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Hedge funds and ESG integration

Introduction

Over the last few years, an increasing number of fund managers have integrated Environmental, Social and Governance (ESG) considerations into their investment products. Given the shareholder influence and control mechanisms, ESG integration efforts initially emphasized long-term equity strategies. However, a growing consensus amongst investors on the merits of ESG integration has expanded the ESG framework across asset classes, strategies, and approaches, including hedge funds. Hedge funds have tended to lag on ESG integration relative to other asset classes; however, this is quickly changing and the industry has made considerable progress, evidenced by ESG integration into existing processes, investor communication and the emergence of dedicated solutions. This article provides an introduction to ESG and hedge funds, focusing on ESG integration. There are other initiatives and innovations, especially around the topic of sustainability, which we plan to explore in future articles.

What are hedge funds doing on ESG?

There are multiple approaches a hedge fund can take to sustainable investing.[1] These range from integrating ESG into the investment process to investing in sustainability themes. Governance and activism has been a long-standing hedge fund strategy and value proposition for alpha generation. Thematic strategies can broaden this further and will often take a multi-faceted approach that includes a variety of elements, such as broad sustainability themes (strategies that provide exposure to environmental and social opportunities) to impact investing (investing with intention to generate positive social and environmental impact alongside a financial return). Negative screening is also used occasionally, though this is not preferred by managers and is seen more frequently when ESG is more difficult to implement, such as in quantitative or high-turnover strategies.

In general, we believe that it is relatively easier for managers to integrate ESG into hedge fund strategies that have a longer time horizon, trade individual securities (especially bonds and equities, and not, for example, index futures) and analyze security fundamentals. For some hedge fund strategies, however, ESG is simply out-of-scope at present. If a strategy mainly trades instruments that do not carry influence/votes or disclose ESG data, or does not hold securities long enough or in enough size to have influence/impact, then ESG is likely out-of-scope.

Notwithstanding the above, hedge funds in general are a rapidly evolving space, where innovation and efficiency are key to driving relative outperformance. Consequently, hedge funds are integrating ESG principles into idea generation and risk management at an increasing pace. The growth of ESG-related data providers and the

[1] See the ABC of ESG for more details: https://www.mercer.com/our-thinking/wealth/the-abc-of-esg.html

standardization and availability of ESG data have facilitated this evolution. Increasingly and further promoted by regulations around the world, investors are demanding evidence of impact and are looking past a simple policy or ESG label. While enhancements in data, technology and reporting are evolving, hedge funds will need to provide transparency on these metrics to remain a part of the conversation.

We provide some examples of ESG integration in hedge fund strategies below:

In equity-oriented strategies, managers with active company engagement typically seek organizational change, as managers look to extract additional value through increased energy efficiency, corporate sustainability, and good governance practices. Additionally, with increased ESG data, managers are analyzing the relative attractiveness of securities, incorporating ESG metrics into valuations. Importantly, industry practice does not rely solely on third parties for ESG data, the reports of which tend to be dated and backward looking. Instead, managers are increasingly leaning on their research and analytical strengths to build proprietary ESG considerations into the investment process.

One activist manager has noted that companies resistant to thinking critically about their business also tend to be resistant to ESG-related issues. Put another way, we believe hedge funds recognize that the most forward-thinking, innovative companies, the ones most likely to generate value over the long term, have already incorporated, or are in the process of incorporating, sound ESG principles into their operations.

Credit-oriented hedge fund strategies are using their influence and reputation with counterparties to demand greater controls around ESG issues, while providing an extra layer of protection at the portfolio level. For example, in mortgages and loan strategies, managers can factor in whether the mortgage servicer is working to keep borrowers in their homes rather than foreclosing. Some managers with sufficient capital are able to engage with issuers to build ESG-related incentives and covenants into new-issue bonds. Next to equity, credit markets are one of the more rapidly developing areas of ESG in hedge funds. Even without a vote, managers can influence broader corporate behavior, albeit indirectly, through engagement.

