



# ALIGNING RETIREMENT ASSETS TOOLKIT #1

The responsible  
retirement plan  
opportunity



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①

# Introduction

Responsible investing, which involves taking a longer-term and broader perspective on environmental, social and governance (ESG) risks and opportunities compared to traditional investment approaches, has been shown to potentially lead to positive investment outcomes over the long-term.

## ① Introduction

Due to the enhanced prospects of outperformance, as well as ancillary benefits, responsible investment is an area of increasing interest among institutional investors as well as the general public. Reflecting the growing awareness that responsible investment could **lead to better investment performance of retirement plan participants' and beneficiaries' assets**, and often driven by employee interest, a growing number of employers have been evaluating how to integrate responsible investment approaches into the retirement plans they offer.

Some employers who have successfully integrated responsible investments into their retirement plans have found that employees – particularly

younger ones – tend to save more for retirement when offered investment options that reflect their values.<sup>1</sup> Spurring such employee engagement is of interest to employers of all types, however developing and implementing an effective and durable responsible retirement plan requires both dedication and a careful, thoughtful approach.

As we will discuss in more detail, retirement plans around the world are highly regulated, which means that making any changes to investment processes to integrate ESG considerations will likely take multiple quarters, if not years, to implement.

The goal of this project is to **improve outcomes for retirement plan beneficiaries** by lowering barriers to the adoption of responsible retirement practices through education, dispelling myths about responsible investing and empowering engaged employees to better understand their possible options to begin saving for retirement responsibly. While the process of implementing a responsible retirement plan may not be a quick and easy one, this project aims to help make the process as straightforward and transparent as possible.

This project is structured in two phases, centered around the publication of “toolkits” that seek to provide practical information about responsible retirement.

### About this project

In June 2018, the **World Business Council for Sustainable Development (WBCSD)** launched “Aligning Retirement Assets” (ARA) as part of its Redefining Value program. The goal of this project is to encourage responsible retirement plan investments since thoughtfully considering ESG factors in investment processes can result in improved risk-adjusted returns for participants and beneficiaries over the longer term.

An additional benefit of this work is that it may help retirement plan sponsors to meet a growing demand for sustainable investments and increase plan engagement, participation and savings rates. Furthermore, plan sponsors have an opportunity to reflect and extend the underlying company's core values and commitment to sustainability by making investment decisions informed by ESG factors, without compromising returns.

Our collaboration partners – including **Allianz Global Investors, BlackRock, Legal & General Investment Management, Mercer, Natixis and the Principles for Responsible Investment** – have joined the ARA steering committee to contribute best practices and innovative thinking on ESG, while helping to educate member companies on incorporating responsible strategies in their retirement plans.

<sup>1</sup> As You Sow (2017). “Aligning Defined Contribution Plans with Sustainability Goals.” Retrieved from [https://static1.squarespace.com/static/59a706d4f5e2319b70240ef9/t/5a72904d53450a892aa6c4bd/1517457487290/401k-White-Paper\\_20171027.pdf](https://static1.squarespace.com/static/59a706d4f5e2319b70240ef9/t/5a72904d53450a892aa6c4bd/1517457487290/401k-White-Paper_20171027.pdf). Pensions & Investments (2018). “Millennials embrace ESG option in Bloomberg’s 401(k)”



## Toolkit

We hope that you will find this first toolkit useful advancing your company's efforts to align its retirement assets with responsible practices.

### #1

is an introduction to retirement plans and how responsibility might be considered in different plan structures and contexts.

The purpose of this toolkit is to answer the question **"What is a responsible retirement plan?"** starting with the basics of how retirement plans are governed and operated.

### #2

(to be released in early 2019)

will provide a more "tactical" approach to responsible retirement plans, with a strong emphasis on helping interested individuals start to have conversations with the right people internally, as well as a series of typical objections that individuals might encounter and ways to respond effectively to them.

This toolkit will answer the question **"How can we develop and implement a responsible retirement plan?"** and will feature case studies highlighting what other companies have achieved.



②

# Corporate retirement plans overview

The following sections introduce the basic structures and legal requirements underpinning corporate retirement plans, in the interest of educating readers whom may be new to the subject.



### A. Types of retirement plans

There are significant differences among retirement plan structures, and these structures determine the considerations employers consider in their approach to offering retirement benefits. A key differentiator among plan types concerns who, whether the plan sponsor or the plan participant, bears the investment risk associated with making investments. A common component of virtually all retirement plan types is that employers will make contributions to employee retirement funds as part of total compensation packages, and frequently employees will contribute a portion of their monthly income as well.



#### i. Defined benefit (pension) plans:

Defined benefit (DB) retirement plans guarantee, or **“define” the benefits that plan participants can expect to receive upon their retirement.** Typically, benefits are calculated according to a formula that takes into account years of employment and salary level, usually providing a percentage of the past three to five years average annual salary to beneficiaries upon retirement. In a DB plan structure, plan sponsors typically invest on their participants’ and beneficiaries’ behalfs with the aid of an investment advisor, or they outsource the investment process to a third party.

**DB structures generally force employers to assume the investment risks for investing on behalf of plan participants,** given that the benefits are defined by contractual agreement when employees are hired, regardless of investment performance or market conditions. As these future benefit payouts to retirees represent significant balance sheet liabilities, many employers have closed their DB retirement offerings to new employees in favor of offering defined contribution plans, however these trends differ significantly between regions.

#### ii. Defined contribution plans:

Defined contribution (DC) plans guarantee, or **“define” the contributions that plan participants can expect employers to make into a retirement account on their behalf.** In such a structure, the employer will frequently guarantee to “match” an employee’s annual contribution to their DC account up to a certain percentage of their salary or total dollar amount, thus providing incentive for employees to save. Furthermore, employers, as plan sponsors, will work with investment advisory firms to determine the number and variety of different funds to offer to their employees as investment options within their plan’s “lineup.”

**DC plan structures therefore offer no guarantees regarding the future benefits that plan participants can expect from their retirement savings, placing the responsibility on plan participants to save and invest their money wisely,** while also requiring participants to bear investment risk. In contrast to DB plans, DC plan structures only require employers to account for retirement plan contributions as future balance sheet liabilities, thus reducing the uncertainty and risks employers are exposed to as plan sponsors.

## ② Corporate retirement plans overview

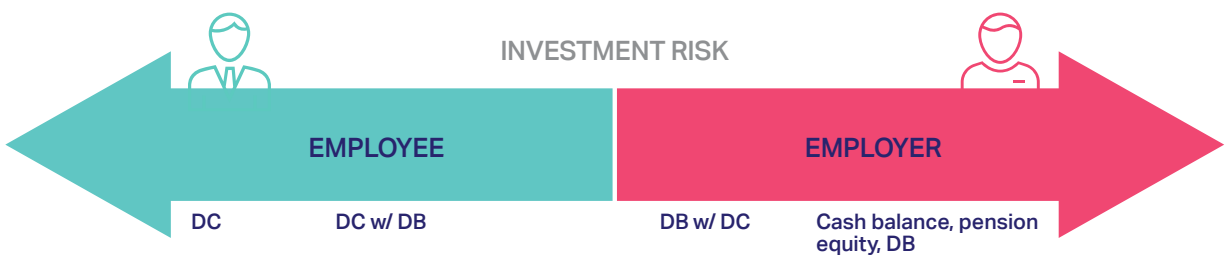
### iii. Hybrid structures:

Beyond traditional DB and DC plan structures there exist a range of other “hybrid” retirement plans that combine features of both to varying degrees.

