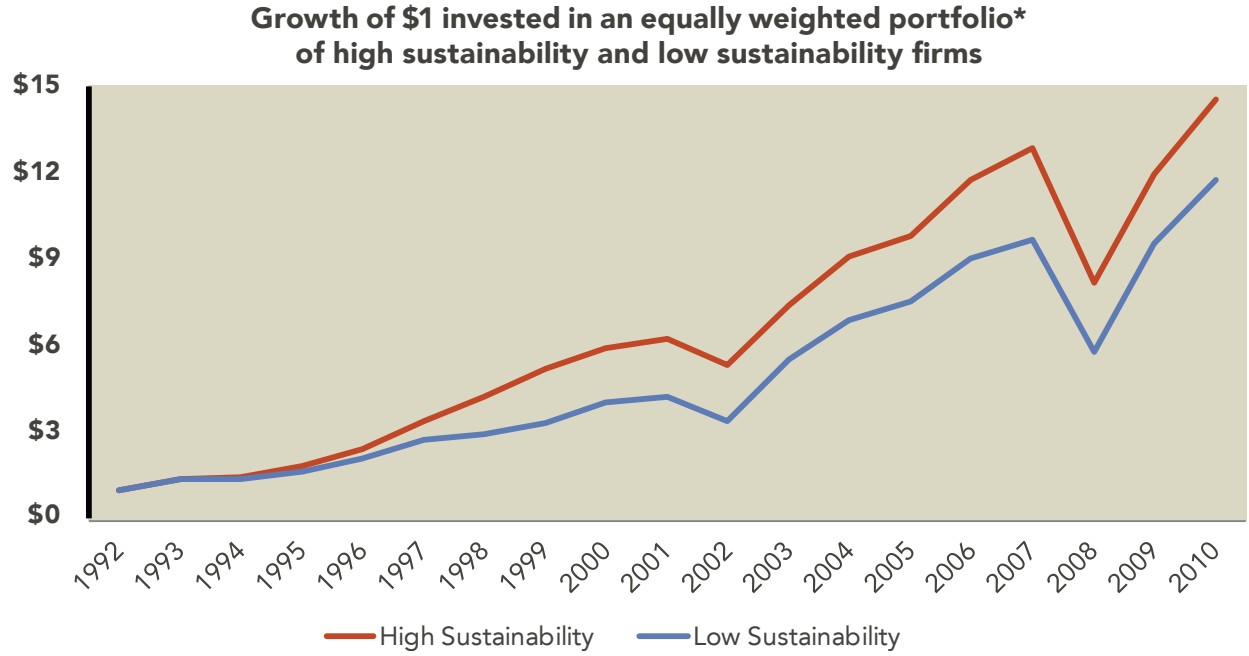
By issuing its most recent guidance, the DOL has effectively impacted market trends both from a supply and demand perspective. In one sense, the change represents a response to investors who wanted to consider ESG strategies but were discouraged from doing so under the prior guidance. From a supply side, the guidance encourages strategies to consider the long-term impact of ESG issues on their investment decision making process. As a result, we expect to see further growth in the interest level of investors as well as the number of ESG strategies offered in the market.

Materiality of ESG Factors

While the DOL has made it easier for fiduciaries to consider ESG factors, the strategies themselves are still required to be considered prudent investments. For years, ESG options have been plagued with doubt as to whether they are able to add value to a plan line-up from an investment returns perspective. There is a general misconception that these investment strategies limit the participant's investible universe and therefore lead to diminished returns. Conversely, investors are now finding that certain non-financial information about a company—including ESG considerations—can provide insight into a company's current and future profitability.

Exhibit 4 below portrays the findings of a study by the Harvard Business School and London Business School. The study found that companies which have adopted a substantial number of environmental and social policies outperform those that have failed to embrace any such policies.[7]

Exhibit 4: Sustainable Companies Outperform



*This chart illustrates two portfolios containing 90 companies each. Each portfolio is equally weighted between the 90 companies (no one company is weighted more or less than another).

Source: Harvard Business School and London Business School

[7] Harvard Business School and London Business School. "The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance." (May 2012).

Traditional valuation methods look at important figures such as cash flow, dividend yield, and price/earnings ratio—certainly valuable information when evaluating a company's future profitability. However, this traditional view fails to adequately account for certain performance indicators such as how a company's labor relations could affect its productivity, or whether lax safety standards could trigger product recalls. These ESG indicators are arguably just as valuable to predicting a company's success since they help safeguard against actual and perceived risk that can ultimately impact stock prices. Without integrating valuable ESG data into the security selection process, an investor may fail to accurately measure the risks of a potential investment.

This approach is further supported by guidance[8] issued in 2010 by the Security and Exchange Commission ("SEC"), which notes that compliance with the SEC's existing disclosure requirements may require the inclusion of climate change related disclosures. With this guidance, the SEC recognizes that companies are at risk of being negatively impacted by both the physical effects of climate change as well as the regulatory and legislative developments that are already underway, thus making it important for investors to account for such factors in their analysis and decision-making. Similarly, on a global scale, the U.K.'s Cambridge Centre for Sustainable Finance recently issued a study that advises financial institutions to invest in tools and methods that integrate environmental risk considerations into their decision making, noting that a general lack of data disclosure serves as a barrier to effective risk analysis.

