WHITE PAPER

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# ESG IN DEFINED CONTRIBUTION PLANS

February 2020
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Environmental, Social and Governance (ESG) investing is garnering attention in Defined Contribution (DC) Plans due to participant demand. As a result, Plan Sponsors are evaluating the ESG landscape and available investment options. To ensure a thorough evaluation, we recommend taking the following four steps: Define, Approach, Implement and Measure.

ESG investing has been evaluated and widely discussed among nonprofits for over a decade. Now, we're seeing heightened interest in DC plans, driven by demand from participants.

Here we create a blueprint for Plan Sponsors to follow when evaluating ESG investing in a DC Plan.

## CURRENT STATE OF THE DC ESG MARKETPLACE

The most efficient method to study the ESG landscape is to look at the current levels of investment, peer practices and steps to prepare for action.

- **Assets Invested.** Assets in ESG investments rose to $12 trillion in 2018, up from $8.7 trillion in 2016[1]. ESG funds saw $5.5 billion of net flows in 2018, the third consecutive year of record net flows.[2]

- **Peer Practices.** A recent study by PIMCO tops the list of additional recommended core strategies to add to a DC investment program[3]. And, as many as 20 percent of Vanguard clients, with over 1,000 participants, offer an ESG fund[4]. While Plan Sponsor adoption has increased, we have yet to see an increase in participant utilization.

## STEPS TO PREPARE FOR ACTION

We encourage Plan Sponsors to think of ESG investing as a four step process: Define, Approach, Implement and Measure.

1. **DEFINE.** ESG covers topics that range from climate change and carbon usage to human rights and religious beliefs. The graphic below helps define the area(s) of focus within ESG.

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[1] US|SIF 2018 Report on US Sustainable, Responsible and Impact Investing Trends
[2] Morningstar- Sustainable Funds Landscape | February 2019
[3] 2019 PIMCO Defined Contribution Consulting Survey
[4] Vanguard, "How America Saves" (2019)

| ENVIRONMENTAL | SOCIAL | GOVERNANCE |
| --- | --- | --- |
| Energy Efficiency | Labor Standards | Shareholder Rights |
| Biodiversity/Land Use | Working Conditions | Transparency |
| Climate Change | Human Rights | Board Structure |
| Water Scarcity | Diversity | Data Security |

Although clients may have different ESG priorities, Plan Sponsors can define the area of focus by looking at their company's ESG efforts and emulate them within the DC Plan.

The United Nations launched 17 Sustainable Development Goals (SDGs) in 2015. The SDGs provide *a shared blueprint for peace and prosperity for people and the planet, now and into the future*[5]. Increasingly, investment managers are adopting these SDGs as a framework for measuring the ESG impact of their portfolio companies. Therefore the SDGs help define the focus for ESG investments within a DC Plan.


[5] Sustainable Developed Goals Knowledge Platform: https://sustainabledevelopment.un.org/sdgs

2. **APPROACH** – Once a Plan Sponsor has defined the area(s) of focus within ESG, it is important to understand the investment approaches available and which is best suited for the DC plan. Four approaches are cited below.

Exclusion and Integration approaches work well within DC plans. An exclusionary approach is best geared toward investors who have a clear and distinct area of focus; whereas integration is better suited for investors looking to create a positive effect through their investments. Proxy voting is effective only when a DC plan has sufficient assets to utilize separate account managers in lieu of mutual funds. In these larger plans, we encourage clients to utilize a third-party firm to vote proxies in line with the ESG policy on behalf of the DC Plan. It is also important to review the cost of these services.

Impact investing is often done in private investment structures and may not be an appropriate approach within smaller DC plans given the illiquidity and higher fees associated these structures.

## THE MISSION-ALIGNMENT DECISION

**EXCLUSION:** The exclusion of sectors or individual securities that are counter to an individual's defined values

**INTEGRATION:** A combination of exclusion and inclusion helping to remove the "bad actors: and emphasizing the "good actors".

**PROXY VOTING:** Exercise your right as an owner by voting your proxies in accordance with your proxy voting guidelines.

**IMPACT INVESTING:** Targeted investment in companies or funds, often private, intended to generate social or environmental impact alongside financial return.

3. **IMPLEMENT** – After narrowing the area(s) of focus and approach to ESG investing, we recommend the following steps to implement ESG in a DC plan:

   **A. Make decisions through the lens of a fiduciary.** The first step is to ensure the Committee considers the philosophy and process for ESG investments. ESG mandates can take different forms, so the Committee should perform a thorough evaluation of active versus passive approaches and the screening process employed by each manager. This should be done in tandem with the overall design of the investment menu and vehicles available to the DC Plan and comply with guidance from the Department of Labor which states returns should not be sacrificed for social policy goals[6].

B. **Explore how ESG can be incorporated into the Investment Policy Statement (IPS).** We recommend discussing with your ERISA counsel any changes needed to the IPS when implementing ESG investing in a DC Plan. This will help ensure all fiduciary considerations are accounted for.

C. **Add a dedicated ESG offering**. Engage the Plan's recordkeeper to add the dedicated ESG mandate to the investment lineup. When an ESG offering is added, to promote participant awareness, we recommend a review of participant communication and education materials.

4. **Measure**- As with any DC Plan option, it is important to monitor both quantitative and qualitative metrics to evaluate a manager's performance. Performance should be measured against a broad based benchmark as opposed to a narrow set of metrics. For example, we suggest the evaluation of the performance of an active U.S. large cap growth fund with an ESG focus against the Russell 1000 Growth® Index and other ESG and non-ESG large cap growth peers.[7]

Increasingly, ESG investing is gaining traction from Plan Sponsors, participants and investment managers. It can be integral in a DC Plan's investment menu and the four steps process of Define, Approach, Implement and Measure discussed here allow a Plan Sponsor to employ a thoughtful, thorough and prudent process.

If you have any questions and want further the conversation on ESG in your DC Plan, please contact any of the professionals at DiMeo Schneider & Associates, L.L.C.

[6] Field Assistance Bulletin No. 2018-01
[7] In addition, ESG funds are starting to publish annual reports that quantify the positive impact created by their portfolio companies. While the data in these reports can be useful to assess the success of ESG manager, it is important to remember that this information is self-reported.

About the Authors:

Based in Texas, Kevin oversees the firm's consulting and new business efforts in the southern region. Kevin services institutional clients by providing advice and counsel on all areas of fund oversight, including investment policy, asset allocation, menu design, manager research and selection, portfolio structure, performance monitoring and overall investment management. Prior to joining the firm in 2019, Kevin was a Partner and DC Client Practice Leader with Aon Hewitt and predecessor firm EnnisKnupp. He holds an MBA from New York University's Stern School of Business and a Bachelor of Commerce degree in Finance from the Odette Business School at the University of Windsor. Kevin is CFA® charterholder, a member of the CFA Society of Austin and previously served as President and Treasurer of the CFA Society of Chicago. Kevin is a founding member and previous member of the Executive Committee of the Defined Contribution Institutional Investment Association (DCIIA) and currently serving on the leadership team of the Investment Policy and Design committee as we enter 2020. He has been a guest lecturer at DePaul and Northwestern University, was the previous President and Treasurer of the CFA Society of Chicago and for several years graded the CFA examination. Kevin previously served in the Canadian Navy (reserve) and Presbyterian World Service. In his free time, he enjoys tennis matches with his wife, working around his ranch and as a native Canadian, poutine. Kevin has 29 years of industry experience.

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