TRANSAMERICA®

SUSTAINABLE INVESTMENTS IN RETIREMENT PLANS

The conversation and considerations

Few words elicit stronger opinions than these three:

- Environmental
- Social
- Governance

Regardless of how people feel when these words are strung together, most agree on at least one thing: investment funds that focus on these factors, known as ESG funds, are very much a part of today's conversations.

How did these funds come to be? Who are their primary investors? And what's next for ESG funds?

These are some of the questions we'll tackle in this paper.

PART ONE: BACKGROUND

WHAT IS ESG INVESTING?

ESG stands for environmental, social, and governance. It's a way of rating how companies operate relative to these factors. And for this discussion, it refers to investments — particularly in qualified retirement plans.

ESG DEFINED

Environmental: Factors impacting the environment such as resource usage and waste management

Social: Stance on social factors, including diversity, inclusion, human rights, and product safety

Governance: Leadership practices, business ethics, and political policies

ESG investing is not new. According to esg.org, the term was coined in 2005. For decades, investors have "voted with their wallets," declining to invest in companies involved in what they viewed as immoral or unsustainable activities. The first ESG mutual fund, the Pax World Fund, was founded in 1971 by two Methodist ministers who did not want church funds used to support the war in Vietnam.

The stage for socially responsible investing was set, and it has continued to grow and evolve. Like the Pax World Fund, other funds were established that excluded companies involved in certain products or services. Later, funds based on including companies that operate according to responsible investing principles were created.

As early as 1994, 26 sustainable funds were available, with some $1.9 billion invested.[1] In 2023, investments in ESG funds are estimated to be as high as $8.4 trillion.[2]

WHY ESG FUNDS ARE IN THE HEADLINES

ESG factors reflect values, which are deeply personal. Not only do people have different values, but they also have different views as to whether investments should be made on the basis of these values. These factors lead to polarized opinions about the merits of ESG investing.

Regardless, ESG investments are here to stay, with predictions of some $160 trillion in assets invested in funds with ESG mandates by 2036.[3]

DEFINING THE TERMS

A few phrases seeking to clarify and even subdivide the term "ESG" have recently come into use. For the sake of clarity, it's worth defining the terms as we'll be using them.

- **Traditional investing** seeks to generate positive long-term, risk-adjusted returns using quantitative and qualitative analysis.
- **Responsible investing** recognizes the need to generate returns while applying ESG factors with a goal of improving investment returns and creating positive social impact. This category includes sub-categories:

ESG excluded investments screen out categories the investor views as objectionable from an environmental, social, or governance perspective	**ESG included** investments apply ESG factors as part of the selection process	**ESG advanced** uses ESG ratings as the primary factor in selecting securities	**Sustainable investments** are selected based on positive screening of a company's sustainability practices for future generations

- **Impact investing** prioritizes social impact over investment returns.

PART TWO: ESG TODAY

THE DOL WEIGHS IN

Selecting retirement plan investments is a fiduciary responsibility. In spite of recent headlines that seem to suggest otherwise, the U.S. Department of Labor (DOL) has taken a neutral position about considering ESG factors when selecting plan investments. ESG factors alone neither qualify nor disqualify a particular investment, according to the DOL.

The DOL's current rule states, "…a fiduciary may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives, and may not sacrifice investment return or take on additional investment risk to promote [other] benefits or goals."[4]

The bottom line is when selecting any plan investment, the interests of plan participants and beneficiaries must always come first — as has been the case since implementation of the Employee Retirement Income Security Act of 1974 (ERISA).

PARTICIPANT DEMAND DRIVES GROWTH

ESG funds saw inflows of just $3.1 billion in 2022, the smallest amount in the prior seven years.[5] Still, some expect ESG investments to reach $34 trillion globally by 2026.[6]

Demand among retirement plan participants plays a role. Schroders 2022 U.S. Retirement Survey found that 74% of participants may contribute more to their plan when they have an ESG option. That's up from 69% in 2021.[7]

Sponsors of defined contribution plans are also interested in how ESG funds may work in the context of a retirement plan investment menu. A recent Callan survey found that 31% said they will consider adding an ESG fund to their plan's investment lineup,[8] consistent with results of a Transamerica survey of plan sponsors wherein 30% said they were extremely or somewhat likely to offer an ESG fund. However, many in the Transamerica survey were not ready to commit, with 34% saying they were neutral on the question and 36% reporting they are extremely or somewhat unlikely to offer an ESG fund.[9]

Retirement plan advisors may wonder where their clients land on the yes/neutral/no spectrum. The next section may provide some basis to help make a decision about introducing the subject to clients.

