IEN SUSTAINABLE RETIREMENTS INITIATIVE

GUIDE TO Sustainable Retirements

Intentional Endowments Network

An initiative of CraneSustainability.org

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PERFORMANCE MODULE

Guide to Sustainable Retirements

OVERVIEW

This guide is designed to provide practical information relevant to plan sponsors, human resources and finance officers and personnel, advocates, employees, investment advisors, legal scholars, and others. The guide aims to address misconceptions related to the use of Environmental, Social, and Governance (ESG) funds in retirement plans. In addition, this guide contains modules on fiduciary duty concerns, a how to guide for plan sponsors evaluating the addition of adding ESGs to retirement plans, and steps outlining how to advocate for ESG integration in retirement plans.

This Performance Module is designed to address the issue of ESG performance in defined contribution retirement plans.

Module Summary

Sustainable investing does not sacrifice financial performance. ESG performance should no longer be an issue for retirement plan decision makers if they carefully consider the merits and applicability of each fund and apply the relevant financial and ESG expertise. Any ESG fund that is offered, like all funds considered for inclusion in a retirement plan, should first meet the financial criteria established in the Investment Policy Statement when selecting funds. Hiring advisor firms who understand this process and understand the value of ESG funds, is an important step in evaluating the performance of ESG funds.

This performance module is designed to:

- Answer the question: Does sustainable investing require a tradeoff in performance?
- Provide factual information and aid in examining the issues surrounding the performance of ESG funds in retirement plans to help shape thinking about the efficacy of adding ESG funds to retirement platforms in the future.

This module considers the following for 401(k), 403(b), and other similar defined contribution plans as it relates to **performance:**

- Plan sponsors and other market participants have a misperception that ESG funds have underperformed in comparison to the performance of the general mutual fund marketplace;
  - o Studies indicate that ESG performance holds up well against the general mutual fund industry.
  - o Studies show that ESG funds actually add value to performance.
- "Over the past several years and especially in 2020, sustainable funds have outperformed their conventional peers," according to Jon Hale at Morningstar. However, despite the many studies available, only 3% of 401(k) plans have an ESG fund according to the Plan Sponsor Council of America; a fraction of plan assets (a tenth of 1%) are held in such funds.

Until recently, there has been a common misperception among decision makers and plan sponsors that selecting ESG funds for inclusion in retirement plans risked sacrificing investment performance relative to other mutual funds. Decision makers, CIOs and fiduciaries of 401(k), 403(b), or similar plans, only sought funds they considered "high performers."

There have been over 2,000 studies designed to understand the relationship between ESG criteria and corporate financial performance. Based on a review by Sustainable Finance and Investment research, "90% of all studies showed a non-negative relationship, indicating that the inclusion of ESG factors did not affect performance. In fact, the majority of the studies reported a positive relationship, indicating that ESG criteria **improved** market performance."

These misconceptions, coupled with the lack of reliable information, have been major obstacles to the inclusion of sustainable investment options in retirement plans. In many cases, decision makers are not asking their advisors to consider ESG funds. Moreover, inconsistent regulations and guidance from the U.S. Department of Labor (DOL) have further complicated the decision process.

The Morgan Stanley Study of over 10,000 funds found:

1. There is no financial tradeoff in the returns of sustainable funds and traditional funds. No consistent or statistically significant difference in total returns existed between ESG-focused and traditional mutual funds and ETFs.
2. Sustainable funds may offer lower market risk. Sustainable funds experienced a 20% smaller downside deviation than traditional funds, a consistent and statistically significant finding.

The Morgan study, along with others, indicate that a comparative analysis between ESG Funds and other mutual funds bolsters favorable perceptions of sustainable investing, which are becoming more widely accepted among investors and asset managers, who see potential for sustainable portfolios to yield attractive financial returns, alongside positive environmental or social impact.

What about during different market cycles? How do ESG funds perform during a recession or long-term volatility?

The same Morgan Stanley study referenced above found that "in years of turbulent markets, such as 2008, 2009, 2015 and 2018, sustainable funds' downside deviation (a measure of downside risk that focuses on returns that fall below a minimum threshold or minimum acceptable return) was significantly smaller than traditional funds." Based on this information, adding ESG funds to a retirement plan lineup, appears to be financially prudent.

In addition, ESG integration practices are employed by investment managers seeking to broaden the scope of investment analysis to include consideration of material risks not always captured in traditional analysis. Accordingly, the managers are seeking to improve financial outcomes. Appropriately, when funds are being considered in a retirement plan, ESG funds should at least be part of the conversation and analysis, as ESG funds seek to improve financial outcomes with an appropriate risk/return analysis

The overarching sentiment of note that Green and others point out is that ESG funds are less volatile as originally thought, particularly as **ESG-related strategies are increasingly outperforming the market.**

What about in 2020, a year with a Pandemic that wreaked havoc on economies across the globe, and had a tremendous first quarter selloff?

