The growing case for ESG in DC plans

Funds that consider environmental, social and governance factors can help members mitigate emerging risks and capture new drivers of long-term growth

Investors with long time horizons need to consider how the world may look tomorrow, not just what it looks like today. That can mean adopting new criteria to assess an investment's potential performance.

The World Economic Forum predicts that seven of the 10 greatest risks facing people, institutions and economies over the next decade come from threats outside of purely financial categories, such as extreme weather events, water and food crises, and the impact of climate change.[1] These risks create opportunities for companies that can adapt to the changing economic landscape.

Traditional investment analysis by itself may not adequately examine these non-traditional drivers of long-term performance. That's why more investors are considering the potential impact of environmental, social and governance (ESG) factors on a company's long-term growth potential.

At its core, ESG investing is based on the idea that environmentally efficient, socially responsible and well-governed firms are better positioned to withstand emerging risks and capitalise on new opportunities. As stewards of their members' assets, scheme sponsors and trustees should consider all the risks and opportunities that can affect long-term investment outcomes. Incorporating ESG into the scheme's investment strategy can help balance risk and potential returns.

The evolution of ESG investing

Although ESG strategies have roots in earlier generations of ethical or socially responsible investing, today's ESG investors may be less motivated by values than they are by ESG factors'

ability to mitigate risk, and to capture opportunities for innovation and growth.

For example, environmentally-efficient firms may consume fewer resources and produce less waste than competitors, helping them generate lower costs and higher returns on capital.

Social factors have emerged as important proxies for management quality, such as studies showing that management teams with greater gender diversity provide superior corporate performance.[2]

The value of good governance is clear as well, especially in light of recent corporate scandals related to auto emissions, food safety and labour issues. Effective, independent boards of directors and strong internal controls can reduce the likelihood of corporate malfeasance, fraud and other ethical breaches that damage shareholder value.

These trends suggest that ESG factors will only become more important to corporate health – and by extension, to shareholder returns – over time. That makes ESG investing especially relevant for long-term investors such as DC plan members.

How ESG can fit into a DC scheme

It has been common for DC schemes to offer an ethical fund for scheme members who wish to choose an investment fund consistent with their personal values. Typically, this would be a fund that screens out certain companies with business activities counter to those principles, for example involvement in the arms trade or tobacco. But the debate is now moving on to the default strategy, given that relatively few scheme members make active investment choices and reflecting the fact that the ESG debate now focuses more on long-term financial risks than on simply values themselves.

Equities form the majority of the growth phase of most default strategies, and most DC plans will have significant exposure to index funds benchmarked to market-capitalisation weighted equities. We expect to see these approaches evolve to reflect ESG principles; excluding some companies – for example, those producing controversial weapons—and tilting towards those that have better ESG credentials. Some early approaches have focused on climate change and tilting towards less carbon-intensive companies, but this can be extended to cover wider environmental issues (such as water and waste) and social issues (such as labour relations and diversity).

Schemes have an obligation to offer members appropriate and well-governed default investment strategies that deliver long-term value – and we believe that ESG has a key role to play in that effort.

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[1] The Global Risks Report 2017, World Economic Forum.
[2] Women on Boards: Global Trends in Gender Diversity on Corporate Boards, MSCI, November 2015.