Minds, Hearts, and Souls: ESG as a Catalyst for Plan Success

Plan sponsors have a lot of priorities to balance. Given limited resources and time, where should environmental, social, and governance (ESG) strategies rank among the many priorities competing for plan sponsors' attention? New research from Wells Fargo Asset Management (WFAM) seeks to answer this question.

New research from Wells Fargo and Gallup explores surveyed investors perspectives on ESG and retirement income investing

WFAM regularly sponsors research in partnership with Gallup, Inc., as part of the Wells Fargo/Gallup Investor and Retirement Optimism Index survey. Fourth-quarter 2017 findings revealed crucial insights, which we present to you in a two-part research series.

This first part reveals that ESG investing can be a keystone in the pursuit of retirement plan success—the answer lies in engaging participants' minds, hearts, and souls.

Enlightening minds

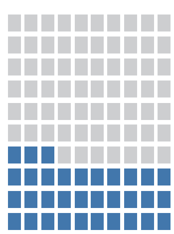
Surveyed investors don't realize they may achieve equal or better financial performance with ESG strategies.

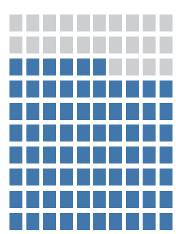
Only 39%

of surveyed investors understand that ESG investments perform the same or better than traditional investments

Winning hearts

Interest in ESG investing more than doubles when surveyed investors can understand and connect with its impact.





33%

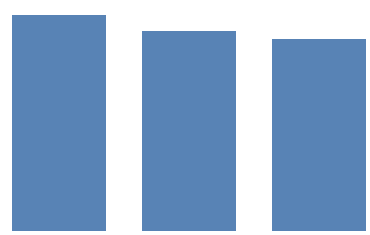
are interested in ESG investments

76%

are interested, on average, in ESG themes when specific impact is expressed

Nourishing souls

ESG investing especially appeals to women, younger, and higher-income surveyed investors who seek alignment between their values and how they live their lives.



49% Women

47% Age 18–49

46% Earning >$90K/yr

Percent who would invest in ESG strategies if offered in a 401(k)

Where should ESG fit in plan sponsor priorities?

To answer this question, we began by surveying nonretired investors on the topic of ESG investing, including a simple question: "Would you include an ESG investment in your 401(k)/defined contribution portfolio if the option were available to you?" While the 44% who answered "yes" is a significant segment, it's not a majority. As a result, some might say that plan sponsors would be better served to focus on other priorities. We disagree.

Contents

Read on to dig deeper into our findings and gain actionable takeaways that plan sponsors can use immediately.

First, simple questions don't always tell the whole story—particularly when the subject of the question is not perfectly understood. As we dug deeper, we uncovered that only 39% of surveyed investors understand that ESG investments may perform as well as or better than traditional investments, as shown in a large body of academic research. In fact, one-third of those surveyed assume that ESG investing results in financial underperformance.

Despite this incorrect perception of the impact of ESG on financial performance, surveyed investor interest in the specific issues that underpin ESG investing is very high. In fact, about three out of four surveyed investors are interested in ESG investing when it is framed in the context of more specific ESG themes, such as:

- **Protecting the environment, including fighting climate change and supporting innovations in energy, pollution, and waste management**
- **Doing social good, such as promoting diversity and inclusion, improving education, or protecting human rights**
- **Promoting responsible corporate governance, including ethics and other behaviors**

Second, workforce demographics are changing rapidly. By 2025, Millennials will make up 75% of the working population, and, as we will see, ESG is a key area of interest for this cohort.[1]

ESG is a missed opportunity

How can plan sponsors use ESG as an opportunity to engage with their participant population when there is clearly a disconnect between what participants care about and how they perceive ESG investing? We believe the answer lies in engaging participants' minds, hearts, and souls.

Read on for more on this as well as the actions plan sponsors can take today.

1. Source: The Brookings Institute

Quick refresh: What exactly is ESG?

One of the challenges with ESG is a lack of standard terminology, which can confuse even industry experts. We think of ESG as the environmental, social, and governance issues that can have a material impact on a company's performance via reputational, operational, and financial risks or via commercial opportunities (such as clean technology innovations to accelerate the transition to a low-carbon economy).

