

IEN Q&A: Defined Contribution Plans with an ESG Overlay: The Hurdles & Untapped Investment Opportunities

While many institutional investors are taking steps forward to confront environmental, social, and governance (“ESG”) related risks in their portfolios, the defined contribution industry may be lagging behind. The lack of clear guidance from regulators, “the set it and forget it mentality” (citation) often associated with retirement plans, misconceptions surrounding ESG, a dearth of education and awareness, are among the obstacles retirement plan sponsors encounter when offering investment options with an ESG lens.

Nevertheless, some market participants believe that the \$8.2 trillion defined contribution industry will increasingly embrace ESG factors within investment products, particularly, as such considerations sharpen risk management tools and result in better investment decisions.

The [Intentional Endowment Network](#) (IEN) is collaborating with market experts on creating a toolkit for sustainable retirement plans to help steer plan sponsors on how to navigate the challenges in offering ESG investment products. This guide is expected to be rolled out by the summer.

In this vein, IEN approached various experts within the defined contribution landscape to understand the challenges regarding ESG focused offerings to plan participants. Such experts included:

- **Erik Gross:** Treasurer, University of New Hampshire Foundation
- **Mike Fiorio:** Trustee, Northland College
- **Tiffany McGhee:** CEO, CIO, Pivotal Advisors
- **Sarah Bratton Hughes:** Head of Sustainability, North America, Schroders
- **Jim Roach:** Senior Vice President, Retirement Strategies, Natixis Investment Managers

IEN: WHAT ARE THE BIGGEST CHALLENGES IN GETTING ESG OPTIONS AVAILABLE TO DEFINED CONTRIBUTION PLANS? WHY?

Gross: The biggest challenges with getting ESG options into our 403(b) plan include:

- Relatively short performance track record on these funds to reassure decision-makers (fiduciaries) that returns won't be threatened.
- Other institutional financial issues are considered more urgent at this time as a result of the pandemic (e.g., expenses dealing with keeping the university open, cash flow challenges due to lost revenue)

- Our program has a self-directed “brokerage” option where employees can make their own investment decisions including access to many ESG options, and so decision-makers feel the opportunity already exists for interested employees to invest in ESG-type funds.
- We did get two ESG funds including in the standard line-up of about 30 funds, but awareness and marketing of these two fund options is very limited, and most employees don’t take the time to consistently review their retirement investment options – the very common “set it and forget it” mentality.

Fiorio: Northland College is part of a consortium of colleges and universities in Wisconsin known as WAICU – Wisconsin Association of Colleges and Universities. Several years ago, as a group they negotiated with an organization to offer a 403(b) that has the “standard” menu of mutual funds covering a wide range of asset classes. In addition, for an annual fee of \$50, the plan offers a self-directed option that would allow the participant to create their own portfolio of funds, which would include any fund that incorporates ESG into its investment objectives.

The challenge with respect to Northland’s retirement plan, is the participant’s knowledge base regarding general investment principles, and how to go about picking and allocating properly to mutual funds that employ some form of ESG screening. The plan participant could engage the services of the plan representative, or engage an independent fiduciary for this advice.

McGhee: The biggest challenges in getting ESG options onto defined contribution plan platforms include:

- Plan consultants not being proactive about suggesting ESG options. Consultants have a great deal of power, particularly ones that work with defined contribution plans. Once a consultant brings on a new plan client, or has a client who transfers to a new record keeper, they create the plan's investment lineup from scratch. This is probably the best time to introduce ESG options in the plan.

Once a plan's fund lineup is constructed, a large part of the consultant's job is to monitor plan funds regularly. Consultants may be focused on monitoring common metrics such as performances, fees, and adherence to style, for the current plan funds. As long as the funds are performing well with regard to the metrics that are being monitored, there is no reason for a consultant to recommend an additional fund. Typically, you want to keep the number of funds in the plan between 20 - 30, with the target date funds counting as one fund. Research shows that more fund choices lead to participant confusion. So, introducing additional funds onto a platform would be a hard sell unless the consultant really has conviction around ESG, or unless the plan sponsors insist.

- Regulation challenges: plan sponsors want to do the correct thing and follow the rules and so do plan consultants. With the recent legislation, they may not want to rock the boat and expose themselves to risk.

Roach: The biggest challenge is education. Many plan sponsors and investment advisors – the people making the investment decisions for Defined Contribution plans – still believe ESG investments sacrifice returns or do not belong in a plan line-up. Applying an ESG investment lens helps money managers make better investment decisions. ESG analysis often leads to identifying stocks and bonds that have the ability to outperform in the future or identifying potential risks that one can avoid. This is simply a better way to invest in today’s world. Regulatory rules from the prior administration muddied the waters on ESG investments. The

current administration and DOL will likely soon clarify the DOL's stance on ESG investments in a Defined Contribution lineup.

