Responsible Investing & TDFs: Discernment required

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Why invest responsibly? And what to keep in mind...

WHY?

- Plan member demand
- Opportunity
- Risk mitigation
- Improving the world

KEEP IN MIND...

- Best financial interest
- One (of many) factors
- Multitude of RI approaches

Responsible investing spectrum

Different approaches to managing ESG risks and opportunities

APPROACH

SCREENING	ESG INTEGRATION	SUSTAINABILITY-FOCUSED	IMPACT-FIRST	PHILANTHROPY

OBJECTIVES

- Primary objective is delivering competitive returns
- Goal of societal and/or environmental impact
- Primary goal is societal/environmental impact

Target Date Funds: A complex multi-asset solution

How to determine a TDF's alignment with ESG

ASSET ALLOCATION	INVESTMENT STRATEGIES	INVESTMENT MANAGER
Some asset classes are more challenging to make ESG-friendly.	Are there specific ESG commitments embedded in each underlying fund's objective?	Where are they in their sustainability journey?

What’s in a name?

Labels don’t tell the whole story

- Labels can be misleading
- There is no common terminology—industry definition
- Responsible investing terms mean different things to different people

Responsible investing

Analyzing the spectrum

SCREENING

ESG INTEGRATION

SUSTAINABILITY-FOCUSED

IMPACT

PHILANTHROPY

Negative screening

Actively eliminate certain investments from portfolio

Driving Forces	• Ethical alignment (values) • Seeking to mitigate risk (financial value)
Features	• One of the oldest forms of Socially Responsible Investment* • Can be activity or norms based
Considerations	• Does not necessarily lead to real change • Constrained investment universe

* In 1758, the Quaker Philadelphia Yearly Meeting prohibited slave trade.

Positive screening (thematic)

Align with sustainability objectives

Driving Forces	• Increased recognition that ESG investing is financially material • Client demand • Expected improvement in long-term risk-adjusted returns
Features	• Activity based • Wide variety of approaches
Considerations	• ESG criteria • Methodologies and rankings are inconsistent • May reduce opportunities for engagement • May not drive real world change

Ratings are useful, but only one part of a bigger picture

Correlations are not high—no consensus among ratings

Legend		
SA = Sustainalytics	MO = Moody's ESG	KL = KLD
SP = S&P Global	RE = Refinitiv	MS = MSCI

	KL SA	KL MO	KL SP	KL RE	KL MS	SA MO	SA SP	SA RE	SA MS	MO SP	MO RE	MO SP	SP RE	SP MS	RE MS	Average
ESG	0.53	0.49	0.44	0.42	0.53	0.71	0.67	0.67	0.46	0.70	0.69	0.42	0.63	0.38	0.38	0.54
E	0.59	0.55	0.54	0.54	0.37	0.68	0.66	0.64	0.37	0.73	0.66	0.35	0.70	0.29	0.23	0.53
S	0.31	0.33	0.21	0.22	0.41	0.58	0.55	0.55	0.27	0.68	0.66	0.28	0.65	0.26	0.27	0.42
G	0.02	0.01	-0.01	-0.05	0.16	0.54	0.51	0.49	0.16	0.76	0.76	0.14	0.79	0.11	0.07	0.30

High correlation >0.59	Medium correlation 0.31 to 0.58	Low correlation <0.30

Source: *Aggregate Confusion: The Divergence of ESG Ratings*, by Florian Berg, Julian F. Kolbel, Roberto Rigobon, MIT Sloan, University of Zurich, April 15, 2022

ESG integration

Explicit inclusion of ESG considerations in investment processes

Driving Forces	• Integrated deepening insights into companies' ESG business issues • Expected improvement in long-term risk-adjusted returns
Features	• The most common form of RI • ESG factors assessed during asset selection, portfolio balancing and risk management processes • More complex than screening: discernment, effort, time, resources required
Considerations	• The most integrated investment approach • True ESG integration requires a deep, long-term, evolutionary commitment • Successful ESG integration should ultimately influence real world change

Sustainability-focused

Address specific societal challenges while seeking competitive returns

Driving Forces

- Investors looking for competitive returns while also making a positive societal and/or environmental impact
- Fund managers compelled to act as responsible stewards
- Companies making a positive impact will likely be rewarded in the long term

Features

- Often begins with positive screening
- Investing in companies with a *core function* that are contributing to a specific E, S and/or G solution

Considerations

- Portfolio can be concentrated due to limited/restricted universe
- There is no perfect company
- Difficult to evaluate impact
- Generally shorter track-records

RI & TDFs: it's a journey

- Responsible investing is **key to the future**
- Plan sponsors' primary responsible is to ensure plan members **achieve their retirement savings goals—and TDFs are usually the default option**
- TDFs need to evolve along the RI spectrum, but they are **complex multi-dimensional** portfolios
- **ESG integration** is by far the most prevalent approach because it arms managers with insights and foresight, which should ultimately lead to the risk-adjusted returns in the long run
- Managers **need to evolve** with this rapidly changing area

RI & TDFs: Assessing your TDF

Discernment is required

Performance

Dedicated RI resources & collaborations

Assessment and alignment

Flexibility

Future plans

Appendix

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Impact-first & philanthropy

Measure progress against specific environmental and social goals

Driving Forces	• Desires by clients to fund change • **Impact-first** combines desire for change and an expected return, may be a lower than market return • **Philanthropy** may seek to invest to drive change
Features	• More of a niche market • Focus tends to be on the cause or concern first • Intentionality, financial returns • Measure progress against specific environmental and social goals
Considerations	• Not appropriate for a financial return focused investor/not adapted for pension industry • Can be very narrowly focused and ignore segments of a market or economy