Nigel Green, CEO of financial advisory firm DeVere, found that the average fund incorporating ESG factors recorded only half the drop experienced by the US S&P 500 Index during the first quarter of 2020. ESG funds are typically less volatile, which is a major reason why they withstood the first quarter drop in 2020. This is true even when you evaluate target date funds. For example, the Natixis Sustainable Future 2035 Fund returned 15.56% by year end 2020, compared to 12.79% for the S&P 500 Target Date 2035 TR USD Fund.

The overarching sentiment of note that Green and others point out is that ESG funds are less volatile as originally thought, particularly as ESG-related strategies are increasingly outperforming the market. These strategies include carefully selected funds focusing on their core objectives while being less volatile.

Sustainable funds outperformed traditional peer funds and reduced investment risk during coronavirus in 2020.

The Morgan Stanley Study found that:

U.S. sustainable **equity** funds **outperformed** their traditional peer funds by a median total return of *4.3 percentage points.*

U.S. sustainable **taxable bond** funds **outperformed** their traditional peer funds by a median total return of *0.9 percentage points.*

U.S. sustainable **equity** funds' median **downside deviation** was *3.1 percentage points less* than traditional peer funds.

U.S. sustainable **taxable bond** funds' median **downside deviation** was *0.4 percentage points less* than traditional peer funds.

Jon Hale's 2021 February blog noted that the better relative performance of ESG funds in 2020 "is tied to their emphasis on companies with better ESG profiles and their thematic alignment with the accelerating transition to a low-carbon economy. In 2020, sustainable funds demonstrated that investing with an emphasis on how a company manages material ESG risks and how it manages key stakeholders can produce better returns in an uncertain economic setting." In a year like no other, most ESG funds weathered the year better than non-ESG portfolios.

With robust evidence showing the favorable risk-return of ESG funds, sponsors have good reason to consider ESG options to their plans. As the DOL provides more regulatory clarity, employee requests for ESG funds become louder, and plan decision makers become more educated on ESG investing, plan fiduciaries should feel comfortable evaluating ESG options, just as any other plan option, for inclusion in their fund lineups.

FURTHER READING

It's Time to Think Sustainably (www.ishares.com)

DOL Paves the Way for ERISA Plan ESG Investments in Final "Pecuniary Factor" Rule (www.natixis.com)

Sustainable Signals: Individual Investor Interest Driven by Impact, Conviction and Choice (www.morganstanley.com)

The Evolving Defined Contribution Landscape Alternatives & ESG as Long-Term Solutions for Long-Term Challenges (www.pgim.com)

COVID-19 & Its Impact on ESG

ESG EXPERTS TO FOLLOW

Megan Starr, the Global Head of Impact for The Carlyle Group

Marty Walsh as Secretary of Labor

Brian Deese as the head of the National Economic Council

Satyam Khanna will serve as Senior Policy Advisor for Climate and ESG (SEC)

Nigel Green, CEO of financial advisory firm DeVere

Kary A. Moore, Senior Corporate Counsel and Senior Vice President

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PLAN SPONSOR MODULE

The Guide to Sustainable Retirements

OVERVIEW

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This Plan Sponsor module serves as a guide on adding ESG funds to retirement plans.

Module Summary

How does an employer begin to evaluate whether the addition of ESG funds in a retirement plan makes sense? In 2015, Maureen Kline, as the Sustainability Officer of Pirelli for North America, faced that very question when a sustainability leader asked, "Does Pirelli have socially responsible funds for investing in the retirement plan? Her first thought was, do I even know ? And why have I never thought of that? She approached the head of Pirelli's Human Resources and raised the question. The head of HR then asked their recordkeeper and eventually their investment advisor firm. The advisor firm was also not familiar with ESG funds and conducted extensive research. During that time, Maureen was added to the Retirement Committee, conducted her own research, and continued to raise questions about the addition of ESG funds. Based on her research, her belief was that ESG funds could provide employees with enhanced retirement outcomes. The advisor firm conducted additional research and found that ESG performance has actually been very strong compared to the general mutual fund industry. After several meetings evaluating ESG costs and performance, the Committee added one ESG fund to their platform in 2017. Employees were sent messages about the new addition, and the ESG fund at Pirelli was born. Since that time, the fund has been one of the best performing funds on their retirement plan platform.

