NORTHERN TRUST

ASSET MANAGEMENT

SHOULD PLAN SPONSORS CONSIDER SUSTAINABLE INVESTING IN DC MENUS?

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Northern Trust Asset Management

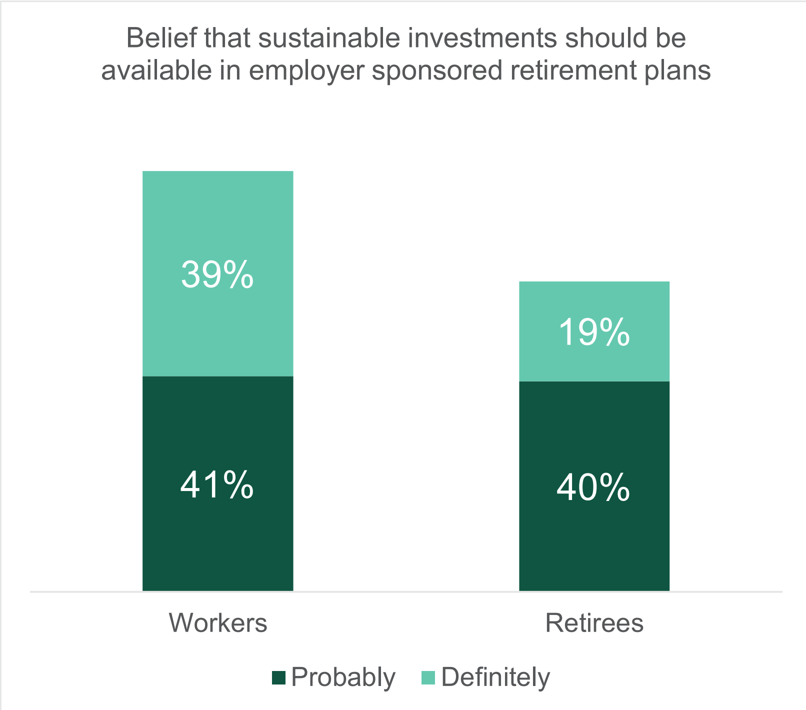
The adoption of Sustainable Investing (SI) strategies, or those that integrate Environmental, Social and Governance (ESG) analytics, has seen considerable growth over the last decade as investor preferences have shifted to these solutions.[1] However, many Defined Contribution (DC) plan sponsors have sat on the sidelines as they wait for clarification from the Department of Labor (DoL) regarding the viability of sustainable strategies in DC investment menus. Plan sponsors are demonstrating an interest in adding SI strategies as a response to bottom-up demand from participants, as well as top-down interest in aligning menu design with organizational sustainability values. In this paper, we will explore whether plans that add a standalone sustainable investment option attract participant engagement or not and how SI strategies perform relative to cap-weighted benchmarks. Furthermore, we will discuss recent guidance from the DoL supporting the use of SI strategies in DC investment menus.

ENGAGING YOUR WORKFORCE THROUGH SUSTAINABLE INVESTING

One potential benefit of adding an SI option to a DC menu could be an increase in participant engagement with their DC plans, which we believe can potentially lead to higher savings. Millennials, a generation that has communicated a growing appetite for SI investment options,[2] are the largest cohort represented in the American labor force.[3] But interest in SI strategies goes beyond just millennial investors. A 2021 study conducted by Northern Trust Asset Management found that roughly eight in 10 workers believe SI options should be available in their 401(k) plans, and approximately six in 10 retirees feel the same way.[4]

[1] Morningstar, "Sustainable Funds U.S. Landscape Report." Data as of January, 2022
[2] https://www.cnbc.com/2021/05/21/millennials-spurred-growth-in-esg-investing-now-all-ages-are-on-board.html
[3] https://www.pewresearch.org/fact-tank/2018/04/11/millennials-largest-generation-us-labor-force/
[4] Northern Trust Asset Management, "Worker and Retiree Survey," 2021

EXHIBIT 1 - Workers and Retirees Believe Sustainable Investments Should Be Available via Employer Sponsored Plans



Source: Northern Trust Asset Management, "Worker and Retiree Survey", 2021.

In addition to being outspoken about securing access to these investment options, plan participants also utilize them when available. Our aforementioned study found that while only 39% of investors have access to sustainable investment through their employer sponsored retirement plan, 67% of those with access invested in the sustainable option. Thus when plan participants are offered a sustainable investment option, there is a high likelihood that participants may allocate to that fund.[5]

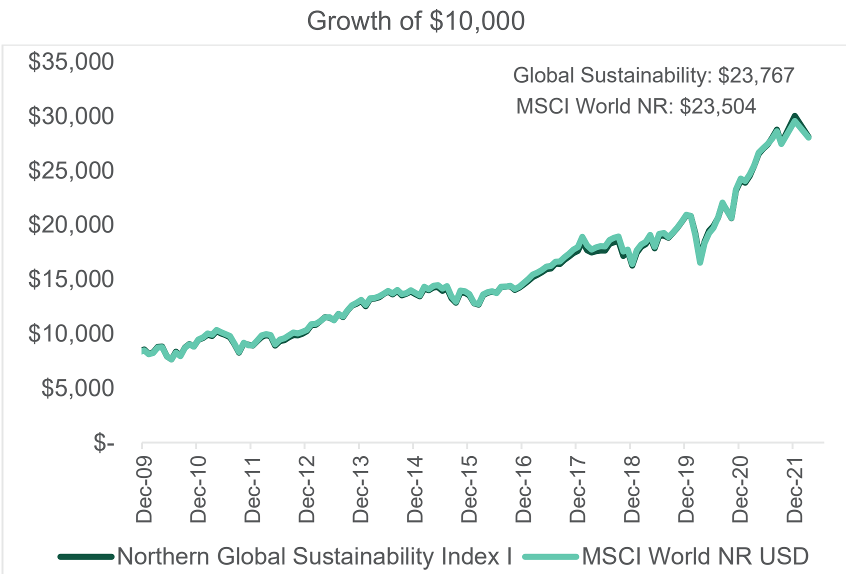
SUSTAINABLE INVESTING MAY NOT MEAN SACRIFICING RETURN