ESG data is improving, but ESG service providers take different approaches and data does not have a long history. However, that has not prevented some quantitative strategies from seeking to incorporate ESG signals into their investment programs, or building models with the goal of extracting alpha from several overarching ESG themes, such as the transition to green energy or resiliency against negative climate events. In some cases, these managers derive relevant data from ESG service providers, but the most sophisticated managers are exploring other alternative data points that they can collate to create proprietary ESG signals.

Throughout the industry, hedge funds are using data to increase their risk management processes. This can be explicit, such as overweighting companies with high ESG scores and *vice versa*. As just one example, research has shown that companies with poor ESG scores are more likely to suffer costly lawsuits, which detracts from shareholder value.[2] In many cases, hedge fund managers simply want to avoid a reputational or regulatory spotlight on a large position.

Evaluating ESG integration at hedge funds

At Mercer, we consider ESG integration within the context of our four-factor framework.[3] The overall ESG score covers the extent to which portfolio managers integrate ESG factors and stewardship into their investment decision-making process. These ratings represent our view of the investment manager's ESG capabilities across the four factors, but also with a view of what is achievable today, given the strategy and approach implemented. Although strategy level integration can vary significantly, in our view, all hedge funds can incorporate ESG principles at a firm-wide level through their internal and external initiatives.[4]

As mentioned above, there are a variety of factors for the hedge fund industry that can make it uniquely challenging to integrate ESG, rendering some strategies and approaches partially or significantly out-of-scope at the present time. This is not necessarily a negative, but more a recognition that the process, data, tools, and instruments may require further evolution to better allow for ESG integration, which we expect will come with time. The areas where we have seen the most adoption and integration include equity related, long/short credit, and event-driven. The disciplines that are mainly out-of-scope now, but where development and evolution is taking place, include multi-strategy, alternative risk premia, global macro, and certain relative value strategies.

Importantly for investors, a strategy or approach does not need to be entirely ESG thematic to achieve a high ESG score. The key is demonstrating a robust and consistent framework across both risks and opportunities, along with the means, the motive, and the mechanics required to integrate ESG holistically. We are pleased with the progress that we are seeing across the landscape and will continue to advocate for integration into existing offerings and future solutions.

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[2] https://www.cfainstitute.org/en/research/financial-analysts-journal/2021/risk-mitigation-csp-us-class-action-lawsuits

[3] These factors are: idea generation; portfolio construction; implementation; and finally, business management. For idea generation, we look for evidence of identifying ESG risks and opportunities at the portfolio level. Portfolio construction considers how effectively the manager translates their ESG views into the active positions in the portfolio. In implementation, we look at evidence of proxy voting if the strategy trades individual equity securities and broader engagement activities. The business management factor considers firm-wide commitment.

[4] Within the hedge fund industry specifically, the main bodies leading ESG development are the UN Principles for Responsible Investment (UNPRI), the Alternative Investment Management Association (AIMA), and the Standards Board for Alternative Investments (SBAI). These bodies have sponsored working groups, discussion papers, due diligence questions for investors and technical guidance for managers.

Considerations for investors

Investors have different views and definitions of ESG, and we believe hedge funds have an important role to play in their growth portfolios.[5] The industry is adapting and innovating and will continue to do so, in part through incorporating ESG frameworks, but equally through opportunities and solutions that will expand the ability to do so. We encourage investors to be open-minded and recognize the significant focus and development around ESG integration in the hedge fund industry. We believe it is a better approach to partner with high conviction hedge funds who lag on ESG integration, as we believe these managers are best suited to adapt to changing market dynamics and investor needs. Additionally, if hedge funds can provide some protection in times of market stress, they can help investors stay the course of a broader, sustainable investment objective within their portfolios. Whilst investors may seek strategies with higher than average and improving ESG scores, we also think giving weight to firm-wide initiatives is important, especially for strategies where ESG integration is currently out-of-scope.

Arguably, ESG may very well be the most significant secular change of our lifetimes, offering the potential of significant alpha and risk mitigation opportunities for investment managers. In our view, robust integration of ESG is a critical component not only for long-term portfolio returns, but an essential part to achieving societal goals of sustainability, equality, and a well-functioning economy.

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[5] https://www.mercer.com/our-thinking/wealth/investing-in-hedge-funds.html

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