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Responsible Investment in Hedge Funds

The Growing Importance of Impact and Legacy

White Paper | May 2019

Investing responsibly

Responsible investment (RI) is among the most prominent themes in asset management today, both across the board and in the hedge fund sector specifically. Investors and managers are paying ever more attention to the integration of environmental, social, and governance (ESG) factors, mirroring the concerns of wider society.

Companies are increasingly judged on their environmental impact, not just their profitability. Individuals are thinking about their legacy in terms of the climate and social issues, not just their finances. The financial services sector has an opportunity to direct investors toward the types of places that they want to put their money, but exactly how to do so is not necessarily clear at this stage.

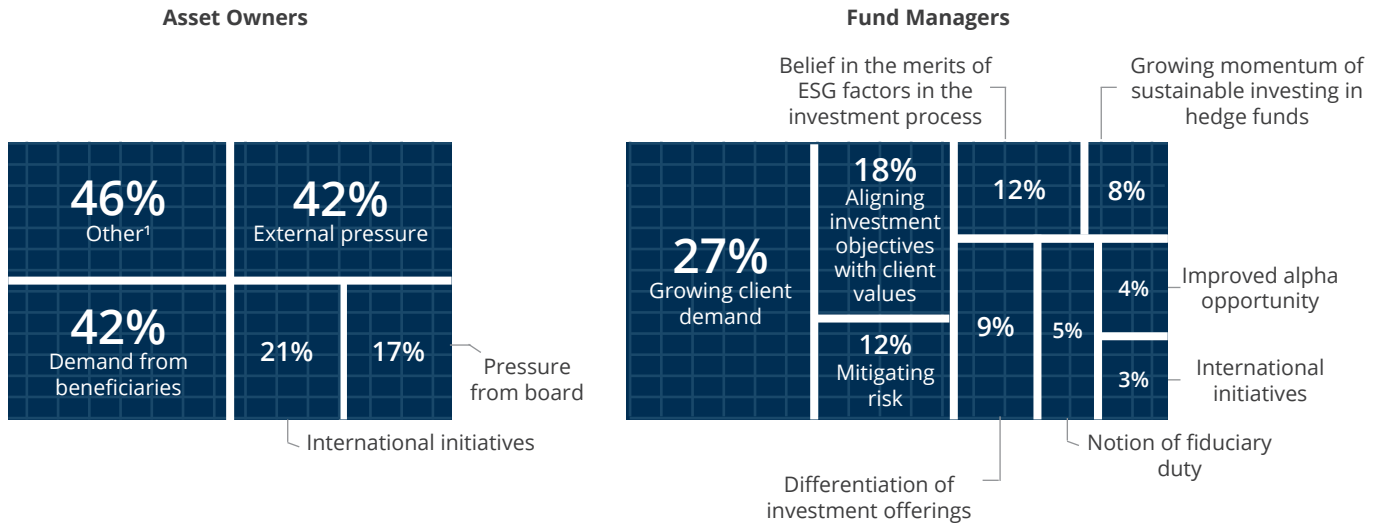
Even the language can be confusing. The terminology varies—ESG, RI, sustainable investing—and market participants must seek a common understanding of what they are trying to achieve. As the space evolves, things should become clearer. Regulation and standardization will help asset owners and asset managers focus their investments and ensure that both parties feel they are investing in a responsible manner. For now, though, the challenge is to determine what ESG could entail for hedge funds.

Our surveys

To get a sense of where the hedge fund industry is currently positioned in terms of ESG, during January and February 2019 Cerulli partnered with the UN-supported Principles for Responsible Investment to launch two unique surveys for hedge fund managers and asset owners globally. The hedge fund survey, with 42 respondents, gave us insight into how managers are positioning themselves with regard to responsible investment. The asset owner survey, with 27 respondents, gave us insight into how important RI practices are in the hedge fund sector, as well as how asset owners are approaching the issue and what they want to see from the industry.

EXHIBIT 1

Asset Owners' and Fund Managers' Views on the Key Drivers of Responsible Investment in Hedge Funds, 2019



Source: Cerulli Associates in association with the UN-supported Principles for Responsible Investment.
 Analyst Note: ¹Includes better financial returns, pressure from investors, and regulation

Our findings

The asset owners we surveyed emphasize the importance of including ESG considerations in investment management agreements. They also want to see increasing use of technologies such as artificial intelligence (AI) and machine learning to improve the gathering, granularity, and frequency of ESG data.

