

Adding Sustainable Funds to Defined Contribution Plans

A RESOURCE GUIDE FOR PLAN SPONSORS



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About the Publisher

The US SIF Foundation, a 501(c)(3) organization, undertakes educational and research activities to advance the mission of US SIF: The Forum for Sustainable and Responsible Investment, the leading voice advancing sustainable investing across all asset classes. Both US SIF and the US SIF Foundation seek to ensure that environmental, social and governance impacts are meaningfully assessed in all investment decisions to result in a more sustainable and equitable society.

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Five Steps to Add Sustainable Funds to Your Plan

This step-by-step guide assists plan sponsors considering the addition of sustainable funds to defined contribution (DC) retirement plans.

Several surveys in recent years have revealed that interest in sustainable investing is strong in the United States.

In 2019, [Morningstar](#) conducted a survey of a nationally representative sample of 948 adults. Seventy-two percent of those surveyed had at least a moderate interest in sustainable investing, and 21 percent could be classified as “sustainability-driven.”¹

Also in 2019, the [Morgan Stanley’s Institute for Sustainable Investing](#) surveyed 800 individual active investors and found that 85 percent were interested in sustainable investing and 86 percent believed that companies with good environmental, social and governance (ESG) practices were better long-term investments. Of Millennials, defined as those of 18 to 32 years of age, 95 percent expressed interest in sustainable investing.²

The findings of a 2019 survey by [Natixis Global Asset Management](#) of 1,000 US employees participating in defined contribution plans also found a strong interest in sustainable investing: 75 percent said it was important to make the world a better place while growing their wealth, and 61 percent said including sustainable funds would make them more likely to contribute to their plan.³

However, sponsors of private sector retirement plans are only beginning to meet this demand. An analysis for the US SIF Foundation by ISS Market Intelligence’s BrightScope platform of the 58,590 401(k) plans totaling \$4.5 trillion that disclosed their investment menu found that 11,488—

fewer than one-fifth—had assets in funds that Brightscope considered “Socially Conscious” based on the fund’s investment strategy as described in its prospectus.⁴

In the last several years, more data has emerged on the competitive financial performance of sustainable funds. In 2015, the US Department of Labor, responsible for enforcing the Employee Retirement Income Security Act (ERISA), gave the green light, with certain caveats, for fiduciaries to consider ESG factors as part of investment analysis. These developments are detailed in this report.

The steps outlined in this guide will assist you, the sponsor, in creating a due diligence process for the review, consideration and addition of a sustainable fund to your DC plan.

STEPS TO ADD SUSTAINABLE FUNDS TO YOUR DC PLAN

- STEP 1** Increase your knowledge of sustainable investing and related performance and fiduciary questions
- STEP 2** Gauge participants’ interest in adding sustainable funds
- STEP 3** Discuss implementation with your consultant and/or plan administrator
- STEP 4** Choose a fund or funds and monitor performance
- STEP 5** Educate participants

¹Morningstar, “Are Your Clients ESG Investors? Looking past stereotypes to understand who are today’s ESG investors,” April 22, 2019.

²Morgan Stanley Institute for Sustainable Investing, *Sustainable Signals: Individual Investor Interest Driven by Impact, Conviction and Choice*, (2019).

³Natixis Global Asset Management, *Retirement Reality Check: A Generational Look at Defined Contribution Plan Participation* (2019).

⁴US SIF Foundation, *Report on US Sustainable and Impact Investing Trends 2020* (2020), p. 61.