IEN: IEN: GIVEN THE NUMBER OF INVESTORS WHO VIEW CLIMATE RISK AS AN INVESTMENT RISK, HOW DO PLANS GET INCENTIVIZED TO OFFER SUCH OPTIONS? COULD PLANS BE IN VIOLATION OF THEIR FIDUCIARY DUTY IF THEY DO NOT CONSIDER THESE OPTIONS AS MATERIAL FINANCIAL RISKS?

Fiori: I don't believe that the regulatory environment currently represents an immediate risk to retirement plans that don't offer ESG options. Nevertheless, considering that most colleges and universities faculty and students are demanding that their institutions divest from fossil fuels and some go even further, why wouldn't they also want to do the same in their own personal retirement accounts? That in itself is enough for institutions to be more receptive towards including ESG in their retirement plan offerings.

McGhee: Not all managers and allocators view climate risk as an investment risk. There are clearly a lot of people who do believe this but often it is a challenge to link material ESG metrics directly to performance. There needs to be more education around the link between performance and risk management and ESG factors, for portfolio managers and investment advisors/consultants.

If an investment advisor/consultant is not considering ESG factors, he or she is not considering all of the data. The more relevant data an investor has, the more information you have about how a fund will perform. This is important in making an informed investment decision.

Bratton Hughes: Climate risk should be assessed on a portfolio level basis, not in just a one-off plan option as we believe that climate change will be a defining driver of the global economy, society and financial markets over coming years, decades and beyond. Whether the global economy is rebuilt on less carbon intensive foundations or the temperature continues to escalate, investors will be unable to avoid its impacts.

Modelling the risks of climate change is not straightforward and most of the tools our industry uses are inadequate and, in some cases, misleading. Measures such as carbon footprints, fossil fuel exposure or green revenue shares are relatively straightforward and easily accessible, but are too simplistic to analyze the complexities of climate change effectively.

Roach: Can plans be in violation of their fiduciary duty if they don't consider ESG options? Investment fiduciaries should consider *all* factors and risks when selecting investments for plan participants. The rule really comes down to what the investment fiduciary believes. I do not expect the government or the laws of ERISA to mandate a fiduciary to account for specific risks. But they can be clearer about allowing ESG factors to be considered – and even encourage it.

IEN: HOW DOES ONE TRULY MEASURE THE ES OR ESG RATING OF A PLAN? WHAT METRICS CAN BE APPLIED?

Fiori: There are many rating sources and it's easy to get paralysis by analysis. My advice is to hire a professional and ask some questions about what their process is, but eventually trust but verify their sources. The rating systems are still evolving and will continue to get better, and the investment companies the same. Everywhere I look, pensions, sovereign wealth funds (including the world's largest, Norway), banks, insurance companies, investment companies and for that matter, individual corporations (including the major oil and gas behemoths) are attempting to de-risk their investments from climate change liability. The world of ESG investing continues to evolve right before our eyes!

McGhee: You have to look at the material metrics of the "E," the "S," and the "G," separately for the underlying holdings of each fund and then also from a holistic plan perspective. Depending on who is making decisions, they may be more interested in the "E" than the "S", but, if you understand that ESG investing is not values-based investing, and remove the personal bias, there is a better chance of actually connecting ESG factors to risk management and alpha generation.

Roach: In the current regulatory environment, I look at ESG in the context of investment performance. That could mean using a broader lens to identify high-quality companies that are more likely to perform better and avoid risks. It might also include identifying megatrends, like the transition to renewable energy, that provide strong macro growth opportunities. But the end result I'm focused on is risk-adjusted return. Beyond performance, there isn't a one-size-fits-all approach to ESG. Investors should have clear objectives for any non-financial outcomes they hope to achieve and invest accordingly.

Bratton Hughes: A problem with traditional ESG analysis is that, while it allows you to assess if a company is good or bad (based on a given definition of good and bad), it doesn't tell you what the potential financial consequences might be for the company in question. By financial consequences, we mean an objective assessment of the impact on its bottom line, not its share price. You might expect the two to be related but the lack of consistency in ESG measurement underlines the confusion among many investors and the limited chance that the market is effectively discounting those impacts. The combination of very real economic forces on companies and market confusion spells opportunity. Combining thoughtful analysis with disciplined valuation analysis – more on this later – can unlock significant value.

We have overcome this shortcoming of traditional ESG analysis through a suite of tools that help quantify many of these externalities. One such tool, SustainEx, was developed through rigorous analysis of more than 750 academic papers and over 70 data points, applied to more than 10,000 companies. It assigns a dollar value to a company's net cost or benefit from society – that is, its "social value". If, as we expect, these externalities crystallize as financial costs, it gives an indication as to how exposed a given company is. By scaling this dollar amount to a company's revenues, we can assess how material these financial risks are. This also allows us to easily compare one company, sector, country, or portfolio, with another.

If you have any questions or comments, please contact: info@intentionalendowments.org