

Getting Started With ESG:

Six Steps for Defined Contribution Plans

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There is growing interest among defined contribution plan sponsors in incorporating consideration of environmental, social and governance (ESG) issues into their plans. The authors suggest six steps for implementing ESG strategies.



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In recent years, defined contribution (DC) plan sponsors have adopted features such as automatic enrollment to increase participation and options including target-date funds to better prepare participants for retirement. Consideration of ESG issues—that’s *environmental*, *social* and *governance* issues—within the participant-directed DC plan structure also has 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 best to incorporate ESG considerations into the stewardship of DC plans.

The Evolution of ESG

The growing interest in ESG investment opportunities within the DC community can be attributed to several factors, including recent guidance from the Department of Labor (DOL), increasing evidence that ESG factors affect financial returns and the emergence of the Millennial investor.

Given the litigious nature of the DC industry, plan sponsors are particularly mindful of their fiduciary obligations in selecting investment options for their plans. Recent DOL guidance addressing these concerns disarms previous misconceptions surrounding ESG strategies and fiduciary obligations and acknowledges that ESG factors may be directly related to the economic and financial value of an investment.¹ The most recent DOL guidance encourages both investors and those managing strategies to consider the long-term impact of ESG issues on their investment decision-making process.

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 can add value to a plan lineup from an investment returns perspective.

However, a recent study by the Harvard Business School and London Business School found that companies that have adopted a substantial number of environmental and social policies outperform those that have failed to embrace any such policies.² It is becoming more apparent that not integrating ESG data into the security selection process may re-

sult in failure to identify certain risks associated with a potential investment.

Finally, there has been a shift in the demographics of the global workforce with the rise of the Millennial generation, which is expected to represent 75% of the global workforce by 2025.³ 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. Millennials are saving at both a younger age and a more aggressive rate than previous generations, in part due to their expectations that Social Security will not be available to them when they retire.⁴ Further, the characteristically altruistic sentiments of Millennials have shifted their generation's expectations surrounding corporate governance. Compared with the overall investor population, Millennial investors are twice as likely to invest in companies or funds that use ESG factors as a value differentiator.⁵

As Millennials continue to enter the workforce and place a greater emphasis on their retirement plans, it may become increasingly important for plan sponsors to cater to this participant base by offering ESG strategies as available investment options.

Nonetheless, there are a number of challenges faced by plan sponsors when incorporating these strategies into their respective plans. First, there continues to be a knowledge gap in the ESG space that serves as a barrier for plan implementation. Even though empirical evidence has shown a positive correlation between the consideration of ESG factors and investment returns, such studies are met with scrutiny, especially from non-Millennial investors. Much of this criticism stems from the lack of consistency surrounding ESG data. Whereas financial data is readily available and disclosure requirements are well-established, investors face a greater challenge when seeking ESG data relevant to investment decisions. For example, in their annual reports, companies rarely include data on their sustainable energy policies or disclosure of political contributions; as a result, portfolio managers are forced to rely on external sources of information when evaluating these companies from an ESG perspective. This inability to easily compare ESG strategies with their non-ESG counterparts makes it difficult for investors to overcome preconceived notions of ESG and give weight to the numerous studies supporting ESG investing.

The biggest challenge for plan sponsors rests in determining which ESG impact to focus on through the incorporated

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Thomas Croft and Annie Malhotra. Greenleaf. 2016.

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TABLE

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		Whistle-blower protection
Energy-efficient facilities		

investment option. 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. ESG investing can take many shapes, achieving financial returns alongside positive impacts in issues ranging from climate change and carbon emissions to board diversity.

Getting Started With ESG

Despite the challenges present, ESG investing has gained momentum, and plan sponsors are now faced with the task of determining how best to implement ESG strategies in their plans. Since most major plan administrators offer open platforms or provide access to at least one ESG option, the real challenge for plan sponsors is determining which nonfinancial collateral benefit, or specific ESG impact, to target given the broad scope of ESG issues.

Plan sponsors can refer to the checklist below as they consider implementing ESG in their plans.

1. Review the Fund Investment Policy and Current Fund Lineup

Adding an ESG investment option to the lineup may require the plan to revise its investment policy, especially in terms of how the plan selects, monitors and evaluates its underlying investment options. For example, in addition to adhering to the financial benchmarks and objectives that are defined for traditional investments, ESG investment options have a collateral benefit for which they were selected that needs to be considered as well.

From a compliance perspective, plan sponsors should ensure that the investment policy clearly defines how the plan will evaluate any selected ESG investment option and measure its impact. It's also important for plan sponsors to keep in mind that each underlying investment option offered should serve a specific purpose; for example, a core bond investment option is used for capital preservation.

Plan sponsors should avoid overlap, such as securities exposure, between the existing investment options and any added ESG investment option that could lead to participant confusion.

Through this initial step, plan sponsors can then determine where an ESG option best fits within the current lineup. For now, Marquette Associates classifies ESG options as *Tier III* investments, meaning that plan sponsors should consider these to be specialty investment options that are offered in limited availability for the plan's most proactive participants—those more sophisticated participants who opt for choosing among their plans' investment options to create their own diversified portfolios.

