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Why sustainability cannot be ignored in defined contribution plans

ESG is no longer a fringe concern for DC plans, but far from seeing it as a potential headache, we believe the right approach can improve long-term value and may also lower risk.

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For plan sponsors of defined contribution (DC) plans, the adoption of environmental, social and governance (ESG) analysis into plan management is somewhat unchartered territory, but it is growing in prominence. We believe an integrated ESG approach – implemented correctly – can materially improve risk-return profiles and is well aligned with the time horizons in DC.

ESG cannot be ignored by DC plan sponsors

In 2015, the US Department of Labor wrote a bulletin outlining how DC plan sponsors can best adhere to the Employee Retirement Income Security Act in light of newer ESG considerations. In it, the department specified that ESG-related risks are "not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary's primary analysis…" [1] Of course, significant discussions, debates (and, headlines) had since carried on about the ERISA rule, and the DOL's guidance. As DC practitioners, we fully respect the rule and every plan's specific adherence to the present guidance.

Historically associated with moral stances, ESG at that point took rank along side traditionally recognized drivers of sustainable retirement returns and prudent plan management. What's more, ESG's proliferation in the broader financial industry is not likely to slow any time soon. In the year of the above bulletin, around 50% of the total global institutional asset base was managed by signatories of the Principles for Responsible Investment (PRI). Further, Schroder's 2019 Global Investor Study – which collects the views of 25,000 people from 32 countries around the world – found that 61% of respondents believe all investment funds should consider sustainability factors.

1 *Sustainable Investing in Defined Contribution Plans*, Defined Contribution Institutional Investment Association, May 2019

What ESG does (and does not) mean

ESG investing, to us, is any approach to investing that consciously recognizes that ESG factors can influence returns. Sustainable investing, a phrase often used interchangeably, is in our eyes typically longer-term in nature. Companies and countries are coming under growing pressure from regulators and society to consider their impacts on challenges like climate change, pollution and obesity. As those social tensions become more acute, it's becoming more likely that these external social and environmental factors will become tangible financial costs for companies.

Sustainability therefore incorporates qualitative and quantitative measures to identify companies with sustainable business models that support long-term share and bond holder value. In either case, the *implementation* of ESG or sustainability considerations – and by extension its potential effect on DC plan value and risk – can differ materially.

Narrow interpretations (such as "green" or "ethical" investing) often lead to "screening", whereby stocks are included (positive screening) or ruled out (negative screening), often on a single concern. Schroders research indicates that many traditional screens have minimal effect on long-term returns, although they can be influential over shorter periods. While we do see a place for focusing on particular investments or for excluding the most egregious offenders, we believe that an "integrated" approach to investing is more appropriate for long-term investments – and, is extremely important for plans that offer a default option

to their participants.

An integrated ESG approach – one in which ESG is factored into the investment process unilaterally – assesses how sustainable a company's operations are in relation to all stakeholders. This involves greater engagement with companies, and will assess the ESG merits of firms which might not otherwise meet the requirements of a screening ESG investor.

The ultimate aim is to bring more companies into the net, rather than simply exclude offending business. This should mean that the universe of suitable investments is wider, but the exposure to ESG-related risks is more fully understood. Over time, we believe this can add value and reduce individual stock risk.

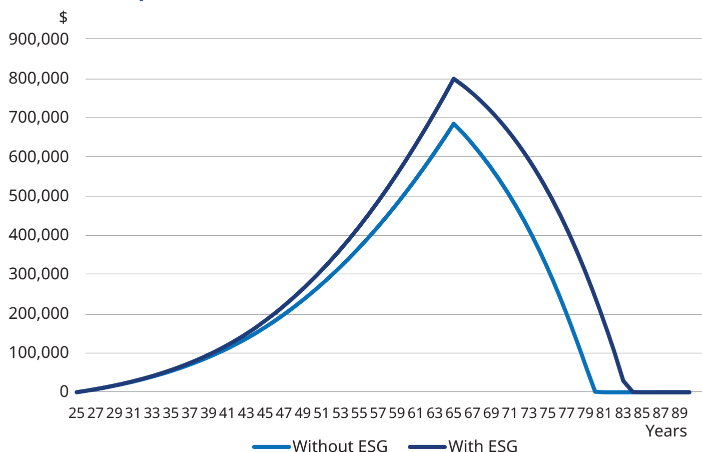
Can ESG improve returns and by how much?

