



**ALIGNING
RETIREMENT
ASSETS TOOLKIT #2**



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①

Executive summary

Aligning Retirement Assets (ARA) Toolkit #2 is intended to provide more “tactical” and specific guidance for retirement plan fiduciaries and sponsors regarding responsible investment implementation methods and considerations.

Our hope is that plan fiduciaries, or interested employees, after reading Toolkit #1¹ will decide that shifting towards what we've termed a "responsible retirement plan" is indeed achievable, and will then return to this Toolkit to understand the tools and processes available to help the retirement plan achieve these goals.

Chances are, if you're reading this document, then the fiduciaries of your retirement plan(s) are evaluating the possible inclusion of responsible investment practices into the retirement plan(s) offered to employees. If that's the case, then it makes sense to start by reviewing some common objections to ESG incorporation in retirement plans, as well as effective responses to those objections.

A. Common misconceptions and abbreviated responses

- *ESG investments reduce performance:* This statement reflects a common misconception regarding the various methods used to integrate ESG factors into investment decision-making, and how ESG integration differs from other responsible investment approaches. Multiple research studies have found that considering ESG factors within investment decision-making is not an impediment to financial performance, and can in fact enhance performance, *if* financially material factors affecting underlying companies are identified and analyzed by investors.

- *Incorporating ESG into the retirement plan might violate regulatory guidelines:* In general, this sentiment is unsupported by recent regulatory actions. The European Union and United Kingdom have taken a regulatory direction of travel that not only encourages ESG-related risk analyses, but *requires* such analyses to be undertaken by retirement plan providers. The United States, on the other hand, has alternated regulatory perspectives on considering ESG factors in retirement plans, while not explicitly declaring ESG incorporation to be against regulations.

- *ESG investing increases costs:* As with most issues of this nature the answer is not straightforward and will differ on a case by case basis. The biggest factors in determining the effect of ESG investing on costs will be the asset class, vehicle type and the style of investment being deployed (e.g. active vs. passive).

Fidelity, utilizing Morningstar fee data as of 31 December 2017, compared ESG share class expenses against the expenses of traditional open ended funds. That comparison, which included a number of asset classes, found that 61% of the ESG share classes evaluated were priced at or below the average expenses of the traditional fund universe when comparing against similar categories.²

- *ESG investing is making a political and/or social statement:* As clarified previously in Toolkit #1, socially responsible investment (SRI) is typically focused on *values alignment* of investments, in particular, with respect to moral and/or political values held by investors. But ESG investing and SRI investing are not the same. While many ESG-themed funds often avoid investments in certain controversial sectors, such as tobacco or firearms, this typically reflects managers' views that the long-term growth prospects of those sectors are limited, i.e. ESG investing is not focused on values or moral considerations, but on economic considerations impacting risk and return.
- *Our investment consultant doesn't support ESG investing:* Unfortunately, it appears that many consultants are unable or unwilling to advise their clients regarding responsible investment matters, either because they perceive that clients are not interested, or due to a perceived lack of credible ESG-related product offerings. However, there are many consultancies who have developed, or are developing, quite robust responsible investment practices, and if retirement plan fiduciaries believe that the advice they are receiving is not reflective of best practices in responsible investment, then there are certainly qualified firms available.

¹ WBCSD & Mercer (2018). "Aligning Retirement Assets Toolkit #1". Available at: https://docs.wbcsd.org/2018/12/ARA-The_responsible_retirement_plan_opportunity.pdf

² Fidelity (2018). "Investing based on your principles." Available at: <https://www.fidelity.com/viewpoints/active-investor/strategies-for-sustainable-investing>.

① Executive summary

- *None of our competitors are integrating ESG:* Depending on global region, it is quite likely that many of your competitors' retirement plans are in fact integrating ESG factors into their retirement plans. PRI offers a useful listing of over 400 asset owner signatories³ to the Principles as of early 2019, with 86 signatories identified either as retirement or pension plans (although a number are public plans). A recent PlanSponsor analysis shows survey data for retirement plan sponsors in the United States regarding their inclusion of at least one "socially responsible" (a term that is undefined in the survey) fund in the plan lineup. Of particular note, the proportion of survey respondents across all industries that offered such a fund is far greater, at 8.4%, than the proportion of Fortune 1000 funds that responded to the survey, of which only 4.8% offered a socially responsible fund.⁴

B. Methods for implementing a responsible retirement plan

Presuming that retirement plan fiduciaries have decided to incorporate responsible investment approaches into the retirement plans, what are the next steps? The following suggestions are based on successful engagements that project participants have had in advising retirement plan fiduciaries on such matters.

i. Assess existing ESG resources (as applicable)

Retirement plans often have access to many different internal and external resources, some of which may have ESG-related capabilities and expertise that fiduciaries may not have taken advantage of previously, including internal expert staff, investment managers, and/or investment consultants. A useful first step to take is to inquire about responsible investment experience, tools and capabilities.

ii. Assess plan fiduciaries' perspectives on ESG risks and opportunities

Retirement plan investment committee members tend to be selected to serve in a fiduciary role because of the experience or perspective they bring to the committee, and many tend to have relevant financial sector and/or human resources experience. Given individuals in such roles are likely to have varying exposure to responsible investment topics, and may bring particular perspectives into such discussions, it can be helpful to hold an educational session for committee members, and then issue a confidential survey to individual fiduciaries to assess their views on material long-term ESG risks and opportunities. The survey results will inform any next steps on ESG incorporation the retirement plan may take.

iii. Update Investment Policy Statement to take ESG considerations into account

Presuming that the steps above have been completed, formally integrating the material ESG considerations identified by committee members into the retirement plan's Investment Policy Statement (IPS) will provide a framework to inform future investment analyses and both asset allocation (for DB plans) and/or investment manager selection processes (for DB and DC plans). These policy updates provide specific guidance to investment managers and advisors regarding where the retirement plan deems ESG factors to be material for investment decision-making, clarifying expectations.

iv. Evaluate current investment managers' responsible investment efforts

The responsible investment industry is growing significantly in the range of products and services that are available to investors. However, it can be challenging for retirement plan fiduciaries to assess the ESG quality of investment funds without access to third-party tools and ratings. Some investment consultants offer ESG ratings of individual investment strategies – a top-down approach assessing managers' idea generation and portfolio construction approaches – while many third party data providers offer issuer (or company) level ESG research and ratings – a bottom-up approach

³ United Nations Principles for Responsible Investment (2019). "Search Results." Available at: <https://www.unpri.org/searchresults?qkeyword=retirement&PageSize=10¶meters=WVSECTIONCODE%7C1018%2CWVFACT2%7C77&cmd=ReplaceKeyword&val=retirement&SortOrder=3>.

⁴ PlanSponsor; 2019 Defined Contribution Plan Survey.

evaluating a particular issuer’s ESG metrics, such as greenhouse gas emissions, or revenue derived from controversial business practices. Utilizing both perspectives in combination can offer useful information for assessing ESG incorporation within investment manager strategies.

v. Evaluate potential replacement or additional responsible investment managers

If an evaluation of the investment strategies currently used within either a Defined Benefit (DB) plan portfolio or offered as part of a Defined Contribution (DC) plan lineup reveals that the strategies don’t offer the responsible investment profile that fiduciaries deem desirable, then retirement plan fiduciaries should decide which responsible investment method(s) fund managers should employ:

- portfolio screening, either negative or positive;
- ESG integration, using ESG factors and data to expand upon fundamental research and analysis;
- thematic investing, focused on offering investors focused exposure to an explicit environmental or social theme;
- and/or active ownership, where investors seek to use their position as equity owners or as creditors to influence the behavior of investee companies.

Once fiduciaries have identified the desired method(s) for managers to use, DB plans can then begin to shift allocations to responsible investment managers. DC plans, on the other hand, can add responsible investment strategies or replace existing strategies in the lineup.

vi. Evaluate portfolio implications

Once a retirement plan has decided to shift toward responsible investments, how the new strategies fit within the existing portfolio construction is highly important, and there are a range of options both DB and DC plans can consider.

- a. DB plans can utilize: an asset class agnostic approach, which designates a separate “sleeve” of ESG assets; an asset class specific approach, which determines a set amount of assets to devote to ESG within existing asset class allocations; or a 100% ESG integrated approach, by integrating ESG considerations into existing asset allocation, portfolio construction and manager selection/monitoring activities.
- b. DC plans can add:
 - one ESG option, which can be a good way for plan sponsors to “test the waters” of offering plan participants an ESG fund while not overwhelming them with too many options;
 - an ESG tier of options, selecting a number of strategies that allow participants to effectively diversify their ESG investments, such as a global active equity fund, a global passive equity fund and a fixed income fund;
 - an ESG default fund, as some investment managers have developed suitable default fund options that integrate ESG factors into the security selection and portfolio construction process.

vii. Communicate responsible investment changes to plan participants

Once changes have been made to the retirement plan portfolio or lineup, informing participants is an important aspect of ensuring that the responsible investment changes – and the rationale behind those changes – are understood by participants who may wish to take advantage of them.

While ESG investment practices have been steadily growing in popularity for many years, much of that growth and investment activity has occurred outside of retirement plans, and as a result, retirement plan participants have not been able to invest their assets in accordance with their views. We hope that this Toolkit, in addition to the first Toolkit in this series, provides useful guidance for fiduciaries and plan administrators in considering how they might integrate ESG factors and considerations into their retirement plans in the near future.



②

Introduction

Integrating environmental, social and corporate governance (ESG) considerations into retirement plans is a growing area of interest for both retirement plan sponsors and participants.

Since the launch of the Aligning Retirement Assets (ARA) initiative in early 2018, we have tapped into a wellspring of enthusiasm and engagement from among members of the World Business Council for Sustainable Development (WBCSD) as well as the broader corporate and investor market. After defining the key issues, considerations and actions, retirement plans can take to address responsible investment themes in Toolkit #1, the question remains: exactly *how* should retirement plans go about adopting responsible investment methods?

