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White
Paper

ALIGNING DEFINED CONTRIBUTION PLANS WITH SUSTAINABILITY GOALS

To Spur Employee Innovation and Engagement



AS YOU SOW

Adding ESG funds to an organization's employee contribution plan enables a corporation to align its stated climate, environmental, social, and other sustainability policies

As millennial-aged employees now represent the majority of the U.S. workforce, it is increasingly important that corporate management finds ways to engage them in the company. Creating defined contribution plans which connect to their core values – like solving human, social and environmental problems through their work and investments – can spur employee engagement and spark innovation.

Furthermore, adding ESG funds to an organization's employee contribution plan enables a corporation to align its stated climate, environmental, social, and other sustainability policies, including adoption of U.N. Sustainable Development Goals (SDGs), and the U.N. Principles of Responsible Investing (UNPRI) with its investment options. The oft-heard phrase, “put your money where your mouth is” has never been truer or easier to implement

Between 2012 and 2016 the market for mutual funds and exchange traded funds (ETFs) with an Environmental, Social, or Governance (ESG) focus has increased \$4.98 trillion, up to \$8.72 trillion, a growth of over 133%.¹ The benefits of including ESG considerations in investment decisions have become more widely understood and the market has responded by increasing investments in funds that include these concerns in their prospectus and holdings. In addition to the potential financial upside of ESG investments, a growing number of investors are moving to ESG-oriented funds as a way to reduce risk and incorporate their values in their investment decisions. This is largely driven by the increasing proportion of millennials in the workforce. A whopping 85% of millennials surveyed in the 2016 U.S. Trust study, “Insights on Wealth and Worth,” said they consider their investment decisions as “a way to express their social, political, and environmental values.”²

Despite the growth of ESG-oriented funds in the wider investment market, the \$8.4 trillion in U.S. corporate defined contribution plans (including 401(k), 403(b), and IRAs) do not reflect this growth and in fact have barely begun to include ESG funds in their portfolios.³ As an example, Vanguard reported that only 9% of its employee plans included ESG funds, most of which offered only a single fund rather than a suite of offerings.⁴ This discrepancy provides a tremendous opportunity for corporate plan administrators to align corporate values and sustainability goals with investments, while simultaneously enticing new employees, retaining existing ones, and increasing participation and contributions through a simple change in policy.

¹ [US SIF Foundation 2016](#)

² [Abbott 2017](#)

³ [Holden and Schrass, 2017](#)

⁴ [Miller 2017](#)

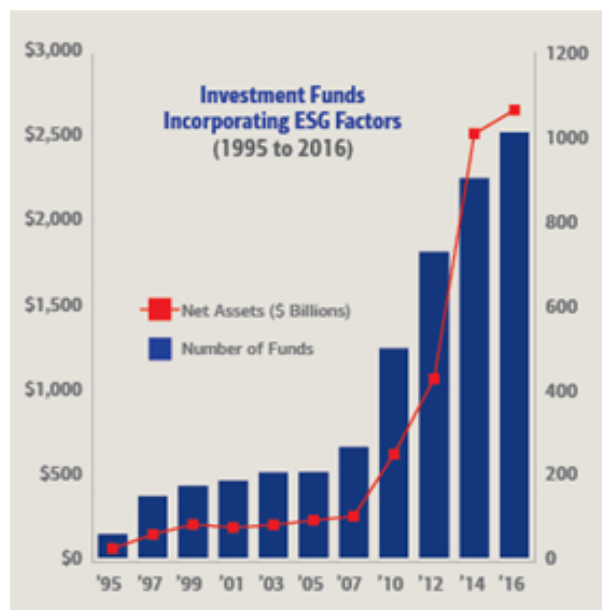


Figure 1: US SIF 2016

A recent 2015 Department of Labor ERISA guidance document indicates that considering ESG issues when making investments is not only allowed as part of a fiduciaries' consideration, but where such issues may directly affect the economic value of an investment, fiduciaries should appropriately consider such factors.

This white paper highlights case studies and recent investing trends demonstrating the benefits of incorporating ESG options into corporate defined contribution plans. It shows that those corporations providing a greater array of ESG mutual funds and exchange traded funds (ETFs) in their plans will benefit from overall corporate coherence of policy and practice and facilitate a shift in corporate culture to respect and amplify employee values. This leads to material benefits for both the company and the employees, is relatively simple to implement once an executive decision is made to make such an adjustment, and is most successful when employees are part of the process from the beginning and through implementation.

