INVESTMENT INSIGHTS

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Target-date Funds Catching the Tailwind of ESG Investing

Over the past 12 to 18 months, environmental, social and governance investment options have become more available in defined contribution plans, but asset growth has been rather limited. That's likely to change — and change quickly — when ESG-based target-date funds become a regular feature on retirement plan fund lineups.

"The real watershed moment will come when more and more plans make a fully diversified ESG option available in their plan, specifically a target-date fund," said Edward Farrington, executive vice president of retirement strategies at Natixis Investment Managers.

The reasons are rooted in supply and demand, the latter coming from the millennial generation, who will make up 75% of American workers by the year 2025. These individuals "are in a financially important part of their life," according to Farrington. "And they are actually quite pragmatic. They're not looking at ESG investment purely for its feel-good characteristics. They want to invest in companies and themes that shape the world they want to live in." Indeed, young people do not even really see ESG as a separate part of the asset allocation process, but consider it as a vital qualification fully embedded in their search for investment options. This will drive allocations to ESG for the foreseeable future as more millennials make contributions to retirement plans.

As they do, target-date funds, which have become one of the most popular default investment options that 401(k) participants use, will become even more alluring. Target-date strategies account for about 20% of DC assets among the top 1,000 retirement plans, according to Pensions & Investments data, and target-date funds are taking in about half of all new assets going into DC plans.

"People like the simplicity of having an asset allocation that changes with them over time to meet their needs as they age," Farrington said. "In the same breath, they want ESG. We just believe that the time has come where you can do both — as a fiduciary who is thinking about nothing but economic interests and as a person who wants to create the best behaviors you can in your plan — and we know that the ESG side of the equation helps do that."

At the same time, recent government initiatives could lead to an increase in supply. First by making DC plans more accessible to the general public. President Donald Trump's Aug. 31 executive order directing administration officials to expand retirement savings options by revisiting rules on open multiple-employer plans and minimum distributions should accomplish this, according to Farrington.

"Anything that makes it easier for participants to have access to a defined contribution plan is a good thing," he said. "This has the chance to make it far easier to have the benefits of scale, specifically the benefits that come with reduced cost and complexity. We think it is a very important step forward."

Separately, the Department of Labor's Field Assistance Bulletin issued earlier this year has led to greater adoption of ESG investing, according to Farrington. The DOL bulletin, an effort to clarify its existing guidance on ESG investing for ERISA plans, initially raised concerns that it would dissuade plan sponsors from pursuing ESG. In fact, the opposite has happened.

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Farrington said many plan sponsors are saying the DOL guidance has simplified ESG investing, because they can just view their ESG options in the same way they view their other investment options.

The result is that simple questions — such as, Are you a good manager? Does your process produce financial outcomes that are helpful to my participants? — can guide the process. "Whether that is ESG or not no longer matters," Farrington said. "What people find when they actually pull the covers back is that ESG done right is additive to risk management."

This is why Farrington believes the real growth will occur when more and more plans make a fully diversified ESG option — a target-date fund — available. And that will happen, Farrington said, because the greater availability of ESG-specific data from companies has facilitated the efforts of money managers.

"One of the reasons we were confident in actually launching an ESG target-date product is that the amount of data now being produced by companies and governments that is ESG-centric has grown exponentially in the last five to 10 years," he said. "Now we are able to complete all of the components of a glidepath." Information is no longer constrained. "You have information on midcap companies, you have information on U.S. companies, you have information on emerging market companies, you have information on bonds."

That wealth of data and information has helped Natixis develop an ESG target-date fund series, called Natixis Sustainable Future Funds, that uses a mix of active and passive investment strategies.

"We're really proud of our active managers, but there are some spaces that are just easier to access through passive structures," Farrington said. For example, to have a value-tilted U.S. equity sleeve, Natixis used a screening methodology to create an ESG value-tilted index. For emerging market exposure, soon Natixis will be adding an ESG EM index to its glidepaths.

"That is a space that is far easier than doing all the fundamental research," Farrington said. "Some places are easier to access via passive, and so we made the decision that we are willing to do that in order to provide proper asset allocation."

There is enough diversification that ESG target-date funds can be included as a qualified default investment alternative, or QDIA, in DC plan lineups, Farrington added. "Many of the firms we are working with have found comfort in that and have actually made us their default."

The last few years have seen a lot of talk about ESG, and in many areas, this talk has started to translate to asset flows. But Farrington and others see the real growth ahead. Target-date funds with a full set of ESG options will unlock this growth.

"If we know the potential performance is there, the risk management protocol is there and the diversification is there, and it helps them have better behaviors, and save more and save sooner," he said, "I just think it is an inevitable movement." ■

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