



From Niche to Mainstream: Responsible Investment and Hedge Funds

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FOREWORD



In February 2018, I had the pleasure of joining several esteemed panelists on stage at the 2018 Cayman Alternative Investment Summit (CAIS) to discuss hedge funds and the future of investing. It didn't take long for us to reach a consensus: responsible investment is here to stay.

Perhaps this may come as a surprise to some in the hedge fund community. After all, the premise of hedge funds is that they are not constrained in the investments they can make. Hedge fund managers value that flexibility, and some have even expressed concerns that adopting responsible investment principles could hurt their ability to protect and grow the capital of their investors.

However, as we found in our recent paper on the future of the hedge fund industry, *Perspectives*,¹ hedge fund firms have always embraced change and responded to investor demand. Responsible investment is no exception to this rule. Hedge fund firms realize that today's investors, be they institutions or individuals, expect to see their principles reflected in their investments. As a result, hedge fund firms are beginning to implement responsible investment, be it through the screening of certain securities, the analysis of environmental, social, and governance factors, or even through impact investing.

While some hedge fund firms are skeptical about how practical it is to implement a responsible investment strategy, the conversations I've had with leaders across the industry reveal a different story. Instead of focusing on the question of whether to adopt responsible investment, a significant number of hedge fund firms are now focusing on how to adopt responsible investment while continuing to deliver the strong risk-adjusted returns that their investors have come to expect.

This work is even more important in light of the recent sustainable finance legislative proposals unveiled by the EU aimed at harnessing the capital markets to help implement the 2015 Paris Agreement. Among the proposals put forward by the EU include a regulation requiring the disclosure of the procedures and conditions applied by financial participants, including asset managers, for integrating sustainability risks in investment decisions.² Certainly, there are still challenges to overcome before responsible investment can become more widely adopted across the hedge fund industry. The first step to overcoming those challenges is understanding how hedge funds currently view and approach responsible investment.

In order to gain that understanding, the Alternative Investment Management Association (AIMA) and CAIS commissioned a survey of hedge fund firms that in aggregate manage an estimated \$550 billion in total assets.

The results of that exercise can be found in this report, *From Niche to Mainstream: Responsible Investment and Hedge Funds*. We found that while we are still in the early days of hedge fund firms embracing responsible investment, there is a groundswell of pressure—both from investors and industry leaders—to act and enter this space.

Sincerely,
Jack Inglis, CEO, AIMA

¹ AIMA. (2018, April). *Perspectives: Industry Leaders on the Future of the Hedge Fund Industry*. <https://www.aima.org/educate/aima-research/perspectives-research.html>

² European Commission. (2018, May 24). *Sustainable finance: Making the financial sector a powerful actor in fighting climate change*. http://europa.eu/rapid/press-release_IP-18-3729_en.htm

EXECUTIVE SUMMARY

Responsible investment goes mainstream

Increasing investor demand for responsible investment is one of the biggest trends shaping the global asset management industry today. Investors are increasingly demanding portfolio solutions that, as well as minimising risks and maximising returns, also take social and environmental concerns into account.

As measured by the population of the 80 hedge fund firms that reported to this survey, at least \$59 billion in hedge fund assets is currently being managed under responsible investment principles.³ Meanwhile, fully 51% of hedge fund firms surveyed reported increased investor interest in responsible investment over the past 12 months, with interest particularly strong in North America, a region that has traditionally been more hesitant to embrace responsible investment.

Big or small, hedge fund firms are adopting responsible investment

Responsible investment is not merely the preserve of the largest of hedge fund firms: smaller firms are embracing it as well. 40% of all hedge fund firms surveyed currently practice responsible investment in some form. This trend encompasses hedge fund firms of different sizes, with 60% of the larger hedge fund firms (\$1+ billion in assets under management) surveyed saying they practice responsible investment, versus 23% of smaller firms (<\$100 million in assets under management). As the number of smaller firms that practice responsible investment grows, the assets being managed under responsible investment principles will expand. It follows then that the adoption of responsible investment is a permanent, structural trend across the hedge fund industry.

Signed, sealed, and delivering responsible investment

Hedge fund firms are increasingly opting to sign the United Nations-backed Principles for Responsible Investment (UN PRI). 36% of hedge fund firms surveyed have already signed the UN PRI, or say they plan to do so. Related to this, 38% of all hedge fund firms surveyed are either already using the UN PRI due diligence questionnaire template during the due diligence process with investors, or plan to begin using it. This is further evidence that responsible investment is becoming top-of-mind for investors, who want to better understand each hedge fund firm's governance and investment processes, including the monitoring and reporting that is needed for a hedge fund firm practicing responsible investment.

³ The population of respondents that reported to this survey may be positively biased towards firms who have an interest in responsible investment.

Investing in responsible investment

Nearly a third of all hedge fund firms surveyed have hired a responsible investment expert, or plan to make a hire in this area over the next 12 months. Hedge fund firms' investment in human capital is the strongest sign yet of the hedge fund industry's commitment to understanding responsible investment and evaluating how best to incorporate it into their investment strategies.

Adoption of responsible investment runs deep...

One in five hedge fund firms surveyed reported having over 50% of their total investment capital being managed under responsible investment principles. Investors now have the opportunity to allocate to firms that embed responsible investment in every investment decision they make.

...but challenges remain

The two most common challenges cited by hedge fund firms surveyed are “inadequate methodologies for the calculation of sustainability risks” and the “lack of relevant disclosures from companies.” Without companies publicly disclosing quality data that shows their performance on ESG issues, many managers will be hard-pressed to find a way to evaluate the social and environmental and governance attributes of a potential investment. However, as hedge fund firms continue to build out their responsible investment infrastructure, and as more companies release information on how they perform on ESG factors, these challenges are likely to be overcome.

UNITED NATIONS PRINCIPLES FOR RESPONSIBLE INVESTMENT



The United Nations-supported Principles for Responsible Investment welcomes this piece of research by the Alternative Investment Management Association (AIMA) and the Cayman Alternative Investment Summit (CAIS). Hedge fund firms form an important part of the global asset management industry, and their contributions to responsible investment will help ensure that asset management is both socially responsible and environmentally sustainable. The United Nations Principles for Responsible Investment looks forward to working with AIMA, CAIS, and others to help the make that goal a reality.

UN PRI

United Nations Principles for Responsible Investment (UN PRI): a set of six investment principles that offer signatories actions for integrating responsible investment into their investment decisions.



- » Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.
- » Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.
- » Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- » Principle 4: We will promote acceptance and implementation of the Principles within the investment industry.
- » Principle 5: We will work together to enhance our effectiveness in implementing the Principles.
- » Principle 6: We will each report on our activities and progress towards.

To learn more or to become a signatory, please visit www.unpri.org.

INTRODUCTION



Responsible investment is today one of the biggest trends reshaping the global asset management industry.

While there is debate within the industry about what exactly can and should be labeled a “responsible investment” (see page 12), experts agree that interest in this area—and consequently capital allocations—is likely to grow.

According to the 2016 Global Sustainable Review, at the start of 2016 there were \$22.89 trillion in global assets being professionally managed via responsible investment strategies. This represents approximately a quarter of total assets being managed by the global asset management industry, and an increase of 25% since the previous estimate was collated in 2014. Just over half of that \$22.89 trillion is being managed by asset management firms located in Europe; roughly 36% is being managed by firms in the United States.⁴

While these numbers include responsible investment strategies with varying degrees of robustness, they suggest that responsible investment is not a short-term trend, but rather a permanent shift in philosophy across the asset management industry. They also suggest that there is substantial capacity for growth in this space across the rest of the world as interest in responsible investment continues to grow.

Many of the world’s largest asset managers are responding to this shift by restructuring their businesses and investment strategies in order to embrace responsible investment. There are two primary reasons for this shift: demographics are changing and investors are increasingly demanding access to responsible investment strategies, and some recent research has pointed to evidence that responsible investment may boost risk-adjusted financial returns.⁵

⁴ Global Sustainable Investment Alliance. (2017, March). *2016 Global Sustainable Investment Review*. http://www.gsi-alliance.org/wp-content/uploads/2017/03/GSIR_Review2016.F.pdf

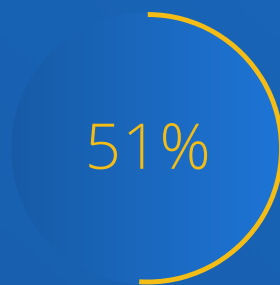
⁵ University of Oxford & Arabesque Partners. (2015, March). *From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance*. https://arabesque.com/research/From_the_stockholder_to_the_stakeholder_web.pdf

WILL THE HEDGE FUND INDUSTRY FOLLOW THE SAME PATH?

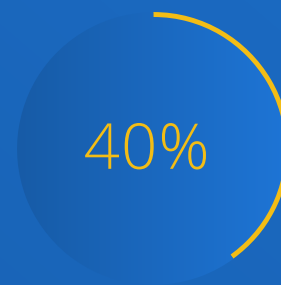
Based on the responses to the survey and the ensuing conversations we held with firms and investors, we believe the answer appears to be yes. In analyzing the survey results, we found that just over half of the hedge fund firms surveyed are seeing increased interest in their responsible investment capabilities from current or prospective investors. In meeting this demand, about 40% of respondents said that they are currently investing using responsible investment principles, including 20% who are committing at least 50% of their firms' assets under management to responsible investment strategies.

The results indicate that there is approximately \$59 billion in total hedge fund assets allocated to responsible investments among the survey population.

Increasingly, many hedge fund investors want more than just financial returns—they want social and environmental returns as well. However, accounting for those considerations without sacrificing financial performance is still seen as a challenge by some hedge fund managers, and is a reason cited by some for delaying their adoption of responsible investment.



51% of respondents are seeing increased interest in their responsible investment (RI) capabilities from current or prospective investors



40% of respondents are currently allocating to responsible investments, representing **\$59 billion** in total assets allocated to responsible investments⁶

⁶ AUM based on midpoint analysis

THE TIDE IS TURNING

BlackRock CEO Larry Fink wrote in his 2017 annual letter to CEOs: “Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society.”⁷

This industry-shaking proclamation put not only public and private companies on notice, but also the asset managers that invest in those companies. While the hedge fund industry has been relatively slow to adopt responsible investment compared to other sectors of the asset management industry, the tide is turning. Several hedge fund firms have recently launched funds that employ a responsible investment focus.

In January 2018, Jana Partners launched the Jana Impact Fund to invest in companies the hedge fund “believes are good bets but could do better for the world.”⁸

Also in January, ValueAct Capital launched the ValueAct Spring Fund, which will invest in companies that are “emphasizing and addressing environmental and societal problems.” In his letter to investors, ValueAct founder Jeff Ubb specifically pointed to the potential for “excess return” by

investing in these companies.⁹ In April, Avenue Capital announced plans to launch a credit fund that will make impact investments in businesses that have a strong social or environmental impact, such as those in sectors like renewable energy, affordable housing and infrastructure resiliency.¹⁰

This is only the beginning. More managers will likely follow as the market matures and interest grows. What is clear is that the hedge fund industry as a whole is beginning to embrace its potential beyond generating financial returns by helping to lead the fight to build a socially and environmentally responsible world.

How will hedge fund firms adapt to the growing demand, and what challenges still remain for those looking to adopt responsible investment?

The answers to these and other questions are the subject of this report.

Sincerely,
Tony Cowell, Partner, Head of Asset Management
for KPMG Cayman Islands & Co-Chair of the
Editorial Committee for CAIS

⁷ BlackRock. (2018, January). *Larry Fink's Annual Letter to CEOs*. <https://www.blackrock.com/corporate/en-us/investor-relations/larry-fink-ceo-letter>

⁸ Benoit, David. (2018, January 7). *Wall Street Fighters, Do-Gooders—And Sting—Converge in New Jana Fund*. Published by The Wall Street Journal: <https://www.wsj.com/articles/wall-street-fighters-do-goodersand-stingconverge-in-new-jana-fund-1515358929>

⁹ Faber, David. (2018, January 19). *Jeff Ubb's ValueAct launching fund with social goals, following similar moves by Jana, BlackRock*. Published by CNBC.com. <https://www.cnbc.com/2018/01/19/jeff-ubbens-valueact-launching-fund-with-social-goal.html>

¹⁰ Delevingne, Lawrence. (2018, April 18). *Avenue Capital to launch 'impact' investment fund, source says*. Published by Reuters. <https://www.reuters.com/article/us-privateequity-avenue/avenue-capital-to-launch-impact-investment-fund-source-says-idUSKBN1HP2AG>

SURVEY METHODOLOGY

To produce this report, AIMA and CAIS collected 80 survey responses from hedge fund firms representing approximately \$550 billion in total assets under management.¹¹ Survey responses were collected from December 2017 to February 2018.

