# ESG, SRI, and the New World of Investing to Make a Difference

## ESG funds in your 401(k) plan can help increase millennial participation.

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Over the past several years, a strong shift in momentum has occurred in the professional investment community and from institutional asset owners towards using *environmental, social, and governance* (ESG) factors to determine portfolio strategies that aim to create positive results that are *sustainable, responsible,* and have high *impact* (SRI). Also known as *socially responsible investing* (another use of SRI), or simply responsible investing (RI), this article will introduce the topic, and help plan sponsors understand how to approach these preferences within a retirement plan. (For brevity, all of these components will be termed "ESG" in this article.)

### Historical Background

The origins of ESG investing can be traced to religious organizations that wished to align their investment strategies with their values. These organizations were among the first to look at how they were generating investment income, how it later was deployed to support their work, and, ultimately, how to align the two ends of that continuum in a meaningful way. What they learned over the course of their experience was that aligning their investments with their values — which often meant excluding some industries or specific companies from their portfolios — had little long-term impact on relative returns.

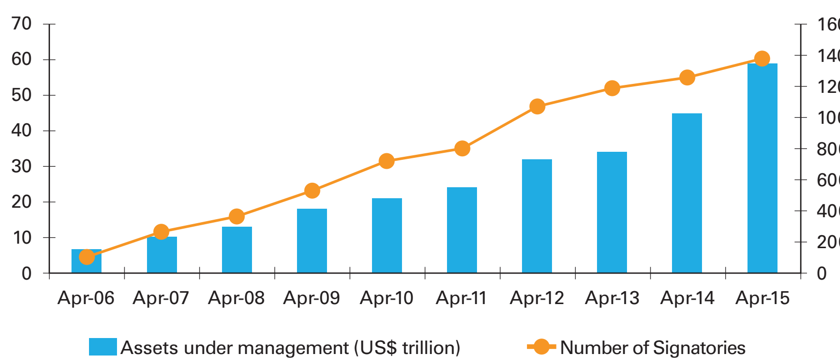
The ESG evolution took a dramatic turn in the 1980's when institutional investors opposed racial injustice in apartheid South Africa by adopting a coordinated program of divestment, which in part, contributed to the formal dismantling of the apartheid system by 1993. This "activist shareholder" movement marked a significant change in the way institutional investors viewed their roles as investors and fiduciaries, as well as paved the way for responsible investment policy.

The true catalyst for mainstream adoption of ESG came in 2006, when the United Nations-supported Principles for Responsible Investing (PRI) was launched. Almost 1,400 asset owners, investment managers, and service providers globally (many of them prominent in the US 401(k) market) have become signatories to this framework, which commits to integrating ESG considerations into investment decision making. The chart in Exhibit 1 demonstrates the significant growth in assets under management (AUM) from PRI signatories, currently at almost $60 trillion.

### The Imperative to Adopt ESG — Risk and Return

The institutional asset management profession has embraced the use of ESG as a way to enhance investment analysis. In a 2015 global survey of investment managers, 63 percent of CFA Institute members noted that they considered ESG issues "to help manage investment risks," the highest common response rate of the eight reasons given. In *Environmental, Social, and Governance Issues in Investing: A Guide for Investment Professionals* published by the CFA Institute (2015), the authors state that *"A key idea is that systematically considering ESG issues will likely lead to*

**Exhibit 1: Global Growth in ESG Investing**




Source: www.unpri.org

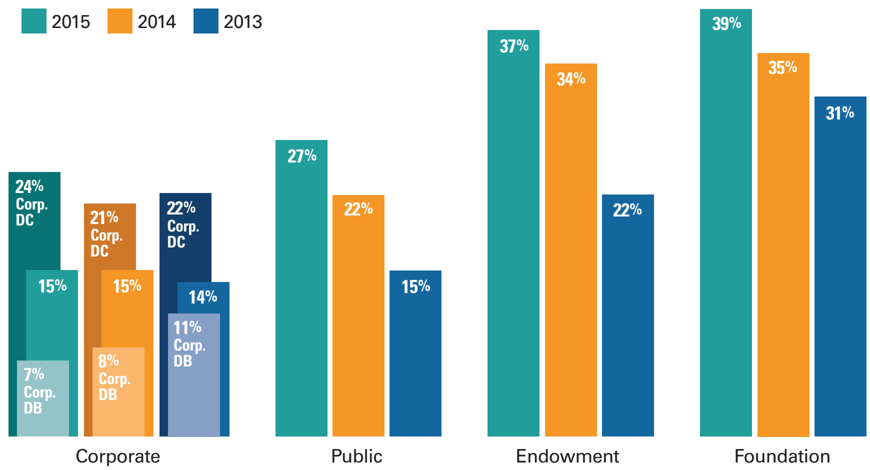
*a more complete investment analysis and better-informed investment decisions."*

