Bit by Bit, Socially Conscious Investors Are Influencing 401(k)'s

By Mark Miller

Peter Rothstein has a job with a social purpose: expanding the clean energy industry in the northeastern United States as a way to mitigate climate change. Soon, he will be able to support that mission when he saves for retirement.

In November, the Boston-based Northeast Clean Energy Council, where Mr. Rothstein is president, will revise its 401(k) plan investment offerings to include mutual funds promoting those sustainability goals. The revamped plan will include a target date fund series that screens for environmental, social and governance factors — so-called E.S.G. investing. The council, a nonprofit business alliance of 250 companies, will continue to offer traditional choices such as total-market index funds, but the E.S.G. option, Natixis Sustainable Future funds, will be the default investment choice for Mr. Rothstein's staff of about a dozen employees.

Mr. Rothstein views the shift as a natural evolution. "We have the expertise to understand that these new business models have the potential to be climate solutions and to grow the economy at the same time," he said. "With that perspective, it makes sense for us to incorporate E.S.G. investing for our retirement plan."

The idea of investing with a social purpose is gaining ground. The broad category of sustainable and responsible investing grew 38 percent in the United States from 2016 to the start of 2018, to $12 trillion in assets under management, according to the US SIF Foundation. That represented one out of every four dollars of the $46.6 trillion under management, the group noted. A wide range of investments were held, including mutual funds, annuities, E.T.F.s and closed-end funds.

Morningstar reported that 2018 marked the third consecutive year of record flows into sustainable funds; the number of sustainable funds also jumped nearly 50 percent.

So far, most sustainable investments are held by institutional and high-net-worth investors. US SIF data showed that of the $12 trillion invested last year, 72 percent was held by organizations such as pension funds, insurance companies and educational and philanthropic groups; 25 percent was managed on behalf of high-net-worth clients or individual investors.

Negligible amounts are held in workplace retirement plans. In 2017, 4 percent of defined contribution plans included E.S.G. funds, according to a survey by the Plan Sponsor Council of America, and they held less than 1 percent of total plan assets.

But some experts think 401(k) plans will play a larger role in E.S.G. investing in the years ahead, driven partly by demand from participants. And interest is widespread. A Morningstar study published this year found that more than 70 percent of the United

States population has “at least a moderate interest” in sustainable investing. The appetite is especially strong among younger workers: A Natixis survey of 401(k) plan participants this year found that 67 percent of millennials would be more likely to contribute, or increase their plan contributions, if they knew their investments were contributing to social good.

That level of interest is motivating employers to consider adding E.S.G. funds to their investment menus. Some observers also link the growing employer interest to changing ideas in board rooms about the broader societal responsibilities of corporations. Those ideas were on display in the recent statement issued by the Business Roundtable calling on corporations to redefine their purpose to include not only shareholder interests but employee interests, environmental protection and fair dealing with suppliers.

Most E.S.G. mutual funds rely on ratings systems that score securities for their exposure to indirect financial factors, including a company’s environmental impact, governance policies or how it treats employees or monitors its supply chains. The funds either underweight or eliminate securities that fund managers expect to have high risk associated with those factors, or tilt toward those that an investor believes will have a positive impact.

Critics of socially responsible investing argue that investors must sacrifice strong returns in return for their socially responsible choices. “There’s been a historical perception that in order to have E.S.G. investments, a participant needs to forego performance,” says Ed Farrington, head of retirement strategies at Natixis. “We’re spending a majority of time educating sponsors and plan participants that we don’t think that is true.”

A growing body of evidence supports Mr. Farrington’s case. Morningstar maintains a group of E.S.G.-screened equity indexes. It reported that, among the most rigorously screened 10 indexes, eight outperform their non-E.S.G. equivalents — in some cases, by substantial margins. The research found that E.S.G.-screened equities also were better than average on measures of quality, financial health and volatility.

The indexes utilize E.S.G. criteria, but also exclude companies involved with tobacco, weapons and civilian firearms, nuclear products and those with significant exposure to gambling, alcohol or adult entertainment.

Natixis Sustainable Futures has been operating for less than three years, but its performance so far is promising. All 10 of its target date series are in the top 1 percent of performance ranked by Morningstar from their inception through the second quarter this year.