This document, ARA Toolkit #2, is intended to build upon the foundation established by Toolkit #1, while providing more “tactical” and specific guidance for plan fiduciaries and sponsors regarding implementation methods and considerations. Our hope is that plan fiduciaries, or interested

employees, after reading Toolkit #1 will decide that shifting towards what we have termed a “responsible retirement plan” is indeed achievable and will then review this Toolkit to understand the tools and processes available to help the retirement plan achieve these goals.

In order to make this document as useful as possible to readers with different responsibilities and vantage points with respect to their retirement plan, we have organized this document to facilitate shared learning:

- Section 2, “Common misconceptions and possible responses” highlights some of the most frequent questions and/or statements that tend to be raised in the context of responsible retirement, as well as potential responses to those statements.

- Section 3, “Methods for implementing a responsible retirement plan” provides the nuts-and-bolts details of how, once the considerations outlined in Section 2 have been appropriately addressed, retirement plans can integrate responsible investment approaches successfully. The advice offered in this section is based off of the combined experience of the ARA Steering Committee members’ engagement on responsible investment incorporation in retirement plan contexts, and it highlights best practices for fiduciaries and plan sponsors to consider.

Throughout this document, we have included several case studies of companies’ experiences at various points along the responsible retirement plan incorporation spectrum to help readers gain additional contextual understanding that may aid their own company’s journey.

CASE STUDY

HSBC’s UK employee pension fund decided in 2016 to change the default fund option in its defined contribution scheme to one that aims to provide better risk-adjusted returns over the long term by using an alternatively-weighted index, while also addressing the financial risks of climate change and benefiting from the transition to a low-carbon economy.

The Future World Fund, managed by Legal & General Investment Management, aims to have a meaningful positive climate impact by favouring low carbon stocks and companies with green revenues, without significantly changing the risk-return profile of the fund. The fund starts with an index of companies which score well on factors such as low volatility. It then applies a climate ‘tilt’ by reducing exposure to companies with higher than average carbon emissions and fossil reserves (to the point of altogether excluding ‘pure-play’ coal companies), while simultaneously increasing exposure to companies generating “green” revenues from low-carbon solutions. In addition, the tilting strategy was designed to work in conjunction with the designated manager’s climate engagement strategy.

More case studies will be published on WBCSD website.

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Common misconceptions and possible responses

Chances are, if you are reading this document, then the fiduciaries of your retirement plan(s) are evaluating the possibility of including responsible investment practices into retirement plan(s) offered to employees. If that is the case, then it makes sense to start by reviewing some common objections to ESG incorporation in retirement plans, as well as effective responses to those objections.

③ Common misconceptions and possible responses

If you have not done so already, we strongly suggest that you review the material in the first Toolkit of this series, which covers the basic elements of fiduciary duty, regulatory considerations and responsible investment approaches and methods, all in the context of retirement plans. The responses below build upon the material presented in Toolkit #1, yet are more focused on responding to the specific objections that may arise as fiduciaries consider responsible investment approaches.

A. ESG investments reduce performance

This statement reflects a common misconception regarding the various methods used to integrate ESG factors into investment decision-making, and how ESG integration differs from other responsible investment approaches.⁵

- Socially Responsible Investment: Modern portfolio theory (MPT) – which is underpinned by the Efficient Market Hypothesis (EMH), and the dominant financial theory in many global markets⁶ – dictates that, were portfolio restrictions or screens are to be employed as in an SRI portfolio, then long-term risk-adjusted performance would be sacrificed compared to an unconstrained portfolio.
- There are indeed examples of instances where organizations have divested from a certain security or sector and experienced worse than benchmark performance as a result, notably in the tobacco industry.⁷ However, more recently, the tobacco industry has faltered⁸ and the validity of extrapolating from these examples to assume negative screening results in losses in all circumstances is not supported by empirical evidence. In fact, negatively screened portfolios often perform in line with and sometimes better than unscreened portfolios,^{9, 10} depending on the industry screened, the timeframe of assessment and the metrics used to evaluate performance.
- ESG: In terms of how strategies incorporating ESG factors perform, a meta-study of over 2,000 primary empirical studies conducted since the 1970s identified that approximately 90% of these primary studies identified a non-negative relationship between ESG criteria and corporate financial performance, with a majority of those studies reporting positive results, rather than neutral.¹¹ Furthermore, an academic study analyzing a sample of more than 2,000 U.S. companies over a 20 year time period has shown that companies with high performance on *financially material* ESG issues within their businesses¹² realized an annualized outperformance of over 6%, whereas companies with low performance on material factors saw alphas ranging between -2.9% to 0.6%.¹³ Considering ESG factors within investment decision-making is therefore not an impediment to financial performance, and can in fact enhance performance, *if* financially material factors affecting underlying companies are identified and analyzed by investors.

⁵ For a full taxonomy of approaches and methods refer to Toolkit #1.

⁶ For a high-level overview of MPT refer to: <https://www.investopedia.com/terms/m/modernportfoliotheory.asp>. For the purposes of this document, it is important to understand that MPT presumes market efficiency and is by far the most dominant investment theory, underpinning most quantitative investment models in use today.

⁷ <https://www.wsj.com/articles/tobacco-gains-prompts-fund-to-reconsider-investment-strategy-1461914447>

⁸ Daniel Thurecht (2019). "The Great Tobacco Selloff of 2018." *Seeking Alpha*. Available at: <https://seekingalpha.com/article/4231320-great-tobacco-selloff-2018>.

⁹ Jeremy Grantham (2018). "The mythical peril of divesting from fossil fuels." *The London School of Economics and Political Science, Grantham Research Institute on Climate Change and the Environment*. Available at: <http://www.lse.ac.uk/GranthamInstitute/news/the-mythical-peril-of-divesting-from-fossil-fuels/>.

¹⁰ Mercer (2017). *Preparing Portfolios for Transformation*. Page 32-33. Available: <https://www.mercer.com/our-thinking/assessing-the-prospective-investment-im-pacts-of-a-low-carbon-economic-transition.html>

¹¹ Gunnar Friede, Timo Busch & Alexander Bassen (2015) ESG and financial performance: aggregated evidence from more than 2000 empirical studies, *Journal of Sustainable Finance & Investment*, 5:4, 210-233, Available at: <https://doi.org/10.1080/20430795.2015.1118917>.

¹² Sustainability Accounting Standards Board (2019). "Find Your Industry." Available at: <https://www.sasb.org/find-your-industry/>.

¹³ Khan, Mozaffar and Serafeim, George and Yoon, Aaron, Corporate Sustainability: First Evidence on Materiality (November 9, 2016). *The Accounting Review*, Vol. 91, No. 6, pp. 1697-1724. Available at SSRN: <https://ssrn.com/abstract=2575912>.

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B. Incorporating ESG into the retirement plan might violate regulatory guidelines

In general, this sentiment is unsupported by recent regulatory actions. The European Union and United Kingdom have taken a regulatory direction of travel that encourages ESG-related risk analyses, and *requires* such analyses to be undertaken by retirement plan providers.

The United States, on the other hand, has alternated regulatory perspectives on considering ESG factors in retirement plans, while not explicitly declaring ESG incorporation to be against regulations. This brief guide cannot provide the level of guidance and context that retirement plan legal counsel can provide on this topic, however we've provided comments on three major retirement plan markets below to indicate areas for further investigation by plan sponsors.



i. European Union regulatory perspectives and history

In December 2016, the European Union officially adopted a revised Institutions for Occupational Retirement Provision (IORP II) Directive,¹⁴ which required that EU member states transpose the Directive into national law by 13 January 2019. The European Commission has declared that it will “carefully examine” how each member state has implemented IORP II to ensure harmonization. Overall, the Directive requires occupational retirement plan providers with more than 100 members to evaluate ESG risks and disclose information to members. As described by the UN Principles for Responsible Investment, the Articles of the Directive require occupational retirement plans to:¹⁵

- a. Invest in accordance with the Prudent Person Principle. The Directive clarifies that this means acting in the best long-term interests of their members as a whole, and that the Prudent Person Principle does not preclude funds from considering the impact of their investments on ESG factors (Article 19).

¹⁴ The full text of the Directive is available here: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32016L2341>

¹⁵ The following bullet points are quoted from United Nations Principles for Responsible Investment (2016). “Policy Briefing: Institutions for Occupational Retirement Provision (IORP) Directive: ESG Clauses.” Available at: <https://www.unpri.org/download?ac=1430>.

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- b. Hold an effective, transparent system of governance that includes consideration of ESG factors relating to investment decisions. This system should be proportionate to the nature, scale and complexity of the IORP (Article 21).
- c. Establish a risk management function and procedures to identify, monitor, manage and report risks. ESG risks associated with the investment portfolio and its management are included in the list of risks that the risk management system must cover. This system should be proportionate to the nature, scale and complexity of the IORP (Article 25).
- d. Carry out and document their own risk assessment at least every three years, or without delay following a significant change in the risk profile. This risk assessment should include, where ESG factors are considered, an assessment of new or emerging risks including climate change, resource use, social risks and stranded assets (Article 28).

- e. Produce and review a Statement of Investment Policy Principles¹⁶ at least every three years, or immediately following significant changes to investment policy. This must be made publicly available and should explain whether and how the investment policy takes into account ESG factors (Article 30).
- f. Inform prospective scheme members whether and how the investment approach takes ESG factors into account (Article 41).

Together with IORP II, the amended Shareholder Rights Directive (SRD II) supporting long-term investment being transposed to national laws in during 2019 enhances the clear direction the EU has for the consideration of ESG factors and long-term investments. It is clear that plan fiduciaries and governance will be required to engage directly on responsible investment topics. This is a contrast to concerns expressed in other jurisdictions.