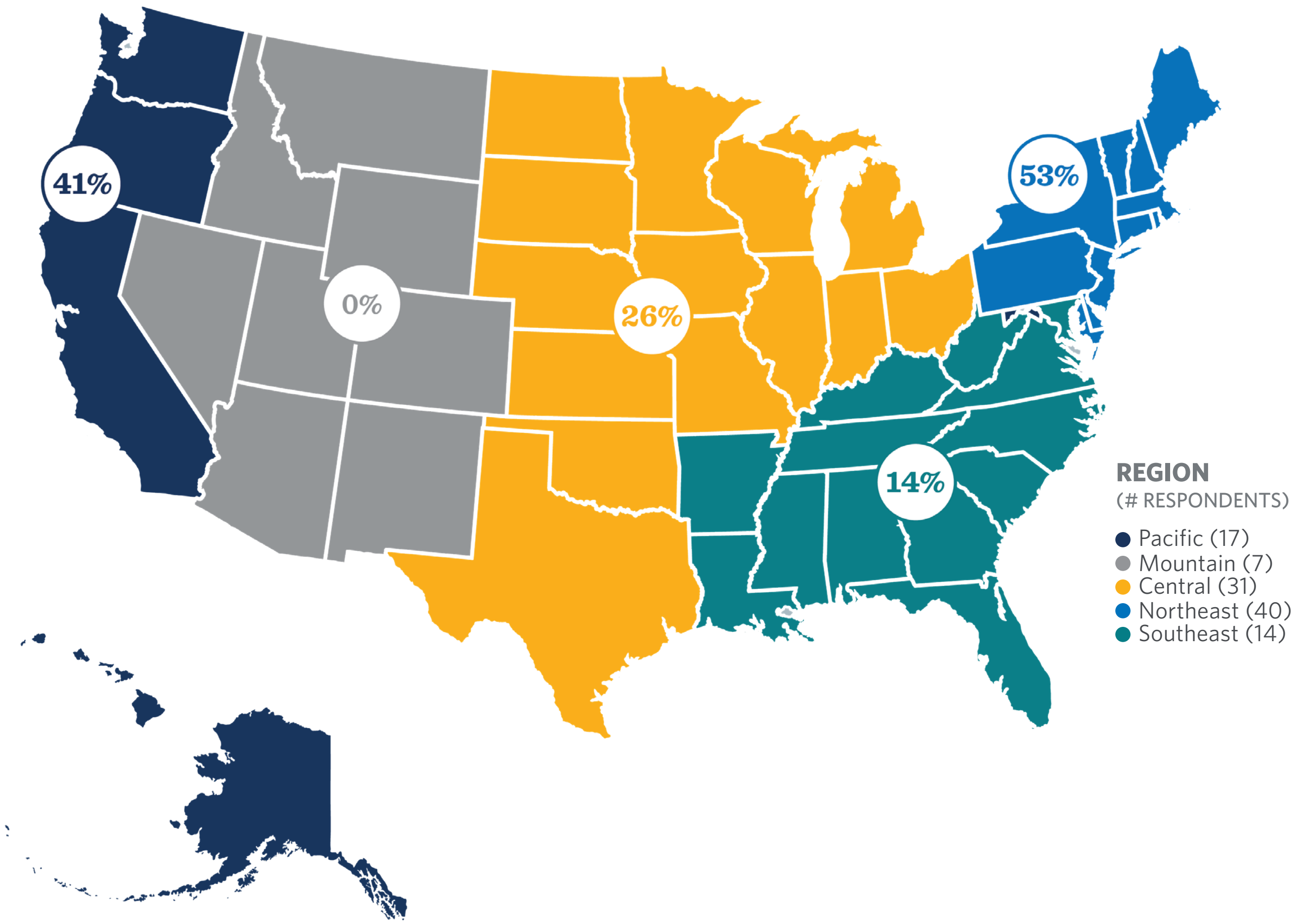
PART THREE: CONSIDERATIONS FOR INCLUDING ESG FUNDS IN QUALIFIED RETIREMENT PLAN MENUS

Advisors are likely to find that some clients have more interest in ESG funds than others. As we've already discussed, not every client will wish to add an ESG fund. But some employers are more willing than others. Here are a few considerations that may lead to an employer that is more likely to bring ESG into the conversation.

