Despite growing demand for sustainable, responsible and impact (SRI) investments from participants, a small percentage of 401(k) plans provide such options in their investment menus. The author reviews the challenges that plan sponsors face in incorporating these investments in their plans and suggests possible approaches.

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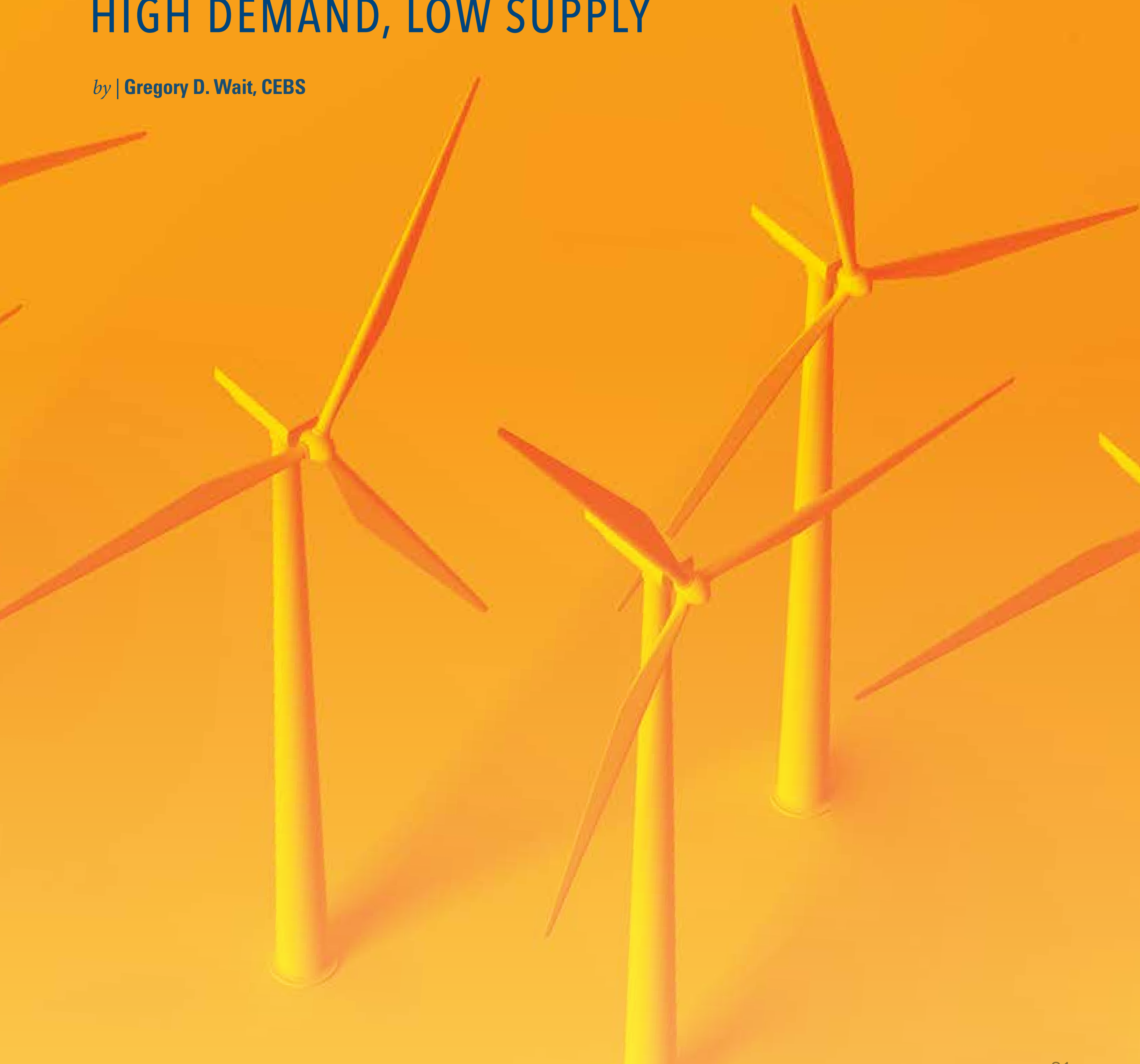
SRI Investments in 401(k) Plans:

HIGH DEMAND, LOW SUPPLY

by | **Gregory D. Wait, CEBS**



Interest in sustainable, responsible and impact (SRI) investments is growing among both institutional and individual investors, with SRI investment assets totaling $12 trillion at the beginning of 2018. That represents a 38% increase since 2016 and amounts to more than 25% of all professionally managed assets in the United States.[1]

In the past, the acronym *SRI* was used to reference the term *socially responsible investing* and generally described the investment approach of excluding specific industries or companies based on moral values, most commonly used by religious organizations. Today, the acronym SRI encompasses the broader investment approach referred to as *sustainable, responsible and impact investing* as described in this article.

SRI investing is a broad term that incorporates various activities dedicated to managing money in a way that results in the *double bottom line* of competitive returns and social good. Approaches can include excluding companies or industries from an investment portfolio because they violate the investor's values or exhibit high social risk profiles, investing in specific themes that are devoted to social good (*impact investments*), selecting investments based on environmental, social and governance (ESG) criteria and engaging with company management on ESG issues. Leading ESG issues, based on the number of shareholder proposals filed between 2016 and 2018, include proxy access, corporate political activity, climate change, labor and equal employment opportunity, executive pay, human rights, board diversity, and sustainability reporting.[2]

A large and growing body of research suggests that incorporating ESG factors in the investment process is not detrimental to portfolio returns. To the contrary, 90% of all studies find a nonnegative ESG relationship with corporate financial performance, and the large majority report positive findings.[3]

While most of this growth in SRI investing has occurred at the institutional level, individuals are also interested in responsible investing. Consumers are voting with their wallets by rejecting products made by companies that are known to have ESG conflicts and purchasing products that they believe have a positive social impact (e.g., TOMS shoes, Adidas Oceans line). This trend is particularly true for younger generations. The Nuveen Fourth Annual *Responsible Investing Survey* reveals continuing interest in responsible investing, particularly among Millennial investors with 93% expressing a strong interest in responsible investing, compared with 78% of non-Millennials.[4]

What About 401(k) Plans?

Defined contribution plans, specifically 401(k) plans, have become the primary savings and investment vehicle for many U.S. workers, with 55 million active participants.[5] Three-quarters of plan participants believe in making the world a better place through their investments, and nearly as many believe there are strong financial incentives for doing so. In fact, 61% of workers said they would be more likely to contribute to their employer's retirement plan if they knew their investments were doing social good. Six in ten employees simply state they would like to see more SRI investments in their plan menu.[6] According to Morningstar, ESG-focused mutual funds and exchange-traded funds had net inflows of $5.5 billion in 2018, the third consecutive year of record annual flows—and by June 30, 2019, these funds had already doubled last year's flows.[7]

Yet, while the demand for responsible investments is high and growing, only 4% of 401(k) plans have an ESG fund in their menu, and only 0.03% of 401(k) plan assets are invested in ESG funds.[8]

takeaways

- Interest in sustainable, responsible and impact (SRI) investing continues to grow with SRI investment assets totaling $12 trillion at the beginning of 2018.
- More than nine in ten (93%) Millennial investors express a strong interest in responsible investing.
- Only 4% of 401(k) plans have an investment option that uses environmental, social and governance (ESG) criteria in their menu, and only 0.03% of 401(k) plan assets are invested in ESG funds.
- Challenges to incorporating SRI options in 401(k) investment menus include plan sponsor concerns about sacrificing return and fulfilling fiduciary duties, as well as a lack of SRI target-date funds (TDFs).
- Plan sponsors that want to add SRI options to their investment menus can consider options such as offering a single balanced SRI fund, creating an SRI track of standalone funds or an investment menu consisting solely of SRI options.