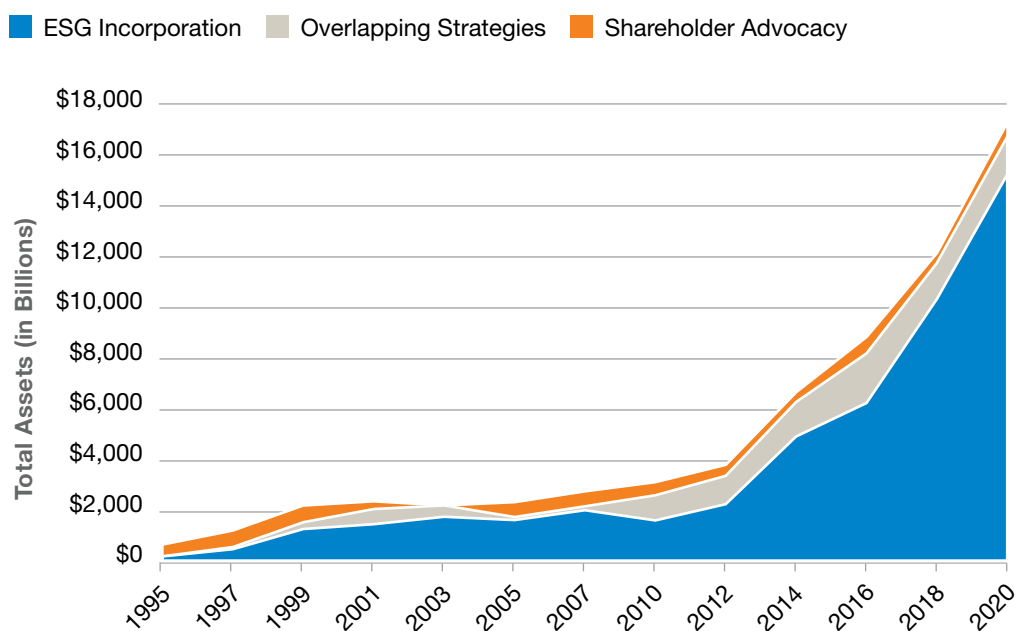
STEP 1: Increase your knowledge of sustainable investing and related performance and fiduciary questions

The total US-domiciled assets under management using sustainable strategies grew to \$17.1 trillion by the start of 2020, an increase of 42 percent from \$12.0 trillion at the start of 2018. These assets now account for one out of every three dollars under professional management in the United States. See Figures 1 and 2. Sustainable investing can be broken down into two main strategies:

- ESG incorporation—the consideration of environmental, social and corporate governance (ESG) criteria in investment analysis and portfolio construction
- Shareholder engagement—a proactive proxy voting policy on ESG issues, filing or co-filing shareholder resolutions, or communicating with portfolio companies on ESG issues

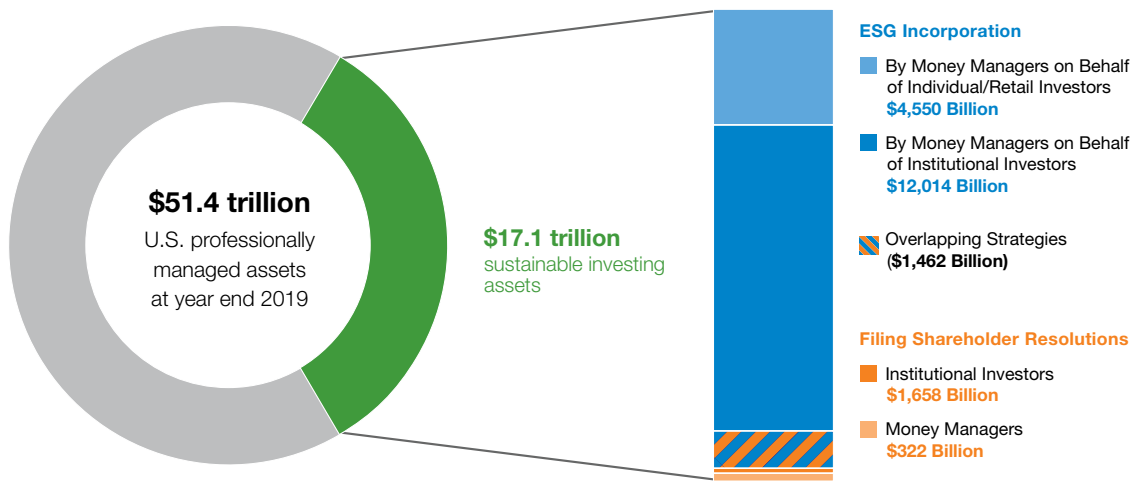
The individuals, institutional asset owners and money managers that practice sustainable investing seek to achieve long-term competitive financial returns. Some investors embrace sustainable strategies to manage risk and fulfill fiduciary duties; many also seek to help contribute to advancements in social, environmental and governance practices, including the UN Sustainable Development Goals. Sustainable investing strategies can be applied across all asset classes to promote stronger corporate social responsibility, build long-term value for companies and their stakeholders, and foster businesses or introduce products that will yield community and environmental benefits. See Figure 3 for examples of ESG criteria.