Maureen's journey illustrates the challenges many companies face when considering ESG funds in their retirement plans and provides an excellent example of how to overcome them. Pirelli went through a deliberate process to determine how and if ESG funds would be a positive addition to their retirement plan platform. To help you gain a better understanding of how to address the ESG question, this module provides a five-step process on how you can implement ESG funds at your organization; very much like the one followed by Maureen and her colleagues at Pirelli.

Included at the end of the module is a summary appendix summarizing the five-steps, along with definitions of terms to aid you in your review.

The following is a five-step process that you can follow to add ESG funds to your retirement plan line-up.

1 Gain a Basic Understanding

The first step is to gain an understanding of the benefits of ESG funds in retirement plans and increase your knowledge of ESG investing by asking some of these questions.

Based on your level of knowledge about ESG funds, there are various questions to ask:

- Why should ESG funds be considered for your retirement plan?
- What is the current regulatory environment regarding ESG funds?
- Are socially responsible funds the same as ESG funds? Are they inherently riskier?
- Should I be concerned about the performance and fees of ESG funds?
- Is it feasible to use ESG funds as aQualified Default Investment Alternative (QDIA)?

The first step in addressing these questions is to increase your knowledge of the benefits of ESG funds. As noted in the introduction, Maureen did her own initial research. The best way to start is to identify existing resources within your firm. Is there an investment committee or Chief Financial Officer who can provide perspectives and feedback? Have any senior management staff worked at other organizations where ESG funds were offered? Has the ESG question been raised in prior Committee meetings? Are there any prior minutes on ESG discussions? Looking inward is a good place to start your quest for information.

If you have an outside investment advisor, you should involve them in your plans, and ask them to research ESG funds that may be appropriate for your retirement plan. If you do not have an investment advisor firm, then this may be the time to hire one. Even once you hire a firm, if you do not raise the ESG question, it may never come up. A recent Cerulli report notes that more than half of U.S. advisors, say they do not bring up ESG investment options unless prompted by their clients.

If you decide to hire an advisor firm, make sure you focus on issues of importance to your organization. Inquire about their investment expertise and their ESG experience, as well as any research they may have conducted on ESG and sustainable funds. You can also look into their process for evaluating ESG funds and the success they've had in conducting searches for ESG managers. As you evaluate advisors, be sure to consider other qualities, such as their qualitative and quantitative approach to monitoring investment options, as well as their fees.

In terms of the regulatory environment, there has been a lot of discussion about the confusion caused by the Department of Labor (DOL) in terms of guidance. This of course has caused plansponsors to take a wait and see approach on how things are going to evolve. However, at the time of this writing, a report by Federated Hermes released in May of 2021, written by Brad Campbell from Faegre Drinker Biddle & Reath LLP, makes it clear that, the "DOL is purposefully sending a clear signal that ESG investing can be appropriate for ERISA plans, and that fiduciaries should not avoid prudent investments utilizing ESG factors." This guidance does send a message that plansponsors should not be afraid to consider adding ESG funds to their retirement platform.

> The best way to start is to **identify existing resources within your firm.**

As a starting point for implementation, it is important to have a baseline level of understating of ESG terminology as noted below:

- **Socially Responsible Investing (SRI)** was the most popular approach earlier in the decade and is now really considered the "old school" approach. SRI takes an avoidance or elimination approach, as these are portfolios that do not allow alcohol or tobacco companies, or companies that produce guns. They are generally not viewed as the best choice in the ESG universe.
- **ESG Integration** is the analysis of all material factors in investment review and decisions, including environmental, social, and governance (ESG) factors.
- **Impact Investing** places an emphasis on selecting investments that will have a positive impact on a specific environment or social issue.

- **Proxy Voting** allows investors to voice their values by exercising shareholder rights. Funds that bring an ESG methodology to their voting practices can help steer the companies they invest in towards more sustainable practices.
- **Engagement** is active dialogue which allows investors to understand risk and advocate positive change at the company/issuer level

In a recent study conducted by PGIM, plan sponsors were asked about use of ESG investments in their plans. The study found that nearly a quarter of plan sponsors indicated they have not taken action to incorporate ESG approaches into the plan over the past three years, while more than half said they have. There was greater interest in incorporating ESG approaches for mid-sized plans with $500 million to $999 million in assets under management.

This Toolkit has a separate section on the performance of ESG funds that you should review, to address common misperceptions around performance tradeoffs. It's a good place to gain some additional knowledge that should be helpful in your journey.

The main objective is to do your homework and gain enough of an understanding to ask the right questions.

