HEDGEWEEK

INSIGHT REPORT

Hedge funds & ESG:

Navigating internal change and responsible investing

MAY 2022

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KEY FINDINGS

Managers grapple with patchwork ESG standards amid ongoing regulatory drive

Market authorities are continuing their drive towards establishing ESG regulations, but the absence of common global regulatory standards and rules means asset managers and investors face continued barriers when it comes to scoring and rating companies on issues such as carbon footprints, social responsibility and good governance. Amid the regional patchwork of initiatives, the 'S' - or social - component of ESG is seen to lag behind environmental and governance standards. As allocator interest in responsible investing continues to accelerate – as evidenced by several industry surveys - hedge funds must look beyond tentative methodologies and metrics, and instead maximise their own internal research and analysis capabilities.

Hedge fund headaches over data 'wild west' and short positions

With market volatility and economic uncertainty on the rise, the way in which different hedge fund strategies – from fundamental long/short stockpickers to computer-based quantitative funds – approach ESG investing is facing closer scrutiny. As the volume of ESG datasets expands, the use of AI and NLP may help managers of all stripes to better interrogate information, which in turn has the potential to strengthen performance. But questions remain over how short positions will be considered by regulators and investors, potentially heralding significant implications for allocator flows and alpha generation.

Investors push hedge funds to rise to the diversity challenge

Investors are now pushing hedge fund managers harder than ever on ESG, diversity and inclusion, which includes tougher due diligence processes and increased demands for practical evidence of impact, beyond simple ESG policies or labels. The Black Lives Matter movement post-George Floyd has calibrated the focus, particularly in the US - but industry data suggests fewer than 5 per cent of hedge fund managers have formally introduced a diversity, equity and inclusion (DE&I) initiative.

Ukraine war and rise of crypto offer fresh portfolio pitfalls

The rapidly accelerating climate emergency, new innovations in fintech, and the constantly evolving geopolitical backdrop continue to pose practical new challenges within the ESG sphere. Russia's invasion of Ukraine has highlighted major risks – from energy security to supply chain dislocation – while cryptocurrencies' carbon footprint and biodiversity concerns are other key themes likely to loom large over the position-building process for years to come.

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BEST PRACTICE? HOW HEDGE FUNDS ARE GRAPPLING WITH FRAGMENTED ESG STANDARDS

As governments strive to meet sustainability targets, the global push for more formalised ESG standards and frameworks is bringing challenges – as well as opportunities – for hedge funds amid a fractured regulatory landscape

With the climate emergency increasingly at the centre of the political agenda, and the focus on environmental, social and governance (ESG) factors in financial markets and investment management continuing to expand, global market regulators are driving ahead with the establishment of formal ESG rules and frameworks.

The European Union's Sustainable Finance Disclosure Regulation (SFDR) – which took effect in March 2021, and forms the core of the bloc's financial markets sustainability push – now applies to a broad scope of financial firms, advisers and products. In addition, the SFDR will, from June this year, require investors to start collecting data on companies in which they invest, with a view to reporting the following year. The SDFR's Level 2 requirements – which include mandatory principle adverse impact statements and other voluntary areas covering valuation risks stemming from environmental impacts – will also take effect in January 2023.

Across the Atlantic, meanwhile, the Securities and Exchange Commission under chairman Gary Gensler has unveiled proposals to shift from a more voluntary, principles-based approach in climate reporting to mandatory disclosures for US companies, with factors such as greenhouse gas emissions included in audited financial statements. US authorities are also setting out plans for increased disclosures for ESG-focused investment funds. In Asia, China is partnering with the EU on ESG taxonomy criteria, while Hong Kong regulators are increasing their focus on climate reporting standards.

Leading the charge

As hedge funds of various shapes, sizes and strategy types look to capitalise on the growing opportunities in sustainable investing, the need to better quantify and assess ESG risks in portfolios and positions is coming into ever-sharper focus.

My-Linh Ngo, head of ESG investment at BlueBay Asset Management, notes how the European sustainable finance-related regulations is set to make a "deeper mark" on financial market participants and issuers, adding that the ongoing rollout of the SFDR regulation, green taxonomy and MiFID sustainability preferences will be added to the mix.

"There's no doubt that Europe has led the charge on the regulatory front," says Edward Lees, co-head of BNP Paribas Asset Management's Environmental Strategies Group and co-manager of its long/short Environmental Absolute Return Thematic (EARTH) strategy. "All of these initiatives are trying in their own way to steer money towards more responsible ends, and ESG is the shorthand for that – responsibility across not just the environment but also social and governance issues."

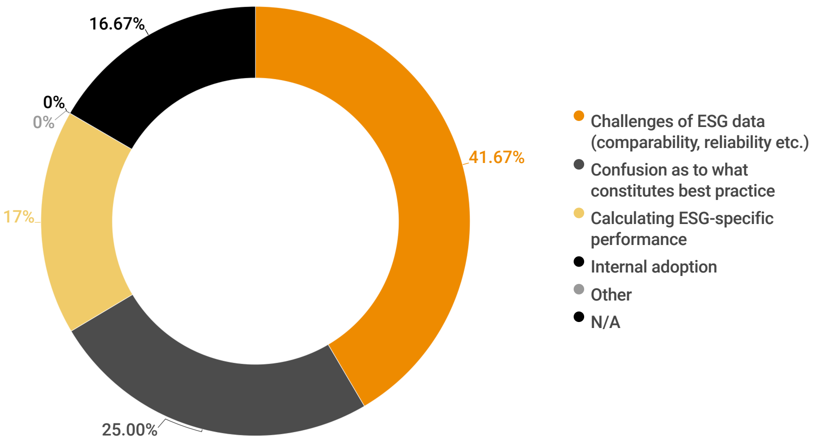
But despite the substantial drive towards a more formal framework - and initiatives such as the UN Principles for Responsible Investing (UNPRI), which now has more than 3,500 signatories spanning asset owners, asset managers, and service providers with assets totaling some USD3 trillion - market participants concede the global regulatory landscape is set to remain fragmented.

In a wide-ranging study published in January, Barclays noted that although the IFRS Foundation's International Sustainability Standards Board has initiated work this year on global reporting requirements for national frameworks, there is still no international market standard for disclosing sustainability information on companies.

This, in turn, potentially heralds sustained ESG integration and transparency headaches for hedge funds and other investment managers.

My-Linh Ngo believes the investment community – particularly those managers marketing in different countries – faces challenges

What do you see as the primary roadblock (if any) to your organisation's ability to successfully integrate ESG investment practices?



Source: Vidrio Financial, 'Vidrio Views' ESG Survey; November 2021

as ESG issues become more complex, with varying approaches emerging from different jurisdictions.

"Clashes of cultural biases, as well as of political and economic agendas, are not a good recipe for harmonisation and standardisation," she observes. "For instance, the European taxonomy of what activities are 'green' may differ to what those North America or emerging markets define as being sustainable. In terms of what products constitutes 'ESG' may vary from one market to the next."

As well as regional divergence, progress also differs across the constituent environmental, social, and governance components of the ESG sphere.

"From our standpoint, we really focus on the 'E' in ESG," Lees explains of his fund's investment strategy. "We view 'E' as being where the world's existential problems are. We view 'E' as being where the billions of government expenditure is focused. We view 'E' as where the huge demand for solutions is from corporates and from people. This is where the cry is at the student level for endowment divestiture; this is what Extinction Rebellion is taking to in the streets. You don't see similar movements on the other two verticals quite as much, in part because environmental issues are in our newspapers every day."