Figure 1. Sustainable Investing in the United States 1995–2020



SOURCE: US SIF Foundation.

Figure 2. Size of Sustainable Investing Assets 2020



SOURCE: US SIF Foundation.

PERFORMANCE STUDIES: Sustainable investing does not mean giving up financial returns. Numerous studies have concluded that there is not a performance cost to sustainable investing, on a risk-adjusted basis.

According to Morningstar’s 2021 [Sustainable Funds US Landscape Report](#), “[s]ustainable funds comfortably outperformed their peers in 2020, especially equity funds.” The returns of 69 percent of sustainable funds ranked in the top half of their Morningstar Category, and 37 percent in the top quartile returns. Morningstar categorizes group funds, both sustainable and conventional, by similar characteristics such as region, market cap and style. Data for the past five years shows similar results—the returns of 69 percent ranked in the top half and 41 percent in the top quartile returns. The report also compared the returns of ESG index funds to conventional index funds. Of 23 ESG index funds analyzed, 22 outperformed their relevant conventional index in 2020.

In 2021, the Morgan Stanley Institute for Sustainable Investing released a study entitled [Sustainable Funds Outperform Peers during 2020 Coronavirus](#). The Institute found that in a year of extreme volatility and recession, funds focused on “on environmental, social and governance (ESG) factors, across both stocks and bonds, weathered the year better than non-ESG portfolios.” The research analyzed more than 3,000 US mutual funds and ETFs, finding that sustainable equity funds outperformed non-ESG peer funds by a median total return of 4.3 percentage points in 2020.

Figure 3: Examples of ESG Criteria



SOURCE: US SIF Foundation.

Meanwhile, sustainable taxable bond funds over the same period outperformed their peers by a median total return of 0.9 percentage points. In 2019, both sustainable equity funds and sustainable taxable bond funds also outperformed their traditional peer funds. Looking at a longer time-horizon, the Institute also found that “in any given year from 2004 through 2018, sustainable funds’ median total returns were in line with that of traditional counterparts and provided more downside risk protection, especially during periods of increased market volatility.”

In 2020, the NYU Stern Center for Sustainable Business released [ESG and Financial Performance: Uncovering the Relationship by Aggregating 1,000 Plus Studies Published between 2015-2020](#), a meta-analysis of meta-studies on both corporate financial performance and investment performance. It came away with multiple conclusions on the relationship between ESG and financial performance, generally finding a positive correlation. Regarding investment performance, the report found that for “studies typically focused on risk-adjusted attributes such as alpha or the Sharpe ratio on a portfolio of stocks, 59 percent showed similar or better performance relative to conventional investment approaches while only 14 percent found negative results.” It also concluded that “ESG investing appears to provide downside protection, especially during social or economic crises.”

In 2018, Nuveen TIAA Investments released [Responsible Investing: Delivering Competitive Performance](#). After assessing the leading sustainable equity indexes over the long term, the report “found no statistical difference in returns compared to broad market benchmarks, suggesting the absence of any systematic performance penalty. Moreover, incorporating environmental, social and governance (ESG) criteria in security selection did not entail additional risk.” The report added that sustainable indexes had similar risk profiles to their broad market counterparts, based on Sharpe ratios and standard deviation measures.

A list of additional studies on financial performance can be found on the [US SIF website](#).

FIDUCIARY DUTY: Internationally, there is a growing consensus that ESG analysis is part of fiduciary responsibility and may be obligatory for retirement plan fiduciaries. In 2005, international law firm Freshfields Bruckhaus Deringer found, after examining fiduciary law in nine developed markets including the United States, that “the links between ESG factors and financial performance are increasingly being recognized. On that basis, integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions.”⁵

In 2020, [a follow-on report](#) to the Freshfields study was produced by the Principles for Responsible Investment and United Nations Environment Programme Finance Initiative. The research, informed by interviews with policymakers, lawyers and senior investment professionals, states that “the integration of ESG issues into investment practice and decision making is an increasingly standard part of the regulatory and legal requirements for institutional investors, along with requirements to consider the sustainability-related preferences of their clients and beneficiaries, and to report on how these obligations have been implemented.”⁶

The authors explain that global policy changes that confirm the materiality of sustainability to fiduciary duty have increased dramatically—“48 of the top 50 economies now have some form of policy designed to help investors consider sustainability risks, opportunities or outcomes.” The authors conclude that “there have been fundamental changes in the expectations of fiduciaries” since the 2005 study and that fiduciaries must:

- Incorporate financially material ESG factors into their investment decision making, consistent with the timeframe of the obligation.
- Understand and incorporate into their decision making the sustainability preferences of beneficiaries/clients, regardless of whether these preferences are financially material.