A brief overview of some hybrid structures and their key features follows. The key differentiators between these options are the

shift in who bears the investment risks and the treatment of benefits accrual.<sup>2</sup>

Figure 1: Different retirement plan types and characteristics



PLAN FEATURE	DC	DC WITH DB	DB WITH DC	CASH BALANCE	PENSION EQUITY	DB
Funding source	Employee (possible employer contribution)	Employee (possible employer contribution)	Employer and employee	Employer and employee	Employer and employee	Employer and employee
Portable to new employer	Yes	Yes	Some	Yes	Yes	No
Responsibility for investment risk	Employee	Employee and annuity provider	Employer and employee	Employer (until separation)	Employer (until separation)	Employer
Rate of return for employee during service	Variable	Variable	Mixed	Guaranteed for employee contributions	Guaranteed for employee contributions	Guaranteed for employee contributions
Accrual of benefits	Front loaded, toward start of career	Front loaded, toward start of career	Part even and part back loaded, toward end of career	Even	Even	Back loaded, toward end of career
Potential to outlive funds	Yes, unless annuity purchased	No, if annuity purchased	No, if service requirement met	No, if annuity selected	No, if annuity selected	No

Source: Robert L. Clark, John J. Haley, and Sylvester J. Schieber, “Adopting hybrid pension plans: financial and communication issues,” *Benefits Quarterly*, First Quarter 2001, pp. 7-17.

Source: Mercer, NASRA

<sup>2</sup> For more information on hybrid retirement plan types, please see: <https://www.nasra.org/Files/Topical%20Reports/Hybrids/Hybrid-primer.pdf>.

### B. Retirement plan governance and administration

Understanding how retirement plans are governed and administered within a company is an essential element of uncovering opportunities to advance sustainability within the plan. The following points are representative descriptions of the role each body or individual plays in governing and/or administering the retirement plan, although note that the specific titles of retirement plan boards/committees/individuals may differ by plan.



#### i. Retirement plan or benefits committee:<sup>3</sup>

Plan committee members are charged with the **overall governance of a retirement plan and setting the plan's long-term direction**. Certain members of the committee are frequently the heads of various key divisions within the plan sponsor company, such as the heads of the human resources, legal, and finance divisions within the firm, although many plan committees have members who are plan participants, retirees (i.e. beneficiaries of the plan) or are independent. Plan committees often adopt committee charters that formalize the committee's structure, mission and duties, as well as establishing rules that stipulate the committee meeting schedule, record retention policies, etc.

#### a. Investment subcommittee:

Many retirement plan committees will establish a separate Investment Committee that oversees the investments made by the retirement plan (for DB plans) or the lineup of investment vehicles that the plan offers to participants (for DC plans). **This committee is often populated by officers and employees of the plan sponsor who have financial expertise**, and the committee may, among other things, develop and adopt an

Investment Policy Statement to guide the plan's investments, monitor investment performance, and hire and assess the performance of third-party vendors to the plan, including the advisor, recordkeeper, and others. As part of the fiduciary duty to diversify, DC plan subcommittee members must ensure that the selection of investment options available to plan participants is appropriately broad across asset classes and categories. This subcommittee generally will provide instructions for the plan sponsor's finance, investments staff or third-party service providers to enact.

#### b. Administrative subcommittee:

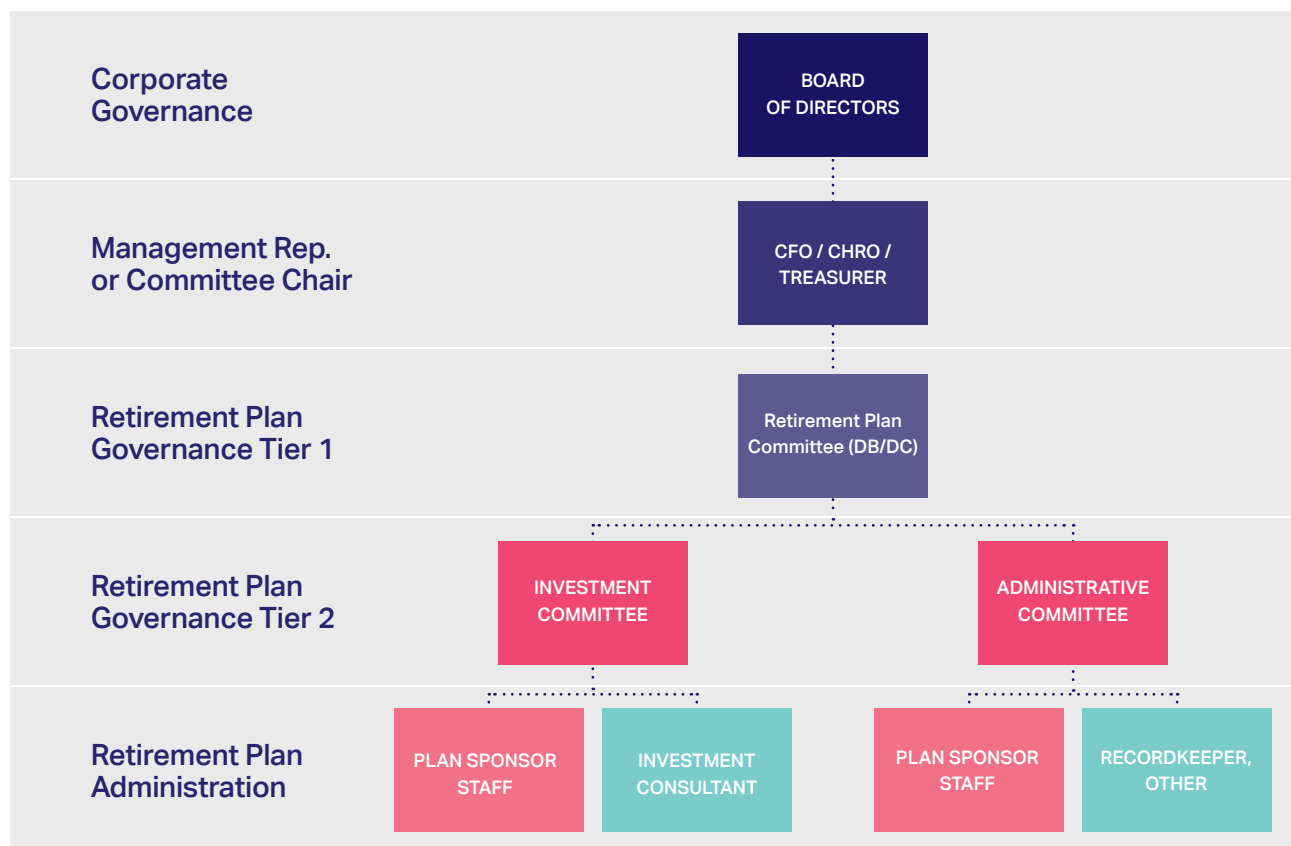
This sub-committee generally **oversees the plan's interaction with government regulators, plan participants/beneficiaries and third-party vendors**. Frequently this subcommittee will establish the rules and procedures for how participants and beneficiaries may make claims against the plan, determine eligibility and access plan educational materials. This subcommittee generally provides guidance and instructions for the plan sponsor's human resources staff to enact.<sup>4</sup>

<sup>3</sup> For benefits, this assumes committee members are responsible for other benefits beyond retirement such as medical/wellness plans.