Lees believes this is partly underpinning the drive among regulators towards stronger climate regulation.

As market authorities push ahead more environmental-focused measures, and industry participants note how the governance element has also emerged as a key component of investor due diligence in aftermath of the 2008 global financial crisis, there remains a need to further bolster the 'S' or social element within ESG frameworks, outlines Manuela Cedarmas, head of ESG & Impact Investing at Investcorp-Tages, the global asset management and seeding firm.

"The fact that the EU regulation is still behind in terms of the social taxonomy compared to the environmental one says a lot about how complex the 'S' part of the work is," Cedarmas observes. "This is common to all the strategies and all geographical areas, but it's one side where we see the biggest differences in approach and evaluation from managers."

Ngo says that beyond environmental sustainability, work on social taxonomy and the focus on human rights is expected to progress in 2022. The EU's Platform on Sustainable Finance is in the initial stages of setting out plans for a Social Taxonomy, to help financial markets participants to better explore how a company's economic activity is socially-responsible.

"Europe is not going to be alone in its efforts as the UK and other jurisdictions look to define their takes on 'avoiding harm' and 'doing good' in terms of economic activities and entity-level conduct," Ngo adds. "With ESG data and ratings increasingly emphasised as the basis for firms evidencing their credentials, the quality, reliability and comparability of these mean providers will also come under greater scrutiny this year."

Salvatore Cordaro, co-CEO of Investcorp-Tages, believes that 'S' is the one part of ESG where there continues to be sharp differences among managers in the absence of a coherent, codified framework. "In the US, the focus may be more on diversity and inclusion, whereas in Europe it may be more about equality and health & safety, and other aspects, for instance," he observes.

Headaches and hurdles

Mirroring this fractured regulatory backdrop, recent industry data suggests hedge fund managers and investors are ultimately split on how they can best integrate ESG factors into their risk and investment processes.

A poll of fund managers, funds of funds, corporate pension funds, endowments and others in North America and EMEA by Vidrio Financial, the alternatives-focused software-as-a-service and data management firm, in November found that a lack of clarity over standardisation, data clarity and comparability is regarded as a major hurdle in ESG integration.

More than 40 per cent of respondents pinpointed ESG data comparability challenges as a key integration barrier, while a quarter of those quizzed cited confusion over what constitutes best practice as the primary roadblock. Some 16 per cent of respondents meanwhile said that calculating ESG-specific performance is the main hurdle to integration into portfolios.

Reflecting on how hedge funds and other asset managers can more effectively incorporate ESG factors into their portfolios, Lees cautions against leaning too heavily on scoring or ratings, instead suggesting portfolio managers and investors should look to carefully deconstruct each element, utilising their own research and analysis capabilities - and not see ESG as a general cure-all or panacea.

"'E' is different from 'S', and 'S' is different from 'G'. Each one of those things needs to be evaluated through a whole host of different KPIs," Lees says of his approach. "When you look at a sub-list of KPIs, it can be a useful tool because it can give you a bird's eye view of a lot of different issues with 'E', 'S', and 'G', and you can spot individual red flags which you can then investigate further.

"The problem arises when you try to add that all up into some number that summarises everything. You then aspire for that number to be comparable to other companies' numbers, so that you can actually make decisions about relative merits. You end up adding and comparing apples and oranges.

"What if there are two companies in different industries, or different countries? People who are pulling it together generally aren't doing detailed company analysis – they're looking for a way to import third-party data and do a lot of math on top of it. Whenever you try to pick an easy, systematic way, you're going to get false positives and false negatives. It doesn't mean that it isn't still useful in some ways, but I personally think the most useful ways to get a look at those underlying KPIs."

According to Barclays' ESG special report, 'The Transition Mission', this ongoing lack of industry standardisation raises both the spectre of crowded trades in certain stocks – potentially squeezing hedge funds' performance – as well as hampering hedge funds' efforts to ultimately strengthen their ESG practices.

"Portfolio managers may see divesting bad apples as the path of least resistance to align with regulation, in turn leading to best-in-class ESG assets receiving oversized flows, and thereby increasingly impacting future returns," Barclays noted in its study.

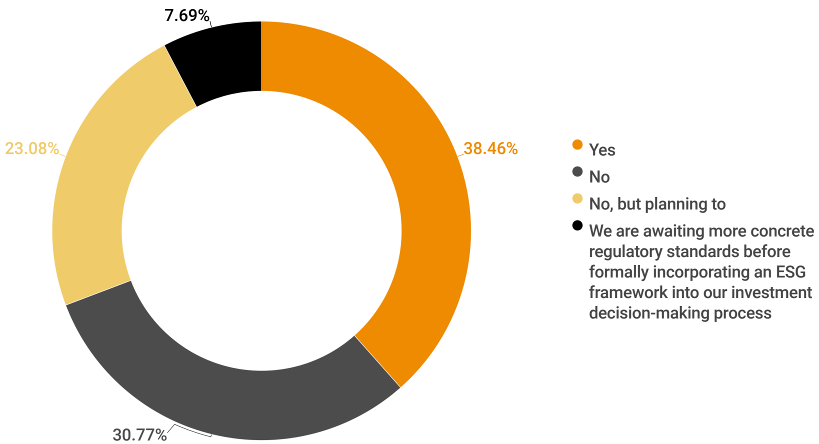
"Ratings can help simplify," says Cordaro. "But as with anything in life, when you try to simplify, you make your life easier but you lose the complexity around those things. My view is that uniformity brings common behaviour - and ultimately an increase in systemic risk, crowding and so forth."

'Great advantage'

In the end, might the continued absence of common industry standards on ESG ratings or a globally-agreed regulatory framework actually offer hedge funds an advantage in their quest to get a lead on their competitors and generate alpha for investors?

> "'E' is different from 'S', and 'S' is different from 'G'"

Are you actively applying ESG factors as part of your risk and opportunity assessments?



Source: Vidrio Financial, 'Vidrio Views' ESG Survey; November 2021

The lack of standards represents a potential opportunity for those managers able to utilise their research and analysis capabilities to zero in on differences between good and bad companies and take advantage accordingly, says Manuela Cedarmas, who notes how differing perspectives across the hedge fund manager community lead managers to contrasting but still equally valid approaches.

"Given that there are still no standards across the globe, this represents even more of an opportunity for the hedge fund space," she notes. "That's why for us it's important to talk to managers to understand the way they look at ESG, given that that there is no one standard method.

"It's important for investors to understand how different managers in different strategies and in different geographies are actually taking those factors into consideration."

What's also important, adds Cordaro, is the value of the work that hedge funds - or any asset manager - can do beyond the ratings, no differently than with other established market metrics, such as credit ratings.

"The ratings are there to synthesize and simplify. But in that simplification, you lose a lot of nuances which sometimes can become incredibly important. Yes, over time we will get to a place where ratings might become more homogeneous than today, but in my opinion we will never get to a place where you will have just one standard framework. This is not about rules, it's also about interpretation – and with ESG in particular, the interpretations, stemming from different values, are not always consistent.

"For instance, is it better to "punish" oil producers, or try to encourage them to move into a clean energy space? There is not an easy black-and-white answer. Ratings can help guide you, but they will never provide you with a comprehensive answer."

He continues: "Hedge funds have the great advantage in that they don't use a benchmark, they can use different instruments and tools, including the ability to short. That's not a trivial thing, especially for sectors that need to transition from an old technology, or an older business model, or an older way of doing things to a newer, more ESG-compliant way.

"The ability to be long and short can definitely help generate more significant alpha."