While less directly focused on retirement plans, another key indication of the direction of regulatory travel in the EU is visible in the European Commission Action Plan for Financing Sustainable Growth, published in March 2018. The action plan has three main objectives:¹⁷

- a. Reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth
- b. Manage financial risks stemming from climate change, environmental degradation and social issues
- c. Foster transparency and long-termism in financial and economic activity

It's beyond the scope of this paper to examine all of the implications of the EU Action Plan, however we encourage readers to investigate these policies further to understand what impacts, if any, there may be for their particular investment contexts.

¹⁶ Statements of Investment Principles (also called Investment Policy Statements in the United States and other markets) are used by plan fiduciaries to guide the plan's investments, monitor investment performance, and hire and assess the performance of third-party vendors to the plan, including the advisor, recordkeeper, and others. These statements can be changed to assimilate updates to the policy through a vote of the fiduciaries, which may include adding explicit references to ESG factors and/or integration approaches the retirement plan will utilize.

¹⁷ The following text is quoted from the European Commission (2018). "Commission action plan on financing sustainable growth." Available at: https://ec.europa.eu/info/publications/180308-action-plan-sustainable-growth_en.

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ii. United Kingdom regulatory perspectives and history

In September 2018, the U.K. Department of Work and Pensions issued a governmental response to a consultation on “Clarifying and Strengthening Trustees’ Investment Duties” that outlined new regulations regarding the consideration of ESG factors by pension plans. The new regulations clarify trustees’ duties on three key topics related to ESG factors and requires them to produce a Statement of Investment Principles that clarifies the following elements:

- a. How the trustees take account of financially material considerations, including ESG considerations, explicitly climate change
- b. The approach to the stewardship of the investments, including engagement with investee firms and the exercise of voting rights.
- c. How they take account (if at all) of member views on “non-financial matters.” Where “non-financial matters” include Members’ ethical views, their views in relation to social and environmental impact and about quality of life of the scheme’s members and beneficiaries.

In addition, the Trustees of schemes “offering money purchase benefits” – defined contribution schemes – are required to:

- a. Publish their revised Statement of Investment Principles publicly on a website.
- b. Prepare or update the default strategy to include consideration of ESG issues, including climate change and;
- c. From October 2020, the trustees are required to produce an implementation report each year to be included in the Scheme’s Annual Report and Accounts and published online.

Such new regulatory actions require U.K. pensions to formally take account of ESG considerations as an integral part of their fiduciary duty in their investment decision-making by clarifying the regulation on how pension trustees should consider such matters.

Furthermore, in the U.K, The Financial Reporting Council (FRC) is consulting on a new UK Stewardship Code,¹⁸ a voluntary action pension funds can take that to set substantially higher expectations for investors in relation to stewardship policy and practice.

The new Code redefines stewardship as:

“The responsible allocation and management of capital across the institutional investment community, to create sustainable value for beneficiaries, the economy and society.”

The revisions to the Code follow an increasing focus on ESG factors, as well as significant changes in the expectations of stewardship in recent years. The draft Code makes explicit reference to ESG factors. Signatories are expected to take material ESG issues, including climate change, into account when fulfilling their stewardship responsibilities.

¹⁸ Further information regarding the Financial Reporting Council’s consultation is available at: [https://www.frc.org.uk/news/january-2019-\(1\)/frc-strengthens-stewardship-code](https://www.frc.org.uk/news/january-2019-(1)/frc-strengthens-stewardship-code).



iii. United States regulatory perspectives and history

The U.S. Department of Labor (DOL) has a long history of issuing public guidance on the consideration of ESG factors in retirement plans governed by the Employee Retirement Income Security Act (ERISA) of 1974. At present, Interpretive Bulletins (IBs) 2015-01 and 2016-01 remain in force and describe a broadly permissive stance toward the incorporation of ESG factors into investment decisions (the former) and active ownership (the latter). However, in 2018 the DOL issued Field Assistance Bulletin (FAB) 2018-01,¹⁹ which sought to clarify IBs 2015-01 and 2016-01 for fiduciaries governing ERISA-compliant retirement plans. In sum, the FAB explained how ESG factors can be taken into account in investing plan assets in four key circumstances (text in quotation marks is quoted from the FAB).

a. The treatment of ESG factors in investment decision-making generally: The FAB clarifies that ESG factors should be considered based on

their economic or financial impact on an investment and non-financial ESG considerations may be used to choose between largely equal alternatives.

b. The addition of so-called ESG-themed funds to a plan's lineup: Where a fiduciary is considering adding an ESG-themed fund option to its plan, the FAB indicates that a fiduciary should consider whether the option constitutes "a prudently selected, well managed and properly diversified ESG-themed investment alternative" and does not "require the plan to remove or forgo adding other non-ESG-themed investment options to the platform."

c. The consideration of an ESG-themed fund as a QDIA: The FAB suggests that it would not be prudent to designate an ESG-themed Target-Date Fund²⁰ (TDF) as the plan's Qualified Default Investment Alternative²¹ (QDIA) "if the fund would provide a lower expected rate of return than available non-ESG alternative target date funds with commensurate

degrees of risk, or if the fund would be riskier than non-ESG alternative available target date funds with commensurate rates of return."

d. The extent to which expenses incurred by the plan in exercising shareholder rights and/or engaging with companies in which the plan owns stock are appropriate: While the FAB does not alter the DOL's position that proxy voting is a shareholder right which must be exercised by plan fiduciaries and investment managers in accordance with fiduciary duties, including those of prudence, loyalty and impartiality, when considering undertaking a corporate engagement strategy focusing on environment or social issues it is important that the plan fiduciary can justify and substantiate any related "routine or substantial" expenses incurred as being in the economic interests of the plan.

¹⁹ U.S. Department of Labor (2018). Field Assistance Bulletin 2018-01. Available at: <https://www.dol.gov/sites/default/files/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01.pdf>.

²⁰ A target-date fund, as defined by Investopedia, "is a fund offered by an investment company that seeks to grow assets over a specified period of time for a targeted goal. Target date funds are usually named by the year in which the investor plans to begin utilizing the assets [typically in retirement]." Investopedia (2017). "Target-Date Fund." Available at: https://www.investopedia.com/terms/t/target-date_fund.asp.

²¹ For employers that choose to contribute a portion of each eligible employee's salary into the employer-sponsored retirement plan, regardless of whether the employee elects to make their own contributions, Qualified Default Investment Alternatives (QDIA) are investment funds selected by retirement plan sponsors to serve as the vehicle for those "nonelective contributions" made on behalf of employees. QDIAs are unique to the United States ERISA regulatory system, although other countries' retirement systems identify DC plan "default funds" that play a similar role. For more information, please see Investopedia (2018) "What is a Nonelective Contribution." Available at: <https://www.investopedia.com/terms/n/non-electivecontribution.asp>.

③ Common misconceptions and possible responses

In summary, the U.S. DOL’s FAB 2018-01 indicates that regulators will focus on ensuring ESG considerations by plan sponsors don’t sacrifice returns or increase risk. While the DOL highlights considerations regarding ESG matters, the Government Accountability Office (GAO),

in a report released shortly after FAB 2018-01, focused its attention on the fact that DOL’s FAB may lead to confusion among ERISA fiduciaries regarding financially material ESG factors especially given the language in the preceding IBs.²² GAO called for further clarification from DOL regarding whether and

how fiduciaries can consider financially material ESG factors in investment decisions, which DOL has not yet committed to address. Ultimately, however, the U.S. regulatory landscape for fiduciary consideration of ESG issues stands in contrast to other major markets.

Figure 1: History of US regulatory action related to ESG incorporation in corporate retirement plans

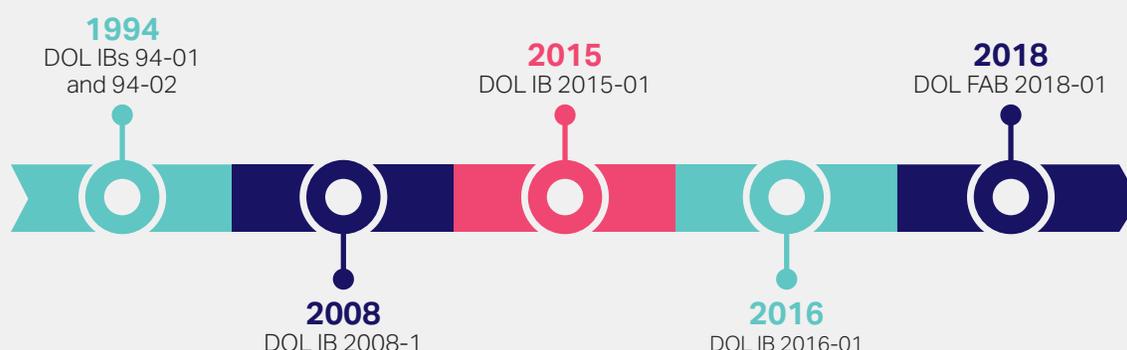


Figure 2: A Summary of ESG-related regulatory guidance from the US DOL currently in force

IV. IB 2015-01 – ESG INVESTING AND ETIS	V. IB 2016-01 – PROXY VOTING AND ENGAGEMENT
<p>Replaced IB 2008-01 and clarified:</p> <ul style="list-style-type: none"> ERISA does not prohibit fiduciaries from incorporating ESG factors in investment policy statements or integrating ESG-related analyses. Consideration of ESG criteria does not presumptively require additional documentation or evaluation beyond generally applicable fiduciary standards. 	<p>Replaced IB 2008-02 and clarified:</p> <ul style="list-style-type: none"> A burdensome cost-benefit analysis is not required for ERISA plans to vote proxies, establish a proxy voting policy, or otherwise exercising shareholder rights. Shareholder engagement around ESG issues can result in long-term financial benefits for shareholders and thus can be considered in active ownership activities of ERISA plans.
VI. FAB 2018-01 – CLARIFYING IBS 2015-01 AND 2016-01	
<ul style="list-style-type: none"> While not overturning prior IBs the FAB strikes a more cautious tone on ESG-themed investing. May require particular attention in the context of QDIAs or when incurring routine or substantial expenses to engage in environmental or social engagement campaigns. 	

