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A REVIEW OF ESG FUND ALLOCATIONS AMONG NEW, DO-IT-YOURSELF DEFINED CONTRIBUTION PLAN PARTICIPANTS

June 2022

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As the retirement solutions provider of PGIM, we deliver innovative defined contribution solutions founded on market leading research and capabilities. Our highly-experienced team partners with clients on customized solutions to solve for retirement income. As of 3/31/2022, PGIM has $180 billion[2] DC assets under management.

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RESEARCH BRIEF

David Blanchett, PhD, CFA, CFP, Head of Retirement Research for DC Solutions and Zhikun Lui, PhD, CFP, Senior Research Associate at Employee Benefit Research Institute, recently published a research paper. Mikaylee O'Connor shares a summary and the key takeaways.

Executive Summary

Investment strategies focused on Environmental, Social, and Governance (ESG) issues have been receiving increased interest among defined contribution (DC) plan sponsors, consultants, and regulators recently despite the relatively low adoption and level of assets in DC plans today.[3] This research explores the allocation decisions of 9,324 new DC participants, across 108 DC plans, who are self-directing their accounts (i.e., are "do-it-yourself" (DIY) investors) and have at least one ESG fund[4] available in their plan's core menu. While this sample is relatively small, the implied participant population required to generate this final dataset is approximately two million participants, given the filters applied and the data requirements.[5]

Key Takeaways

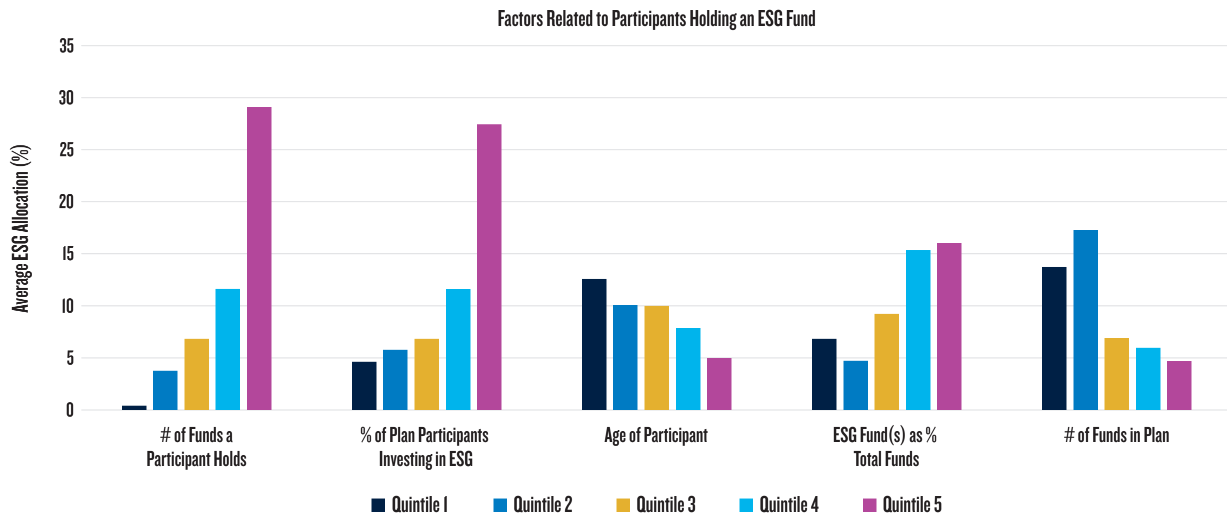
- **Allocations to ESG funds among DIY investors are relatively low.**

  Only 8.9% of new DC participants allocated to an ESG fund, and the average allocation to ESG funds among those who held at least one ESG fund was 18.7% of their total balance. The average allocation to ESG funds among all DIY participants included in the analysis was 1.7%.

  One potential driver of the low allocation to ESG funds is the relative scarcity of ESG funds in DC core menus. For example, among DC plans that offer ESG funds, 76% offered only one ESG fund, which was most commonly an equity fund (77% of funds), with Large Blend being the most common investment style (51% of all ESG funds available).

- **The two largest factors related to participants having an ESG allocation were the number of funds in a participant's portfolio and the percentage of participants in the respective DC plan allocating to an ESG fund.**

[1] PGIM DC Solutions does not establish or operate pension plans.
[2] Reported data reflects the assets under management by PGIM and its investment adviser affiliates for defined contribution investment purposes only.
[3] For example, according to Cerulli (2021), only 13% of plan sponsors note affirmatively currently offering an ESG fund, while 29% said they are likely to add at least one fund in the next 24 months.
[4] Based on a Morningstar classification: Sustainable Investment – Overall = Yes (in Morningstar Direct).
[5] Assuming 30% of new participants opt to self-direct their accounts, of those self-directing only 15% have plan tenures of two years or less, and only 10% of plans offer an ESG fund.



Source: Data as of November 30, 2021. The recordkeeper providing the underlying data for this analysis is not identified due to privacy concerns, please reach out to the authors with additional questions regarding the source.
The exhibit shows how different factors relate to participants' allocations to an ESG fund. For example, as the number of funds a participant holds increases (Quintile 1 = few funds, Quintile 5 = many funds), the average allocation to an ESG fund also increases.

The notable increase in the probability of owning an ESG fund as the number of fund holdings increases, along with other core menu relationships, suggests naïve diversification is likely driving a significant amount of the ESG fund allocation decisions (i.e., the decision to allocate to the ESG fund is likely based on a weak preference, not conviction in ESG).

The fact that ESG allocations increase with higher participant acceptance of ESG funds within a plan suggests plan level interest effect could be an especially strong driver of future growth in ESG funds (despite relatively low usage today).

