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NORDSIP
NORDIC SUSTAINABLE INVESTMENTS

ESG
IN ALTERNATIVE INVESTMENTS

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INTRODUCTION

HedgeNordic is the leading media covering the Nordic alternative investment and hedge fund universe. The website brings daily news, research, analysis and background that is relevant to Nordic hedge fund professionals from the sell and buy side from all tiers.

HedgeNordic publishes monthly, quarterly and annual reports on recent developments in her core market as well as special, indepth reports on "hot topics".

HedgeNordic also calculates and publishes the Nordic Hedge Index (NHX) and is host to the Nordic Hedge Award and organizes round tables and seminars.

PUBLICATION PLAN 2021:

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Editor´s Note...

The Nordics´ Firm Grip on ESG

With their world-renowned commitment to sustainable investment, the Nordic countries have been at the vanguard of the revolution in Socially Responsible Investment (SRI) implementation for many years, still routinely appearing atop global sustainability rankings.

This is not accidental. The relative cultural, historical and socioeconomic homogeneity of the rump Nordic countries, in tandem with their strong, entrenched social welfare models allowing for considerable bargaining power, power-sharing and participatory approaches, have created the favourable conditions for mutually reinforcing approaches to Corporate Social Responsibility (CSR) and, consequently, SRI. The scope of CSR has expanded dramatically across the investment universe over the years, now covering aspects of business operations as diverse as corruption in supply chains, local environmental efforts and the broadly ethical composition of portfolios. This has helped to strengthen the introduction of relatively harmonized regulatory frameworks and standards aimed at promoting and integrating Economic, Social and Corporate Governance (ESG) across the Nordic region, of which SRI is an increasingly clear and vocal expression.

The Nordics have a global reputation for excellent performance in SRI-related rankings, such as the Human Development Index and the Environmental Performance Index, with their business communities and government policies often held up as an

example to other countries. In addition, Sweden, Denmark, Norway and Finland all routinely feature in RobecoSAM's annual Country Sustainability Ranking, which is based on 17 environmental, social and governance indicators. Finland, a latecomer to SRI by comparison with its Nordic peers, has also been rapidly making up the difference. The Nordics also often feature heavily in the Dow Jones Sustainability Index, alongside other leading global sustainability indices.

In turn, the alternative investment space, and hedge funds in particular, typically stands out as being entrepreneurial, opportunistic and fast-moving towards new trends and opportunities. At the same time, we all know, unfortunately, that hedge funds do not enjoy the best of images and reputation, the least since 2008. Being "good, caring investors" therefore seems such a reasonable and obvious route to redemption. There is plenty of academic evidence showing that being a responsible investor has a positive effect on risk mitigation and performance. Notably pressure from investors to comply with ESG standards should be a strong incentive to do so as well. So why is the space seemingly slow and resistant to take on, and create for itself a better ESG profile? Or are we falling into the misconception trap?

Hedge fund managers, indeed, have stepped up their ESG efforts, with the advance primarily driven by institutional investors and their consultants. This is according to the hedge fund managers' survey conducted by AIMA, CAIA, CREATE-Research and KPMG, which was published earlier this year. This study will be introduced in an article later in this paper.

We are pleased to have been able to span a wide range in the maturity in managers' efforts, from early adapters active in the field for years or decades to those taking their first steps. Alternative investments include a good breadth and depth of strategies with their unique challenges and opportunities to improve their ESG-ability. At times in small steps, as not all strategies are born equal to overcome their challenges and hurdles to a more sustainable investment process. More recent innovations such as ESG-futures contracts are certainly supporting efforts even among strategies where a sustainable approach seemed more challenging, such as the Managed Futures space, for example.

And indeed, the first contribution in this special report is by Dutch CTA pioneer Harold de Boer, where he is "Embracing Diversity of Opinions and Variety of Approaches Regarding Responsible Investing." Emerging markets, too, for some time, seemed a more challenging arena for sustainable investors. PineBridge's John Bates looks into "How ESG Can Enhance Outcomes in Emerging Markets Fixed Income." Staying on subject, Jens Nystedt and Oliver Faltin-Trager at Emso Asset Management claim "EM ESG Fixed Income Strategies Pass Their First Stress Test," while Declan O'Brien of UBS Asset Management shows how "ESG and Infrastructure – Moving Towards a Better Future." Man Group's Robert Furdak tells the "Short, But Sweet" story on Returns from Irresponsible Companies. CARN Capital's Melanie Brooks Cautions to "Mind the Gap from Exclusion to ESG to Sustainability."

Jack Inglis' contribution takes us back to the roots as he reminds us of "The Goal of Sustainable Finance," while CME Group describes the "Remarkable Progress, Evolving Indices and Futures Growth" and finally, we look into the before-mentioned study on "Hedge Fund Investors Driving ESG Uptake."

I managed to get through this without mentioning Covid – good on me!

KAMRAN GHALITSCHI

CEO & PUBLISHER HEDGENORDIC

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From Mortgages to Wheat – Part 1

Embracing Diversity of Opinions and Variety of Approaches Regarding Responsible Investing.

By Harold de Boer – Transtrend

Harold de Boer,
Managing Director &
Head of R&D – Transtrend

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“Responsible investing should start in our own backyard.”

- » Responsible investing, in our view, is about making conscious choices in every step of the investment process.
- » We should be careful with creating an objective and uniform definition of what is ‘ESG’.
- » What we invest in matters, but the way of investing and its impact surely matter just as much.

Transtrend has had a Responsible Investment policy in place since 2010. It was not coincidentally written soon after the Credit Crisis, which provided a stark reminder of the interdependence between our financial markets and our society. While some in the financial sector no doubt felt like this crisis happened to them, in reality we (the financial sector) ourselves were to a very large extent responsible for it. And its consequences were severe: people lost their homes, their jobs and their savings, banks were bailed out by tax payers’ money, and the resulting extremely low interest rates are still hurting people’s ability to provide for their old age. The wave of criticism of the industry that followed was completely understandable and justified. Financial firms do not necessarily have to behave as charitable organizations, but we do not deserve our pay if we do not feel responsible for our own actions.

Back in 2010, Responsible Investment policies mainly focused on evaluating companies based on certain environmental, social and/or governance (ESG) criteria. Which, if you think about it, is ironic at the very least given the mess the financial industry managed to make in its own backyard. Responsible investing should therefore start in our own backyard.

A recurring point of discussion with respect to responsible investing is whether ESG considerations are in conflict with financial best interests. We have absolutely no doubt that responsible investing will benefit investors. Surely in the longer run. The Credit Crisis painfully proved that irresponsible investing will dramatically hurt most investors.

The crisis taught us something else as well. At that time, Responsible Investment policies tended to focus on avoiding thorny issues like tobacco, weapons or child labor, often through exclusion lists. However, at the root of the Credit Crisis was a mortgage bubble in the United States. In itself there is nothing wrong with providing mortgages. It only ran out of control when banks and investors started to massively invest in these mortgages through collateralized debt obligations (CDOs). It seemed that many had no idea what they were really investing in. The most important thing seemed to be that these CDOs were triple-A rated. The mortgages themselves didn’t harm society – the rather naïve and irresponsible way of investing in them did.

This is one of the reasons why we believe that Responsible Investment policies should go beyond merely evaluating companies based on (standardized) ESG criteria and utilizing exclusion lists. It is entirely possible to apply such practices without taking responsibility for the choices made. Especially now that ‘ESG’ is such a hot topic among investors, this could prove especially counterproductive. We believe there is a real risk of ‘ESG’ becoming the ‘CDO’ from 15 years ago. The investment community is already searching for an objective and uniform definition of what is ‘ESG’ and an objective and uniform way of measuring it. We do understand this desire, but we should be careful. Do we really want to see triple-A ESG-ratings (again)?

Responsible investing, in our view, is about making conscious choices in every step of the investment process, taking into account:

1. The role of the underlying asset (financial instrument, commodity, company, etcetera) in society.
2. The role of the market for (derivatives on) those assets.
3. The particular investor’s role in that market.

This will probably result in different choices made by different market participants. Which is only healthy. Different participants fulfill different roles, in society as well as in the market. And just as important, different people have different beliefs. We should embrace this diversity. A healthy adaptive society requires that people can, and do, act upon their own beliefs.

Historically, large changes in society would not have happened if everyone would have waited for consensus, or, even worse, general acceptance. Forerunners took the lead in for instance the abolition of slavery, general education, industrialization, and the digital revolution. And the large energy transition that is happening right now is also led by activist forerunners. Historically, successful investors tended to be part of this group. This is another reason why we do not believe in the effectiveness of general ESG standards implemented through generally accepted definitions and measures. Standards stifle progress.

Let’s apply our Responsible Investment framework to the main ingredients of the Credit Crisis – mortgages and CDOs:

> "A healthy adaptive society requires that people can, and do, act upon their own beliefs."

1. The role of the underlying asset will be clear: mortgages offered low and middle income families the opportunity to buy a home. This principle was embraced by both sides of the political spectrum in the United States.

2. The fact that these mortgages could be traded on a market – separately or bundled into CDOs – offered lenders the opportunity to offset their risk. In itself, this is an important role of the market. But one could have questioned whether this specific market wasn't becoming too technical and miraculous at the expense of transparency.

3. And an investor's role in that market? The answer to this question is different for every market participant. But which participant's role is it to buy something just because it is triple-A rated? (And who should have addressed this issue?)

This same set of considerations can be applied to every other investment. For instance in wheat. The role of this 'asset': wheat feeds a large part of humanity. Not many will see harm in that. Does this, however, justify a passive long-only investment in wheat futures, either directly or as part of a broader investment in commodities? This depends on the answer to another question: would such an investment contribute to feeding the world? Different investors will have a different view on this, ranging from:

a. yes, positive impact;

b. no (significant) impact;

c. no, negative impact;

d. not clear / haven't thought about this / no idea.

We have our own stance on this particular question, and those of you who wish to know more may read the *"Trading in risk"* section of our Responsible Investment policy. However, our view on this question essentially isn't that relevant. From a responsible investing point of view it suffices that only investors who believe that a) or b) is the case invest in wheat futures in this particular way. And even more important,that investors who would answer c) or d) refrain from doing that.

How ESG Can Enhance Outcomes in Emerging Markets Fixed Income

By Kamran Ghalitschi – HedgeNordic

Throughout the low-interest-rate period and most recently with disruptions related to the coronavirus pandemic, investor interest in environmental, social, and governance (ESG) factors has continued to accelerate, both as a way to express their philosophies through portfolio allocations and to potentially generate better investment outcomes. In emerging market fixed income, PineBridge claims, the full integration of ESG analysis into their investment processes has enabled the asset manager not only to isolate potential downside risks, but also to spot critical inflection points in a company's lifecycle – uncovering compelling opportunities in the process. John Bates, Head of Emerging Markets Credit Research at PineBridge Investments, discusses some commonly asked questions about ESG investing in this asset class with HedgeNordic and explains how PineBridge seeks to deliver better results through ESG analysis.

"Our clients normally express their level of ESG tolerance, and we are guided by this input when aligning our positioning."

Investors and asset managers are increasingly realizing that companies with strong environmental, social, and governance practices can help to mitigate financial risks, and may therefore perform better over the long run than those with weaker ESG policies. The idea is intuitive: Companies that comply with environmental standards may face fewer operational disruptions and avoid hefty fines. Robust corporate governance practices may mitigate losses from fraud and allow for sounder and more transparent decision-making at the top. Social responsibility is reflected in the quality and safety of a company's operations and products, and therefore affects demand. So, while many ESG practices may appear non-financial, they can have a measurable material impact on companies' credit fundamentals and default risk; factors that ultimately impact portfolio outcomes.