Sample of ESG issues, examples, impact, and financial implications

Environmental	Social	Governance
Biodiversity & land usage Climate change Green building Renewable energy Water stress/pollution	Consumer protection Diversity & inclusion Human capital Labor standards Privacy & data security	Accounting Board structure Business ethics & fraud Corruption Executive compensation
INCIDENT **BP Deepwater Horizon oil spill** April 2010	INCIDENT **Equifax data breach** September 2017	INCIDENT **Enron accounting fraud** October 2001
Environmental impact: More than 200 million gallons of oil pumped into the Gulf of Mexico	**Social impact:** Personal information compromised for 143 million Americans	**Governance impact:** Largest corporate bankruptcy at the time with more than 20,000 jobs lost
Financial implications: Record fines of more than $20 billion	**Financial implications:** Short-term stock price dropped 20%, a loss of $4 billion in shareholder value	**Financial implications:** Stock price dropped from $13.90 to $0.26 in one month

Sources: *The Wall Street Journal,* yahoo.com, epa.gov, nytimes.com, and cnn.com

ESG performance myth is still believed by many investors

Only
39%
of surveyed investors understand that ESG investments perform the same or better than traditional investments

Enlightening minds

Studies reveal the impact of ESG on performance is not negative

There was a strong perception in the 20th century that responsible investing equated to simply screening out sin stocks. The perception of the reduced opportunity set led some investors to expect lower returns compared with the market portfolio. Nearly two decades into the 21st century, our research shows that this underperformance myth still persists. Investors broadly are unclear about the performance of ESG strategies relative to traditional, mainstream strategies. In our research, 61% of surveyed investors either believe ESG investments underperform or are unsure about the performance of ESG investments. Only 39% believe ESG investments may deliver the same or better performance.

Academic research, including a meta-analysis of over 2,200 individual studies conducted in 2015,[2] has shown a non-negative relation between ESG and corporate financial performance, and a large majority report positive findings. In fact, 48% of vote-count studies and 63% of meta-analysis show a positive link between ESG and corporate financial performance. Clearly, this is a misunderstanding that must be addressed with more education.

SPOTLIGHT

Academic research supports the non-negative impact of ESG on performance

Roughly 90% of the ~2,200 studies reviewed show a non-negative relation between ESG and corporate financial performance, and a large majority report positive findings.

Vote counting: A method for synthesizing evidence from studies, comparing the number of studies showing benefit with the number of studies showing harm. **Meta analysis:** A method for combining pertinent qualitative and quantitative data from several studies to develop a single conclusion that has greater statistical power.

Source: *Journal of Sustainable Finance & Investment*[2]

Implications for plan sponsors

Plan sponsors have the chance to position themselves as forward thinkers by helping participants understand that, historically, performance usually has not been sacrificed by ESG investing; it has been at least neutral, if not beneficial, according to the most comprehensive academic studies. With this knowledge, participants can come to see a natural alignment between their financial goals and their personal values rather than thinking that a focus on one results in a sacrifice of the other.

2. Gunnar Friede, Timo Busch, and Alexander Bassen. 2015. "ESG and Financial Performance: Aggregated Evidence From More Than 2000 Empirical Studies," *Journal of Sustainable Finance & Investment*, 5:4, 210–233, DOI: 10.1080/20430795.2015.1118917.

Winning hearts

ESG issues matter to participants

Sometimes emotions trump all. When asked in general terms about ESG, just 33% of surveyed investors expressed initial interest. Yet, three out of four expressed interest in ESG themes—such as protecting the environment, doing social good, and promoting responsible corporate governance. On average:

- 76% are interested in at least one of the ESG themes
- 59% are interested in all three ESG themes

The more participants can understand and connect with the impact their investment makes, the higher the level of interest in ESG investing across all participant segments.

Investors are interested in doing good

78%

of surveyed investors expressed interest in **protecting the environment**, including fighting climate change and supporting innovations in energy, pollution, and waste management

76%

of surveyed investors expressed interest in **doing social good**, such as promoting diversity and inclusion, improving education, and protecting human rights

74%

of surveyed investors expressed interest in **responsible corporate governance**, including ethics and other behaviors

Emotions are key drivers of behavior, and plan sponsors may benefit from engaging participants by speaking to their emotions and values. Many companies spend significant resources developing sustainability reports, promoting corporate citizenship, and providing a variety of benefits that enhance stakeholder engagement. Employees are an important stakeholder. Why not take advantage of ESG as another way to engage the employee population?