Myths and Challenges for Plan Sponsors

Plan sponsors have been reluctant to add SRI funds to their 401(k) plan menus for the following reasons:

- The persistent—and debunked—myth among plan committee members that an investor must sacrifice returns in order to invest with environmental or social responsibility
- Employees are generally reluctant to express their wishes to employers regarding their 401(k) plan, and few employers survey their participants to ask about those wishes.
- Plan committees are sensitive to their fiduciary duty and often have been provided inconsistent guidance regarding SRI investments.
- While there has been a proliferation of new SRI mutual funds over the past few years, there is still only one SRI target-date fund (TDF) in the marketplace. Because TDFs have become the default investment in most 401(k) plans, they have seen significant growth in recent years.[9] It is estimated that $1.1 trillion and 21% of 401(k) assets are invested in TDFs.[10]
- Even though employers are struggling to find workers in today's low-unemployment economy, and many companies have embraced the concept of corporate responsibility and social impact, they have not yet made the connection between adding SRI funds to their 401(k) menu and the attraction and retention of employees (especially Millennials).

Plan advisors and consultants are the main source of information about the demand for SRI investments and educating plan sponsors on the risk/return and fiduciary merits of offering these funds. However, nearly two-thirds (64%) of investment advisors have not recommended SRI investments to their clients.[11] Retirement plan consultants tend to be conservative in their recommendations and often suggest the addition of a single SRI fund to a 401(k) plan menu to satisfy participants who may be interested.

The fiduciary concern and confusion about SRI among plan sponsors is understandable. For years, Department of Labor (DOL) guidance on the issue of ESG investment was murky, but an *Interpretive Bulletin (IB 2015-01)* issued in 2015 clarified that "[ESG] issues may have a direct relationship to the economic 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."

However, a more recent DOL *Field Assistance Bulletin (FAB 2018-01)* issued in 2018 seems to again discourage the use of ESG, stating "Fiduciaries must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision. It does not ineluctably follow from the fact that an investment promotes ESG factors . . . that the investment is a prudent choice for retirement or other investors."

Nothing in this seemingly conflicted DOL guidance is truly new under ERISA. Plan fiduciaries must evaluate investments in an objective manner, and all investments must pass criteria established in the plan's investment policy statement (IPS). Any SRI funds under consideration must satisfy the same criteria.

SRI fund managers understand that the *materiality* of ESG criteria varies among industries and companies to be evaluated for investment consideration and that the best risk/return tradeoffs are realized by such selective scrutiny. For example, managing environmental impact is an important consideration for companies in the fossil fuel and transportation industries but less important for financial and health care companies. Many long-term investors have experienced superior outcomes as a result of this approach, and plan fiduciaries should not shy away from it.

The fiduciary standard is to make decisions solely in the best interests of plan participants and their beneficiaries. If the availability of SRI funds in a 401(k) plan menu would encourage higher rates of participation and higher savings rates, while also generating equal or superior risk/return outcomes, it seems that the fiduciary standard is met.

bio

Gregory D. Wait, CEBS, is a partner at Riverwater Partners, LLC, an investment management and advisory firm dedicated to responsible investing and the first Certified B Corporation in Milwaukee, Wisconsin. Wait is an active member of US SIF: The Forum for Sustainable and Responsible Investment, Investment Management Consultants Association, Plan Sponsor Council of America and the Wisconsin Retirement Plan Professionals, Ltd. He is a member of the International Society of Certified Employee Benefit Specialists (ISCEBS) Milwaukee chapter. Wait holds a bachelor of business administration degree from the University of Wisconsin-Whitewater.

401(k) SRI Approaches

Plan sponsors that decide to add SRI options to their investment menus can consider a few options.

Some 401(k) plan sponsors have added a single SRI equity index mutual fund to their plan menu to satisfy participants who desire to invest responsibly, but they provide a disservice to those same participants who also would benefit from a diversified portfolio tailored to their time horizon and risk tolerance. For plan sponsors that prefer a limited menu and want to offer a single fund, a balanced SRI fund may be the best option since these funds include both stocks and fixed income investments.

The one SRI TDF series currently in the marketplace does not yet have a three-year track record, so it would not meet most plans' IPS criteria. However, when it has reached the three-year mark, it can be considered for those plan sponsors that prefer a single fund approach. It is likely that more TDFs will come to market in future years, which will make for a higher and better level of evaluation among competing investments in a few more years.