Institutional clients who look for strategies that integrate ESG analysis in their investment processes may be motivated by a variety of factors. The desire to measure their impact on the planet, or to align with specific beliefs. "As securities selectors, it's our responsibility to express our clients' philosophies or beliefs in the portfolios we manage", Bates argues.

Bates explains PineBridge´s approach to ESG in fixed income, stating that "for us, ESG analysis is not a box-ticking exercise, but a dynamic and disciplined process. As active managers, we look at each issuer in the emerging market universe. We gather data and score issuers according to a number of factors aligned with the UN Principles for Responsible Investment (PRI). These scores, together with our analysts' extensive research of credit fundamentals, are the basis of the team's decision whether or not to invest. We apply our proprietary scoring system uniformly across all emerging market fixed income strategies we manage. As of July 2020, we have more than 400 companies across emerging markets under active coverage, each with a full suite of ESG data."

"This level of data gathering is only possible with a dedicated analyst team that is constantly engaging with companies; kicking the tires, asking company management teams pointed questions, and recording the outcomes within their ESG scores," Bates believes.

An approach based on negative screening is suboptimal in Bates´ view. "Our focus in ESG analysis is risk identification and management. While we do use a weighted scoring matrix that analysts assign to each issuer, that is only one step in our credit selection process. We don't just buy the highest-ranked issuers and underweight the lowest-ranked," he explains.

Bates uses an example to highlight the case: "we analyzed one country's national power company, which has the lowest credit ratings, the highest spread versus its host country's bonds, and the highest-risk ESG score; all of which makes intuitive sense given that higher risk equals higher spreads. The national gas producer from another country, on the other hand, has a higher credit rating, a comparatively high-risk ESG score, and yet the lowest spread versus its host country's bonds. Several factors explain this anomaly, and as such, our investment decision goes beyond these scores."

Bates stresses that PineBridge does not simply walk away from lower-scoring companies. "Our clients normally express their ESG preferences, which guides our positioning. Moreover, we recognize growing indications that engaging with lower-scoring companies to improve on their ESG records, rather than screening out companies based on a point-in-time ESG metric, is a potential opportunity to generate alpha."

Strong evidence now suggests that the addition of an ESG framework does provide an extra layer of protection, especially in periods of market stress. However, the generation of stronger returns across all periods of a market cycle is still an open question.

The MSCI Emerging Markets Leaders Index, a capitalization-weighted equities index providing exposure to emerging market companies with high ESG performance relative to their sector peers, has shown similar return performance to an equivalent non-ESG index, albeit with much lower volatility.[1] In the real world, managing emerging market fixed income involves liquidity considerations that may limit an asset manager's ability to simply switch in and out of weaker investments in a time of crisis. "During the Covid-19 pandemic, for instance, we've found that companies with the weakest ESG scores performed the worst in the March selloff but were then the top performers in the second quarter", Bates observes. "So the answer, at least for now, is that comprehensive ESG scoring does not replace a traditional credit review process, but rather enhances it and helps provide a more forward-looking investment thesis."

Bates is convinced that ESG is not just another investment style fad. "ESG investing isn't like "fast fashion, we believe comprehensive ESG analysis will generate alpha over the long term."

The diversity of the investible market in emerging markets demands an active, credit-intensive, and selective approach, he believes. For Bates, this means going beyond relying on predetermined metrics in an index and asset managers must engage with company management teams to assess the corporate culture and controlling influences.

[1]*Source: J.P. Morgan, Bloomberg Barclays as of 30 June 2020*

> "We believe the growing evidence of alpha potential from ESG analysis will prove durable over the long term."

"It wasn't long ago that we were often asked only whether we had an ESG framework integrated into our investment process," Bates recalls and continues "today, we are increasingly called on to illustrate how we use it, provide evidence of the outcomes, and – most importantly – show how we are making an impact through our engagement" efforts with companies. The ESG lens trained on investment managers has grown increasingly powerful, a trend that will only accelerate amid mounting evidence that companies' strength in ESG measures can translate into stronger returns."

During the Covid-19 crisis, participants in all areas of investment have faced challenges to varying degrees, from asset owners to asset managers to investee companies and governments. Bates explains that a robust investment process has helped PineBridge to navigate the crisis so far and has deepened what was already a strong focus on ESG-related issues for the firm.

"ESG data for emerging market issuers has become more accessible in step with growing demand for investment vehicles that incorporate ESG, and products to meet this demand have increased. We expect these trends to continue if funds that incorporate ESG considerations deliver strong risk-adjusted returns, as we would expect – and as emerging market debt investors seek not only a more robust approach to managing risk but also a way to pursue impact investing without missing out on returns", Bates concludes.

EM ESG Fixed Income Strategies Pass Their First Stress Test

By Jens Nystedt and Oliver Faltin-Trager – Emso Asset Management

In recent years, ESG has commanded significant interest from investors across all asset classes, including emerging markets fixed income. As EM ESG fixed income mandates and benchmarks are still relatively young, the March 2020 market shock served as the first major stress test for such strategies. Overall, when compared to their non-ESG counterparts, we feel that the performance of these ESG mandates during the sell-off and the subsequent recovery will likely be an important driver for the pace of ESG asset growth and investor interest going forward.

Financial markets came under intense pressures in March as the world-wide lockdowns to combat the Covid-19 outbreak essentially shut down the global economy. EM fixed income assets were no exception to the pressures of Covid-19, and, as a result, they suffered significant losses as the overall shock was magnified by a poorly-timed oil price war between

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Russia and Saudi Arabia that weighed heavily on oil-exporting countries and their corporates. Market liquidity conditions were also quite challenging as market participants were forced to relocate to work from home setups or disaster recovery locations. This made it particularly challenging for EM to deal with large outflows, as many investors, particularly those that are retail based, headed towards the exit. In the months following, there was an unprecedented recovery across markets that was driven by the incredible fiscal and monetary stimulus actions from governments and major central banks. Looking back, the period from March to July gives a unique timeframe to analyze how ESG indices and mandates performed during a crisis and resulting market rebound.

Oliver Faltin-Trage
Portfolio Manager
Emso Asset Management

These mandates have grown exponentially in a very short time. J.P. Morgan's EM ESG benchmarks launched in April 2018, and within just two years, the benchmarks saw growth to over USD 13 billion of assets that are currently tracking them. After the Covid-19 sell-off, J.P. Morgan expects that overall assets that track against their benchmarks will grow to over USD 20 billion by year-end .

EM ESG fixed income indices outperformed the traditional EM fixed income benchmarks during this period, , as shown in Table 1 below, and were accentuated by smaller drawdowns in March. While there was outperformance across the EM ESG sub-strategies, we found that the extent of outperformance was determined by the ESG benchmark's overall reduced exposure to lower-rated issuers and oil producers. In the case of hard currency sovereigns, the ESG benchmark outperformed its non-ESG counterpart by nearly 1.3% during March alone. In our view, such outperformance for a year would typically be quite impressive and to achieve that in one month alone is quite exceptional. The degree of outperformance across all EM ESG fixed income categories during March provides a strong foundation to support the view that EM ESG

Jens Nystedt
Senior Portfolio Manager
Emso Asset Management

"The degree of outperformance across all EM ESG fixed income categories during March provides a strong foundation to support the view that EM ESG benchmarks are capable of outperforming non-ESG benchmarks during market sell-offs"

Table 1. 2020 monthly returns for the key non-ESG and ESG EM fixed income benchmarks

	Dec '19	Jan '20	Feb '20	Mar '20
Hard Currency Sovereign	2,01%	1,52%	-0,97%	-13,85%
ESG Hard Currency Sovereign	1,98%	1,69%	-0,70%	-12,58%
Diff	-0,03%	0,17%	0,27%	1,27%
Inv Grade Hard Currency Sovereign	0,65%	2,29%	0,56%	-8,07%
ESG Inv Grade Hard Currency Sovereign	0,59%	2,34%	0,67%	-6,98%
Diff	-0,06%	0,05%	0,11%	1,09%
High Yield Hard Currency Sovereign	3,65%	0,64%	-2,77%	-20,74%
ESG High Yield Hard Currency Sovereign	4,04%	0,76%	-2,70%	-20,11%
Diff	0,39%	0,12%	0,08%	0,62%
Hard Currency Corporates	0,97%	1,54%	-0,01%	-11,52%
ESG Hard Currency Corporates	0,87%	1,59%	0,01%	-11,25%
Diff	-0,10%	0,05%	0,03%	0,27%
Local Currency Sovereigns	4,13%	-1,29%	-3,41%	-11,07%
ESG Local Currency Sovereigns	4,07%	-1,24%	-3,00%	-10,59%
Diff	-0,06%	0,05%	0,41%	0,48%

Source: J.P. Morgan, year-to-date figure as at 5 August 2020.

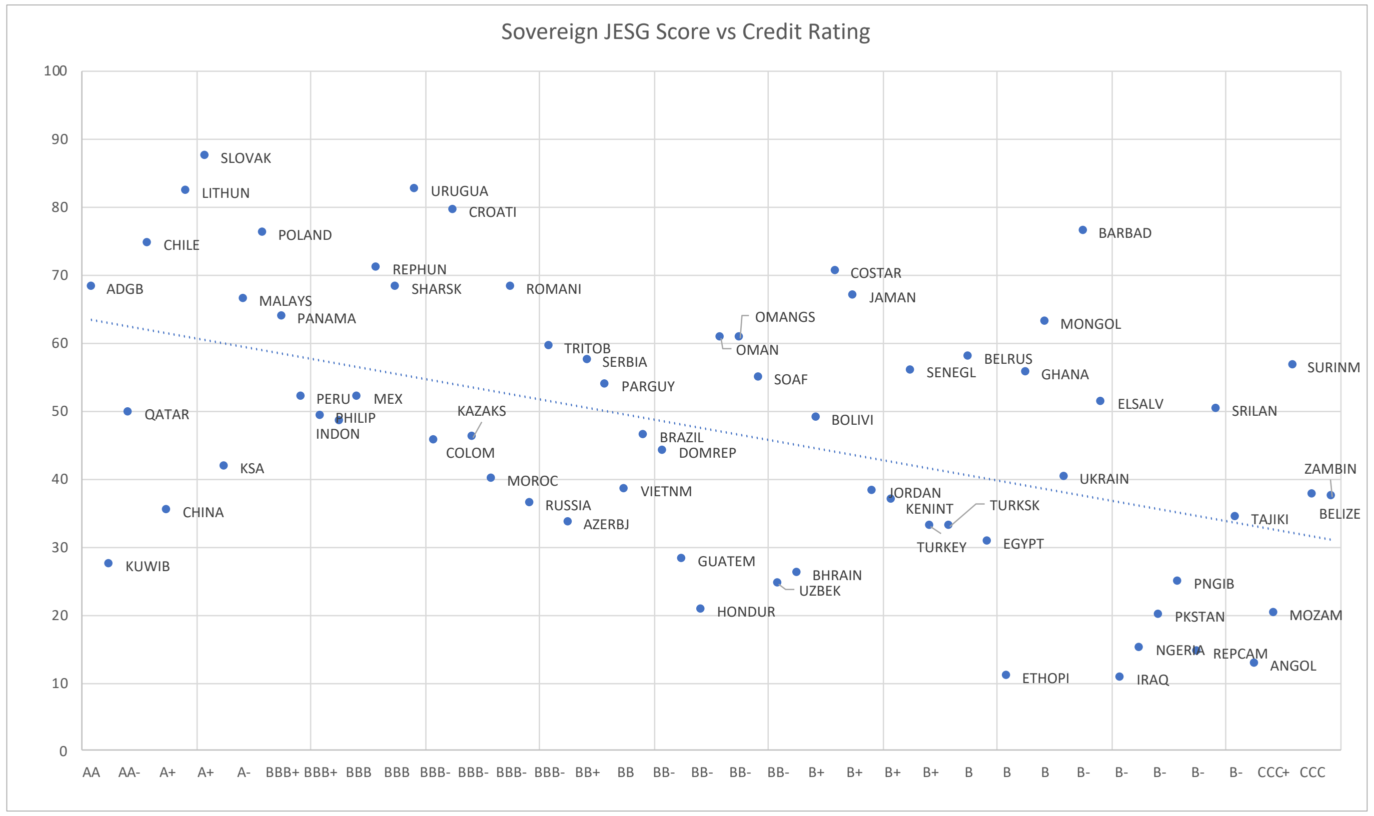
benchmarks are capable of outperforming non-ESG benchmarks during market sell-offs.