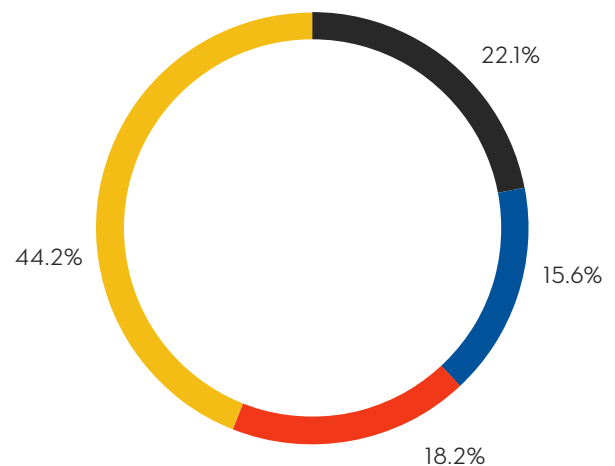
The population of respondents that reported to this survey may be positively biased towards firms who have an interest in responsible investment.

For the purposes of this report, smaller hedge fund firms are defined as those firms managing less than \$100 million in assets, mid-sized hedge fund firms are those with between \$100 million and \$1 billion in assets under management, and larger hedge are those with over \$1 billion in assets under management.

Please note that numbers represented in the charts in this report may not add up to exactly 100% due to rounding.

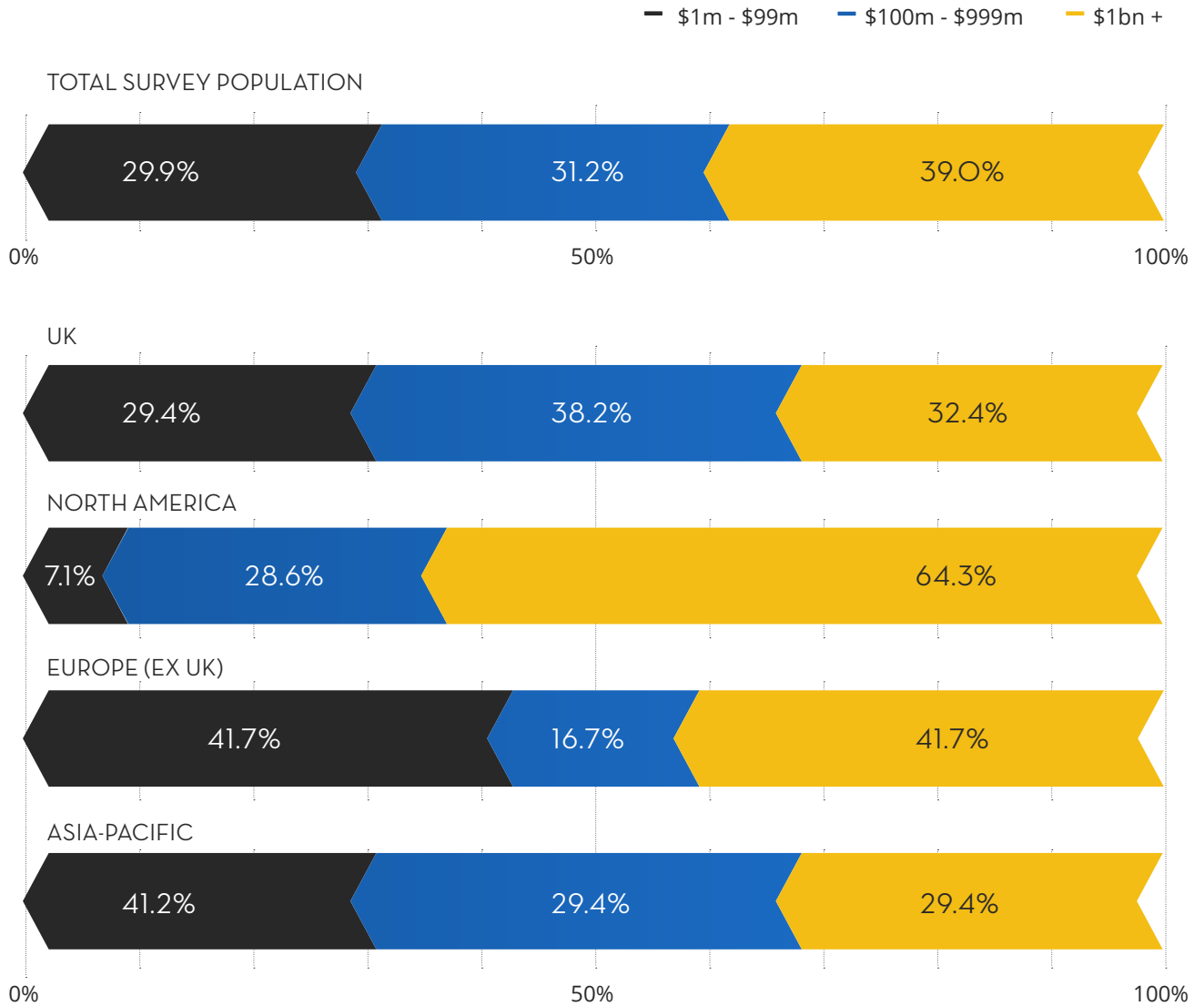
WHERE IS YOUR FIRM BASED?

- Asia-Pacific
- Europe (ex UK)
- North America
- UK



¹¹ AUM figure based on midpoint analysis

WHAT IS YOUR FIRM'S AUM?



WHAT IS RESPONSIBLE INVESTMENT?

The United Nations-supported Principles for Responsible Investment agency (UN PRI) defines responsible investment as “an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate long-term returns.”¹²

Responsible investment may encompass one or more of the following industry-specific terms.

ESG INVESTING – Identifying traits of a security that may not have been taken into account by that security’s price but which may affect its desirability, from both a moral and a profit point of view.

SOCIALLY RESPONSIBLE INVESTMENT – A screening process which excludes certain securities from a portfolio based on perceptions of their moral worth.

IMPACT INVESTING – The allocation of capital with the express purpose of generating a positive social or environmental impact alongside a financial return.

SUSTAINABLE INVESTMENT – An investment approach that considers environmental, social and governance (ESG) factors in portfolio selection and management.

ETHICAL INVESTMENT – Using one’s ethical principles as the main filter for securities selection. Ethical investing depends on an investor’s views; some may choose to eliminate certain industries entirely or to over-allocate to industries that meet the individual’s ethical guidelines.

GREEN INVESTMENT – Activities that focus on companies or projects that are committed to the conservation of natural resources, the production and discovery of alternative energy sources, the implementation of clean air and water projects, and/or other environmentally conscious business practices.

¹² UN PRI. *What is responsible investment?* <https://www.unpri.org/about/what-is-responsible-investment>

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Alternative investment firms are adopting more sophisticated approaches to integrating ESG as part of decision making and performance assessment. Many are launching impact investing funds focusing on companies that offer scalable solutions to social and environmental challenges. Investor demand is growing for these types of investments, and investors are increasingly holding firms accountable for delivering both expected returns and impact.

Tania Carnegie, Chief Impact Officer and Leader, Impact Ventures Practice at KPMG

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We believe transparency, accountability and good governance are key to investing in hedge funds. Through the adoption of a policy on responsible investment we enhance the risk management of our investments, deepen the level of engagement we have with our managers, and have more active dialogue with our clients and interested external parties on ESG related aspects. Our approach towards responsible investment revolves around the identification of key investing issues that we believe have a significant impact on risk and where we have significant ability to monitor and influence the outcome of the issues.

Russell Barlow, Global Head of Alternative Investment Solutions, Aberdeen Standard Investments

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Institutional investors recognize that long-term financial performance is materially impacted by ESG factors and are demanding that managers take them into account. Fund managers who ignore this trend are likely to have a harder time attracting investor capital over time.

Fran Seegull, Executive Director, U.S. Impact Investing Alliance

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Responsible investment is no longer a fad of the environmentally passionate. The evidence is clear—making long term investment decisions that affirm the protection of the natural ecosystem that sustains our lives is true sustainability. We do best in open market conditions that allow the power of capital to deliver services and products that the public need. But we fully truly thrive when the power of consumption is balanced by the imperative for ecological protection and, in this balance, the investment market is playing a most vital role by pointing out that there is a better way than just ‘more.’ The best investments are those that genuinely serve the most compelling objectives of a responsible and sustainable future.

Lord Dr. Michael Hastings of Scarisbrick CBE, Global Head of Citizenship, KPMG

INVESTORS ARE DEMANDING RESPONSIBLE INVESTMENT

Investor demand for responsible investment, once largely limited to religious organizations and Scandinavian countries, is fast becoming mainstream. Responsible investment is a broad phenomenon based on two theses: (1) investments should reflect the morals of the investor making them, and (2) things like environmental degradation and socially irresponsible business practices are long-term risk factors to which the market has yet to attach an accurate price.

These two theses have led to a variety of potential responsible investment strategies, which are discussed in a later section of this report. While every investor will have a different view of how their capital should be allocated, the overall trend toward increased demand for responsible investment is clear.

Our data shows that over half (50.6%) of our survey respondents have experienced an increase in interest in their firm's responsible investment capabilities from current or prospective investors over the past 12 months. Geographically, interest is particularly strong in North America, where 71.4% of hedge fund firms reported increased investor interest in responsible investment. Given that North American investors have traditionally been more cautious about adopting responsible investment, this surge in demand relative to the rest of the survey population may be a sign that North America, and the U.S. in particular, will be a major staging ground in the next evolution of responsible investment. In fact, in just the last couple of years several large, influential U.S.-based institutional investors, including CalPERS and the New York State Common Retirement Fund (NYSCRF), have publicly announced commitments to making more long-term, sustainable investments.^{13, 14}

A similar movement is already well under way in Europe, which historically has been ahead of North America when it comes to institutional investors integrating responsible investment into their portfolios. Still, demand remains high, with nearly half of European hedge fund firms reporting increased interest in responsible investment across their investor base and among prospective investors over the last year.

Diving deeper into the data, we found that investor interest in responsible investment was strongest among the largest hedge fund firms and allocators, with 80% of firms with over \$1 billion in AUM reporting increased interest in their responsible investment capabilities. By contrast, only about a third of sub-\$1 billion hedge fund firms have reported the same.

¹³ CalPERS. *Sustainable Investing*.

<https://www.calpers.ca.gov/page/investments/governance/sustainable-investing>

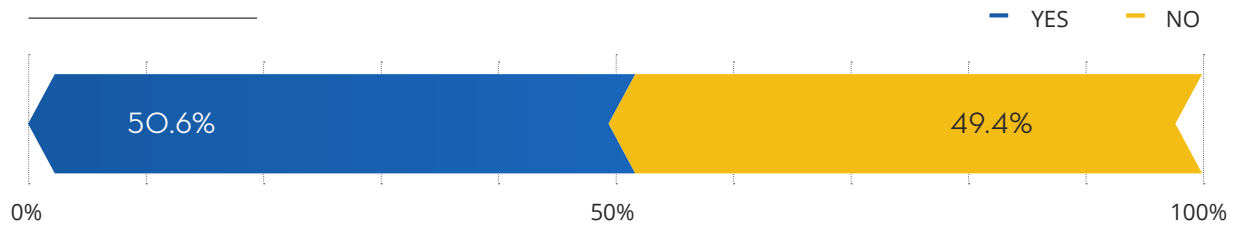
¹⁴ Office of the New York State Comptroller. (2018, January 31). *NY State Comptroller DiNapoli Doubles Low Emissions Index Investment to \$4 Billion*. <https://www.osc.state.ny.us/press/releases/jan18/013118.htm>

Larger hedge fund firms tend to have a greater variety of investors who can express interest in responsible investment in the first place. That being said, responsible investment is in no way limited to the largest of hedge funds. While not every hedge fund firm will adopt responsible investment practices in the near future, the confluence of investor demand, improving ESG data, and technological capacity may push managers of all sizes to offer their investors more responsible investment opportunities.