PENSION FUNDS LEAD ON ESG

With pension funds trailblazing in ESG, long/short equity and credit strategies are proving the most progressive with regards to these considerations, with investors increasingly demanding transparency metrics on ESG from hedge funds

About a third of hedge funds invest in ESG-dedicated strategies leading to investment demand being considered a 'primary driver' in improving ESG, research from BNP Paribas shows. One-fifth of investors plan to increase this in 2022 and a further 23 per cent are considering an investment.

Pensions remain the leaders in this space, with analysis showing how 25 per cent of public pension funds invested in ESG hedge funds along with 22 per cent of corporate pension funds.

Societal trends, greater awareness regarding the environment and equality, and efforts from governments have all pushed institutional investors in particular to want to become more responsible with their allocations.

Despite this, data from Eurekahedge in 2021 showed there were still only 65 live ESG hedge funds: approximately just 3 per cent of all hedge funds in the industry.

Though this isn't a positive indicator, firms are increasingly seeing efforts from hedge funds across both Europe and the US.

Tom Wrobel, Société Générale's director of capital consulting and capital introduction, explains that the first signs of movement in ESG came from European hedge funds, with the US now looking to catch up and fulfill investor demands.

"At the top level, it's something hedge funds have realised they can't ignore. There's been some more proactive engagement and now most are open to at least discussing ESG conditions within a portfolio. Some have even built customised mandates for investors, such as Bridgewater who recently launched a Sustainable Investing & ESG Policy," he comments.

Jamie Kramer, head of the alternatives solutions group at JP Morgan Asset Management echoes this, stating that there are only two out of the 100 hedge funds the firm works with who haven't yet drafted an ESG policy.

Trends

"In the US, DE&I and climate change have been the two most important issues around ESG; investors and allocators who care about ESG are very focused on these two topics," observes Julliette Menga, chair of the ESG committee at Aetos Alternatives Management.

Research from Bloomberg tracked its transcripts between Q3 2015 and Q4 2020 and saw a sharp uptick in mentions of 'ESG' from Q1 2020 to Q4 2020, where mentions increased by approximately 12,000.

"I've worked in the hedge fund space for two decades and since 2020, it's clear that the trend with these two core issues has been steadily upwards; everything just accelerated very significantly in 2020 and I don't think the momentum will slow down anytime soon," Menga adds.

Mercer principal Robert Howie echoes this, stating: "The pace of change has been phenomenal; it's being driven by investors who want accurate ESG reports and for hedge funds to be responsible with their investments."

While trading and arbitrage strategies in the hedge fund space still lag behind, long/short and credit strategies are experiencing lots of movement and progress on the ESG front.

"Private credit, and credit more generally, within hedge funds is also seeing greater growth in the adoption of ESG-focused investments," says Kramer.

Menga adds: "For long/short and credit-type managers, there's been a lot of movement there with ESG. However, arbitrage and trading strategies still haven't figured out how to think about and incorporate ESG."

"When you're running an equity strategy, such as equity long/short driven strategies, it's easier to fulfil ESG demand by either filtering out any negatively perceived ESG stocks from your investment universe, or by being proactive and looking for impact ESG investments," Wrobel notes.

Other ESG trends in hedge funds include the energy transition and carbon allowances, with regulators giving indications of support for both of these, according to Wrobel.

ESG has taken the industry by storm in the past five years, but do the promising figures necessarily mean real change?

Many advisers remain optimistic for this pace of momentum and change in attitude, but not all.

One adviser believes that the big

multi-manager, privately-owned hedge funds won't be in any rush to implement ESG metrics, even if investors call for it.

Mercer's Howie thinks that, while ESG is important to certain hedge funds, the quality of the returns and how a portfolio is managed remain more important.

Public pensions have been putting pressure on their managers, along with some of the bigger institutions who have the resource and capacity to have a real impact and instigate change.

Menga suggests that the pressure comes from the fact that they are government funded pensions and adds private and corporate pensions are much less likely to care about ESG considerations.

For now, actionable steps, including net zero and DE&I goals, have been put in place – the question is whether they will transpire in the future.

One motivation could be the data which shows that ESG can be used to create better returns.

"It's potentially a source of enhancing returns. We've seen many hedge funds that not only use ESG as a risk-management tool, but also as something you actively use to deliver returns for investors," says Howie.

ESG roles

One noticeable change which has taken place is the creation of ESG-related roles within firms.

Research from AIMA in 2020 found that half of EMEA-based hedge funds have one member of staff in an ESG-dedicated role to promote sustainable investment, with the US lagging on this front with only 15 per cent of firms doing so.

However, while this is a positive change within the industry, a recent study by employment data platform, HFObserver found that over half of new hedge fund ESG jobs have been filled by women in the past two years.

With an industry such as the hedge fund space which has been criticised so heavily with diversity, these statistics, compared with the 29 per cent of hedge fund appointments women account for across the industry, are not impressive.

Reflecting on this, Black Hedge Fund Professionals Network founder Andra Ofosu notes: "Let's start with the positive: whenever new seats are created in the industry or open-up, that's a positive. The ability to broaden the scope of who can participate in the space is always positive.

"Having said that, we need to watch out for clustering of certain groups – by gender, by ethnicity – into certain roles. We need to be careful of any underlying or inherent biases that might promote or encourage that kind of clustering. Whether it's women in ESG roles, or looking across our membership, people of colour in the hedge fund industry clustering in middle or back-office roles."

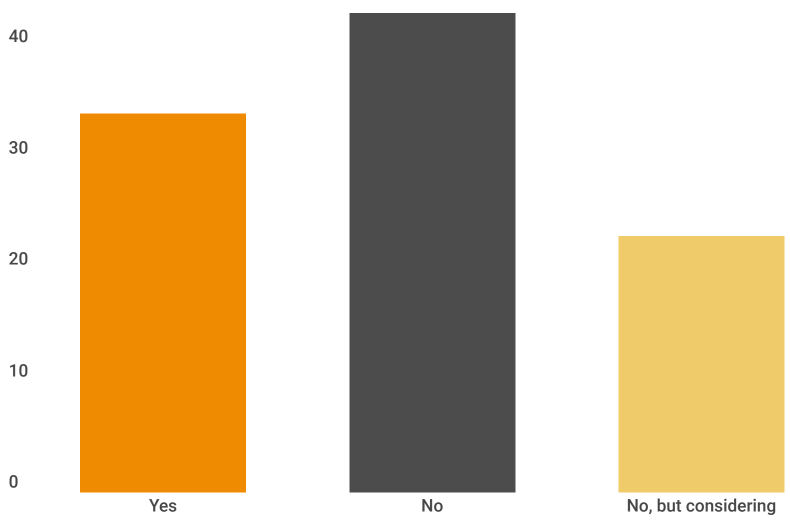
What next?

The future of ESG in hedge funds points in only one direction: growth.

"I suspect we'll see a divergence of hedge funds that want to engage and receive capital from more institutional sources and therefore ESG will have to be ingrained throughout their business and investment process on all elements of ESG," says Wrobel.

