DECEMBER 2021

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NORDSIP
NORDIC SUSTAINABLE INVESTMENTS

SPECIAL REPORT: ESG & ALTERNATIVE INVESTMENTS

Contents

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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.

HEDGENORDIC PUBLICATION PLAN 2022:

February:	Thematic Investing / Sector Investing
March:	Nordic Hedge Fund Industry Report
June:	Real Assets / Private Markets

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Editor´s Note ...

Leaded no More.

There is little doubt that ESG is one of the dominant investment megatrends of our day. According to Bloomberg Intelligence, Global ESG assets are on track to exceed $53 trillion by 2025, representing more than a third of the $140.5 trillion in projected total assets under management.

But here is the thing. I am not sure ESG is even a thing. Or at least, I hope it will not be in the near future. Let me try to explain:

In my home country, Austria, catalytic converters for motor vehicles became mandatory in 1987. It was the first European country to introduce this eco-friendly step. I was 13 at the time, and I remember the heated discussions pro and con we had at school and in the family. The topic was just all over the place. One detail, though, I distinctively recall is that the catalytic converters required unleaded fuel, and not all petrol stations supplied that yet during the transition phase. There were, after all, more cars on the road without converters than those with. So the petrol stations would have big signs and stickers out promoting their eco-friendliness and that they did offer unleaded fuel. You'd even hear the list of new petrol stations with unleaded fuel read out by the newscast, right after the news on the radio.

Now, more than 30 years later, no petrol station would start a big promotion with the notion they had unleaded fuel available. It is just a natural, a given.

My take is, it will be the same in asset management, say another 30 years from now. No asset manager will have a significant edge or distinction criteria alone by waving around their ESG policy during a sales pitch. Investors and society, as well as the asset managers themselves, will, of course, have incorporated ESG factors deep into their DNA in their investment process.

A seismic shift has been taking place and, initiated by pioneers, sustainable investing has clearly transformed from something perceived as a little quirky or niche to the "way it is done properly."

But how far has sustainable investing penetrated into the alternative investment space? In this special report on "ESG in Alternatives," which HedgeNordic is co-publishing with NordSIP, we cover a wide range of topics on sustainable investing within the alternatives industry.

Ashok Kumar Muthusamy, Senior Quantitative Researcher at Man Numeric, starts off with a discussion on "Costing the Transition to Net Zero" for companies that have already embarked or will embark on their paths towards net zero. Fernando Olaso, the co-head of the real assets team at Altamar CAM Partners, talks about the private markets specialist's co-investment real assets fund that has "Sustainable Megatrends at the Core of Co-Investment Strategy." With scope for a huge scaling up of blended finance to accelerate developing countries' transition towards lower carbon future, Nadia Nikolova, Lead Portfolio Manager in Development Finance at Allianz Global Investors, sees "Blended Finance at an Inflexion Point" with "Positive ESG Impact and Reasonable Return."

A naïve application of ESG investing in sovereign fixed-income markets could exacerbate SDG funding gaps, warns the World Bank, with average Sovereign ESG scores exhibiting a near 90 percent correlation to a country's level of income. A team at Emso Asset Management – Jens Nystedt, Oliver Faltin-Trager, Shikeb Farooqui, Joe Leadbetter, Mark Quandt – and Teal Emery of Teal Insights provide an update on the "Progress Towards a Sovereign ESG 2.0 Framework" that can halt the perverse effect of skewing capital flows towards rich countries and away from developing economies with the most significant SDG funding gaps.

Lindsay Thompson, Director and Head of EMEA Client Success at SS&C Eze, provides answers to a set of questions on "The Role of Technology in Navigating Complex ESG Requirements." As sustainable investments grow, so too does the need for risk management solutions that are specifically tailored to ESG criteria. Payal Shah, Director and Equity Research and Product Development at CME Group, talks about "ESG Futures – Defining a Sustainable Core."

Julia Axelsson of NordSIP revisits "The Sustainability of Short Selling" by discussing the pros and cons of short selling and where short selling meets ESG. Jack Inglis, the CEO of the Alternative Investment Management Association (AIMA), seeks to answer the question of whether 2022 is the "Year ESG Growth Finally Becomes Sustainable?"

Turning to the Nordic hedge fund industry, Finnish asset manager Afalon Investment Management has launched a hedge fund focused on "Dividend Harvesting from Sustainability Themes." Head of Sustainability Ann-Sofie Odenberg and Sustainability Manager Hampus Hårdeman from Brummer & Partners talk about "Managing ESG as a Multi-Manager" and their ESG Risk Rating Matrix that is currently in development.

Hamlin Lovell's editorial observes that "Hedge Fund Managers Accelerate ESG Integration" and "Diverse Approaches Exist Because No One Size Fits All Credit Investors." Lastly, Stefan Roos of Origo Fonder, Christer Bjørndal of CARN Capital and a team at Norron Asset Management argue that "Sustainability: More Than Just a Catchphrase" among Nordic long/short equity managers.

We hope you find some interesting content to read, enjoy and debate and enjoy the upcoming holiday season.

Very best wishes,

Kamran Ghalitschi

Kamran Ghalitschi
PUBLISHER, HEDGENORDIC

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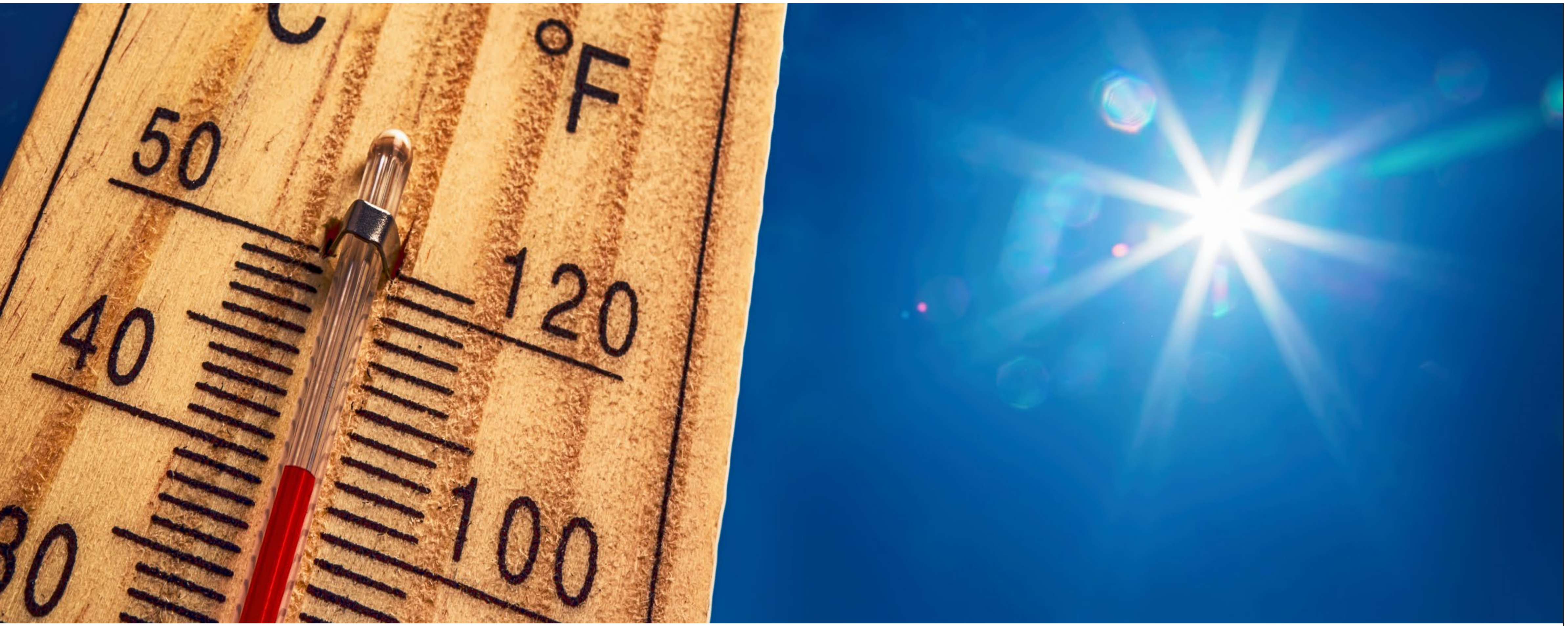

“Companies begin their path towards net zero from different starting places, and that therefore the cost of transition is different based on how far the company needs to travel from its current business model to reach net zero.”

Costing the Transition to Net Zero

Ashok Kumar Muthusamy – Man Numeric

INTRODUCTION

Over the next 30 years, the world will alter unrecognisably. The scale of the change will be comparable to any of the great secular revolutions that changed the way we lived – the industrial revolution, the mechanisation of agriculture, the age of technology.

Decarbonising a world addicted to oil, coal and gas will require innovation, creativity, collaboration. It will ask management teams to construct new futures for their businesses decoupled from carbon.

Investors will also need to reimagine their portfolios in a net-zero world. We believe that – notwithstanding the elements of uncertainty in the route to net-zero – it’s incumbent on us as portfolio managers to attempt to put a cost on the process of transition. As such, we have constructed a dynamic model that works with the most up-to-date climate models and company information to show how valuations will change as we move towards 2050.

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> "It's important to draw a distinction between 1.5-degree alignment and carbon intensity as measures of a company's vulnerability to transition risk."

THE COST OF TRANSITION

It goes without saying that companies begin their path towards net zero from different starting places, and that therefore the cost of transition is different based on how far the company needs to travel from its current business model to reach net zero. Figure 1 shows the two dimensions we use to track where a company is on its journey to net zero.

We have scored the S&P 500 Index according to two different elements. The first is what their current emissions are. This is largely a facet of which business they are in. We then look at how closely aligned they are to the emissions reductions required by the Paris Agreement.

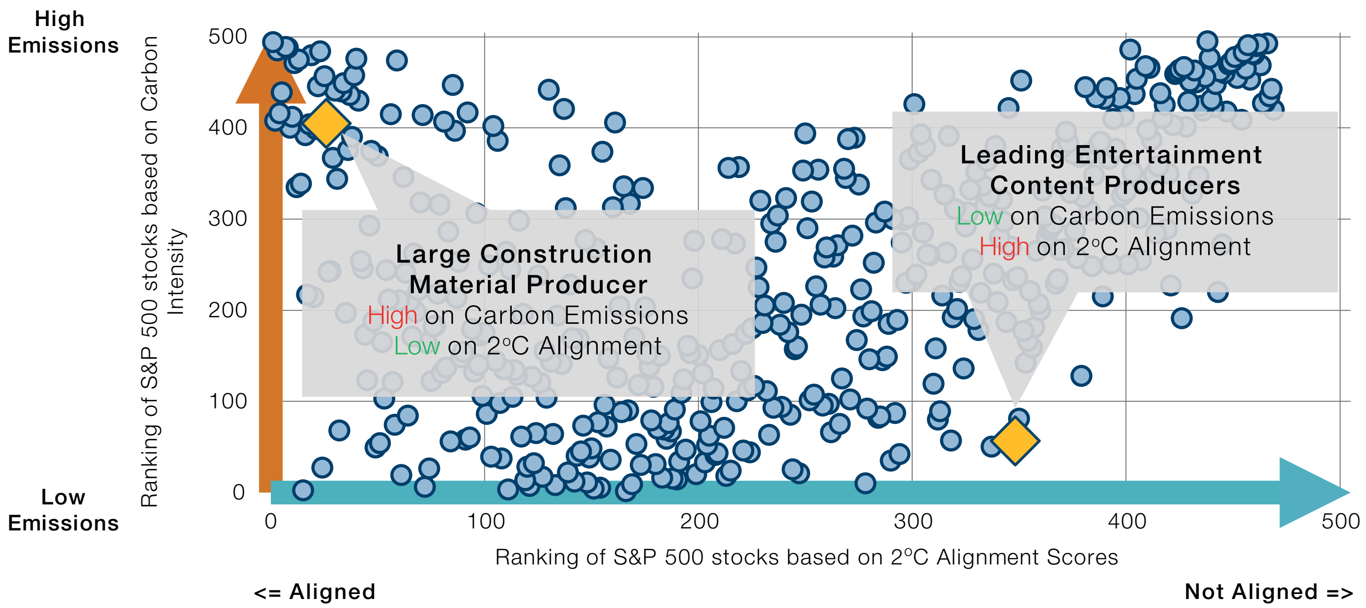
To do this, we use data provided by the Science Based Targets Initiative ('SBTI'). This is a partnership organisation – between the Carbon Disclosure Project, the United Nations Global Compact, the WWF and others – that has come up with a framework to determine the extent to which each industry must reduce their emissions if we are to achieve the Paris Agreement. The SBTI data looks at both the realistic measures firms in an industry might take to reduce their emissions and what lower-carbon alternatives there might be to their business models, before allocating each firm a series of emissions targets.

The top left point of Figure 1 represents a 'large construction material producer', which necessarily emits a lot of carbon and hence scores very highly on the carbon emissions dimension. However, we don't have any alternative for cement yet. Thus, in order to support the economy, we have to allow cement companies to keep emitting. Therefore, notwithstanding the higher emissions, from an alignment angle, this company scores amongst the highest in the S&P 500 (note a lower score here represents better alignment).