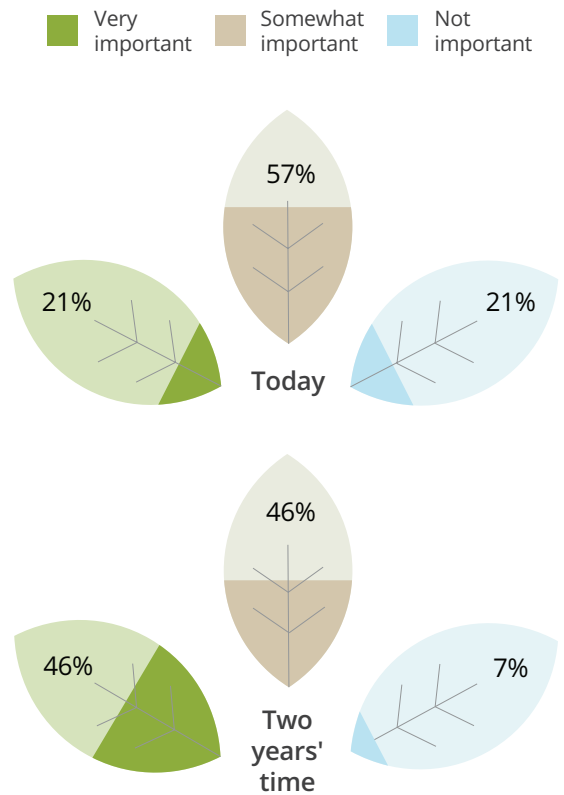
The hedge fund managers we surveyed report that they face increasing demands from asset owners that want improved ESG reporting standards and increased commitment to ESG integration and engagement. Asset owners also want hedge funds to integrate ESG factors into their investment decision-making in a sophisticated way.

Asset owners are increasingly asking hedge funds to make their RI policies more transparent and show how they integrate ESG considerations into their investment decisions. Of the hedge fund managers Cerulli surveyed, 27% said that growing client demand is the key driver for increasing ESG integration in the hedge fund industry (see Exhibit 1).

Like their peers in other asset classes, investors in hedge funds want to know the impact of their money—for good and bad. Focusing on extra-financial returns is still rare, but many asset owners are keen to limit the negative impact of their investments. Despite growing evidence that investing responsibly does not necessarily have a financial cost attached (and can, in fact, boost returns), 74% of our asset owner respondents are still not sure whether ESG factors have a positive effect on their investments (see Exhibit 3).

EXHIBIT 2

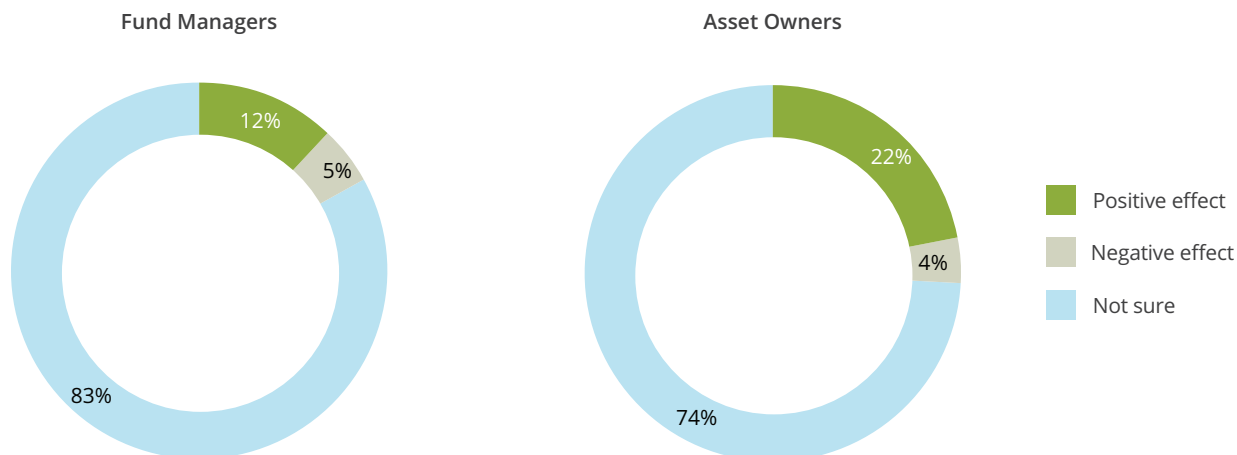
Asset Owners' Views on the Importance of Integrating Responsible Investment Practices into Hedge Funds Today and in Two Years' Time, 2019



Source: Cerulli Associates in association with the UN-supported Principles for Responsible Investment.