When analyzing the source of the outperformance, it is not surprising that EM investment grade issuers, whether sovereign or corporate, outperformed high yield issuers during the March sell-off. However, even within the IG space, the ESG benchmark outperformed its non-ESG counterpart. We believe that this is a result of the fact that the J.P. Morgan ESG benchmarks and ESG mandates held greater exposure to higher quality issuers over the stress test period. There appears to be a clear correlation between the ESG score and credit rating, as illustrated in Figure 1 below, which supports the view that incorporating ESG scores could limit downside performance during periods of market stress.

A focus on environmental factors typically also means that an ESG mandate or benchmark would have a lower allocation to commodity producers and oil exporters that screen poorly against ESG metrics. For example, the exclusion of Mexico's state-owned petroleum company, Petróleos Mexicanos (Pemex), which until mid-April was rated IG by Moody's but excluded from the ESG benchmarks since it did not meet the minimum criteria, helps explain nearly 20% of the outperformance of the ESG hard currency benchmark. Moreover, the exclusion of some oil exporters from the ESG sovereign HY benchmark, including Nigeria and Angola, helped it to outperform the non-ESG version.

Financial markets experienced an unprecedented recovery in the April through July time frame following the massive policy actions taken by DM and select

Figure 1. Higher-rated countries also tend to have a higher ESG score



Source: J.P. Morgan as of 24 June 2020

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EM fiscal and monetary authorities in response to the slowdown. However, EM ESG benchmarks, given their higher weighting to IG credits as outlined in Table 2 below, have lagged the broad-based beta rally. Additionally, oil exporting credits that drove the underperformance in March have also been important drivers of the recovery. As an example, the Angolan subcomponent posted a return of over 30% in June as it looked increasingly likely that it would benefit from partial official sector debt forgiveness and after the country decided to tighten its fiscal belts assuming a more realistic budgeted oil price. Overall, the IG component of the ESG indices have had a much better track record than ESG HY, which has had a more difficult time given it still had exposure to distressed sovereign names such as Ecuador, Lebanon, and Argentina which all have idiosyncratic problems. Given that the ESG HY benchmark actually had higher allocations to these countries than the non-ESG version, it illustrates that no benchmark is perfect and that there is still plenty of opportunity for active management.

> "It is not surprising that EM investment grade issuers, whether sovereign or corporate, outperformed high yield issuers during the March sell-off."

Table 2. J.P. Morgan's ESG Hard Currency Sovereign benchmark has a larger weight in Investment Grade credits

	Dec '19	Jan '20	Feb '20	Mar '20
Inv Grade Hard Currency Sovereign	53,6%	54,1%	54,3%	58,0%
High Yield Hard Currency Sovereign	46,4%	45,9%	45,7%	42,0%
ESG Inv Grade Hard Currency Sovereign	59,1%	59,5%	57,3%	61,0%
ESG High Yield Hard Currency Sovereign	40,9%	40,5%	42,7%	39,0%
Higher weight of IG in ESG bechmark	5,6%	5,3%	3,0%	3,0%

Source: J.P. Morgan, year-to-date figure as at 5 August 2020.

But active managers did not perform as well as passive managers during this recovery period. While active EM ESG funds in aggregate underperformed their ESG benchmarks in March, hard currency sovereign EM ESG funds, which account for 70% of the USD 2.5 billion in publicly traded daily ESG funds with a J.P. Morgan ESG benchmark[2] we track, actually outperformed their non-ESG benchmark. Looking at average year-to-date performance, all active EM strategies, except the blended ESG mandates, underperformed their ESG benchmarks. We feel that the aggregate underperformance of active managers was likely related to concentrated exposures in countries that became debt restructuring candidates due to the crisis.

We believe that active management of EM fixed income mandates with a strong ESG overlay should be able to differentiate from benchmark returns. During the sharp risk-off period in March 2020, we remained focused on higher quality and higher-rated issuers, employing many of the same bottom-up research principles that we utilize across the firm's other mandates. We believe that active managers in this space can outperform both passive managers and the ESG benchmark by following two strategies:

1. Start with fundamental analysis when evaluating investments for inclusions in an ESG mandate. We believe that you cannot focus on ESG factors alone. Traditional bottom-up analysis, which is required to assess the ability and willingness of an issuer to pay, needs to be applied first. As we saw during the sell-off, enhancing yields of a mandate by moving down the credit spectrum without due regard for credit fundamentals did not prove to be a successful investment strategy. For example, active managers would have benefited from excluding Lebanon and Ecuador from their mandates because of their credit difficulties before March and April, despite these countries still meeting JP Morgan's score criteria for ESG benchmark inclusion.

2. Use of an ESG score as a portfolio screening tool needs to be balanced against real-time world events. Active managers should consider that solely using ESG scores as a screening tool may not perfectly capture cyclical or permanent effects. While some EM issuers may have high ESG scores, they can also make decisions that will negatively impact future scores. And vice versa, low scoring EM issuers can also make critical decisions that will drive improvement to their ESG scores in the future. These decisions typically take time to be reflected in a country's ESG score. Active managers, who employ a fundamental analysis approach can look to capitalize on this temporary score dislocation, helping to drive performance.

We believe that the recent outperformance of EM ESG benchmarks in March will continue to drive interest in ESG-based investment strategies in EM fixed income going forward. While investors can have greater confidence that EM ESG mandates can perform well during a volatile period, they are right to be concerned whether active management can outperform passive counterparts. To benefit from growing investor inflows into these mandates, we believe that active managers will need to apply fundamental investing principles alongside sustainability to drive performance and differentiate themselves.

[1] Source: "JESG on Cloud Seven", J.P. Morgan, 7 May 2020.
[2] Source: Emso and J.P. Morgan, 31 July 2020.

ESG and Infrastructure – Moving Towards a Better Future

By Declan O'Brien – UBS Asset Management, Real Estate & Private Markets

Declan O'Brien
Head of Infrastructure Research & Strategy
UBS Asset Management

The headlines make for formidable reading: 2Q 2020 saw record flows into sustainable funds with over USD 54bn[1] raised, and the performance of ESG aligned stocks are up 78%[2] year to date as investors look to re-position their portfolio post-COVID-19 and pre-regulatory changes.

This follows the broader market sentiment. In 2019, UBS Asset Management (UBS-AM) surveyed over 600 institutional investors worldwide, representing more than EUR 19tn in combined AUM and a majority said they believe environmental factors will matter more to their investments than traditional financial criteria over the next five years. These eye-catching figures predominately relate to public market activity.

Private markets also have an important role to play in sustainable investing, particularly the infrastructure market. While the private infrastructure sector was initially slow to integrate ESG best practice, the past five years have seen a rapid transformation. Infrastructure investors are finding innovative ways to measure ESG performance for an asset class which spans diverse sectors. Upcoming EU regulation and ESG-related disclosure will further accelerate this change.

Infrastructure investing covers a wide range of investments from energy and utilities, digital infrastructure, transportation and social infrastructure. Within the infrastructure sector, clean energy is the poster child for ESG-focused investors. However, other sub-sectors can also create positive ESG benefits, whether that be connecting rural areas with fiber-optic cables or providing health care services, schools and housing.

> "While the private infrastructure sector was initially slow to integrate ESG best practice, the past five years have seen a rapid transformation."

Clean energy is a large segment of the infrastructure investment universe (accounting for almost 50% of deal volumes from 2012-2019[3]). Public support is high for clean energy and with more than 20 countries signing up for net zero targets[4], the investment opportunity looks set to grow. What started as investing into renewables has extended into storage and energy efficiency investments. The decarbonization of electricity over the past 10 years

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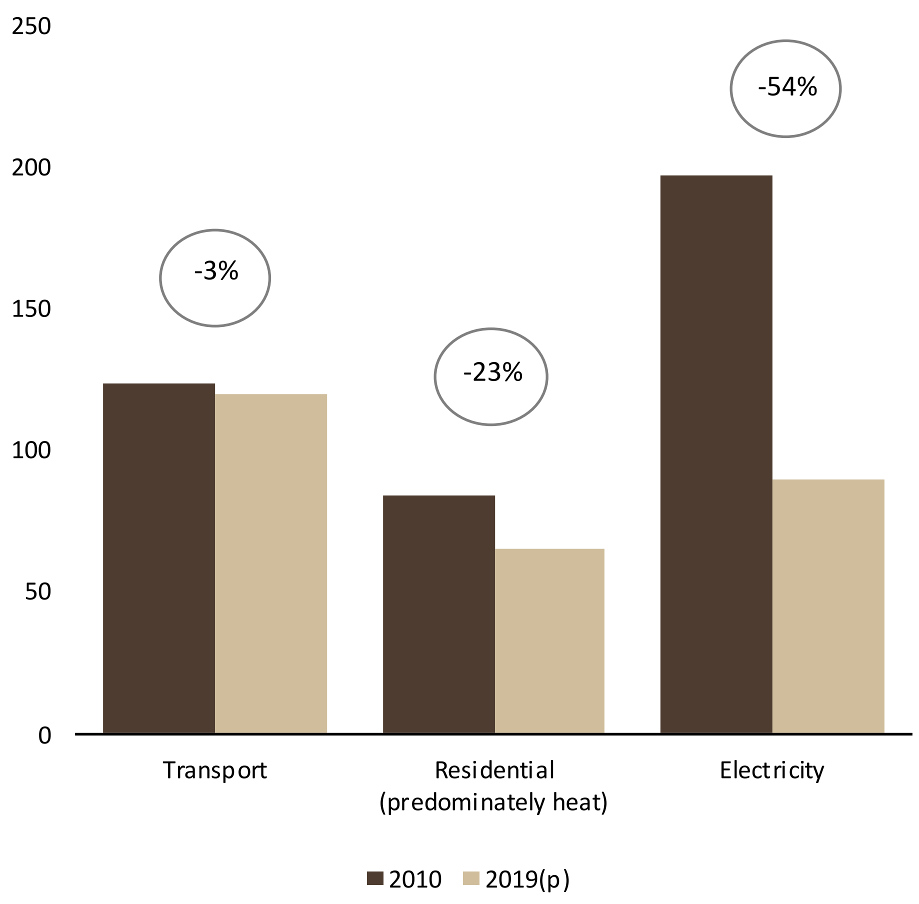
Electricity leading way in decarbonization; transport challenging

Millions of tonnes of carbon dioxide equivalent, UK



Source: National Statistics, 2019 UK greenhouse gas emissions, provisional figures

has been remarkable, largely thanks to the growth in renewables and the phasing out of coal. The next wave of investment in this sector, such as hydrogen, will help to reduce carbon in hard-to-abate sectors such as heat, transportation and industrial process, significantly lowering emissions.

