Is Your Fundraising Sustainable?

Stockholm (HedgeNordic) – By Niclas Düring – Steward Redqueen B.V.: Sustainability has gained a lot of traction among asset owners over the past 10+ years. And where asset owners go, prospective managers of their assets follow. Usually.

What at first glance might seem puzzling however, is the large difference between asset classes in how far they have come with sustainability integration. Private equity on the one hand has long been engaged in ESG discussions. Private debt has made good strides and to some extent also benefitted from the thinking of their private equity counterparts, as well as from providing debt alongside equity investors with pronounced ESG ambitions. Public equity, infrastructure and real estate have also come a long way. Hedge funds on the other hand have, with a few exceptions, been lagging behind.

A non-comprehensive set of explanations for this lag could include lack of external pressure, internal stakeholder hesitation, and the somewhat unique set of circumstances for hedge funds which makes ESG implementation more challenging. Specifically, investors may not have a firm view and thus no corresponding externally imposed requirements either on how to integrate ESG in hedge funds. From an internal perspective a hedge fund manager may simply not believe that ESG could have an impact on returns (why beliefs should be allowed to influence this decision while other decisions are guided by facts is an interesting contradiction). A third explanation could be the type of hedge fund involved – the exposures sought, and the instruments used to deploy the strategy may not immediately point to an obvious approach for how to integrate ESG (ex. CTAs and macro funds). There are surely also other explanations, but these three are quite common.

Leaders, Laggards and Those in Between

One option is of course to stick to the way things always have been done and not consider ESG in the slightest. The cost of doing so could be considerable in terms of fundraising and investors pulling out, while the benefit from such a course of action is not obvious, at least not in monetary terms. And if ultimately deciding to change tack, hedge funds coming late to the race will have to run a lot harder to catch up.

Another approach is to follow the general trends and get the basic building blocks in place. This could entail establishing some basic checks and exclusions, setting exposure limits and implementing reporting on select KPIs. This is essentially a hygiene factor approach. It is meant to avoid negative risk, i.e. investors dropping out, rather than seizing the opportunity to increase commitments and attract new investors.

Alternatively, one could just treat it like any other set of factors with a potential to impact the fund portfolio. Normally that would involve setting out the analytical framework, gathering and analysing the facts, run backtests and correlation analyses and estimate the explanatory power of each of the variables involved. In some ways ESG risks should not be treated differently from how other types of risks and exposures are considered. Applying such an approach will not deter any investors, so the downside risk is limited. The upside however is the possibility of attracting new clients, and larger commitments, not least as the hedge fund in question may qualify for other parts of the asset allocation for different investors.

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Default Strategies

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The oldest approach is so-called negative screening, in which “sin industries” like tobacco, weapons and a few other sectors are either excluded or have defined exposure limits. ESG integration is the systematic inclusion of ESG factors throughout the investment processes, including risk and opportunity identification and potential impact on valuations. Best-in-class is about applying an additional filter in the investment process and select assets with a relatively better sustainability performance than the rest. These strategies are broadly applicable to most hedge fund types.

In addition, there are a few which are useful to some types of hedge funds. Active ownership is relevant where equity is held in individual companies and where investors seek to impact their investments during the holding period through dialogues, proxy voting and other channels. Ethical or norms-based approaches on the other hand could for example be deployed in more country index- or government bond related exposures. The approach identifies entities or states failing to meet generally accepted international norms like the UN Declaration of Human Rights, or who perform poorly on indices related to corruption or democracy for example. The underlying assumption, or even established fact, is that doing so will over time have a negative impact on how the markets develop as well.

From Principles to Practices

How to implement an ESG approach is not straight forward, and particularly not when it comes to hedge funds. As a set of guiding principles, ESG implementation in hedge funds becomes more challenging:

- The further away a portfolio is from individually identifiable corporate entities,
- if the instruments traded are not securities of the actual underlying exposures, but derivatives, swaps, options or indices of the same; and
- when the costs are high and/or markets are insufficiently liquid and/or lack sufficient volume.

In more practical terms, a long equity strategy is probably one of the most straight forward situations. The approach to integrating ESG may not differ much from how mutual funds or private equity funds function in this sense. Where actual stocks are held in the portfolio one could deploy a combination of negative screening and active ownership for example.

The picture gets a bit more complicated when it comes to broader types of indices on country, sector or other levels. At the same time, the number of indices with different kinds of built-in sustainability filters is expanding rapidly. An important consideration in exploring such indices is of course to ensure there is adequate liquidity and trading volume in relation to the hedge fund in question. As an option, an index exposure could be tweaked to some extent by shorting and thus netting out some of the not-desired exposures in the index.

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As a second example, and a significantly more challenging one, imagine a macro strategy fund with some currency, bond and equity exposure, all obtained through derivatives (eg. currency forwards, government bond futures, country equity indices etc). Negative screening is still an option, i.e. avoiding exposure toward certain countries. Turning it around toward positive screening instead, a number of countries have begun issuing green bonds over the past 3-4 years. Considering these and exploring the related derivatives of such issues could further enhance the ESG credentials of the portfolio. Also, as far as the equity indices go, the same approach of shorting certain sector exposures or individual assets to net out the exposure is a viable approach also in this case. More refined approaches are also possible but require more tailoring and adaptation to the individual strategy, capabilities and willingness to commit resources.

What does matter regardless of the approach chosen is to do what makes sense from a logical, analytical, and data perspective. If it doesn't make sense to the fund itself, it will hardly make sense to anyone else either, including potential investors.

Same Efforts, Different Rewards

The correlation between effort and value is clear; Not addressing ESG as a hedge fund will over time become increasingly questioned. It is the equivalent of getting negative value (fundraising issues) for no money (at no effort, but still…). Getting zero or potentially some minor value with a fair bit of effort is equal to adopting a basic approach in line with general market trends and expectations. To stand out in the market and for ESG to contribute positively to fundraising, marketing, and overall portfolio performance, more effort is needed.

It only takes one or a few examples within each hedge fund type to show how it can be done for investors to question the others why they are not doing it. And just like a marathon, the effort involved is similar for everyone, but the price – in the form of branding, fundraising etc – is only awarded to the first few movers. Moving quickly and addressing ESG thoroughly thus adds to their sets of competitive advantages.

Fundraising from a Shrinking Pool of Assets – or Not?

Three things are clear: First, asset owners' understanding of sustainability and their related requirements are on the increase. Second, the general public is decreasingly likely to accept that some institutions, political entities or other participants in the economy should be allowed not to integrate ESG in how they think and operate – while no one can do everything, everyone can do something, and that includes hedge funds. Third, when broken down into sufficiently specific matters, it comes down to risk management (and opportunity identification). As such, it becomes difficult (and unimportant) to separate from other types of risk and risk management, and it will increasingly become regarded as part and parcel of looking after the value of your investors' capital.

But perhaps most important of all – as ever more asset owners require robust sustainability approaches, the smaller the pool of assets from which to fundraise for those asset managers who do not embrace sustainability. Conversely, those do who adapt, and who invest significant effort and resources into fully integrating sustainability may just have found (another) competitive advantage to boost their fundraising efforts.

ESG is not going away. So, where are you going?

This article was written by Niclas Düring, and featured in HedgeNordic's special report on "Marketing & Sales for Hedge Funds." Niclas Düring is an Associate Partner with Steward

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