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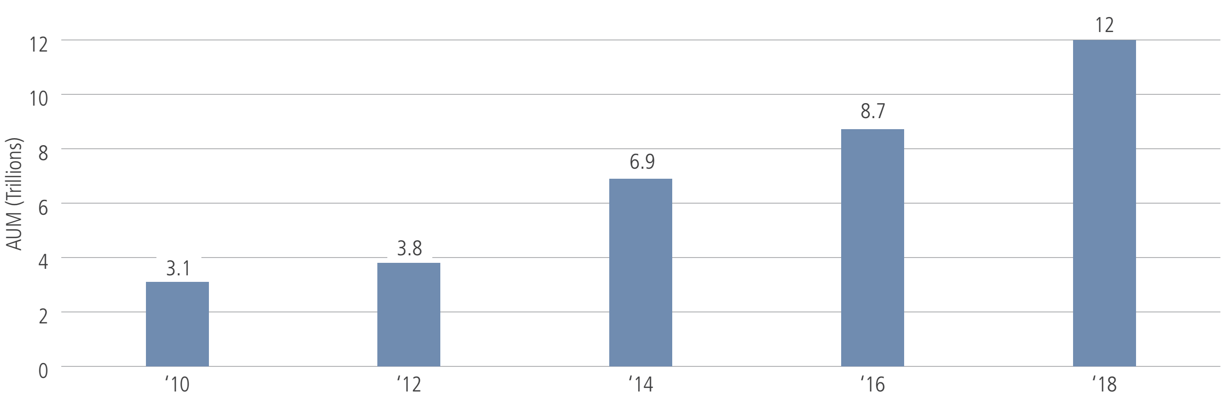
ESG and DC: Perfect Together

Adding active ESG-integrated options to a diversified menu may provide an attractive risk/return profile and help engage more participants.

Fund strategies that incorporate Environmental, Social and Governance (ESG) factors into their investment processes are gaining increased interest on the part of defined contribution participants, but many sponsors remain unconvinced about their potential value, especially in light of the trend toward simplification of plan menus. Here are three ideas we believe are worth considering as you assess the whys and hows of ESG inclusion in your plan menu.

ESG INVESTING CONTINUES TO GAIN TRACTION



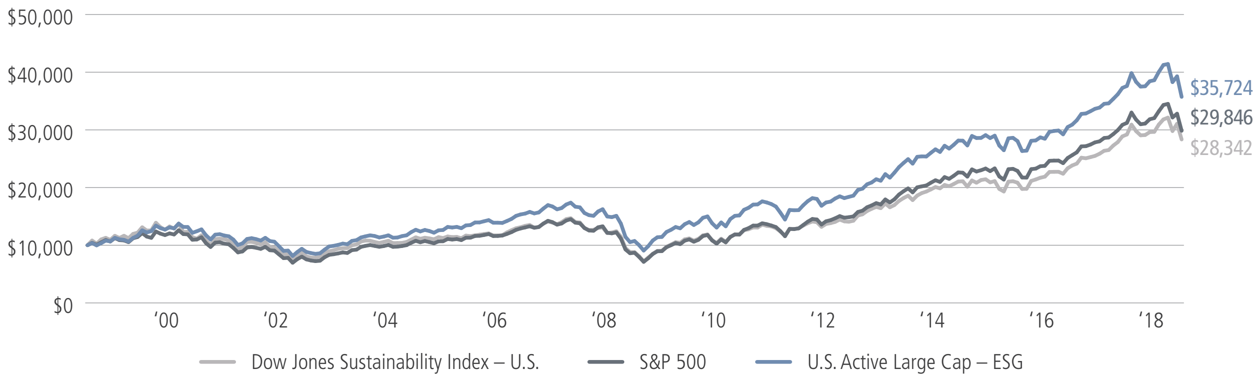
Source: Forum for Sustainable and Responsible Investment (US SIF Foundation) Report on Sustainable, Responsible and Impact Investing Trends 2018.

1. ESG options may augment existing plan options with favorable risk/return and potential benefits for the employer and participants.

Evidence is growing that investment strategies that integrate ESG considerations into the fundamental investment process may positively impact a company's profitability. In other words, investing in ESG strategies may provide competitive long-term risk-adjusted returns, as reflected in the display below.

ESG STRATEGIES CAN DELIVER ATTRACTIVE LONG-TERM PERFORMANCE

Growth of $10K – Since Inception of the Dow Jones Sustainability Index (January 1, 1999)



Source: Morningstar. As of December 31, 2018. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principle. Past performance is no guarantee of future results.