Contribution and Participation Rates

As employees move a portion of their personal investments into ESG funds, they are seeking similar options in their work-based defined contribution plans. Among millennials offered a defined contribution plan, the current take-up rate is only 52% as opposed to the 72% average across all ages.⁵ By failing to enroll these employees, organizations are leaving tax benefits on the table, and financial advisors to these funds are not optimizing their potential commissions. Though employees are reluctant to lose out on immediate income, according to a [2016 Natixis study](#), 62% of all employees and 72% of millennial employees said they would increase their contributions if their investments were doing social good.⁶

The potential for overcoming employee inertia in contributing to retirement plans through the addition of ESG funds has been validated through case studies in smaller companies. Stok, a real estate services firm, experienced an extremely low 401(k) plan participation rate of 14% of employees and an average individual contribution rate of 1.6%.⁷ The company's investigation into why current employees were not contributing identified concerns such as: "It doesn't make any sense for me to invest my hard earned money into business models that are destroying the future."⁸ Through partnerships with HIP Investor's mutual fund ratings and Communitas Financial Planning, Stok replaced a number of its existing funds with ones that not only scored higher on social and environmental impacts, but also matched or exceeded historic performance indicators. The addition of these [ESG] funds helped Stok increase its plan participation from 14% to 95% and average contribution rate from 1.6% to 7.1% in only two years⁹, exceeding national averages for any age group's 401(k) participations rates. Today, more than 75% of Stok employees invest their 401(k) to be 100% fossil-fuel-free of coal, oil, gas and related fossil-fuel energy companies.

Employees have been more and more willing to take the initiative in seeking ESG offerings in their defined contribution plans. For instance, over 60,000 people signed the [Divest-Invest Fossil Fuels pledge](#) (along with [\\$5.2 trillion in AUM by foundations](#)) to sell their equities in the 200 companies with the largest reserves and invest in fossil free alternatives

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[5 Retirement Plan Access and Participation Across Generations 2017](#)

[6 Natixis 2016](#)

[7 Fossil Free 401\(k\) : A New Way To Reduce Your Environmental Impact | Stok" 2017](#)

[8 Fossil Free 401\(k\) : A New Way To Reduce Your Environmental Impact | Stok" 2017](#)

[9 Fossil Free 401\(k\) : A New Way To Reduce Your Environmental Impact | Stok" 2017](#)

as soon as those options become available. By engaging such individuals through values based offerings, a company can significantly improve both its participation and contribution rates.

Employee Engagement

In addition to the organizational tax benefits of increased participation and contribution rates, bringing ESG-based options into a company's plans serves to deepen an employee's engagement and commitment to the business. In a [June 2017 Povaddo survey](#) of employees inside Fortune 1,000 companies, 74% felt that having socially responsible funds offered through their 401(k) plans was important.¹⁰ This is consistent with the desire of employees, especially among millennials, to align their own value systems with those of their place of employment: 52% of employees indicated a meaningful effort by their CEO to make a difference on these issues would increase their day-to-day engagement with the business.¹¹

Highly engaged employees have 18% higher productivity, 12% higher customer satisfaction and, most importantly, 12% higher profitability

These gains in employee engagement can have significant impacts on bottom line growth. [The Sustainability Advantage](#) found companies with highly engaged employees have 18% higher productivity, 12% higher customer satisfaction and, most importantly, 12% higher profitability.¹² Engaged employees are not just more productive, they are more creative as well. "59% of engaged employees said their job brings out their most creative ideas versus 3% of disengaged employees."¹³

In addition to increasing the engagement of existing employees, adding ESG oriented options can help to attract top talent. In response to the addition of ESG funds to Stok's plan offerings, 20% of employees felt this was a significant differentiating factor in their compensation package.¹⁴ This is consistent with industry surveys which indicate 65% of millennials feel that a company's actions taken on societal issues impact their decision to maintain or pursue employment with that company.¹⁵ As one of the few channels through which an organization may reach every employee simultaneously, a simple change to a defined contribution plan provides a rare opportunity to positively affect employee engagement and to attract and retain top talent throughout the company.

Alignment with Corporate Policy and U.N. Sustainability Development Goals (SDGs)

A company's alignment with ESG issues not only increases the satisfaction of employees, it is increasingly demanded by the company's investors. As institutional investors become more aware of the impact of effective ESG policies on returns, they are giving greater weight to companies that incorporate and advance ESG considerations in their operations. Investment firm U.S. Trust found "45% of all high-net-worth investors either own impact investments or are interested in adding them to their own portfolios."¹⁶ In 2015 the Rockefeller Brothers, World Resources Institute, London School of Economics, and others collectively committed to divesting \$3.4 trillion in assets from fossil fuels,¹⁷ a commitment that has grown to \$5.2 trillion since the Paris Climate Summit.¹⁸ Similarly, in a 2016 survey by ShareAction, 84% of institutional investors indicated they would allocate capital to investments supporting the U.N.'s Sustainable Development Goals (SDGs).¹⁹ The incorporation of ESG funds in a company's defined contribution plan portfolio can demonstrate true alignment with these key issues, attracting long-term investors.