⁵Freshfields Bruckhaus Deringer, *A Legal Framework for the Integration of Environmental, Social, and Governance Issues into Institutional Investment*, UNEP Finance Initiative (2005).

⁶UNEP Finance Initiative and The Principles for Responsible Investment, *Fiduciary Duty in the 21st Century: Final Report*, UNEP Finance Initiative (2020).

- Be active owners, encouraging high standards of ESG performance in the companies or other entities in which they are invested.
- Support the stability and resilience of the financial system.
- Disclose their investment approach in a clear and understandable manner, including how preferences are incorporated into the scheme's investment approach.

While guidance and rules in relation to Employment Retirement Income Security Act (ERISA) governed pension plans in the United States have varied over the past several years, under the Biden administration, there appears to be an understanding of the validity of ESG considerations. In October 2015, the US Department of Labor (DOL), under the Obama administration, rescinded a 2008 bulletin that had discouraged private sector retirement plan fiduciaries from considering environmental and social factors in the companies and funds in which they invest. In its place, the Department issued [a new bulletin](#) that assured that retirement plans subject to ERISA “need not treat commercially reasonable investments as inherently suspect or in need of special scrutiny merely because they take into consideration environmental, social, or other such factors.”⁷ The revised guidance provided reassurance to plan sponsors and fiduciaries who had questioned whether they could offer sustainable funds. It also allowed ERISA fiduciaries—and ultimately their plan beneficiaries—to benefit from additional analytical tools to assess risks, opportunities and impact of their retirement plans. Just as important, the decision freed investment professionals to exercise their judgement and expertise in the service of beneficiaries.

In April 2018, the DOL issued a lower level “[field assistance bulletin](#)” that generally reaffirmed its 2015 guidance while offering specific instructions on the Qualified Default Investment Alternative (QDIA).⁸

An October 2020 Trump administration rule would have required fiduciaries considering ESG factors in their retirement plans to supply additional documentation to justify why ESG factors are “pecuniary.” It also effectively prohibited ESG considerations in QDIAs. The proposed rule, which was [opposed by 95 percent](#) of firms and individuals who submitted comments to DOL⁹, provided no evidence that plan fiduciaries have inappropriately selected ESG investments or given up returns in exchange for ‘non-pecuniary’ benefits.

In March 2021, the DOL, under the Biden administration, [announced that](#) it will not enforce the 2020 rule and instead will conduct “significantly more stakeholder outreach to determine how to craft rules that better recognize the important role that environmental, social and governance integration can play in the evaluation and management of plan investments, while continuing to uphold fundamental fiduciary obligations.”¹⁰ In May 2021, the Biden administration issued an executive order that directed the DOL to propose new rules by September 2021 to replace the Trump-era rules.¹¹

ADDITIONAL RESOURCES ON SUSTAINABLE INVESTING:

For further information on sustainable investing, including lists of websites, investor initiatives, stock indexes and other resources, see the “Selected Resources” section at the end of this guide. Additionally, your company, if it has dedicated staff managing corporate social responsibility (CSR) or sustainability issues, may be a resource. CSR managers are often familiar with sustainable investing and already networked with sustainable research and investment firms.

⁷ Department of Labor, Employee Benefits Security Administration, *Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments*, October 26, 2015.

⁸ US SIF, *US SIF Comments on DOL Field Bulletin on the Fiduciary Standards under ERISA*, August 20, 2020.

⁹ US SIF, *US SIF, Investor Organizations and Financial Industry Firms’ Analysis of Public Comments on Department of Labor ESG Proposal Shows Landslide of Opposition*, August 8, 2020.

¹⁰ Department of Labor, Employee Benefits Security Administration, *US Department of Labor Statement Regarding Enforcement of Its Final Rules on ESG Investments and Proxy Voting by Employee Benefit Plans*, March 10, 2021.