<sup>4</sup> Investment and admin committees are often combined. Other committee titles sometimes used include DC committee, pension committee, 401k committee (in the US), etc.

## ② Corporate retirement plans overview

Figure 2: Representative diagram of retirement plan governance structure



Source: Mercer

### ii. Retirement plan administrators:

Frequently comprised of the staff who work for the CFO/CIO and/or Chief Human Resources Officer (or officers with similar titles) these administrators carry out the directions provided to them by the retirement plan committee and subcommittees. Given they have day-to-day oversight of the retirement plan(s) being offered by a company, these administrators can be excellent sources of information regarding the details of the plan, its institutional history and additional context around the particular views of key plan decision makers and stakeholders.

### iii. Investment managers:

These firms manage the investments entrusted to them by plan sponsors (in DB plans) and participants (in DC plans). Investment managers offer funds that provide investors exposure to securities of different asset classes and categories, such as global equities, or investment grade fixed income (i.e. corporate bonds). DB plans will invest with different managers to achieve plan goals for performance and diversification across the investment portfolio, among other goals. DC plans will select different managers across asset classes and categories to offer to plan participants to invest in, in line with the duty to

diversify noted above. For both DB and DC plans, the investment manager selection and monitoring process is an essential element of fiduciary duty with respect to plan management, ensuring that managers' performance is meeting or exceeding expectations, the investment team/process remains consistent, etc. Fiduciaries may elect to shift the plan's investments away from managers that consistently underperform, have fees that exceed those of competitors or if other plan circumstances change (e.g. liabilities increase, participant expectations change, mergers and acquisitions occur).

**a. Qualified Default Investment Alternative (QDIA):** a key element of DC plan investment lineups is offering a QDIA to plan participants, which is a fund that a participant's retirement savings are placed into when that individual has not selected other funds for investment. Given that a significant proportion of plan participants may leave their investments in the QDIA, fiduciaries must ensure that these funds are appropriately diversified to reduce the risk of loss. Investment managers have developed a range of QDIA-qualified products that satisfy those requirements. **Asset class products structured to reflect an appropriate asset allocation for a participant's age and expected date of retirement.** For example, younger participants will tend to have more aggressive asset allocations with a higher proportion of equity investments, while older participants' TDFs will be shifted towards a higher proportion of fixed income investments that offer stable income, albeit with lower return potential.

#### **iv. Advisors, recordkeepers and other service providers:**

Retirement plans typically engage a range of third parties who provide important services to the plan to ensure it is fulfilling its fiduciary duty to participants and beneficiaries.

**a. Investment advisors:** plan sponsors (led by administration staff and/or committees) typically hire an investment advisory firm to provide advice on the investment selection and monitoring process on a regular basis. Tracking the performance of investment managers and researching their capabilities – typical advisor services – are specialized tasks which most plan sponsors do not have the capacity to conduct internally. Gaining such outside expertise is also generally interpreted as being consistent with the fiduciary duty of prudence as it provides decision makers with objective third-party information regarding investment options and supports the selection of appropriate investments for the plan. Given their role as experts, investment advisors play an important role in helping plan fiduciaries consider the risks and opportunities of various investment options, and in ensuring that fiduciaries are informed of relevant market developments.

**b. Recordkeepers:** as the name suggests, recordkeepers track key administrative information about a retirement plan: determining eligibility to participate, enrollment tracking, participant investments tracking (for DC plans) and plan withdrawals, among other functions. In addition, recordkeepers maintain the website and customer service portals where participants can log in to track their account information, so they play an important role in ensuring participants are informed and educated regarding their retirement plans.

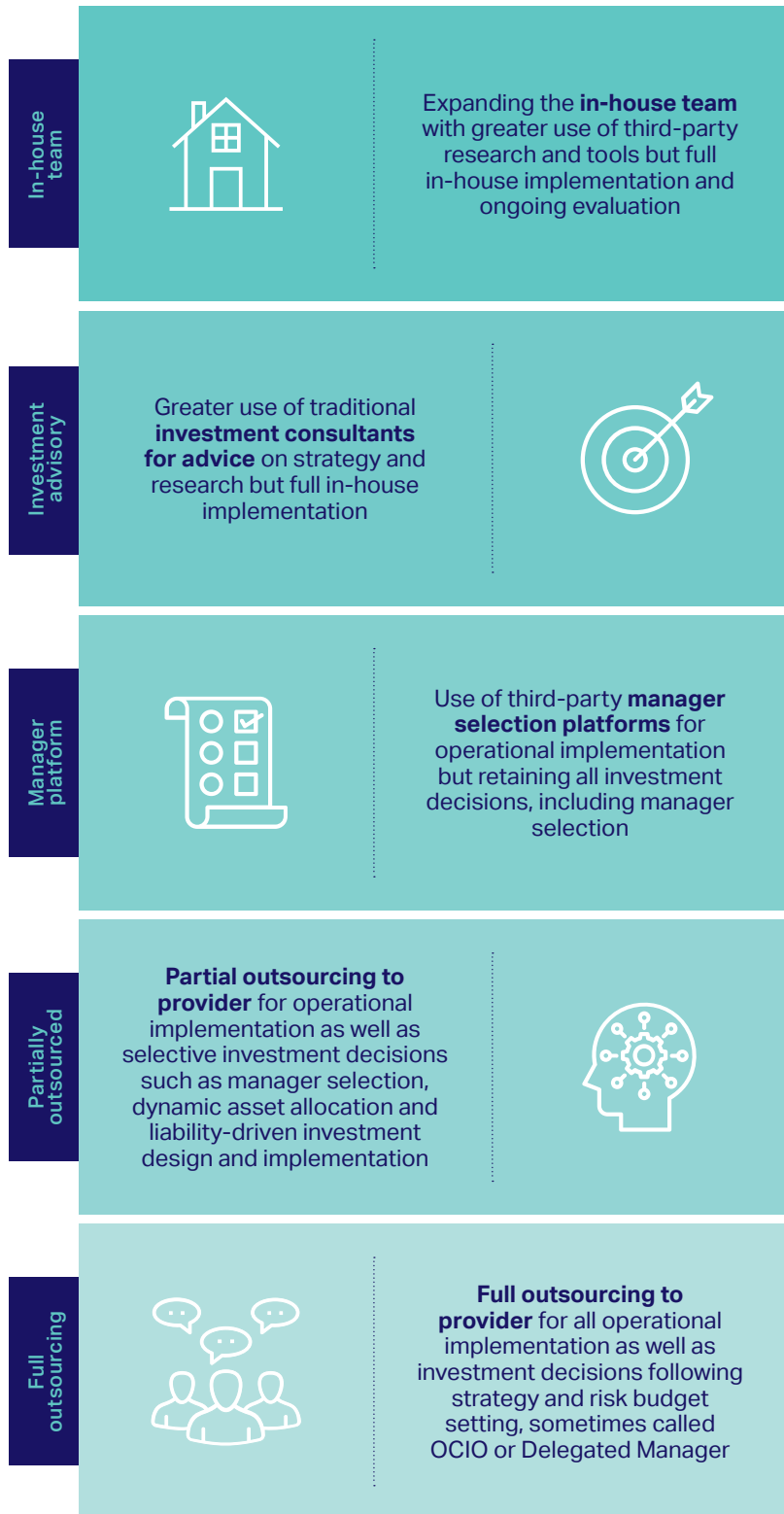
**c. Other service providers:** depending on the size and/or complexity of the retirement plan, plan fiduciaries may elect to engage other outside service providers, including benefits consultants, lawyers, accountants or actuaries. Such entities may provide important services to retirement plans yet are less commonly hired than are recordkeepers and investment advisors.