²² U.S. Government Accountability Office (2018). “Retirement Plan Investing: Clearer Information on Consideration of Environmental, Social, and Governance Factors Would Be Helpful.” Available at: <https://www.gao.gov/assets/700/691930.pdf>.

③ Common misconceptions and possible responses

C. ESG investing increases costs

As with most issues of this nature the answer is not straightforward and will differ on a case by case basis. The biggest factors in determining the effect of ESG investing on costs will be the asset class, vehicle type and the style of investment being deployed (e.g. active vs. passive). For the sake of brevity, we will focus in this paper on fees associated with investments made in active or passive equity funds with the understanding that these asset classes broadly will reflect the dynamics in other asset classes.

- Active equity: While accessing data regarding the expense ratios for ESG, active equity strategies (or any asset class) can be challenging to find in many cases. Fidelity, utilizing Morningstar fee data as of 31 December 2017, compared ESG share class expenses against the expenses of traditional open ended funds. That comparison, which included active equity strategies, found that 61% of the ESG share classes evaluated were priced at or below the average expenses of the traditional fund universe when comparing against similar categories.²³ While the historical data implies that ESG-aligned investments in active equity need not be

more expensive than traditional approaches, the record-breaking growth of responsible investment funds in both the European and United States markets, where 147²⁴ and 72²⁵ sustainable equity funds launched in 2018, respectively, indicates that increasing competition among fund managers should drive future costs down further and provide fiduciaries a greater range of options.

- Passive equity: ESG index funds tend to be higher cost than funds tracking equivalent market-cap weighted indices due to the current common practice amongst index managers of passing the extra costs of ESG research onto investors in these specialized funds. However, some ESG index funds have come to market at prices below equivalent standard funds lately.²⁶ This means the ESG fund expenses will be competitive with the average index fund in the category, but they will not be the lowest cost option. Increasingly index fund managers are exploring “self-indexing” whereby they acquire third-party ESG data from multiple sources and develop their own specialized indices. This can reduce cost, as they are not paying the index creator a fee to track the published index.

D. ESG investing is making a political and/or social statement

As clarified previously in Toolkit #1, socially responsible investment (SRI) is typically focused on *values alignment* of investments, in particular, with respect to moral and/or political values held by investors. But ESG investing and SRI investing are not the same. SRI has traditionally focused on exclusions of disfavored companies or industry sectors based on moral underpinnings, however similar motivations have frequently been ascribed to any investors who consider financially material ESG factors in investment analyses. However, such a conflation is inaccurate and inappropriate. While many ESG-themed funds often avoid investments in certain controversial sectors, such as tobacco or firearms, this typically reflects managers’ views that the long-term growth prospects of those sectors are limited, i.e. ESG investing is not focused on values or moral considerations, but on economic considerations impacting risk and return. Managers may take similar long-term perspectives on certain fossil fuel sectors, which, based on numerous reports and projections,²⁷ face an uncertain future in a time of transition to a new global energy system.

²³ Fidelity (2018). “Investing based on your principles.” Available at: <https://www.fidelity.com/viewpoints/active-investor/strategies-for-sustainable-investing>.

²⁴ Hortense Bioy (2019). *European Sustainable Funds: 2018 in Review*. Morningstar. Available at: http://images.mscomm.morningstar.com/Web/MorningstarInc/%7B-8f5366b4-9511-448e-9d19-6ae42c12c5e3%7D_2018_ESG_funds_review_final.pdf.

²⁵ Jon Hale (2018). *Sustainable Funds U.S. Landscape Report*. Morningstar. Available at: https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/Sustainable_Funds_Landscape.pdf. Page 9.

²⁶ Hortense Bioy (2019). *European Sustainable Funds: 2018 in Review*. Morningstar. Available at: http://images.mscomm.morningstar.com/Web/MorningstarInc/%7B-8f5366b4-9511-448e-9d19-6ae42c12c5e3%7D_2018_ESG_funds_review_final.pdf. – “iShares and L&G launched ESG-screened core ETFs that are cheaper than most non-screened rivals, with ongoing charges ranging from 0.05% to 0.20% depending on the geographic exposure. The ETFs exclude companies that operate in controversial industries such as tobacco, weapons, and coal mining in addition to those in violation of the United Nations Global Compact principles. For the first time, investors can buy a range of sustainable portfolio building-blocks without having to pay a premium for the privilege. Surely, this must be one of the strongest signals that ESG investing is fast becoming mainstream.”

²⁷ McKinsey & Company (2019). *Global Energy Perspective: Accelerated Transition*. Available at: <https://www.mckinsey.com/solutions/energy-insights/global-energy-perspective-accelerated-transition>.

③ Common misconceptions and possible responses

Again, what might be perceived as political or values-based judgments may in fact simply reflect a manager's view that the long-term risks of investing in such sectors may outweigh any expected returns. It is important that investors understand the analyses supporting managers' decisions on ESG topics, to ensure that the manager's perspective on long-term trends aligns with those of prospective investors.

E. Our investment consultant doesn't support ESG investing

Some consultants are unable or unwilling to advise their clients regarding responsible investment matters, either because they perceive that clients are not interested, or because of a perceived lack of credible ESG-related product offerings. A 2017 UN Principles for Responsible Investment (PRI) paper reviewing investment consulting services found that "most consultants and their asset owner clients are failing to consider ESG issues in investment practice... There currently seems little commercial imperative for investment consultants to extend the coverage of ESG integrated services among their clients."²⁸

However, there are many consultancies who have developed, or are developing, quite robust responsible investment practices, and in fact there are third-party surveys that rank consultancies on their responsible investment practices, most notably the Independent Research in Responsible Investment Survey 2017, which highlights both leading advisory firms as well as individuals, based on surveys of asset owners and asset managers.²⁹ If retirement plan fiduciaries believe that the advice they are receiving is not reflective of best practices in responsible investment, then there are other qualified firms available.

F. None of our competitors are integrating ESG

Depending on global region, it is quite likely that many of your competitors' retirement plans are in fact integrating ESG factors into their retirement plans. PRI offers a useful listing of over 400 asset owner signatories³⁰ to the Principles as of early 2019, with 86 signatories identified either as retirement or pension plans (although a number are public plans). In the United States, data gathered by the US Sustainable Investment Forum indicated that between 2014 and 2016 the number of

retirement plans investing in "sustainable, responsible and impact" funds grew 70%, with related plan assets growing 71% from USD \$2.7 billion to USD \$4.61 billion.³¹ PensionsEurope conducted a survey of members in 2018 which found that pension funds expect that the share of sustainable investments in their portfolios will increase in coming years, due to a combination of such investments becoming more mainstream, regulatory and legislative encouragement and interest by plan participants.³² Global trends appear to be all pointing in one direction when it comes to the incorporation of responsible investment practices into retirement plans, and for that reason, concerns over competitors not integrating responsible investment practices appear to be largely unfounded.



²⁸ United Nations Principles for Responsible Investment (2017). *Working Towards a Sustainable Financial System: Investment Consultant Services Review*. Available at: <https://www.unpri.org/download?ac=5167>. Page 3.

²⁹ SRI-CONNECT (2018). "Independent Research in Responsible Investment Survey 2017." Available at: https://www.sri-connect.com/index.php?option=com_content&view=category&layout=blog&id=201&Itemid=1827. NB: Free registration may be required to view results.

³⁰ United Nations Principles for Responsible Investment (2019). "Search Results." Available at: <https://www.unpri.org/searchresults?qkeyword=retirement&PageSize=10¶meters=WVSECTIONCODE%7C1018%2CWVFACET%7C77&cmd=ReplaceKeyword&val=retirement&SortOrder=3>.

³¹ Judy Faust Hartnett and Rebecca Moore (2018). "SRI Holdings in ERISA Plans Gaining Ground, but Concerns Remain." *Plan Sponsor*. Available at: <https://www.plansponsor.com/sri-holdings-erisa-plans-gaining-ground-concerns-remain/>.

³² PensionsEurope (2018). *PensionsEurope survey report on drivers of equity investments by pension funds*. Available at: <https://www.pensionseurope.eu/system/files/PE%20survey%20report%20on%20drivers%20of%20equity%20investments%20by%20pension%20funds%20-%20September%202018%20-%20FINAL.pdf>. Pages 7-8.

③ Common misconceptions and possible responses

The table below shows survey data for retirement plan sponsors in the United States regarding their inclusion of at least one “socially responsible” (a term that is undefined in the survey) fund in the plan lineup. Of particular note, the proportion of survey respondents across all industries that offered such a fund is far greater, at 8.4% than the

proportion of Fortune 1000 funds that responded to the survey, of which only 4.8% offered a socially responsible fund. In addition, while out of the broader cohort of all industries, the larger plan sizes (those over USD \$1 billion in plan assets) were more likely to offer a socially responsible fund, at 10.6%, the opposite was true among Fortune 1000 companies,

as funds over USD \$1 billion in plan assets were less likely to offer such a fund, at 3.8%, compared to 4.8% across all Fortune 1000 plan sizes. There may be many underlying reasons for these trends, however the clear finding is that there is significant room for growth among large retirement plans to offer additional socially responsible funds to participants.

