INSIGHTS INVESTMENT

Edward Farrington
Executive Vice President
of Retirement Strategies
Natixis Investment Managers

ESG investing: New DOL guidance may boost adoption

The recent Department of Labor effort to clarify its existing guidance on environmental, social and governance investing for ERISA plans raised concerns that it might dissuade plan sponsors from pursuing ESG – despite growing demand from plan participants. But Edward Farrington, executive vice president of retirement strategies at Natixis Investment Managers, welcomed the guidance and said it may, in fact, lead to greater adoption of ESG strategies and funds.

"There is demand from participants and interest from plan sponsors, so it's very reasonable for the Department of Labor, which is responsible for these plans, to issue an opinion," he said. "The opinion is well formed and well thought out, and we think plan sponsors will find great managers that meet the fiduciary responsibility but also provide access to the investments that their participants want."

In a nutshell, the DOL "Field Assistance Bulletin" reaffirms the department's guidance from 2015 and 2016, which allows fiduciaries to consider ESG factors when those factors might have an economic impact on the plan, but also states that fiduciaries must not "too readily treat ESG factors as economically relevant."

To Farrington, that simply means going back to basics and putting the needs of plan participants ahead of the needs of plan sponsors. "I think there's a connection here between participant demand, the growing number of investment managers using environmental, social and governance data, and the DOL," he said. "It was wise for them to update the 2015 language to reinforce the idea that the fiduciary's role is really to be sure that plan participants have the best possible options for growing their wealth over time, so they retire the way they deserve to retire."

Farrington pointed out that the DOL may have been concerned that the growing number of investment managers offering ESG strategies or funds led to plan sponsors becoming more lax in reviewing those options.

"The guidance was clear that when an investment committee or plan sponsor adds an option to a plan, that option has to be chosen based on the economic benefit to the participant," Farrington said. "When you think about ESG, socially responsible investing or impact investing as you're interviewing managers, it's really important to ask why they are using ESG, why they are using SRI or what is their definition of impact, because every manager will have a different answer.

"We think it's critical for investment committees and plan sponsors to ask those questions. They shouldn't add something solely because of its social benefits," he continued. The answer needs to be about performance, about investable themes." The DOL guidance should also give comfort to investment committees that have been grappling with the issue of including ESG strategies and funds in their plans.

> "It gives plan sponsors some guardrails, and we think they'll be very pleased with the options they find."

"Investment committees have had a lot of questions over the past few years about how to update their investment policy statements for ESG," Farrington noted. "Just view the manager as a manager. This may actually be liberating for investment committees and plan sponsors because they can feel confident using traditional metrics to evaluate potential managers — ESG or not — and hold them all to the same standards."

When the dust settles, plan sponsors most likely will be happy for the fresh guidance, Farrington said. "It gives plan sponsors some guardrails, and we think they'll be very pleased with the options they find," he said.

The timing is good because not only is fiduciary responsibility a hot topic, the demand for ESG options is expected to grow. Research from Natixis found that 82% of plan participants want their investments to reflect their personal values. What's more, 77% of millennials would like to have more socially responsible investments in their retirement plans, and 71% say they would either contribute for the first time or increase their retirement plan contributions if they knew their investments were doing social good.[1] That's important because by 2025, 75% of U.S. workers will be millennials.

"Over the next six, seven, eight years, millennials will be the participant base in the 401(k) universe," Farrington said. "As an industry, we need to respond to their needs, their wants, their demands and their hopes. We have to provide everything we can to be sure that not only are they participating, but participating at a level that will allow them to retire with dignity."

The other critical factor, which dovetails with the DOL's updated guidance, is that millennials' interest in ESG is not simply about doing and feeling good, Farrington said, it's about performance.

"Millennials absolutely have an interest in investing in companies that they believe will positively shape their future. Companies that will be around in 10, 15, 20 years and will benefit from trends that are quite predictable, like the scarcity of resources, urbanization, the aging population and the changing nature of financial services," he said.

"The things they care about are additive to the business," he continued, citing strong management teams and business practices, and the ability to attract the best talent. "Their attitudes are not simply those of do-gooders; they're very pragmatic."

The DOL guidance also covered how plan sponsors handle qualified default investment alternatives, better known as QDIAs. The department's approach was consistent with its overall view regarding the best interest of participants. For Farrington, that's another piece of good news for plan sponsors.

"The minute you default somebody into an investment, there is a higher bar, not just an option that someone might or might not choose," he said. "The [QDIA] language on ESG goes back to the simple notion: Can an ESG framework exist in a QDIA framework? The answer is yes, but you better make sure you can prove that when you do the due diligence on the underlying fund or funds. We believe that when plan sponsors do that due diligence, they're going to find that these two things can coexist." ■

www.pionline.com/Natixis_ESG

[1]Natixis Investment Managers, Survey of Defined Contribution Plan Participants compiled by CoreData Research, August 2016. Survey included 951 U.S. respondents.