PlanPILOT | Better Outcomes, Less Risk

ESG & Retirement Plans

The Case for Greater Compatibility

EXECUTIVE SUMMARY

Environmental, social and governance ("ESG") investing is growing in its understanding, acceptance and usage in the retirement plan industry. The use of stand-alone options using these strategies in retirement plans is still limited primarily due to modest but growing demand and on-going fiduciary oversight concerns, but given the expanding social consciousness, the usage is likely to develop.

As with any investment option, it is important to understand the potential benefits and risks involved.

The opportunity for competitive returns and enhanced risk management from investment in socially aware methods can benefit the retirement plan's participants, while also aligning their investments and values.

While considering the use of these strategies, it is an important part of plan fiduciary oversight to assess them thoughtfully and consistent with ERISA's fiduciary requirements. PlanPILOT's goal is to provide an assessment to help you understand the impact of ESG solutions and the potential benefits and risks for your retirement investment program now and going forward.

What is ESG Investing & Why Are Investors Embracing It?

Approximately $23 trillion globally is managed today using some socially aware investment style. This represents more than a quarter of the $88 trillion of assets under management globally, a McKinsey & Co. study found. These styles of investing have been fast-growing at a rate of 17 percent a year, McKinsey reported. They accounted for 26 percent of professionally managed assets in the U.S. in 2016 compared with 21 percent in 2012[1].

The approach to socially aware investing has changed. In the past, screening out companies in specified industries or lines of business was the approach typically used (commonly known as socially responsible investing or SRI). This has grown into more positive approaches that evaluate companies constructively based on defined characteristics in the environmental, social and governance areas (ESG), and can involve more pro-active forms of advocacy of company management. These three main techniques for portfolio management can be summarized as follows:

Technique	Negative Screening	Positive Screening	Proactive Engagement
Description	▪ Avoid material environmental, social, and governance (ESG) risks or comply with values-based investment thesis ▪ Exclude particular companies or sectors from investment universe based on ESG concerns	▪ Acknowledge potential positive correlation between ESG quality and returns ▪ Integrate financial implications of ESG factors in research and analysis ▪ Weight fund toward holdings with higher ESG quality	▪ Identify ESG as a level for value creation ▪ Pursue improvements in a company's ESG performance by engaging with board or management
Examples of Application	Exclusion of companies for such reasons: ▪ Noncompliance with values chosen by the government or fund ▪ Recommendations by ESG team ▪ Additional qualitative analysis of ESG risks	▪ Investment managers include ESG factors in fundamental analysis ▪ Investments concentrate on specific sustainability themes (e.g. green bonds, clean tech, low carbon)	▪ Dialogue and involvement with enterprises in which investors hold significant stakes and see potential to create value by improving ESG performance (e.g. by increasing energy efficiency)

Source: McKinsey & Company

1 *McKinsey & Company*, "From 'why' to 'why not': Sustainable investing as the new normal," https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/from-why-to-why-not-sustainable-investing-as-the-new-normal, October, 2017

Driving the change in approach and the growth in ESG assets under management is the belief that sustainable investing can increase returns – or at least produce market-like returns as effectively as other investment approaches, McKinsey found. McKinsey also said investors believe integrating ESG factors into their approaches strengthened risk management. Competitive returns and enhanced risk management with an alignment of the priorities of investors is fueling the growth.

The growing evidence that ESG investing can produce competitive returns and manage risk, while also meeting investors' desire for doing good for society, also meets the criteria established by the Department of Labor ("DOL") for retirement plan fiduciaries evaluating plan investment options, as discussed further below.

How is ESG Usage Evolving?

As mentioned above, the early approaches based on negative screening remain prevalent today, representing two-thirds of sustainable investment assets, according to McKinsey. In contrast, newer strategies are designed to achieve a more conventional investment aim: maximizing risk-adjusted returns. Many institutional investors have now adopted approaches that consider ESG factors in the portfolio management and security selection process. The McKinsey report further identified these key points driving the new applications:

- **Enhancing returns.** Researchers continue to explore the relationships between ESG investment strategies and investment returns. Several studies have shown that sustainable investing and superior investment returns are positively correlated (although other studies have shown no such correlation). Recent research demonstrates sustainable investing is uncorrelated with poor returns, meaning an investor should not expect non-competitive performance from ESG at the least case.

- **Strengthening risk management.** Risks related to ESG issues can have a meaningful impact on a company's market value, as well as its reputation. Companies have seen their revenues and profits decline, for instance, after worker safety incidents, waste or pollution spills, weather-related supply-chain disruptions, worker harassment and other ESG-related incidents that have come to light. Investors have also raised questions about whether companies are positioned to succeed in the face of risks stemming from long-term trends such as climate change and water scarcity.