Many companies have built brands that are consistent with responsibility as to environment, social and governance issues. Offering plan investment options in line with such standards may reinforce the companies' reputations. More concretely, offering ESG strategies as plan investment options may provide traction for engagement on the part of participants, as discussed below in point 2.

Plan sponsors often ask how to best incorporate ESG strategies into a retirement plan. While there are a variety of ways, we believe that offering standalone ESG options alongside non-ESG strategies can provide optimal choice for participants while avoiding the risk of diluting a menu for those who may not be interested in ESG disciplines.

2. ESG provides a way to engage millennial and other interested employees.

Millennials, born 1982 – 2000, make up more than one-quarter of the U.S. population and, with 83.1 million members, outnumber baby boomers (at 75.4 million). Many millennials believe businesses can do more to address society's challenges in the areas of climate change and resource scarcity; some even say that the primary purpose of businesses is to improve society.

90% | of millennials want sustainable investing options as part of their 401(k) plans.

Source: Morgan Stanley Institute for Sustainable Investing, "Sustainable Signals", August 7, 2017.

Introducing ESG options into a plan may capitalize on this interest and help to rectify an ongoing issue with millennials: chronic under-participation in and disengagement from retirement savings plans. Women are also considered receptive to ESG considerations in making investment choices. As women take more ownership over their financial lives, their interest could also help support broader plan participation.

3. Actively managed ESG provides additional opportunity in today's environment.

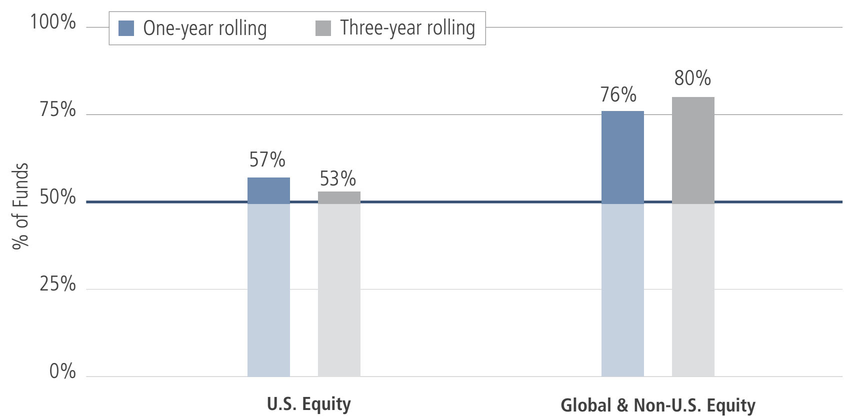
Plan sponsors often look to passive strategies first as a low-cost option. And while this is an understandable instinct it also comes with some pitfalls. Passive strategies typically employ broad, simplified ESG screens that rely heavily on voluntary company disclosure, and may be backward-looking and limited in scope.

Active ESG strategies, on the other hand, often employ multiple sources of research and data to identify relevant ESG considerations and fundamental issues that could affect both ESG and overall return objectives. Active managers may capitalize on deep knowledge of companies, business practices and industries in making investment decisions. They may also play a key role in engaging with company management around ESG and other factors that could influence results over the long term.

In our view, the benefits of active management are clear when it comes to ESG performance. Over rolling one- and three-year periods since 1999, active ESG strategies have beaten their passive counterparts after fees more than 60% of the time across market capitalization ranges and geographies.

ACTIVE ESG EQUITY INVESTMENT HAS BEEN MORE SUCCESSFUL THAN PASSIVE OVER MARKET CYCLES

Percentage of Time in Which Active ESG Equity Strategies Have Beaten Passive Ones After Fees, January 1999 through December 2018



Cumulative excess return over the past 20 years

34.81%

Active U.S. Equity

110.30%

Active Global & Non-U.S. Equity

Source: Morningstar. Morningstar category net average annualized return covering 229 (rolling one-year returns) or 205 (rolling three-year returns) time periods (January 1999 through December 2018). Weighted averages are based on the number of socially conscious ETFs, passively managed open-end U.S.-domiciled funds and actively managed open-end U.S.-domiciled funds with one- or three-year track records as of December 31, 2018, including funds that have been liquidated. Performance is based on funds' oldest share class. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

Final Thoughts

As ESG investing becomes more mainstream, plan sponsors are gaining access to a greater variety of investment options to meet participant needs. Active ESG-integrated investments provide a way to connect participants' sustainability preferences with the plan's investment options while still focusing on providing strong investment returns. As with all other plan investment options, plan fiduciaries need to make sure they follow their IPS and be careful to document all of their decisions. It is important to be thoughtful in understanding available ESG strategies, the credibility of their investment processes and track records, and the tenure of investment personnel when evaluating them for plan lineups.

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