[10 Povaddo 2017](#)

[11 Povaddo 2017](#)

[12 Willard 2016](#)

[13 Willard 2016](#)

[14 Fossil Free 401\(k\) : A New Way To Reduce Your Environmental Impact | Stok" 2017](#)

[15 Povaddo 2017](#)

[16 Bennett 2017](#)

[17 Schueneman 2017](#)

[18 Divest Invest 2016](#)

[19 What do UN Sustainable Development Goals Mean for Investors, 2016](#)

Fiduciary Responsibility

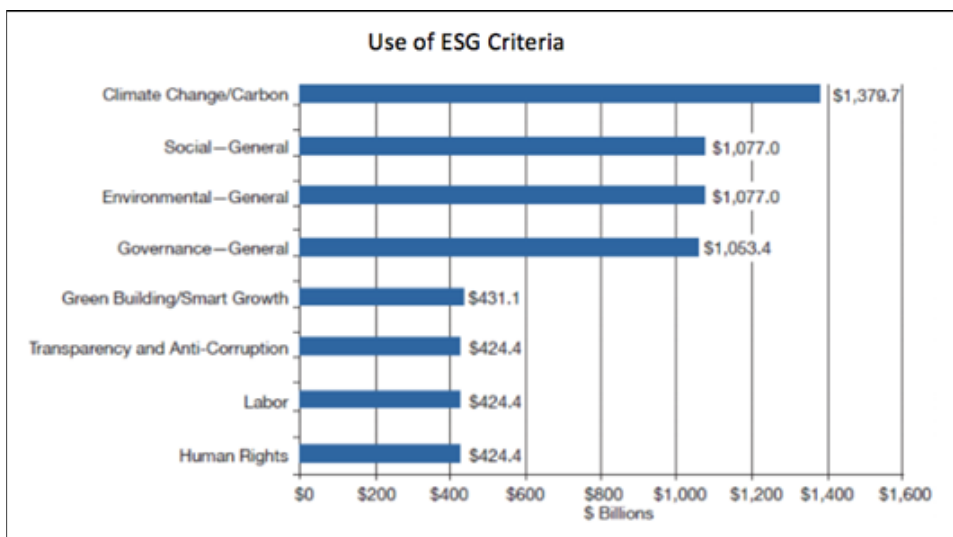
As the Department of Labor (DOL) has become aware of the “growing body of evidence that shows [ESG considerations] directly and significantly impact financial returns on investments”²⁰ it issued an Interpretive Bulletin in 2015 to the Employee Retirement Income Savings Act (ERISA)²¹. This Bulletin clarifies that ERISA fiduciaries can take ESG factors into economic analysis of investments. Specifically:

ESG factors may have a direct relationship to the economic and financial value of the plan’s investment. In these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary’s primary analysis of the economic merits of competing investment choices.

Further, a fiduciary may incorporate ESG factors in investment policy statements and integrate ESG-related tools, metrics, and analyses to evaluate an investment’s risk or return, or choose among otherwise equivalent investments.

As most ESG oriented funds are actively managed, they tend to have higher fees than passive indexes. However, fees on many ESG funds are decreasing due to price competition among ESG fund providers and increases in automation.²²

According to DOL, “ESG issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary’s primary analysis of the economic merits of competing investment choices.”



ESG Fund Performance

Since the 1970s, over 2,000 published studies have tried to understand the relationship between ESG criteria and corporate financial performance. A [meta review by Sustainable Finance and Investment](#) of this research gives a clear indication of how ESG funds compare to traditional funds.²³ 90% of all studies showed a non-negative relationship, indicating that inclusion of ESG factors did not affect performance. In fact, the majority of these studies reported a positive relationship, indicating ESG criteria improved market performance. According to [a Bank of America Report](#), S&P 500 companies with high ESG ratings averaged 5% higher return on equity.²⁴ ESG criteria do not just help to increase returns, they can also be used to forecast and mitigate risk. By investing in stocks with above average ESG ratings, an