EXHIBIT 3

Fund Managers' and Asset Owners' Views on Whether the Effects of ESG Factors on Risk-Adjusted Returns are Positive or Negative, 2019



Source: Cerulli Associates in association with the UN-supported Principles for Responsible Investment.

Providing ESG options

Asset managers' approach to ESG investing has followed a broadly standard pattern. The first step is simple exclusions: avoiding investing in so-called "sin stocks" such as alcohol, tobacco, and arms. A more sophisticated approach is to employ a "best-in-class" strategy, identifying and investing in companies that perform better than their peers in terms of ESG criteria. The next step is full integration, with managers viewing all investments, not just individual RI-branded products, through the lens of ESG. Finally, some managers may go as far as impact investing, aiming specifically to do good, potentially at a financial cost.

The hedge funds we surveyed employ a wide range of RI strategies, with ESG integration, used by 61% of respondents, the most popular (see Exhibit 4). Hedge funds must work with their investors to determine what approach to ESG is best for them. A "one-size-fits-all" approach will not be enough: managers will need to be able to offer a range of options, including a combination of approaches. If taking a thematic approach, they may also choose to focus on environment, social, or governance factors rather than attempting to cover all of them in one product. It is important that, when devising their ESG strategies, hedge funds engage with their clients, building relationships and agreeing on the best approaches

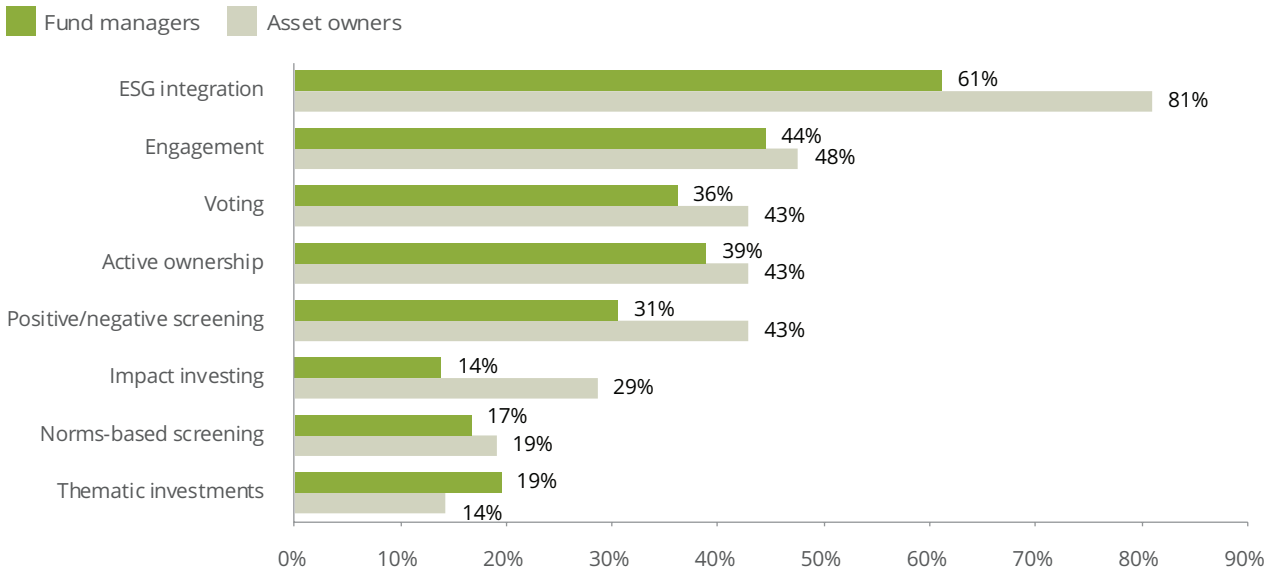
Many asset owners are well aware of the most high-profile issues that RI approaches seek to address, including climate change, carbon use, and sustainability. When hedge funds are devising their ESG strategies, they may want to consider the UN's Sustainable Development Goals (SDGs), which can provide a useful framework. These long-term goals, which came into effect in January 2016, include broad targets such as ending poverty and ensuring access to clean energy for all.