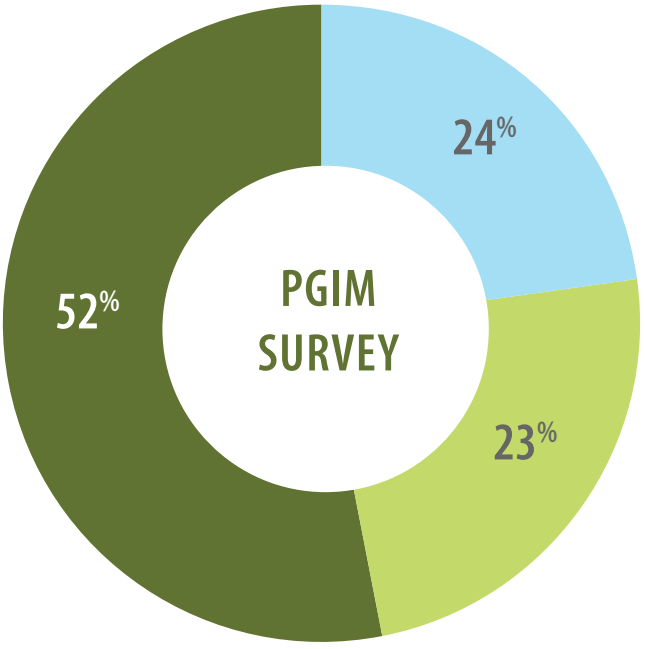
The survey results highlighted the demand from employees to invest in **retirement options that aligned with their values and beliefs.**

2 Examine the Interest of Your Employees

How much should employee interest influence fund selection? Would employees use the funds if they were added to the platform?

It is important to determine if employees would be interested in having these funds on the investment platform and determining whether adding to and/or replacing current funds with ESG funds is the way to go. Considering the following options are also a part of this step:

- Adding one ESG fund
- Adding a sleeve of ESG funds
- Adding an ESG default option/QDIA
  - o Model portfolio comprised of other funds
  - o Target date funds



Plan sponsors who have not taken action to incorporate ESG approaches into the plan over the past three years

Plan sponsors who have taken action to incorporate ESG approaches into the plan over the past three years

Neutral

A survey of employees is always an option to consider. Asking such questions as their desire to invest in retirement funds that align with climate or social justice outcomes is a good place to start. In 2019, Natixis conducted a plan participant study of employees in defined contribution retirement plans. The survey revealed that adding an ESG fund can be a major incentive to boost plan participation. Sixty-one percent (61%) of participants indicated they would be more likely to contribute, or increase contributions, if they knew their investments were doing social good. The survey results highlighted the demand from employees to invest in retirement options that aligned with their values and beliefs.

As discussed in this 2017 report from AsYouSow, a real estate services firm had a low employee participation rate of 14%. The firm discovered (through a survey) that employees did not feel the investment lineup represented their interests. The firm addressed this by adding social and environmental funds. The addition of these ESG funds increased participation from 14% to 95% in two years!

3 Implementation (Selecting Funds for Consideration)

Hiring the right investment advisor firm can make a significant difference. Many recordkeepers have open platforms, some with over 10,000 funds to choose from. Finding the right ESG fund(s) to add can be a major task. It helps to have in mind the type of fund(s) you want selected and the costs to add funds based on the fees of the recordkeeper. Too many times, investment menus have 30 or 40 funds, and employees are paralyzed by too many options. A recent report examines this very problem of "paralysis by analysis" of too many investment options in retirement plans. A more modest selection of 15-20 thoughtfully selected funds can make the process more manageable for your employees and will likely result in a better decision-making experience for them.

As you approach the implementation process, much thought should be given to the selecting of funds. Some things one may want to consider in building a list of candidate funds includes such questions as:

- What if any ESG funds are available on the existing platform?
- What are the available third-party resources available for fund ratings, including ESG scores, Morningstar, AsYouSow, and others?
- What's the voting record of the fund, or what's the impact on investing?
- How does the fund fit in your existing menu in terms of style?
- Does the decision of adding a fund come at the expense of deleting another fund?
- What type of outcome would satisfy both fiduciary duties of loyalty and prudence, and participant's desires?

These are just a few of the type of issues to evaluate as you conduct the implementation process, as you should examine the right mix of adding ESG funds to the platform.

Once the decision is made to move forward, all appropriate documents should be updated including the organization's Investment Policy Statement (IPS). The IPS serves as the document that guides the investment decisions related to your retirement plan. Plan fiduciaries utilize the IPS for decision making related to the investment lineup, including the use of ESG or sustainable funds that are included in the investment lineup. The IPS serves as a critical part of the compliance process as you build any investment lineup.