²⁰ US SIF Foundation 2016

²¹ Department of Labor 2015

²² Schultz 2017

²³ Povaddo 2017

²⁴ Bank of America – Capitalism and the Rise of Responsible Growth 2017

90% of over 2,000 published studies showed...inclusion of ESG factors did not affect performance. The majority of these studies reported a positive relationship, indicating ESG criteria improved market performance.

investor could have avoided 90% of company bankruptcies since 2008.²⁵ Despite the slightly higher-cost due to active management of these funds, there is evidence that those funds that include ESG criteria in their selection process will match or exceed the fees-adjusted returns of their traditional counterparts. As an example, Fourstar Connections, a contract manufacturing services firm, decided to add sustainable investments to its 401(k) plan, despite worries it could lead to smaller returns for employees. What the company found is that there “are many investments available that are not only impact-focused, but can also offer bigger returns and less risk than stocks or mutual funds that do not focus on sustainability.”²⁶ By and large incorporating ESG concerns into investment decisions has been tied to superior performance in the market.

Unanswered Questions

Given the results of the studies and data cited above, including improved employee engagement and retention, attracting the best talent, corporate tax advantages, positive fiduciary governance, equal or outperformance on returns, and alignment with corporate and U.N. SDG sustainability goals; the unanswered question is why does the inclusion rate of ESG funds in defined contribution plans not match that of individuals’ investments? When the authors anecdotally asked a number of 401(k) administrators and financial advisors about this, two categories of responses emerged.

One was the assumption that if you add an ESG fund you must swap out a current offering to keep the number of funds in a plan unchanged. This is logistically more complex than adding a new fund and may cause employees owning that fund to object. When asked, why not just add a new one, there was general belief that, “too much choice means no choice.” An academic study on selecting gourmet jams²⁷ was often cited to support this concern. Given that there is not agreement on the optimal number of funds in a plan, and the relative ease of adding new targeted ESG funds, this may just be inertia.

The second anecdotal reason may be more to the point, which is that companies that offer value-aligned funds and cause increased participation and contribution, will have an increased cash cost from their match. This may explain why the majority of companies, when a new employee is hired, ask them to opt-in rather than opt-out of the plan, which decreases participation rates. While companies may want to avoid employee participation due to cost considerations, creating and maintaining employee engagement through the addition of ESG funds can be a long-term benefit to the company.

²⁵ Bank of America – Capitalism and the Rise of Responsible Growth 2017

²⁶ Grant 2017

²⁷ Iyengar and Lepper 2000

Conclusion

The benefits of adding ESG criteria into company investment decisions and employee benefit plans include aligning with stated sustainability goals, reducing investment risk, and attracting and retaining the best talent. In addition, there is a growing belief that, "if your 401(k) is invested for the next one to three decades, your options should be reflective of what the solutions will be in the next one to three decades."²⁸

Essentially, employees, millennials in particular, seek to invest their retirement money in ways that will benefit the world in which they will live in the future. Once within the organization, these value alignments keep employees focused and engaged with the business, driving real bottom line growth. Externally, investors are also increasingly looking to develop a portfolio that they believe is having positive impact on the future by aligning with the U.N.'s Sustainability Development Goals.

The time has come for the private sector to demonstrate industry leadership and open the door to the internal and external benefits of incorporating ESG funds into defined contribution plans.

Appendix

Resources for Successful Implementation

- [Addressing ESG Factors Under ERISA](#)– Legal perspectives clarifying call for incorporation of ESG factors in prudence consideration
- [Divest Invest Guide](#)– Network of Individuals and Organizations seeking to divest from fossil fuels
- [Forum for Sustainable and Responsible Investment](#)– A resource guide for adding sustainable and responsible investing options to defined contribution plans
- [Fossil Free Funds](#)– Toolkit for assessing and updating holdings based on inclusion of fossil fuels
- [HIP Investor Ratings + Portfolios](#)– Investment ratings of 75,000 stocks, bonds and mutual funds; and investment portfolios that seek human impact and profit
- [Principles for Responsible Investment](#)– How to address ESG factors under ERISA
- [Tobacco Free Funds](#)– Toolkit for assessing and updating holdings based on inclusion of tobacco companies and those promoting tobacco products

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About As You Sow

As You Sow is a nonprofit organization dedicated to increasing environmental and social corporate responsibility. Founded in 1992, *As You Sow* envisions a safe, just, and sustainable world in which environmental health and human rights are central to corporate decision making. Its Energy, Environmental Health, Waste, and Human Rights programs create positive, industry-wide change through corporate dialogue, shareholder advocacy, coalition building, and innovative legal strategies. www.asyousow.org

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