The SDGs are not a one-off solution, however. Because they are so broad, they can be tough to measure—and some are not investable. One option for hedge funds is to dig below the 17 main goals to the 169 sub-goals, which are significantly more granular and easier to integrate into an investing strategy.

Our hedge funds survey found that only 2% of respondents have SDG-related products, although a further 17% plan to launch such products. The remaining 81% should consider doing so as well (see Exhibit 5).

EXHIBIT 4

The Responsible Investment Approaches Used by Asset Owners and Fund Managers for Hedge Funds, 2019



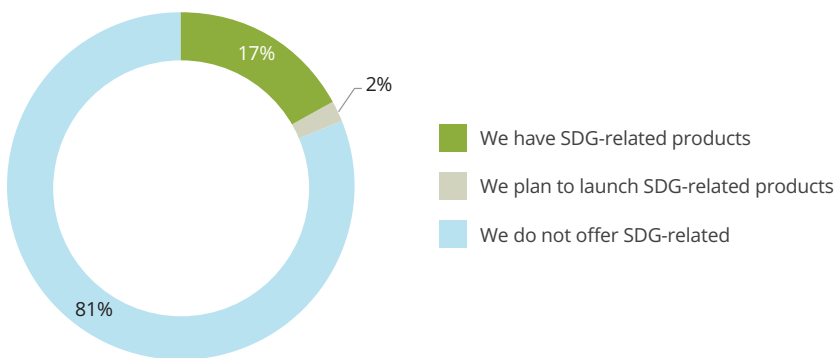
Source: Cerulli Associates in association with UN-supported Principles for Responsible Investment.

Hedge funds can incorporate ESG investing across many strategies and asset classes—they have a range of options. Our survey found that equity long/short is the strategy where the most respondents (46%) currently incorporate RI criteria and plan to do so in two years’ time (65%). The hedge funds we surveyed plan to increase their integration of ESG into all of the asset strategies, which suggests they are moving in the right direction, but there is plenty of room for improvement (see Exhibit 6).

The reason that many hedge funds are focusing on implementing RI in their equity long/short strategies is that it can be easier to integrate ESG criteria into investment decision-making in this area. Managers such as Nordea, Brummer & Partners, and Man Group have developed proprietary research structures to assess companies’ ESG performance. They can then identify the strong performers that are suitable for long positions, as well as the weak performers that are more suited to shorting.