2. Educate the Decision Makers

When considering a lineup change, plan fiduciaries and decision makers should be well-versed in the proposed investment option. For ESG investment options, it's important to understand the different implementation strategies, from negative/positive screening to direct impact. It's also critical to understand how the ESG reporting element can differ among strategies. Plan sponsors can seek education on ESG investment options from a variety of sources, including consultants, recordkeepers and similar experts. Any questions and

takeaways

- Consideration of environmental, social and governance (ESG) issues has gained momentum among defined contribution retirement plan sponsors.
- A recent study by the Harvard Business School and London Business School found that companies that have adopted a substantial number of environmental and social policies outperform those that have failed to embrace such policies.
- Compared with the overall investor population, Millennials are twice as likely to invest in companies or funds that use ESG factors as a value differentiator.
- The biggest challenge in incorporating ESG strategies is determining which ESG impact to focus on.
- Plan sponsors should seek feedback from participants to determine which collateral benefit to address through an ESG investment option.
- Plan sponsors should consider ESG options as Tier III investments—specialty investment options offered in limited availability for the plan’s most sophisticated participants.

concerns should be adequately addressed before moving forward.

3. Survey Plan Participants

Because ESG covers a plethora of issues, and interest from participants is equally as diverse, plan sponsors should seek feedback directly from participants to determine which collateral benefit to address through an ESG investment option.

Gathering feedback from plan participants can be as simple as working with the recordkeeper or consultant to draft and administer a survey. The survey should seek to determine both the level of interest in ESG investing as well as the specific areas of most importance. Survey questions should try to identify the participants’ risk appetite and other financial goals in addition to any specific companies, geographical locations or other issues participants wish to target through their investments. Employers administering these surveys also will likely benefit through employee satisfaction, since participants generally appreciate this level of

engagement even if their individual interests are not ultimately addressed by the selected investment option.

4. Outline Criteria for Search and Selection

Once the plan sponsor identifies participant needs and interests surrounding ESG investing through step three, the plan sponsor can begin to outline the search and selection criteria for the ESG investment option. At this point, the plan sponsor should determine if the plan is seeking ESG integration, a thematic fund or other ESG alternatives based on the findings from the participant survey.

ESG integration refers to the systematic and explicit inclusion by investment managers of ESG factors into financial analysis. The benefit to utilizing a broad-based ESG integration option is that the investment focuses on impacting a variety of collateral benefits, which may satisfy the needs of more plan participants. Conversely, these types of investment options are more difficult to measure from an im-

pact perspective since the impact is not clearly defined.

Thematic funds focus on specific ESG issues, such as water or carbon reduction, and tend to negatively screen out or positively screen for investment opportunities that align with the desired impact. Because these funds generally rely on indices or lists of companies from reputable sources, the impact measurement component is fairly straightforward. On the other hand, it may be difficult for a plan sponsor to find consensus among plan participants regarding the specific ESG issues to be targeted through the investment option. The plan sponsor will need to balance plan investment goals with the needs of the plan participants to determine which type of ESG investment option is most appropriate for the plan.

In addition to satisfying the scope of the search as defined by the plan sponsor, any ESG investment option undergoing evaluation should adhere to the search and selection criteria as outlined in the plan investment policy. For example, the investment option should be evaluated on its risk-adjusted return, portfolio management team and expense ratio.

Plan sponsors should further outline search and selection criteria to evaluate the ability of the investment option to clearly define the role of ESG in its investment strategy, find the appropriate research needed to make certain ESG-related investment decisions and measure the impact of its strategy for the benefit of its investors. Finally, some plans may expect the investment manager to reflect these same ESG values in its own firm management, perhaps through diversity and other corporate governance best practices.

5. Make Selection and Add to Lineup

By completing steps one through four, plan sponsors should be prepared to select an ESG option for the plan lineup. While most DC platforms offer some form of an ESG investment option, plan sponsors should first consult with their respective recordkeepers to determine if there are any limitations on their ability to select certain investment options. The transition and communication process for adding an ESG investment option to a plan lineup is no different from the process for traditional investment options. Plan sponsors should refer to their plan documents to ensure that they are taking the appropriate actions to implement any lineup changes.

6. Educate Plan Participants

Finally, participant engagement through education is necessary to adequately inform participants of their investment choices and to help bridge the knowledge gap on ESG issues. Education can be administered through newsletters or other forms of targeted communications as well as online or in-person presentations by investment consultants, recordkeepers and similar experts.

The communication should provide an overview on ESG investments; for example, participants should be informed that ESG analysis can assist in uncovering additional investment opportunities and hidden risk. Further, it's important to notify participants that ESG investment options are assessed for both potential financial return as well as their impact on the targeted collateral benefit.

Participants should then be educated on the specific ESG investment option that has been selected for the plan. The communication should clearly establish the basic investment fundamentals of the strategy, similar to what would be communicated for a traditional investment option, as well as define how the strategy measures its ESG impact. Communicating these factors will allow participants to adequately assess the strategy prior to making an allocation.

Conclusion

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 nonfinancial data.

Nonetheless, the industry is expected to 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. ●

Endnotes

1. Interpretive Bulletin 2015-01, 29 CFR §2509.2015-1, 80 FR 65135 (October 26, 2015).
2. Harvard Business School, *The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance* (May 2012).
3. The Council of Economic Advisors, *15 Economic Facts About Millennials* (October 2014).
4. Transamerica Center for Retirement Studies, *Perspectives on Retirement: Baby Boomers, Generation X, and Millennials* (August 23, 2016).
5. Morgan Stanley, "Sustainability Through the Eye of the Investor" (February 27, 2015).

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