Although there is participant demand for SI strategies, the most frequent question plan sponsors ask is if these strategies can perform well relative to non-SI strategies. The answer is yes, as there are SI funds that are designed to generate market rate returns. That said, as plan sponsors assess capabilities, it is critical that they consider which ESG data is used and how it is integrated into the portfolio construction process. We see many plan sponsors attracted to rules-based, passively managed ESG indices because they fit into largely passive plan designs, they provide transparency into how ESG data is being leveraged in the investment decision making process, and are easy to compare to a market cap weighted benchmark.

[5] Northern Trust Asset Management *Worker and Retiree Survey,* 2021.

One such example is the MSCI World ESG Leaders index, which was designed to leverage ESG risk ratings to provide relatively low tracking error and broad market exposure. This index, which is tracked by the Northern Global Sustainability Index fund, launched in Q4 2007. It has largely performed in line with the market cap weighted benchmark during its 15-year life cycle, and thus provides a great live illustration of a sustainable strategy designed to perform.

EXHIBIT 2 - Cumulative Index Performance (December 2009 – December 2021)



Source: Morningstar Direct. Data as of 12/31/2021.

We can find other examples of SI design and implementation in other index families and across asset classes, but equities tend to be the most common area of implementation within DC plans.[6]

In spite of this evidence, the growing suite of diversified capabilities available in the marketplace and the demonstrated appetite of plan participants, we continue to see certain plan sponsors hesitate to add a strategy in light of the lack of clarity in the DoL's guidance on the inclusion of ESG investing in retirement plans.

REGULATORY ENVIRONMENT SHIFTING TO A FAVORABLE TONE

Current DoL guidance affirms that plan sponsors may add sustainable strategies to menu design as standalone options. Where the DoL has not been clear is around the consideration of ESG strategies as default options in plan design. It's unfortunate that the inclusion of SI strategies in ERISA

[6] Blanchett, David and Liu, Zhikun, ESG Fund Allocations Among New, Do-it-Yourself Defined Contribution Plan Participants. June 29, 2022.

plans has become “an unhelpful regulatory game of ‘ping pong’”,[7] which has created confusion for plan sponsors. However, the Biden-led DoL has taken a positive stance on the inclusion of strategies that integrate material ESG analytics in ERISA plan assets, with its recent proposed rule titled “Prudence and Loyalty in Selecting Plan Investment and Excursing Shareholder’s Rights”. This proposed rule, released in 2021, suggests that ESG factors can have material financial impact on investments, just as traditional financial factors (e.g., quality, value, size, etc.) do and, as such, can be an appropriate consideration when plan fiduciaries are evaluating DC Plan investments. This perspective aligns with Northern Trust Asset Management’s philosophy of SI, and we were happy to submit a comment to the DoL in support of this.

While this is certainly a favorable shift in tone for plan sponsors who wish to incorporate SI strategies in their plans, it is important to note that this is still a proposed rule and not yet a final ruling. The release date of the formal rule is not known but is expected at some point in 2022.

For the time being, it is prudent for plan fiduciaries to gain an understanding of the proposed ruling and how it aligns with their view on the use of ESG factors in the investment decision-making process. It is also a good time for plan sponsors to gain an understanding of how their current investment managers are (or aren’t) currently using ESG analytics in their investment approaches. And we continue to observe sponsor engagement on the topic, particularly regarding adding standalone options.

Our belief is that material ESG factors are pre-financial indicators that can affect a company’s future financial viability and clients’ long-term risk-adjusted investment returns. Consistent with our view that investors should be compensated for the risks they take, we believe evaluating companies’ performance using ESG criteria enhances our forward-looking view of risks and opportunities, and that such analysis bolsters our ability to future-proof portfolios and grow clients’ capital. This underscores our firm belief that DC investors can benefit from seeking SI strategies without foregoing performance over the long-term.

CONCLUSION

Plan sponsors are beginning to incorporate SI strategies in their DC menus, and we see this trend continuing in the years ahead. Our recent research demonstrates that participants are interested in SI strategies and engage with them when provided access to these options in their retirement plans. SI strategies can complement the existing DC menu with the potential to mitigate risks and capture new opportunities for long-term investors. We find that SI options are gaining traction as plan sponsors work to increase engagement and align DC menus with participant demand and institutional values, while being conscious of their fiduciary responsibilities.

NORTHERN TRUST RETIREMENT SOLUTIONS

As one of the largest managers of retirement assets in the United States, our team has deep expertise in developing innovative answers to challenges

[7] Fact Sheet Notice of Proposed Rulemaking on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights. October, 13, 2021.

faced by many plan sponsors, retirement advisors and individual investors. We take a consultative approach to addressing our clients' needs and offer a suite of solutions aimed at improving retirement outcomes.

NORTHERN TRUST ASSET MANAGEMENT

As a leading global asset management firm, our investment expertise, strength and innovation have earned the trust and confidence of the world's most sophisticated institutional and individual investors.

With $1 trillion in total assets under management[8] and a long-standing history of solving complex challenges, we believe our strength and stability drive opportunities for our clients. Our comprehensive asset class offering includes passive, factor-based, fundamental active and multi-asset class solutions that are available in a variety of investment vehicles.

[8] Assets under management as of June 30, 2022.

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