EXHIBIT 5

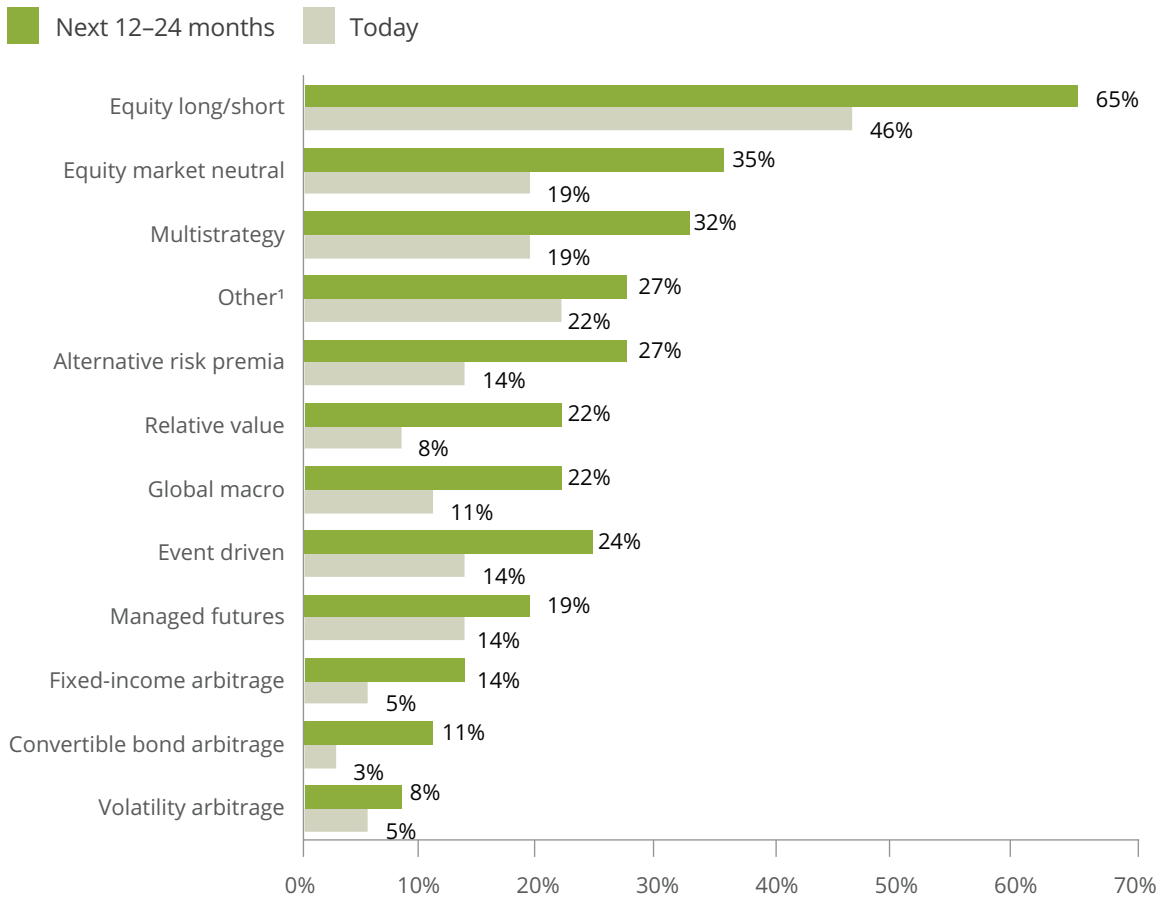
Hedge Funds’ Development of Strategies Related to the Social Development Goals, 2019



Source: Cerulli Associates in association with the UN-supported Principles for Responsible Investment.

EXHIBIT 6

Fund Managers' Incorporation of Responsible Investment Criteria in Hedge Fund Strategies Today and in the Next 12–24 Months, 2019



Source: Cerulli Associates in association with the UN-supported Principles for Responsible Investment.

Analyst Note: ¹Includes credit funds and answers depicting incorporation across all hedge fund strategies.

For other strategies, the best way to integrate sustainability may be less obvious. However, hedge funds can find a way to tailor RI to their approaches. For example, macro strategies can incorporate factors relating to ESG, particularly governance. Hedge funds should keep in mind that asset owners increasingly expect those managers that do not integrate RI considerations into their investment process to have a good explanation for not doing so.