Figure 3: DC plan investment offerings survey data

PLANSPONSOR SURVEY DATA ³³	ALL INDUSTRIES (N=4000)		FORTUNE 1000 (N=194)	
	Overall	>USD \$1B	Overall	>USD \$1B
Plan size				
% of plans offering a socially responsible fund ³⁴	8.4%	10.6%	4.8%	3.8%

CASE STUDY: PIRELLI NORTH AMERICA

Pirelli Tire LLC is a US subsidiary of WBCSD member Pirelli & C, a global tire manufacturer. As a perennial sector sustainability leader recognized by leading global indexes and third-party organizations, Pirelli has committed to continually enhancing its environmental, social and governance performance.

In 2015, Pirelli North America’s Public Affairs team began to recognize that offering an ESG option as part of the company’s defined contribution plan lineup could be an effective way to provide plan participants with enhanced retirement outcomes that reflect a longer term perspective on risks and opportunities. However, initial inquiries with the HR department, which were well-received, did not lead anywhere because the investment managers told HR representatives that there wasn’t an available “sustainability” option. Later, it became clear that there had been a “social responsibility” fund option available but that there was confusion between the terms “sustainability” and “social responsibility.”

The HR representative reported in 2015 and 2016 that the Defined Contribution Investment Committee was nevertheless looking into the request and had discussed it at quarterly meetings.

In the Fall of 2016, new committee members found that the committee, and its key service providers, were interested in the topic of ESG but not fully familiar with it, and a question was raised about whether there could be a trade-off between financial performance and ESG performance. The plan’s investment consultant agreed to do research, and returned to the committee with a complete report and comparative information on a passive sustainable equity strategy, as well as an ESG integrated active equity strategy. After considering fees and risks related to the relative concentration of the active equity strategy, the committee decided to add the passive sustainable equity strategy to the DC plan lineup in Q3 2017.

At the beginning of 2018, assets in the sustainable fund were at a low level, yet grew by 170% over the course of the year as the fund saw significant new allocation and re-allocation from participants, revealing strong demand for this sustainability-oriented investment option.

³³ PlanSponsor; 2019 Defined Contribution Plan Survey.

³⁴ PlanSponsor does not define

④

Methods for implementing a responsible retirement plan

Presuming that retirement plan fiduciaries have decided to incorporate responsible investment approaches into the retirement plan, what are the next steps?

④ Methods for implementing a responsible retirement plan

The following are suggested steps to take, based on successful engagements that the participants in this project have had in advising retirement plan fiduciaries on such matters. While these steps are laid out in a deliberate order, different plans will have different governance structures and/or third-party relationships, which may render certain steps redundant. Nonetheless, we believe that the steps outlined below will be applicable to the majority of retirement plans around the world.

A. Assess existing ESG resources (as applicable)

Retirement plans often have access to many different internal and external resources, some of which may have ESG-related capabilities and expertise that fiduciaries may not have taken advantage of previously. For example, retirement plans that have devoted significant resources to developing internal staff investment capabilities may not employ third-party investment consultants³⁵ to aid in investment manager selection processes and other aspects of retirement plan governance. It's possible that certain retirement plan staff may

have some interest or untapped expertise in ESG topics, but have not had the opportunity to demonstrate that expertise.

Other retirement plans may discover that the investment managers whose strategies they are invested in have ESG capabilities and guidance to offer plan fiduciaries. This is because many managers are rapidly developing their ESG expertise in response to market demand. While not strictly hired to perform such tasks, investment managers can frequently provide insights on ESG topics (or indeed, many other topics) based on their experiences, although many retirement plan fiduciaries may not be aware of such capabilities.

Finally, many other retirement plans engage a third-party consultant to aid in key elements of retirement plan activities, in particular, Investment Policy Statement (IPS) maintenance and the investment selection and monitoring process. Consultants are generally expected to be well-informed about investment managers and their products, as well as their particular capabilities; as such, consultants are typically a key source of information to investment committees, helping them balance risks

and opportunities in relation to various investment options. Many consultants also offer ESG-related capabilities to clients through retainers or project-based engagements.

As retirement plans generally have existing relationships with at least one of the resources noted above – internal expert staff, investment managers, and/or investment consultants – inquiring about those resources' responsible investment experience, tools and capabilities could be a worthwhile first step to take. If the resource offers some capabilities to draw upon, then retirement plan staff could request an educational session regarding the current retirement plan portfolio (for DB plans) or lineup (for DC plans) and potential areas for ESG incorporation that fiduciaries could consider.

If existing resources do not have robust responsible investment track records or resources, or appear resistant to engage on the topic, retirement plans can seek outside advice – specific to responsible investment topics or otherwise – from consulting firms for a fee, or issue RFPs/tenders to seek new relationships with resources with more advanced RI capabilities.³⁶

Figure 4: Steps toward retirement plan ESG incorporation



³⁵ While this paper refers to investment “consultants,” we recognize that the term investment “advisor” is frequently used synonymously, although typically in reference to retail investment relationships, rather than institutional investment relationships. As this paper is oriented toward institutions, we will use the term consultant.

³⁶ One possible source for assessing investment consultants' ESG capabilities is the 2017 Independent Research in Responsible Investment Survey, which (as of this writing) is being updated for 2019, and surveyed over 1,000 professionals working in responsible investment, corporate governance or other functions with insight into ESG practices from over 40 countries. The 2017 survey results can be found here: https://www.sri-connect.com/index.php?option=com_content&view=category&layout=blog&id=201&Itemid=1827.

④ Methods for implementing a responsible retirement plan

B. Assess plan fiduciaries' perspectives on ESG risks and opportunities

Retirement plan investment committee members tend to be selected to serve in a fiduciary role because of the experience or perspective they bring to the committee, and many tend to have relevant financial sector and/or human resources experience.

Given individuals in such roles likely have varying exposure to responsible investment topics, and may bring particular perspectives into such discussions, it can be helpful to hold an educational session for committee members to provide a common foundation to ensure consistency regarding ESG topics, definitions and implications in a retirement plan context.

Investment advisors can typically conduct such sessions during regularly scheduled committee meetings, presuming they have sufficient background in responsible investments.

Following the education session, a useful next step to engage retirement plan fiduciaries is to develop and issue a confidential survey regarding committee members' views on material long-term ESG risks and opportunities that the plan should actively consider in investment decisions. This survey could be administered through an online tool, or an in-person meeting, although the emphasis should be placed on gathering the views of individual fiduciaries in their roles governing the retirement plan, and therefore should be confidential or anonymous.

If administering a survey is not feasible or is otherwise undesirable, engaging committee members in a discussion around long-term risks and opportunities, and how such considerations are considered in the retirement plan's overall strategy (if at all) can result in useful guidance.

Some example topics for members to respond to include:

- Do fiduciaries believe that considering ESG factors in investment decision-making is aligned with fiduciary duty?
- Do fiduciaries believe that considering ESG information as part of the investment process can help identify material financial issues and can contribute to better risk adjusted returns?
- Do fiduciaries believe that investment stewardship – or proxy voting and engagement with investee companies – can enhanced corporate governance and long-term financial performance?
- Do fiduciaries believe that reputational issues or long-term financial performance considerations connected to certain investments present material risks, and should therefore be considered for exclusion from the investment portfolio? If so, what are those industry sectors or topics?

The plan advisor and/or staff should then aggregate all responses and analyze them for trends before presenting the results to the committee.

If fiduciaries indicate in the survey that the majority hold views about the materiality of ESG incorporation methods to investment performance, then considering how to integrate such perspectives into the committee's investment strategy would be a prudent next step.



④ Methods for implementing a responsible retirement plan

C. Update Investment Policy Statement to take ESG considerations into account

Presuming that the steps above have been completed, formally integrating the material ESG considerations identified by committee members into the retirement plan's Investment Policy Statement (IPS) will provide a framework to inform future investment analyses and both asset allocation (for DB plans) and/or investment manager selection processes (for DB and DC plans).

The Principles for Responsible Investment (PRI) published useful guidance to aid investment committees in considering responsible investment in their investment policies, including the following questions to consider as part of the policy development process:

- Does your organization have a comprehensive investment strategy which accounts for long-term trends? PRI's *Crafting an Investment Strategy*³⁷ guidance on investment strategy development highlights key aspects to consider.
- How does your organization view ESG factors? Are you conducting this review for risk-management purposes, to unlock new opportunities, or is it a combination of both?

- What is your rationale for updating your policy? And why now? Is it a best practice/regulatory requirement?
- What considerations must your policy include to meet your organization's investment strategy and objectives?³⁸

Crafting responses to these questions, ideally with help from an experienced advisor or consultant to guide the process, can provide useful support to the committee for drafting and adopting updates to the IPS that reflect ESG considerations. These policy updates will, in turn, provide specific guidance to investment managers and advisors regarding where the retirement plan deems ESG factors to be material for investment decision-making, clarifying expectations.

D. Evaluate current investment managers' responsible investment efforts

The responsible investment industry is growing significantly in the range of products and services that are available to investors. Between 2015 and 2017, over 100 different sustainable open-ended mutual and exchange-traded funds were launched in the United States,³⁹ and in 2018, over 290 sustainable funds were launched in Europe alone.⁴⁰

A recent report estimated that the global responsible investment market grew to exceed USD \$30 trillion in AUM in 2018, up from USD \$23 trillion in 2016.⁴¹ It's clear the responsible investment market is growing, dynamic and innovative across the world. In the face of this dynamism, many methods of analyzing the ESG quality of investment funds and issuers of securities (primarily publicly traded companies) are emerging.

i. Fund-Level ESG commitment and investment process

In order to evaluate the best course of action for aligning a retirement plan with responsible investment, a prudent first step for plan sponsors is to ask investment consultants or other resources about their capabilities for assessing investment managers' ESG approaches. Driven by growing client demand, numerous investment consultants are enhancing their research and capabilities around responsible investments, with ESG ratings of investment strategies being one approach that is being increasingly developed by consultancies.