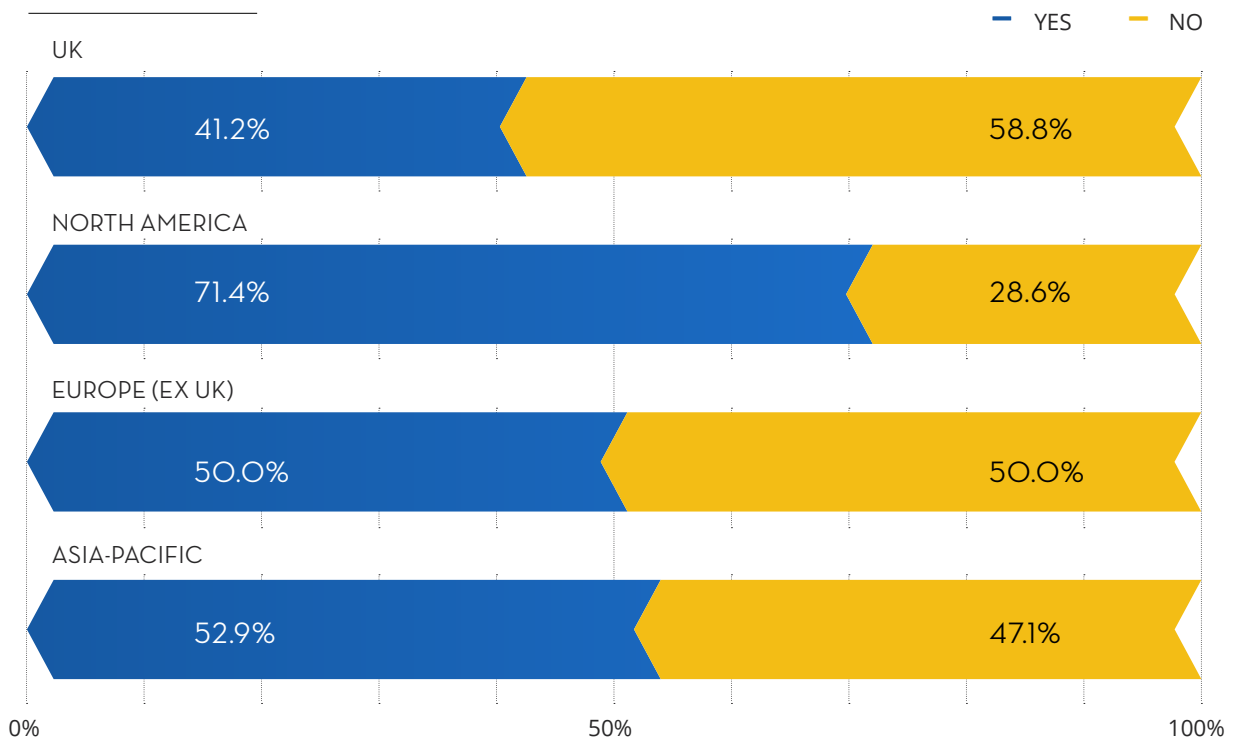
Looking to the future, investors are increasingly demanding that their capital be put towards a more responsible form of investing. For some this is a product of changing risk perceptions. Many investors now worry about long-term risks such as environmental damage, a concern that was uncommon in years past. This shift in thinking is also part of a generational change. Millennials are actively thinking about ESG as a guiding principle for their investments, and are already allocating their capital accordingly.¹⁵

¹⁵ U.S. Trust. (2017, June 13) 2017 *Insights on Wealth and Worth*.
<https://www.ustrust.com/articles/insights-on-wealth-and-worth-2017.html>

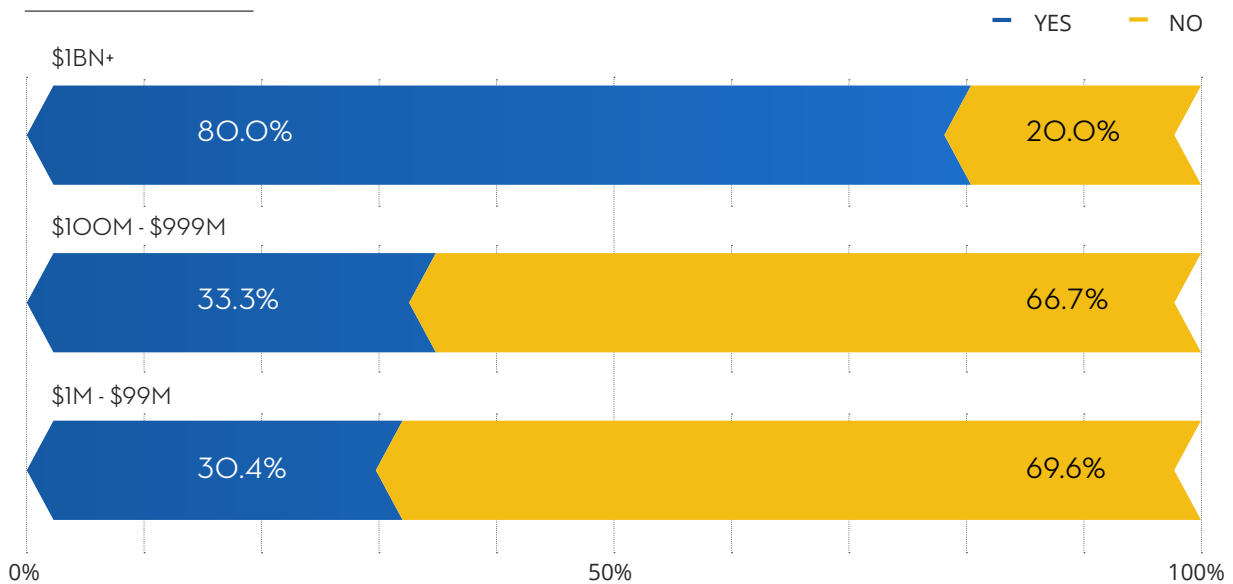
INCREASED INVESTOR INTEREST IN THE LAST 12 MONTHS?



INCREASED INVESTOR INTEREST IN THE LAST 12 MONTHS? (BY REGION)



INCREASED INVESTOR INTEREST IN THE LAST 12 MONTHS? (BY AUM)



HEDGE FUND FIRMS ARE COMMITTING TO RESPONSIBLE INVESTMENT

More than a third (36%) of survey respondents have either signed or plan to sign the United Nations Principles for Responsible Investment (UN PRI), a UN-backed set of six principles for implementing responsible investment. Hedge fund firms with more than \$1 billion in AUM are the most likely to be UN PRI signatories, indicating the importance of responsible investment expertise for firms that have large institutional investors or are looking to attract such investors to invest in their business. Exactly half of such larger firms have already signed the UN PRI or plan to do so, compared to 21% of mid-sized firms (\$100-\$999 million in AUM) and 35% of smaller firms (less than \$100 million in AUM).

This reflects the fact that hedge fund firms typically look to institutionalize their businesses as they grow in size. Early on, the priority for most firms is earning strong returns and raising assets. However, as they continue to grow and begin relying more heavily on larger institutional investors with deeper pockets and broader investment remits for allocations, they may realize the importance of committing to responsible investment.

The same divide in responses can be found in the number of hedge fund firms that have filled out the Responsible Investment Due Diligence Questionnaire (RI DDQ)¹⁸ for hedge funds, introduced by the UN PRI in conjunction with AIMA in 2017 in order to provide a tool for investors to assess hedge fund firms on their responsible investment policies and practices. Since signing the UN PRI comes with many of the same requirements as filling out the RI DDQ, it is not surprising that the survey results would be similar. Respondents from larger hedge fund firms are the most likely to have filled out the RI DDQ, with half of \$1 billion-plus firms saying they have already filled it out or plan to do so soon, compared to 21% of mid-sized firms and 39% of small firms.

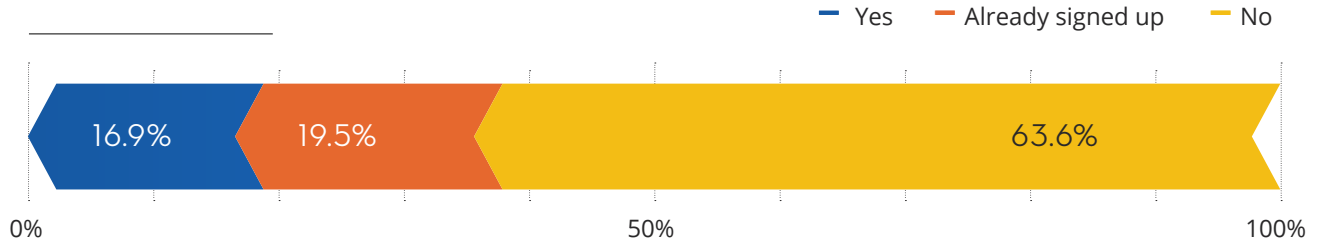
Geographically, the results are somewhat different. UK-based hedge fund firms are far more likely to have signed the UN PRI or completed the RI DDQ than managers from other parts of the world. North American-based hedge fund firms are less likely to have done so. Our findings reveal that just 21% of all North American hedge fund firms that participated in our survey have signed the UN PRI or plan to do so and only 14% have filled out the RI DDQ or plan to do so. Since North American firms dominate the overall hedge fund industry assets under management, it will be interesting to see whether this gap closes in the coming years.

¹⁶ The UN PRI were officially released in 2005. The Principles were launched in April 2006 at the New York Stock Exchange. Since then the number of signatories has grown from 100 to over 1,800.

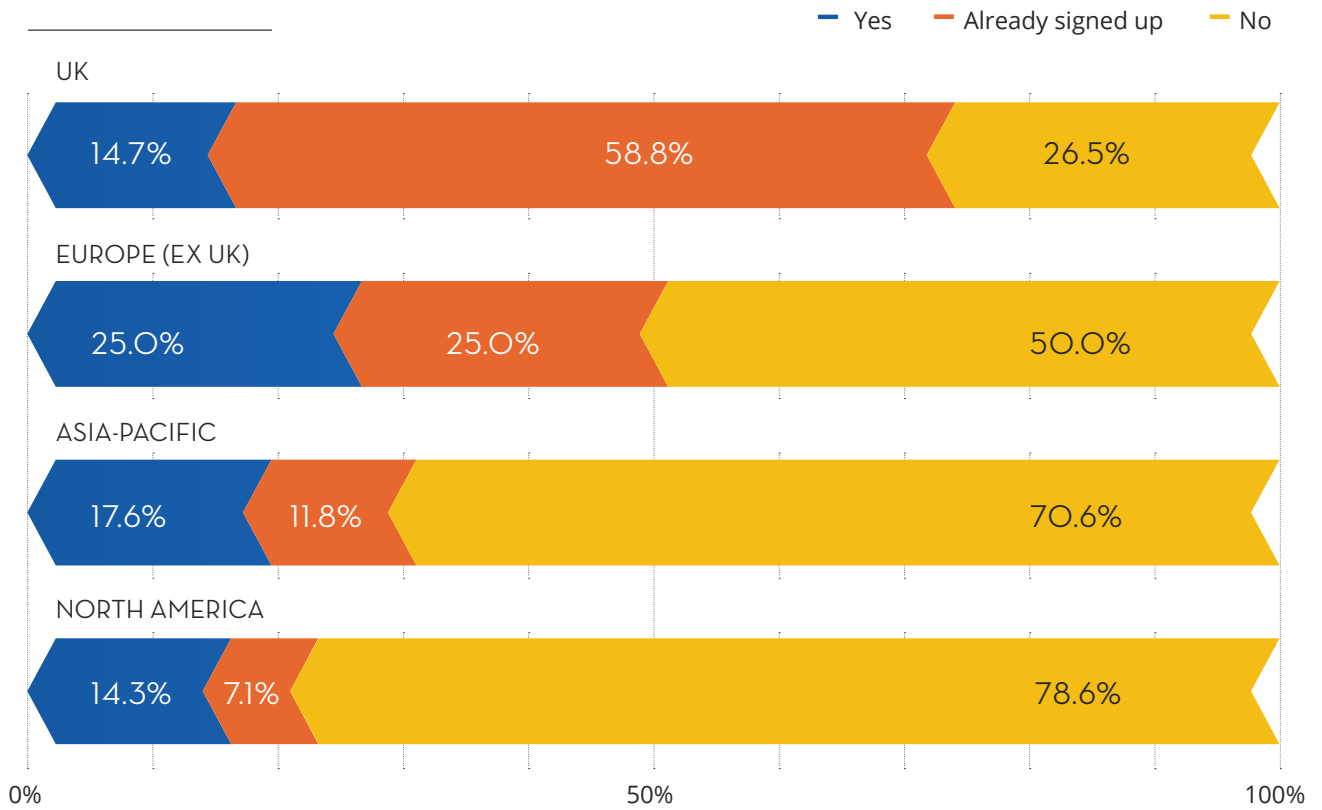
¹⁷ The Responsible Investment DDQ was officially released in May 2017.