On the other hand, let's look at the example of a 'leading entertainment company' on the bottom right. The company emits very low amounts of carbon but still doesn't score well on the alignment angle because compared to its industry trends and based on what it could realistically achieve, it is still emitting more than it ought to be emitting.

So, transition costs are a function of both the current level of emissions and the potential for alternatives/ reduction in carbon usage of each company's current business model.

FIGURE 1: THE TWO DIMENSIONS OF A COMPANY'S CARBON FOOTPRINT



Source: Man Group, TruCost; as of April 2021

Transition costs can manifest themselves in a variety of different ways, and we would suggest that the model above is just the starting point for a discussion of transition risks. It is, for instance, more difficult for heavily emitting firms to secure insurance, given the greater risk profiles of their businesses. Seventeen major firms, including Chubb, Generali, Swiss Re, Axis Capital, QBE, and Allianz, have announced that they will limit insurance provided to energy firms because of climate concerns. AXA has announced that it will cease providing coverage to any new oil pipelines, coal plants, and tar sands projects. As the company's CEO, Thomas Buberl, put it: "A +4°C world is not insurable."

It's also harder for such firms to get even basic banking services. HSBC, for instance, recently announced that it will no longer finance the construction of offshore petroleum projects in the Arctic, tar sands developments in Canada, or most coal-fired power plants. Other large banking institutions such as ING, BNP Paribas, Wells Fargo, Morgan Stanley, Legal & General, JPMorgan, Deutsche Bank, and the World Bank have announced similar policies regarding their relationships with fossil fuel companies.

It's important to draw a distinction between 1.5-degree alignment and carbon intensity as measures of a company's vulnerability to transition risk. Different firms will be in different positions as far as a number of elements extraneous to the mandates of the Paris Agreement are concerned. These include the stringency of local regulations and government interpretations of pledges – note that the Netherlands pursued Shell in the landmark court case earlier this year even though other energy firms are far less aligned; on the other hand, Australia has been consistently unwilling to penalise coal

Ashok Kumar Muthusamy, Senior Quantitative Researcher - Man Numeric

producers. There are also second-order impacts like investor sentiment and pressure from employees, suppliers, customers and other stakeholders.

In order to achieve a rounded picture of transition risks, it's important to consider not only where a firm lies in relation to its declared goals, but also to the second order pressures that it faces from its wider ecosystem.

One final point worth noting here: it may seem at first glance that we will therefore be predisposed to invest in companies who are less likely to face pressures from government, investors and their wider stakeholders. This is obviously a perverse situation and we remedy it by increasing our estimates of the physical costs faced by these companies as a result of climate change. Physical costs represent the higher price of insurance as well as natural disaster risks the company may face and recognises the fact that transition risk and physical cost are to some extent mutually exclusive. That is, if a government cracks down on a company's emissions, it will face near-term costs to meet regulations but potentially be less impacted by overall climate change; conversely, firms who aren't penalised may benefit in the near term, but suffer more serious long-term consequences.

Want to read more on how to position your portfolio for a warming world? Scan the QR code and download our white paper.

Fernando Olaso, Managing Partner – Altamar Capital Partners

Sustainable Megatrends at the Core of Co-Investment Strategy

By Pirkko Juntunen – HedgeNordic

Buzz words in investments come and go, rising to the top of marketing brochures and investor communications. However, it seems that the biggest of them all, sustainability, is increasingly taking root within the very investment strategies of investors.

Altamar CAM Partners, the global private markets specialist, is launching its first dedicated co-investment real assets fund with a focus on sustainability. The key to their strategy is investing in previously identified sustainable Megatrends, combining strong industry tailwinds with demonstrable scope for achieving ESG goals. These Megatrends include digital transformation, healthcare, new ways of living, clean energy, supply chain revolution and sustainable cities.

Fernando Olaso is the co-head of Altamar CAM's real assets team, which has been involved in co-investments since launching in 2004. He was quick to point out that this kind of investing is not new to the team, but the dedicated nature of the product and the top-down focus on sustainability is.

> "Knowing the sectors is critical. You can have a lousy investment in a good sector."

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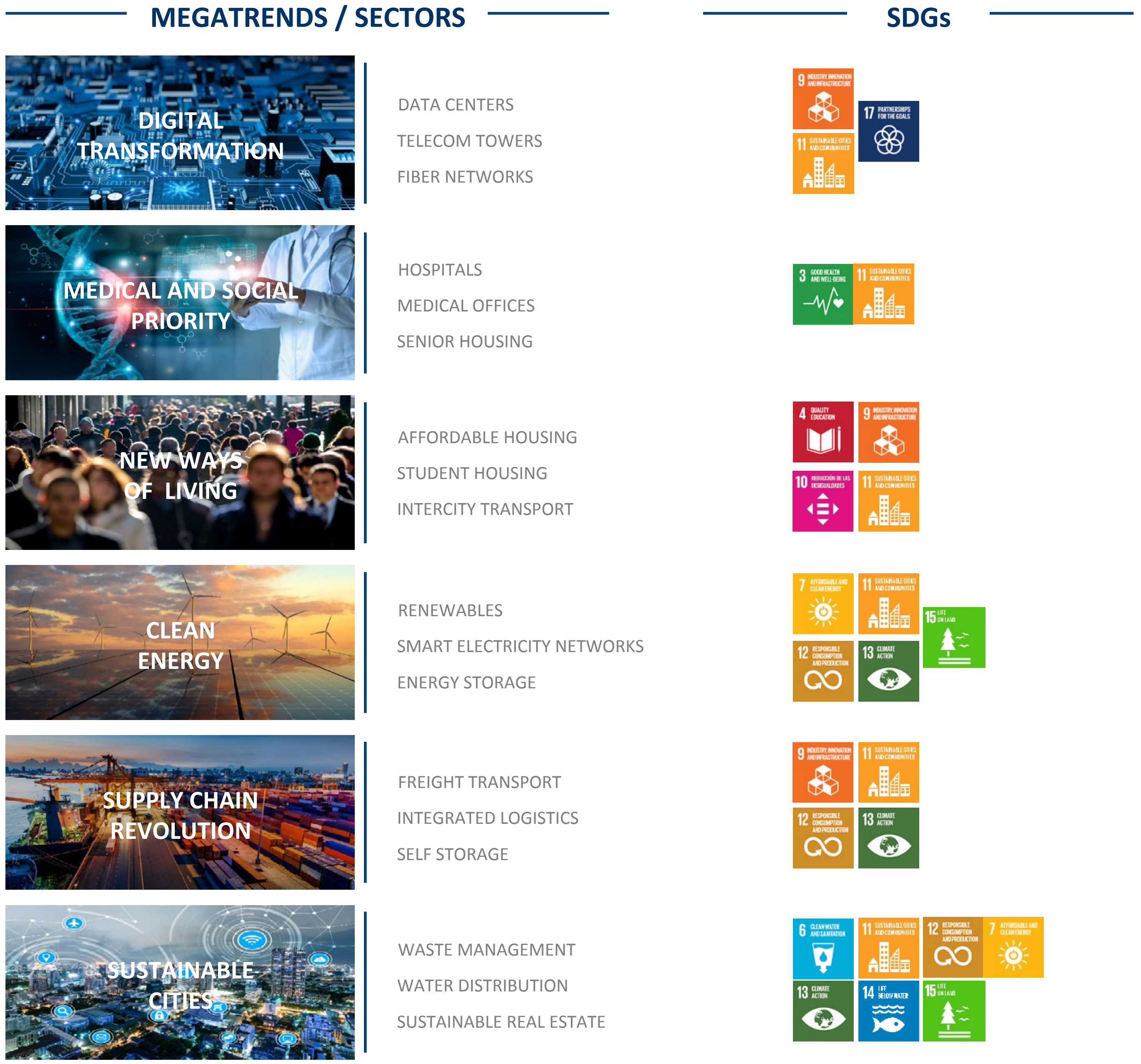

"My team has already accumulated strong investment experience in these Megatrends," he said. "The environment remains challenging in almost all asset classes, but I believe Altamar CAM has the right mix of dealflow, relationships and team experience to identify attractive investment opportunities. It's no great secret that a lot of capital is chasing deals in these sectors, but our track-record, experience and access to excellent opportunities alongside trusted managers across Europe and the US put us in a great position."

Many of these strong relationships with managers come from Altamar CAM's sizeable fund of funds business, through which Olaso's team invests in real assets funds across the globe. "Those funds are a great source of co-investment opportunities for us. The managers know us and value us. Most of our team come from a direct investment background which gives us the ability to underwrite direct deals thoroughly and quickly," Olaso said. "We can move swiftly and this is important because most co-investment opportunities work under tight timeframes."

Olaso recognises that identifying assets with strong tailwinds does not guarantee success, and that the rigorous research and bottom-up analysis carried out by his team is essential to the success of the fund. "Knowing the sectors is critical," he noted. "You can have a lousy investment in a good sector. Our outstanding success rate in co-investments is testament to the strength of our due diligence process."

For the past few years institutional investors have been allocating an increasing percentage of their assets to private equity, real estate and infrastructure, but many are wary of the double layer of fees in co-investment funds. Olaso argues that the way Altamar CAM has set up this fund it is 'very LP friendly'. He explained that fees are similar to that of a direct investment fund. "Typically speaking the GPs with which we co-invest can offer us lower fees compared to a direct fund, on average, because we have a relationship with them," he said.

The sectors that the fund targets, such as clean energy, healthcare or sustainable cities, are by default focused on ESG and sustainability. Interestingly, the fund will mainly target brownfield assets, with a minor allocation to greenfield. Olaso highlighted that there is a huge opportunity to upgrade existing buildings and infrastructure assets, which some sustainability-focused managers might neglect.

Recently Altamar CAM sold a portfolio of multifamily assets to Allianz, the German insurer. Altamar CAM had improved efficiency and reduced the carbon footprint of the assets by more than 60%, and Olaso is convinced that this was a crucial factor in the success of the deal. "Allianz would not have bought it had we not had such a strong sustainability focus," he said. "Tenants want to lease and rent space that is sustainable and investors want the same." Olaso noted that Allianz is one of the founding signatories of the UN-covened Net-Zero Insurance Alliance, committed to reaching net-zero greenhouse gas emissions across its portfolio by 2050.

Monitoring and measuring the effectiveness of ESG investments has gained a lot of attention as the popularity of impact investing grows. Olaso pointed out that the purpose of the new fund is not impact investing but ESG enhancement. He said there are several stages where the ESG criteria are checked and consistently measured. "We want to work alongside GPs who have not only strong general ESG objectives and policies in place, but also specifically defined objectives for the assets in which we co-invest. We will be tracking the ESG impact with measurable KPIs and we will produce regular reports to show the progress," he explained.

Because of the layers of due diligence, the likelihood of an asset being classified as negative from an ESG perspective is extremely low. "We will simply not invest in sectors that rank low from an ESG perspective. Those sectors are banned through our screening system. We have been UNPRI signatories since 2016 – with an A+ rating in all categories - and more recently implemented a company-wide exclusion list." Olaso added.

The recent COP26 event gained much media attention and Olaso believes it is important to get policymakers, corporates and scientists together to send the right signals. He believes the real engine of change is with the general population and private markets, working together towards a more sustainable future. "An investment is not a good investment if it is not sustainable in the long run. There is no doubt that investing sustainably is critical for returns. We are thrilled to see more investors taking this on board, and pushing the dialogue surrounding sustainability to new levels," he concluded. "I´m sure this is only the beginning."

> "We want to work alongside GPs who have not only strong general ESG objectives and policies in place, but also specifically defined objectives for the assets in which we co-invest."

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Nadia Nikolova, Lead Portfolio Manager in Development Finance – Allianz Global Investors

Blended Finance at an Inflexion Point

Positive ESG Impact and Reasonable Returns

By Hamlin Lovell – HedgeNordic

It is now widely accepted that ESG investing can be consistent with strong risk-adjusted returns and might even enhance them, but there is more debate over whether different types of impact investing need to sacrifice some risk-adjusted return for their objectives. The answer is yes and no according to blended finance. One group of private sector investors can invest in impact projects with competitive risk-adjusted returns precisely because another group of mainly public sector and voluntary investors are prepared to bear a bigger share of risks.

FILLING THE FUNDING GAP

Blended finance is essential to fill the USD 4.2 trillion funding gap for meeting the UN SDGs by 2030 that exists in many emerging and frontier market countries, which is holding back their economic growth and fulfilment of potential in areas including health, life expectancy, education, employment opportunities (especially for women), and climate friendly growth. The Net Zero Asset Owner Alliance, which is chaired by Allianz board member, Gunther Thallinger, is not only focused on developed countries' carbon emissions but also sees scope for a huge scaling up of blended finance to accelerate developing countries' transition towards lower carbon future, set out in its "Scaling Blended Finance" paper published in November 2021.

Many developing economies are so small that some of these countries have no presence or only a tiny weighting in market cap weighted emerging market bond indices, which means they will not attract meaningful amounts of capital from passive or benchmark constrained investors. And even unconstrained active private investors will seldom invest independently and directly into such countries. "The perceived and actual risks include politics, credit risk, repatriation of capital, structural complexity and familiarity. Why risk sub-Saharan Africa when you could get the same yield in the EU or US?" says Nadia Nikolova, Lead Portfolio Manager in Development Finance at Allianz Global Investors.