Interest more than doubles when investors understand and can connect with ESG's impact

33%

of surveyed investors are interested in ESG investments

76%

of surveyed investors are interested, on average, in ESG themes when specific impact is expressed

Investors are interested in doing good with their investments while achieving financial objectives

59%

of surveyed investors are interested in all three ESG themes

Implications for plan sponsors

There is significant potential to improve engagement and investing for retirement by helping plan participants understand the ESG alignment and impact of their investments by using robust, tailored ESG participant communications. Plan sponsors also can partner with asset managers to understand how their existing plan's investment lineup aligns with their organization's values and to illustrate the impact to plan participants.

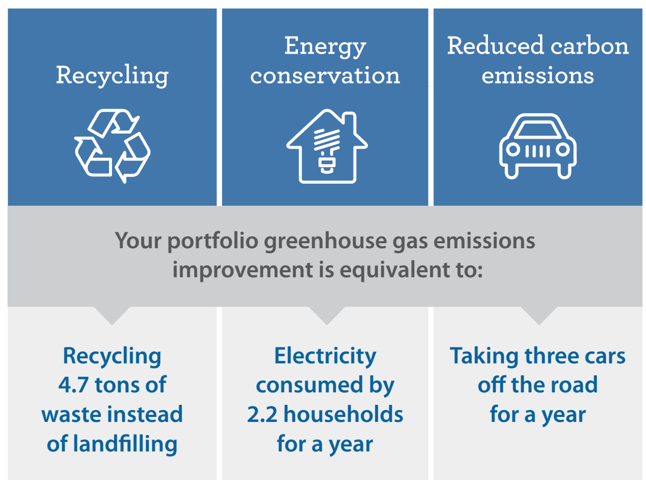
Below is an example of expressing a portfolio's carbon-footprint improvement through investing in an ESG-focused strategy. This expression of tangible ESG impact across themes can help plan sponsors appeal to participants' hearts.

SPOTLIGHT

Educating participants on the positive impact of their ESG-focused investments

Illustration of the carbon footprint in a 401(k) portfolio

The carbon-footprint improvement for a $100,000 investment in a low-carbon-emissions global equity fund versus the mainstream parent index (MSCI ACWI)



Source: www.epa.gov. Calculated on the www.epa.gov Greenhouse Gas Equivalencies Calculator; using MSCI ESG CO_2 Emissions/$1m invested and calibrating the data on the Morgan Stanley Capital International (MSCI) All Country World Index (ACWI) (Net) and the MSCI ACWI Low Carbon Target Indices (2015) to reflect a $100,000 portfolio.

Customized participant statements have the potential to express environmental impact—in this case, carbon-footprint improvement—in a highly visual and impactful way.

Nourishing souls

Key participant cohorts support ESG investing

ESG investments in a plan lineup can improve how participants feel about their retirement plans as well about their employers. If ESG investments were made available in their retirement plans, more than one-third of participants say they would have a more favorable view of their employer.

There are clear gender and generational differences with respect to attitudes toward ESG investing. As plan sponsors look to serve the needs of all participants, they also should recognize the appeal of ESG investing to important cohorts, such as women, young participants, and higher-income investors. For example, it is important to these cohorts to walk the walk with respect to how they incorporate their social and environmental values into core aspects of their lives, and investing is no exception. They support social and environmental causes through all aspects of their lives—the products and services they purchase, their choice of careers and the reputation of the firms they choose to work for, and the investments they hold in their portfolios.

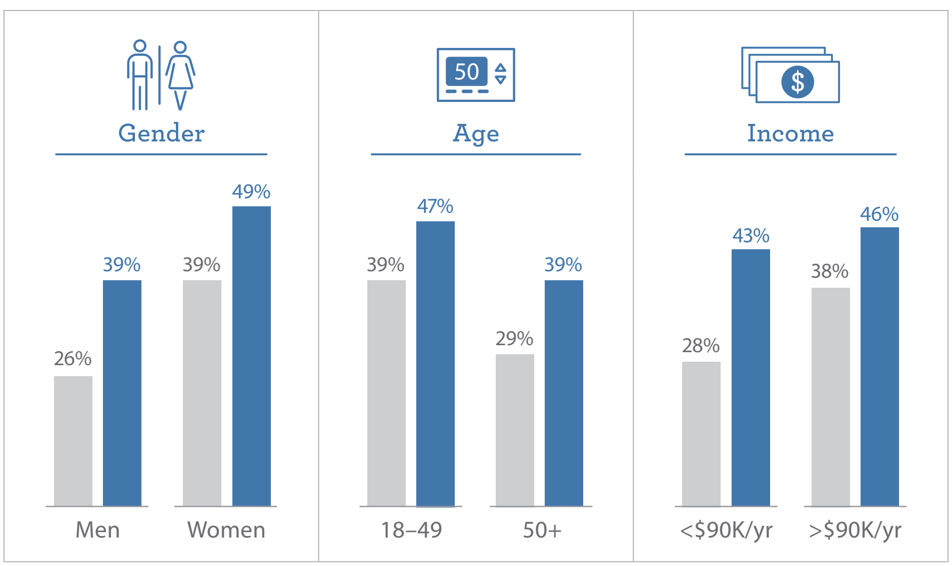
ESG investments can drive participant satisfaction