- **Aligning strategies with the priorities of investors.** As noted above, demand from investors has followed greater public attention to the global sustainability discussion. Sustainable investing strategies appear to have particular appeal among women and younger investors, as discussed below. Some investors simply wish to do good for society by providing capital to companies with favorable ESG features (without compromising risk-adjusted returns).

- **What ESG factors are material?** Research has shown that companies that focus on material ESG issues produce better financial performance than those that look at ESG issues more broadly and indiscriminately. Efforts to define those material factors are well under way. In the United States, for instance, the Sustainability Accounting Standards Board has developed the leading approach for identifying the unique ESG factors that are material in each asset class.

- **Does the investor engage with company management teams?** Some investors try to improve the performance of companies by taking board seats or engaging in dialogue with management on sustainability issues and pool shareholder voting rights to influence management decisions. This approach can also be helpful in sustainable investing strategies: an investor might choose to acquire a stake in a company with subpar ESG performance, then engage with its management about potential improvements, hopefully leading to better overall corporate performance.

To assist investors in implementing these strategies pro-actively, Morningstar has developed a Sustainability Rating as part of its assessment of funds. The Morningstar Sustainability Rating is a measure of how well the holdings in a portfolio are managing their ESG opportunities and risks relative to their Morningstar Category peers.[2]

The rating is a holdings-based calculation using company-level ESG analytics from Sustainalytics, a leading provider of ESG research. The rank is reduced by any company involvement in ESG-related controversies. To summarize, the portfolio sustainability score is calculated as:

Portfolio Sustainability Score = Portfolio ESG Score – Portfolio Controversy Deduction

Morningstar Sustainability Rating

Distribution	Score	Descriptive Rank	Rating Icon
Highest 10%	5	High	
Next 22.5%	4	Above Average	
Next 35%	3	Average	
Next 22.5%	2	Below Average	
Lowest 10%	1	Low	

Source: Morningstar

Based on their portfolio sustainability scores, funds are assigned absolute category ranks and percentile ranks within their Morningstar Categories. Scores are calculated for funds and indexes globally. These scores provide a standardized way of measuring the ESG impact of funds.

2 *Morningstar*, "The Morning Star Sustainability Rating," https://www.morningstar.com/company/sustainability, September, 2016

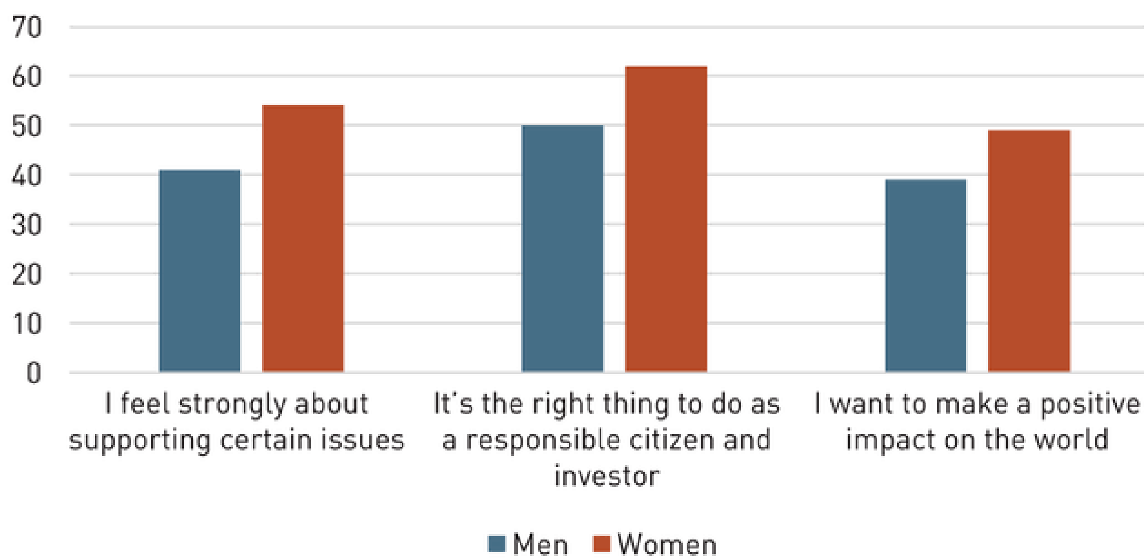
Where is the Demand Coming From?

The increasing demand for ESG is most specifically attributed to two groups of investors: women and millennials. Each group has financial values and goals that differ from those of more traditional investors, especially on investing for social or environmental impact[3].