ESG has thus broadened from its original values-based approach to now include a value-driven framework. By integrating ESG factors into an overall investment process, better risk management may be achieved because traditional financial analysis may not uncover material issues that can meaningfully impair value. For instance, the 2010 Deepwater Horizon Gulf of Mexico oil spill slashed billions of dollars off the market value of BP, which for years had demonstrated a poor maintenance and safety record. More recently, Volkswagen's poor governance practices enabled the falsification of vehicle emission reports, which, upon discovery, caused a significant drop in their stock price, a ten-billion-dollar lawsuit, and a massive vehicle recall.

On the return side, there is growing evidence that suggests that ESG factors, when integrated into investment analysis and decision making, may offer investors potential long-term performance advantages. Leading global consulting firm Mercer has observed that while people question whether these strategies will be able to outperform benchmarks, they believe ESG integration could improve performance over the long term. For example, a company that maintains sound corporate governance practices or manages its business in light of global environmental or social sustainability challenges will perform better than peers that do not. Aon Hewitt has also stated that there is widespread empirical support for the conclusion that companies adopting strong ESG principles into their business operations enjoy a variety of benefits, including a reduced cost of debt and equity, improved profitability, and better incentive alignment between managers and investors.

The empirical evidence is mixed, but there will be much more data in the future. Currently, there is no overwhelming case to be made that ESG investing is either very costly or very rewarding.

**Exhibit 2: Respondents that have incorporated ESG into investment decisions**




Source: Callan Investments Institute, Survey, Dec. 2015

## The Growth of ESG

Meg Voorhes, Director of Research for US SIF (The Forum for Sustainable and Responsible Investing) noted in an ESG roundtable discussion at the 2016 PSCA Annual Conference that assets invested using ESG strategies in the U.S. had grown rapidly over the few years: from $3.7 trillion in 2012 to $6.6 trillion in 2014 — a 78 percent increase. As a percent of overall investable assets, ESG market share has risen from 12 percent to 18 percent over the same time period.

The types of institutional asset owners utilizing ESG is also instructive. In their most recent annual survey, Callan Associates detailed strong rates of adoption by foundations and endowments, with especially notable growth from public pension funds. See Exhibit 2.

## DOL Re-emphasizes ESG

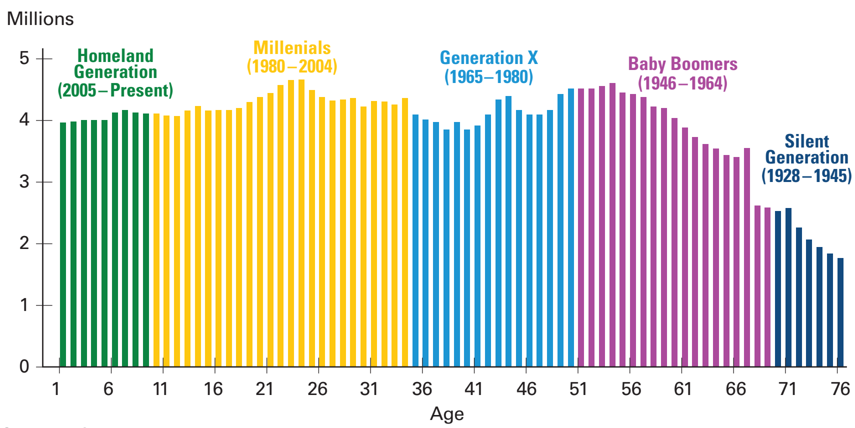
In October of 2015, the Department of Labor issued Interpretive Bulletin 2015-01 to counter a misperception that prior bulletins were discouraging the use of ESG. DOL stated that "Environmental, social, and governance issues may have a direct relationship to the economic value of the plan's investment. 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."*

To further emphasize this point, the DOL said: "Fiduciaries *need not treat commercially reasonable investments as inherently suspect or in need of special scrutiny* merely because they take into consideration environmental, social, or other such factors." Finally: *"The Department does not believe ERISA prohibits a fiduciary from incorporating ESG factors* in investment policy statements or integrating ESG-related tools, metrics and analyses to evaluate an investment's risk or return or choose among otherwise equivalent investments." In sum, plan sponsors have a clear "green light" to incorporate ESG products into their plans.