“It’s performed pretty well so far — I’d expect to see it get more traction when it has a three-year record,” says Jon Hale, head of sustainability research at Morningstar.

E.S.G. investing is different from the first waves of socially responsible investing, which began during the 1960s era of shareholder activism, divestment initiatives and impact investing. The early fund offerings often focused on a single, narrow area of investments, or only on exclusion of specific investment categories, such as fossil fuels.

Image
Shira Tannor is chief administrative officer at Veritable Vegetable in San Francisco. The produce distributor has offered socially responsible mutual funds in its 401(k) since 1995.

Veritable Vegetable, an organic produce distributor in San Francisco with about 130 workers, was part of that early wave, and has included socially responsible mutual funds since starting its 401(k) plan in 1995.

The company traces its roots to the 1970s, when it was the organic produce arm of the People's Food System, a network of worker-owned cooperative stores and businesses in the Bay Area.

"Since the beginning we've been committed to nurturing and promoting environmental sustainability in everything that we do," Shira Tannor, the company's chief administrative officer, said. Veritable Vegetable is a certified B Corp, which means that it meets a set of standards for social and environmental performance.

"We have a different vision of what profitability means," Ms. Tannor said. "We aim to pay a good living wage to our workers, and sustainable prices to the farmers we work with, and to help people eat healthy food. We're a for-profit business, but if we have nothing left over after that, we consider that a success."

Veritable Vegetable's 401(k) investment menu is typical of first-generation socially responsible investing. There are 18 fund options, most of which are actively managed. Expense ratios — which indicate how much of a fund's assets are used for administrative and other expenses — range from 1.3 percent (Shelton Green Alpha) to 0.79 percent (American Century One Choice, which is a target date fund).

"No doubt the fees are higher — we understand that," Ms. Tannor said. "But we don't make decisions based just on financial return — we're always looking at it through the lens of sustainability. It's in our DNA."

The evidence that E.S.G. can match or beat traditional investment options is piquing greater interest among plan sponsors.

"We're getting more questions from plan sponsors — they're asking if they should be adding this to their investment menus," says Mikaylee O'Connor, head of defined contribution solutions at RVK, a New York-based investment firm that advises workplace retirement plans. "What's driving many of the conversations with plan sponsors is there is more research that supports consideration of sustainable investing."

But obstacles remain — starting with regulatory uncertainty.

Under federal law, plan sponsors have a fiduciary obligation to employees to put the economic interests of participants ahead of other considerations when making decisions about retirement benefits. But guidance issued in recent years by the Labor Department on whether E.S.G. products meet that obligation has shifted repeatedly.

Sponsors typically take a conservative approach to change. “Part of the issue is a reluctance to upset the apple cart,” said Timothy Yee, a specialist in E.S.G. investing and co-founder of Green Retirement, which advises 401(k) plans, including Veritable Vegetable’s. “Some senior managers view their 401(k) plans simply as a cost center, rather than as a way to promote company values, or retain employees.”

Most experts agree that E.S.G. investing in workplace plans will take off only if it becomes available more widely through target date funds, which automatically reduce participants’ exposure to stocks as retirement approaches. Target date funds have been the overwhelming favorite in 401(k) plans since they were designated by the Department of Labor as a qualified default investment choice.

Many plan sponsors view these funds as the most cost-efficient way to deliver improved retirement outcomes to plan participants of various ages.

But there’s an expense hurdle stopping target date funds from becoming socially responsible funds. By definition, E.S.G. and socially responsible investing funds are actively managed and typically carry higher expense ratios than passive index funds. The Natixis target date fund series, which is marketed as an E.S.G., carries an average expense ratio of 0.58 percent, which is a bit lower than the 0.62 percent average for all market-weighted target date funds in 2018, according to Morningstar. But the industry’s most efficient passive target date fund offerings are far less expensive than that — Vanguard’s charged just 0.12 percent last year.

Mr. Rothstein remains bullish, noting that the council’s shift to a socially responsible 401(k) plan was resonating with employees.

“Everyone working in this industry, and more people in general, are recognizing that this matters,” he said.