While the social and economic benefits of investment in transportation are clear, the emissions from the sector are sizable. What's particularly interesting is that while the electricity sector has halved emission over the past decade in certain countries[5] , transportation has been stubbornly flat, aside from the short-term drop as a result of COVID-19. However, this does not mean that investments in the transportation space cannot have a positive ESG angle. If the net zero and 1.5 degree pledge under the Paris Agreement have any chance of being met, transportation needs to be decarbonized. Momentum is growing in the electric vehicle (EV) market and this will require new charging infrastructure and reinforcements to grid networks, providing a boon for infrastructure investment.

However, we cannot transport to a world that is fueled by zero carbon energy, transport and industry overnight. The key term is transition. In many industries there will be intermediary steps to reduce carbon emission before more sustainable sources are widely and economically available. In the energy sector, gas-fired generation will be critical to replace coal and support the growth of intermittent renewables until storage is competitive. In the shipping market, diesel vessels will be replaced with liquefied natural gas (LNG) vessels – reducing Co2 by around 25%[6] – in the short-to-medium term until hydrogen becomes competitive. All of this needs to be financed and will be an important investment towards decarbonizing our economy.

> “The infrastructure sector provides a unique opportunity to access direct investments in sectors with attractive ESG fundamentals such as clean energy, eco-transport, digital and social infrastructure.”

UBS-AM is a global leader in sustainable investments with USD 41bn[7] of sustainability-focused AUM and ESG has always been central to our investment approach. To overcome some of these reporting and disclosure challenges mentioned earlier, our infrastructure business was an early signature to the GRESB standards and commissioned a bespoke ESG model for our debt funds. For our new infrastructure equity fund, we took the further step of engaging ERM, an ESG-consultant to calculate the carbon footprint of our investments and set measurable ESG KPIs. Our commitment is to improve these KPIs during the holding period of our investments.

The momentum on ESG in the traditional public equity and fixed income markets is very encouraging. We expect to see a continuation of this trend in private markets. Improvements in disclosure and transparency will make it easier for sustainability-focused investors to access the asset class. The infrastructure sector provides a unique opportunity to access direct investments in sectors with attractive ESG fundamentals such as clean energy, eco-transport, digital and social infrastructure. Furthermore, the sector has been resilient to COVID-19 to date, and the pandemic has only accelerated the attractiveness of clean energy, good broadband connection and access to quality healthcare.

[1]Morningstar, June 2020

[2]Forbes, Sept 2020

[3]Inframation database, January 2020

[4]The UN Global Compact Business Ambition for 1.5 °C campaign calls for businesses to do their part in limiting global temperature rise to 1.5°C in response to the global climate crisis and in order to meet the 1.5°C global warming target in the Paris Agreement.

[5]UK: National Statistics, 2019 UK greenhouse gas emissions, provisional figures

[6]Sustainability 2020, 12, 2080; doi:10.3390/su12052080

[7]As at 30 June 2020

Short, But Sweet: Returns from Irresponsible Companies

By Robert Furdak – Man Group

Robert E. Furdak
Chief Investment Officer for ESG
Man Group

Let's conduct a thought experiment. There exists a factor which many people contend causes some stocks to outperform.

Most hedge funds would argue that there is a simple way to exploit this. Buy the stocks positively exposed to the factor, short stocks negatively exposed, and construct the portfolio so that it remains neutral to the movement of the index itself. Indeed, betting on both the long and short side is an intrinsic part of being a hedge fund: this is how we 'hedge'.

If this decision was taken with reference to traditional factors it would be so passé as to be unworthy of comment. But what if the factor in our experiment above is a company's environmental, social and governance ('ESG') ranking?

For some reason, when it comes to responsible investing, very few investors wish to discuss shorting, happy simply to restrict names which don't match their values and move on. By failing to short companies which rank poorly on ESG criteria, we implicitly take one of two views: 1) that we are prepared to sacrifice performance for moral rectitude; or 2) we believe firms who have good ESG performance will (vastly) outperform peers, so there is no need to focus on the poorly ranked companies.

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SHOULD YOU SHORT IT?

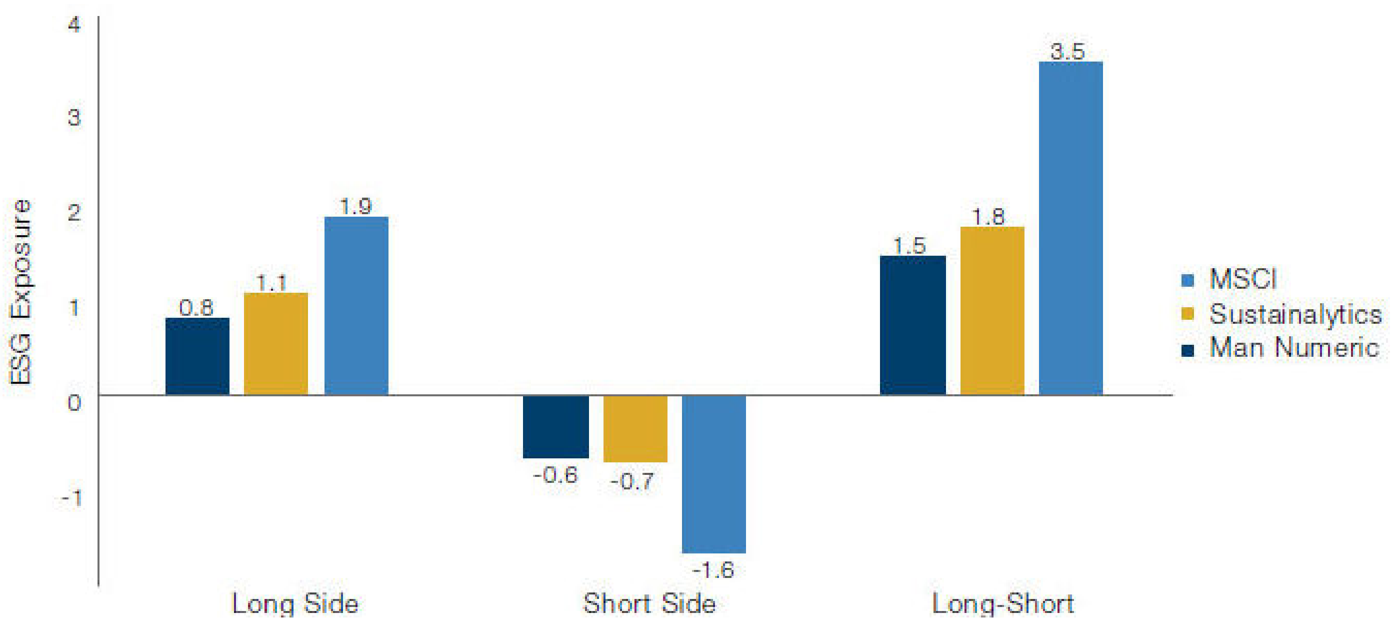
To explore the implications of shorting 'bad' ESG companies, we constructed sector-neutral, decile long-short portfolios from a universe of about 4,500 of the most liquid developed market stocks between 1 January, 2013 and 31 December, 2019. Portfolios are formed by longing (shorting) the best (worst) 10% of firms within each sector, selected based on various ESG characteristics. We examined three broad-based strategies, including two commonly used data vendors (MSCI and Sustainalytics ESG rankings) as well as Man Numeric's proprietary ESG model. Man Numeric's proprietary ESG model is based on 15 fundamental ESG pillars, which are sector neutral and neutral to common factors. We also evaluate performance from the long (short), high (low) carbon efficiency level data from Trucost and an event-driven strategy built by shorting firms associated with negative ESG news using natural language processing ('NLP') techniques – something we have previously covered in our paper "Natural Language Processing: Shakespeare Without the Monkeys".

> "For some reason, when it comes to responsible investing, very few investors wish to discuss shorting, happy simply to restrict names which don't match their values and move on."

By shorting, one can almost double a portfolio's overall exposures to ESG factors (Figure 1). The sector-neutral decile return (Figure 2) shows that firms with poor ESG performance underperform in the market. Moreover, our analysis indicates that returns were about equal from both the long side and short side of all broad-based ESG strategies, including MSCI, Sustainalytics and Numeric models, as well as the carbon-efficient strategy. NLP news-driven strategies have a stronger return form the short side than the long side.

Shorting poor ESG firms can offer other added benefits. Analysing the Barra factor exposures of

Figure 1: Shorting Doubles Portfolios' ESG Exposure



Source: Source: MSCI ESG score, Sustainalytics ESG score: as at 31 December 2019

Figure 2: Bad ESG Companies Have Underperformed

Simulated past performance is not indicative of future returns.

Source: MSCI ESG score, Sustainalytics ESG score: as at 31 December 2019
All model spread performance shown is gross-of-fees and does not represent the performance of any portfolio or product. To calculate long-only model spreads, we invest in the top 10% ranked names within each sector and display the gross of fees return. To calculate long-short model spreads, we invest long in the top 10% ranked names within each sector and are short the bottom 10% ranked names within each sector and display the gross of fee return. These spread returns are instantaneously rebalanced and do not reflect transactions costs. Rankings are based on Man Numeric's internal Alpha model scores.

The simulated data should not be used as a guide to the future. This approach has inherent limitations, including that results may not reflect the impact material economic and market factors might have had on an investment manager's decision-making and/or the application of any trading models had a strategy been managed throughout the period over which the simulated performance is illustrated.