"Blended finance aims to de-risk investments so that returns are commensurate with risk," she says. Risk mitigants include development banks or other financial institutions and donors anchoring funds or individual deals by one or more of: taking a junior position that would bear the first loss in a structure;

providing guarantees and investing over a longer time horizon to take care of time related tail risks. Whether or not there is any explicit political risk insurance, collaboration with development institutions provides a considerable degree of comfort: "Private investors are implicitly insuring against political risk by coinvesting with development banks," argues Nikolova.

WHICH COUNTRIES?

Since China and some other larger and wealthier emerging market countries already have well developed capital markets, blended finance tends to focus more on dozens of countries in sub-Saharan Africa; the Caribbean and South Asia. "There we see the largest gaps between the need for investment and capacity, given constrained balance sheets. Many frontier and emerging market sovereigns were indebted before Covid, and they now have a higher debt burden," says Nikolova.

Some countries subject to certain EU and UN or other sanctions would need to be excluded.[1] For instance, in South America: Venezeula and Nicaragua, and in Africa: Guinea; Mali; Libya; Sudan; South Sudan; Central African Republic; Democratic Republic of the Congo; Somalia and Zimbabwe.

WHICH PARTNER INVESTORS?

In blended finance, private investors are partnering with public, hybrid public/private, and voluntary entities. Most development banks are publicly owned but a few such as the Netherlands' FMO Entrepreneurial Development Bank may have some minority private shareholders. Foundations and charities usually raise funds from the private sector, including their founders, but some of them may also receive public funding. The foundations involved in blended finance tend to be the larger ones.

Development banks can be global, such as the IFC, regional, such as the Inter-American Development Bank. Mexico has several that invest in Mexico. They may be multilateral, like the EBRD or EIB or African Development Bank, or bilateral, such as the national development banks of most European countries eg Denmark's IFU or Sweden's Swedfund. Allianz in 2017 partnered with the IFC for the Managed Co-Lending Portfolio Program (MCPP) but has now broadened out the model to work alongside potentially hundreds of development finance institutions (DFIs).

"Blended finance aims to de-risk investments so that returns are commensurate with risk."

Sometimes the first loss risk could also be shared with one or more development agencies, which might provide guarantees (the Swedish Development Agency (SIDA) provided a guarantee to the IFC for part of the first loss funding for MCPP).

RETURN AND RISK PROFILE

The DFIs and donors invest in the junior tranche of a fund, which might be the bottom 10-15%, while the senior tranche is for private investors. "The thickness of the junior tranche is determined by cashflow waterfall, risk and diversification in the fund, and will vary between funds," says Nikolova. The first loss attachment point is calibrated to give the private investors a return and risk profile comparable to investment grade credit, though neither the fund nor the underlying loans have any credit rating, let alone an investment grade one. This is not surprising when 88% of emerging market countries are not classified as investment grade.

In terms of solvency II risk weightings under the standard model, which are relevant to various public and private insurance organisations and some pension funds covered by Solvency II, the capital charge should be very close to investment grade.

In the current fundraising, for Allianz Climate Solutions Emerging Markets Debt strategy*, Allianz is anchoring the senior tier with $350 million, another $500 million is sought from external investors and up to $150 million will be in the junior tier.

The target IRR return for the senior tranche is an average of 4.5% net of fees at current interest rates, but since the loans are floating rate this could tick up if interest rates pick up. "The return is not only interest but also up-front and commitment fees, and varies between projects," says Nikolova. "The senior tier of the fund is expected to have at least 90% exposure to senior debt of individual deals, but it could have small amounts of mezzanine or subordinated exposure when this suits projects," she adds.

The first loss tranche receives a dividend, and the return target is not disclosed though profit is not the only motive. This is classified as "non-concessionary" financing, which is on terms that are more favourable to borrowers than normal market conditions. Thus, the first loss investors are potentially sacrificing some return for the impact objective, whereas the private investors are aiming for reasonable risk-adjusted returns.

PROJECTS MAJOR ON RENEWABLES

Allianz has previously managed blended finance funds focused only on infrastructure but now the mandate is broader: The Allianz Climate Solutions Emerging Markets Debt strategy focuses on Paris-aligned investments. It will lend to the private sector, often via special purpose vehicles dedicated to specific projects.

"Renewables such as solar and wind farms; solar panelled rooftops; energy efficiency; smart climate technology; electricity grids; smart agriculture; smart home cooking, and switching from old to LED electric bulbs are examples," says Nikolova. The split between water, wind and solar power will vary depending on countries' natural resource endowments. Progress towards electrification and electric vehicle charging infrastructure will also vary enormously between countries. Though some of the projects could drill down to small scale domestic objectives, this is not a microfinance strategy. The deployment of capital also broadens the relationship with development banks, which help to source the deal-flow, in addition to sometimes being junior investors in Allianz's (or other) blended finance funds.

ESG, SDGS, IMPACT, AND EU SUSTAINABLE FINANCE

The choice of projects is partly based on screening for positive and negative impact, in line with the IFC's Operating Principles for Impact Management, which are also followed by 140 institutions, and Allianz's private debt ESG policies.

"Excluded sectors include tobacco, weapons and some carbon intensive sectors. In Emerging Markets, there is a social cost of not investing in transition fuels such as natural gas. This is particularly the case in countries

> "The return is not only interest but also up-front and commitment fees, and varies between projects."

where electricity connectivity is low, or the economy is heavily dependent on gas/oil. With respect to natural gas, most Net-Zero investors tend to exclude new investment even in Emerging Markets," says Nikolova.

Given the Paris agreement alignment, the strategy is clearly focused on UN SDG 13, and it could also touch on any or all of the other SDGs. Impact performance reporting will not necessarily be mapped onto the 17 SDGs however. "It is more important to be able to quantify impact indicators, such as how many people are employed in permanent positions, or how much carbon is removed. Carbon reporting will start with scope 1 and 2, and could over time add scope 3 plus breakdowns into different greenhouse gases, where this is available," says Nikolova.

In terms of the EU Sustainable Finance Disclosure Framework (SFDR), the fund will target compliance with article 9, which is something of a moving target as the legislation is still evolving. "Although the scope of the EU Taxonomy is limited to European Union, and therefore emerging markets borrowers do not always disclose requested information, the strategy aim to "shadow" the taxonomy by initially monitoring screening for eligibility and alignment with the EU environmental taxonomy. When the social taxonomy comes into force, there could also be some screening for it," says Nikolova.

ENFORCING ESG PERFORMANCE

The strategy's ESG approach is distinguished by the DFI's robust and very active methods of enforcing ESG compliance, which have also been adopted by other development banks. Whereas some impact strategies incentivize ESG improvements through coupon reductions, this strategy hard codes ESG requirements into loan covenants, and a breach of the covenants is classified as a default. "In cases of default the objective would be to engage and negotiate improvements to remedy the breach, rather than foreclose and call in the loan. The governance structure of deals gives the development banks a seat at the table which lets them influence ESG on each project," says Nikolova.

1 EU Sanctions Map

* Private debt investments are highly illiquid and designed for professional investors pursuing a long-term investment strategy only. Pre-Marketing Communication. This is an incomplete draft. It does not contain sufficient information to allow potential investors to take an investment decision. It does not constitute an offer or an invitation to subscribe for interests, units or shares of an Alternative Investment Fund. The information presented herein should not be relied upon, since it is not final, incomplete and may be subject to change. AdM 1962264


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PROGRESS TOWARDS A SOVEREIGN ESG 2.0 FRAMEWORK – AN UPDATE

By Jens Nystedt, Oliver Faltin-Trager, Shikeb Farooqui, Joe Leadbetter, Mark Quandt –

all Emso Asset Management and Teal Emery (Teal Insights)

ESG investing faces growing pains. ESG investing rapidly outgrew its origins in the equity market and spread to many other asset classes. Earlier this year, the World Bank warned that a naive application of ESG investing in sovereign fixed income markets could exacerbate SDG funding gaps.[1] Average Sovereign ESG scores have a near 90% correlation to a country's level of income.

Tilting investment portfolios by score levels that are so highly correlated with country income could have the perverse effect of skewing capital flows towards rich countries and away from developing economies with the most significant SDG funding gaps. In a follow-up paper, the World Bank outlines elements of a Sovereign ESG 2.0 that better balances purpose and profit.[2]

A. WORLD BANK FINDINGS

Diagnosis

Sovereign ESG deserves special consideration. Sovereigns fundamentally differ from corporations in size, function, and motivations. What E, S, and G mean in the context of sovereigns is different than for corporates.

Sovereign ESG scores do not quantify sustainability. Instead, sovereign ESG scores attempt to measure ESG factors that are financially material to a sovereign's creditworthiness. In other words, a sovereign ESG rating examines which environmental, social, and governance factors affect a country's willingness and ability to pay its debts in full and on time.

Considering ESG factors as an input to the investment process will not necessarily lead to progress on sustainability goals. Targeting purely higher sovereign ESG scores could exacerbate SDG funding gaps and incentivize investment in countries with higher per capita CO_2 emissions.[3]

Average sovereign ESG scores have a near 90% positive correlation with a country's level of income. Investment practices or regulations incentivizing investing in countries with higher ESG scores could skew capital flows towards rich countries and away from poorer nations with the most significant development needs. Other common sovereign-level measures of sustainability such as the SDG Index, Notre Dame's Global Adaptation Initiative Country Index (ND-GAIN), and the Yale Environmental Performance Index (EPI) are also highly correlated with a country's level of income.[4]

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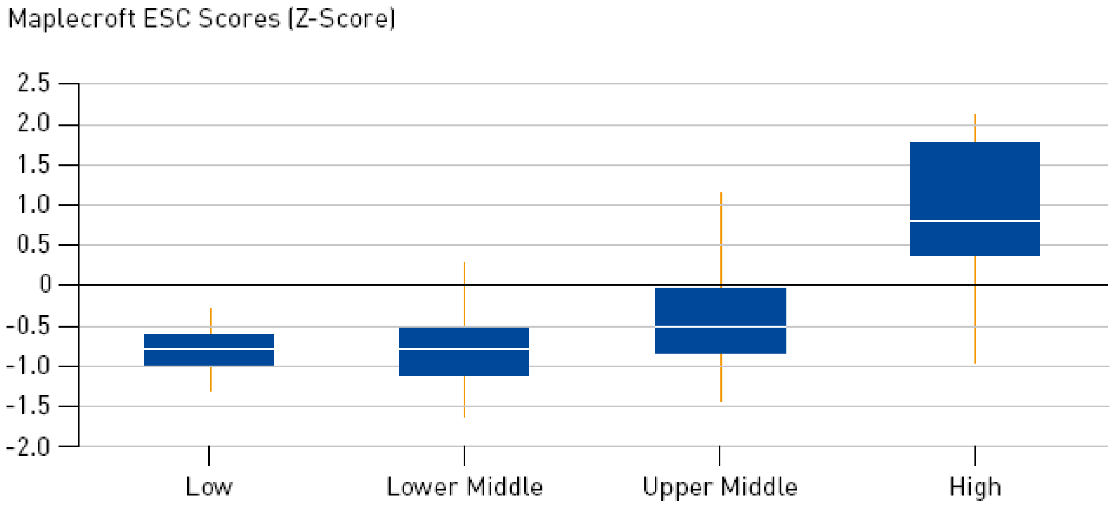
Figure 1: Maplecroft ESG Scores by Income Group

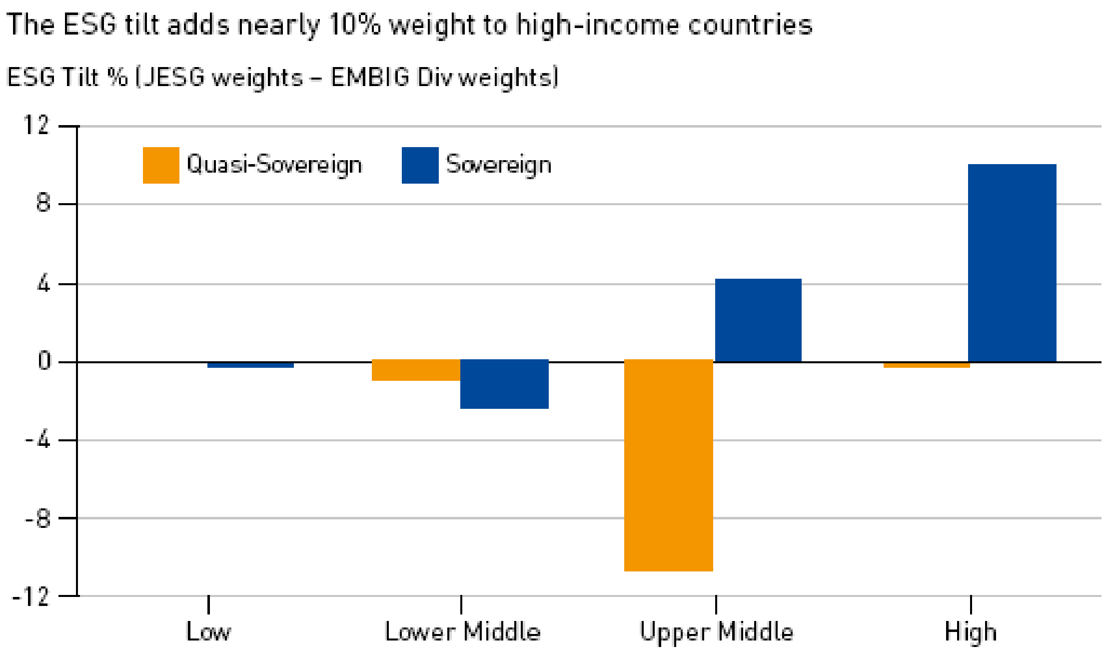


Source: Verisk Maplecroft and World Bank.