Many plans offer multiple tracks of investments to their participants. For example, they may have a traditional menu of standalone mutual funds in one track and TDFs in another. Some plans may include another track that includes index funds or global funds. In order to incorporate SRI funds into their plan investment menu, plan sponsors could consider adding an SRI track of standalone funds that would mirror the menu in the traditional standalone mutual fund track (See Table I). This would allow socially conscious participants the ability to build a well-diversified portfolio consisting entirely of SRI funds.

In the author's experience, plan sponsors that have adopted investment menus similar to the menu illustrated in Table I either have an environmental element in their corporate mission statement or have a management team that strives to be a good corporate citizen. These employers are also finding it challenging to hire new employees in today's tight labor market and are seeking a competitive advantage in recruiting. The SRI funds were added to the plan menu within the past two years.

TABLE I

401(k) Plan Investment Menu That Includes an SRI Track

Track One (Core)	*Track Two (SRI)*	*Track Three (Do It for Me)*
U.S. Large Cap Stock Fund	**SRI U.S. Large Cap Stock Fund**	**Target-Date 2020 Fund**
U.S. Small Cap Stock Fund	**SRI U.S. Small Cap Stock Fund**	**Target-Date 2030 Fund**
International Stock Fund	**SRI International Stock Fund**	**Target-Date 2040 Fund**
Balanced Fund	**SRI Balanced Fund**	**Target-Date 2050 Fund**
Core Bond Fund	**SRI Core Bond Fund**	**Target-Date 2060 Fund**
Money Market Fund	**SRI Money Market Fund**	

Thus far, there has been very low participation in these funds due to insufficient employee communication efforts and the fact that TDFs are the qualified default investment alternative (QDIA) option in the plans.

Employers whose mission includes some form of environmental or social responsibility may conclude that offering a 401(k) investment menu consisting solely of SRI options is the right approach and could continue to satisfy their fiduciary duties in doing so. In this case, one track might consist of standalone SRI funds, and the second track might consist of SRI TDFs when available and if a fund series passes IPS criteria. Prior to the maturation of the SRI TDF market, this employer could consider creating a few risk-based model portfolios that include the SRI funds available in the first track (See Table II). This course of action could require employing an investment advisor who can manage such portfolios on a discretionary basis and accepts 3(38) fiduciary responsibility. With this approach, one or more of the risk-based portfolios would likely be considered the QDIA.

TABLE II

401(k) SRI Investment Menu Consisting Solely of SRI Options

Track One (Core SRI)	*Track Two (Risk-Based Models)*
SRI U.S. Large Cap Stock Fund	SRI Conservative Asset Allocation Portfolio
SRI U.S. Small Cap Stock Fund	SRI Moderate Asset Allocation Portfolio
SRI International Stock Fund	SRI Aggressive Asset Allocation Portfolio
SRI Core Bond Fund	
SRI Money Market Fund	

The Future of SRI

Some investment professionals believe that incorporating ESG criteria in the investment process will become mainstream in the not-too-distant future. Traditional investment managers are beginning to view ESG data simply as additional information that can help them make better decisions. Many traditional managers have long considered corporate governance to be critical in their evaluation of a quality company and its long-term financial outlook; increasingly, they are understanding that companies also must pay attention to business risks relating to environmental and social issues.

While more money managers are understanding the financial merits of SRI investing, individuals who want their investments to have positive social and environmental outcomes often prefer fund managers that actively engage with corporations or invest in securities that have explicit impact, for example, bonds that support low-income housing development or renewable energy projects.

Positive long-term environmental and social benefits can result when institutional investors and money managers engage in discussions with corporate management about ways to further improve their ESG policies. SRI investment firms that are leaders in shareholder advocacy and impact investing are intentional with these efforts. ESG integration may become mainstream soon, but it could take longer for traditional investment firms to embrace the concept of corporate engagement on social and environmental issues. Plan sponsors should consider their corporate mission and their employee population when considering investment managers for their plans.

Endnotes

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