Figure 3: Portfolio Exposure to Barra Risk Factors, Bucketed by ESG Scores

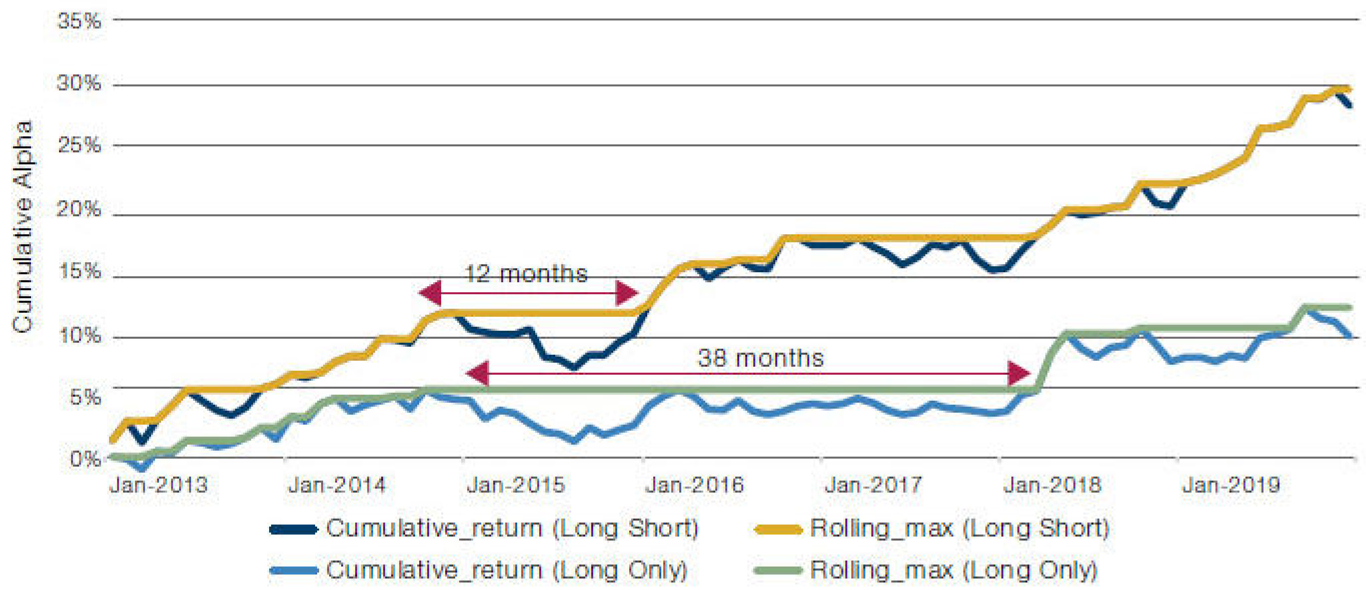
Source: Barra risk model. Man Numeric: as at 31 December 2019

> "In our simulations, shorting poor ESG companies allowed portfolios to achieve a higher exposure to ESG signals and realise higher returns, lowering overall risk exposure and drawdown."

the long and short sides of the portfolios (ranked on Man Numeric proprietary ESG scores) illustrated that betting against bad companies greatly reduces portfolios' risk and lowers the drawdown. As shown in Figure 3, we found that while both groups had lower residual volatility than the overall universe, the stocks with good ESG scores had much less residual volatility exposure. Moreover, poorly ranked ESG firms had much lower investment quality, lower earnings quality, and lower profitability.

We further compared the drawdown patterns of the long-short portfolio and long-only portfolio. Figure 4 shows the cumulative returns from 2013 to 2019 for both portfolios. First, we found that the long-short portfolio realised more than double the cumulative return compared with the long-only portfolio at the end of 2019. From 2015 to 2016, both portfolios

Figure 4: Long-Short Portfolios Are More Resilient Than Long-Only Portfolios



Simulated past performance is not indicative of future returns

Source: Bloomberg, Man Numeric: Between 1 January 2013 to 31 December 2019
Performance is gross of any fees or expenses and should be considered hypothetical. The simulated data should not be used as a guide to the future. This approach has inherent limitations, including that results may not reflect the impact material economic and market factors might have had on an investment manager's decision-making and/or the application of any trading models had a strategy been managed throughout the period over which the simulated performance is illustrated.

experienced drawdowns, with the maximum peak-to-trough decline of 4.3% for the long-short portfolio, while the long-only portfolio had a 4.1% drawdown. Though the long-only portfolio had a slightly lower absolute drawdown, it took more than three years to exceed the prior peak level, while it only took a long-short portfolio 12 months to recover the loss.

In our simulations, shorting poor ESG companies allowed portfolios to achieve a higher exposure to ESG signals and realise higher returns, lowering overall risk exposure and drawdown. Thus, it is natural to ask: why not profit from both good and bad companies, especially if those companies are unfriendly to the environment, employees or shareholders?

Furthermore, it allows portfolios to properly capture the value of a growing risk: the risk that companies fail to deal with the transition to more responsible models of operating, overstating the value of potentially stranded assets and failing to account correctly for the ESG risks to which their businesses are exposed.

More importantly, however, going short marks the evolution of responsible investment from a more passive approach (that just excludes stocks based on a categorical restriction list) to a more active approach that uses all available information to fully reflect their views in their positioning.

CONCLUSION

We recognise that some investors operate under constraints which could make shorting or even holding poorly ranked ESG stocks inappropriate. However, for those who are not constrained, it seems illogical not to harvest the full spectrum of available ESG information. Indeed, maximising performance is a fiduciary duty for investors. If that can be done while taking responsible investment one (short) step further, why not do it?

Man Group is a proud signatory to the United Nations-supported Principles for Responsible Investment ('PRI') and we have long recognized how responsible investing is fundamental to the firm's fiduciary duty. Follow the link for more information on Man Group's Responsible Investment ('RI') fund framework, policies, stewardship and latest responsible investment insights:

https://www.man.com/responsible-investment

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Melanie Brooks
Head of Sustainability
CARN Capital

Mind the Gap: From Exclusion to ESG to Sustainability

By Melanie Brooks – CARN Capital

Diverging strategies and confusing terminology regarding sustainable investment increase the risk for greenwashing and, in worst case, misallocation of capital. For CARN, ethical exclusions and ESG tilts on their own are not enough to achieve sustainability. We have therefore chosen an alternative approach, investing actively for a sustainable future.

After decades of occupying a niche corner in the world of finance, sustainable investment is going mainstream. 2019 appears to have been a pivotal year in this transition, with over $20 billion of new money flowing into strategies related to ESG and sustainability more broadly, according to data from Morningstar.

Driven by a growing awareness of sustainability issues, institutional and retail investors alike are increasingly interested in investing in companies they perceive to be part of the solution to global challenges such as climate change. There is also a realization that investing sustainably does not have to mean sacrificing returns, and that a sophisticated and well-executed sustainable investment strategy can create significant value for investors. CARN Capital's Long Short fund is a great example of this. With sustainability at the core of our investment strategy, we have delivered 15.3% in annualized returns since the fund was started in 2015.

> "For CARN, ethical exclusions and ESG tilts on their own are not enough to achieve sustainability."

Growth in demand from sustainability-minded investors has resulted in an explosion in the availability of new or rebranded funds marketed by fund managers. According to Morningstar, more than 500 actively managed funds added high-level ESG language to their prospectuses in 2019. However, this appears to be due, at least in part, to otherwise conventionally managed funds saying that they now consider ESG factors, without sustainability being central to their investment strategy or decision making.

This increased interest in investing sustainably is undoubtedly positive as finance has an important role to play in the transition to a more sustainable and equitable economy. However, the devil is in the details. Sustainable Investment is an umbrella term covering a range of strategies with vastly different approaches and outcomes. This has resulted in terms with very different meanings being used interchangeably, such as ESG being confused with sustainability or even used as a synonym for cleantech. This unfortunate development can result in confusion at best and a misallocation of capital at worst. Investors need to understand the characteristics and limitations of various approaches. This will facilitate investments

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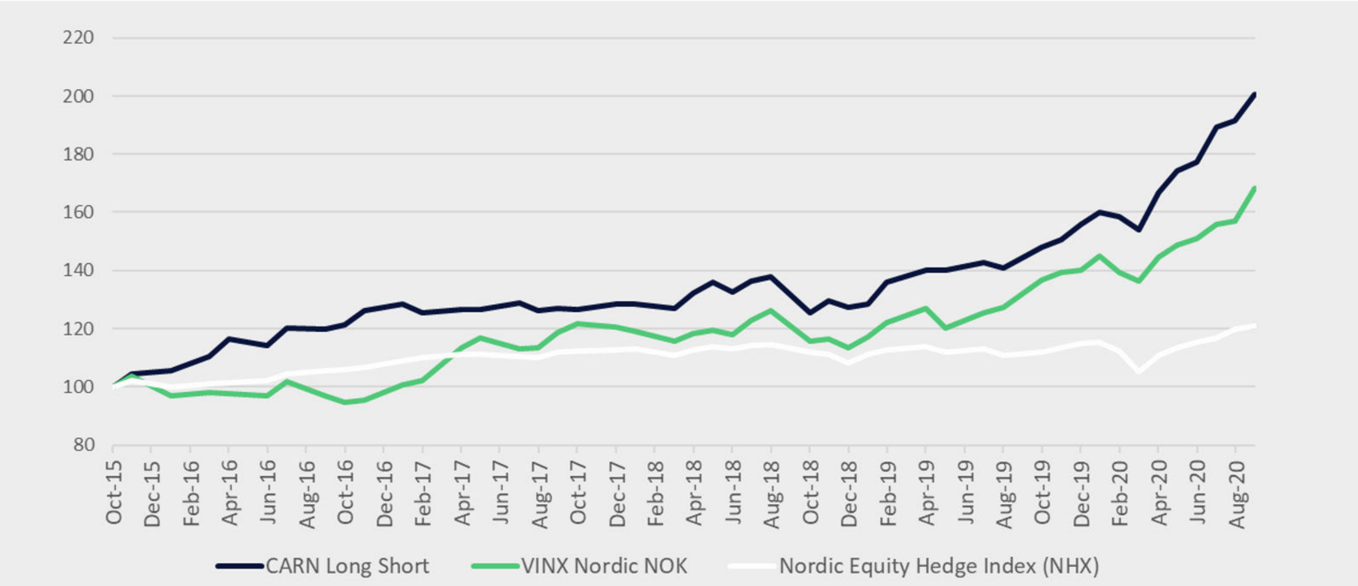
CARN Long Short's Track Record



Since launch	**101.1%**	**Positive months**	**69%**
Return per year	**15.3%**	**Correlation VINX Nordic NOK**	**0.6**
Sharpe	**1.31**	**Annualized alpha**	**7.6%**

Numbers are net of all fees. As of September 2020. The track record is a combination of the equity strategy of CARN from November 2015 to November 2016 and the CARN Long Short Fund (OPA3) established November 2016. During the first period the strategy was run in a Limited Liability Company (AS). In November 2016 the capital was consolidated into a UCITS fund. Past performance is not necessarily indicative of future results and you may not retrieve your original investment.

into sustainable solutions and avoid investors being disappointed by what they find in portfolios marketed as sustainable but that in practice fall short of this label.

We'd like to help provide some clarity as to the main characteristics of the most common approaches to sustainable investment in listed equities today, and associated terminology. The figure below illustrates at a high level the spectrum of approaches often grouped under the umbrella of sustainable investment. It is CARN's view that no single approach is sufficient to ensure sustainability and profitability on its own, and we have therefore chosen to incorporate elements of the full range of approaches in our investment strategy.

The first approach shown is exclusion, also commonly referred to as negative screening. This approach has a long history and entails excluding companies deemed unethical or otherwise unacceptable from the investment universe. It is relatively straightforward to implement due to transparent rules and thresholds rooted in commonly accepted definitions of unacceptable products or behavior. An example of this is excluding companies that produce tobacco or certain types of weapons, or that have been found in breach of ethical norms such as those related to human rights. The Guidelines for Observation and Exclusion from the Norwegian Sovereign Wealth Fund are a good reference on ethical exclusions.

On the other end of the spectrum is thematic and impact investing, where the goal of the strategy is to invest more or exclusively in companies that create a measurably positive impact on society and/or the environment, in addition to delivering financial returns. An example of this would be targeted investments in renewable energy. The main difference between the approaches is that the return requirements may differ. Thematic investing aims to make strong or even superior financial returns while investing in sectors, companies and technologies that help solve sustainability challenges. Impact investing on the other hand usually places more emphasis on measurably positive outcomes for society and/or the environment, with secondary emphasis or even reduced expectations on financial returns.

While now ubiquitous, ESG as a term and concept is a relative newcomer to the scene, having been engrained in the Principles of the UN PRI in 2006. ESG is an umbrella term and covers all environmental, social and governance considerations that companies encounter in their business activities. ESG relates primarily to processes in a company, rather than the products or services it provides. In this way it is different from thematic and impact investing.