## ② Corporate retirement plans overview

### v. Insourcing vs. outsourcing

Plan sponsors engage with third-party service providers in a variety of different ways. **As stated above, one of the most important relationships plan sponsors maintain is with their investment advisor.** Traditionally advisors have provided plan sponsors with advice on their portfolio asset allocation (DB), lineup construction (DC) and manager selection/monitoring (both) and plan sponsors have maintained the responsibility for implementation of investment portfolios and managing other third-party relationships (e.g. recordkeeper). Though today the nature and extent of this advice can vary substantially, up to and including a fully outsourced model. A description of the various modes of advisor engagement for plan sponsors follows.



Source: Mercer

### C. Fiduciary duty

The term “fiduciary” derives from the Latin fides, meaning “trust,” or “faith,” and in the sense of a financial relationship, means “held or founded in trust or confidence.”<sup>5</sup> Fiduciaries are individuals, or entities, who act on behalf of others in their management of financial affairs. At their core, fiduciary duties “ensure that those who manage other people’s money act in the interests of beneficiaries, rather than serving their own interests.”<sup>6</sup>

It is essential to understand the responsibilities of fiduciaries because virtually any action that a corporate retirement plan sponsor takes in relation to its retirement plan is subject to scrutiny by regulators, and therefore retirement plan fiduciaries continually consider their responsibilities under the law.

#### i. Defining fiduciary status:

In the United States corporate retirement plan context, “[u]sing discretion in administering and managing a [retirement] plan or controlling the plan’s assets makes that person a fiduciary to the extent of that discretion or control”<sup>7</sup> according to the United States Department of Labor, the federal retirement plan regulator. In this sense, all individuals making decisions regarding the administration of the retirement plan, as well as all individuals serving on a plan’s administrative committee (if the plan has such a committee) will be considered fiduciaries from a legal and regulatory standpoint.

In the United Kingdom, the Law Commission defines the fiduciary relationship in two ways:

- **Status-based:** where a relationship falls under a previously recognized category, such as a solicitor and client, trustee and beneficiary, and agent and principal; or

- **Fact-based:** where the particular facts and circumstances of a relationship clothe it in a fiduciary character... the presence of the following factors may give rise to a fiduciary relationship:

- A. An undertaking to act on behalf of or for another person;
- B. A discretion or power to act which affects the interest of that other person;
- C. The peculiar vulnerability of that other person, shown by:
  - i. Dependence on information and advice;
  - ii. A relationship of confidence; or
  - iii. The significance of a particular transaction.<sup>8</sup>

While these two countries offer slightly different approaches to defining fiduciaries in law, the following graphic summarizes how fiduciaries are typically defined in practice.

 <b>WHO IS A FIDUCIARY?</b>	
<b>NAMED FIDUCIARY</b>	Anyone specifically named in the plan document as fiduciary (plan sponsor is the fiduciary by default if nobody is specifically named)
<b>DISCRETIONARY ROLE</b>	Anyone with authority to make decisions about plan management or assets
<b>INVESTMENT ADVICE</b>	Anyone who provides investment advice for compensation (direct or indirect)
<b>INVESTMENT MANAGER</b>	Registered investment advisors, banks, or insurance companies, that acknowledge in writing that they are plan fiduciaries

Source: Mercer

<sup>5</sup> Fiduciary. (n.d.) In Merriam-Webster’s collegiate dictionary. Retrieved from <https://www.merriam-webster.com/dictionary/fiduciary>.

<sup>6</sup> PRI, UNEPFI, UN Global Compact, UN Inquiry (2015). “Fiduciary Duty in the 21st Century”. Retrieved from <https://www.unpri.org/download?ac=1378>

<sup>7</sup> The U.S. Department of Labor’s Employee Benefits Security Administration (2017). “Meeting Your Fiduciary Responsibilities”. Retrieved from <https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/publications/meeting-your-fiduciary-responsibilities.pdf>.

<sup>8</sup> The Law Commission (2013). “Fiduciary Duties of Investment Intermediaries: Summary of the Consultation Paper”. Retrieved from [https://s3-eu-west-2.amazonaws.com/law-com-prod-storage-11jxou24uy7q/uploads/2015/03/cp215\\_fiduciary\\_duties\\_summary\\_web.pdf](https://s3-eu-west-2.amazonaws.com/law-com-prod-storage-11jxou24uy7q/uploads/2015/03/cp215_fiduciary_duties_summary_web.pdf)

## ② Corporate retirement plans overview

### ii. Complying with fiduciary duty requirements:

#### Fiduciary duty in the United Kingdom

The U.K. Law Commission indicates that the “irreducible core of fiduciary duty is the duty of loyalty” which the Commission defines according to four categories:



#### DUTY OF LOYALTY (U.K.)

No conflict rule:	No profit rule:	Undivided loyalty rule:	Duty of confidentiality:
“A fiduciary must not place themselves in a position where their own interest conflicts with the principal.”	“A fiduciary must not profit from their position at the expense of the principal.”	“A fiduciary owes undivided loyalty to their principal, and therefore must not place themselves in a position where their duty towards one principal conflicts with a duty they owe to another principal.”	“A fiduciary must not use information obtained in confidence from a principal for their own advantage or for the benefit of another.”

#### Fiduciary duty in the European Union

In contrast to the U.K. concept of the duty of loyalty lying at the core of fiduciary duty, the European Union’s Institutions for Occupational Retirement Provision (IORP II) Directive, adopted in December 2016 indicated that regulated entities must **“invest in accordance with the ‘prudent person’ rule...”**

Below is a diagram illustrating three core fiduciary rules incorporated into the IORP II regulations.



#### PRUDENT PERSON RULE (E.U.)

“The assets shall be invested in the best long-term interests of members and beneficiaries as a whole. In the case of a potential conflict of interest, an IORP, or the entity which manages its portfolio, shall ensure that the investment is made in the sole interest of members and beneficiaries.”	“Within the prudent person rule, Member States shall allow IORPs to take into account the potential long-term impact of investment decisions on environmental, social, and governance factors.”	“The assets shall be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole.”
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While financial regulatory authorities in other countries may interpret fiduciary duties in different ways, the general principles outlined above are fairly common internationally.



### Fiduciary duty in the United States

In the United States, private sector retirement plans are governed by the Employee Retirement Income Security Act (ERISA) of 1974. Under ERISA, fiduciaries' responsibilities span multiple duties.



#### FIDUCIARY DUTY (ERISA)

##### Duty of Loyalty:

A fiduciary must "run the plan solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits and paying plan expenses"

##### Duty of prudence:

A fiduciary must "discharge his duties with respect to a plan with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims"

##### Duty to diversify:

A fiduciary must "diversify plan investments so as to minimize the risk of large losses"

Failure to follow these principles of conduct may render a fiduciary personally liable to restore any losses to the plan, or to restore any profits gained through improper use of plan assets. The imposition of personal liability is intended to ensure that fiduciaries act prudently and without conflicts in managing retirement plan assets.



