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The Case for the ESG Hedge Fund

By: Andrew Koski

A focus on environmental, social, and governance ("ESG") criteria has taken the investing world by storm, more than tripling the AUM in these strategies over the past eight years, ***surpassing an astonishing $40 trillion in 2020*** according to research by Opimas (by comparison, BCP pegged the total AUM of professionally managed assets at $89 trillion in 2019).[1,2] Yet, hedge funds have noticeably lagged their peers in the ESG space which has long been dominated by passive, long-only, and private equity funds. According to a study conducted by KPMG, AIMA, and CAIA, ***only 15% of hedge fund managers have embedded ESG factors across their strategies.***[3]

The very idea of an ESG hedge fund might sound a bit oxymoronic. After all, sustainable investing is a particularly long-term strategy in its time horizons, whereas many hedge funds pride themselves on their nimbleness and ability to pivot in the moment. More cynically, hedge funds have (and perhaps always will be) focused exclusively on one thing: generating alpha regardless of market conditions. But as many have already realized, ***it is possible to put capital to work for a better world without sacrificing returns***.

As traditional hedge fund allocators—particularly endowments, pension funds, and high net worth millennials—demand more ESG options, an increasing number of hedge funds will inevitably offer more ESG solutions out of necessity. The main driver of ESG adoption is, unsurprisingly, investor demand, as allocators large and small seek out more ways to put their assets to work in sustainable and responsible ways. After all, fledgling hedge funds need any edge they can get to win allocations these days; 2019 marked the fifth straight year where hedge fund liquidations exceeded hedge fund launches, according to Hedge Fund Research.[4]

Hedge funds can offer something their active long-only and passive peers cannot: sustainable and socially responsible returns uncorrelated to stock and bond markets, investments suitable for an ESG mandate with upside *and* downside capture, and risk mitigation during periods of increased volatility (especially with an ongoing pandemic and a contentious presidential election on the horizon). Activist hedge funds have long used their influence to effect change and maximize shareholder value, so it is not by any stretch of the imagination to envision activist funds applying the ESG principles of engaged ownership to promote positive changes at their target companies. Many already are.

The demand for ESG suitable products is clear. European institutional investors have led the charge, with the vast majority surveyed (89%) now considering ESG related risks during the investment process, up from 55% in 2019.[5] While U.S. investors have been slower to adopt, Deloitte projects that ESG-mandated assets could "could grow almost three times as fast as non-ESG-mandated assets to comprise half of all professionally managed investments by 2025."[6] ***The preferences of a rising generation of investors have also changed the expectations faced by fund managers***. Millennials, between 24 and 39 in 2020, are entering their prime earning years as a generation, and surveys demonstrate that they value ESG factors significantly more than older generations.[7] Hedge funds have also taken notice: Over half of the hedge fund respondents in the KPMG-AIMA-CAIA survey said there had been "significant increase" in

[1] "ESG Data Integration by Asset Managers : Targeting Alpha, Fiduciary Duty & Portfolio Risk Analysis," Opimas, 17 June 2020.
[2] "Global Asset Management 2020: Protect, Adapt, and Innovate," Boston Consulting Group, 19 May 2020.
[3] "Sustainable investing: fast-forwarding its evolution," KPMG-AIMA-CAIA, February 2020.
[4] "HFR® Global Hedge Fund Industry Report – Year End 2019," Hedge Fund Research.
[5] "European asset allocation insights 2020," Mercer, August 2020.
[6] "Advancing environmental, social, and governance investing," Sean Collins and Kristen Sullivan, *Deloitte Insights,* 20 February 2020.
[7] "Sustainable Signals – The Individual Investor Perspective," Morgan Stanley Institute for Sustainable Investing, 2019.

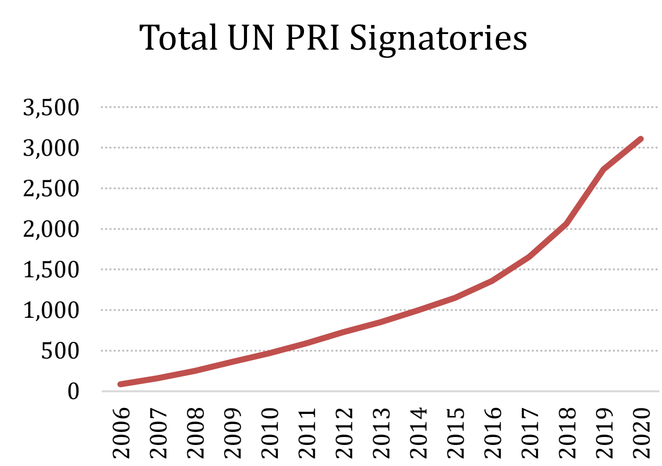
interest regarding their firm's ESG capabilities or strategies over the prior 12 months.

There is a strong case to be made for the ESG hedge fund, ***but not simply because it is an easier path for them to win business***—hedge funds are actually the best equipped to handle the challenges of developing ESG into a robust strategy with a measurable impact. ***Hedge funds are among the most sophisticated public securities investors***, at the cutting edge of both quantitative and fundamental strategies, ***making them well suited to be at the cutting edge of ESG strategies as well***. It is already being portrayed onscreen: The subplot of the current (5th) season of the premium cable hedge fund drama *Billions* involves brilliant emerging manager Taylor Mason turning their fund into an ESG hedge fund. The story, albeit a fictional one, is far closer to reality than we realize, and it is far more believable some of the embellishments found in rest of the show.