One consequence of the rise of ESG has been a shift in focus to relative rather than absolute sustainability performance at the company level. The scoring of companies on ESG indicators in relation to their industry peers means that companies can receive positive ESG ratings on a relative basis, even if in absolute terms they generate negative externalities

"Our sustainability focus is integrated into each step of our investment process, from defining our investment universe to carrying out company analysis, portfolio construction and active ownership."

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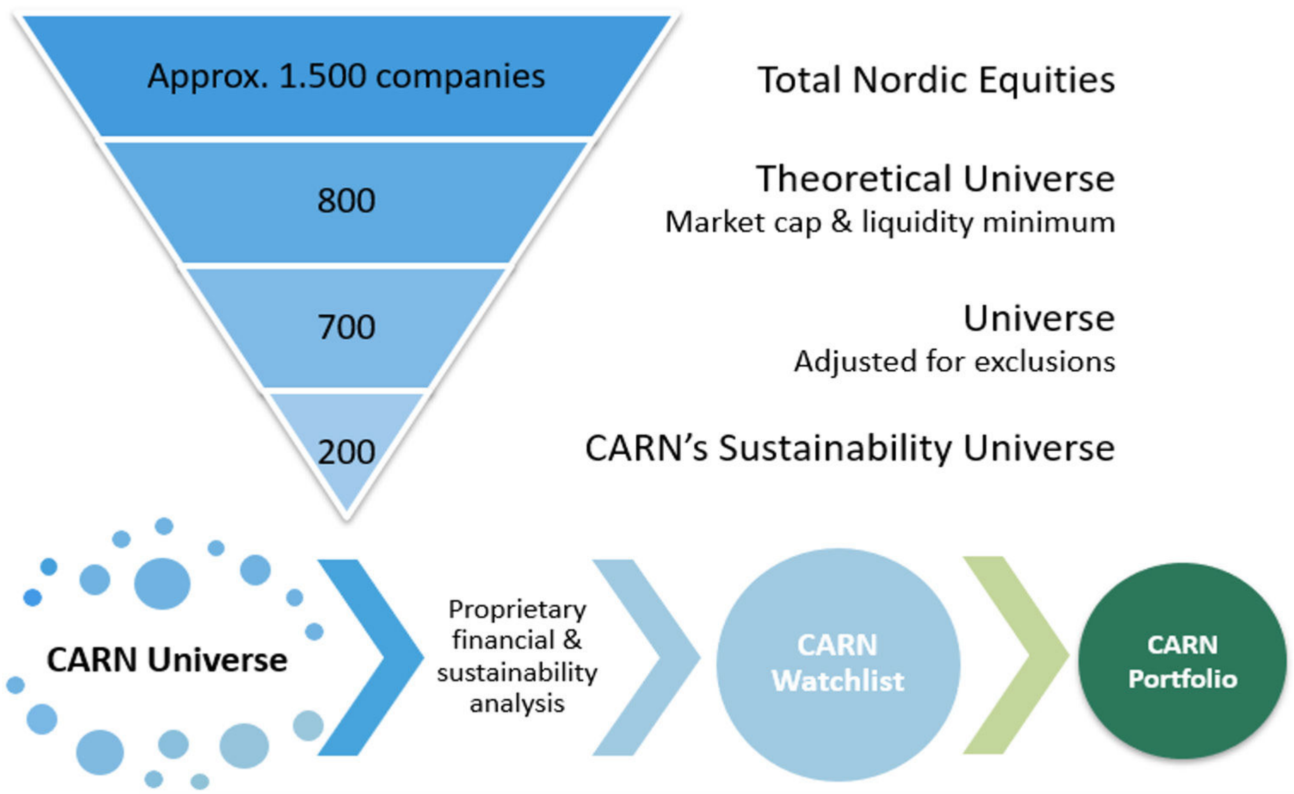
to the environment or society. To illustrate, a tobacco manufacturer or thermal coal producer can score relatively well on ESG if they have well-functioning boards, treat their employees well and reduce inputs of water and energy in their production processes.

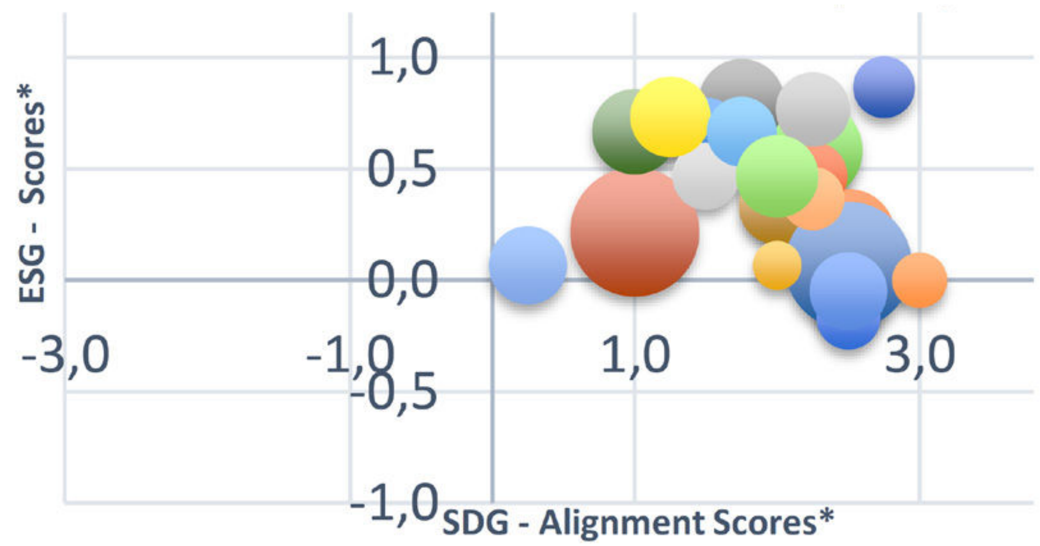
Integrating ESG considerations in company analysis and portfolio construction can encourage companies to improve on ESG in order to attract capital. There is also some evidence that companies who are better at managing material ESG issues relative to their industry peers may also be characterized by lower earnings volatility and higher returns than peers with poor ESG performance.

Excluding unethical companies and assessing ESG on a relative basis are both good places to start when embarking on a process to invest more sustainably. Moreover, these approaches are not mutually exclusive and are often combined. We would argue though that as investors we cannot exclude our way to a sustainable future, nor can we get there by assessing relative ESG performance in unsustainable industries. Investing in a way that is truly aligned with sustainable development requires an approach that channels capital to companies that are sustainable both in terms of how they operate and in terms of the impact their products and services have on society and the environment.

CARN's Investment Universe
Sustainable Nordic Companies



CARN Portfolio Sustainability Map



* Bespoke methodology for ESG and SDG alignment scoring. PF as of 1.10.2020

This is the CARN way. We do not provide capital to companies or industries that inherently undermine sustainable development. We invest in companies whose business models, products and services are aligned with economic, environmental, and social sustainability, concepts which are also the basis of the UN Sustainable Development Goals (SDGs). Moreover, we expect companies we invest in to have good ESG practices embedded in their processes, including how they treat their employees, manage natural resources and work on behalf of shareholders and other stakeholders.

Our sustainability focus is integrated into each step of our investment process, from defining our investment universe to carrying out company analysis, portfolio construction and active ownership. We believe this is the best way to protect and grow our investors' capital and to contribute to sustainable development.

Our approach has resulted in strong risk-adjusted financial returns and a portfolio that scores high both in terms of ESG performance relative to industry peers and sustainability, measured in terms of alignment with the UN SDGs.

The Goal of Sustainable Finance

By Jack Inglis – AIMA

Jack Inglis, CEO
The Alternative Investment Management Association

Responsible investment is no longer the sole purview of long-only investment management. An increasing number of hedge fund managers are formally integrating environmental, social and governance (ESG) concerns in their investment decisions. Given their flexibility and sophistication, hedge fund managers are well positioned to implement responsible investment; their ability to sell assets short and their experience in facilitating governance reforms in invest companies are or particular use.

Any discussion of responsible investment must first come to grips with the fact that responsible investment can mean different things to different people. Indeed there seems to be little agreement on what to even call responsible investment. Alternative Investment Management Association (AIMA) North American members, for instance, tent to call it "ESG", while our Continental European colleagues favor "sustainable finance". Then, of course, there are the acronyms of which there are enough to make even a hardened government bureaucrat blush.

Luckily, the hedge fund industry is a partial place and we tend to see things through the prism of results. As such, when approaching responsible investment, we try to ignore the jargon and ask a simple question: what is the goal? In our experience, there are generally three answers: limiting unwanted risk, enhancing returns and creating a positive impact. Hedge funds, by their very nature, are well suited to accomplish each of those goals.

Let's begin with the limiting of unwanted risks. One of the most important reasons to consider ESG factors when analyzing an investment is thet such factors can constitute risks.

A company with high carbon emissions, for instance, might be vulnerable to carbon taxes or an energy transition; a resource extraction company, meanwhile, may depend on the goodwill of the local community to carry out its business. These risks are every bit as real as those reported on a balance sheet and investors have every right to expect their investment managers to protect against them.

Hedge fund managers are uniquely well suited to do. By using short selling, hedge fund managers can not only hedge against common market risks, but also against non-traditional ESG risks. Hedge fund managers can, for example, use short selling to hedge their exposure to carbon emissions and the attendant risks.

"Hedge fund managers are ensuring the companies in which they invest are safer, more environmentally friendly and better governed'."

The flip side, of course, is such risks also present the opportunity to generate above-average returns, which is also something of a speciality for our industry. Hedge fund managers can use short selling to deliver returns to their investors bu identifying issuers that perform poorly on ESG metrics or are unduly exposed to ESG risks.

For instance, a hedge fund manager might sell short the securities issued by a company with lax safety practices, on the assumption that the price of those securities fall if the company is involved in an industrial accident.

Hedge fund managers can, however, go beyond simply dealing with ESG risks. They can also help mitigate them. The hedge fund industry has a proud track record of facilitating improvements in corporate governance and even in unmasking corporate malfeasance. The most recent example is the alleged fraud at Wirecard; were it not for the bravery taking action against the company, the damage to investors would probably have been even more significant.

Managers of hedge funds are already leveraging this expertise to ensure the companies in which they invest are safer, more environmentally friendly and better governed. This is a win-win: society benefits and the companies become better investments.

Hedge fund managers, in summary, bring unique skills to the world of responsible investment. We at AIMA are supporting them, working with our members to create guidelines on responsible investment policies, corporate ESG considerations, and our upcoming paper on short selling and responsible pieces exploring the adoption of responsible investment in our industry. We will continue working to ensure the strengths hedge fund managers bring to responsible investment are not just recognized, but put to good use.

Published in the Sunday Times supplement on Responsible Investment published on August 9th 2020

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ESG – Remarkable Progress, Evolving Indices and Futures Growth

By Payal Lakhani – CME Group

The unprecedented economic turmoil caused by the COVID-19 virus has led for calls to reshape the global economy to make it fairer and more environmentally sustainable. Campaigners are challenging governments to direct their record stimulus funds towards projects and investments that benefit broader society.

As pressure builds on improving businesses' performance in terms of Environmental, Social and Governance (ESG), it is no surprise that the world is also seeing a corresponding boom in socially responsible investing.