¹⁸ UN PRI (2017, May 9). *Responsible investment DDQ for hedge funds*. https://www.unpri.org/download_report/31412

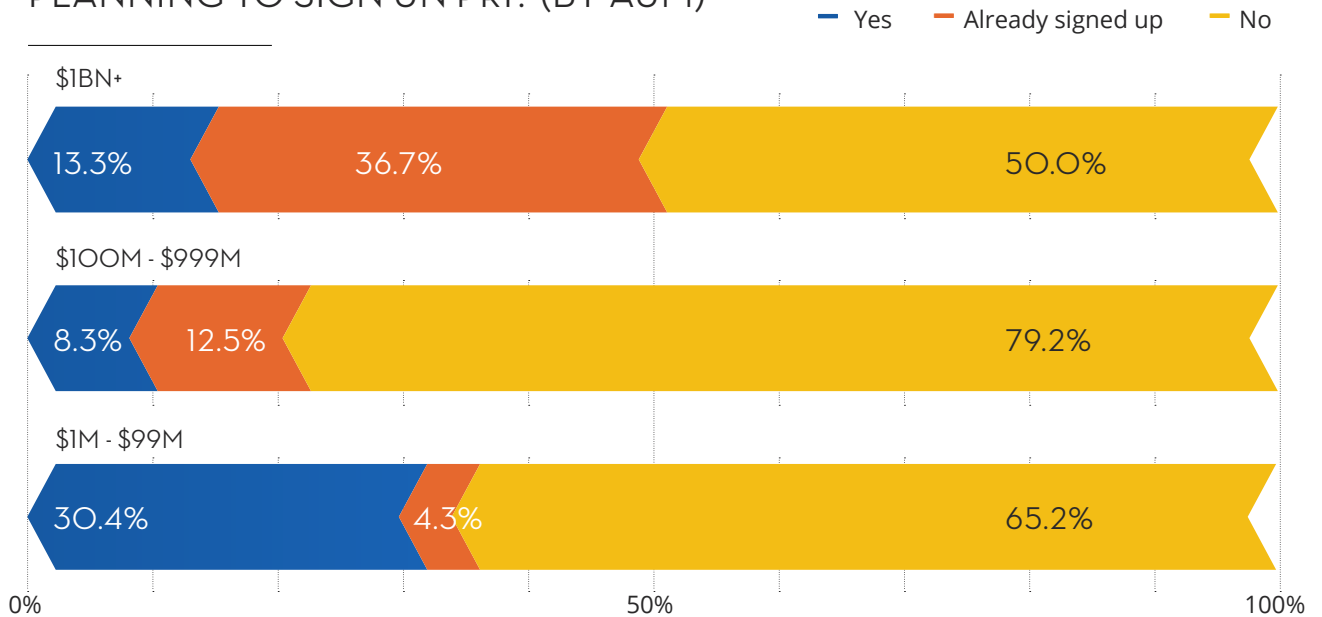
PLANNING TO SIGN UN PRI?¹⁶



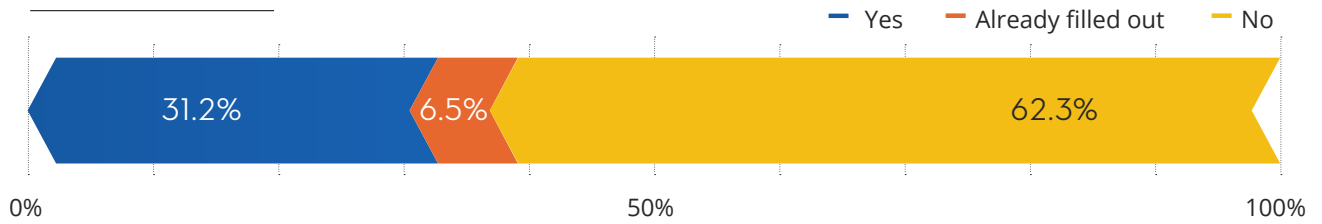
PLANNING TO SIGN UN PRI? (BY REGION)



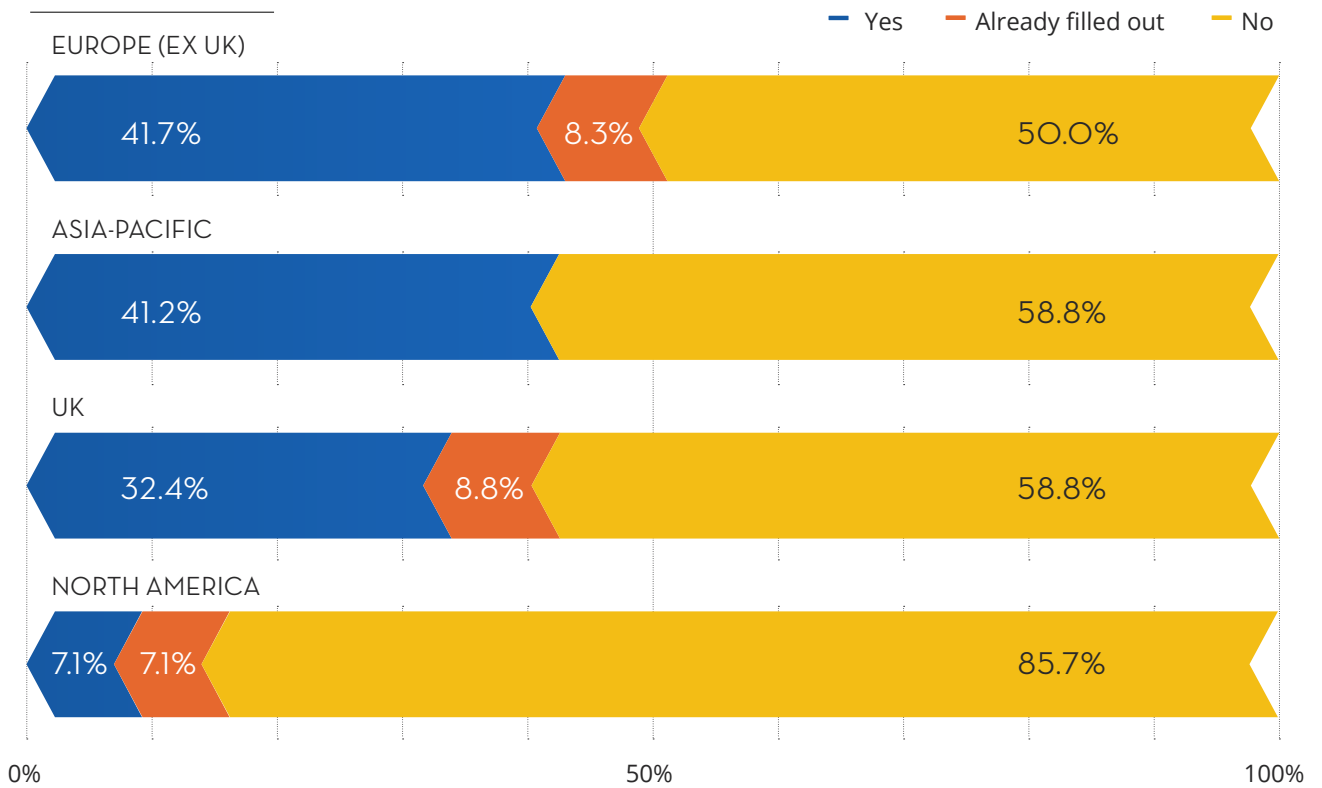
PLANNING TO SIGN UN PRI? (BY AUM)



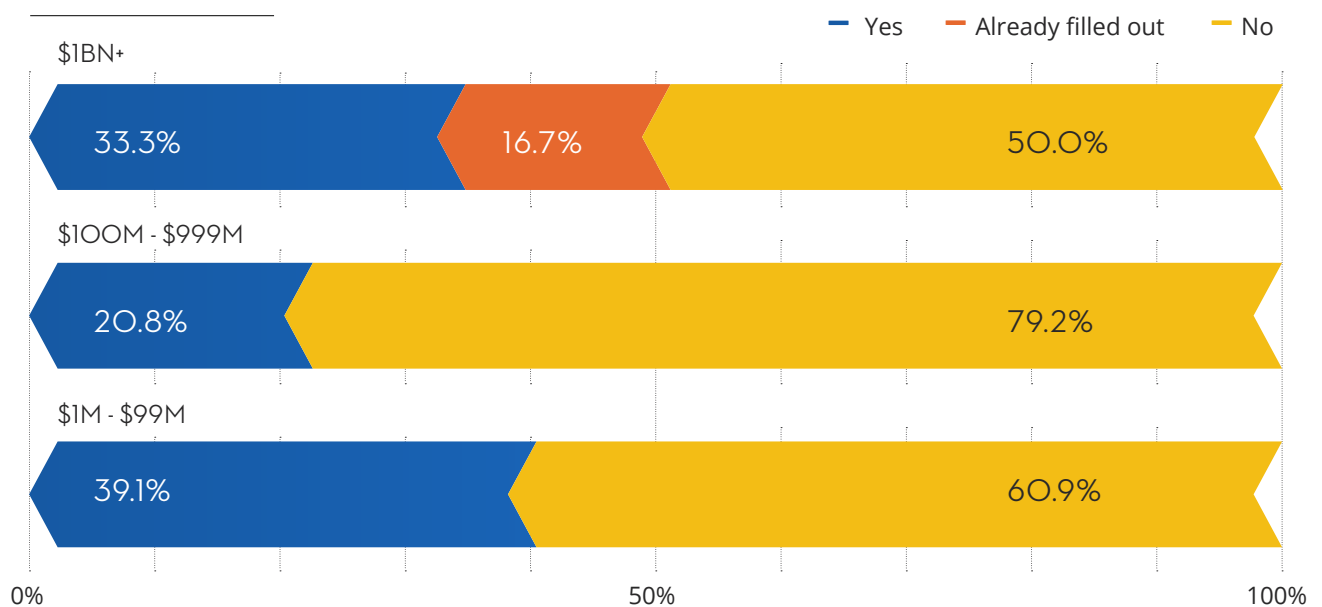
PLANNING TO FILL OUT RESPONSIBLE INVESTMENT DDQ?¹⁷



PLANNING TO FILL OUT RESPONSIBLE INVESTMENT DDQ? (BY REGION)



PLANNING TO FILL OUT RESPONSIBLE INVESTMENT DDQ? (BY AUM)



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I have always believed that you need to invest in companies that matter. If they were to disappear tomorrow would they be missed? Sustainability is simply identifying companies that plan on being around for not just the next quarter but for generations. Preserving resources, minimizing waste, being efficient, and improving the well-being and health of the customers and employees is just good, long-term business.

Marc Lasry, Chairman, CEO and Co-Founder, Avenue Capital Group

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In the past, ESG considerations often came as a distant afterthought in the portfolio construction process. This was largely due to a lack of convincing backtest evidence that ESG selection criteria can act as a return enhancer for equity portfolios. This situation has more recently evolved with more and more asset management firms finding investment value in applying ESG as one element of their out-of-sample alpha forecasts. Unigestion in particular has been relying on factors such as CO₂ intensity and quality of governance/accounting practices in an effort to both reduce portfolio volatility and improve risk-adjusted return.

Alexei Jourovski, Head of Equities/Managing Director, Equities, Unigestion

””

We are at an inflection point with internalization of externalities with high ESG adoption and we believe that ignoring ESG factors is taking inadvertent investment risk. Societal norms are changing and aligning with environmental, social and governance norms. ESG momentum is becoming a coincident indicator of overall company outperformance and investment companies will reallocate capital flow to companies with strong ESG mandates. Pollution is causing governments to internalize true environmental costs to businesses and the virtue discount associated with ESG is or will be gone.