As research progresses on the long-term impact of ESG factors, reliance on non-traditional valuations and the use of ESG strategies will follow suit.

Demographic Shifts: The Rise of Millennials

The millennial generation, comprised of those persons born between 1980 and 2000, currently represents the largest and most ethnically diverse generation in the United States and is expected to represent 75% of the global workforce by the year 2025.[9] This cohort grew up using advanced digital technology and mass media, providing them with seemingly unlimited access to information. Many millennials entered the workforce in the years following the Great Recession and have been forced to confront historically high unemployment rates. While unemployment rates have since improved, millennials are also saddled with unprecedented levels of student debt.

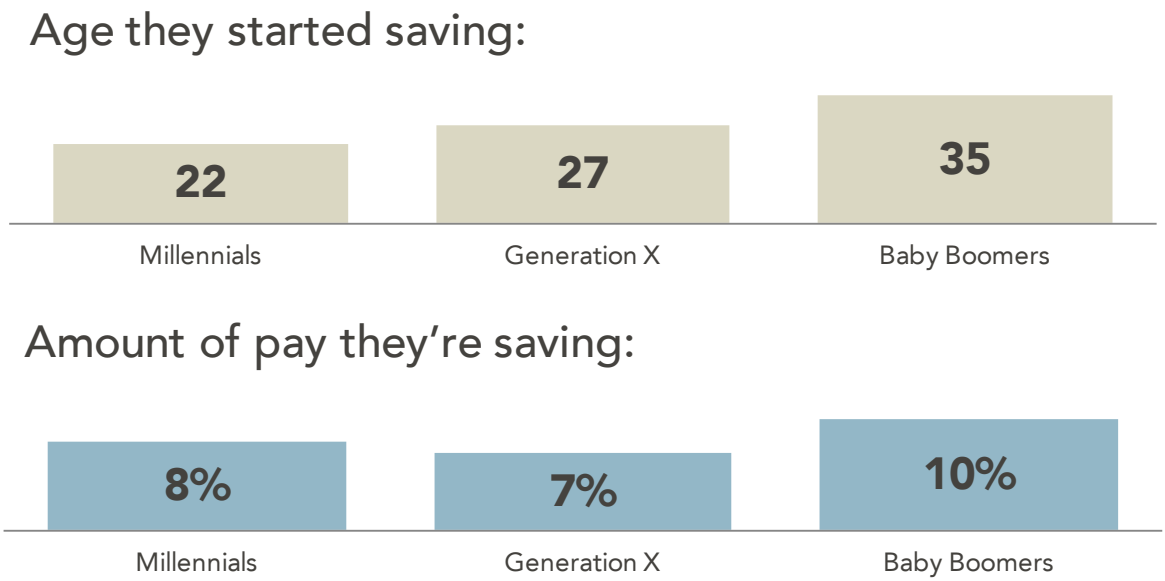
While economic instability following the 2008 financial crisis impacted all generations, many millennials were uniquely disadvantaged as they first entered the workforce. As a result, millennials' attitudes about investing differ from prior generations. First, millennials place a higher value on contributing towards their retirement earlier in their careers than previous generations, due in part to their expectations that Social Security will not be available to them when they retire. According to recent data depicted in Exhibit 5, millennials are saving at both a younger age and more aggressive rate than previous generations.[10]

[8] Commission Guidance Regarding Disclosure Related to Climate Change, SEC Release No. 33-9106 (February 2, 2010).

[9] The Council of Economic Advisors, "15 Economic Facts About Millenials" (October 2014).

[10] Transamerica Center for Retirement Studies, "Perspectives on Retirement: Baby Boomers, Generation X, and Millennials" (August 23, 2016).

Exhibit 5: Millennial Saving Trends



Source: Transamerica Center for Retirement Studies

Second, the altruistic sentiments of millennials have shifted their generation's expectations surrounding corporate governance. Almost all millennials—nearly 90% according to a Deloitte survey—believe that businesses should be based on more than just profits.[11] This represents a significant shift from 1970, when Milton Friedman famously wrote: "There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits..." Millennials in the Deloitte survey named the following four issues as the biggest challenges for the future: unemployment, resource scarcity, climate change / protecting the environment, and wealth inequality. Contrary to prior generations, millennials feel that the government should not bear the full burden of these challenges, but that rather businesses and government sectors should work together to address these issues. This holistic view of the world has impacted the manner in which millennials invest; compared to the overall investor population, millennial investors are twice as likely to invest in companies or funds that use ESG factors as a value differentiator.[12]

Research indicates that, like every generation, the macroeconomic conditions faced by millennials in their younger years will likely impact the way in which they approach financial decisions as adults.[13] Given millennials' experiences with the Great Recession and corporate wrong doing, and in light of the generation's already evident altruistic attitude, ESG strategies seem like an inevitable trend for this generation. As millennials continue to enter the work force and place a greater emphasis on their retirement plans, it will become increasingly important for plan sponsors to cater to this participant

[11] Deloitte, "The Millennial Survey 2014" (January 2014).