Younger participants with higher deferral rates and higher incomes were more likely to allocate to an ESG fund as well, but it was the third largest factor.

- **Participants who invest in ESG funds tend to invest more aggressively[6] and have higher expected returns than the average DIY participant, although they have lower expected risk-adjusted returns.**

DIY participants in general have expected returns that are approximately 100 basis points lower than investors using professionally managed portfolios, such as target-date funds and managed accounts, ignoring any additional cost associated with the service/ solution.[7] With ESG investors having higher equity allocations and holding more funds in their portfolios, it also suggests that ESG investors on average are building less efficient portfolios.

This suggests adding ESG funds to DC core menus may create an additional implicit return "cost" that should be considered by plan sponsors, since the typical default strategy is not ESG-focused and multi-asset ESG strategies (e.g., balanced funds[8]) are not widely used.

Overall, this research provides new insights into the usage of ESG funds within DC plans and suggests that plan sponsors should take a thoughtful approach when considering ESG (versus simply adding a few funds to a core menu).

[6] Part of this effect is likely due to the fact most ESG funds are equity funds.
[7] There would not typically be any additional fees for target-date funds, although there would for a retirement managed account service.
[8] Balanced funds represent approximately 10% of ESG funds currently being used.

IMPLICATIONS FOR DC PLAN SPONSORS

Mikaylee O'Connor, Senior Defined Contribution Strategist within PGIM DC Solutions, shares her perspective on this research paper and its implications for DC plan sponsors.

Initial reactions

Over the years, I've talked with several DC plan sponsors who are grappling with the topic of ESG - what is it, do my participants want this, how would I go about implementing it, what are the benefits, etc. Most of the available ESG data on investor interest and usage is based on survey information. What's exciting about this new research is it provides data-driven insights from DC participants who had access to and invested in ESG funds within their DC plans. It sheds light on participant decision-making surrounding ESG investing in DC plans, which can be helpful for plan sponsors exploring this topic and trying to determine their next steps forward.

Takeaways

- **Investment design matters.** Before assuming participants aren't interested in ESG given low utilization in DC plans, consider the impact plan design may have on how participants invest. An increasing number of DC plans have adopted auto enrollment paired with a qualified default investment alternative (QDIA). And according to a recent Vanguard report, 79% of participants remained 100% invested in the default option after three years, and another 17% contributed to the default and other plan investment options[10]. This leaves only 5% of auto-enrolled participants who elected the DIY route.

  This suggests that 1) plan design has a huge influence on how contributions are invested, 2) the role of the core menu and individual options may be evolving, and 3) it's not too surprising that ESG fund usage is low in DC plans given these two observations.

> 56% of Large DC Plans have adopted auto enrollment; 88% of Large DC plans offer a QDIA[9]

- **Know your ESG objectives.** Since there are a variety of ESG strategies available, starting with your objectives can help to narrow your focus more efficiently. What is the reason you are exploring ESG? The answer should influence your approach and the types of investment strategies to consider. For some, there is a desire to screen out investments that don't align with their organization's beliefs or views; for others it may be a recognition that integrating ESG factors into the investment process will enhance risk-adjusted returns. In addition, certain plan sponsors are more interested in the ESG practices of their DC plan's service providers (e.g., investment managers, consultant, recordkeeper, etc.)

> **What is the reason you are exploring ESG?**
> a) Employee demand
> b) Company culture and beliefs
> c) Risk management
> d) Legislative directives

- **Align your implementation approach with your objectives.** While there are different ways a plan sponsor can implement or integrate ESG into their DC plan, this new research highlights the potential challenges with adding an ESG fund to the core menu and supports a continued focus on professionally managed solutions for DC plan participants. It doesn't opine on the benefits of ESG, but instead reinforces that how you offer ESG to DC participants matters in more ways than one. Let's explore this a bit more with two implementation approaches:

  1. Adding an ESG Fund to the Core Menu – Setting aside the efficacy of an ESG strategy, the research suggests that many DIY investors may not be intentionally investing in the ESG fund(s) within their DC plan – instead their allocations to ESG are likely a result of naïve diversification. The exception is when there is a "plan level effect", such as a strong culture or business alignment with E, S, and/or G that results in broader acceptance of ESG by participants. If ESG funds are being viewed just like any other fund on a core menu, this is an important consideration for plan sponsors as they look to align their ESG implementation approach with their overall objectives.

[9] Cerulli Associates "The Cerulli Report | U.S. Retirement Markets 2021".
[10] Vanguard Research "Automatic Enrollment: The power of the default" February 2021.

2. Integrating ESG Factors Across the DC Plan – To have a greater impact or reach, ESG integration may be a more effective approach. ESG integration is a process where an investment manager incorporates ESG data and information into their investment process to improve risk-adjusted returns. ESG factors can be integrated across all or some of a DC plan's investment options (core menu and the plan default), leading to greater coverage of participant assets. This could be particularly impactful for default investments, as the research shows that participants who invest in professionally managed investment solutions earn higher risk-adjusted returns than DIY investors. It also provides better alignment for DC plans that employ auto features.

Integration does have its challenges as it requires a more thoughtful approach and is often more time consuming since it entails additional manager due diligence. Additionally, the usage and impact of ESG integration varies by asset class, investment manager, and strategy. Also, it can be challenging to benchmark and communicate to participants. This is not typically an approach that can be implemented quickly (versus simply adding a fund), but instead, can be an incremental process over time.

There are many other considerations that plan sponsors should be aware of – too many for the purposes of this paper – but hopefully this brief can help DC plan sponsors understand the potential implications of this new research.

NOTES TO DISCLOSURE

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PGIM DCS-20220513-43