There is little agreement on what constitutes good sovereign environmental performance. The average correlation of the environmental pillar scores between data providers is 42% versus 85% for aggregate ESG scores. It is not easy measuring environmental progress if one cannot confidently measure actual performance.

Three challenges explain the divergence in environmental scores between data providers. First, broadly comparable sovereign-level environmental time series suffer from severe data gaps and lags. Creating estimates to fill those gaps and lags requires interpolation and extrapolation. Second, environmental scores may mix financial materiality with environmental materiality, resulting in an overall score that is difficult to interpret.[5] Third, climate risks are non-linear and likely to get worse in the future[6] and as such, require forward-looking approaches with deep uncertainty.

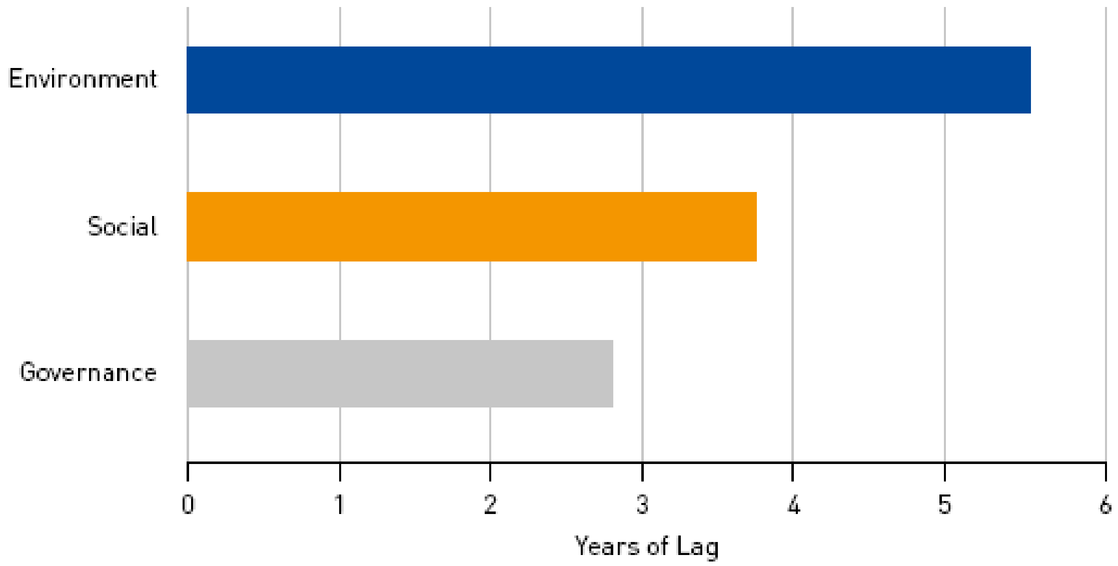
Figure 2: JESG EMBIG's ESG tilt



Source: J.P. Morgan and World Bank.

Finally, the underlying data is a bottleneck. Most underlying data comes from the international public sector or large NGOs. As illustrated in Figure 3, an analysis of the World Bank's Sovereign ESG data portal shows that the median lag for social and governance data is three years, and the median lag for environmental data is five years. In 2021, the latest environmental datapoint would commonly be from 2016, which, in our view, is too late to be considered very useful. That said, big data approaches offer a potential path forward, but in our view, they are not a panacea.

Figure 3: Average Lag in Years by Pillar



Source: World Bank Sovereign ESG Portal.

B. EVALUATING EMSO'S SOVEREIGN ESG FRAMEWORK

Emso's history of incorporating ESG into its investment process dates back many years, but has recently accelerated. As a component of fundamental fixed income investing, Emso has since our inception in 2000, put an emphasis on understanding governance factors. In recent years, we have tried to thoughtfully incorporate further select ESG factors into the research and investment process. We formalized our dedication to ESG with our first ESG policy in 2014 that guided incorporation of at least a minimal level of ESG into our investment process. We further codified our ESG integration by becoming a UN PRI signatory in 2015. Emso's approach to ESG factors has evolved over the ensuing years as we have worked to devise a robust and substantive approach to ESG investing the emerging markets fixed income space.

Historically, Emso has focused on incorporating ESG factors that are financially material for asset prices, with a particular focus on governance factors over time. Taking an empirical approach to using ESG data has improved model accuracy across many of our medium-term fair value models, thereby enhancing our investment process and ultimately, we hope, our investment outcomes.

In line with the World Bank's recommendations, our approach is forward-looking and emphasizes a country's momentum. The framework that we utilize in our mandates which have an explicit ESG overlay allows for the inclusion of improving ESG stories that are not part of the J.P. Morgan JESG EMBI Index (JESG EMBI) if we believe that their ESG scores will improve above the threshold for inclusion in six to 12 months. The ingrained income bias with ESG scores tends to unduly reward high-income countries at the expense of low-income countries which are on

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the right track and, frankly, should be rewarded with marginal capital inflows. For example, despite the impressive efforts of the Angolan government to combat corruption and deliver meaningful structural reforms to the economy under its International Monetary Fund (IMF) program, Angola remains excluded from the JESG EMBI because it started from such a low base, and the data is lagging. We also believe that, within a total return framework, we should have the ability to short countries where the ESG scores are likely to deteriorate. For example, despite a clear deterioration in governance in Lebanon, it remains part of the JESG EMBI.

C. WHERE TO GO NEXT IN TERMS OF ESG INTEGRATION?

There is no free lunch; ESG as a factor in investing

We disagree with investors who propose that ESG considerations can always offer superior return performance, in addition to their positive impact: we believe there is no such thing as a free lunch. Adopting an ESG strategy will, by definition, decrease the size of the investment universe, reducing potential return drivers, at least over the short and medium term. For example, an investor may believe that taking a short position, or no position at all, in oil producers will produce higher risk-adjusted returns in the long term. However, they will have to accept a potential for short-term underperformance as oil prices fluctuate. Over a long-term investment horizon, we believe that giving ESG considerations a higher weight makes sense, but investors need to be aware that such considerations may not be reflected in asset prices anytime soon.

EM fixed income is still mostly pricing the capacity and willingness of a debtor to pay. To the extent that ESG considerations have an impact on these two factors, including them in any, whether explicitly an ESG overlay or not, could enhance investment returns, but there is no guarantee. Excluding poorly rated ESG issuers or overweighting positive ones is a style factor which historically has outperformed in some markets, while underperforming in others for many asset classes, including EM fixed income. Arguments made for ESG as a positive return driver in the short term are usually based on selective or limited data sets that do not have long enough cycles to assess. In EM fixed income, especially in local rates, ESG overlays that shift allocations to higher-rated issuers have also led to longer duration exposures, which has proved beneficial over the past few years, but not because of any ESG component.

Move towards outcome based instruments

At Emso, we are constantly on the lookout for better and more timely sources of ESG data. Data providers are putting increasing effort into providing improved ESG data for sovereigns and quasi-sovereigns. However, timely and relevant environmental coverage remains elusive. We are optimistic about geospatial technology which might significantly improve sovereign-level environmental data. Verisk Maplecroft, for example, have full spectrum coverage across all physical and natural capital risks at resolutions from <1km² to 22km².

Larger firms are rapidly acquiring innovative ESG data start-ups. It will be important that new approaches are thoroughly vetted before being incorporated into existing product offerings and innovation is not halted prematurely. We remain very optimistic about the evolution and quality of ESG data, which means we would not want to tie ourselves down to any one data provider at this stage.

The rise of labelled bonds

Emso's focus has so far been on integrating financially material ESG factors in its investment process across strategies. Labelled bonds, and sustainability-linked bonds provide a way to link investment with sustainability outcomes.[7] Whether green, blue, social, sustainable, or sustainably-linked, these instruments have seen a surge in investor interest over the last 18 months, but the lack of standardization and third-party monitoring still raises challenges of greenwashing and verification. These bonds cannot promise sustainability outcomes and a lot of work remains to adapt labelled bonds to a sovereign context.

Investor engagement the next frontier

Academic literature[8] suggests that investor engagement is the most effective tool for driving the sustainability outcomes that end-investors increasingly expect. There remain open questions as to the most appropriate and effective areas for sovereign creditor ESG engagement, but we believe that progress is being made.[9] Traditionally, investors met mostly with economic policymakers in a finance ministry and central bank. Some sovereign debt issuers, proactively trying to adapt to the shift in investor sentiment towards sustainability, are beginning to facilitate investor dialogue with a wider set of policymakers on sustainability issues.[10]

Emso is currently actively involved at the working group level in the Investor Policy Dialogue on Deforestation (IPDD) which is a collaborative investor initiative established in July 2020 to engage with public agencies and industry associations in select countries on the issue of deforestation. Investors within this group recognize the crucial role that tropical forests and other types of natural vegetation play in tackling climate change, protecting biodiversity, and ensuring ecosystem services. As of July 2021, IPDD is supported by 54 global institutional investors from 18 countries. The coalition now represents approximately USD 7.2 trillion of AUM. The goal of the initiative is to coordinate a public policy dialogue on halting deforestation and to raise awareness within the investor community about deforestation trends and its impact. It also intends to present a stronger representative voice to regulators. The initiative started with Brazil, and as of January 2021, has expanded to include Indonesia.

E. CONCLUSION

At Emso, we will continue to strive to develop new and innovative ways to incorporate ESG across our strategies. We believe that our research presents a valid assessment of the potential trade-offs of ESG strategies. Our ESG framework has focused on integrating financially material ESG factors into the investment process. We integrate the data into our investment process via an econometric modelling framework that we believe allows us to improve investment outcomes. However, we acknowledge this approach utilizes ESG more as a risk mitigation tool than delivering on the UN's SDGs or the Paris Climate Agreement targets. We believe that rather than overpromising what ESG led strategies can deliver, it is more fruitful to engage with asset owners on what goals they are planning to achieve (outcome based or financial materiality) and at what cost over the relevant investment horizon.

Looking ahead, we have taken stock of Emso's Sovereign ESG framework to see how it aligns with the World Bank's Sovereign ESG 2.0 framework. We are encouraged by the World Bank's recommendation as it is very much in line with the direction that we are already heading. However, the World Bank's approach also highlights ample room for improvement and suggests where we might want to go next. Data availability will remain an outstanding issue in our view, and it is useful to reiterate the need to avoid the ingrained income bias. Moreover, we think that the rapid surge in labelled bonds presents interesting, more outcome-based, opportunities for EM ESG investing. We see the most room for improvement in engagement; particularly between sovereigns, quasi-sovereigns, and investors. We see the work the IPDD is doing as a useful model, and we are looking for other areas where we can draw on their lessons and use it in other countries and contexts. Finally, we believe that taking short positions in poor ESG performers is an important approach to reduce the costs of an ESG overlay; why should we only focus on "improving stories" when additional alpha opportunities can be identified by, for example, highly-rated ESG issuer reversing course? We see a role for taking short positions in any ESG based absolute or total return strategy.

1) Gratcheva et. al. 2021b

2) Gratcheva et al. 2021a

3) Typically, richer countries tend to have higher emissions per capita, so just evaluating a country on pure ESG scores may result in higher per capita C02 emissions compared to a lower-rated ESG country.

4) The World Bank research reports name this phenomenon "ingrained income bias". See Gratcheva et al 2021b, p. 31-33.

5) Boffo et al. 2020, "ESG Investing: Environmental Pillar Scoring and Reporting", OECD Paris, www.oecd.org/finance/esg-investing-environmental-pillar-scoring-and-reporting.pdf.

6) Bolton et al. 2020. "The Green Swan: Central Banking and Financial Stability in the Age of Climate Change." Basel: BIS. https://www.bis.org/publ/othp31.pdf.

7) See Boitreaud et al. 2021 p. 22-24 for a discussion of the relative strengths and drawbacks of labeled bonds from an asset manager perspective.

8) Kölbel et al 2019

9) Equity holders are partial owners of the companies they are invested in. Sovereign debt holders have a very different relationship with governments whose debt they own, meaning that the nature of engagement will be different and more limited in scope.

10) The World Bank, as part of its advisory services, has provided guidance to debt management offices (DMOs) on engaging with investors on ESG issues. See Hussain et al 2020.

The Role of Technology in Navigating Complex ESG Requirements

By Lindsay Thompson, Director, Head of EMEA Client Success – SS&C Eze

"Generating accurate investor reports and navigating complex compliance rules can prove difficult if fund managers don't have the right technology to automate and simplify the process."

Q. What are the main challenges facing fund managers managing ESG strategies and what do they need to do to address them?

Sustainable investing has been one of the fastest-growing asset management trends in the last few years. As a result, managing ESG strategies is no longer about simple restrictions; it's evolved from an informal goal into a more complex criterion rooted in investment strategies. Nevertheless, many fund managers still find managing their ESG mandates tedious, time-consuming, and requiring hands-on management.