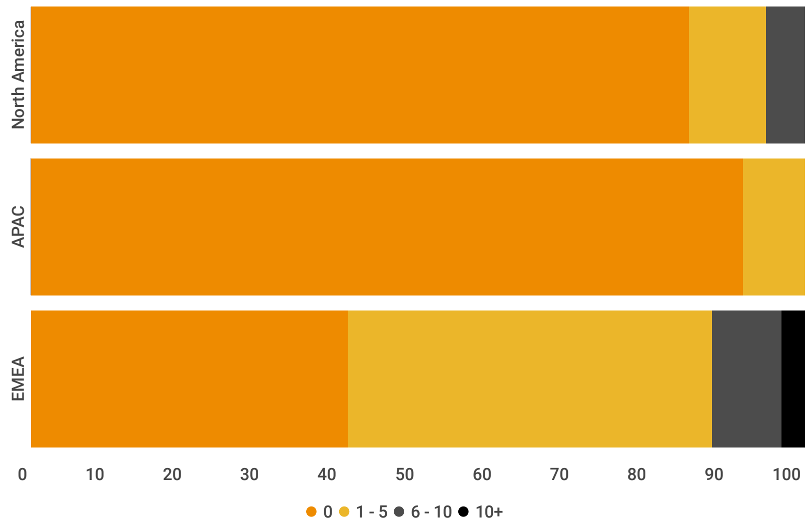
"However, for players who source more niche sources of capital and don't rely on public capital so much, I believe ESG may remain something that they don't take much interest in, and the same could be said across the investor universe. I think we're going to see a split," he adds.

Do you invest in ESG-dedicated strategies?

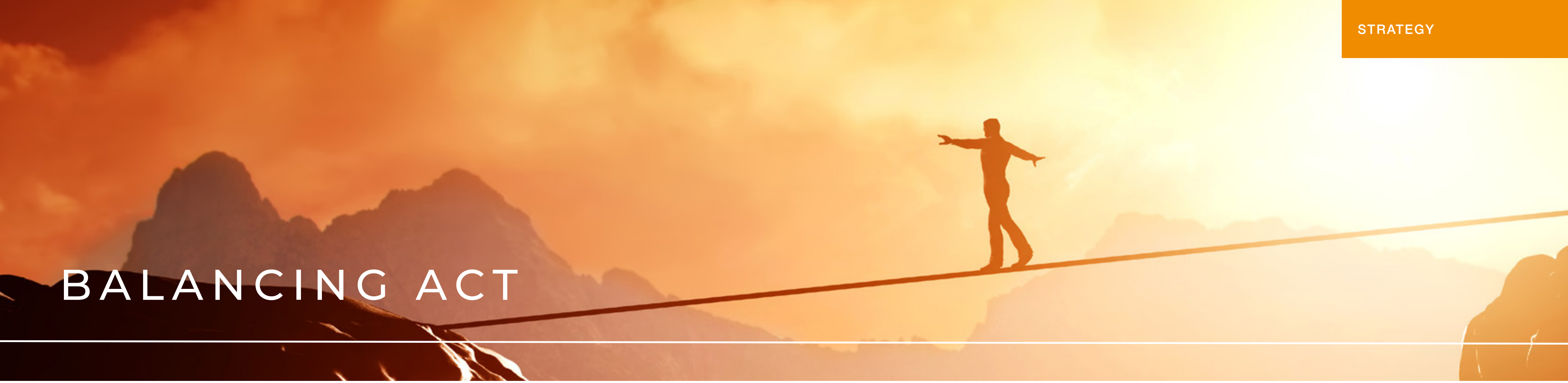


Source: BNP Paribas, 2022 Alternative Investment Survey

How many people does your firm have in ESG dedicated roles?



Source: 2020 KPMG/AIMA Global Hedge Fund Survey



BALANCING ACT

With the ESG juggernaut gathering pace in financial markets, how hedge funds traverse short-selling challenges, tech advances, and the data "wild west" will be key to unlocking future returns

Long seen as the preserve of traditional long-only buy-and-hold strategies, impact investing and sustainability-focused themes have gathered pace within the global alternative investment community over the past decade.

In times past, industry concerns centred around whether effective ESG implementation could ever be compatible with alpha generation. But as allocators place greater scrutiny on how their portfolios and investments can meet the expanding set of climate change, diversity and corporate governance challenges, an assortment of high-profile brand-name hedge fund management firms – including Man Group, Sir Chris Hohn's TCI Fund, JPMorgan and Caxton Associates – have emerged as leading ESG advocates.

At the same time, successive industry studies continue to chart a sustained surge in appetite among investors for a greater focus on ESG within their hedge fund allocations.

In 2020, a wide-ranging study by Deutsche Bank found that ESG factors are informing the allocation decisions of roughly two-thirds of hedge fund investors. Meanwhile, in more practical terms, more than a third of investors (34 per cent) now actively allocate to an ESG-focused hedge fund strategy, according to BNP Paribas' 2022 Alternative Investment Survey, compared to 43 per cent who do not, though a further 23 per cent are considering an investment. According to BNP's study, published in March this year, more than a fifth of investors (22 per cent) expect their allocations to ESG strategies to increase in 2022.

The same study also found that 38 per cent of investors now invest in women- or minority-owned managers, up from 21 per cent five years ago. A further 18 per cent of those quizzed are expecting this to grow in 2022, and about a fifth are considering investing for the first time.

'Huge opportunities'

"There are huge opportunities because there are huge problems," says Edward Lees, co-head of BNP Paribas Asset Management's Environmental Strategies Group.

He believes that investors keen on ESG themes - but nervous about increased exposure to market direction - may tilt towards the hedge fund space, such as market neutral and long/short strategies, amid the prevailing market volatility and economic uncertainty.

"We are now in an interesting environment, relative to last year – we're moving from an environment from which the market was just trending up to where the market is now much choppier."

That said, hedge funds and other alternative asset managers still face practical headaches when it comes to successfully implementing sustainability metrics and other factors into their strategies and utilising ESG to help deliver alpha - a key barometer of success in the hedge fund industry.

The continued lack of industry standardisation of the way certain factors – such as carbon emissions, socially-responsible management, and effective corporate governance – are identified, measured and quantified, coupled with the ongoing challenge of greenwashing, is now pushing some asset managers towards data and technology solutions.

With ESG data now seen as a hot commodity, AI, machine learning algorithms and natural language processing techniques can potentially help managers and investors contend with the rapid expansion of datasets and disclosure demands, and delve deeper into the at-times dizzying array of available information.

According to a report by SS&C and the Alternative Investment Management Association in September, there are now more 100 data vendors supplying the market with ESG scores, ratings and reports on companies based on company disclosures and independent research.

Quality not quantity

Speaking at an ESG-focused webinar in November, Richard Peterson, director and product head of credit data and analytics at FIS, and a member of the firm's steering committee for integrating ESG initiatives, suggested large parts of the investment management industry are "still in the wild west" when it comes to ESG analysis of companies and the level of data provision - adding that the social and governance elements of ESG remain trickier to quantify and benchmark.

My-Linh Ngo, head of ESG and portfolio manager at BlueBay Asset Management, says technological advances such as AI and NLP can help investors and managers collect and analyse larger volumes of data more easily and faster than humans, which in turn can better help identify trends.

"ESG data is necessary but not sufficient in and of itself to do ESG investing well – it needs to be combined with the necessary tools, analytics, and expertise to effectively interpret it and inform decisions," says Ngo. "While in some cases there is a case of there not being enough information, in others, there is actually too much. The issue is quality and not quantity."

While the increased volume of ESG data is likely to lend itself more immediately to quantitative and computer-based hedge fund strategies, Ngo also believes improvements in data processing will also allow fundamental and discretionary managers to better cut through the sizable swathes of information in order to strengthen investment theses.

She says: "Traditional strategies will find value in applying these to identify quality investments which will be stable over the long term, whilst other quant strategies can benefit from acting on the shorter to medium term signals generated, which over the long-term means they may still hold their own performance-wise as well."