The role of education and communication

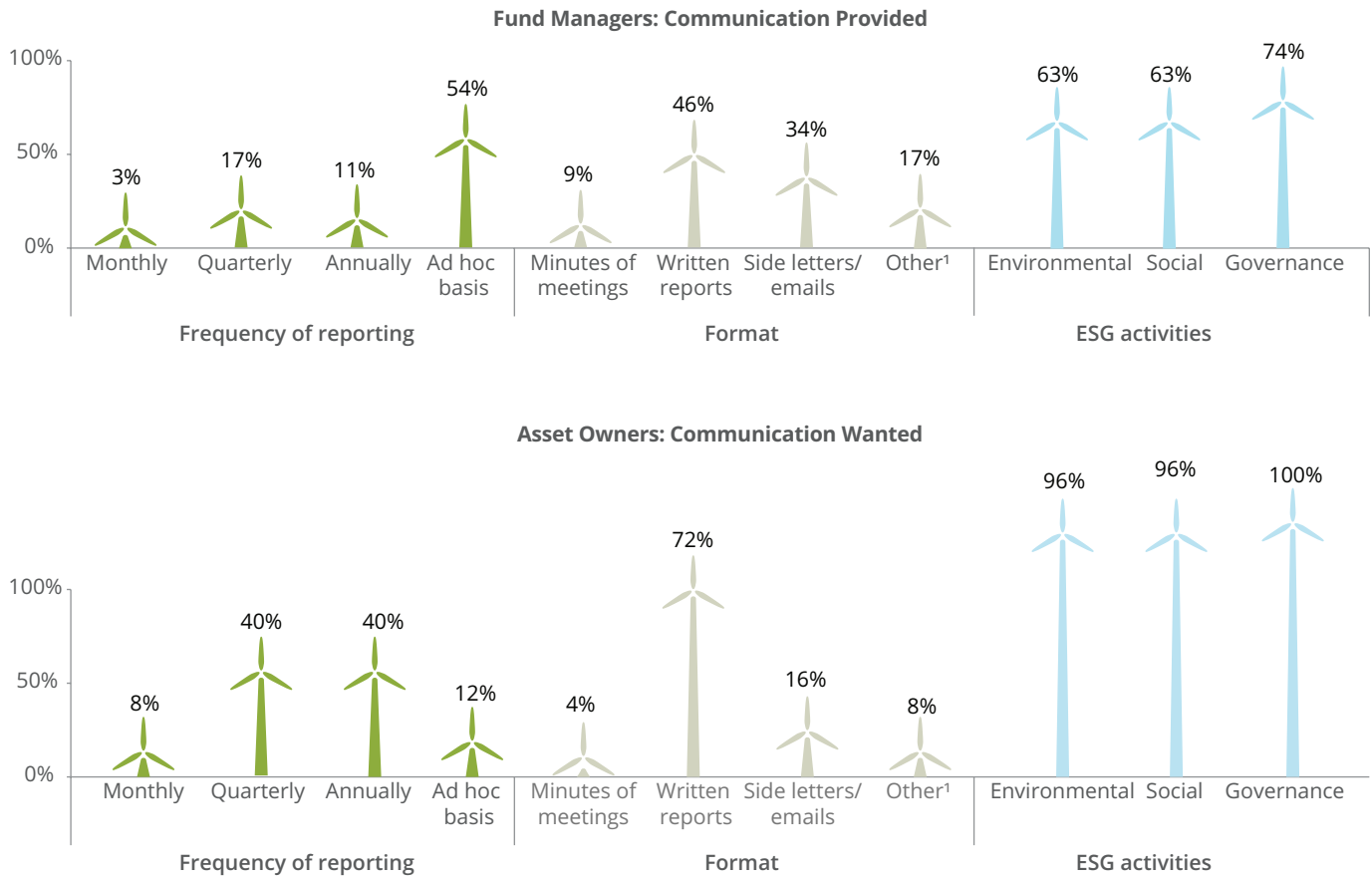
Many asset owners will have their own definitions and expectations of ESG. Others, however, will need guidance on how best to adopt RI approaches. Hedge funds can explain the detail of ESG to clients and outline the different ways to invest responsibly. For example, exclusions are easy to understand and make sense on a basic level, but are not the only way.

Hedge fund managers that adopt more sophisticated approaches to RI must be able to explain that it is not necessarily just about identifying “good” and “bad” companies—the direction of travel is important. Managers employing a best-in-class strategy may be investing in companies that asset owners would expect to be excluded, such as oil and gas firms. However, if those companies are in the process of embracing renewable energy, they may meet managers’ criteria for inclusion in ESG funds. Hedge funds should be prepared to explain and justify such decisions to their clients.

If hedge funds do opt to focus on investing in businesses that aim to make the world cleaner, safer, or healthier, they will have plenty of choice. They will be able to identify many mid-cap options in a global marketplace covering renewables, electric vehicles, the internet of things, healthcare, education, and other sectors. It is a truism that RI is not just about feeling good: returns can be better from ESG investments.

EXHIBIT 7

Hedge Funds' Communication with Investors Regarding ESG Considerations and Asset Owners' Communication Preferences, 2019



Source: Cerulli Associates in association with the UN-supported Principles for Responsible Investment.