Portfolio managers and analysts churning extensive data sets from different sources and vendors to devise proper weightings can be costly and inefficient. The best way to alleviate this is to integrate your ESG data source of choice into your order management system. A competent OMS should have a vendor-neutral architecture so you can connect with any data source and be able to automate data unification, whether third-party or internal. This will enable you to speed up ESG implementation and produce results.

Another challenge is the lack of standardization in the industry regarding reporting frameworks. Generating accurate investor reports and navigating complex compliance rules can prove difficult if fund managers don't have the right technology to automate and simplify the process. Even by aggregating the most crucial ESG data, without fully integrated pre- and post-trade compliance, funds promising any level of ESG mandates can find themselves over or underexposed and trading non-compliant securities.

Investors are looking for ESG transparency. As a result, firms are under tremendous pressure to find

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Lindsay Thompson, Director,
Head of EMEA Client Success – SS&C Eze

Lindsay is Director, Head of EMEA Client Success at SS&C Eze. In this role, she manages EMEA's Client Success team, which drives continued client satisfaction by maintaining high-touch relationships and developing deep understandings of clients' business needs. Lindsay acts as a strategic advisor, overseeing upsell opportunities and leading company-wide client focus programs to ensure Eze continues to provide value.

Lindsay joined SS&C Eze in 2012. Before leading the Client Success team in London, she worked in Boston and New York as a Senior Business Consultant focusing on Eze Investment Suite implementations. She later held the role of Associate Director, EMEA Client Solutions, during which she helped implement a new client service model and led a team of 20 client service professionals in the day-to-day support of global Eze Investment Suite clients.

Lindsay holds a bachelor's degree in Economics and Environmental Studies from Bates College.

technology to help them better monitor and report on portfolio-level ESG exposure. SS&C recently launched ESG Reporting Solutions, allowing portfolio managers to understand ESG exposure in portfolios and support investor reporting. Technology plays an integral part in helping improve the management of ESG mandates, which can help firms get ahead of investor demands and the competition.

Q. What features should fund managers be looking out for from their technology provider?

Whether you manage a single ESG fund or apply ESG criteria across your universe of portfolios, your order management system should enable simplified workflows and controls.

Modeling and analytics tools enable portfolio managers to monitor, manage, and track specific ESG metrics relevant to portfolios. For example, look for a platform to let you slice and dice your portfolio by ESG rating or simulate changes in a portfolio to see how they impact exposures.

With multiple sources providing ESG scoring data, your system must connect to third parties and load this data consistently and seamlessly across the enterprise. Additionally, unique custom fields at the security level allow additional flexibility when integrating data into the system.

A flexible compliance engine is a prerequisite if you want to effectively automate pre-and post-trade processes and gain holistic control of your ESG operations. Your system should make it straightforward to track and compare benchmarks and perform complex calculations within a portfolio, in addition to restricting specific securities. You should be able to monitor data in real-time proactively and receive critical rule violations notifications, market creep, and security master data changes. Additionally, an integrated, intuitive rule builder should create custom rules based on ESG criteria at the portfolio, fund, and account level. Creating compliance rules on your ESG data should automate labor-intensive workflows and remove manager discretion risk, allowing your portfolio managers to concentrate on alpha-generating tasks.

At SS&C, we pride ourselves on our client service and expertise. Leveraging an experienced, personalized client service team with deep knowledge of your operational workflows will undoubtedly make for a smoother transition to ESG-conscious investing.

Q. What is your outlook for the future of ESG investing?

Changing demographics, an increasingly competitive landscape, deeper insight into companies' social responsibility strategy and better access to data have led to a growing affinity for ESG-conscious firms. As a result, ESG is a trend that will continue to gain pace for investors of all sizes in the years ahead.

Fund managers who are not currently employing ESG strategies may want to consider how their technology can support ESG-focused operations. Managers using ESG strategies are likely to see increased interest. As a result, they should think about reassessing the technology they currently operate on to ensure it is as effective and efficient as possible.

Partnering with the right technology vendor who understands your business, has experience implementing various ESG principles, centralizing internal and third-party data, and puts compliance first will be the key to success.

"ESG is a trend that will continue to gain pace for investors of all sizes in the years ahead."

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ESG Futures – Defining a Sustainable Core

By Payal Shah – CME Group

"The E-mini S&P 500 ESG future reached its 2-year anniversary, establishing itself as the most liquid ESG equity index futures on the globe."

The COP26 climate conference was dubbed the 'investment COP.' Participants weighted their expectation on the global financial community and governments to mobilize finance flows at scale for climate mitigation. At the other end of the spectrum, sustainable investing also moved into the mainstream, despite – or perhaps because of – the COVID-19 crisis, as both institutional and retail investors recognize ESG investing's potential to provide superior returns and mitigate risk.

RAPID GROWTH OF ESG DERIVATIVES

As sustainable investments grow, so too does the need for risk management solutions that are specifically tailored to ESG criteria. Specialized ESG versions of existing, highly successful and highly liquid benchmarks are market preferred.

The S&P 500 index is perhaps the world's most widely quoted index. Its ESG version – the S&P 500 ESG index – has a 5-year tracking error against the S&P 500 index of just 1.06%. As a result, the S&P 500 ESG index has emerged as a leading candidate to provide a general benchmark for the ESG investment sector that is backed by a deep, liquid futures market.

The E-mini S&P 500 ESG future reached its 2-year anniversary, establishing itself as the most liquid ESG equity index futures on the globe. The chart shows the accelerating Average Daily Volume (ADV) and Open Interest (OI) of the contract. Given liquidity begets liquidity, this pattern could continue into 2022. ADV for 2021 is 1,000 contracts per day and OI is currently over 14k contracts ($3bn notional) and reached a record of over 22k in the Sep expiry week.

MANAGING ESG RISKS

The use of derivatives allows firms to manage specific risks related to ESG factors. They allow funds to meet target allocation in a more cash efficient way than investing directly in the underlying stocks - potentially enabling more capital to be channelled towards sustainable investments.

Futures on indices, such as the S&P 500 ESG or S&P Europe 350 ESG, provide a ready means for ESG investments. Both indices are Article 8 compliant which adheres to the recent EU taxonomy regulations. The European Green Deal and increased emphasis on ESG initiatives and the new U.S. administration will increasingly incentivise financial participants to meet their ESG targets.

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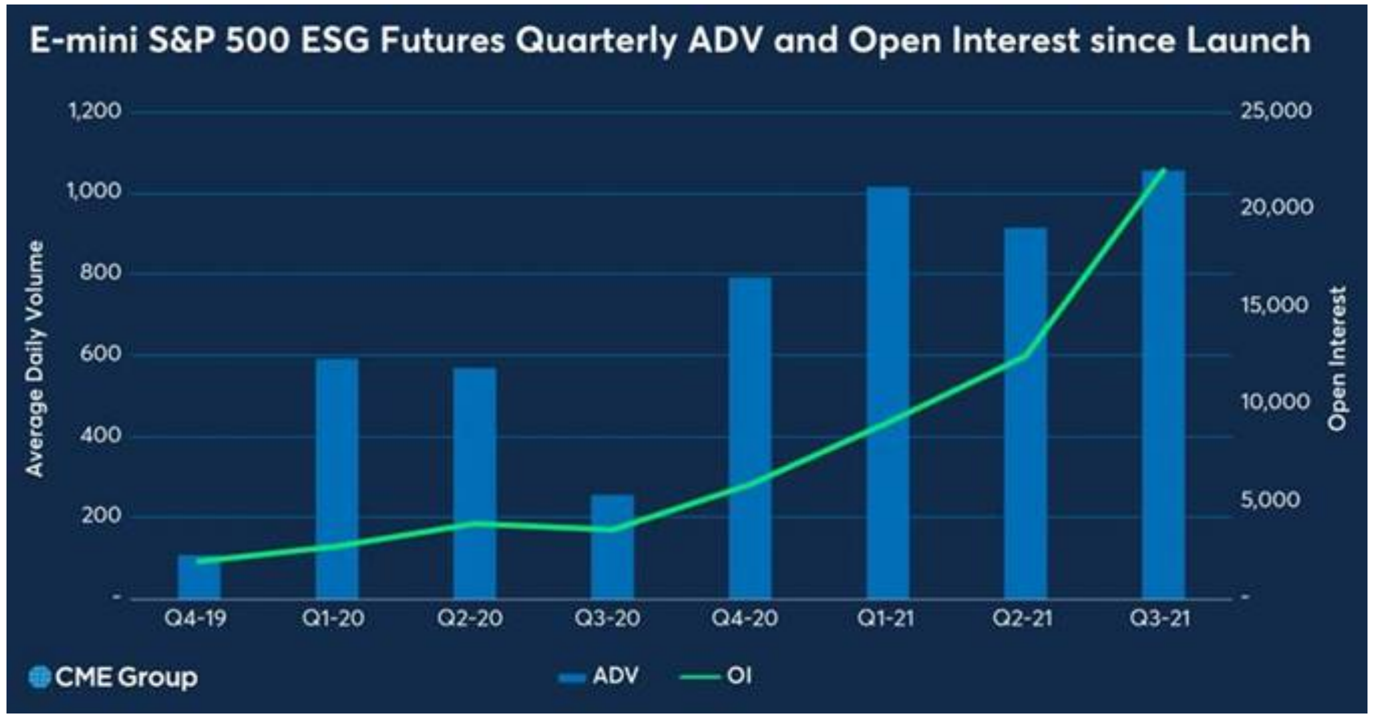

Source: CME Groupi

	S&P 500	S&P 500 ESG	S&P Europe 350	S&P Europe 350 ESG
Number of Constituents	505	315	363	244
10 Year Annualized Returns (TR, %)	14.84	15.22	8.49	8.36
10 Year Standard Deviation (%)	13.59	13.4	13.7	13.73
10 Year Risk-Adjusted Return	1.09	1.14	--	--
5 Year Risk-Adjusted Return	--	--	0.68	0.71
10 Year Tracking Error (%)	--	1.06	--	1.04

Source: SPDJI as at June 30, 2021

ESG INDEX METHODOLOGY MATTERS

Both the S&P 500 ESG Index and the S&P Europe 350 ESG Index are based on an exclusion methodology that allows investors to eliminate certain types of exposures, while retaining similar risk-return characteristics to the parent benchmark. The ESG version excludes: Controversial Weapons, Tobacco, Thermal Coal (> 5% of revenue), Low UNGC Score and importantly also excludes the lowest 25% of S&P DJI ESG scoring companies in each GICS Industry Group.

LIQUIDITY

Tight bid-ask spreads seen in both the US and EMEA morning hours are indicative of the fact liquidity is available. It is also worth noting that there is a strong arbitrage channel between the parent E-mini S&P 500 futures and the ESG version. The bid-ask spread during US hours when the underlying stocks are open is extremely liquid with a bid-ask of circa 2 basis points. The top of book size is on average 10 contracts ($2mn notional).

The EMEA bid-ask is 5 basis points wide outside of US hours. Investors are taking advantage of this out of hours liquidity as seen by the fact 20% of all trades in E-mini S&P 500 ESG are occurring before the US cash market opens.

Importantly during the recent roll activities, some clients performed an inter-product switch – out of the E-mini S&P 500 and into the E-mini S&P 500 ESG futures contract. High correlation with other ESG based indices (typically 99.5%+) has meant clients benchmarked to those indices are likely adopting this product for liquidity characteristics.

2022 OUTLOOK

Developments in ESG are happening at speed. New regulations, such as the sustainable finance disclosure regulation (SFDR) and the EU Taxonomies are creating demand for more products.

The ongoing growth in ESG equity index futures will be crucial in facilitating the development of liquidity pools and will make risk management straightforward and economic.

Payal Shah, Director,
Equity Research and Product Development – CME Group

The Sustainability of Short Selling – Revisited

By Julia Axelsson - NordSIP

> "Short sellers are also often accused of disrupting the market as they have the ability to transform downturns into full-blown panics."

For responsible investors, the question of whether short selling is a practice they should shun or embrace remains as unclear as always. The arguments that short selling in aggregate helps with price discovery and market liquidity have yet to dispel the public perception of the strategy as unethical. Reddit activists have recently joined the discourse, reinforcing the ranks of nay-sayers. Those hoping for regulators to shed more light on the sensitive issue must have been disappointed by the mere acknowledgement that it received in the latest draft of the Regulatory Technical Standards (RTS) of the Sustainable Finance Disclosure Regulation (SFDR).

SHORT SELLING 101: THE PROS AND CONS

Short selling is an age-old strategy employed as early as the 16th century by the famous Dutch tulip traders. The principle is simple: for an investor who identifies an overvalued financial asset, selling this asset 'short' provides an opportunity to benefit from its expected price correction. 'Naked' selling (the notion of selling a security without any underlying asset) is no longer legal, of course, so short sellers first have to borrow the asset. Then, once the position has depreciated sufficiently, they hope to buy it back at a profit. Paying interest for borrowing the asset and maintaining a margin account can make the strategy costly even when the bet is correct. And if the trade goes the wrong way, the downside is theoretically unlimited.

Let's not forget to mention that shorting can also be used to 'hedge', meaning that if a short position matches, at least in part, the exposure of a long position (that is a position held in the portfolio) then it can function as a risk mitigator. Whichever the movement of the underlying market, the two positions will move in opposite directions thereby cancelling out the risk attributed to the market.