In 2008, Mercer developed an integrated approach to rating investment strategies for how actively the strategy incorporates ESG factors and active ownership approaches into investment decision-making, to accompany the company's existing traditional

³⁷ A complete guide to investment policy development can be found in UNPRI's *Investment Policy: Process & Practice* document, available for download here: <https://www.unpri.org/download?ac=1605>.

³⁸ Principles for Responsible Investment (2016). "Getting started on an integrated investment policy." Available at: <https://www.unpri.org/asset-owners/getting-started-on-an-integrated-investment-policy/411.article>.

³⁹ Jon Hale (2018). *Sustainable Funds U.S. Landscape Report*. Morningstar. Available at: https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/Sustainable_Funds_Landscape.pdf. Page 7.

⁴⁰ Hortense Bioy (2019). *European Sustainable Funds: 2018 in Review*. Morningstar. Available at: http://images.mscomm.morningstar.com/Web/MorningstarInc/%7B-8f5366b4-9511-448e-9d19-6ae42c12c5e3%7D_2018_ESG_funds_review_final_.pdf.

⁴¹ Axel Pierron (2019). "ESG Data: Mainstream Consumption, Bigger Spending." Opimas. Available at: <http://www.opimas.com/research/428/detail/#>.

④ Methods for implementing a responsible retirement plan

ratings of the likelihood that the strategy would outperform its peers. Mercer then started to issue separate strategy ratings for both outperformance (A, B+, B, and C) as well as ESG integration, ranging from ESG1 – indicating that the strategy is a leader in the integration of ESG factors and active ownership into core processes – to ESG4 – indicating that the strategy offers little to no apparent ESG integration.

The ultimate goal of such a ratings approach is to offer a durable perspective regarding a manager's ESG integration approach that is relatively qualitative in nature, reflecting the manager's conviction in and implementation of ESG integration at the strategy level. However, if retirement plan fiduciaries do not have access to such ESG ratings, then evaluating strategies according to the following characteristics can be helpful for differentiating ESG integration approaches.

a. Idea generation and portfolio construction (active managers only): Has the manager made explicit efforts to identify and integrate ESG factors into active fund positions as a source of added value? Has the manager explicitly identified the ESG factors considered material to the strategy's performance, and how those factors are evaluated against other considerations? Do the key members of the strategy team – the portfolio manager and analysts, primarily – demonstrate skill and thoughtfulness in evaluating ESG factors and performing research to support investment theses? Where does the strategy team source its ESG data from to inform decision-making? Are the third-party data sources reputable as ESG data providers? Does the firm conduct any proprietary ESG research in-house, in addition to any third-party data providers? And does the firm have the human resources in place to support these efforts appropriately?

b. Active ownership and firmwide commitment (active and passive managers): Is the manager clear and transparent about perspectives and policies for engaging with investee companies and/or voting proxies on material ESG issues? Does the manager articulate a clear rationale for how such engagement practices fit into an integrated approach (in addition to fundamental ESG research) for enhancing shareholder value? Is it apparent that the investment firm, at a high level, supports such engagement activities through appropriate resource (human and otherwise) allocations? Does the manager indicate how the results of such active ownership efforts will be communicated to investors in a timely and transparent fashion, so that impacts can be tracked? Does the manager publicly participate in any national or international collaborative engagement efforts around ESG topics? Has the manager publicly endorsed any responsible investment pledges as a sign of commitment?

While the questions above are not exhaustive, they offer some guidelines for evaluating investment managers' ESG approaches and evaluating managers' styles and substance against each other in the absence of more formal strategy-level ESG ratings.



④ Methods for implementing a responsible retirement plan

ii. Issuer-level ESG research and ratings

While the ESG ratings approaches outlined above take a fundamentally “top down” approach to rating investment strategies, many ESG data providers offer some form of ESG ratings at the individual security level. This “bottom up” approach evaluates individual securities issuers (in this sense, referring to the companies or other entities that *issue* the underlying financial securities, whether stocks, bonds, or otherwise) on their ESG metrics, such as greenhouse gas emissions, fossil fuel reserves, or revenue derived from controversial business practices, and tallies

those metrics to produce ratings of an issuer’s exposure to ESG risks and opportunities typically adjusted by each industry sector. While both approaches offer fundamentally different views of ESG ratings, many practitioners believe that such ratings can offer deep insights if used in combination. For example, while an investment manager may claim to exclude investments in firearms from a particular strategy, using bottom up data from a third-party database can allow investors or advisors to screen a given portfolio for exposure to such issuers in underlying holdings. If any such holdings

are found, investors can use that data to engage with investment managers to understand why such investments were made, and how the manager intends to address the issue.

Issuer level ESG ratings also give investors an independent third-party view of the ESG quality of a given portfolio. If a manager claims to be taking ESG issues into account in its investment process as indicated by a fund level rating but the manager’s portfolio scores poorly on issuer level ESG characteristics, then some explanation for this mismatch may be sought.

FUND LEVEL ESG RESEARCH AND RATINGS	ISSUER LEVEL ESG RESEARCH AND RATINGS
<p>What does it measure?</p> <p>The quality of an investment manager’s ESG investment process as it relates to a given investment strategy.</p> <p>How is it developed?</p> <p>Through reviews of investment manager documentation and conversations with portfolio management staff.</p> <p>How can it be used?</p> <p>Identify quality ESG managers for related mandates.</p> <p>Identify manager alignment with best practices in ESG integration across asset classes.</p> <p>Identify manager alignment with investor goals and expectations on controversial issues.</p>	<p>What does it measure?</p> <p>The ESG quality of individual issuers of securities (ESG rating values can be aggregated for portfolios).</p> <p>How is it developed?</p> <p>Issuer research by specialized ESG research firms. Different methods of research are applied including the manual review of public documents by analysts to quantitative approaches using Natural Language Processing (NLP).</p> <p>How can it be used?</p> <p>Monitor portfolio exposure to controversial products/practices.</p> <p>Gather third-party views on exposure to ESG risks and track compliance with its ongoing mandate.</p> <p>Identify ESG opportunities.</p>
POWERFUL IN COMBINATION	
<p>Intent and implementation do not necessarily align</p> <p>Understand (un)intentional ESG tilts in portfolio</p> <p>Provide investors with supplemental ESG lens for manager selection, monitoring and engagement efforts</p>	

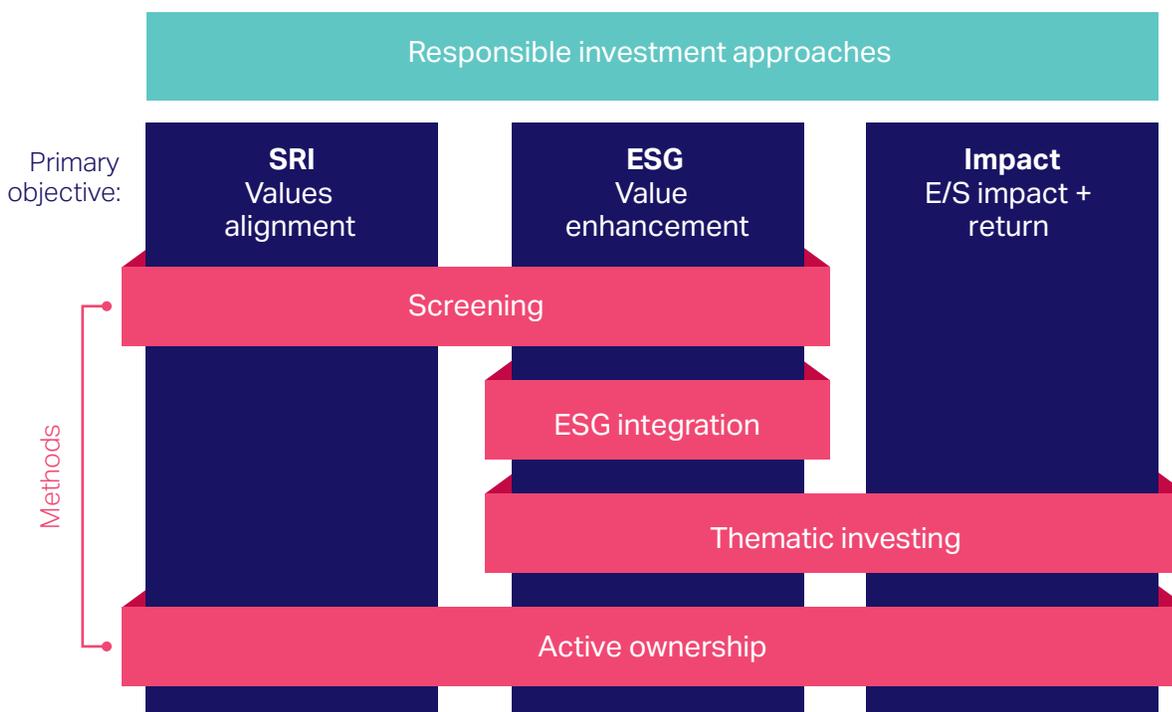
Source: Mercer

④ Methods for implementing a responsible retirement plan

E. Evaluate potential replacement or additional responsible investment managers

If an evaluation of the investment strategies currently used within either a DB plan portfolio or offered as part of a DC plan lineup reveals that the strategies don't offer the responsible investment profile that fiduciaries deem desirable, then explore the following key "next steps."

Figure 5: Responsible investment approaches and methods



Source: Mercer

i. Decide which responsible investment method(s) fund managers should employ

Retirement plans that engage with responsible investment have typically utilized investment approaches that take ESG factors into account to enhance value.

To the extent that ESG strategies expand on fundamental research to consider material non-financial factors from a risk and opportunity perspective, such approaches are typically viewed as being in alignment with fiduciary duty. This perspective of ESG integration aligning with fiduciary

considerations contrasts views of the investment constraints engendered by the exclusionary practices of SRI funds, as well as often illiquid and thematically oriented impact strategies, which are often seen as misaligned with fiduciary duty in many jurisdictions.