GEOGRAPHY

As stated at the outset, ESG can be a political hot potato. It's no surprise that employers and employees in certain areas of the country may be inclined to include ESG funds with their plan's investment menu. In areas where ESG is viewed favorably, employers and employees may be eager to add a fund to the lineup.

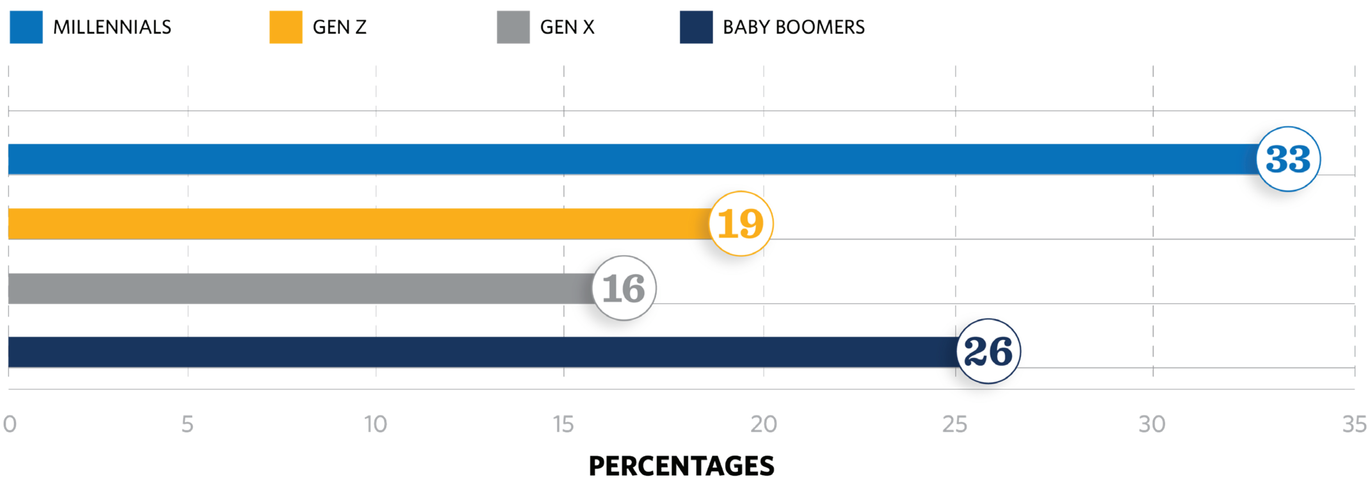
Regional breakdown of ESG incorporation by institutional investors[8]



GENERATIONAL MAKEUP OF WORKFORCE

Younger people are often more likely to strongly consider ESG factors when selecting investments. In fact, 90% of Millennials say they are interested in pursuing sustainable investments, according to a recent Nasdaq article.[10] The article continues with a generational comparison:

Often or exclusively use investment products that consider ESG factors:[10]