Critics of the practice do not lack arguments. To start with, they advance, speculating on a price drop is unethical because it means profiting from the demise of others. Think of George Soros, who made billions on the British Pound crash. The strategy is also prone to manipulation, as investors who speculate on a price fall benefit from spreading negative information, even if it is false. Short sellers are also often accused of disrupting the market as they have the ability to transform downturns into full-blown panics.

Proponents of the strategy counter with two main arguments, supporting their claim that short sellers make financial markets more efficient: they enhance market liquidity and help determine the correct price of assets. Evidence collected during periods

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of short-selling bans, like those imposed by most regulators in the financial crisis 2007-2009, pointed to deteriorating liquidity and slowed price discovery. Moreover, as academic studies have shown, short sellers "play a significant role in identifying and mitigating the effects of financial misconduct."

Responsible investors need to tackle further challenges when considering short selling. Even those who buy into the benefits of short selling and disregard ethical arguments, need to consider the fact that some of the strategy's very advantages might turn counterproductive from a sustainability perspective. For instance, a well-intended bet, like shorting ESG laggards or fossil fuels, could end up promoting these assets by enhancing their liquidity.

WHERE SHORT SELLING MEETS ESG

Between regulatory shyness and social media attacks, industry bodies have stepped in to provide some guidance on the benefits of this investment strategy.

According to a joint report by the Alternative Investment Management Association (AIMA) and international law firm Simmons & Simmons, short selling can be used to achieve responsible investment goals. The paper strives to bust the myth that responsible and ESG investing must always be a long-term buy-and-hold strategy.

"Short selling can be an excellent tool for achieving two common goals of contemporary responsible investment: mitigating undesired ESG risks, and, when taken in aggregate, creating an economic impact by influencing the nature of capital flows through 'active' investing," the report states.

AIMA presents strong arguments that hedge fund managers would be better off publishing a net carbon exposure figure than disclosing their gross Weighted Average Carbon Intensity (WACI) score, which would account for their long and short positions. Admitting that this doesn't solve the problem of funding carbon-intensive businesses through the long positions, AIMA points out that short selling would, in any case, allow hedge fund managers to create a portfolio that is carbon neutral or, theoretically, even 'short carbon' in terms of its net carbon footprint.

In the same vein, when it comes to the practice of hedging, it is important to note that even if a position is 'hedged', as for example in the case where a long carbon exposure is 'netted off' by a short one, the investor remains the owner of the long position. It is therefore tricky to argue that a hedged position is 'carbon free'.

In their technical guide "ESG incorporation in hedge funds", published in May 2020, the Principles for Responsible Investment (UNPRI) also acknowledged the potential utility of short selling when implementing responsible investment strategies, albeit in just a few words. The paper states clearly that "short selling is one way for a hedge fund manager to express the view that an entity is not adequately incorporating ESG factors."

SHORT SELLING ACTIVISTS STEP UP THE WAR ON GREENWASHING

Since short-sellers are particularly adept at exposing companies that have improperly inflated their performance or misled investors, short-selling could be valuable to sustainable investors by helping them identify potential green-washers undermining the ESG market.

According to Nathan Anderson, founder of successful short seller Hindenburg Research, the ESG sector is particularly fertile ground for companies that overstate what they do. "When people feel good about giving away their money or investing their money, they are less likely to scrutinise where it's going." An example of this chain of events was the case of Nicola, an electric truck start-up shorted by Hindenburg, which had to admit that it did roll one of its trucks down a hill in a video that made the vehicle look like it was capable of moving under its own power.

Despite their unflattering reputation, short sellers might prove to be well-suited for the task of curbing the enthusiasm of over-eager investors, who do not have the patience or the expertise to conduct their due diligence properly. Even busy financial regulators concerned about insufficient resources should be grateful to short sellers for the help they get in uncovering frauds.

THE SHORT OF IT

As always, there is no silver bullet, no one-size-fits-all and the devil is in the detail. No wonder regulators haven't yet issued clear guidelines endorsing or undermining short selling in the context of sustainable finance. The market needs protection from investors going rogue, but a diversity of strategies and financial creativity can also bring along positive change. Transparency is one aspect that should, no doubt, be encouraged and that is precisely what the new disclosure regulation is attempting to achieve.

For now, it is crucial to remember that short selling, just like other investments involving derivatives or leverage, comes at a significantly higher risk than simply buying stocks 'long', where 'only' the initial capital is at stake. For investors willing to take this kind of increased risk, upholding high ethical and ESG standards may prove challenging when the rubber hits the road, as the temptation to stray tends to be stronger when there is more at stake.

These considerations need to be firmly anchored into short sellers' values for them to credibly claim that they belong to the sustainable investing family. With the increasing appeal of applying a coat of green on a new or existing strategy, it is only a question of time until we find out who has been swimming without a proper ESG suit.

"Short selling can be an excellent tool for achieving two common goals of contemporary responsible investment: mitigating undesired ESG risks, and, when taken in aggregate, creating an economic impact by influencing the nature of capital flows through 'active' investing."

Jack Inglis, AIMA´s CEO (left) with Kamran Ghalitschi, Publisher at HedgeNordic at the Nordic Hedge Award

Is 2022 the year ESG growth finally becomes sustainable?

By Jack Inglis, CEO – AIMA

It's hard to remember a time before ESG or to pinpoint exactly when it broke through into the mainstream narrative in financial markets. To borrow from Hemmingway, it seems to happen "gradually, then suddenly". From AIMA's perspective, ESG has been a focal point of our market research and events calendar for several years now and the topic has never failed to draw a crowd.

Despite the overwhelming interest in ESG, the sector still has some fundamental wrinkles that must be ironed out to allow alternative investment market participants to buy into the movement completely. Chief among these concerns is the lack of consistent, comparable corporate data on which to base ESG assertions – noting the clear desire of firms to avoid "greenwashing" by misleading investors about their credentials. But change is coming as standard setters increasingly turn their attention to an overhaul of corporate reporting requirements, improving the ability of investment managers to develop products that prioritise ESG considerations and report against key ESG metrics.

THE ESG REGULATORY LANDSCAPE

In the EU, the Sustainable Finance Disclosure Regulation (SFDR) is the centrepiece of the bloc's focus on sustainability and has made it a global leader in the race to tackle greenwashing and steer capital towards greener investments. It had a phase-one implementation in March 2021 and phase two will come into force in 2022, bringing additional requirements to boost transparency about the sustainability of the products that firms distribute. Moreover, its impact is being felt globally, given the fact that SFDR's disclosure requirements capture not only firms based in the EU but also those who service EU investors.

In the US, the SEC recently created the Climate and ESG Task Force to study the issues surrounding this evolving investment area and is likely to pursue its own rulemaking – both at the level of corporate disclosure and the at the level of the information provided by investment managers to their investors. Regulators in APAC's financial centres, such as Tokyo, Singapore, Hong Kong (SAR), and China are also pursuing green agendas.

WHAT'S HOLDING BACK ESG ADOPTION?

Despite how much ESG dominates the financial narrative, and the sharp uptick of so-called ESG fund launches – many of which are seeing massive inflows – in the passive and active management spaces, there appears to still be a huge amount of headroom left for further growth.

In the wider alternative investment universe institutional investors, particularly pension funds, are understood to be driving demand for products and strategies tailored to their bespoke ESG policies, ranging from exclusion stock lists to bespoke strategies that fulfil their version of sustainable investing.

Investors are not only looking for a wider array of products, but they are also increasingly insisting that ESG criteria should be included in hedge funds' investment strategies. Even though ESG-led investing is not new, hedge funds are taking an incremental approach, given the lack of consistent data and the expertise to interpret it, as well as disharmony over ESG investing rules in different jurisdictions.

A recently published report by AIMA and KPMG included a survey of 126 hedge funds representing approximately $1 trillion in AuM, found that almost a third (29%) believe it is difficult to develop ESG investment products owing to the different perspectives and definitions by investors and policymakers. In addition, 23%, the next largest segment, say they are still researching the comparative performance of ESG-focused versus traditional products. Some managers interviewed for the report described how investor sentiment varies around ESG scores or sustainability factors and that it is challenging to develop products until there is more specific clarity from the regulators on requirements. This may go some way to explaining why only 6% of respondents offer ESG products as part of their customisation initiatives.

In fact, in the same survey, when asked which of the various regulatory concerns present today will pose the most significant challenge to your firm over the next 12 months, conflicting multi-jurisdictional regulations was the most popular choice (28%), followed closely by ESG-related disclosure rules (26%).

The problem has been identified but solving it will require global cooperation among regulators and industry stakeholders to ensure any new rulesets serve to build confidence in the sector without stifling innovation. AIMA, for its part, is proactively engaging with rule makers to achieve this aim.

ESG IN PRIVATE MARKETS

Elsewhere in the alternative investment universe, ESG has also already gained significant ground in the private markets. Our Financing the Economy research showed that most private credit managers now incorporate ESG into their investment process and that they are playing a key role in driving sustainability changes among small and mid-sized companies.

> "Despite how much ESG dominates the financial narrative, and the sharp uptick of so-called ESG fund launches – many of which are seeing massive inflows – in the passive and active management spaces, there appears to still be a huge amount of headroom left for further growth."

ESG is also influencing loan documentation with covenants and coupons being redesigned to reflect sustainability linked KPIs. This mixtures of carrots and sticks is becoming more prevalent in the market as private credit managers address their investors' ESG needs.

Private markets have come a long way in a short time and there are inevitably different views on what good looks like with respect to ESG and how to benchmark performance. 2022 is likely to see different initiatives converge to provide investors with a more consistent picture and one of AIMA's priorities in the New Year will be to drive and co-ordinate this at an industry level.

WHAT'S PUSHING ESG FORWARD?

As mentioned above, the ESG sector is largely being driven forward by demand from investors, both institutional and retail, which is more than enough to sustain its trajectory while it works through its teething problems. A recent AIMA survey of hedge funds managing a combined $1.65 trillion asked hedge funds to list what was driving their interest in ESG investing, with 85% pointing to institutional investors, and 39% citing institutional consultants.

Conversations with AIMA's manager members this year also revealed that these investors are increasingly attaching ESG-related criteria to their allocations, even if the capital is not going towards a responsible investing strategy. Throughout the year, AIMA's market research has found significant interest in ESG-related tools and products which will further lead many hedge funds to embrace responsible investing ethos in 2022 and beyond. Beyond financial markets, the ESG agenda benefits from the major tailwinds of feeding into the global narrative around combatting climate change, which has significant political support and was encapsulated this year in the COP26 event in Glasgow.

What this means in practice is that the ESG sector will continue to thrive for the foreseeable future. But, for the sustainable investing movement to mature and move beyond the innovation phase, it requires solid foundations based on coherent and coordinated standards that will give investors and asset managers the confidence to step forward into the new, greener world before us.

> "A recent AIMA survey of hedge funds managing a combined $1.65 trillion asked hedge funds to list what was driving their interest in ESG investing, with 85% pointing to institutional investors, and 39% citing institutional consultants."

Jaakko Soini, CIO – LS Fund – Incomea Steady Opportunities

Dividend Harvesting from Sustainability Themes

By Eugeniu Guzun – HedgeNordic

Thematic investing seeks to capitalize on significant secular trends in the economy or business climate, with sustainability themes increasingly becoming too important to ignore. Finnish asset manager Afalon Investment Management has launched a hedge fund that seeks to identify investments aligned with an array of sustainability themes.

"The investment approach evolves around the idea of sustainability," says Jaakko Soini, the CIO of LS Fund – Incomea Steady Opportunities. "The secular trends related to sustainability and ESG will be the major investment themes going forward." Soini currently follows six sustainability-linked areas, including ecologically-conscious fibers, plant-based food, cybersecurity, sustainable transportation, electrification and remote work technologies.

Soini seeks to build a more ESG-aligned portfolio by removing stocks with low ESG ratings from the entire universe of publicly-listed stocks. "The number of tradable companies in the Western hemisphere probably reaches about 40,000 companies," says Soini. "By applying ESG and sustainability filtering, you probably still have roughly 10,000 companies to choose from," he continues. "This pool will contain enough companies to pick and choose from."

Structured as a UCITS fund, Incomea Steady Opportunities follows the concentration limits set down in the UCITS regulations. No more than four holdings will account for a maximum of 10 percent of the fund's portfolio each, with the remaining 60 percent allocated across at least 12 holdings. "Since we follow six themes on average, UCITS regulations enable us to invest in two companies or more across each theme," explains Soini.

OPTIONS PREMIUM COLLECTION ON DIVIDEND-PAYING STOCKS

The relatively concentrated portfolio is combined a premium collection strategy that involves buying short-dated out-of-the-money call options on its long holdings. This covered call strategy provides Incomea Steady Opportunities with a source of income in the

"The secular trends related to sustainability and ESG will be the major investment themes going forward."

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form of options premiums while capping some of the upside potential from the underlying investments. “I use options on most names in the long portfolio,” says Soini. “Although I believe our long holdings will perform, I am willing to sell 5 percent or 10 percent short-dated out-of-the-money call options to collect premiums,” he continues. “If I were to sell call options on all the underlying shares I have, the delta of those options would be between 0.40 to 0.25, which means that delta-adjusted net exposure of the long portfolio would be between 60 percent and 75 percent.”