A state of flux

With market authorities now circling the worst carbon emitters, and ESG playing an ever-greater role in allocator decisions, the ways in which different hedge fund strategies are best suited to applying responsible investing techniques are now firmly in the spotlight. As well as heralding major implications for investor flows into different segments of the industry, it could also recalibrate the ongoing discretionary-versus-quant debate, market participants say.

Reflecting on the broad spectrum of hedge fund types - from traditional long/short bottom-up fundamental stock-picking strategies and discretionary activist approaches to algorithm-based quantitative funds and AI trading which remove human emotions from the investment process - James Jampel, founder of HITE Hedge Asset Management, believes quant methods will face greater challenges than discretionary and fundamental approaches when it comes to building successful ESG-friendly portfolios.

Noting how government policy, regulatory initiatives and investor sentiment are all in a state of flux, Jampel explains: "In a world where the future is going to be so different from the past, it seems less appropriate to use quant analysis where you're implicitly assuming the future is going to be something like the past. We are fundamental analysts, and fundamental analysis allows for discontinuities and sharp break points.

"Count me as a sceptic about whether ESG factors will be predictive of returns."

He continues: "The quants, by their nature, are not going to be activists - they're not going to take positions on boards and vote. The only argument they can make is that their shorts are more carbon intensive than their longs. That's the only way they are going to attract any capital within these ESG frameworks. The quants might be good at generating alpha for investors – in the end, hedge funds are there to make money – but it's only going to be considered impactful from a cost of capital standpoint."

Speaking at EisnerAmper's 6th annual Alternative Investment Summit last October, Scott Radke, CEO of New Holland Capital, pinpointed how various strategies are utilising both defensive and offensive approaches. The defensive approach centres around risk identification, with bottom-up equity and credit strategies zeroing in on the earnings or balance sheet implications of an environmental or social event or catalyst in order to develop trading themes or investment ideas. Meanwhile, the offensive implementation involves managers building portfolios specifically designed to have an impact orientation.

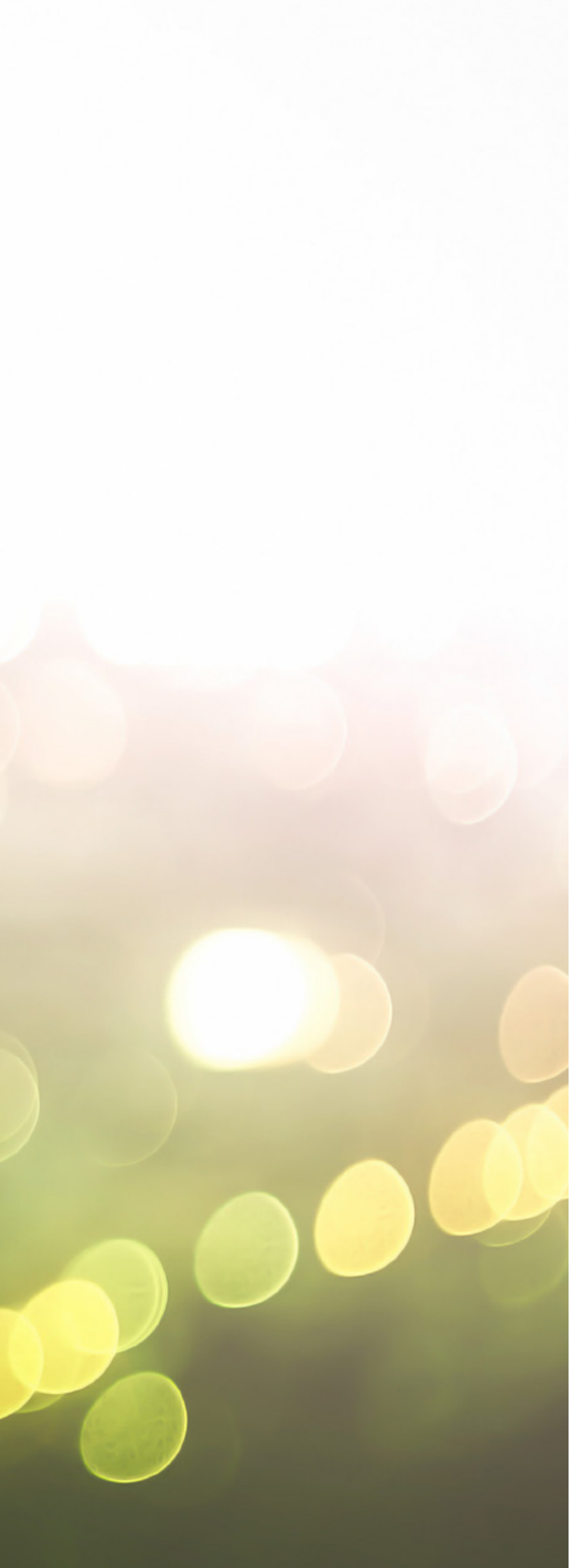
Short shrift?

Over the past decade, the traditional asset management approach towards impact investing has evolved from divesting out of 'bad' companies towards more activist-style stances, taking stakes in companies and agitating for change at the management level.

But this shift is now posing a conundrum for investors who are mandated to curb their portfolios' carbon net financing.

"They are unsure if they should be increasing their net financing of high-carbon entities now, and then using their influence in trying to change those entities over time, or if they should be decreasing their carbon net financing immediately by divesting," Jampel says.

> "There are huge opportunities because there are huge problems"



"Do allocators today want a high 'carbon footprint' set of managers, however defined, that have potential to make change or, instead, a low carbon footprint in order to ensure they are not seen as financing or profiting from high emitters in the short run?"

Crucially for the hedge fund community, this has also thrown the spotlight onto how allocators and policymakers view short positions – a key tool in hedge funds' trading arsenal.

Hedge funds' ability to take short positions and hold derivatives creates an added dimension of different exposures, risks and ESG characteristics, further complicating the carbon footprint debate. Industry participants say shorting ESG-negative companies may also prove more effective in instigating change, rather than simply taking long positions and agitating for reforms.

Jampel believes the biggest regulatory risk for hedge funds is that future ESG standards are written in a way that fails to acknowledge how shorting and the use of derivatives operate. Specifically, the key issue centres around whether allocators should screen on a simplistic model of current carbon 'footprints' at all – or if a more sophisticated and inclusive model based on the potential to affect change is more aligned to the net-zero economy.

He says hedge funds firstly need to argue for the use of this more comprehensive model of potential for influence. Secondly, if current financing is to be used as a metric, hedge funds need to ensure shorting is included as negative in that calculation – and not erroneously ignored.

"You will hear critics argue that shorting has never removed a single tonne of carbon from the atmosphere. But then selling a long position and divesting doesn't either. This is a red herring that needs to be debunked," Jampel says.

"The short book has to be thought of completely differently to the long book. Shorting is not investing – it is a financial transaction in which you will profit if the stock goes down. Shorting is not financing a company. Intellectual consistency demands that shorts be counted as negative carbon financing."

Jampel explains how HITE Hedge's High Carbon Offset strategy takes short positions in the heaviest carbon emitters and goes long those companies that are not the heaviest carbon emitters.

He says: "Our biggest concern is that if major bodies come out with language that does not allow shorts or derivatives to be counted, then our portfolio will appear to be one where we are net financing emitters and profiting from them, when in fact we are not. The challenge we have is convincing potential allocators that we can - and do - have an ability to decrease their financial risk of owning emitting companies that we are helping move in the right direction. That will become more difficult if the regulations are written in a sub-optimal or less-than-thoughtful way."