3

# The responsible retirement opportunity

Having established the basic elements of how retirement plans are structured and managed, we can now turn to examine how sustainable investment considerations and practices can be integrated into corporate retirement plans.

### A. What is a responsible retirement plan?

Compared to a standard retirement plan, a plan that could be considered “responsible” will take a range of ESG considerations into account in selecting investments and constructing a portfolio (for DB plans) and in offering investment fund options to participants and evaluating investment manager performance (for DC plans). It is important to note, however, that considering ESG factors in investing does not necessitate sacrificing investment performance.



#### i. Overview of responsible investment approaches:<sup>9</sup>

Figure 3 indicates how the three primary responsible investment approaches outlined in the following paragraphs can be arranged on a spectrum; from most to least similar to conventional investing. All four approaches rely on access to ESG-related data to inform the investment process and do not necessitate the sacrifice of returns. There is a growing convergence in how investors are implementing these approaches as the practices are integrated into financial practice more broadly. Working definitions of each approach follow:

**a. Responsible investing:** an approach to investing that takes one or all of the following investment strategies into account (SRI, ESG, or impact). Considering sustainability in investments typically indicates that an investor takes a longer-term view with respect to desired investment outcomes and a broader perspective on the risks and opportunities facing investments.

Typical bottom-up concerns related to sustainability could be a company’s impact on the environment, how a company’s

operations might be affected by climate change impacts (both physically and financially), or the impacts that social inequality can have on a company’s future growth outlook. Sustainability concerns may also extend to top-down, or “macro” consideration of how issues like climate change and social inequality might impact financial markets at large.

#### b. Socially responsible investment (SRI):

an investment approach that emphasizes *values alignment*, typically achieved through avoiding investments in certain sectors and/or companies by negatively screening a portfolio for investments deemed to be unacceptable typically on moral/ethical grounds, but also in reaction to concerns regarding the financial stability of sensitive industries, such as tobacco or firearms manufacturers. SRI can also utilize positive screening methods, where an investor seeks out companies that are “best in class” on ESG matters for inclusion in an investment portfolio.

A related strategy is for investors to actively engage with the companies and investment managers they are invested with, also known as *active ownership*, in order to drive those firms to act in ways that are aligned with investors’ views on social responsibility.

<sup>9</sup> Responsible Investment, which aligns with the terminology popularized by the UN Principles for Responsible Investment, is often used as a synonym for Sustainable Investment. These terms go in and out of favor depending on the geographic region or the constituency being addressed. In this paper the terms are used synonymously.

### ③ The responsible retirement opportunity

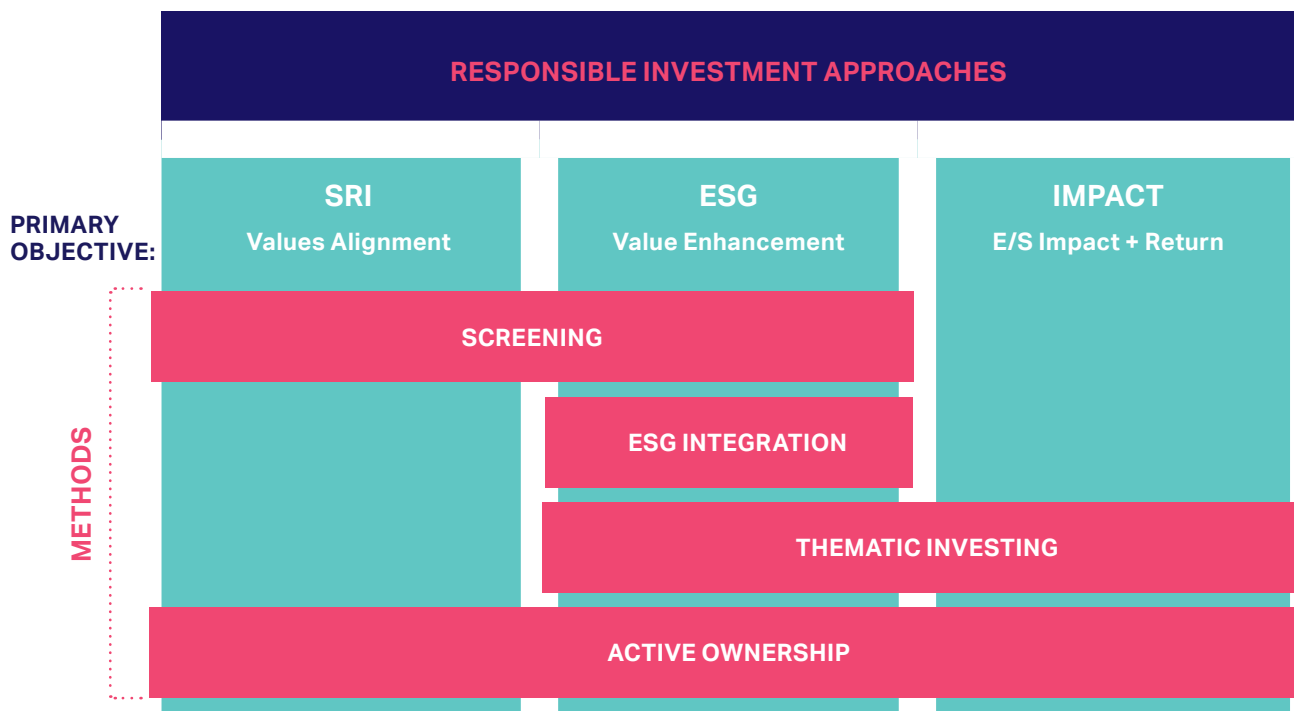
**c. ESG Investment:** this approach prioritizes *value enhancement* through the integration of information regarding ESG topics into the assessment of investment risks and opportunities, with an emphasis on evaluating ESG information that is material to a company's financial performance. Greenhouse gas emissions, labor law violations or the alignment of senior management compensation with environmental

performance are examples of ESG data that investors might take into account in evaluating a company for investment, and certain "thematic" funds are organized around investing in reference to such ESG themes.

**d. Impact investment:** this approach places an explicit emphasis on the intention underlying an investment decision, where

an investment is intended to have a positive impact on a specific environmental or social issue or theme, while earning competitive investment returns.<sup>10</sup> A related element is measurement and quantification of the impact that an investment has on the issue or theme to be addressed, and disclosure of those figures, in order to better inform overall impact investment practices.

**Figure 3: A representative taxonomy of responsible investment approaches and methods**



Source: Mercer

<sup>10</sup> Note, some impact investments are made intentionally at below market financial rates of return. However such investments are typically made by foundations and so are not considered here. For more information regarding impact investing see: <http://www.thegiin.org/>

## ii. Overview of Responsible Investment Methods

**a. Screening:** there are two types of screens employed:  
*Negative screening:* the exclusion of companies that are involved in activities or products with a perceived negative impact on society, such as armaments manufacturing, tobacco production, gambling, alcohol, and animal testing, or companies with poor records of ESG performance. While these decisions are most often driven by ethical/moral considerations, in some cases a stronger financial perspective to exclusions is emerging.