The covered call strategy fits well with Soini’s stock selection criteria that predominantly favors lower-risk/lower-reward high-dividend paying stocks. “On the equity selection, we mostly pick dividend paying companies that fit within our themes,” explains Soini. “This may sound too simple for an absolute return strategy, but our approach involves looking for companies that pay out dividends, for companies that are profitable enough to pay out dividends,” he continues. “In addition to providing us with an income stream, dividend paying companies generally do not trade at so high valuation multiples because of the stage in their business life cycle,” emphasizes Soini. “We do not want our portfolio to be prone to a decline in valuation multiples, so we do not have many holdings with high multiples.”

Soini’s focus on dividend paying companies with low valuations implies a lower likelihood of sudden and sharp movements in the stock prices, which suits his covered options strategy. As long as the stock price remains below the strike price of an out-of-the-money call option through expiration, the option expires worthless and Incomea Steady Opportunities keeps the premium without running the risk of selling a stock for more than the current price. The use of call options also determines Soini’s investment horizon.

“My investment cycle rhymes in a two- to three-month period,” explains Soini. “We sell out-of-the-money call options for the long positions, so if a stock goes up over 10 percent until expiration two or three months out, I get to the re-evaluation window where I decide whether to buy right back and sell another set of 10 percent of out-of-the-money call options,” he adds. “The portfolio might turn at most four times per year, which happens if everything is called out. When options expire worthless and we get to keep the premiums, we might hold the stocks for an unidentified period of time. If we like the company, we can always buy back into it.” Soini also has the ability to hedge the portfolio using index futures in times of market turbulence, all with the aim of delivering absolute returns for investors.

> “On the equity selection, we mostly pick dividend paying companies that fit within our themes. Our approach involves looking for companies that pay out dividends, for companies that are profitable enough to pay out dividends.”

FROM PULP FICTION TO BOTANICAL FIBERS IN FASHION

One of Soini’s themes involves the transition from virgin cotton- and plastics-based fibers to sustainable fibers in the clothing industry. “The clothing industry is one of the most upselling markets in the world where people change clothing based on fashion, although some more than others, of course,” explains Soini. “And over 50 percent, in some cases up to 70 percent, of all the fabrics are made from fossil fuels-based non-recycled plastics. The rest is cotton, which requires a substantial amount of water,” he continues. “Consumers are increasingly demanding sustainable fibers and recycled, bio-degradable non-fossil fuel-based clothing. There are not many options available at the moment, but there are companies making fabrics out of botanical, cellulose fibers such as pulp.”

Soini and his team follow Finnish listed company Spinnova and soon-to-be-listed Infinited Fiber as part of this theme. “Both companies have a solution to either produce fabrics from the recycled cotton mass or from botanical fibers,” says Soini. But both companies have yet to reach the point in the business cycle Soini is most interested in. “Infinited Fibers financials are similar to Spinnova’s, characterized by low turnover and large bottom-line losses, which is quite understandable at this stage of their journey.”

Austrian Lenzing, which produces and markets botanic cellulose fibers, appears to be a better fit for Incomea Steady Opportunities. “Lenzing has over 270 global brands in the fashion and clothing industry as its clients. The company has branded textile products available to consumer brands in Asia, Europe, and the Americas,” says Soini. “Lenzing is expected to have over 2 billion euros in sales, be profitable and pay a dividend for the year 2021. Fashion is a tricky business, but if you make fabrics in a sustainable non-fossil fuel-based way, you should be fine.”

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MANAGING ESG AS A MULTI-MANAGER

By Eugeniu Guzun – HedgeNordic

Ann-Sofie Odenberg, Head of Sustainability and Hampus Hårdeman, Sustainability Manager – Brummer & Partners

> "Thanks to the partnership structure, we are striving to always be aligned in our sustainability ambitions and we support all investment managers in the group on policy development, ESG strategy, screenings and measurements and also client dialogue and reporting."
>
> Ann-Sofie Odenberg

The Nordic countries might well have been at the forefront of worldwide sustainability efforts in recent years. With Brummer & Partners being one of the leading players in the Nordic hedge fund industry since its early days in the 1990s, the Stockholm-based hedge fund group has also played a major role in pushing sustainability forward in the industry.

Brummer & Partners, which has built – and is continuously reshaping – a family of funds through strategic relationships with hedge fund managers from different corners of the world, has a unique ability to encourage its underlying fund managers to develop and embrace sustainability efforts. "Thanks to the partnership structure, we are striving to always be aligned in our sustainability ambitions and we support all investment managers in the group on policy development, ESG strategy, screenings and measurements and also client dialogue and reporting," says Ann-Sofie Odenberg, Head of Sustainability at Brummer & Partners.

The level of environmental, social and governance (ESG) integration varies from manager to manager, particularly in the highly heterogenous hedge fund industry. Therefore, there is no one-size-fits-all responsible investing approach that Brummer & Partners can ask from and enforce upon all its investment managers. "It is important to note that given the diverse range of investment strategies managed in the Brummer group and constituents of Brummer Multi-Strategy (BMS), there cannot be a one-size-fits-all policy," emphasizes Odenberg. "Hence the policies include some minimum criteria but are otherwise tailored to the specific investment strategies managed."

EVALUATION PROCESS

In the evaluation of new investment management teams, Brummer & Partners looks for investment strategies that complement the group's existing strategies and that are expected to contribute to Brummer Multi-Strategy (BMS)'s risk-adjusted return. Brummer & Partners continually works with all investment management teams in the group to develop, cultivate and promote responsible investing efforts. "All new investment managers joining the Brummer group must commit to supporting BMS's sustainability work," says Hampus Hårdeman, Sustainability Manager at Brummer & Partners. This commitment involves adhering to the group-wide exclusion list of companies that could have Principal Adverse Impacts.

"All new investment managers joining the Brummer group must commit to supporting BMS's sustainability work."

Hampus Hårdeman

The commitment restricts all exposure to controversial weapons and long exposure to companies in breach of international norms or involved in thermal coal. "It also includes transparency and disclosures on sustainability and ESG, expectations on ESG integration and continuous learning in the field of sustainability and ESG," adds Hårdeman. "Apart from the exclusions mentioned above, they are also screened for exposure to ethically sensitive sectors."

In addition to meeting the minimum requirements laid down by the Brummer & Partners group, each fund manager tailors its approach to sustainable investing depending on its investment strategy. "All new investment managers are expected to formalize Responsible Investment policies that suit their investment strategies and the financial instruments traded," Hårdeman points out.

CONTINUOUS MONITORING AND ESG RISK RATING MATRIX

Brummer & Partners regularly monitors its investment managers to ensure that all investment strategies continue to meet the group's and the managers' own policies. "All underlying investment strategies are screened quarterly to ensure compliance with their own and BMS's policies," says Ann-Sofie Odenberg. "Thanks to our partnership structure, we have a deep relationship and continual dialogue with all investment managers in the group," claims Odenberg. "We screen all strategies at least quarterly to ensure compliance with the Responsible Investment policies."

"While the result of the screening is one part of the dialogue with the fund managers, we also are continually, as partners, in dialogue with the fund managers to support the development of their approach to sustainability, discuss emerging sustainability themes and global best practices, among other topics," elaborates Odenberg. "We also ask them to complete and submit ESG questionnaires, which are followed by formal due-diligence processes by the Risk and Compliance teams."

Brummer & Partners is also in the process of developing a new tool that will assist its evaluation and monitoring activities. "We are currently also in the process of implementing additional so-called Principle Adverse Impact metrics and measurements, EU taxonomy alignment measurements, SDG impact ratings and WACI measurements (weighted average carbon intensity)," elaborates Odenberg. "The results are and will be used in our dialogue with the fund managers." The results from the screening and engagement with the fund managers will feed into an ESG Risk Rating matrix.

"The ESG Risk Rating matrix is a new tool currently being developed," Odenberg tells HedgeNordic. "It will be updated quarterly by the Sustainability Working Group ("SWG") with representatives from BMS's investment team, the Risk team and the Sustainability team," she explains. Brummer & Partners aims to have its ESG Risk Rating matrix fully operational by the end of the year 2021. "A repeatedly poor ESG Risk Rating or ignorance of BMS's recommendations regarding sustainability practices will be considered in the investment decision," says Odenberg.

INCREASING – NON-UNIFORM – ESG DEMAND

Investing based on ESG factors, investor awareness and demand for sustainable investing show no signs of slowing down, yet there is a lack of uniformity in regional approaches to ESG. ESG awareness and demand among investors have "intensified even more over the past two years although the ESG approach among investors seems to differ," Odenberg points out. "The Nordic investor base favours negative screening and exclusions of companies with exposure to ethically sensitive sectors including fossil fuels apart from ESG integration and generating sustainability outcomes," she elaborates. Meanwhile, "our international investor base does not typically want exclusions but rather prefer us to focus on ESG integration and sustainability outcomes."

There may be many ways to incorporate ESG into investment decisions. However, at the heart of all ESG investing sits the simple idea that companies are more likely to generate strong risk-adjusted returns if they are well-governed and consider all stakeholders involved rather than just company shareholders. "The consideration of ESG risks and opportunities will hopefully result in more well-informed investment decisions and hence, stronger risk-adjusted returns," concludes Odenberg.

"Given the diverse range of investment strategies managed in the Brummer group and constituents of Brummer Multi-Strategy (BMS), there cannot be a one-size-fits-all policy."

Ann-Sofie Odenberg

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Hedge Fund Managers Accelerate ESG Integration

Diverse Approaches Exist Because No One Size Fits All Credit Investors

By Hamlin Lovell – HedgeNordic

Hedge fund managers are sometimes perceived as slow movers on the ESG front. For instance, a survey by investment consultants, bFinance, in April 2021 found that many investors interviewed viewed hedge funds as lacking a high degree of integration of ESG factors. The survey was however optimistically entitled "From Laggards to Leaders", which hints at the rapid rate of change underway

"A BNP Paribas survey found that the majority of hedge funds will integrate ESG by 2022, mainly due to client demand."

Many hedge fund managers have been quietly running separately managed accounts catering for clients' ESG preferences for some years, though they did not always make a lot of noise about the details for fear of sending a mixed message, and had not always formally documented all of their ESG policies. That is changing fast: a BNP Paribas survey found that the majority of hedge funds will integrate ESG by 2022, mainly due to client demand.

There is not always an easy "cookie cutter" template when applying ESG to various hedge fund strategies. The nuances of adapting ESG to different strategies can be partly addressed through a due diligence questionnaire (DDQ) available via several platforms: the The United Nations Principles for Responsible Investment (UNPRI); the Alternative Investment Management Association (AIMA); the Standards Board for Alternative Investments (SBAI), eVestment and DiligenceVault. To help with completing various DDQs and RFPs (requests for proposals), a growing number of hedge fund managers are developing formal and documented responsible investment policies and putting in place a governance framework for monitoring the policies.

The UNPRI has also published a paper on incorporating ESG into hedge funds. The UNPRI hedge fund advisory committee includes representatives from many hedge fund managers who have featured in HedgeNordic, including Brummer and Partners and Nordkinn Asset Management, in the Nordic region, as well as LGT Capital Partners, Macro Currency Group and Quantica Capital AG outside Scandinavia.

The report argues that, "governance has always been core to activist hedge funds which often take a more proactive and public stance than long-only managers on poorly governed businesses. A natural extension of this approach might be engagement on issues such as climate change,". Indeed, one of the largest and longest established activists in London, Sir Christopher Hohn's The Children's Investment Fund (TCI), has launched an influential "Say on Climate" initiative, which asks companies for annual climate

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"In principle ESG at the firm level should be similar for hedge fund managers and other asset managers, but in practice the small size of some hedge fund teams can require a pragmatic and flexible approach towards some typical ESG objectives."

disclosures, climate transition action plans aligned with the Paris Agreement, and lets shareholders vote on these plans at Annual General Meetings. TCI's Say on Climate resolutions have been supported by some of the world's largest asset managers as well as proxy advisor firms such as ISS, which advise asset owners and asset managers on how to vote.

One example of why ESG needs to be tailored to strategies is that climate may be less relevant than other environmental issues for some industrial sectors. For instance, Sweden's award-winning healthcare long/short manager, Rhenman and Partners, has identified water usage in countries with scarce water, as being an important area to monitor in drug manufacturing, where carbon footprints tend to be quite low. In other generally low carbon sectors, such as information technology and social media, ESG issues such as potential misuse of private data or workforce diversity, might be prioritised over carbon.

It is in some cases easier to apply ESG to equities than to corporate bonds – where there are usually no voting rights – though some corporate bond strategies do fit into one ESG framework, the EU SFDR (Sustainable Finance Disclosure Regime). For example, Norron, based in Sweden and Norway, is one manager that has designated its investment grade and high yield corporate bond strategies as article 8 under SFDR.

ESG is more commonly applied to any kind of company security than for macro markets such as equity indices, interest rates, government bonds, currencies and commodities, and adoption has so far been somewhat lower and slower for global macro and CTA strategies at the time of writing. Yet some systematic and quantitative CTA managers, such as Aspect Capital, have started using company-specific ESG data as part of their inputs. And CTAs such as TransTrend have been trading carbon emissions contracts for years, adding liquidity to these new markets. European carbon emissions, which have hit all time highs in late 2021, are most well known but there are also contracts in California and other regions on the US.