This being said, the same methods utilized by SRI and impact investors can be employed by ESG investors so long as the intent behind their implementation is to drive value enhancement for participants.

Using the responsible investment framework in the graphic above, it's possible to see that investment strategies following the "ESG" approach will draw upon all four responsible investment methods to varying degrees.

④ Methods for implementing a responsible retirement plan

The following summarize how these methods are used in practice by investment managers in ESG integration-oriented strategies.

Overview of responsible investment methods

a. Screening:

Negative screening: This type of screen excludes companies with a business involvement in activities or products with a perceived negative impact on society, such as firearms manufacturing, thermal coal mining/power production, tobacco product manufacturing or distribution, gambling, alcohol, animal testing or companies with poor records of ESG performance. While these decisions are most often driven by the ethical or moral considerations of investors, in some cases exclusions can be strategically utilized to avoid investment exposure to industries or companies that an investor perceives as being in long-term decline.

Positive screening: This method affirmatively *includes* certain stocks or bonds based on whether the underlying company has positive ESG characteristics, such as an overall high ESG score, the company's participation in a certain industry sector or other favorable characteristics desirable to the investor and/or beneficiaries. Positive screening typically indicates that an investor believes that such characteristics will help the company outperform over the long-term.

b. ESG integration: Investors using this method typically draw on ESG factors and data to expand upon their fundamental research, analysis and decision-making processes. In general, no sector or investment opportunity is automatically excluded from an ESG integrated portfolio. While ESG indicators are frequently used purely for risk management purposes, other investors use ESG factors as a fundamental aspect of idea generation and portfolio construction processes, as well as to help drive outperformance. Integrating ESG considerations can aid investors in making buy/hold/sell or overweight/underweight decisions.

c. Thematic investing: Thematic investment approaches focus on offering investors focused exposure to an explicit theme, which may have an environmental or social thematic focus. Such funds have proliferated in recent years, driven by the emergence of sustainability as a key societal and investment trend driving long-term growth and returns in incumbent and new industries. Within the governance arena, focus funds or activist funds can be seen as thematic. Socially-oriented thematic funds can often be found in microfinance, urban regeneration, property and social infrastructure projects. Environmental funds generally focus on renewable energy, energy efficiency or clean technology.

d. Active ownership: Also known as investment stewardship, active ownership is an investing method whereby investors seek to use their position as equity owners or as creditors to influence the behavior of investee companies. The most typical examples of this method are proxy voting and corporate engagement by investors. The aim of using the active ownership method is usually to bring a corporation in line with best practice in a particular area, and is most commonly used to improve corporate governance standards, as well as to better understand a company's fundamental business risks and opportunities related to ESG issues. When used in combination with other responsible investment approaches, active ownership should better align the time horizon and interests of the corporation with that of its long-term investors.

It's important for retirement plan fiduciaries to understand how managers employ these responsible investment methods to varying degrees within prospective replacement investment strategies, to ensure that fiduciaries are comfortable with the overall investment strategy.

④ Methods for implementing a responsible retirement plan

ii. DB plan potential action: shift allocations to responsible investment managers

Once DB plan fiduciaries have determined their areas of ESG emphasis and evaluated the ESG capabilities of current managers, they can determine plan allocations to such strategies and managers. This may require a reallocation among current managers and/or a formal search for new strategies or managers. If the plan is using an investment consultant, the consultant can handle the search process. If no assistance is available, then following the series of questions in sections 4A and 4B can aid in assessing potential managers and their strategies across responsible investment parameters.

iii. DC plan potential action: add responsible investment managers or replace existing managers in lineup

Similar to DB plan next steps, DC plans that have decided to add a responsible investment option(s) to add to the existing plan lineup may seek to have an investment consultant conduct a search on their behalf. As will be discussed in the next section, portfolio construction implications of how such plan options are added are quite important to consider, as there may be fiduciary and/or regulatory considerations to consider.

For example, in some jurisdictions, it may be most prudent to add one or more ESG-aligned options to the lineup, while maintaining the existing lineup, in order to offer plan participants a larger selection of both ESG and traditional investment options. Replacing existing traditional strategies with ESG aligned options may be viewed by regulators in some jurisdictions as reducing participant choices in a manner that is not consistent with fiduciary duty. For these reasons, it may be a good “rule of thumb” to offer more choices, rather than fewer, when it comes to adding ESG funds to DC plan lineups.

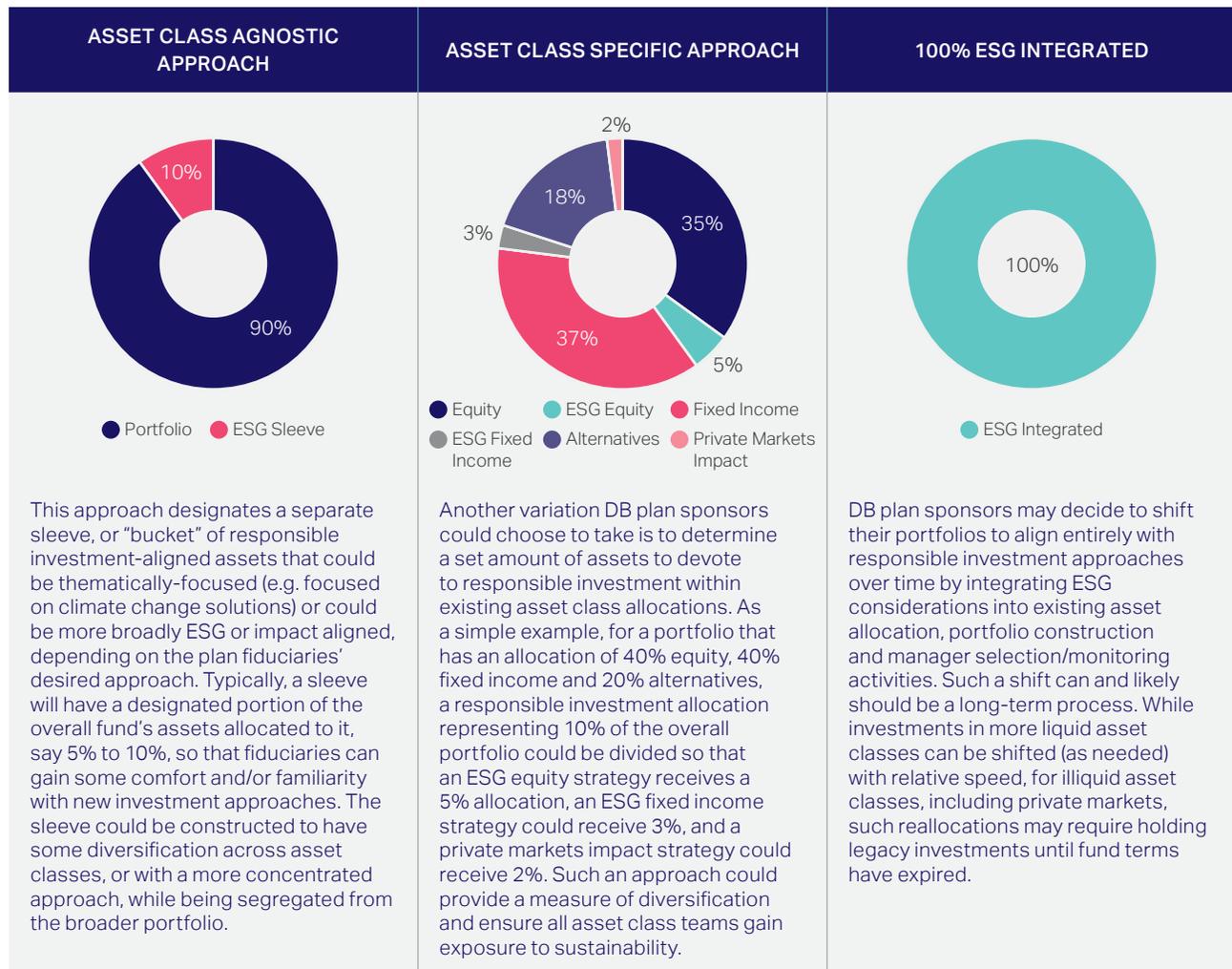


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F. Evaluate portfolio implications

Once a retirement plan shifts toward responsible investments, how the new strategies fit within the existing portfolio construction is highly important, and there are a range of options both DB and DC plans can consider.

Figure 6: DB plan responsible investment asset allocation options



The option set described in this table is not exclusive. Other options for ESG incorporation into portfolios may be available for plan sponsors to pursue.

i. DC plan – Add one ESG option, an ESG tier, or an ESG lifecycle⁴² default (e.g. a target-date fund)

DC plans have three primary options for responsible investment incorporation into their plan lineups. The representative DC plan structure diagram below illustrates how each option could

be integrated into an existing DC plan, with the colors and numbers corresponding to the different options in the diagram. Different global jurisdictions and regulatory systems will allow for varying

degrees of divergence from the representative diagram below, however the goal of this graphic is to highlight three primary ESG incorporation options for plan fiduciaries to consider.

⁴² Lifecycle funds are related to target-date funds, as according to Investopedia, both “are a type of asset-allocation mutual fund in which the proportional representation of an asset class in a fund’s portfolio is automatically adjusted during the course of the fund’s time horizon. The automatic portfolio adjustments run from a position of higher risk to one of lower risk as the investor ages and nears the fund’s utilization date.” Investopedia (2017). “Life-Cycle Fund.” Available at: https://www.investopedia.com/terms/l/life_cycle_funds.asp.