Dr. Johann Koss, President, Waratah Impact

””

Our holistic investment research process seeks to integrate all drivers of long-term value creation. We think an in depth analysis of environmental, social and governance matters provide invaluable insights on businesses and can provide a truly differentiated source of alpha both on the long and short side of the portfolio.

Arnaud Langlois, Portfolio Manager, Lombard Odier Investment Managers

HEDGE FUND MANAGERS ARE STARTING TO PUT CAPITAL INTO RESPONSIBLE INVESTMENTS

Nearly 40% of all respondents currently use responsible investment principles for some or all of their investments. As a measure of the AUM being invested according to responsible investment principles, we found that the hedge fund firms surveyed have approximately \$59 billion in total assets in responsible investments.¹⁹ Notably, nearly half of that population subset (equivalent to 20% of the total population of respondents) allocate over 50% of their total AUM strategies using responsible investment.

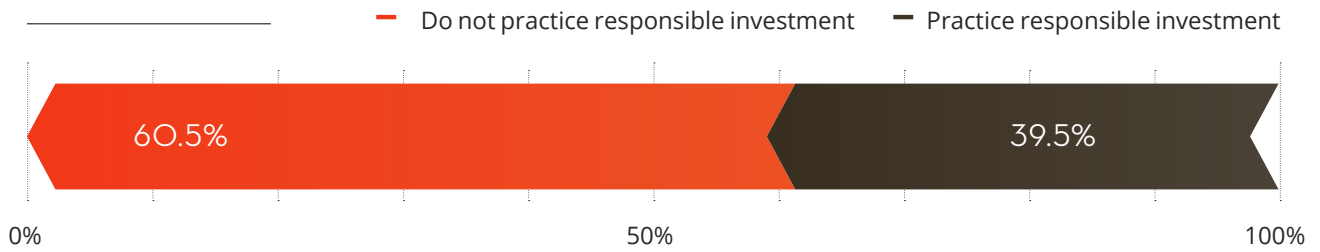
While smaller hedge fund firms (with less than \$100 million in total firm AUM) are less likely to engage in responsible investment on an absolute basis, they are far more likely to commit a significant portion of their assets thereto. Nearly a quarter (23%) of these firms said that more than half of their AUM is invested according to responsible investment principles, suggesting that these are specialized firms that are committed to responsible investment.

In contrast, firms with more than \$1 billion in total firm AUM are most likely to have capital invested in responsible investment strategies, but their levels of commitment can vary. This may reflect the difficulty of integrating responsible investment into an existing investment strategy or philosophy.

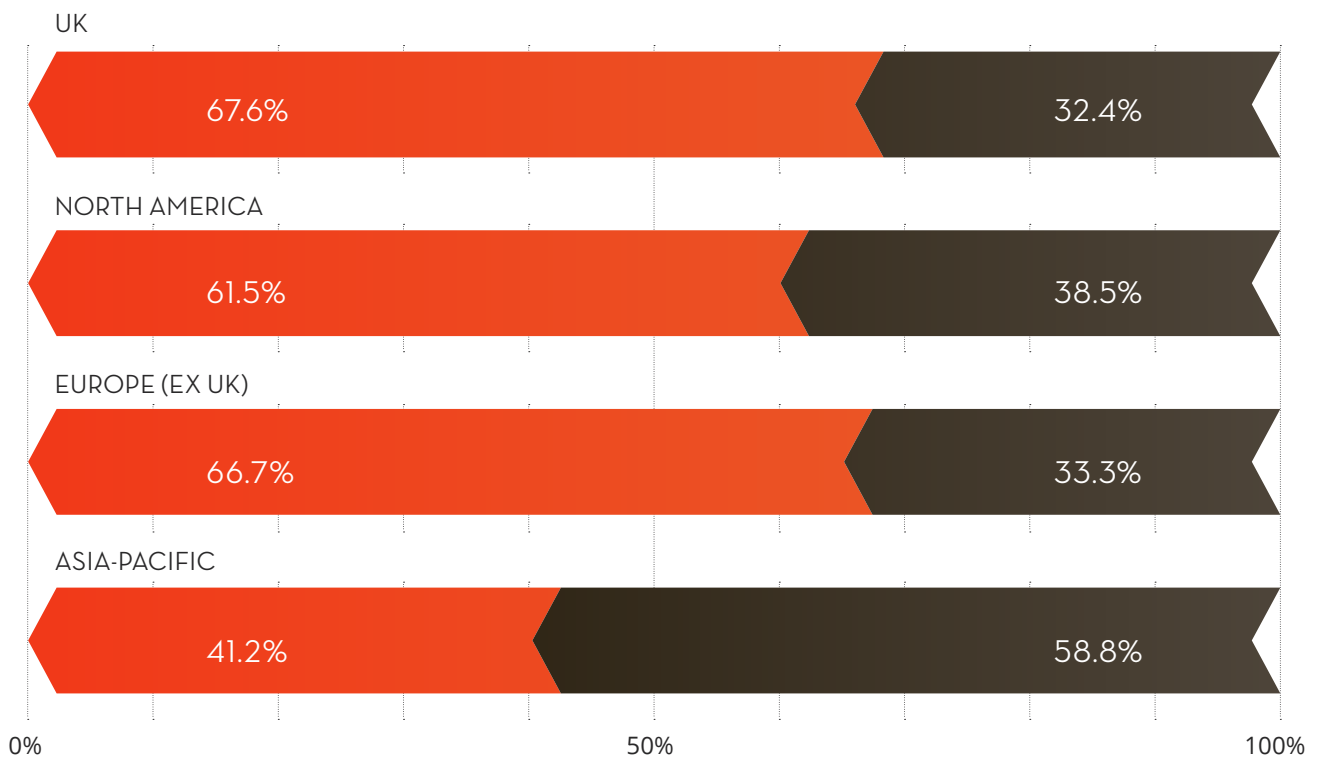
Mid-sized firms, those hedge fund firms with between \$100 million and \$1 billion in AUM, are caught in the middle. While less than a third (29%) of them engage in responsible investment, those that do are likely to have committed a significant portion of their assets to strategies governed by responsible investment principles.

¹⁹ Measure calculated using mid-point analysis of the respondents total AUM.

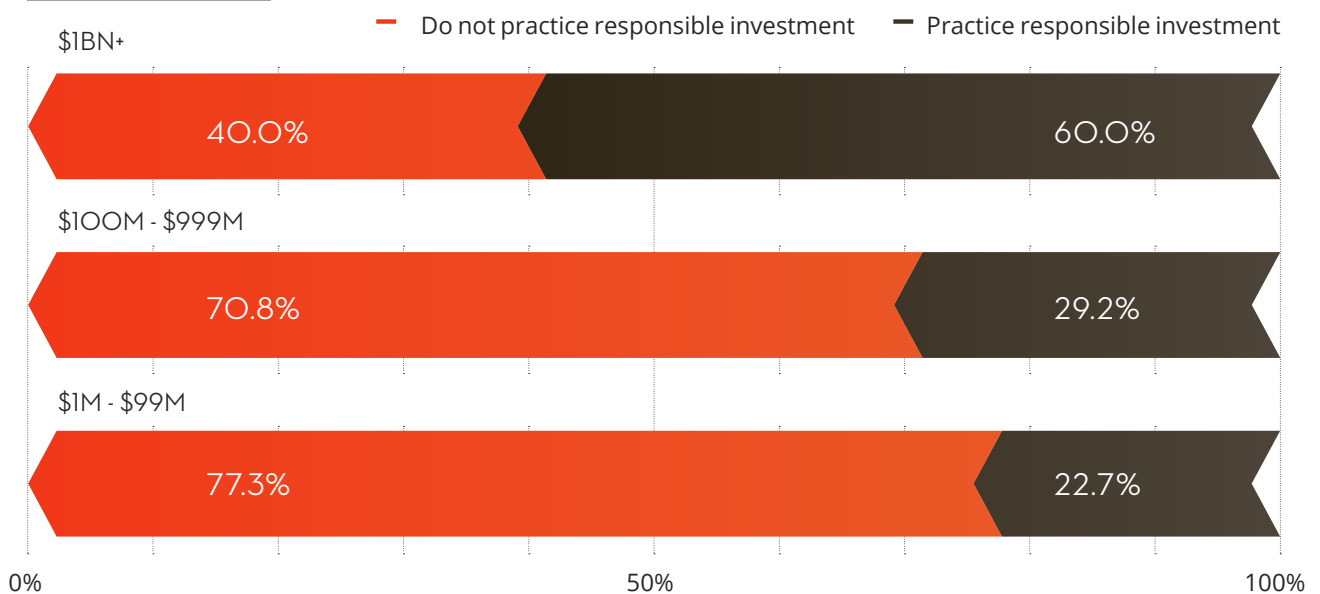
DO YOU ENGAGE IN RESPONSIBLE INVESTMENT?



DO YOU ENGAGE IN RESPONSIBLE INVESTMENT? (BY REGION)



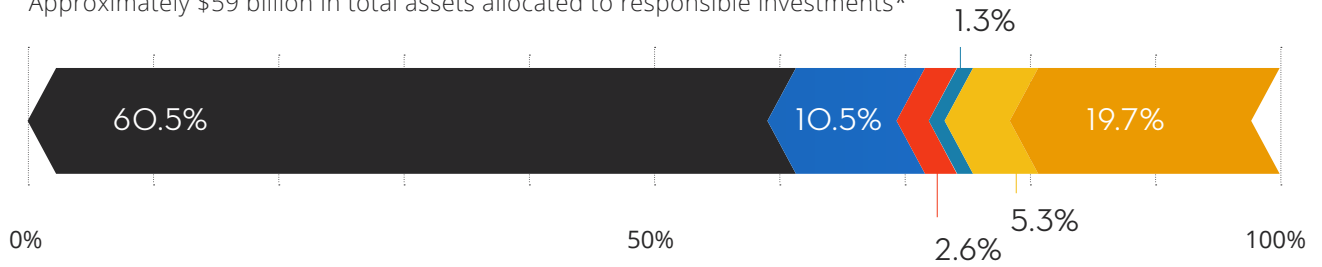
DO YOU ENGAGE IN RESPONSIBLE INVESTMENT? (BY AUM)



% AUM IN RESPONSIBLE INVESTMENTS?

— 0% — 1% - 5% — 6% - 10% — 11% - 25% — 26 - 50% — 50% +

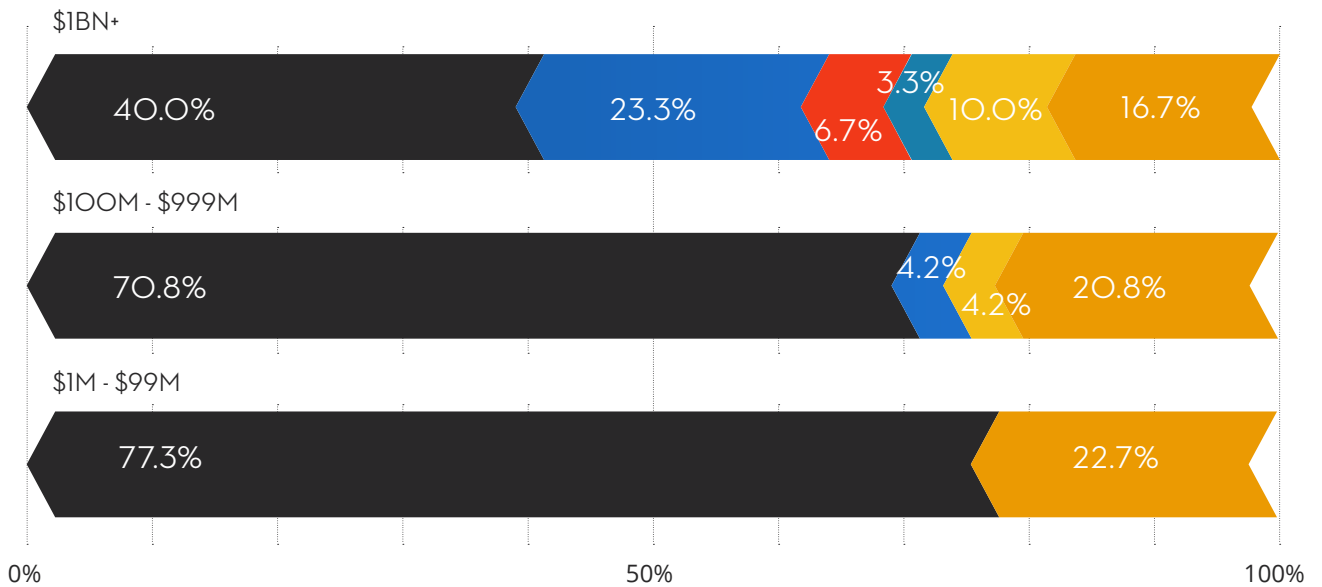
Approximately \$59 billion in total assets allocated to responsible investments*



*Based on midpoint analysis

% AUM IN RESPONSIBLE INVESTMENTS?