34%

of surveyed investors say an ESG option would give them a more favorable view of their employer

ESG investing has broad-based appeal, especially among women, younger, and higher-income investors

Within each cohort of surveyed investors, interest in ESG investing increases if strategies were offered in 401(k) plans



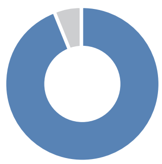
Indicates % of surveyed investors "very interested" or "somewhat interested" in ESG investing

Indicates % of surveyed investors who would "definitely" or "probably" invest in ESG strategies if they were offered in their 401(k) plans

SPOTLIGHT

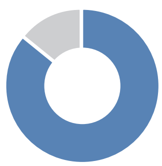
Millennials support ESG causes in all aspects of their lives, including in their investments

In a recent survey, we found that Millennials—more than other generations—prioritize living their lives to promote the greater good. Millennials seek alignment between their values and how they live their lives. This extends to the brands they purchase or boycott and the firms they want to work for, which then extends to their investments, as they want to avoid ESG hypocrisy in their portfolios.



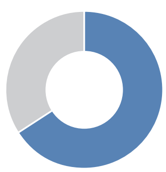
94%

say making a difference for the greater good is important to them



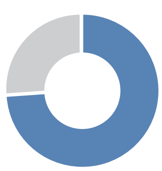
86%

say that, if given $1,000, they would invest in a company that makes the world a better place with their product



66%

want to avoid investments that do not align with their values



74%

say it would be easier to stomach the ups and downs of investing if the investments made are having a positive impact on the world

Source: Wells Fargo Asset Management 2017 Millennial Survey: Uniting Happiness and Money.

Implications for plan sponsors

Key cohorts—and, particularly, the Millennial generation—continue to grow as a percentage of total plan participants. Since Millennials will make up 75% of the working population by 2025, participant interest in ESG investing is likely to further increase over time. Plan sponsors have an opportunity to get ahead of tomorrow's trend by exploring and incorporating ESG today.

SPOTLIGHT

U.S. Department of Labor (DOL) fiduciary rule and ESG investing

While plan sponsors often recognize the opportunity to connect with participants at a deeper level via ESG, many also are understandably cautious given the regulatory environment and anxiety around potential litigation. The good news is that the DOL has taken key steps to alleviate these concerns.

In October 2015, the DOL issued an interpretive bulletin on ESG pertaining to the fiduciary rule in ERISA plans, replacing previous guidance from 2008. The new guidance outlines the view that it is acceptable, and in fact encouraged, that ERISA fiduciaries consider ESG when setting and implementing their investment policies.

Excerpts from the news release accompanying Interpretive Bulletin 2015-01:

"The new guidance confirms the department's longstanding view [from IB 94-1] that fiduciaries may not accept lower expected returns or take on greater risks in order to secure collateral benefits but may take such benefits into account as tiebreakers when investments are otherwise equal with respect to their economic and financial characteristics. ***The guidance also acknowledges that environmental, social, and governance factors may have a direct relationship to the economic and financial value of an investment. When they do, these factors are more than just tiebreakers but rather are proper components of the fiduciary's analysis of the economic and financial merits of competing investment choices."***

We believe the bulletin helps alleviate fiduciary concerns that may have prevented plan sponsors from considering ESG investments. We also believe it paves the way for plan sponsors to consider ESG issues as primary factors in evaluating investments where they are expected to affect an investment's risk/return profile. Of course, there is still an expectation that ESG investments should be selected only where a committee can reasonably conclude that future returns will be competitive on a risk-adjusted basis.