¹¹ The White House, *Executive Order on Climate-Related Financial Risk*, May 20, 2021.

STEP 2: Gauge participants' interest in adding sustainable funds

With the growing public interest in sustainable investing, plan participants may make requests to add sustainable funds to their DC plans.

An excellent way to gauge the demand for sustainable investment funds within your organization is to survey plan participants. Surveys need not focus solely on interest in sustainable investing and can be broad enough to determine interest in adding other investment options to plans and satisfaction with the current line-up. It would be helpful to include explanatory information about sustainable investing at the beginning of such a survey to ensure a level of understanding.

The survey could include the following questions:

1. Are you satisfied with your retirement fund options?
2. What changes or improvements, if any, would you like to see in your retirement plan?
3. We'd like to ask you about sustainable investing. Sustainable investing is an investment discipline that considers environmental, social and corporate governance criteria to generate long-term competitive financial returns and positive societal impact. Fund managers can select companies and investments that have good practices in these areas and avoid companies and investments that do not. Would you like your retirement plan to include sustainable funds?
4. What specific issues are you most concerned about that you would like fund managers to address? (Check all that apply.)
 - a. Environment/climate change
 - b. Diversity and equal employment opportunity
 - c. Labor conditions and labor rights
 - d. Avoidance of tobacco or other unhealthy products
 - e. Corporate governance issues, such as ensuring that executive pay is not excessive
 - f. Other
5. If you had sustainable funds available, how likely are you to start investing in these options?
 - a. Very likely
 - b. Somewhat likely
 - c. Not likely
 - d. Don't know or need more information

STEP 3: Discuss implementation with your consultant and/or plan administrator

It is prudent early on to research your existing plan administrator platform and external advisers. They may have information about sustainable funds.

PLAN ADMINISTRATOR PLATFORMS: Many major plan administrator platforms provide access to at least one sustainable fund or have an open structure—that is, they are able to include any fund option on their platform. Your plan's platform may already offer a sustainable fund. If so, find out which fund is available and how it was chosen. If your plan administrator does not currently provide a sustainable fund, see if it is able to add one.

Be sure also to inquire if there are significant fees and/or administrative issues associated with adding a new fund to your investment line-up. If that is the case, external advisers may be able to assist with negotiating lower fees.

EXTERNAL ADVISERS: Showing a clearly articulated plan and method for adding a sustainable fund with appropriate due diligence is key to supporting the plan's fiduciary duty, just as it is with any other type of fund option. External consultants and advisers can assist with procedural and reporting aspects of this process, particularly as more consultants are developing expertise in sustainable investing.

If you are currently working with a consultant, you might ask them the following questions:

1. What is your level of knowledge and experience with sustainable investing?
2. What is your view of sustainable funds as part of a DC line-up?
3. Have you conducted successful sustainable investing searches for DC plans?
4. Do you have in-house research on sustainable investment managers and strategies, or access to specialized vendor research in this area?
5. Do you have dedicated staff knowledgeable about sustainable investing?
6. How do you evaluate a sustainable investment fund?
7. What is the universe of sustainable investing funds that you consider for a DC plan?

STEP 4: Choose a fund or funds and monitor performance

CHOOSING A FUND: Plans that are looking for sustainable investment funds have many options from which to choose. While domestic equity funds are the most prevalent, sustainable investment funds are also available in other asset classes and geographic regions. Sustainable fund vehicles have expanded in recent years to include exchange traded funds and passively managed funds; lifestyle and target date funds are also emerging. For a list of sustainable investment mutual funds offered by US SIF members, visit <http://charts.ussif.org/mfpc/>.

In choosing a new fund, your organization may raise the following questions with your retirement committee and/or consultant:

1. Will the sustainable fund fill a gap for an asset class not represented in your plan, or will it be an additional option within an existing asset class?
2. What is the appropriate asset class, style and vehicle for a sustainable fund in your plan?
3. What performance benchmark is appropriate for the additional fund or funds?