4 Communicate and Educate Employees

All plans covered by or following ERISA must follow a process to communicate plan changes to employees prior to the change taking place. That process should be followed when offering ESG funds. The education and communication efforts should be especially robust. This education should be married with other information, such as the importance of saving and long-term investing. There have been instances when organizations add new funds, and a brief communication is delivered but employees are left on their own to do their homework. We believe all employee communication on funds offered in a retirement plan should have education included about the fund. That communication should come from the employer as employees typically pay more attention to communication that comes from their employer. For example, communication about a new growth fund should include communication on the type of investments in the portfolio, or how the fund is designed to include companies who are positioned for future growth. If it happens to also be an ESG fund, an additional comment can be included that the fund is also

focused on environmental issues and is considered an ESG fund. When employees have better communication and understanding about their investment options, it allows them to make better personal decisions.

5 Monitor the Funds

All funds in your investment menu should be monitored for performance, strategy adherence and fees on an ongoing basis. There should be benchmarks for each investment, and a process should be followed in each case to mitigate risk for the organization and for the participants. ESG funds should be subject to the same performance review and benchmarking as other funds on your platform. You may also wish to review thee ESG funds in your plan for their adherence to the environmental, social, and governance objectives they outline in their prospectuses and marketing material. Analysis of the investments should be documented and provided to an internal committee that provides oversight of the plan.

Qualified Default Investment Alternatives (QDIA) options

QDIAs have become a popular plan feature for plan sponsors to ensure employees are enrolled in plans when they have not finalized their enrollment choices. Typically, these options are target date funds. Target date funds have become a powerhouse in workplace retirement plans and very popular amongst new enrollees. Plan sponsors/fiduciaries should take a hard look at criteria that platforms use to make their own decision. There are only a few ESG focused target date funds, and they should be assessed for performance, fees, and glidepath, like any other target date funds. You should establish a process to compare and select target date funds based on these type of criterion.

Companies perceive ESG funds as a litigation risk due to so many 401(k) and 403(b) lawsuits that have taken place over the last few years. However, simply adding ESG funds on an investment platform to meet the ESG screening, is not the right approach. Any ESG fund that is offered, should first meet the financial factors established in the Investment Policy Statement when selecting funds through the plan's prudent process.

This all means that a thorough review of funds must always take place when considering ESG funds for a retirement lineup, and that includes target dates funds as well as other investment alternatives.

Finally, Plan Sponsors have the fiduciary duty under Employee Retirement Income Security Act of 1974 (ERISA) to diversify plan investments and administer the plan in the best interest of participants and beneficiaries. Given the significant impact that climate change and social inequity can have on economic outcomes, it can be argued that not considering ESG funds could be a breach of fiduciary duties.

Whether you handle the process internally or in partnership with your investment advisor, the process should be well thought out and recorded in writing for the protection of your plan, participants and organization. Following these steps can help you make good investment decisions for your plan, minimize the risk of regulatory and legal issues, and take real steps to provide retirement security for your employees and a better future for all. ■

FURTHER READING

ESG Investing After the New Labor Department Rule on "Financial Factors"
(https://clsbluesky.law.columbia.edu)

ESG EXPERTS TO FOLLOW

Brad Campbell – Partner Faegre Drinker

Rob Sitkoff – John L. Gray Professor of Law, Harvard Law School

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APPENDIX A

Five-Step Process to add ESG funds to your retirement plan line-up.

1. Gain a Basic Understanding
2. Examine the Interest of Your Employees
3. Implementation (Selecting Funds for Consideration)
4. Communicate and Educate Employees
5. Monitor the Funds

APPENDIX B

Definitions

ESG Fund	A Fund that integrates ESG Factors in its portfolio analysis in order to obtain superior returns without undue risk.
Qualified Default Investment Alternative (QDIA)	QDIA is a default investment used when money is contributed to an employee's retirement account, but the employee has not made their investment election as it is done automatically for them.
Sustainable Investing	Is described as focusing on impact, or environmental, social, and governance (ESG) factors in its investing. ESG concerns must be central to its investment process and the fund's intent should be apparent from a simple reading of its prospectus. In particluar, the Principle Investment Strategies section of the fund's prospectus should contain enough detail to leave no doubt that ESG concerns figure prominently in the fund's investment process.
The Employee Retirement Income Security Act (ERISA) of 1974	Is a federal United States tax and labor law that establishes minimum standards for pension plans in private industry. It contains rules on the federal income tax effects of transactions associated with employee benefit plans.