[12] Morgan Stanley, "Sustainability Through the Eye of the Investor" (February 27, 2015).

[13] Kahn, L.B., "The Long-term Labor Market Consequences of Graduating College in a Recession." *Labour Economics* (2010). See also Oreopoulos, P., T. von Wachter and A. Heisz, "The short-and long-term career effects of graduating in a recession." *American Economic Journal: Applied Economics* (2012).

base by offering ESG strategies as available investment options. Not only will consideration of such strategies engage younger participants, thereby increasing the total plan participant base, but it will also serve as a recruiting tool for employers seeking to hire this cohort.

Where Do We Go From Here?

In light of these ESG tailwinds, plan sponsors are now faced with the task of determining how best to implement ESG strategies into their respective plans. Since most major plan administrator platforms either offer an open platform or provide access to at least one ESG option, the real challenge for plan sponsors is in selecting the collateral benefit that is to be achieved through the addition of the ESG option.

ESG strategies range from funds that are focused on environmental factors and specifically target certain themes like fossil fuels and water conservation to funds that seek to impact governance issues such as gender diversity and human capital issues. There are also options which seek to broadly incorporate ESG factors into their investment process. In terms of participant interests, a recent survey of over 1,000 401(k), 403(b), and 457 retirement plan participants indicates that interest in these ESG issues is equally as diverse.[14]

One way that plan sponsors can determine how best to meet the needs of their participant base is through engagement. Investment consultants can assist in this engagement process by working with plan recordkeepers to draft and administer surveys that gauge participant interest in ESG and determine the specific areas of concern for participants.

Exhibit 6: Checklist for DC Plan Sponsors: Getting Started with ESG

1	**Review the fund's investment policy and current fund line-up** Does the policy need to be adjusted? Where would an ESG option fit into the current line-up?
2	**Educate the decision-makers** Seek education from consultants and recordkeepers and address all questions and concerns.
3	**Survey plan participants** Determine level of interest in ESG options, as well as areas of importance (i.e. climate change or labor relations).
4	**Outline criteria for search and selection** Define whether you seek ESG integration, a thematic fund (such as water or carbon reduction), or other alternatives.
5	**Make selection and add to line-up** Discuss options, select best candidate, and initiate transition.
6	**Educate plan participants** Prepare communications to explain the new line-up and rationale behind it.

[14] Calvert Investments (August 2015).

Participant engagement through education is also crucial in bridging the ESG knowledge gap that is generally found among the investor base. Given the misconceptions surrounding ESG strategies, participants will require more in-depth education on the fundamentals of ESG strategies as well as the investment metrics of any specific ESG option offered to participants. As a result, Marquette classifies ESG strategies as "tier III" investment options; plan sponsors should consider these specialty investment options for their most proactive participants and should offer them in limited availability.[15] Education can be administered to participants through newsletters or other forms of targeted communications, including plan enrollment forms, or through presentations by investment consultants, plan recordkeepers, and similar experts. Any communication addressing a specific ESG investment option should clearly set forth the basic investment fundamentals of the strategy as well as define how any ESG impact is measured; this will allow the participant to adequately assess the strategy prior to making an allocation.

Finally, it's important for a plan sponsor to maintain a well-defined, well-documented policy in place for considering its investment line-up. Contained within this policy should be a process for selecting and monitoring all investment choices, including ESG options. Like any investment, it's imperative that an ESG option meets its investment objectives. In addition to applying the assessment tools used to monitor traditional investment options, ESG options require plan sponsors to ensure that the investment is in fact achieving the collateral benefit for which it was selected. Again, investment consultants are well equipped to monitor these investments and can assist plan sponsors in developing the appropriate policies and processes for this level of oversight.

Conclusion: Know Your Participants and Make Use of ESG Data

While regulatory changes, new research, and shifting investor demographics have fostered increased interest in ESG investing, these strategies are not yet considered mainstream investments. ESG strategies face a number of hurdles, the majority of which surround disclosure and reporting mechanisms, as well as the need for education regarding the merits of non-financial data. Nonetheless, the industry will soon face increasing demand for ESG strategies and plan sponsors should be prepared to adapt their investment options to accommodate the changing landscape. Fiduciary obligations require a comprehensive evaluation of an investment's risk, and traditional methods without ESG data will no longer offer sufficient insight. Investors can look forward to a future when ESG data disclosure will be commonplace and they can direct their retirement funds in support of a more sustainable future.

Top 5 Reasons to Add ESG to DC Plans

1. Fiduciary responsibilities
2. Comprehensive risk management
3. Identify quality investments
4. Encourage employee participation
5. Attract young professionals

[15] See Defined Contribution Plans: A Look at the Past, Present & Future white paper for more information.

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