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OPTION #1: ADD ONE ESG OPTION	OPTION #2: ADD AN ESG TIER	OPTION #3: ADD AN ESG DEFAULT OPTION	
Potential DC plan structure considerations (representative example)			
Tier I Default/lifecycle option "Do it for me"	Tier II Passive core options "Help me do it"	Tier II Active core options "Help me do it"	Tier III Specialty options "Leave me to it"
Default option (target date funds/ lifecycle strategy)	Diversified fixed income	Capital preservation	Specialty funds
		Diversified fixed income	
	Large cap equity	Real assets/inflation protected	#1: Sustainability themed fund [global equity]
		Large cap equity	
#3: ESG default option	Small/mid cap equity	Small/mid cap equity	#2: Global sustainable equity index
			#2: Global sustainable fixed income index
	International equity	International equity	#2: Global sustainable equity
			#2: Global sustainable fixed income
<small>Copyright © 2019 Mercer (US) Inc. All rights reserved. The option set described in this table is not exclusive. Other options for ESG incorporation into portfolios may be available for plan sponsors to pursue.</small>			
<p>Add one ESG option: Plan sponsors frequently choose to add a single ESG aligned option to the existing plan lineup. This approach could be a way to "test the waters" of offering plan participants an ESG fund while not overwhelming them with too many options.</p> <p>The emerging best practice for offering one ESG fund option is to select a fund that offers broad diversification – likely a global equity fund option – as the experiences of some plan sponsors has shown that some participants choose to make significant allocations to the ESG option in the plan lineup. In order to offer such participants some risk diversification if the plan will only offer a single ESG fund, offering a global strategy aligns well with fiduciary duty considerations.</p>	<p>Add an ESG tier of options: For plan sponsors who wish to offer participants a range of ESG strategy options in addition to existing plan options, selecting a number of strategies that allow participants to effectively diversify their ESG investments is a strong practice.</p> <p>For example, one approach could be to offer a global active equity fund, a global passive equity fund and a fixed income fund (perhaps with a regional focus oriented to the plan sponsor's jurisdiction). As with other fund selection processes, close attention should be paid to managers' differentiating factors regarding their ESG research and decision-making processes, as managers have adopted a range of approaches within the active global equity universe, for example.</p> <p>While there are a growing range of ESG aligned funds available in different asset classes, it may not be possible for fiduciaries to construct an ESG tier that directly mirrors the existing DC plan options, and so some compromises may be necessary.</p>	<p>Add an ESG default fund: Some investment managers have developed suitable default fund options that integrate ESG factors into the security selection and portfolio construction process, with the underlying idea that ESG incorporation will aid in generating long-term returns while reducing risks from financially relevant ESG factors. Different jurisdictions have taken a range of views regarding whether ESG funds can be chosen as the default option for plan participants. As noted earlier, the United States Department of Labor issued a guidance document declaring that an ESG-themed default fund could be designated as a default option only if the risk/return prospects of the fund are equivalent to or better than non-ESG alternatives. Other regulators, notably in the UK,⁴³ have not raised such considerations, however plan sponsors seeking to designate an ESG fund as a default option may anticipate needing to demonstrate evidence of expected risk and return outperformance as a measure of alignment with fiduciary duty.</p>	

⁴³ Susanna Rust (2016). "HSBC UK pension scheme adopts climate 'tilted' fund as DC default." *IPE*. Available at: <https://www.ipe.com/news/esg/hsbc-uk-pension-scheme-adopts-climate-tilted-fund-as-dc-default/www.ipe.com/news/esg/hsbc-uk-pension-scheme-adopts-climate-tilted-fund-as-dc-default/10016045.fullarticle>.

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For the options noted above, retirement plans of sufficient size are able to work with investment managers to develop customized solutions which integrate ESG considerations to the plan sponsor's desired amount.

ii. Monitor manager ESG performance regularly

Once the portfolio or plan lineup has been altered to incorporate responsible investment principles, monitoring managers' ESG performance to ensure alignment with stated strategy goals is an important exercise that should be conducted regularly. As with the other process steps outlined above, investment consultants can typically aid in this process, which can be conducted as part of annual (or more frequent) performance reviews.

Consultants may have their own resources which they can bring to bear to support ESG performance monitoring, though as an alternative, sponsors may be able to rely upon managers' responsible investment and/or impact reports regarding their ESG efforts as the basis for discussion. If such reports are not available, then analyzing a manager's holdings and/or proxy voting records and policies can provide useful indicators of the fund's actions. If it is uncovered that managers have made investments, or have cast proxy votes, that appear to be out of alignment with the declared ESG priorities of the strategy, then engaging with the manager to understand their decisions on these issues will help ensure that plan participants' interests are being upheld appropriately.

G. Communicate responsible investment changes to plan participants

Once changes have been made to the retirement plan portfolio or lineup, informing participants is an important aspect of ensuring that the responsible investment changes – and the rationale behind those changes – are understood by participants who may wish to take advantage of them. DB and DC plans have differing considerations for educating plan participants, which we will outline below.

A common question for plan fiduciaries of both DB and DC plans to consider is whether retirement plan communications should move in one direction only – from plan sponsor to plan participants – or if they should be a two-way dialogue be established. Such questions have primarily been raised in the UK and European Union, while retirement plan participant engagement has been a particular

feature of pensions in Denmark and the Netherlands, where plan participant representatives hold fiduciary positions (although the practice of plan participants or beneficiaries holding fiduciary positions is by no means exclusive to those countries).⁴⁴

The aforementioned 2018 UK Department of Work and Pensions consultation on trustees' investment duties had originally indicated that pension plan trustees *must* take account of plan participants' views through surveys or other means. However, after concerns were raised by many stakeholders in the public consultation process, the language was clarified to *allow* trustees to take account of participants' views on non-financial or other matters, but are not required to do so.⁴⁵ Similar regulatory discussions regarding participant engagement are not being held widely in the U.S..



⁴⁴ EY (2017). *Investing in a sustainable tomorrow: ESG integration in European pensions*. Available at: [https://www.ey.com/Publication/vwLUAssets/ey-investing-in-a-sustainable-tomorrow/\\$FILE/ey-investing-in-a-sustainable-tomorrow.pdf](https://www.ey.com/Publication/vwLUAssets/ey-investing-in-a-sustainable-tomorrow/$FILE/ey-investing-in-a-sustainable-tomorrow.pdf). Page 13.

⁴⁵ UK Sustainable Investment Forum (2018). "Policy update: DWP clarifies trustees' fiduciary duties in law." Available at: <http://uksif.org/wp-content/uploads/2018/09/FidDutyDWP-2018MemberBrief.pdf>.

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i. DB Plans

As DB plan sponsors bear virtually all investment risks the necessity of with communicating responsible investment plan changes to participants is commensurately lower than for DC plans. Depending on the current level of communication with plan participants, descriptions of the responsible investment changes the plan has made could be integrated into regular plan communication documents, or included as a special section or insert, describing what responsible investment is, why the plan has decided to adopt these changes, and what it means for individual plan participants. Regardless of how DB plans communicate responsible investment plan changes to participants, it is important to have any communications reviewed by legal counsel before distribution.

ii. DC Plans

Given that plan participants bear virtually the entire investment risk in DC plan structures, participant communications are far more important, and can receive greater regulatory scrutiny as to whether they are aligned with fiduciary duty. A particular consideration of DC plan sponsors is how to communicate the unique features and investment theses underlying responsible investment options added to DC plan lineups while not appearing to *favor* those funds over other investments available in the plan. A potential approach to overcome such considerations is to offer plan participants ESG educational information as one component of broader “financial wellness” educational literature.

Most ESG investment managers produce additional literature on a quarterly or annual basis that provides thought leadership or additional information regarding the manager’s ESG approach and results. Another potential approach is to make ESG investment manager literature (e.g. sustainability or impact reports) available to participants in addition

to traditional fund literature. This will help participants understand the broader considerations that such funds take into account compared to more traditional investment options. Additionally, as ESG incorporation efforts progress, plan sponsors may wish to make the ESG portfolio characteristics of lineup funds available to participants alongside historical financial performance information, which is usually made available to participants at the point of investment selection.

While ESG investment practices have been steadily growing in popularity for many years, much of that growth and investment activity has occurred outside of retirement plans, and as a result, retirement plan participants have not been able to invest their assets in accordance with their views. We hope that this Toolkit, in addition to the first Toolkit in this series, provides useful guidance for fiduciaries and plan administrators in considering how they might integrate ESG factors and considerations into their retirement plans in the near future.



CASE STUDY: BLOOMBERG, L.P.

As a global business and financial information and news leader, innovation is at the core of Bloomberg's business model, driven by a set of principles established by its founder, Michael Bloomberg.

In line with Bloomberg's broad offering of ESG data and tools on the Terminal, the company signed on to PRI as a service provider in 2009. Becoming a PRI signatory emphasized the firm's commitment to support their clients' implementation of the Principles by providing and developing respective services.

In 2015, Bloomberg's Investment Committee worked with Mercer, the DC plan's consultant, to perform a search for an ESG-driven investment option to add to their plan lineup. The search came in response to requests from some of the company's key stakeholders, particularly millennial employees seeking sustainable investment options as part of their retirement planning.

Four investment managers presented their strategies for plan inclusion, and the committee selected U.S.-based Parnassus Investments to offer their U.S. Core Equity fund to Bloomberg retirement plan participants.

In late 2017, the committee voted to sign the PRI as a plan sponsor, making Bloomberg the first U.S.-domiciled corporate plan sponsor to sign the initiative.

In accordance with the plan's pledge, the committee incorporated a specific section on ESG integration into its Investment Policy Statement.

Bloomberg's Investment Committee continues to explore opportunities to not only meet its fiduciary duties and fulfill its reporting obligations to the PRI, but to further advance the practice of considering ESG factors in retirement plans.



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Please note that data published in this report reflects knowledge up to March 2019.

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