Three key takeaways and action items

ESG investments present new ways for plan sponsors to offer the potential for more successful retirement outcomes for their participants. These include selecting competitive and appropriate ESG investment options as well as providing education and customized communications that strongly connect ESG issues to participants' minds, hearts, and souls.

Below are key takeaways and action items to help plan sponsors begin incorporating ESG investments in their retirement plans.

1 Reputational benefits with stakeholders

ESG investment strategies can provide both internal and external reputational benefits, with participants and the public developing a more favorable impression of the plan sponsor.

- ☐ Determine ESG values at the plan sponsor level.
- ☐ Assess the ESG exposures of the plan's current investments.
- ☐ Align the investment lineup to plan sponsor level ESG values.
- ☐ Create customized ESG reporting and communications.

2 Participant engagement

ESG investing is a powerful way to help participants, particularly Millennials, connect to their inner drivers of happiness This connection also may result in greater interest in their retirement plans. This may be particularly true for women and young participants.

- ☐ Engage with participants to understand what values win their hearts.
- ☐ Connect with key participant cohorts around opportunities for ESG investing to nourish their souls.

3 Participant connection

Participants want to do good while doing well. Plan sponsors can educate participants about ESG investing and financial performance and express the social impact of participants' ESG investments in tangible ways.

- ☐ Create communications that enlighten the minds of participants about the benefits of ESG investing, including the potential impact and the historically often-positive financial performance.
- ☐ Provide customized participant communications outlining the tangible impacts of key themes, such as carbon emissions.

Partner with WFAM on ESG investing

ESG investing at WFAM is focused on delivering holistic, portfolio-level solutions for institutional clients and intermediaries across a wide range of asset classes and ESG investment approaches. This holistic approach encompasses stakeholder management and communications, ESG analytics and risk reporting for clients, investment stewardship, ESG investment policy statement advice, proprietary ESG investment research, and ESG-focused product development and thought leadership.

We identify three main investor motivations and align three ESG investment approaches spanning our investment platform to address them. Underpinning each of our approaches are two foundational commitments: **Stewardship and ESG Risk Management.**

Investor motivations	"Investing in a world that's changing"	"Investing in a world I believe in"	"Investing to change the world"
WFAM ESG approaches	**Integration** Incorporating material ESG considerations to gain additional insight into the return opportunities and risks that can affect the performance of an investment with the aim of providing better risk-adjusted returns	**Values alignment** Seeking to ensure investments are aligned with client values; methods can include negative screening (exclusions) and positive screening on E, S, and G metrics to arrive at desired portfolio-level ESG characteristics	**Impact** Delivering both investment return and impact by identifying environmental or social themes with investment opportunity and the ability to generate and/or accelerate long-term global sustainability
The ESG foundations	**WFAM Stewardship** **WFAM ESG Risk Management**		

WFAM Stewardship refers to our commitment to impel investee companies through activities such as engagement and proxy voting in making positive changes on ESG issues to promote long-term value creation.

WFAM ESG Risk Management is part of our firmwide risk platform, overseen by the Office of the CIO. This dedicated team and function provides proprietary tools to identify the most significant risks related to ESG issues across all strategies and at the firm aggregate level.

Get started today

Working together is key to success for our shared mission of investing in the world we want to live in. We invite you to a dialogue on these critical matters. To continue the discussion, contact Jessica Mann, Wells Fargo Asset Management's head of ESG, at jessica.mann@wellsfargo.com or wfaminstitutional@wellsfargo.com.

Methodology

About the Wells Fargo/Gallup Investor and Retirement Optimism Index

These findings come from the Wells Fargo/Gallup Investor and Retirement Optimism Index survey, conducted by telephone November 1–5, 2017. The index includes 1,015 investors age 18 and older that were randomly selected from across the U.S. with a margin of sampling error of +/- 4 percentage points. Results based on 475 nonretired investors with a 401(k) have a margin of sampling error of +/- 6 percentage points. For this study, the American investor is defined as an adult in a household with total savings and investments of $10,000 or more. About two in five U.S. households have at least $10,000 in savings and investments. The sample size consists of 67% nonretirees and 33% retirees. Of total respondents, 41% reported annual income of less than $90,000; 59% reported $90,000 or more. The median age of the nonretired investor is 47 and the retiree is 68.