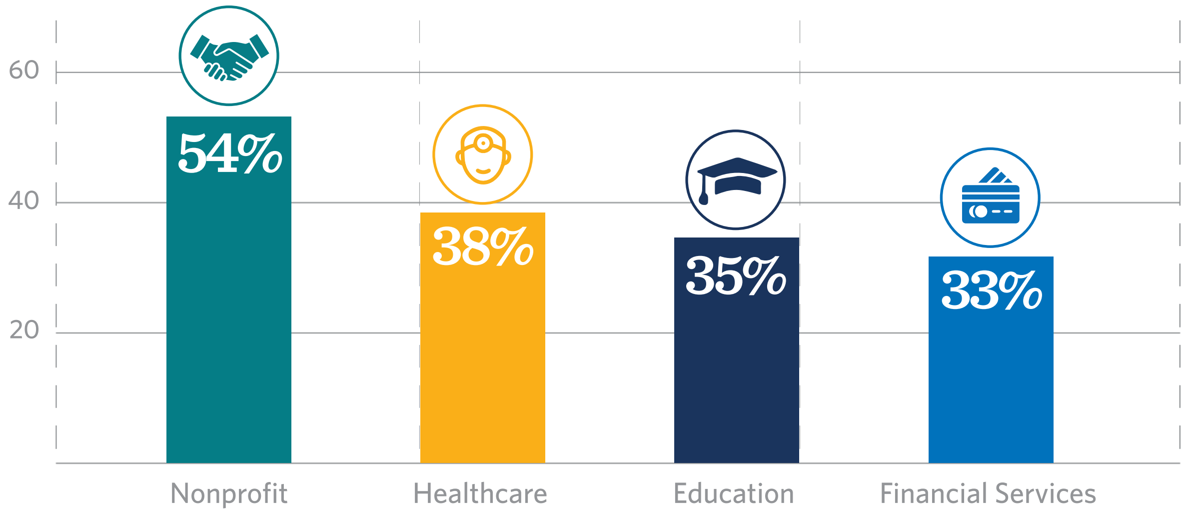


Millennials are voting with their wallets, and since many are now approaching 40 and may have more to invest, their opinions matter. In 2020, Millennials contributed more than $51 billion into sustainable funds, according to Morningstar, compared to $5 billion only five years earlier.[10] Many in this generation stand to inherit additional wealth from their Baby Boomer or Gen X parents, which may add weight to their already strong opinions about how and where to invest.

More investment decisions made by younger generations are made with their hearts. But their heads are in the game, too. There is debate in some quarters about whether investment returns suffer when ESG factors are part of the selection process, and even whether that matters. Either way, as younger groups age and earn more money, their opinions will likely overshadow those of the generations that came before them.

SECTOR

Certain sectors tend to attract employees who are favorably inclined toward ESG investing. The Callan Institute found that nonprofits, healthcare, and higher education employers have higher rates of ESG-focused investments. Interestingly, the financial services sector is also interested in ESG funds according to Callan.[11]



FINAL THOUGHTS

An ESG fund can exist side-by-side in the investment lineup with value funds, growth funds, or others chosen for their specific objectives. Any retirement plan investment should be evaluated for how it will fit within the rest of the menu and against the parameters set by the plan's investment policy statement. Just like other investment funds, ESG funds should be selected based on how they compare to available alternatives in their category.

The underlying principle of prudence applies, too. Selecting a qualified plan's investment menu is a fiduciary responsibility and is therefore subject to ERISA. Plan fiduciaries must make decisions, including those about all investments, no matter how noble their goals, in accordance with ERISA duties. Plan fiduciaries must use care, skill, and diligence as they select a plan's investments. They must act prudently and in the way someone familiar with such matters would act. As long as these principles are followed and actions are documented, an ESG fund can make a valuable addition to the investment menu of a qualified plan.

ABOUT TRANSAMERICA

Transamerica is one of the largest and most trusted retirement plan providers in the industry with more than 85 years helping employees enjoy a secure retirement. Our integrated approach provides employers and their advisors with a variety of programs to enhance the financial and personal well-being of employees.

Transamerica offers a variety of ESG funds. Contact your Transamerica representative for more information about our funds and how we can help employees live their best lives.

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[1] "ESG Investing Comes of Age," Morningstar, 2023

[2] "Sustainable Investing Overview," 2022 US SIF Trends Report

[3] "How ESG Investment Returns are Growing as Market Evolves," Sustainability, March 2022

[4] 29 C.F.R. §2550.404a-1(c)(1)

[5] "Sustainable Funds U.S. Landscape Report," Morningstar, February 2023

[6] "Asset and wealth management revolution 2022: Exponential expectations for ESG," PwC's Asset and Wealth Management Revolution 2022 report

[7] "U.S. Retirement Survey," Schroders, 2022

[8] "Callan ESG Survey," ESG Survey, Callan Institute, 2022

[9] Internal Transamerica data collected from single employer plans in all market segments through CX platform Medallia May-August 2023

[10] "How Millennials and Gen Z are Driving Growth Behind ESG," Nasdaq.com, September 2022

[11] "Callan ESG Survey," ESG Survey, Callan Institute, 2022

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