Women are more inclined to look to wealth to provide not just for themselves but for society at large. They have more desire to use wealth to create positive change. The IWI Wealth Monitor story highlighted a U.S. Trust survey in which 63 percent of women said they consider the social, political or environmental impact of an investment option important in their investment decisions.

Women are more inclined than men to tie their interest in impact investing to particular issues: more than half of women (32 percent more than men) say they feel strongly about supporting specific issues. In other words, for women it's not simply about a general sense of doing good. Whether it's the environment, women's rights or similar issues, women want to see progress.

Figure 2 MOTIVATIONS FOR IMPACT INVESTING 1

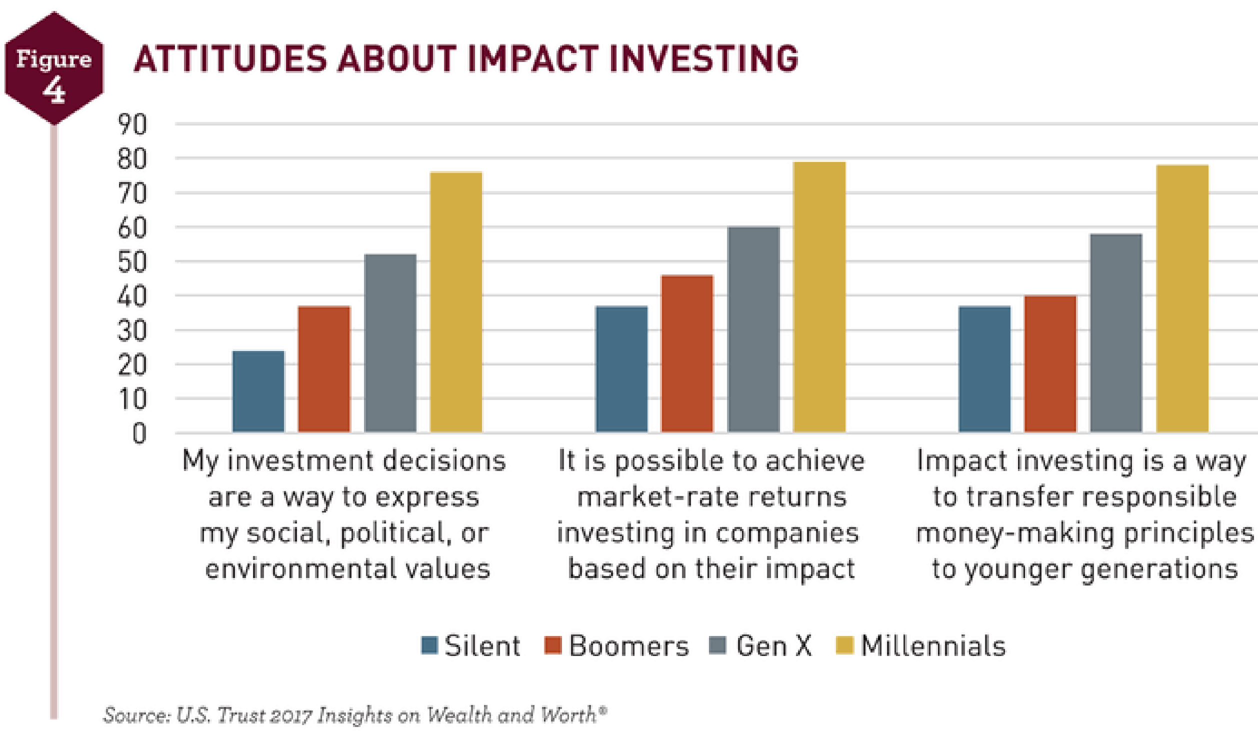


Source: U.S. Trust 2017 Insights on Wealth and Worth®

3 Jackie VanderBrug, "How Gender and Generation Could Help Reshape the World," *Investment and Wealth Institute Wealth Monitor*, http://www.iwmonitor-digital.com/iwmonitor/november_december_2017, November, 2017

Similarly, many millennials look to integrate their investments and values. Three-quarters of millennial investors in the U.S. Trust survey agreed with the statement, "my investment decisions are a way to express my social, political or environmental values," while only one in five agree that impact investing "is not important to me."

Many millennials bring a more holistic or inclusive view that uses a broad spectrum of impact-producing tools: buying, giving, investing and volunteering. Nearly 80 percent say they would invest in companies that have a positive impact rather than avoid investing in companies that are harmful. Millennials say that evidence of positive social and environmental impact would be more likely to motivate them than evidence of positive returns (45 percent vs. 41 percent). This slight preference is not due to a lack of interest in performance, but rather to seeing no trade-off between the two.