In addition to where the sustainable fund might fit within your existing line-up, the specific type of ESG incorporation strategies the fund uses should also be considered. Stringency on negative screens for sectors such as tobacco, alcohol and weapons differ by fund manager. The same is true for screens on issues such as the environment, labor and human rights. Some funds use positive/best-in-class screening to seek out the leaders on an issue or within an industry (and avoid screening out sectors completely). An increasingly popular approach is “ESG integration,” where specialized research teams assess key ESG indicators and risks as part of overall due diligence and financial analysis. Investments focusing on treatment of women, environmental opportunities, community development and religious beliefs also exist. For more on ESG incorporation strategies, see: <http://www.ussif.org/esg>.

The following questions can help you narrow the list of sustainable fund candidates:

Do your plan participants have specific values or beliefs that will affect your choice of a sustainable fund?

In the case of funds that invest in equities, do you or your plan participants prefer funds that have a proactive proxy voting policy on ESG issues or that file shareholder resolutions or communicate with portfolio companies on ESG issues?

Consultants are seeing more requests for proposals (RFPs) issued by clients searching for sustainable funds with specific characteristics. RFPs that include the preferred characteristics for the sustainable fund help focus the search on the most relevant funds and managers.

MONITORING SUSTAINABLE FUNDS: As with any investment decision, once you have selected a fund option, the next step is to set up a system for monitoring its performance. A monitoring program implemented internally or through a consultant should regularly assess that the sustainable fund is meeting its objectives. Questions to pose to your sustainable investment fund manager or to your consultant to evaluate your sustainable fund’s financial performance include:

1. Is the fund meeting return expectations, net of fees, in relation to its benchmark and peers?
2. Is the fund maintaining its stated investment style, including its sustainability approach?
3. Are the fund manager’s fees reasonable, when compared to the fund’s peer group?

STEP 5: Educate participants

This is a critical step. When a sustainable fund is added to your plan, plan participants should be alerted to it with appropriate educational materials, whether as part of regular communications on plan options, or through specific presentations on sustainable investing by sustainable investment firms, consultants or industry experts.

Your plan administrator, sustainable fund manager, or consultant should be able to provide information about the sustainable funds within your line-up and their particular strategies.

Specific considerations for introducing sustainable investing and your specific sustainable fund to participants include:

1. How will the sustainable fund be presented to participants when they are making their allocation? Where will it appear in the lineup and how will it be described/named?
2. Does the information provided to participants enable them to compare a sustainable with a non-sustainable fund based on financial performance and fees?
3. Does the information explain the specific ESG criteria the sustainable fund manager uses?
4. Does the information explain the active ownership aspects (proxy voting, filing or co-filing shareholder resolutions, and communications with portfolio companies) of the fund?
5. Are additional sources of information or education available to participants who want to learn more about sustainable investing?
6. How will you gauge employee satisfaction with, or gather employee feedback on, the new option?

Selected Resources

Educational Sources on Sustainable Investing

[US SIF: The Forum for Sustainable and Responsible Investment](#) is the leading voice advancing sustainable investing across all asset classes. US SIF provides information on a range of sustainable investing issues including investment performance through the following links:

- [Center for Sustainable Investment Education](#)
- [Common Misperceptions](#)
- [Options for 401K and other DC Retirement Plans](#)
- [Research by the US SIF Foundation](#)
- [Research by US SIF Members](#)
- [Sustainable Investing Basics](#)
- [Financial Performance with Sustainable Investing](#)

Sustainable Mutual Funds & ETFs

- [List of sustainable mutual funds and ETFs offered by US SIF Members](#)
- [As You Sow Invest Your Values tool](#)

Investor Initiatives & Organizations

These initiatives for investors focus on deriving long-term enhanced returns from the analysis of ESG factors. The members or signatories of these initiatives are primarily investment managers, public pension funds and mission-based organizations seeking to align investments and ownership activities with their fiduciary mandate to minimize risk and provide long-term returns.

- [CDP](#)
- [Ceres and the Investor Network on Climate Risk](#)
- [Council of Institutional Investors](#)
- [Principles for Responsible Investment](#)
- [United Nations Environment Programme Finance Initiative](#)
- [Value Reporting Foundation](#) (merger of SASB and IIRC)

Sampling of ESG Indices

- [Dow Jones Sustainability Indices](#)
- [FTSE4Good Indices](#)
- [MSCI ESG Indices](#)
- [S&P ESG Index Family](#)
- [STOXX ESG Indices](#)

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