

Integrating ESG in quantitative investment processes

Stockholm (HedgeNordic) – Offering sustainable investment is first and foremost about ensuring investors that moral values, negative externalities as well as financial aspect will be taken into consideration when investment decisions are made. However, these considerations should not necessarily come at the detriment of return and risk. Early on, Informed Portfolio Management (IPM), the Swedish systematic investment manager, understood achieving strong long-term investment results should not be at odds with actively promoting social and environmental issues and improving corporate governance.

While the firm is mostly known for its systematic macro strategy, it has been offering long-only equity products with a sustainable profile since 2006. The firm has integrated ESG factors into the investment process through a number of specifically tailored investment models. For example, IPM's investment process penalises companies that do not meet specific ESG-related requirements, while systematically recovering the lost exposure from exclusions with the help of an optimiser, resulting in a "best in class" approach rather than solely exclusions. When it comes to the risk side of the equation, the longer-term effects of sustainable investing are easier to understand. Avoiding investments in companies with poor governance or that are environmentally damaging is expected to reduce risk in the long run. HedgeNordic sat down with IPM CEO Stefan Nydahl and Anna Frimodig, the Chair of IPM's ESG Committee (pictured), for a discussion of IPM's unique approach to sustainable investing.

Cutting edge, but continuously improving

When it comes to its ESG policy, IPM focuses not only on investment results. The firm also strives to have a positive bearing in term of ESG on the companies its equity funds invest in, while complementing existing efforts in terms of Corporate Social Responsibility (CSR) through supporting various charities and other activities. Finally, IPM works to concurrently integrate CSR standards among the firm's own staff.

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IPM's stated philosophy is to support the principle that companies have a duty to comply with international norms – even if they are not legally obliged to do so -, and as a result, IPM's equity funds categorically do not invest in companies that do not meet a required standard of business practice based on international norms such as UN Global Impact or weapons-related conventions.. Since 2010, the firm is a signatory to the Principles for Responsible Investment (PRI), which provides the broad ESG assessment benchmarks by which it operates. The company is proud of its rating from PRI, but, as Nydahl emphasises, its norms and requirements change on a yearly basis, as PRI sharpens tools of evaluation and adds new clauses, driven by reported incidents and improved information gathering in the investment space. This means IPM, too, on a continuous basis must adapt its own methodology, where it can prove difficult to adopt everything at once, underscoring the importance of early and continuous engagement with both evolving norms and investors' preferences and needs. "This is a long-term commitment by IPM" says Nydahl. "It's not enough that the CEO or clients are saying [ESG is] a good idea. The ESG effort involves constant work on integration and closely following the evolution of ESG standards, which is part of its appeal."

Active ownership & innovative tools

As an active owner, IPM engages in direct dialogue with the companies in its investment universe that violate UN Global Compact or other well-established international guidelines and conventions. It does this through collaborative efforts, engaging through its own initiative, and with the use of an engagement service provider. Its process is based on results from GES's Global Ethical Standard analysis model, which measures compliance with such norms as the UN Global Compact, OECD guidelines for multinationals, and ILO, environmental, human rights and weapons-related conventions. Companies failing to respond to red flags are excluded from the equity funds' investment universe.

The firm's ESG policy in terms of norms-based screening and engagement is implemented in four main steps. First, IPM's ESG Committee is responsible for overseeing all responsible investment efforts and for providing guidance on responsible investment. Second, the equity funds maintain a focus list of screening companies breaching UN Global Compact or other principles, and to verify signs of progress with compliance via its engagements. Third, it maintains an exclude & engage list for companies that do not respond to its engagement, where excluded companies remain so until they qualify for re-inclusion. As a fourth step, IPM's Risk Office independently performs daily checks to ensure that the portfolios comply with IPM's ESG policy. Importantly, "to mitigate potential lost exposure due to exclusions," Nydahl explains, "IPM has developed an optimiser that identifies and overweighs companies with similar characteristics as the excluded ones but that comply with the norms, thus applying a 'best-in-class' approach."

IPM also exercises its right – or as they see it, its obligation – to vote according to best corporate governance standards in the companies in which its equity funds are invested. To this end, in 2016 it launched a new website to support its ESG implementation effort, in collaboration with Institutional Shareholder Services Inc. (ISS) to not only disclose its historical voting record but also to communicate how it intends to vote ahead of general meetings and provide real-time updates. "This brings our ESG initiative to another level as it increases the transparency towards our investors and invested companies, but hopefully also encourages others to follow our path leading to collectively promote better standards," says Frimodig.

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Pros and cons - the earlier, the better

Currently, IPM only applies its ESG methodology to long-only equity products. Naturally, IPM continuously searches for methods to integrate sustainable investing principles into its hedge fund strategies. However, ESG screening makes little sense when it comes to strategies such as global macro that rely on assets that do not directly relate to individual companies, such as currencies and interest rates. The IPM Systematic Macro fund does not invest in commodities, which can be seen as a way to exclude all carbon-related products, but such an exclusion cannot be compared to the active approach used for its equity strategy. "It's certainly a challenge to integrate ESG when it comes to hedge funds, with a wide spectrum of specialised fund categories," says Nydahl. However, he believes that IPM is well positioned to use the experience accumulated since 2006 on the equity product to also be an advocate for an increasing ESG focus within hedge funds. There are signs that hedge funds' interest in ESG is picking up. In a recent initiative the Alternative Investment Management Association (AIMA), in which IPM is a member, worked with PRI to help develop ESG

guidance for hedge funds. IPM was an active participant in the working group supporting this effort.

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Nydahl also thinks there is a possibility to create new alternative products that will benefit from IPM’s learning curve. Evidence shows that IPM’s ESG implementation has improved investment results: “We have shown that we can provide a portfolio that is just as competitive while simultaneously being ESG compliant – and perhaps, in the future, in the alternative space as well,” adds Nydahl.



IPM CEO Stefan Nydahl

When it comes to offering new sustainable alternative investment products, IPM might have an advantage over those who have not formally implemented sustainable investing principles for as long as IPM has. As previously mentioned, the PRI has become more demanding over the years, making the slope steeper for a first-time ESG implementation. Another advantage is that “we get a better feeling over time about where the focus is shifting”, Frimodig says. “We know what is new and what has always been there.” This allows IPM to be more efficient at implementing new requirements.

IPM has also adapted its governance with respect to who in the organisation oversees and is accountable for responsible investment, and who does the actual implementation. “It is hard to come in and adapt to everything ESG related at once”, adds Frimodig. Initially, the firm only engaged an ESG specialist to carry the efforts, but it soon became obvious that it was not effective enough. It

became a matter of thinking through the entire organisation, where and how ESG implementation affects decision-making across all its levels, including budgeting. ESG needs to be done continuously as a firm-wide project. This, IPM says, translates into an argument for adopting ESG as early as possible: the later companies comply with normative standards that are increasingly enforced at the broader social level, the more difficult it becomes. "There are so many dimensions to take into consideration," Nydahl says. "Should PRI demand less or more from different categories of fund managers? Are the holdings in our hedge funds applicable? Is a new normative idea feasible? ESG integration, yes, but into which of our investment processes, and how? The key is to approach it not from the simplest perspective of how it can apply immediately, but from the intelligent perspective of how and why it makes sense taking all internal and external factors into consideration simultaneously."

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At IPM, as is clear, ESG is far from a normative burden or an infringement on investment results. On the contrary, it represents the opportunity to rethink its strategies continuously, thereby maximising potential and enhancing client satisfaction.