— 0% — 1% - 5% — 6% - 10% — 11% - 25% — 26 - 50% — 50% +



HEDGE FUND MANAGERS ARE TAKING DIFFERENT APPROACHES TO RESPONSIBLE INVESTMENT

Among all hedge fund firms surveyed, nearly one third (31%) currently rely on separately managed accounts (SMAs) or custom accounts. Approximately 18% of the hedge fund firms surveyed rely on systematic trading processes. Although this form of investing has grown rapidly in the hedge fund industry in recent years, the relative lack of data regarding responsible investment opportunities makes it difficult to build an algorithm to evaluate responsible investment opportunities.²⁰ However, given increased computing power and the wider accessibility of data, this will likely soon change. Further, some have hypothesized that firms using systematic approaches could have an easier time implementing responsible investment, especially since they tend to hold a higher amount of equities compared to discretionary funds, and thus can more easily substitute 'irresponsible' equities for 'responsible' ones.²¹

There is also broad differentiation in how hedge fund firms approach responsible investment, with the use of ESG factors to evaluate investment opportunities by far the most common approach. Negative screening continues to be used by many hedge fund firms as well, although there is an ongoing debate over whether negative screening actually results in a long-lasting social impact on a meaningful scale.

In a recent blog post about negative screening, AQR founder Cliff Asness argued that "pursuing virtue should hurt expected returns" and result in investors in 'irresponsible' securities earning higher returns. The reason is simple: companies that are weak on ESG, or "sin stocks" as Asness calls them, must offer a higher expected return to entice enough investors to own their stock.²²

²⁰ EY. (2017). *Is your nonfinancial performance revealing the true value of your business to investors?* [http://www.ey.com/Publication/vwLUAssets/EY_-_Nonfinancial_performance_may_influence_investors/\\$FILE/ey-nonfinancial-performance-may-influence-investors.pdf](http://www.ey.com/Publication/vwLUAssets/EY_-_Nonfinancial_performance_may_influence_investors/$FILE/ey-nonfinancial-performance-may-influence-investors.pdf)

²¹ AIMA. (2018, April). *Perspectives: Industry Leaders on the Future of the Hedge Fund Industry*, p. 63. <https://www.aima.org/educate/aima-research/perspectives-research.html>

²² Asness, Cliff. (2017, May 18). *Virtue is its Own Reward: Or, One Man's Ceiling is Another Man's Floor*. Published by AQR. <https://www.aqr.com/cliffs-perspective/virtue-is-its-own-reward-or-one-mans-ceiling-is-another-mans-floor>

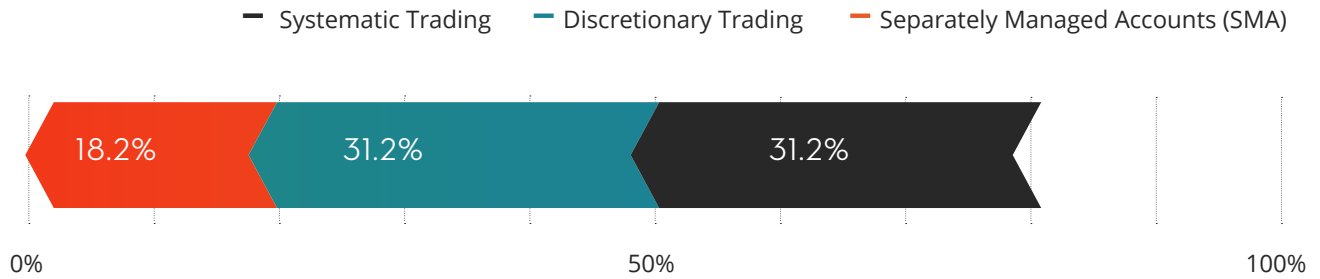
As a result, responsible investment leaders are continuing to push asset management firms, including hedge fund firms, to engage with companies on ESG issues, rather than simply screening such companies from their portfolios. Just 5% of the survey respondents said that they engage directly with companies on ESG issues. While not every hedge fund firm wants to be known as activist, recent history has shown that companies are likely to be more receptive to pressure on ESG issues than, for instance, proxy votes or stock buybacks.

According to a 2012 Harvard Business School study, successful activist engagements can lead to cumulative abnormal returns of 4.4% in the year following the engagement.²³ While the exact return will of course depend on the specific investment opportunity, there is a clear opportunity for hedge fund firms to take a more activist approach by proactively engaging with company management on ESG issues.

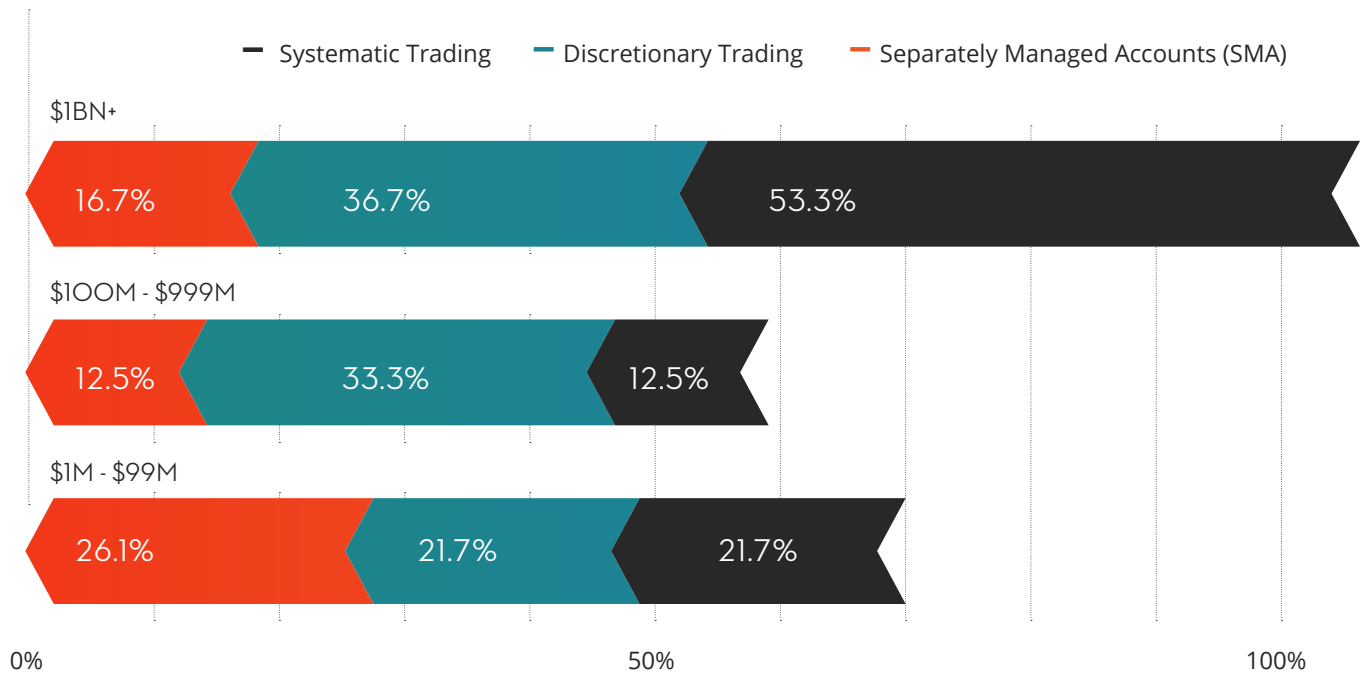
Another 5% of respondents are engaged in “impact investing,” which differs from other types of responsible investment in that it involves investing in companies that generate a positive social or environmental impact (versus screening out companies that have a negative impact). This is an approach taken by some institutional investors, including endowments and foundations, family offices, and high-net-worth individuals. The capital invested can come in the form of a debt or equity investment and is commonly intended to allow a public or private social enterprise to scale.

²³ Dimson, E., Karakas, O., & Li, X. (2012, December 17). *Active Ownership*. Published by Harvard Business School. http://www.people.hbs.edu/kramanna/HBS_JAE_Conference/Dimson_Karakas_Li.pdf

HOW DOES YOUR FIRM PRACTICE RESPONSIBLE INVESTMENT? (CHOOSE ALL THAT APPLY)

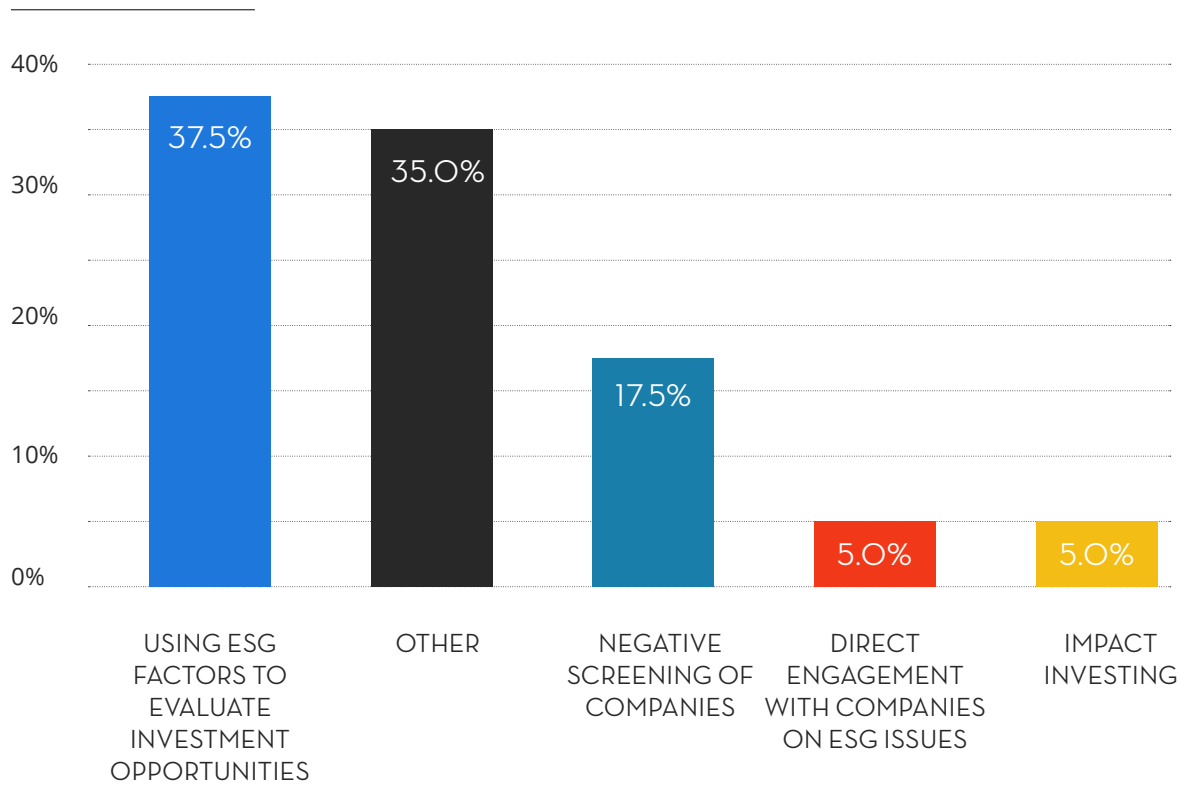


HOW DOES YOUR FIRM PRACTICE RESPONSIBLE INVESTMENT? (BY AUM)