While still in its infancy, ESG designated strategies have commanded strong inflows, ***particularly in the active management space,*** which has ceded ground to passive strategies over the ten-year bull run. Even still, it may come as a shock that one third to a half of all professionally managed assets in the world are truly sustainable or socially responsible. A clear issue in the rush to market funds as ESG-compliant is an inclination to greenwash strategies that in actuality have a very marginal ESG impact. Who is managing all these so-called ESG assets and how rigorously are they applying ESG criteria? Perhaps these numbers above ought to be viewed with some skepticism—depending on how broadly minimum ESG standards are applied, a fund could be counted as an ESG fund simply because it is managed by a United Nations Principles for Responsible Investment signatory, regardless of whether the fund itself explicitly focused on these issues.

Today there are over UN PRI 3,300 signatories, a number that has increased significantly in recent years. While this growth is an encouraging development for overall ESG adoption, the increasing ubiquity of PRI signatories necessitates a higher bar for investors seeking an ESG fund. The PRI has also faced criticism that its objectives may be too vague and ultimately unenforceable to meaningfully change behemoth financial firms' behavior. Researchers Soohun Kim and Aaron Yoon published findings earlier this year that showed ***the impact of becoming a PRI signatory had much more to do with subsequent fund inflows than measurable ESG impacts and investment performance.***[8]

In June, the UN PRI announced new reporting requirements for signatories that seek to address such criticisms—in 2021, firms will be required to identify the targets and outcomes of their investments as they relate to the UN's Sustainable Development Goals.[9] ***Becoming a signatory cannot be just a marketing strategy.*** We all need to work together to ensure that our assets are having a real impact and hold one another accountable. But in order to do so, we will need to perform significant research to determine how to measure ESG impact concretely. Hedge funds can and should play a significant role in this research. While the UN Principles for Responsible Investment only recently turned its attention to hedge funds as a category, releasing its [Technical Guide for ESG Incorporation in Hedge Funds] in May 2020, some fund managers have been signatories for over a decade (HFR Investments, LLC is a UN PRI Signatory).



Source: unpri.org/signatories/signatory-resources/signatory-directory

[8] "Analyzing Active Managers' Commitment to ESG: Evidence from United Nations Principles for Responsible Investment," Soohun Kim and Aaron Yoon, March 17, 2020.

[9] "Investing with SDG outcomes: a five-part framework," UN PRI, 15 June 2020.

A significant issue in measuring the impact of ESG strategies is that ESG data is inconsistent, often self-reported, and without consensus amongst providers. A majority of hedge fund managers surveyed by KPMG-AIMA-CAIA agreed that a lack of consistent data is a major reason for their hesitance to adopt ESG strategies, with 63% reporting their "progress hampered by lack of robust templates, consistent definitions and reliable data." Unsurprisingly, recent academic research agrees that there is little agreement in the ESG ratings offered by third party service providers. Researchers at the Geneva Finance Research Institute analyzed S&P 500 firms from 2013 to 2017 and the corresponding ESG ratings provided by the six largest ESG ratings providers, and they found that the average correlation between overall ESG ratings is about 0.46, while the average correlation for governance scores is only .19.[10]

We need hedge fund managers to actively parse conflicting and incomplete data sets using their quantitative and fundamental skillsets. Until ESG data is further developed and standardized, how much faith can you place in a passive strategy that trades only on data that in some cases barely correlates with its peers? Investors agree: According to data from EPFR, active funds have seen steadily increasing outflows since 2008, while passive funds have seen consistently rising inflows, ***but inflows into active ESG funds have slightly outpaced passive ESG funds***.[11] Of course, there is room for all types under the ESG tent, as every investor has different goals and risk tolerances, but until ESG strategies are more codified, ***there will be significant demand for an active investment team and their analysis***.

Despite opacity surrounding ESG's measurable impact, the tailwinds in the strategy are here to stay. As the European Union plans their post-COVID recovery trajectory, policymakers have made it clear that they intend to build a "greener" economy going forward. In July the EU announced that a third of funds raised for the EU's €750 billion COVID recovery package could come from green bonds, which will direct public investment spending towards sustainability-focused infrastructure projects.[12] If the Democrats prevail in November, Joe Biden's platform of similar sustainable infrastructure investment and green COVID recovery may be realized. State governments in New York and Rhode Island have already invested in wind farms on their coasts, with the Empire Wind (Equinor-BP) and Mayflower Wind (Shell-EDP Renewables) projects, respectively.[13,14] On both sides of the Atlantic, government sustainability mandates will ensure tailwinds for ESG funds for years to come.

Throughout their history, hedge funds have been maligned—whether it is because they personify (to some) the greatest excesses of Wall Street, or because too many mediocre fund managers' performance cannot justify their costly fees—but facing the current ESG demand , ***they have a chance to redefine themselves as an industry***, by developing environmental, social, and governance criteria into a robust investing strategy, with a quantified impact and without sacrificed returns**.**

Contact the Author
Andrew Koski, Senior Analyst
andrew.koski@hfr.com

Learn more about HFR Investments at:
hfr-investments.com
or reach out to
investments@hfr.com

[10] "ESG Rating Disagreement and Stock Returns," Rajna Gibson, Philipp Krueger and Peter Steffen Schmidt, *Swiss Finance Institute*, 22 December 2019.
[11] EPFR Data, epfrglobal.com, 1 August 2020.
[12] "Third of EU's 750 billion euro recovery fund may come via green bonds: S&P," *Reuters,* 15 July 2020.
13 "Equinor's Empire Wind" equinor.com/en/what-we-do/empirewind.html.
[14] "Mayflower Wind," mayflowerwind.com.

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