Additionally, more fundamental questions surrounding the ethics of short-selling – and whether the practice ultimately contradicts the spirit of responsible investing – remain the subject of some debate.

In a July 2020 commentary on short-selling and ESG, AIMA and Simmons & Simmons noted how shorting can be used to trade on ESG concerns over corporate governance, environmental issues, and alleged human rights abuses, helping expose failings of issuers and bolstering market transparency for investors. The report highlighted short-sellers' early public campaigns against Wirecard AG, the scandal-hit German e-payments firm which collapsed in 2020 amid accounting fraud.

"There is a lot of debate around shorting, and whether you should be shorting bad companies and bad industries," observes Patrick Ghali, managing partner and co-founder of global institutional investment advisor Sussex Partners.

"You have the purists who say you should not be making any money shorting, for example, fossil fuel companies because you are benefitting from a negative. Then there are other people who say you should absolutely be shorting them and making money from it because, first of all, you will be generating returns, and secondly you might also be able to force them to change their ways and take an activist approach that might be beneficial. There is still ultimately no consensus."

WHEN WILL DIVERSITY IN HEDGE FUNDS FINALLY IMPROVE?

With recent research from Knight Foundation revealing that as little as 0.04% per cent of US-based AuM is managed by diverse-owned hedge funds, investors are increasingly requesting data and actively looking to invest in diverse funds

The asset management sector has never been applauded for its efforts in diversity; Knight Frank's data reveals that only 1.4% of total US-based AuM was managed by diverse-owned firms in 2021. This only reflects a 0.4% growth on from 2016.

Across 10 years, these figures haven't improved very significantly. Currently, for hedge funds, 3.4% of US-based AuM is managed by minority-owned firms and 2.2% is managed by women.

While disappointing, it seems that investors have finally had enough and are calling for improvements on DE&I in hedge funds.

"We've seen intermediaries becoming a lot more structured and systematic with the information and data they collect. They're stricter with their due diligence, in terms of ESG and DE&I, and also measuring the progress," notes Andra Ofosu, founder of Black Hedge Fund Professionals Network and director at Aspect Capital.

This change is directly linked to institutional investors increasingly requesting data on DE&I from hedge funds, encouraged by the revival of the Black Lives Matter movement in May 2020 according to Impactus Partners co-founder and 100 Women in Finance director, Ulrika Robertsson.

A study from AIMA showed that 90% of hedge funds surveyed viewed improving DE&I as a 'very important' or an 'important' theme in terms of how the hedge fund industry sources talent.

However, Preqin data also shows that fewer than 5% of hedge fund managers have formally introduced a DE&I initiative.

Are hedge funds missing a trick by not putting in the effort to diversify their teams?

"Just from a research point of view, cognitive diversity is great in an investment process. You have people from different backgrounds and with different mindsets who therefore challenge each other and ultimately make the better investment decisions," says Mercer principal, Robert Howie.

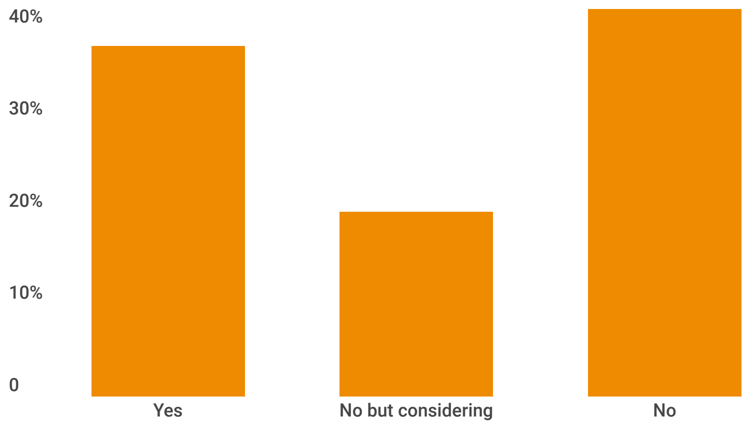
Investor demand

Either way, it's clear that this is quickly becoming something investors are increasingly paying attention to. Investors are investing in women and minority-led funds 21% more than they were five years ago, and 18% expect to grow this in 2022, according to a BNPP 2022 survey.

According to ESG research from investment consultant, Mercer, investors are increasingly demanding evidence of impact and are looking past a simple policy or ESG label which so many hedge funds have historically used.

Key trends from investors have included an increase in the search for diverse managers, as

Do you invest in women and minority owned managers?



Source: BNP Paribas, 2022 Alternative Investment Survey well as ESG questionnaires from consultants becoming more nuanced and specific – specifically with regards to DE&I.

The biggest problem has always been on the investment side, according to Juliette Menga, chair of ESG committee at Aetos Alternative Management. She believes more targeted questionnaires which look to analyse the diversity of a firm's team and board point to progress.

For example, head of alternatives solutions group at JP Morgan Asset Management, Jamie Kramer has made a point of asking the investment committee whether they considered investing in any diverse managers in the due diligence process.

"We've always seen those questionnaires from consultants and other allocators asking about DE&I, but now we're seeing more consistent questionnaires asking about the diversity of a team and the decisionmakers which are more nuanced than before," adds Menga.

However, while there may be signs of progress, this isn't necessarily the case across the entire industry.

"DE&I, the composition of teams, questionnaires and just generally holding managers accountable is a much bigger topic in the US compared to Europe," notes Robertsson.

She adds that, while she works mainly with Nordic, Swiss and British investors, she doesn't see the same drive for DE&I as there is across the pond. Questions from investors are much more focused on the environment and climate.

Hiring and talent

The future looks promising, with Société Générale capital consulting and cap intro director, Tom Wrobel suggesting that hedge funds are starting to realise the importance of the 'S' and 'G' in ESG and think a little more about how they're running their business rather than just ignoring it altogether.

"One visible change is how some of these larger firms are hiring heads of DE&I for the first time and investing in something which they deem important," notes Ofosu.

"Firms have gone from identifying this as an important area, to actionable steps to engender real change. For instance, especially within HR, there's increased understanding of what practices can engender a more inclusive firm, such as blind CVs, to overcome biases in the hiring process," she adds.

One of the most common excuses for hedge funds not being diverse enough is a lack of women and minority talent within the space.

"When people tell me that they can't find female talent, I ask, where are you looking? Every university in the US has over 50% of students who are women and can be trained. It doesn't take a finance major to forge a path in this industry," Kramer points out.

Robertsson thinks that the way this is pitched and sold is key to solving the issue.

"My view is that this needs to be presented as an opportunity, in a commercial way. If you tell hedge funds and institutional allocators that they're missing out on superior returns and opportunities, purely because they're not hiring from the biggest universes of talent, it could help to create this momentum and drive to invest in diverse fund managers," she says.

PROGRESS IN SIGHT

Andra Ofosu, founder of Black Hedge Fund Professionals Network, speaks on the diversity, equity and inclusion challenges in the hedge fund industry and advises on solutions for improvement

ANDRA OFOSU, FOUNDER OF BLACK HEDGE FUND PROFESSIONALS NETWORK (BHFPN) AND DIRECTOR, US SALES, ASPECT CAPITAL

Knight Foundation research shows that only 0.04 per cent of US-based AuM is managed by diverse hedge funds; why is this percentage still so low and what barriers to entry remain in existence?
We know that it's not for lack of aptitude, and it's not for a lack of talent. So if we're seeing this dynamic of numbers remaining so low, it must be because of systemic issues that exist. When you speak to different groups, you speak to different entities and you'll find a variety of answers in terms of what those systemic barriers are.