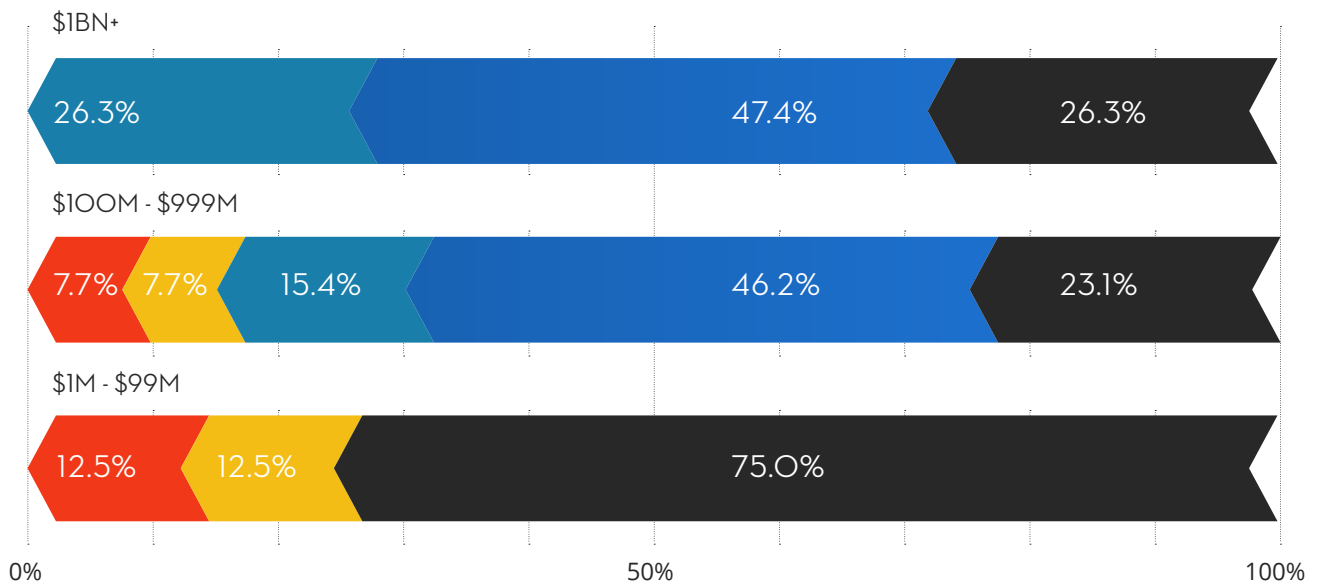
Not showing firms which do not offer responsible investment

APPROACH TO RESPONSIBLE INVESTMENT? (CHOOSE ALL THAT APPLY)



APPROACH TO RESPONSIBLE INVESTMENT? (BY AUM)

■ Direct engagement with companies on ESG issues
 ■ Impact investing
 ■ Negative screening of companies
■ Using ESG factors to evaluate investment opportunities
 ■ Other



””

We believe quantitative investment approaches can take ESG analysis a step further – by developing a more rigorous and consistent framework for comparing companies’ ESG credentials. As with so many areas of investment, where the line between quantitative and discretionary approaches is thinner than ever, we could see discretionary managers making use of such quant capabilities to strengthen their ESG processes in the coming years.

Steven Desmyter, Head of Responsible Investment at Man Group

””

The main challenge is education-ensuring all stakeholders know what is being implemented and why as well as being conversant and comfortable with the risks. That’s why when developing and implementing responsible investment strategies for NGOs and corporate clients, we always set from inception clear expectations of financial returns and social impact. The returns will be financial (measured against a benchmark) and we map the social impact to the UN SDGs.

Giles Gunesequera, CEO, Global Impact Initiative

””

We believe that returns in sustainability-focused companies can (and do) achieve above market returns. Those companies that embrace robust environmental, social and governance (ESG) standards are also best positioned for sustainable growth and profitability over the long term. ESG integration in fundamentally oriented portfolios is both a lens by which to identify opportunities for investment and a method to mitigate risk. Our research processes combine deep sector and geographic expertise together with a focus on material ESG factors that impact valuations. We believe this gives us an information advantage and is a source of outsized returns over a long-term horizon.

David Smith, CIO and Portfolio Manager, Greentech Capital Advisors

””

When we consider a wide range of ESG issues, it can be difficult to determine which are actually material. Materiality is often company specific, and can differ by asset class. For example, what is material for the performance of the equity of an issuer may not be material to the performance of the bonds of the same issuer. The work of the Sustainability Accounting Standards Board has helped to provide a framework to consider materiality, and increasingly we are seeing portfolio managers using ESG-related research to drill down to identify specific material issues rather than just using broad ESG scoring.

*Jason Milne, Vice President,
Corporate Governance & Responsible Investment at RBC Global Asset Management*

HEDGE FUND FIRMS FACE CHALLENGES IN IMPLEMENTING RESPONSIBLE INVESTMENT STRATEGIES

Hedge fund firms are faced with several challenges when looking to incorporate responsible investment into their investment strategies. The two most commonly cited challenges by the firms that we surveyed were “inadequate methodologies for the calculation of sustainability risks” (45%) and the “lack of relevant disclosures from companies” (44%). These two challenges go hand-in-hand. Without companies publicly disclosing data that shows their performance on ESG issues, many firms may be hard-pressed to find a way to evaluate the environmental or social impact of a potential investment.

However, there are now several initiatives under way from organizations such as the GRI Standards,²⁴ the Sustainability Accounting Standards Board (SASB)²⁵ and the Carbon Disclosure Project (CDP)²⁶ to encourage more companies to report on such things as carbon emissions, gender diversity, and employee compensation. Even companies such as ExxonMobil are embracing these kinds of disclosures, in large part due to continued pressure from investors demanding that such companies study the impact of their businesses on climate change.²⁷

It is widely accepted that there is an enormous disparity in the methods being used by asset management companies to integrate the practice

of responsible investment, and in particular ESG analysis into investment decisions. While the need for improved measurement is commonly cited as one of the biggest barriers in the responsible investment industry, it's far from the only such obstacle.

Approximately a third (35%) of respondents mentioned that they were skeptical about the viability of their investments being able to generate double-digit returns when implementing responsible investment. Further, a quarter (25%) of survey respondents said that there was a lack of attractive investment opportunities when considering a responsible investment approach. Such concerns may fade as responsible investment becomes more common, and more research is done on its effects on portfolio performance.

The issues cited by respondents were fairly consistent across firms of different sizes, with a few notable exceptions. Smaller hedge fund firms were more likely to cite the potential costs of implementing responsible investment as a challenge. Mid-sized firms were mainly concerned about the lack of relevant disclosures that they might receive from companies, while larger firms were mostly concerned with the lack of access to robust data.

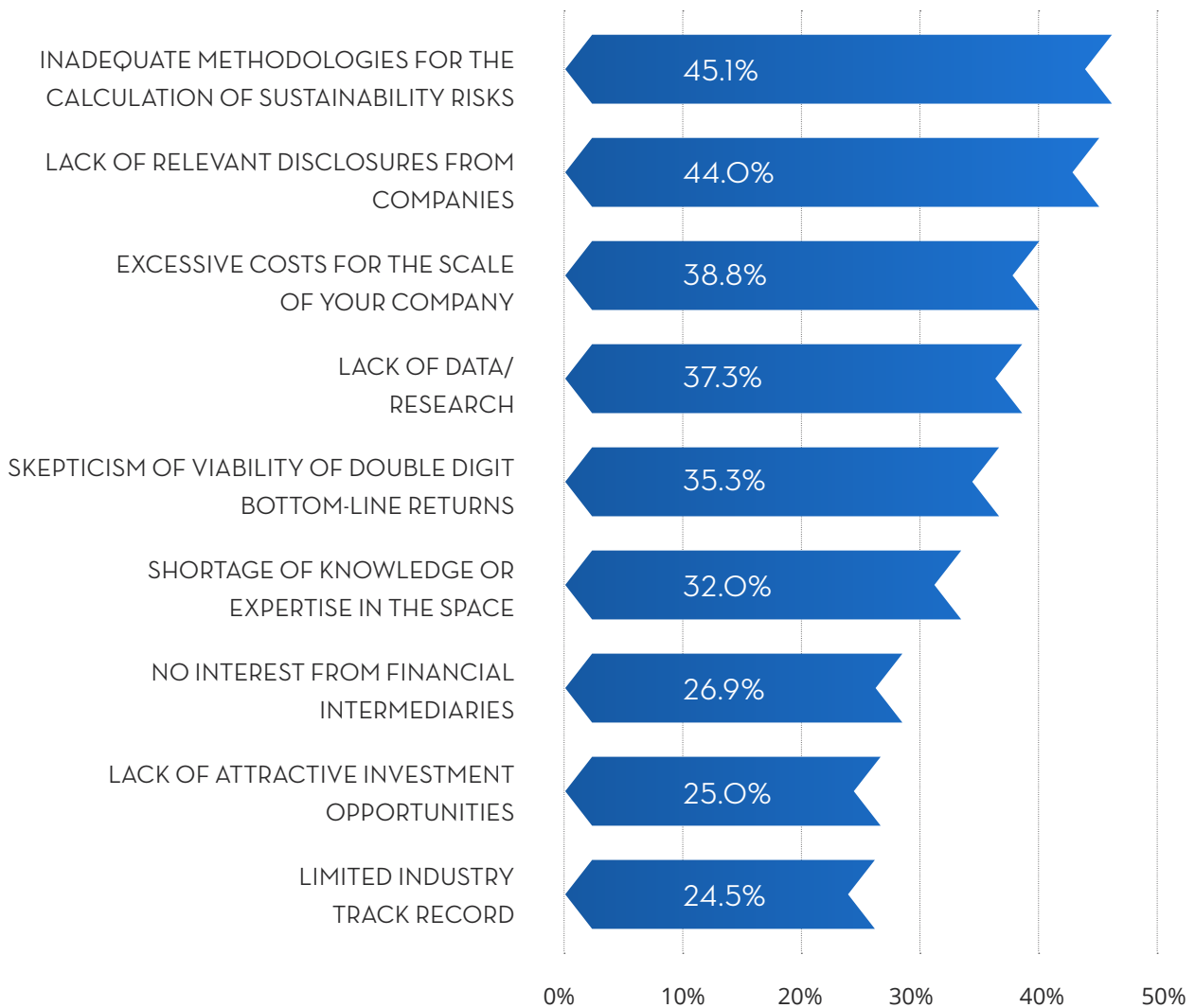
²⁴ Global Reporting. *About GRI*. <https://www.globalreporting.org/information/about-gri/Pages/default.aspx>

²⁵ SASB. *Sustainability Accounting Standards Board*. <https://www.sasb.org/>

²⁶ CDP. *Carbon Disclosure Project*. <https://www.cdp.net/en>

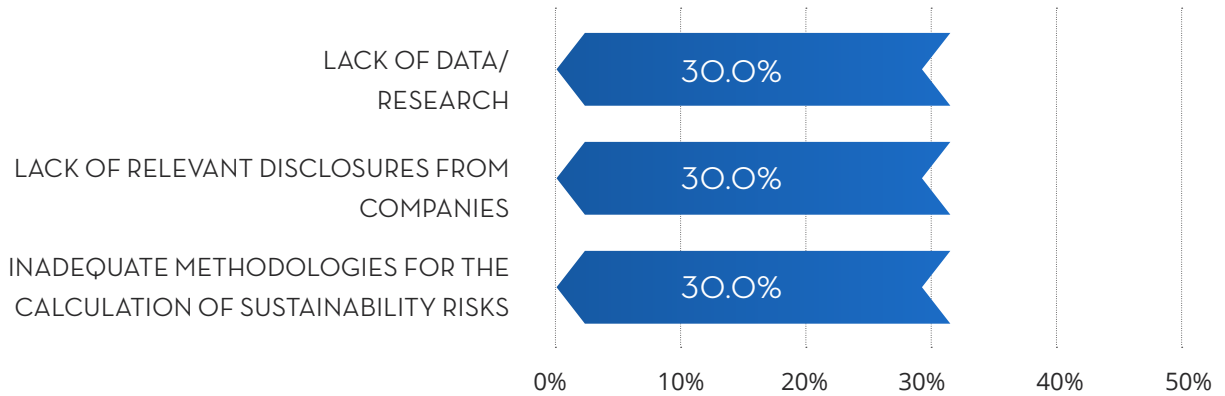
²⁷ ExxonMobil. (2018, February 2). *ExxonMobil Releases Energy & Carbon Summary and Outlook for Energy*. <http://news.exxonmobil.com/press-release/exxonmobil-releases-energy-carbon-summary-and-outlook-energy>

BIGGEST CHALLENGES TO ADOPTING RESPONSIBLE INVESTMENT STRATEGIES?