There are different opinions about how to use ESG equity indices. A growing number of ESG, low carbon and climate aligned equity indices exist, and they might well be used for performance benchmarking at least for long only strategies, or some long-biased hedge fund strategies. However, where index derivatives, such as futures or ETFs listed on CME Group, Eurex, or other exchanges, exist for such indices, they will currently tend to be much smaller and less liquid markets than traditional standard equity indices. There is therefore a potential conflict between the aspiration to use an ESG equity index derivative, and concerns about liquidity and transaction costs in these still nascent instruments.

The most ambitious ESG policies will apply beyond corporate securities to all asset classes. To this end, the PRI has published a paper on integrating ESG into sovereign debt, which includes assessments of factors including countries' governance, corruption and rule of law; social progress on education and living standards and of course environmental quality in terms of climate and energy transition risk. There are also recommendations for controversial commodities such as palm oil and timber, and for ascertaining the provenance of metals and minerals based on OECD guidance.

Given the variety of different opinions and approaches around ESG, one approach is to offer clients a menu of customised ESG related options. For instance, one of Brummer's Lynx's programs, Lynx Dynamic, has excluded energy markets after discussions with key clients while other Lynx programs continue to trade energy.

ESG is most visibly associated with investment policies but it can also consider the company's own firm policies. In principle ESG at the firm level should be similar for hedge fund managers and other asset managers, but in practice the small size of some hedge fund teams can require a pragmatic and flexible approach towards some typical ESG objectives. In terms of checks and balances, individuals inside the firm may be each wearing several hats, and functions such as risk management and compliance need to be at least partly outsourced for additional oversight. If a hedge fund firm contains only two or three people, and a low level of assets, they might well use a third party management company. If they set up their own management firm, it could, at least initially, be unreasonably expensive to put in place a large board containing a majority of experienced and dedicated independent directors.

And if the founders of a hedge fund are all white males, and there are only two of three of them, it is simply not possible to demonstrate a "diverse and inclusive" workforce in the way that larger firms can. Such small firms are often outsourcing many operational, compliance and other functions to a variety of service providers, so diversity measurements could arguably include the people working for their extended ecosystem, including their prime broker, administrator, custodian, auditor, legal adviser and so on.

Sustainability: More Than Just a Catchphrase

By Eugeniu Guzun – HedgeNordic

> "We consider ESG as an opportunity contributing to positive alpha."
>
> Johan Svantesson

Investors have broadly been allocating to hedge funds to achieve alpha and risk mitigation – the latter stemming from diversification benefits, tail risk reduction, or diminished correlation. It is becoming increasingly clear that neither of these objectives can be maximized without a commitment to sustainability. The teams behind several long/short equity funds from the Nordics are in exact agreement that integrating sustainability and environmental, social, and governance (ESG) considerations in the investment process helps build more resilient portfolios able to deliver better long-term, risk-adjusted returns.

"Our approach to ESG has more of an operational focus. We view the sustainability of a business model as something different and broader than ESG," co-founder Christer Bjørndal explains CARN Capital's approach to sustainability. "ESG issues are typically something we can engage a company on, as it may relate to board composition, disclosure or reporting. We can affect change in these areas as an active owner," elaborates Bjørndal, the co-founder of the Norwegian asset manager that runs long/short equity fund CARN Latitude. "Sustainability, on the other hand, relates to the business model itself, and is much more difficult to change."

Bjørndal goes on to emphasize that integrating ESG considerations in the investment process can lead to better long-term, risk-adjusted returns. "While we believe sustainability is more important ("the what"), ESG analysis certainly tells us something about "the how" when it comes to how a business is managed," reiterates Bjørndal. "Among other things, ESG metrics can tell us something about operational efficiency, risk management, brand value, employee attraction & retention, and access to capital, customers, and markets," he adds. "These are clearly important drivers of risk and return."

The team at Norron Asset Management, which has two long/short equity funds on its extended range of products, corroborates Bjørndal's insights, with portfolio manager Johan Svantesson pointing out that "we consider ESG as an opportunity contributing to positive alpha." Svantesson and his colleagues "consider financial risks equated with ESG risks," implying that sustainability risk corresponds to investment risk for investors.

Another Norron portfolio manager, Marcus Plyhr, believes that "companies that have an active approach to ESG and transition their businesses can lead to higher multiples by lower cost of capital." According to Plyhr, "large investments have to be made to reach the Paris agreement and the Sustainable Development Goals. We expect the companies that enable this transition towards a more sustainable economy will benefit from higher growth." This means that a focus on sustainability can lead to long-term, risk-adjusted returns.

Stefan Roos, the founder of Stockholm-based hedge fund manager Origo Fonder and the CIO of its long/short equity fund Origo Quest 1, "absolutely" believes that the consideration of ESG aspects in a portfolio improves risk-adjusted returns. "Already when we started Origo back in 2013, engagement and responsible ownership was a cornerstone in our investment process," says Roos, who manages Origo Quest 1 alongside fund manager Christoffer Ahnemark. "We are active owners and have pursued several important issues ourselves or together with other owners. We clearly see that this has created alpha."

Marcus Plyhr,
Portfolio Manager – Norron Asset Management

Clara Hamrén,
ESG Manager – Norron Asset Management

Johan Svantesson,
Portfolio Manager – Norron Asset Management

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Christer Bjørndal,
Co-Founder – CARN Capital

"As fundamental conviction-driven investors, the more we know about a company, the better. ESG analysis is a key component in building that conviction."

Christer Bjørndal

INDIVIDUAL APPROACHES TO ESG

There is a wide range of approaches within sustainable investing, with significant differences both in investment objective and purpose. Yet, all sustainable investing involves pioneering better ways of doing business. "We have always believed that a quality company beats a mediocre company over the long run and having a sustainable business model is really the first principle of quality," Stefan Roos explains Origo Fonder's initial approach to sustainable investing. In 2018, the Origo team crystallized the approach by creating an advisory board with the Nordics' leading sustainability expert Sasja Beslik and digitalization expert Ulrika Viklund, Former Head of International Growth at Spotify.

"Together, we developed a definition and vision that we strongly believe in, and that is our guiding star in the daily management of our fund Origo Quest 1," says Roos. The process includes three important steps. "First, we exclude sectors that never will meet our basic requirement. This exclusion is also stated in the fund´s regulations," starts Roos. "Secondly, we look for companies that generate both shareholder value and societal benefit. And finally, we are committed owners and drive various issues directly to the companies' management and boards."

Sharing a similar mindset as active owners, Norwegian asset manager CARN Capital follows a similar playbook for sustainable investing as Origo Fonder. "At CARN, ESG and sustainability analysis are fully integrated components of our investment process, where we combine exclusion, positive selection, and ESG integration," explains Christer Bjørndal. "As fundamental conviction-driven investors, the more we know about a company, the better. ESG analysis is a key component in building that conviction," he continues. "Every member of our investment team is wholistically responsible for the analysis of a company's fundamentals and its ESG or sustainability profile."

"In and of itself, an average or below average ESG score may not necessarily deter us from investing, because affecting positive change can actually create or crystallize value," Bjørndal elaborates on CARN's approach to sustainable investing. "But if the business model is not sustainable, we would not invest," emphasizes the co-founder of CARN Capital. "An unsustainable business model simply offers an inferior long term risk/reward."

Classified as article 8 funds under the Sustainable Finance Regulation Disclosure (SFDR), Norron's absolute return funds – Norron Select and Norron Target – promote environmental or social characteristics and integrate sustainability into their investment process. "We are active investment managers that promote sustainability in all our investments," says portfolio manager Johan Svantesson. "We report taxonomy and SDG [Sustainable Development Goals] data monthly since October this year. We do ongoing ESG research on all of our investments and we have strict exclusion criteria's that apply to all of our funds," adds Marcus Plyhr.

EXTERNAL ENGAGEMENT AND EXTERNAL DATA

All three interviewed asset managers rely on external engagement to nudge their approaches to sustainable investing in the right direction. In addition to creating a sustainability-focused advisory board back in 2018, Origo Fonder also lets an external investment bank analyze its ESG-profile "to ensure that we are on the right track," says Stefan Roos. "This is greatly appreciated by our investors and other stakeholders."

CARN Capital, meanwhile, "made the decision to engage with the Swan label to have our strategy achieve that certification as a quality stamp on our process as such," explains Christer Bjørndal. "With SFDR and further regulation dictating how asset managers can claim to approach this subject matter, such independent certifications become less important in terms of credibility," acknowledges Bjørndal. "A more homogenous framework for evaluating an asset manager's approach to ESG and sustainability is a good thing, in the sense that it more easily allows transparency and comparisons. A concern we have, however, is that ESG and sustainability is becoming more of a compliance issue, rather than one of making better investment decisions and actively contributing to positive change."

The team at Norron Asset Management "base our ESG processes on the EU legislation, and stay open-minded towards the development of regulations and how the market will develop," says Clara Hamrén,

Stefan Roos,
Founder and CIO – Origo Fonder

"We are active owners and have pursued several important issues ourselves or together with other owners. We clearly see that this has created alpha."

Stefan Roos

ESG Manager at Norron Asset Management. "We are positive to the new regulations and do believe that this will lead to more transparency, comparability and knowledge and therefore less greenwashing," she continues.

Both Norron and CARN have built their sustainability approach on the UN Sustainable Development Goals. "There are many different definitions of sustainability," says Clara Hamrén. "At Norron, we define sustainability in accordance with the Sustainable Development goals and the EU legislation," she elaborates. "In our assessment of sustainability, we use the UN sustainable development goals as a framework," confirms Christer Bjørndal of CARN Capital. "We are risk and return-driven in our approach, but we seek exposure to companies who are positively aligned with the UN sustainable development goals, and emphasize avoiding businesses that hurt our planet and the people who inhabit it."

Stefan Roos of Origo Fonder, however, does not place too much emphasis on ESG metrics and data. "We do not believe so much in big ESG data because of the simple fact that they do not have correct KPIs on Nordic small caps," argues Roos. "Garbage in, garbage out is a clear risk if you completely build your process on those data basis." With a concentrated long/short portfolio focused on unique Nordic small caps, "we focus much more on what the companies actually are doing in terms of green innovation and transformation," says Roos. "We have access to company management teams and to other shareholders, which is important if you are claiming that you are an active and sustainable investor," he continues. "Our approach is based on analysis, a deep understanding of each company´s unique challenges and active ownership. Sustainability is an important part of our company analysis and should contribute with positive return, not something that is conducted from a sales- or PR perspective."

INCREASING ESG AWARENESS

With a fair amount of greenwashing and other ESG-related window dressing going on, investors need to extend their due diligence and be more attentive, argues Stefan Roos. "I believe that many of the large fund companies have enormous challenges in this area and that customers will increasingly question what they are getting for their money," argues Roos. "We see, for example, that funds have been renamed but have the same holdings as before. And we are not going to talk about all index funds or funds with low active share," he continues "How can you call yourself sustainable when you are a truly passive owner and almost own every share that are included in the index?"

However, investor awareness and knowledge about sustainable investing is constantly increasing. "In the Nordic region, there has been an increasing demand when it comes to ESG awareness," says Clara Hamrén from Norron. "However, outside the Nordic region we have noticed that the shift has been somewhat slower. On the positive side, we have seen that the ESG awareness is now increasing outside of the Nordic region, too."

"Looking at flow numbers, the increasing ESG awareness and demands among investors seem quite clear in this regard," confirms Christer Bjørndal. "In general, our investor base has a high level of awareness when it comes to ESG and sustainability. This is probably part of the reason they invested with us in the first place," argues Bjørndal. "Our customer base largely consists of foundations, family offices and municipalities and for them this is already an important area," says Stefan Roos about ESG awareness among Origo Fonder's investor base. "But we notice that more and more ESG-conscious private investors are contacting us now, so the demand is clearly increasing."

Sustainable investing is much more than a catchphrase in the fund management industry, with long-term sustainability trends set to create winners and losers and thereby alpha opportunities for long/short equity managers. "We promote ESG investing and believe that sustainability is crucial in the long run," argues Clara Hamrén. "In order to meet the Paris Agreement and the Sustainable Development Goals, not only us, but all investors have to support and promote investments towards a more sustainable society."

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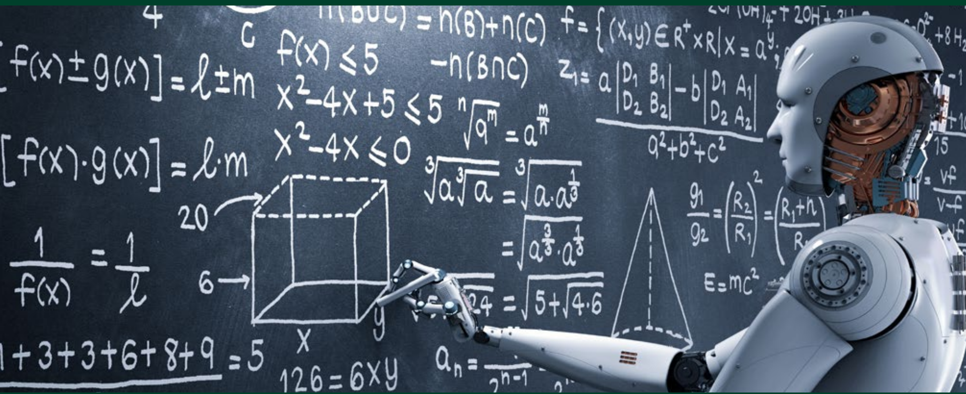

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