Now, more than ever, investors are accelerating their search for opportunities that align with their values. ESG is increasingly shaping the investment landscape, and a whole new ecosystem is evolving to meet changing demands.

Exchange Traded Funds (ETFs) focused on ESG are booming, while derivative solutions, such as the CME E-mini S&P 500 Index ESG Futures contract, have emerged to allow for hedging and portfolio diversification, thus giving investors the products that align with their values.

ESG GROWTH

ETFs that prioritise ESG matters have grown exponentially, surpassing $100 billion in August 2020[1].

An increasing number of investors now know it is perfectly possible to link index management with responsible investment by choosing an ESG index-based future, index fund or ETF for the core of their portfolio. The number of European pension plans that have explicitly created and formalized ESG beliefs has increased significantly, from 19% in 2019, compared with 55% in 2020[2].

EVOLVING ESG INDICES TO MATCH INVESTOR CONVICTIONS

As ESG ideologies and thoughts continue to evolve, index providers are on the quest for the right methodology and exclusions; ensuring that their criteria effectively allow socially conscious investors to assess the behaviour of companies.

For many investors, climate change is one of the most important ESG risks and investment opportunities. Increasing attention on fossil fuel exposures has been bought into stark focus by the Paris Climate agreement. This has led an increasing number of investors to commit to divest from thermal coal companies by the end of 2020.

THERMAL COAL CONSULTATION

In response to these changing investor demands, S&P Dow Jones Indices (S&P DJI) conducted a consultation on thermal coal. Based on the results of the consultation, from market open on Monday, September 21, 2020 the S&P 500 ESG Index eligibility rules will be modified to exclude companies that generate 5% or more of their revenue from thermal coal.

S&P DJI have opted for the strictest measure based on the consultation results. The options presented in the consultation were to exclude companies generating more than, a) 25% b) 10% or c) 5% of revenue from thermal coal.

In order to properly frame the potential impact of this exclusion, the individual index objectives must be considered. The S&P 500 ESG Index aims to offer a more sustainable variant of the broad-based S&P 500 Index, with similar risk and return, while at the same time achieving a boost in S&P DJI ESG Score performance.

Built on the traditional broad-based S&P 500 Index, the S&P 500 ESG Index is comprised of companies that best manage their business while conforming to ESG principles. Eligibility and inclusion in the S&P 500 ESG Index are based on a robust ESG scoring

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Table 1.

	S&P 500 INDEX	CURRENT S&P 500 ESG INDEX (INCL. TC)	S&P 500 INDEX WITH THE METHODOLOGY CHANGE TO EXCLUDE COMPANIES WITH MORE THAN 5% REVENUE DERIVING FROM TC
Total Return	-0.84%	1.72%	1.34%
Annualized Volatility	32.28%	32.37%	32.22%
Tracking Error	-	1.08%	1.11%

system. Currently, those firms with the lowest ESG compliance, meaning those involved in tobacco, controversial weapons, with a low UNGC[3] score, or in the lowest ESG ranked quartile of their sector are excluded. Post the implementation of this methodology change, those companies with more than 5% revenue deriving from thermal coal will also be excluded from the S&P 500 ESG Index.

Using data from the April 2019 rebalancing up to the end of April 2020, Table 1 shows the total return, annualized volatility, and tracking error of the S&P 500 ESG Index versus the S&P 500 Index, as well as the hypothetical results that would have occurred had the thermal coal (TC) methodology change to 5% been in effect.

Using data from the April 2019 rebalancing, Table 2 shows the rebalancing changes and the weight impact that would have resulted had the methodology change options been in effect at that time.

There were a further seven companies that feature in the headline index that are involved in thermal coal which were not included in the respective ESG index.

The newly rebalanced S&P 500 ESG Index should be better aligned with investors objectives where they are increasingly taking a stand with their investment choices.

For companies, growing regulatory importance makes inclusion in an ESG index more relevant now than ever before. It also demonstrates adherence to specific investor values and so makes it easier for money managers to allocate funds.

THE ESG FUTURES SPACE

The addition of E-mini S&P 500 ESG Index futures provides a cost effective way for market participants to gain access to one of the most actively traded ESG benchmarks, it also allows opportunities for investors to effectively manage risk whilst further adding to liquidity.

Since launch in November 2019, the E-mini S&P 500 ESG Index futures contracts have surpassed $10bn of traded notional and at the start of September 2020 had accumulated over 4,350 contracts of open

Table 1.

THERMAL COAL EXCLUSIONS	EXCLUSION LEVEL	IMPACT	WEIGHT
American Electric Power	25%	Drop	0.2283%
CMS Energy Corp	10%	Drop	0.0852%
Duke Energy Corp	10%	Drop	0.3584%
Alliant Energy Corp	10%	Drop	0.0603%
Nisource Inc	10%	Drop	0.0560%
NRG Energy	10%	Drop	0.0626%
Pinnacle West Capital (AZ)	10%	Drop	0.0578%
Xcel Energy Inc	10%	Drop	0.1572%
AES Corp	10%	Drop	0.0613%
Dominion Energy Inc	5%	Drop	0.3367%

interest, equivalent to $650 million. The contract enjoys the highest average daily volume (ADV) of any ESG future listed globally in terms of notional traded per day in 2020.

Unusually for a relatively new future, the majority of the orders are occurring on the central limit order book rather than via blocks (although block functionality is available). At its recent peak[4], over 5,000 contracts were traded in a single day.

More than 100 different market participants have used this product so far, with demand largely being driven from asset managers and hedge funds.

Clients are using the ESG Future for beta exposure, to cash equitize and for easy-access hedging purposes. They are using it in both ESG specific funds where they need more ESG-orientated solutions and in non-ESG funds, where, from a top-down perspective having an ESG future helps make the overall portfolio more ESG friendly.

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USING E-MINI S&P 500 ESG INDEX FUTURES TO MANAGE THE REBALANCE

As the September futures roll period nears, the implementation of the Thermal Coal Consultation, via an extraordinary index rebalance taking place at the close on Friday 18, September, to be in effect for the start of trading on Monday, the 21st, is likely to be a key driver in increased activity into the autumn. The ESG future can offer a liquid and cost-efficient alternative to incorporate these changes into investment strategies and manage undesired sustainability risks.

Market participants can enjoy several versatile ways to manage positions. Flexible execution, through the Basis Trade at Index Close (BTIC) mechanism or block trades ensures liquidity can be found. Both outright and BTIC transactions on ESG futures will be block eligible. Margin offsets will also be available for those interested in trading or spreading ESG futures versus other CME stock index products to maximise capital efficiency. This should further encourage and facilitate transfer to ESG benchmarks.

Liquidity is very important. Clients will often need liquidity in non-roll periods to manage their portfolios and the open interest and volumes are equally strong in non-roll months. The bid-ask is currently around 2 basis points wide in US hours, allowing investors the possibility to manage risk and benefit from all market scenarios.

STRONG ESG RETURNS

Investors have long debated if ESG detracts from returns. In the year to May 2020, the S&P 500 ESG Index provided outperformance of +2.68% to the S&P 500 Index. The 5-year tracking error is 0.83%, allowing clients S&P 500-like performance in an ESG positive manner. The E-mini S&P 500 ESG Index Future, is one of the most actively traded ESG benchmark index investment products globally. Furthermore, correlation to MSCI ESG benchmarks is typically 99.5% or higher, so clients benchmarked to MSCI can also enjoy the liquidity benefits from the S&P 500 ESG ecosystem whilst still getting the performance exposure they require.

2020-21 OUTLOOK

Renewed focus and innovation are being driven by several factors. Firstly, amid growing concern for the future of our planet, ESG investment is being spurred by the transfer of wealth to a younger, more environmentally conscious generation.

On the regulatory side, there is tremendous activity at the European Union level– such as developing climate benchmarks and a common taxonomy. Clearer guidelines and details on regulation will help build momentum in terms of index and product development. ESG is set to be a part of the MiFID II sustainable finance measures, scheduled for early 2021.

International Organization of Securities Commissions (IOSCO) aims to harmonize global sustainability disclosure standards to make comparing information easier for investors. Such reporting requirements will mean asset managers face greater pressure to invest in these areas and will further drive volume in ESG products.

In the equity market, exclusion from an ESG-focused benchmark may mean that raising equity capital may become harder or more expensive for a company.

Any lingering reservations about ESG investments — performance, data and analytics, cost, and choice — seem in decline. The ecosystem now exists. The rise of ESG derivatives provide asset managers who have strict mandates to achieve ESG compliance with a flexible, cost efficient solution, with capital efficiencies and proven liquidity.

The prior years have seen tantalizing growth in ESG investing. This has brought renewed focus, innovation, regulatory reporting requirements and many more opportunities for the next year and beyond. CME ESG Futures provide a capital efficient, liquid way to allocate to this important and growing segment.

References

1. *Research carried out by ETFGI*
2. *According to a survey carried out by Mercer*
3. *The United Nations Global Compact is a non-binding United Nations agreement to encourage businesses worldwide to adopt sustainable and socially responsible policies, and to report on their implementation.*
4. *May 19, 2020*

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Hedge Fund Investors Driving ESG Uptake

By Eugeniu Guzun – HedgeNordic

One of the main attractions of hedge funds to institutional investors has been their ability to deliver uncorrelated absolute returns. A report published earlier this year, in February, indicates that institutional investors now want their hedge fund managers to "target double bottom-line benefits: do well financially by doing good socially and environmentally."

The report by a collaboration of industry partners, including AIMA, CAIA, CREATE-Research and KPMG, reflects two separate electronic surveys, one focusing on hedge fund managers and the other on their institutional clients. According to this survey, 55 percent of institutional investors include environmental, social and governance (ESG) considerations as part of the due diligence process before allocating to a hedge fund manager.

Institutional investors expect hedge fund managers to deliver attractive risk-adjusted returns while considering the environmental and social risks associated with their investments. "Thus, the traditional risk-return equation is being rewritten to include ESG factors," said Anthony Cowell, Head of Asset Management at KPMG in the Cayman Islands and co-author of the report. "In the hedge fund industry, ESG has gone from being a nice-to-have to a must-have."

Hedge fund managers, in turn, have stepped up their ESG efforts, with the advance primarily driven by institutional investors and their consultants. According to the hedge fund managers' survey, 85 percent of survey participants indicate that institutional investors are the biggest drivers of demand for ESG-oriented hedge funds. The report summarising the results of the two surveys also highlights that 59 percent of hedge fund managers are either at the 'mature' or 'in progress' stage of implementing ESG through appropriate policies, committees, research and data.

"Recognising that purpose and profit are no longer mutually exclusive, a growing number of institutional investors expect hedge fund managers to incorporate environmental, social and governance (or ESG) factors into their investment activities," wrote Jack Inglis, the CEO of AIMA, in connection with the publication of the report. "We are not yet able to pronounce unequivocally that ESG-compliant investments will lead to better returns," acknowledged Inglis. "But every indication, from managers and investors alike, suggests that ESG integration is not just increasingly important, but for savvy managers, it can go hand-in-hand with generating alpha."