Can ESG Meet Fiduciary Responsibility in Retirement Plans?

While ESG usage has grown in interest and scope, the challenging question remains the ability of plan fiduciaries to use these styles in retirement plans and meet their fiduciary responsibilities. The DOL has periodically over decades considered the application of ERISA's fiduciary rules to plan investments selected because of the economic or social benefits they offer in addition to their investment returns. More recently, the DOL has given more flexible and supportive guidance on the topic that could clear the way for expanded usage in retirement plans.[4]

While ESG and SRI are more commonly used terms, the DOL uses the expression "economically targeted investing" ("ETI"). ETI broadly refers to any investment that is selected, at least in part, for its collateral benefits apart from the investment return and risk itself to the retirement plan investor.

The DOL previously addressed this in Interpretive Bulletins in 1994 and 2008. The DOL's stated objective was to correct a popular misperception that ETI is incompatible with ERISA's fiduciary obligations. The preamble to the 2008 Interpretive Bulletin explained that the requirements of ERISA sections 403 and 404 do not prevent plan fiduciaries from investing plan assets in ETIs if the ETI has an expected rate of return that is commensurate to rates of return of alternative investments with similar risk characteristics that are available to the plan, and if the ETI is otherwise an appropriate investment for the plan in terms of such factors as diversification and the investment policy of the plan. This has been referred to as the "all things being equal" test.

While the DOL stated that a plan fiduciary may consider collateral benefits in choosing between investments that have comparable risks and rates of return, it has consistently held that fiduciaries who are willing to accept expected reduced returns or greater risks to secure collateral benefits are in violation of ERISA. Effectively, this stance has had a chilling effect on ETI usage as having been taken to mean that the 2008 guidance sets a higher but unclear standard of compliance for fiduciaries when they are considering ESG factors or ETI.

4 Department of Labor, "Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments," 80 FR 65135, October, 2015

The DOL again recognized that these publications discouraged fiduciaries from considering ETIs. In particular, the DOL expressed concern that the 2008 guidance may be dissuading fiduciaries from:

(1) pursuing investment strategies that consider environmental, social and governance factors, even where they are used solely to evaluate the economic benefits of investments and identify economically superior investments

(2) investing in ETIs even where economically equivalent to alternative choices.

This led the DOL to issue a new Interpretive Bulletin in 2015. Consistent with the shifting socially aware investing approach to more positive screening, an important purpose of the DOL's Bulletin was to clarify that plan fiduciaries should appropriately consider multiple factors that potentially influence risk and return. The DOL noted that environmental, social and governance issues may have a direct relationship to the economic value of the plan's investment. In these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary's primary analysis of the economic merits of competing investment choices.

Fiduciaries need not treat reasonable investments as inherently suspect or in need of special scrutiny merely because they take into consideration environmental, social or other such factors. When a fiduciary prudently concludes that such an investment is justified based solely on the economic merits of the investment, there is no need to evaluate collateral goals as tie-breakers, but rather as another primary consideration.

Consistent with fiduciaries' obligations to choose economically superior investments, the DOL said it does not believe ERISA prohibits a fiduciary from addressing ETIs or incorporating ESG factors in investment policy statements or integrating ESG-related tools, metrics and analyses to evaluate an investment's risk or return. Nor do ERISA sections 403 and 404 prevent fiduciaries from considering whether and how potential investment managers consider ETIs or use ESG criteria in their investment practices.

Whether a particular fund or investment alternative satisfies the requirements set forth in ERISA sections 403 and 404 and the 2015 Bulletin is an inherently factual question that the appropriate plan fiduciaries must decide based on all the facts and circumstances of the individual investment option. This complexity further illustrates the importance of having effective fiduciary governance and investment monitoring in place and facilitated by experts in retirement plan advising.

CONCLUSION

ESG investing is growing in its understanding, acceptance and usage in the retirement plan industry. While the current use of these strategies in retirement plans is experiencing modest but growing demand and on-going fiduciary oversight concerns, given the expanding social consciousness, especially among women and millennials, the usage is likely to develop.

As with any investment option, it is important to understand the potential benefits and risks involved. ***The opportunity for competitive returns and enhanced risk management from investment in socially aware organizations can benefit the retirement plan's participants, while also aligning their investments and values.***

While considering the use of these strategies, it is an important part of plan fiduciary oversight to assess them thoroughly in light of DOL guidance and ERISA requirements. An experienced consultant can effectively guide you in your analysis of this important topic.

If you would like more information or guidance on ESG solutions and consulting services, please contact PlanPILOT at info@planpilot.com or (312) 973-4911.

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