When I look at it from our perspective, and the network that we've interacted with, two themes jump out as pervasive barriers, and I put them in the category of exposure and access: that's both access to opportunity and access to capital.

In terms of exposure, when I talk to our members, many say they stumbled into the hedge fund industry. It's not a very well understood space, especially when you're speaking to people earlier in their educational path. With this dynamic, you end up with people who don't know that they should have taken a certain course, or they should have done certain internships, to be able to put themselves on the hedge fund career path. By the time they see that this is a viable space for them, it's too late.

It's very clear that there are systemic barriers that are still being worked on across different areas, whether it's in the recruitment process, the hiring process, or the retention process. In the recruitment process, a common dynamic we see is an overreliance on pedigree as a proxy for aptitude. You might have someone who didn't go to an Ivy League college, not because they didn't have the aptitude, but because their family couldn't afford it, or they weren't on the right pathway to even know how to get into these types of schools. These are all very talented people who could still do very well in our industry, but don't get the opportunity.

In terms of access to capital, the early stages of a fund launch process are very reliant on personal wealth, and also on friends' and family wealth. We broadly understand the hurdles to that kind of wealth creation and the lack of generational wealth amongst diverse communities. So it limits the scope for being able to create institutional-sized, diverse-owned firms when the capital that they need to get started is limited in the first place.

An AIMA survey from late 2021 found that 90 per cent of hedge funds thought that it was 'important' or 'very important' to improve DE&I within the industry – what have you witnessed in terms of reform and change in 2022?
One of the most visible changes that we've seen, especially post-George Floyd, is exactly what the results point to: the widespread understanding and acceptance that this is an area that is important and deserves focus.

What's more encouraging is the fact that this acceptance is especially visible at the top echelons of firms. It's the leaders of the firms, the CEOs, the CIOs, the heads of HR, who are speaking openly about diversity being an area of focus for them.

Some of the systemic issues that we're collectively trying to push against run deep; many are not on the surface and some of them are not even visible when you're talking about certain unconscious biases that feed into recruitment, retention and promotion.

Therefore, I believe the path to change in this area is very much a marathon and not a sprint. It's going to take a concerted and sustained effort to grow the number of diverse investment professionals and with time, to see the dynamic of the Knight Foundation statistic change.

How are organisations such as BHFPN changing the face of the hedge fund industry?

We've centralised our mission and activities around a few main themes.

The first is, for those who are already in the industry, we've provided a community and network. Many members of BHFPN are in small and mid-sized hedge fund firms, with very few colleagues who look like them. That experience can be isolating. So, creating a community where people can come meet others in the same boat, working in similar roles, finding peers, finding mentors, disseminating information and opportunities, is really one of the central areas where we see our mission: supporting diverse individuals who are already in the industry.

The second alludes back to this lack of access to information on career pathways in the hedge fund industry. We launched an initiative early last year called Future Founders - its central premise is to introduce early career professionals to the hedge fund industry and, more specifically, to help them envision what an investing career path in the industry looks like. The diversity numbers are even more sparse in the investment space, so we've created this programme with a laser focus on an area that's most challenged, which is identifying those starting out in their careers and offering them a vision for a career as a fund manager.

We invite Black-owned founders, CIOs and senior investment professionals to have conversations with early career professional about their careers, the steps they took, and their missteps. This also allows people to connect the dots in terms of access to opportunity. We encourage members to share job postings from their firms for early career professionals. We want to play a role in the transition to entry hedge fund roles.

The final thing is the dissemination of best practices for the broader hedge fund community. We highlight what other peer firms are doing well and share feedback on the experiences of Black professionals in the industry, providing insights on how they can be improved.

We're looking to launch a sentiment survey to survey Black professionals in the hedge fund industry, to ask things such as: 'What have you experienced in the industry?'; 'How did you get into the industry, how have you progressed?'; 'What's your perception of how the industry is nurturing your abilities and your talent?'

We want to reflect this information back to the industry to show the areas where we've done well, and the areas where we can improve in terms of supporting professionals of colour in the industry.

How important is the issue of diversity among investors/allocators when it comes to allocating money to a hedge fund?

That's one of the most impactful changes we've seen in the last few years. Allocators have been willing to use both their voices and their money to

> Firms have gone from identifying this as an important area to actionable steps to engender real change

nudge managers to improve their DE&I and ESG metrics.

We've also seen an increased demand from allocators for fund managers who are women and people of colour. We all see the data and statistics that show that women and people of colour perform just as well, if not better. So this evolution is not about charity - it's about creating diversified portfolios that increase the return potential for investors.

There is still work that remains to be done in terms of matching allocators' demand with supply. This goes back to some of the systematic barriers I mentioned earlier on in terms of access to capital. Early-stage seed capital, personal wealth and friends and family wealth gets managers to the point where they're considered institutional - typically three years track record and ~USD100 million in assets - but when I count the number of Black-owned hedge funds in the ecosystem that we track, who meet this historical criteria, it is a small handful. So it's clear that collectively we need to think outside the box in terms of such metrics and also think creatively about solutions to close the capital gap and harness the skills of talented diverse investment professionals.

What else needs to be done to improve issues of diversity and representation in this space and by whom?

I think this is such a multifaceted area and for things to change there are so many people who need to be working together. Conversations I've had with BHFPN members point to one area that needs a lot of focus at some firms, and that is a disconnect between HR professionals and senior leaders leading the charge on DE&I, and the hiring managers at the forefront of recruitment, retention and promotion. At many firms there remains a lack of broader buy-in into DE&I goals. When you have that kind of disconnect, it means that HR might be shouting from the rooftops about the importance of diversity, but a hiring manager goes in and interviews candidates and may not doesn't necessarily care. They may be set in their ways in terms of candidates they consider a good "cultural fit" for their team which is sometimes interchangeable with certain affinity biases. We need to close the gap between DE&I as a HR and senior manager-led issue, and DE&I as a business issue that is owned across a firm from the bottom to the top.

It's one of the areas where we could see the biggest systemic improvement. It's about an understanding of the demographic evolution that we have where populations are becoming more diverse and understanding that diverse employees don't want to work at firms where they don't feel valued.

Closing that gap between senior managers, HR, and the people at the frontlines is about winning the war for talent and understanding the headline risks that are embedded in continuing to have a homogeneous and non-inclusive culture.

BEYOND THE HORIZON

Industry participants explore the key ESG issues looming large over the next few years

Digital assets

As hedge funds pour more money into cryptocurrency strategies, the need for managers and investors to balance the shift towards sustainability and responsible investing with crypto's energy-intensive mining process will become crucial.

In an in-depth commentary last year, Robert Furdak, chief investment officer for ESG at Man Group, suggested that bitcoin and sustainability - two major investment trends looming large over the asset management industry – may be set for a "head-on clash".

Manuela Cedarmas, head of ESG & impact investing at Investcorp-Tages, notes that beyond the amount and types of energy used in cryptocurrencies, questions also remain over the regulatory, governance, and operational risks stemming from digital assets.

"We have been looking at the differences between cryptocurrencies in terms of the sources of energy that are used for mining, considering also the magnitude of their emissions versus what the impact of the traditional banking industry is, for example," she says. "All of these concerns are taken into consideration at the same level as operational issues, because those are equally important. We would never want to run unwanted risk in this regard, even if the opportunity is quite attractive."