*Positive screening:* the inclusion of stocks/bonds based on whether the company has a positive ESG trait, such as an overall high ESG score, whether the company belongs to a certain industry sector, or displays other favorable characteristics desirable to the investor or its beneficiaries.

**b. ESG Integration:** Investors utilizing this method are typically traditional fund management companies which have begun to actively take ESG issues and themes into account in the fundamental research, analysis and decision-making processes.

Typically, no sector or investment opportunity is automatically excluded from a portfolio. Some investors utilize ESG indicators purely for risk management purposes, while for others, these indicators are fundamental to idea generation and portfolio construction as well as for alpha generation. Such integration considerations can typically lead investors to make buy/hold/sell, or overweight/underweight decisions.

**c. Thematic Investing:** While not all themed funds are focused on sustainability, many do have a clear environmental or social thematic focus. These funds have proliferated in recent years with the emergence of sustainability as a key societal and investment trend driving long-term growth and returns in incumbent and new industries. Focus funds or activist funds can be seen as themed funds within the governance area. Funds with a social theme can be found in microfinance, urban regeneration, property and social infrastructure projects. Environmental funds tend to focus on renewable energy, energy efficiency or clean technology.

**d. Active Ownership:** Also referred to as investment stewardship, active ownership is an investing method whereby investors seek to use their position as an equity owner - or as a creditor - to influence the activity or behavior of investees. This typically manifests through the activities of proxy voting and engagement. The aim is usually to bring a corporation in line with best practice in a particular area, and most commonly to improve standards of corporate governance, as well as to better understand fundamental business drivers related to ESG issues. In combination with other responsible investment approaches, active ownership should better align the time horizon and interests of the corporation with that of its long term investors.



### ③ The responsible retirement opportunity

#### B. Context for the implementation of a responsible retirement plan

As noted above, for DB plans, pursuing an ESG integration approach might involve considering ESG factors in the process of selecting investments and constructing a portfolio. On the other hand, DC plan fiduciaries might consider

ESG factors in evaluating what investment fund options to offer participants, and in evaluating investment manager performance. Overall, a variety of plan sponsor investment activities can feasibly consider ESG factors (see Figure 5).

However, in order to reach the point of implementation, retirement plan sponsors will first need to understand their specific regulatory context and address concerns regarding the relevance of ESG to financial performance, both of which will have direct bearing on interpretation of their fiduciary duties.

Figure 4: The relevance of ESG considerations to various plan sponsor investment activities

ACTIVITY	Asset allocation	Portfolio construction <sup>11</sup>	Lineup construction	Manager selection	Manager monitoring	Participant communication	Proxy voting / engagement
PLAN TYPE	DB	DB	DC	DB/DC	DB/DC	DB/DC	DB/DC
EXAMPLES OF ESG RELEVANCE	DB plan sponsors might consider the impact of systemic risks like climate change or social inequality on their overall asset allocation strategy.	DB plan sponsors might consider their exposure in public equities say to ESG risk characteristics similar to considering exposure to other risk factors like value or growth. characteristics similar to considering exposure to other risk factors like value or growth.	DC plan sponsors might consider the interests of participants in offering standalone ESG-themed or sustainable investment options.	DB/DC plan sponsors might consider the quality of the ESG investment process adopted by potential managers in selection decisions, and/ or the ESG characteristics of current/past portfolios.	DB/DC plan sponsors might monitor managers for the implementation of their ESG investment process and/ or the ESG characteristics of their portfolios.	Communicating to participants in both DB and DC plans regarding the impact of their investments on environmental and social outcomes.	Monitoring investment managers' voting and engagement activity particularly on controversial ESG issues (where voting and engagement authority is delegated by the sponsor to managers).

<sup>11</sup> While asset allocation provides investors with the asset class framework for allocating capital, portfolio construction involves implementing in each asset class. There are many different ways investors can gain exposure to asset classes today which vary by strategy type (e.g. active vs passive), vehicle (e.g. separately managed accounts (SMAs) vs mutual funds), etc.

### i. Regulatory landscape:

Across the globe there are two primary legal frameworks that govern the interpretation and application of law in each country: common law and civil law. Common law, which broadly derives from English law traditions, is frequently found in countries with historical ties to England, including Australia, Canada,

South Africa, the United Kingdom and the United States. Civil law countries include Germany, Japan, France and Brazil, among others. Apart from these overarching legal frameworks, ESG and fiduciary duty considerations have been interpreted and codified quite differently in different countries, with frequent

developments shifting guidance for investors. While it is not the goal of this document to provide legal advice, nor to catalogue all elements of international financial regulations, the following is a short review of recent developments in three major markets:

### Common law jurisdictions

In these countries, laws are generally uncodified, which means that there is no comprehensive compilation of legal statutes and codes. Common law generally relies on judicial precedent, or decisions that have been made in similar cases, in addition to legislative actions that define statutes.<sup>12</sup>

Under common law systems, fiduciary duties represent the core source limits of discretion of investment decision makers, and these duties stand apart from any regulatory or contractual constraints imposed on investment decision makers. These duties are articulated in statutes and may be reinterpreted over time.<sup>13</sup>

ESG and fiduciary duty considerations will be subject to interpretation under common law regimes, likely supported by legislative and/or statutory changes.

### Civil law jurisdictions

In civil law countries, laws are generally codified, meaning that the law is encompassed in legal codes that are comprehensive and continuously updated. Under this system, the role of judicial precedent is less significant than is the role of legislators who draft and interpret the codes.<sup>14</sup>

Under civil law systems, therefore, the concept of “fiduciary duty” is encoded in statutory provisions that regulate the conduct of investment decision makers. However, formal recognition of these duties does not necessarily exist separately from the relevant statutes.<sup>15</sup>

In civil law countries, considering ESG as a core component of fiduciary duty may require the adoption of supportive legal statutes to legally embed ESG into investment practices.

<sup>12</sup> The Common Law and Civil Law Traditions. (n.d.). Retrieved from <https://www.law.berkeley.edu/library/robbins/CommonLawCivilLawTraditions.html>

<sup>13</sup> PRI, UNEPFI, UN Global Compact, UN Inquiry (2015). “Fiduciary Duty in the 21st Century”. Retrieved from <https://www.unpri.org/download?ac=1378>.

<sup>14</sup> The Common Law and Civil Law Traditions. (n.d.). Retrieved from <https://www.law.berkeley.edu/library/robbins/CommonLawCivilLawTraditions.html>

<sup>15</sup> PRI, UNEPFI, UN Global Compact, UN Inquiry (2015). “Fiduciary Duty in the 21st Century”. Retrieved from <https://www.unpri.org/download?ac=1378>.

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**European Union:** In December 2016 the European Union officially adopted a revised Institutions for Occupational Retirement Provision (IORP II) Directive,<sup>16</sup> which required that EU Member States integrate the directive into national law within 24 months. The Directive requires occupational retirement plan providers with more than 100 members to evaluate ESG risks and disclose information to members. As described by the UN Principles for Responsible Investment, the Articles of the Directive require occupational retirement plans to:<sup>17</sup>

- Invest in accordance with the Prudent Person Principle. The Directive clarifies that this means acting in the best long-term interests of their members as a whole, and that the Prudent Person Principle does not preclude funds from considering the impact of their investments on ESG factors (Article 19).