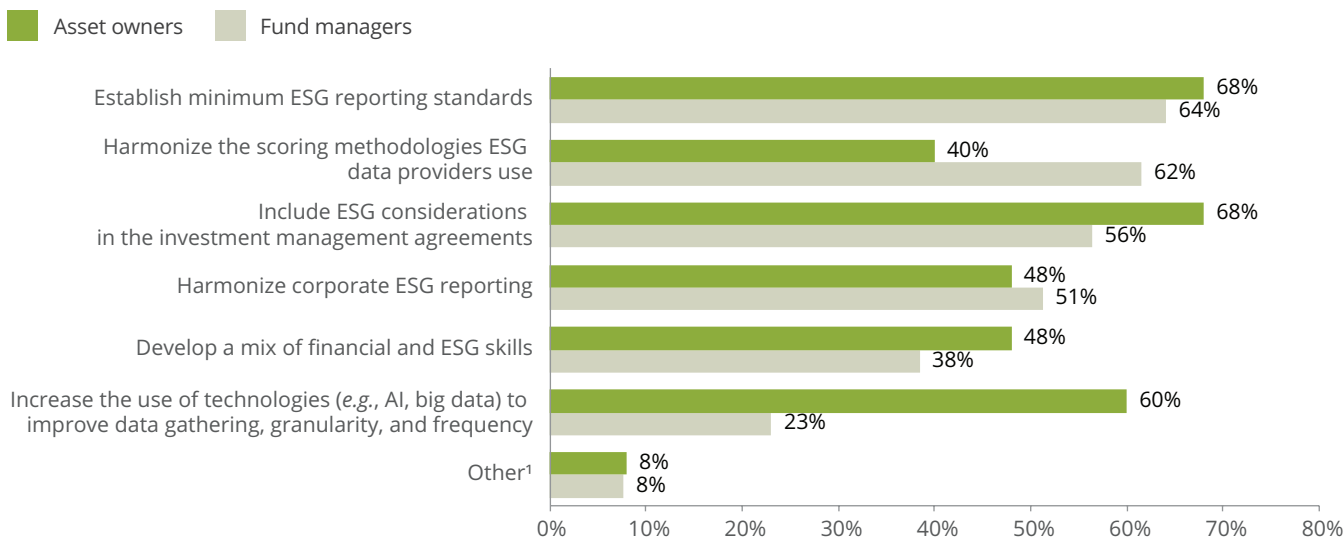
In addition, by employing ESG strategies, hedge funds can help their clients avoid the possibility of serious reputational damage from investments in “bad” companies. Limiting reputational risk is crucial: investing in the wrong places can leave asset owners open to harm in the event of environmental catastrophe such as BP’s Deepwater Horizon oil spill or governance issues such as VW’s emissions scandal.

A further point to consider is that ESG regulation is coming and it will be better to be out ahead of it than to be forced to react. Hedge funds can help investors navigate the issue and those firms with solid ESG strategies will be well placed to do so. Similarly, the world is moving toward a low-carbon future and hedge funds can give investors access to low-carbon companies.

Throughout the process of implementing ESG approaches, clear communication is vital. Asset owners’ survey responses suggest that hedge fund managers’ annual reporting is currently insufficient: 40% of the asset owners we surveyed would like to receive information about hedge fund managers’ ESG activities and risk assessments quarterly and 8% would like that information monthly. Nearly half (46%) of the hedge fund managers we surveyed provide written reports and around one-third (34%) provide side letters/emails, but that is clearly not enough either (see Exhibit 7). Asset owners want to receive written reports on all of managers’ ESG activities.

EXHIBIT 8

Hedge Fund Managers' and Asset Owners' Views on What Needs to be Done to Advance Responsible Investment Within the Industry, 2019



Source: Cerulli Associates in association with UN-supported Principles for Responsible Investment.

Analyst Note: ¹Includes harmonizing ESG data, increasing transparency, and focusing on data availability and integrity.

Act now

Cerulli believes that hedge funds—and asset managers more generally—have a role to play in countering the challenges the world faces by deploying capital wisely and in the best places. RI is an opportunity to show the positive side of finance, while providing clients with good returns.

Asset owners and managers are increasingly aware that RI goes beyond just exclusions and does not mean sacrificing returns. Any investor whose sole purpose is financial returns should take ESG factors into account—failure to do so will put those returns at risk. However, Cerulli believes that hedge funds should be moving beyond this type of thinking.

Asset managers can divert capital to the right places. In time, the value of a business will be its impact on societal issues; asset owners recognize this and hedge fund managers have a role to play in helping them make good choices.

Engagement is a key theme: companies must be part of the solution to challenges such as climate change and inequality. Hedge funds can help to ensure that the companies their clients invest in are good bets in financial and reputational terms. They can help individual and institutional investors secure legacies that incorporate financial, climate, and social considerations—asset owners do not want to choose between these criteria and hedge funds can make sure they do not have to.

Although communication between asset managers, businesses, and wider society is not easy, it will be central to the rise of RI. Incorporating ESG factors into hedge fund strategies will be a long-term journey for all concerned, but the financial and nonfinancial returns will be worth the effort.



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