Speaking to Hedgeweek earlier this year, Anatoly Crachilov, founding partner and CEO of digital assets fund manager Nickel Digital Asset Management, hinted that ESG and cryptocurrency could work conjointly, pointing to how bitcoin miners have taken the opportunity to switch from coal-based power in China towards greener forms of energy, such as solar, in the US and Kazakhstan.

Salvatore Cordaro, co-CEO of Investcorp-Tages, details: "We haven't made an investment in crypto yet, precisely because we have several concerns that we're trying to get more comfortable with. Clearly, environmental issues and governance issues are among those."

Russia

Russia's invasion of Ukraine has highlighted a battery of ESG and ethical concerns for investment managers of all stripes and strategies. In an interview with Bloomberg last month, US hedge fund titan Ken Griffin, CEO of Citadel, warned US sanctions on the Putin regime could backfire, forcing Russia to look elsewhere – such as China – for software solutions. Separately, some industry participants believe certain sectors and stocks traditionally considered "ESG negative" – such as missiles companies and weapons manufacturers – could be re-evaluated if they can be shown to be bolstering the Ukrainian resistance.

Edward Lees, co-head of BNP Paribas Asset Management's Environmental Strategies Group, says the war has highlighted the growing challenge of geopolitical energy security, noting how the UK and Germany have ramped up their renewables targets in response to Russia's energy dominance. "A whole host of countries have, in the last month, basically gone stratospheric with their 2026 and 2030 targets," he comments.

"If you are vulnerable to, and exposed to, the up-and-down swings of oil prices and gas prices, and if your existence relies on it, and in a cold winter you need it and you can't produce it, that's a big issue."

He adds: "One of the other things this war has shown, beyond the need for solar and wind to replace oil and gas, is the fragility of global supply chains across a broad range of industries, particularly when those are tied to regimes that aren't stable or that we don't have a stable relationship with. It's not just the gas that comes out of Russia, and some metals

> The importance of natural capital and biodiversity will gain greater significance

like nickel; it's also China, which dominates a lot of the rare earth, lithium battery, and solar component production. The US and Europe does not produce enough of these things – and you need them for these new industries, for electric vehicles, for solar, for energy storage."

Even prior to the conflict, Russia had been considered a red light with regards to corruption and political risk, more than a narrow social or governance issue, observes Salvatore Cordaro.

"I see the social and governance issue becoming a micro part of the thinking around Russia, with the political risk being the macro point on being in or not being in Russia," he says. "I think the issue of how managers will incorporate ESG will re-emerge stronger when markets reopen and assets become investable again."

Biodiversity

One of the newer, emerging themes within the ESG sphere centres around natural capital and biodiversity, which is driven not only by continued concerns over climate change, but also the systematic risks resulting from global dependence and unsustainable management of ecosystems and other environmental assets.

"The importance of natural capital and biodiversity will gain greater significance," says My-Linh Ngo, head of ESG investment and portfolio manager at BlueBay. "Expect to see increased attention on marine environments - 'the blue economy' - and terrestrial ecosystems, particularly forests. Topics such as the change of land use linked to food and agriculture, extractive and infrastructure activities will be key, alongside a greater emphasis on a circular approach to production and consumption."

Lees points out: "Ukraine produced a lot of food which the UN bought to help feed many countries in Africa. Food prices have been going up, not just because of the Ukraine war, but also because of things like weather disturbances. There been a lot of crazy weather patterns; we had huge disturbances in Brazil which impacted coffee crops, or instance.

"There is also the magnitude of topsoil loss in many places in the world – if commercial farming keeps going the way it's going, it's not going to be able to produce the same amount. Global farming is now facing a challenge. One of the things in our sustainability remit asides from decarbonisation and renewable energy has been the need to deal with biodiversity loss, food security, and a more intelligent food supply – such as the ways technology can be used to limit the use of water, the use of fertilisers and chemical pesticides."

The next step of the biodiversity COP15 is due to take place in April, Ngo says, which includes the aim of securing government commitment to '30x30', a pledge to protect 30 per cent of lands and oceans by 2030.

Talent

With investors increasingly placing ESG at the heart of their portfolio selection, how is this trend shaping hedge funds' hiring and staffing policies?

Cordaro identifies two main approaches, with certain managers running some strategies which require dedicated ESG resources – whether that's hiring a dedicated analyst or even a chief sustainability officer - while others are opting to incorporate ESG as part of their broader overall research and risk framework.

"I think it depends on how much weight you give to ESG today in your investment process and in the success of your strategy," he observes. "For some it's incredibly important - one fund we seeded 12 months ago has hired a dedicated chief sustainability officer because their strategy is grounded on engaging with companies that are in distress, and helping them to improve and get out of their distressed state by getting better recognition in the market, which includes strategically improving their environmental footprint.

"Other hedge funds use that as part of their regular assessment – they consider any material risks coming from environmental, social or governance in the same way as the consider risks coming from liquidity or other investment factors."

My-Linh Ngo says: "We don't see the wider trend in terms of increasing demand for ESG expertise in the industry being any different in the hedge fund world – particularly when the regulation doesn't make any distinction as is the case in Europe with its sustainable finance package.

"But clearly the hedge fund world has some unique attributes in terms of approaches to investing which require more technical understanding in order to bring this together with ESG thinking. There needs to be more developed thinking as the asset class brings with it opportunities for ESG as well as challenges."

WILL KEUPER, VP OF PRODUCT AT VERITY

Hedge funds need to focus on the fundamentals of ESG, approaching it from a bottom-up perspective, no doubt like many treat their investments.

LP and regulatory expectations will continue to change, but tomorrow's expectations can be much more easily met by firms implementing an ESG strategy and process today, compared to those waiting on the sidelines.

The funds that have fully integrated ESG data - or "turnkey ESG" - can streamline ESG, impact related workflows, and make it more engrained in the day-to-day.

Data has become more specialised and it can be deployed for much more specific and nuanced purposes. Data can be tailored to specific portfolio goals, especially on the environmental side, much more today than was possible even one or two years ago. Funds which understand the important role data can play, but also that it is not the end all be all, will be well-served.

Hedge funds need to start asking difficult questions, and accept the world is changing. Many allocators no longer simply expect alpha – they expect their capital to be put towards good as well. Hedge funds will more often be called upon to be 'stewards' of investor capital; this is becoming less exclusive to traditional investment management vehicles. Funds can prepare for this by approaching ESG and impact in the portfolio much like they do the fundamentals - asking companies difficult questions, sifting through the noise, and building the 'impact story'. Investor expectations will be met at funds with an adaptable investment approach and internal emphasis on ESG and impact as part of the core investment process – not simply as a check-the-box exercise.

Investors should expect to see an added level of granularity and specificity when it comes to ESG data and the overall ESG process at a fund; especially with fundamental managers and impact investing. Targeted ESG questionnaires and manager interviews can help investors identify those managers with ESG at the core of the investment culture. Investors should expect managers to articulate the ESG process, point to specific investment examples in detail, and describe in equal detail the role ESG places in investment decisions. Investors will also be wise to understand ESG's role in all firm portfolios, not just those funds flagged as 'ESG' or 'impact'. At Verity, our ESG and engagement reporting tools help funds answers these questions and build the ESG story in a streamlined and simple way.

Fund managers should take time to better understand the data they are leveraging and its specific utility in portfolio construction – ideally using ESG more as a reason 'to invest', versus only as a screening tool. For example, many holdings of ESG funds fall well short of their expected benchmark, especially on the environmental side. Hedge funds that understand the role both internal ESG processes and external data together, when leveraged appropriately, can play will be far less likely to be caught flat footed by the inevitable changes in investor and regulatory expectations.

HEDGEWEEK

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