- Hold an effective, transparent system of governance that includes consideration of ESG factors relating to investment decisions. This system should be proportionate to the nature, scale and complexity of the IORP (Article 21).
- Establish a risk management function and procedures to identify, monitor, manage and report risks. ESG risks associated with the investment portfolio and its management are included in the list of risks that the risk management system must cover. This system should be proportionate to the nature, scale and complexity of the IORP (Article 25).
- Carry out and document their own risk assessment at least every three years, or without delay following a significant change in the risk profile. This risk assessment should include, where ESG factors are considered, an assessment of new or emerging risks including climate change, resource use, social risks and stranded assets (Article 28).

- Produce and review a Statement of Investment Policy Principles at least every three years, or immediately following significant changes to investment policy. This must be made publicly available and explain whether and how the investment policy considers ESG factors (Article 30).
- Inform prospective scheme members whether and how the investment approach takes ESG factors into account (Article 41).

Such clear and multifaceted requirements, which respond directly to questions of fiduciary duty and ESG, will provide some clarity to EU retirement plan fiduciaries regarding their duties with respect to ESG integration.



<sup>16</sup> The full text of the Directive is available here: <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32016L2341>

<sup>17</sup> The following bullet points are quoted from United Nations Principles for Responsible Investment (2016). "Policy Briefing: Institutions for Occupational Retirement Provision (IORP) Directive: ESG Clauses." Retrieved from <https://www.unpri.org/download?ac=1430>.





**United Kingdom:** In September 2018, the U.K. Department of Work and Pensions issued a governmental response to a consultation on **“Clarifying and Strengthening Trustees’ Investment Duties”** that proposes out new regulations regarding the consideration of ESG factors by fiduciaries. The new regulations clarify that it is the duty of pension trustees to consider financially material risks and opportunities, including ESG topics like climate change, in addition to traditional financial metrics. A core element of the proposed new regulations is that, as of October 1, 2019, certain retirement plans will be required to update their “Statement of Investment Principles” (also known as Investment Policy Statements in other markets) to reflect both how they take ESG issues into account, as well as stewardship polices defining how these plans engage with investee firms and vote their proxies.<sup>18</sup> Such new regulatory actions appear set to dramatically shift the landscape of how U.K. pensions account for ESG considerations in their investment decision making.



**United States:** In 2018 the U.S. Department of Labor (DOL) issued Field Assistance Bulletin (FAB) 2018-01,<sup>19</sup> which addresses the extent to which fiduciaries governing ERISA-compliant retirement plans can take ESG factors into account in investing plan assets. FAB 2018-01 cautions fiduciaries against too readily treating ESG factors as economically relevant, as well as sacrificing return or increasing risks **“to promote collateral social policy goals.”** While the DOL indicates skepticism regarding ESG matters, the Government Accountability Office (GAO), in a report released shortly after FAB 2018-01, highlighted the fact that DOL’s FAB may lead to confusion among ERISA fiduciaries regarding financially material ESG factors.<sup>20</sup> GAO called for further clarification from DOL regarding whether and how fiduciaries can consider financially material ESG factors in investment decisions, which DOL has not yet committed to issue as of this writing. Ultimately, however, the U.S. regulatory landscape for fiduciary consideration of ESG issues stands in contrast to other major markets for the lack of clarity from regulators.

<sup>18</sup> Department of Work and Pensions, United Kingdom (2018). “Clarifying and strengthening trustees’ investment duties: Government response.” Retrieved from [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/739331/response-clarifying-and-strengthening-trustees-investment-duties.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/739331/response-clarifying-and-strengthening-trustees-investment-duties.pdf).

<sup>19</sup> U.S. Department of Labor (2018). Field Assistance Bulletin 2018-01. Retrieved from <https://www.dol.gov/sites/default/files/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01.pdf>.

<sup>20</sup> U.S. Government Accountability Office (2018). “Retirement Plan Investing: Clearer Information on Consideration of Environmental, Social, and Governance Factors Would Be Helpful.” Retrieved from <https://www.gao.gov/assets/700/691930.pdf>

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#### ii. Data Issues:

Responsible investors argue that the past is no longer prologue to the future, that we are entering new economic regimes driven by changes in the environment and society which cannot effectively be analyzed using backward-looking quantitative approaches, as are often emphasized in investment decision making. For example, it is difficult to back test for the impact of climate change on investments since climate change to the extent expected has not happened previously in human history.

**One approach that investors and others have taken to mitigate such data challenges is to develop scenario analyses that attempt to analyze possible future financial and economic outcomes according to different levels of global average temperature increase.**

For example, Mercer's climate change model, released in 2015, evaluated the expected performance of various asset classes across a number of different potential climate scenarios, providing quantitative guidance to investors seeking to build more climate-resilient portfolios.<sup>21</sup>

While not all systemic environmental and social challenges or "megatrends" can be addressed in the same way, investors could benefit from considering risks and opportunities in a similarly forward-looking, qualitative manner as part of due diligence processes.

To support the assessment of idiosyncratic ESG issues which differ at the company level, a host of ESG data providers have entered the market offering competing and complimentary data services to investors.

**By some accounts, over 150 providers of ESG data on companies are in the market, offering more than 650 individual data products.<sup>22</sup>**

The proliferation of ESG data has been aided by increasing transparency of sustainability activities<sup>23</sup> and a simultaneous lack of ESG data standards<sup>24</sup> creating a need for third-party research and interpretation of disclosed (and undisclosed) information.

Such data diversity impedes regular quantitative back testing methods used often to analyze financial data which is more reliably reported and audited. Also, many ESG data providers necessarily utilize subjective methodologies to fill gaps in reported data or to make assumptions about company disclosures and these methodologies sometimes change over time. Moreover, even the most robust ESG databases only extend one or two decades back in time. All of this can make finding a clean, clear and long-term dataset to support statistical analysis challenging.



<sup>21</sup> Mercer. (n.d.). Investing in a Time of Climate Change. Retrieved from <https://www.mercer.com/our-thinking/wealth/investing-in-a-time-of-climate-change.html>

<sup>22</sup> Global Initiative of Sustainability Ratings (GISR) – Data Hub, accessed August 2017

<sup>23</sup> Governance & Accountability Institute. (n.d.). FLASH REPORT: 85% Of S&P 500 Index® Companies Publish Sustainability Reports In 2017. Retrieved from <https://www.businesswire.com/news/home/20180320006125/en/FLASH-REPORT-85-SP-500-Index%C2%AE-Companies>

<sup>24</sup> While several organizations including most notably the Sustainability Accounting Standards Board (SASB) and the Taskforce on Climate-Related Financial Disclosures (TCFD), are working to develop disclosure/reporting standards for ESG data, no notable standards are imposed by regulators today.