Hedge fund managers' survey — Key data points

85% Institutional investors are the biggest drivers of demand for ESG-oriented hedge funds

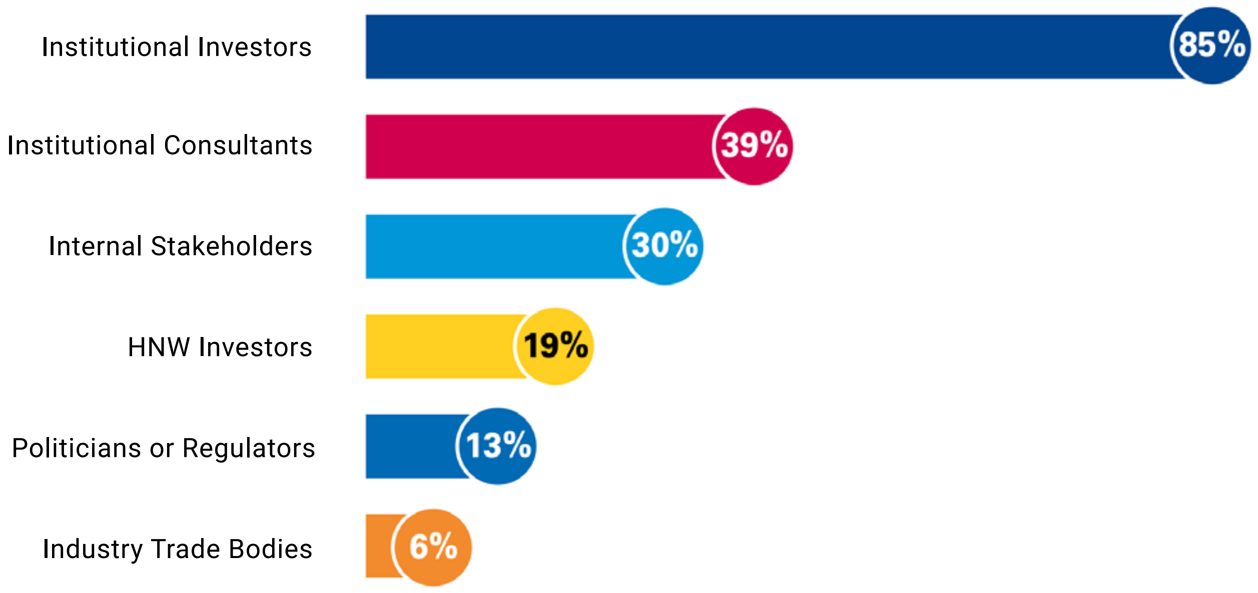
55% ESG-oriented hedge funds continue to target alpha returns, while managing fat-tailed far-off risks

15% Hedge fund managers have embedded ESG factors across their strategies

63% Progress hampered by lack of robust templates, consistent definitions and reliable data

ESG awareness is increasingly extending its footprint in the hedge fund industry, with the heterogeneity of the space also reflected in each manager's approach to ESG integration. In the process of incorporating ESG factors into their activities, three approaches have been used by at least three in every ten surveyed hedge fund managers, with many of them adopting more than one approach. The first avenue is ESG integration (52 percent), which involves identifying material ESG factors and incorporating them into the investment process. The second avenue is negative screening (50 percent), which involves the exclusion of stocks that sit uncomfortably with the personal values of investors. The third avenue is shareholder engagement (31 percent).

Who is driving interest in ESG investing?



Source: KPMG–CAIA–AIMA–CREATE Survey 2020

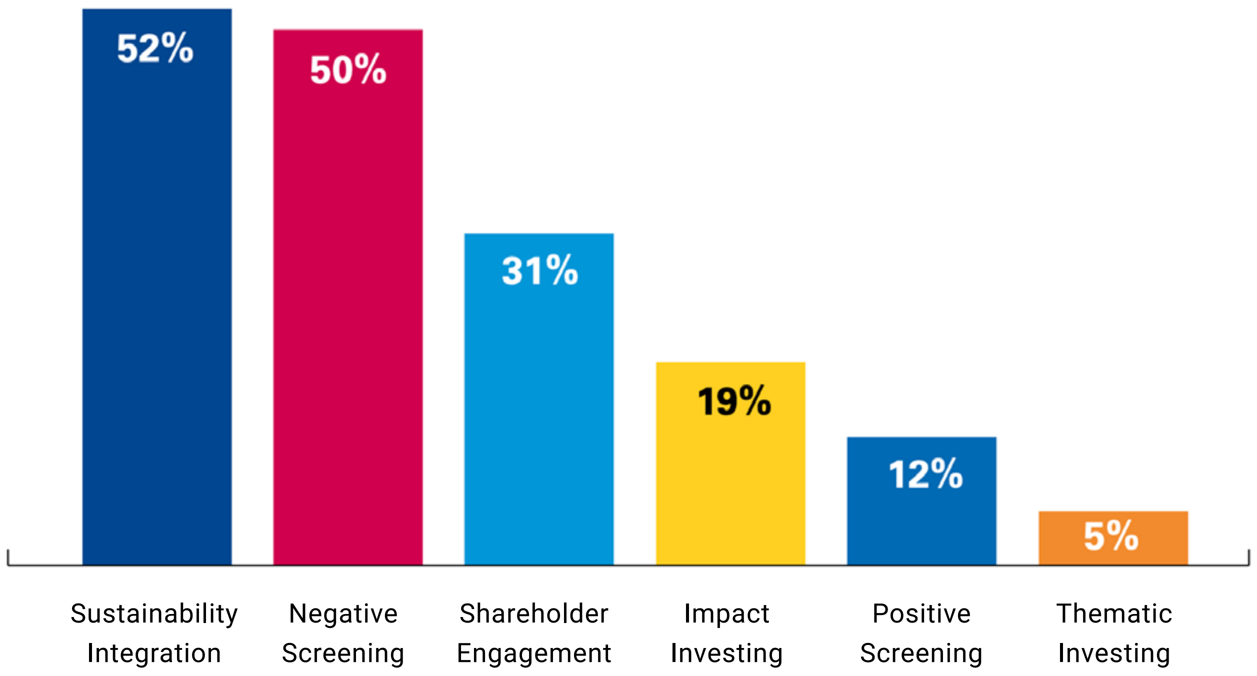
> "Hedge fund managers are ensuring the companies in which they invest are safer, more environmentally friendly and better governed'."

According to the report, shareholder engagement has been gaining traction as companies and their management teams have been slow to react to ESG challenges and opportunities. Shareholder engagement on the part of hedge fund managers can serve two purposes. First, it can enrich their investment process with first-hand knowledge about their underlying investments. And second, shareholder engagement can steer companies into the ESG space through discussion, dialogue and proxy voting.

WHAT BARRIERS ARE HOLDING BACK THE PACE OF PROGRESS?

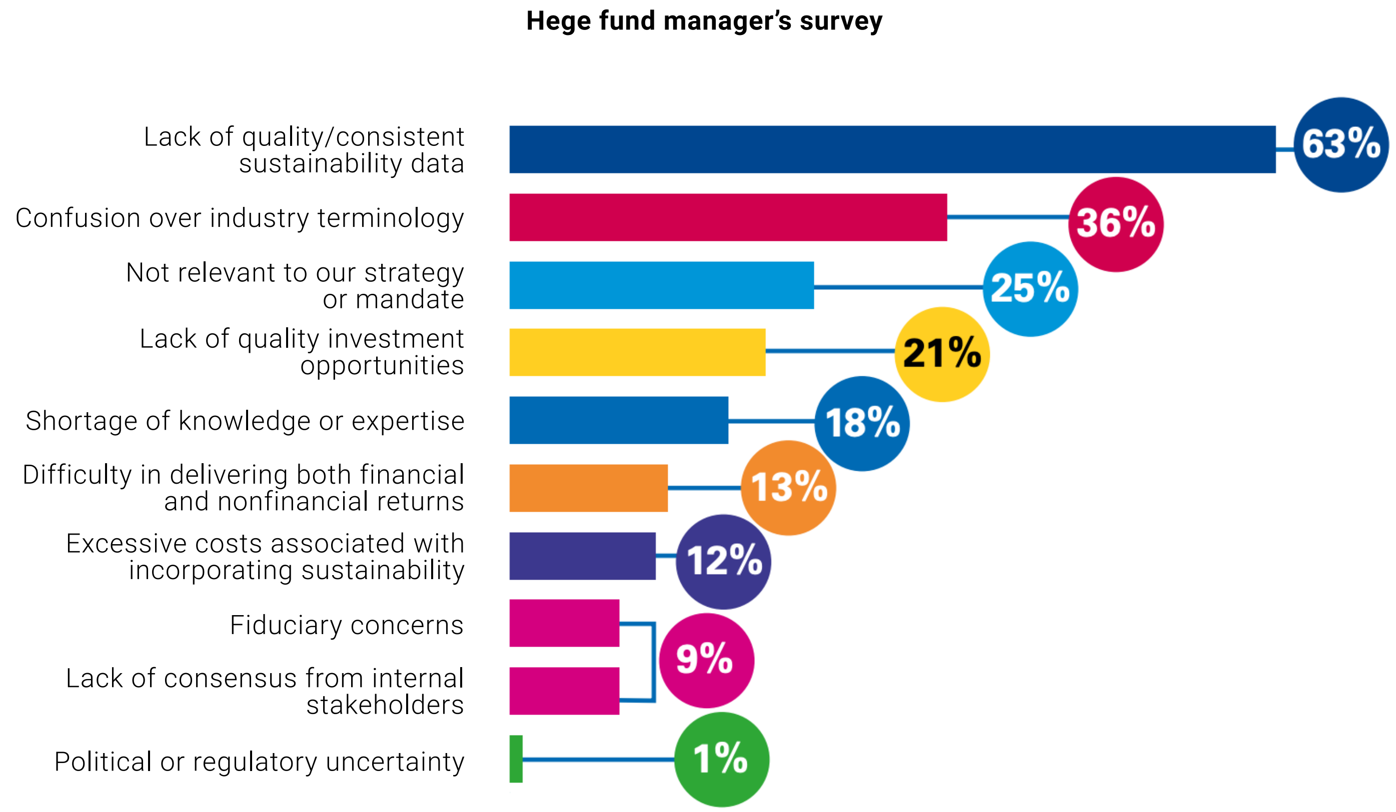
A lack of quality data is currently the biggest obstacle to the scale of ESG adoption among hedge fund

Which of the following best describes your organization's strategy when it comes to ESG?



Source: KPMG–CAIA–AIMA–CREATE Survey 2020

What are your organization's biggest challenges in making ESG-oriented investments?



Source: KPMG–CAIA–AIMA–CREATE Survey 2020

managers. "A number of factors have conspired against progress thus far," writes the report, which adds that "far and away, the most important one is the lack of quality and consistent data on ESG factors, as cited by 63 percent of our hedge fund respondents." Another factor that hampers the progress of ESG integration is the confusion over industry terminology. About one in every four hedge fund managers surveyed, meanwhile, indicate that ESG factors are "not relevant to our strategy or mandate."

About 18 percent of hedge fund also cited a "shortage of knowledge or expertise" as one big challenge in making ESG-oriented investments. Whereas there might have been a shortage of investment professionals able to combine financial expertise with ESG experience in the early days of ESG, this challenge is increasingly less of a problem. Many hedge fund managers in the Nordics and beyond have been able to hire ESG specialists, even build dedicated ESG teams, and join advisory committees at standard-setting organisations in the ESG space, among other things.

Another challenge relates to the high costs of implementing ESG considerations across the organisation. These costs could relate to investments in talent, investments in data from third-party providers or investments in marketing to help build credibility in the market. According to a Nordic hedge fund manager interviewed in the survey, "small hedge fund managers face excessive costs in implementing sustainability, while large ones have a marketing machine to help greenwash."

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