## Broadening DC Plan Adoption

While most large plans are well aware of ESG, many small to mid-size plans are just becoming aware of the topic. What is sure to move ESG into the mainstream for all plans over time is the emphatic preference by younger participants for principles-based investing. A recent study[1] concluded that 71 percent of individual investors are interested in sustainable investing, with millennials scoring the highest at 85 percent. In addition, the study reported

**Exhibit 3: US Population Distribution by Age, 2013**




Source: Census Bureau

that female investors are more interested than males (76 percent vs. 62 percent).

Demographic trends will inexorably lead to demand for ESG options. The graph in Exhibit 3 provides clear evidence of how millennials will become the dominant group of participants in DC plans in the not too distant future; plan sponsors would do well to begin now to understand how to provide solutions.

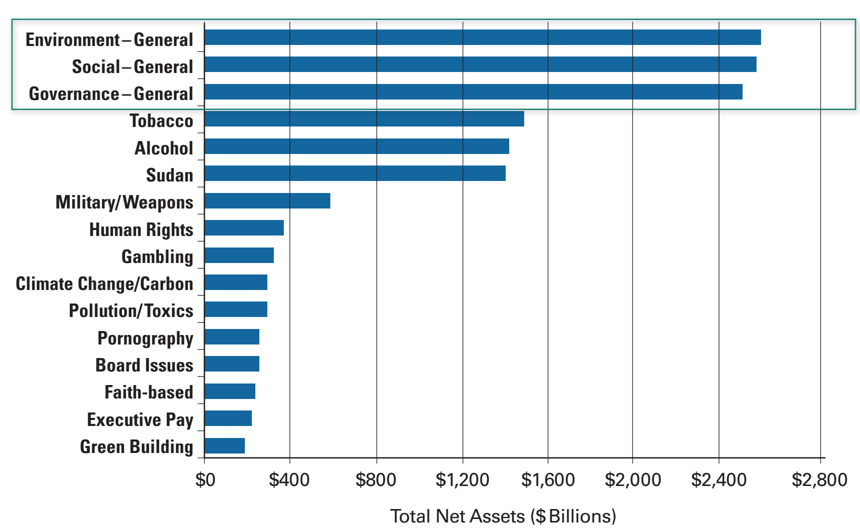
## Challenges and Solutions to Adopting ESG

Tanya Svidler, MSCI's head of Americas ESG Products, noted during the same ESG roundtable discussion at the 2016 PSCA Annual Conference that the seeming complexity of the ESG space can be daunting for new investors. MSCI, for example, currently tracks 240 ESG oriented equity indices globally, and 600 fixed income indices (in collaboration with Barclays).

Svidler noted that many DC plans begin by adopting a broad ESG fund as a start, which is consistent with findings by US SIF that "General" investment vehicles receive the bulk of ESG-oriented investment dollars. See Exhibit 4.

There are now many dedicated businesses within leading global investment providers that offer ESG research, indices, mutual funds, and separate accounts. These providers can deliver a much more sophisticated product due to advances in technology, and highly developed and consistent analytical frameworks that allow for precise ESG research and scoring, resulting in more accurate and reliable ratings for securities and investment vehicles. Plan sponsors can work with their internal staff or external service providers to access this information (some of which is public and some of which is subscription-based).

**Exhibit 4: Leading ESG Criteria, by Assets, for Investment Vehicles 2014**




Source: US SIF Foundation

## Conclusion

ESG is a comprehensive framework for investing responsibly to achieve common investor goals of risk reduction and return enhancement, while addressing issues relevant to a plan sponsor and their participants. As the plan sponsor community develops a greater sense of ESG policies and benefits, they will find robust asset management solutions already developing to meet capacity needs. It is a worthy and timely topic to explore.

*The authors are members of the ESG working group tasked by the PSCA Investment Committee to study this topic.*

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[1] "Sustainable Signals: The Individual Investor Perspective", Morgan Stanley Institute for Sustainable Investing, Feb. 2015