### iii. Empirical Evidence:

A frequent question investors ask is whether considering ESG factors in decision making necessarily involves sacrificing some measure of investment performance. To the extent that applying an SRI-focused approach of screening out sensitive investments from a portfolio reduces the investable universe available to an investor, then modern portfolio theory (MPT) which is underpinned by the **Efficient Market Hypothesis (EMH) dictates that long-term risk-adjusted performance would be sacrificed compared to an unconstrained portfolio.**<sup>25</sup> There are certainly examples of instances where organizations have divested from a certain security or class thereof and experienced financial losses as a result.<sup>26</sup>

However, in examining research on SRI investment performance, theory has not always played out in practice. In fact, negatively screened portfolios often perform in line with and sometimes better than unscreened portfolios<sup>27</sup> though much depends on the industry screened, the timeframe of assessment and the metrics used to evaluate performance.<sup>28</sup>

In examining ESG integration investment approaches, the empirical record shows generally positive contributions to portfolio performance. In 2018 the U.S. Government Accountability Office (GAO) conducted a detailed study of ESG investment trends in retirement plans and conducted its own meta-study of ESG investment research articles. In looking at studies conducted between 2012 and 2017, the GAO found that 88% of scenarios evaluated in those studies found a neutral or positive relationship between the consideration of ESG data and financial returns when compared to otherwise comparable investments.<sup>29</sup>

The GAO also notes that a study commissioned in 2017 by the U.S. Department of Labor reported that a review of academic literature published between 2006-2016 found that incorporating ESG factors in investments typically produced performance that is comparable to or better than investments that did not incorporate ESG.<sup>30</sup>

Active ownership, which entails voting proxies and engaging with company management teams around controversial ESG management practices, is another investment technique often employed by responsible investors. While less well studied than ESG integration, active owners have demonstrated a positive impact on return outcomes. Analyzing a database of environmental and social engagements with US public companies over 1999–2009, a group of researchers found engaged companies produced cumulative abnormal returns of +1.8%. After successful engagements, companies experienced improvements in operating performance profitability, efficiency and governance.<sup>31</sup>

While misperceptions regarding ESG investment approaches are unfortunately persistent among investors and the public, an increasing amount of evidence<sup>32</sup> indicates that ESG integration tends to produce positive performance outcomes far more often than not.

<sup>25</sup> For a high-level overview of MPT refer to: <https://www.investopedia.com/terms/m/modernportfoliotheory.asp>. For the purposes of this document, it is important to understand that MPT presumes market efficiency and is by far the most dominant investment theory, underpinning most quantitative investment models in use today.

<sup>26</sup> The Wall Street Journal (2016). Soaring Tobacco Stocks Prompt CalPERS to Reconsider Investment Strategy. Retrieved from <https://www.wsj.com/articles/tobacco-gains-prompts-fund-to-reconsider-investment-strategy-1461914447>

<sup>27</sup> Mercer (2017). Preparing Portfolios for Transformation. Page 32-33. Retrieved from <https://www.mercer.com/our-thinking/assessing-the-prospective-investment-impacts-of-a-low-carbon-economic-transition.html>

<sup>28</sup> Jeremy Grantham (2018). The mythical peril of divesting from fossil fuels. Retrieved from <http://www.lse.ac.uk/GranthamInstitute/news/the-mythical-peril-of-divesting-from-fossil-fuels/>

<sup>29</sup> U.S. Government Accountability Office (2018). Retirement Plan Investing: Clearer Information on Consideration of Environmental, Social, and Governance Factors Would Be Helpful. GAO-18-398. Pages 7-8.

<sup>30</sup> Ogechukwu Ezeokoli, et al., Summit Consulting, LLC (2017). Environmental, Social, and Governance (ESG) Investment Tools: A Review of the Current Field.

<sup>31</sup> Dimson, Karakas & Li; Active Ownership (2013)

<sup>32</sup> For perhaps the definitive meta-analysis of ESG studies, see: 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*, vol. 5 no. 4.

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#### C. How could responsible retirement plans impact fiduciary duty considerations?

As noted at the opening of this report, considerations of fiduciary duty lie at the heart of how retirement plans are governed and must be considered in any course of action a retirement plan might take. While the following comments are not intended to be definitive in nature, and it is prudent to consult with retirement plan counsel regarding any proposed changes to retirement plan structures, policies, or investments, it could be useful to consider how sustainable retirement approaches might impact fiduciary duty.<sup>33</sup>

##### i. Duty of loyalty:

A common misconception regarding ESG integration into the investment process is that taking such considerations into account is to insert the ethical and/or political views of the plan sponsor into a retirement plan. If a plan sponsor were to utilize ESG investing to pursue policy or other goals, then such an approach would violate the duty of loyalty. However, given that ESG integration practices are generally employed by investors seeking to broaden the scope of investment analysis to include consideration of material ESG

risks which may not be evident in financial statements, far from imposing ethical or political views on the investment process ESG integration is instead focused on improving investment outcomes for beneficiaries. Therefore, ESG integration can be considered an operating the plan "solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits and paying plan expenses."



<sup>33</sup> United Nations Principles for Responsible Investment (2016). "Fiduciary Duty in the 21st Century: US Roadmap." Retrieved from <https://www.unpri.org/fiduciary-duty/fiduciary-duty-in-the-21st-century-us-roadmap/265.article>.

### ii. Duty of prudence:

As evidence and common global practice indicates, considering ESG risks and opportunities may help plan participants avoid losing investment value or enhance returns by broadening inputs to decision making versus traditional investment approaches. Given this context, fiduciaries would be acting “prudently” in ensuring that ESG risks are considered in the investment decisions impacting the retirement plan(s) they govern. Given the additional ESG data investors now have access to regarding companies and investment strategies compared to even a few years ago, it would seem imprudent to simply disregard considering such data in investment decisions simply because it is “new” or “non-standard.” Instead, **it would be sensible that a prudent person would consider as many material data points as possible in making investment decisions,** and therefore ESG integration is well-aligned with the duty of prudence.

### iii. Duty to diversify:

This duty directs fiduciaries to **“diversify plan investments so as to minimize the risk of large losses.”** While considering ESG factors in investment processes does not inherently provide additional diversification compared to traditional investment approaches, ESG considerations may lead investors to weight certain investments differently or to make different asset class or security selection decisions. For instance, investors may choose to tilt all or portions of their portfolio towards “best in class” companies in terms of ESG performance, and those companies may not be included in more traditional investment strategies where ESG performance is not considered, thus offering some potential diversification benefits in line with fiduciary duty. Similarly, for a DC plan sponsor, adding a new ESG option to a plan lineup increases the fund choices available to participants and can enhance participant diversification potential.

In conclusion, while integrating responsible investment considerations into retirement plans has frequently been mischaracterized as sacrificing returns, forcing political or ethical views into the investment process, or as opposed to fiduciary duty considerations, this toolkit was designed to help readers understand why these views are too narrowly construed and not necessarily correct. Instead, responsible investment approaches can be integrated into retirement plans of all types and sizes, if done thoughtfully and in full consideration of available regulatory guidance, research and products.

The second toolkit in this series, to be released in early 2019, will offer guidance to retirement plan fiduciaries and administrators for how they can implement responsible investment approaches within their own plans, featuring more detail and case study examples. We hope you have found this paper useful, and that you will find the second paper equally helpful to advancing your sustainable retirement plan goals.

## AUTHORS

**Christopher Walker** (WBCSD)

**Max Messervy** (Mercer)

**Alex Bernhardt** (Mercer)

## OTHER CONTRIBUTORS

**Dr. Rodney Irwin** (WBCSD)

**Yi Sun** (WBCSD)

**Tomi Nummela** (Mercer)

**Nicolas Jammes** (WBCSD)

**Juliet Taylor** (WBCSD)

**Tony Calandro** (Purposeful Strategies)

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**Mercer** (project consultant)

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for Sustainable Development**

Maison de la Paix  
Chemin Eugène-Rigot 2B  
CP 2075, 1211 Geneva 1  
Switzerland

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