We believe over the long term, the ability of companies to create shareholder value is intrinsically linked to their ability to navigate changing social and environmental pressures. This aligns especially well with the time frames of DC plans, where contributions need to build up over many years and (based on recent research) typically remain untouched throughout.

An aggregate report conducted in 2015 found that of over 2,000 studies – published since 1970 – around 90% yielded a positive correlation between ESG integration and improved financial performance. A 2014 Oxford-Arabesque study further supports the findings, revealing that companies with poor ESG records face clear fundamental or operational headwinds that affect shareholders.

The study indicated that, among other things, firms with significant environmental concerns pay higher borrowing costs than those that do not. Similarly, positive ESG engagement was shown to (logically) confer an equity cost advantage. Better corporate governance reduces information asymmetries through better disclosure. Where environmental impacts are well controlled, employee relations are strong and product safety is high, cost of equity should in practical terms decline.

Additional returns of 1% per annum can add materially to the size of a DC plan



Source: Schroders. Allocation based on average glide path with 90% in global equities, 10% in global (developed market) government bonds at age 25 reducing down to 30% equities, 70% bonds at age 65. Contributions of 9% per annum (p.a.) on a starting salary of $40,000. Inflation assumed at 2% p.a. with salary inflation of 2.5% p.a. Equity returns of 6.3% p.a. without ESG and 7.3% p.a. with ESG. Global government bond returns of 3.3% p.a. For illustration only. Actual results will vary. The above does not offer nor suggest any investment strategy can guarantee future outcomes.

To judge the amount of the value that can be added to a DC plan account, we have modelled the impact of an ESG premium to a hypothetical 1% per annum (p.a.) on equity returns in what we consider a "typical" target date fund. Even at this level, the compounding impact of the increased return over the 40-year average saving period for an individual in a typical target date fund results in a savings balance 16% higher (below left). This is equivalent to an additional 1.5% p.a. of contributions.

Moreover, the estimate above could be considered conservative. A study by MSCI into passive "ESG-tilted" and "ESG momentum" equity strategies showed that these added value of 1.1% p.a. and 2.2% p.a., respectively, albeit over a fairly short time period. Similar conclusions were reached in a paper supported by the Harvard Business School (HBS). This study pitted "high sustainability" companies against comparable "low sustainability" companies between 1993 and 2010, with the high sustainability peer group again outperforming.

These examples are equity focused, but the impact of an ESG approach to other asset classes can and should be similarly positive. Indeed, the aggregated "study of studies" mentioned earlier, concluded that "more than two-thirds of studies [relating to bonds and real estate] uncover significant positive performance relations to ESG criteria".

Follow the money

Over and above empirical indications that ESG integration can improve returns, its roots – with investors seeking simply to "do the right thing" – should not be overlooked. Deloitte in 2015 wrote of its projections that Generation X will, by 2030, hold 31% of total net wealth in the US. Millennials, according to the report, will experience faster growth still, albeit with a share of total net wealth below 20% by the end of the period.

Both cohorts have indicated more concern about investing in companies that have a social or environmental bias than have previous generations. Schroders' 2019 Global Investor Study indicated that millennials and "Gen Xers" are noticeably more engaged than their preceding generations on sustainability factors in investing.

We expect that the distinct priorities and perceptions of these age brackets will feed into widespread changes in consumer markets, talent pools and other areas of society over time as their economic importance grows. With Gen Xers even more strongly engaged with ESG than millennials, companies must recognize that these priorities are now multi-generational, and here to stay. The importance of reflecting these values in company operations and investment cannot be overlooked.

About the authors

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Joel Schiffman is Head of US Defined Contribution and Insurance Sales at Schroders. In his role, he oversees Schroders' existing Sub-Advisory and Insurance businesses as well as manages business development of the firm's Defined Contribution segment. Prior to Schroders, Joel was Vice President & Director at Janus Henderson Investors where he was responsible for overseeing sales and clients services for insurance and defined contribution clients. He was a senior relationship manager at Columbia Threadneedle Investments responsible for building and maintaining relationships with retirement platform record keepers and insurance companies in the U.S. And prior to Columbia, Joel served as Director of Platform Relationships at Lord Abbett & Co. Joel has a Bachelor of Arts degree in Economics from UCLA and has been a member of the investment community since 1982. He holds his CIMA® designation and Series 7, 3, 24 and 63 licenses.

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