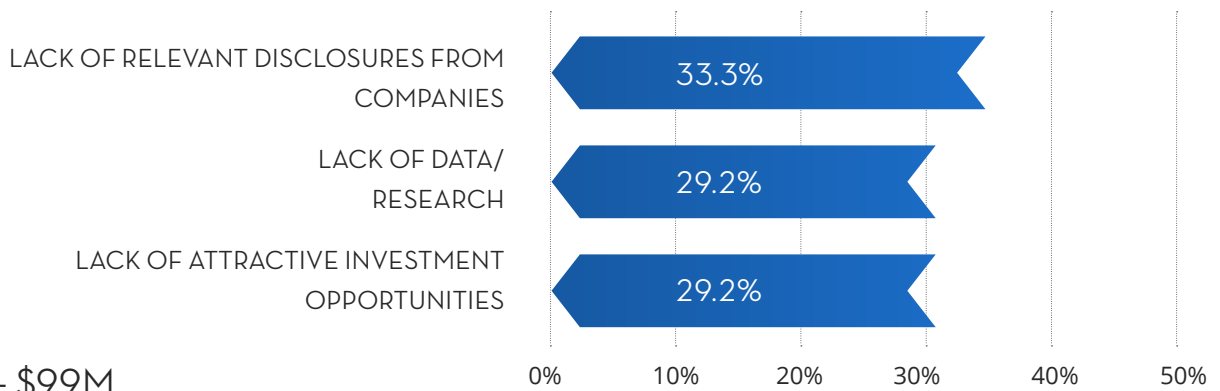


BIGGEST CHALLENGES TO ADOPTING RESPONSIBLE INVESTMENT STRATEGIES?

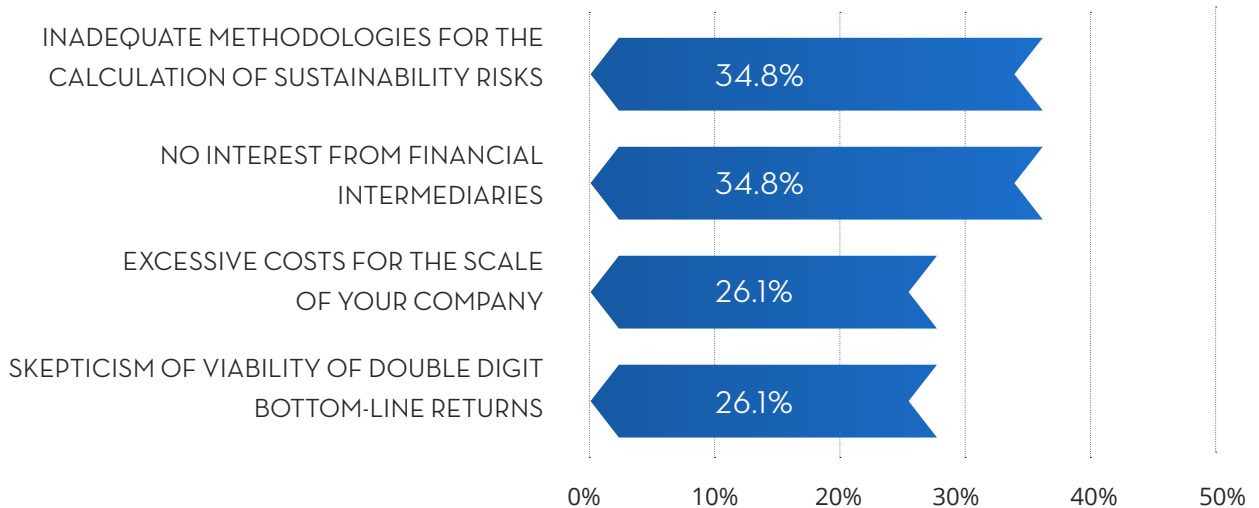
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HEDGE FUND MANAGERS ARE LOOKING TO EXPAND THEIR RESPONSIBLE INVESTMENT EXPERTISE

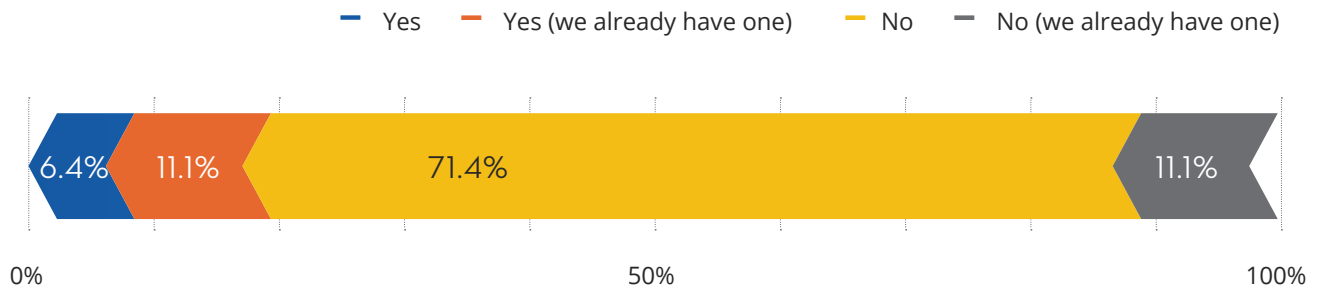
Nearly a third (29%) of all hedge fund firms surveyed have hired a responsible investment expert, or plan on doing so in the next 12 months. This is a clear sign that hedge fund firms are investing in the necessary infrastructure to incorporate responsible investment into their businesses, suggesting that responsible investment is indeed here to stay.

While hedge fund firms are experts at measuring financial performance, gauging the responsibility of a company's practices may be a different matter. This is because the results of adhering to such policies may require a long time to emerge, and because there is no single agreed-upon standard that is endorsed by the industry for measuring the 'responsibility' of a company's practices. For example, while an investment in a firm that provides renewable energy to a developing country may contribute positively to the environment, it could take a decade or longer to deliver both the financial returns as well as the desired environmental impact and related positive social effects.

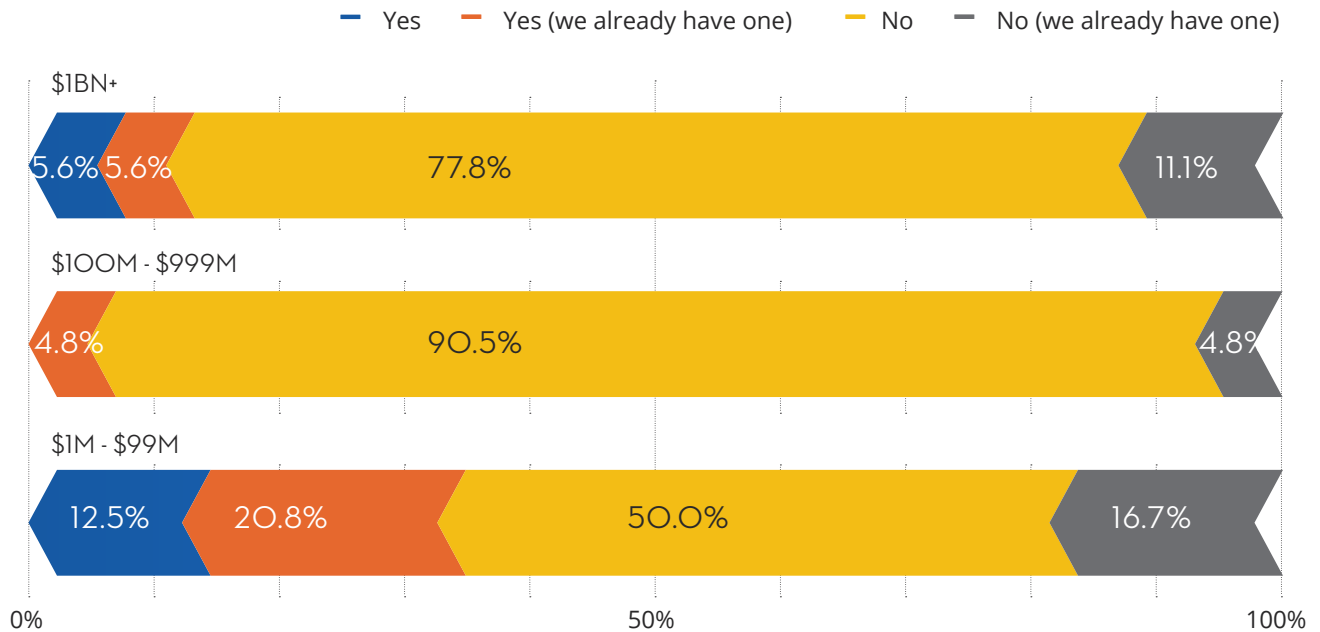
Responsible investment experts are more than just experts in evaluating potential investment opportunities: they are experts in talking to investors and explaining how the impact of adopting responsible investment is being measured. With more investors demanding that their asset firms have responsible investment capabilities, this expertise is likely to become even more important over the coming years.

Indeed, several of the hedge fund firms cited in this report, have recently announced additions to their responsible investment teams. The competition to hire such talent is likely to be a fierce one, with many institutional investors, banks, private equity firms and other asset managers also looking to augment their responsible investment expertise.

HIRING RESPONSIBLE INVESTMENT EXPERTS IN THE NEXT 12 MONTHS?



HIRING RESPONSIBLE INVESTMENT EXPERTS IN THE NEXT 12 MONTHS? (BY AUM)



CONCLUSION

With over \$3 trillion in assets under management and connections to some of the most influential investors in the world, the hedge fund industry has an opportunity to influence the conversation on responsible investment.

Investing more capital according to responsible investment principles is a good start. The UN estimates that achieving the 17 Sustainable Development Goals (SDGs) by 2030 will require \$5-\$7 trillion of investment each year. These goals include everything from “ending poverty in all its forms” (goal 1) and “achieving gender equality” (goal 5) to “ensuring sustainable consumption and production patterns” (goal 12) and “taking urgent action to combat climate change” (goal 13).²⁸ Even with traditional asset management firms committing increasing amounts of capital to responsible investments, more investment is still needed. Hedge fund firms can play a role in helping to close the funding gap.

However, the most important role for hedge fund firms may be in helping to solve some of the structural challenges currently plaguing the responsible investment industry, such as a lack of standardized ESG metrics. The hedge fund industry has a well-earned reputation for being

Meeting the UN Sustainable Development Goals by 2030 will require an estimated **\$5-\$7 trillion** in investments per year²⁹

at the forefront of some of the biggest trends disrupting financial services, from creating new investment products and entering new markets to embracing quantitative-driven trading. This kind of ingenuity and willingness to pioneer is crucial to the success of the responsible investment movement.

The adoption of responsible investment in the hedge fund industry is still in its early stages, and it will take a large degree of trial and error to determine which approaches work and which still need to be pioneered. Continuing the dialogue around responsible investment is necessary for industry adoption to continue growing. No single investment firm can solve all these challenges on their own, but—together—the hedge fund industry just might.

²⁸ United Nations. *Sustainable Development Goals*. Published by United Nations Development Programme. <http://www.undp.org/content/undp/en/home/sustainable-development-goals.html>

²⁹ United Nations. (2014). *World Investment Report 2014*. Published by the United Nations Conference on Trade and Development (UNCTAD). http://unctad.org/en/PublicationsLibrary/wir2014_en.pdf

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ABOUT AIMA



The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with more than 1,900 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than \$2 trillion in hedge fund or private credit assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 100 members that manage \$350 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, www.aima.org.

ABOUT THE CAYMAN ALTERNATIVE INVESTMENT SUMMIT (CAIS)



The Cayman Alternative Investment Summit (CAIS) is an annual global conference designed to help shape, guide and sustain a vibrant alternative investment industry and provides a platform for the industry to share ideas, insights and networking opportunities. Hosted by Dart Enterprises, CAIS is a not-for-profit event dedicated to advancing philanthropic efforts both in the Cayman Islands and internationally. For more information, please visit www.caymansummit.com.