HEDGE FUNDS AND ESG

FINDING THEIR PLACE ON THE ESG SPECTRUM

BNP PARIBAS

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October 2020

CONTENTS

4 FOREWORD

5 INTRODUCTION

6 EXECUTIVE SUMMARY

8 THE ESG SPECTRUM

10 PART 1: THE CURRENT STATE OF INTEGRATION

22 PART 2: HOW TO INTEGRATE

28 PART 3: CORPORATE SUSTAINABILITY

32 PART 4: LOOKING AHEAD

36 CONCLUSION

38 ESG REGULATORY ROADMAP

40 METHODOLOGY

FOREWORD

BNP Paribas is one of Europe's largest banking institutions, with strong credentials in sustainable finance and a commitment to promoting policies to bring about positive environmental, social, and governance (ESG) outcomes.

BNP Paribas is also a significant counterparty to many of the world's largest and most sophisticated hedge funds, and is committed to growing its business with them.

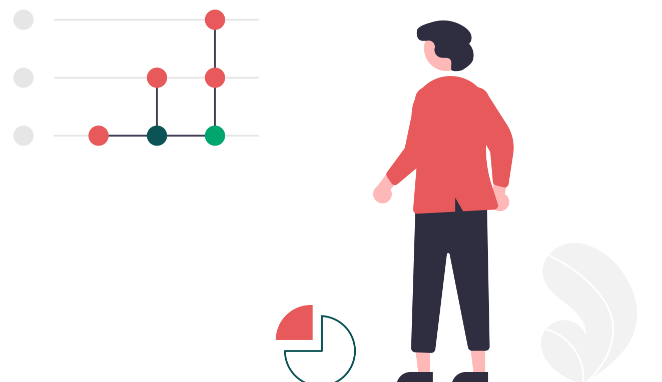
Although an economic argument in favour of ESG is clearly emerging – as indicated by various statistics including the net inflow of USD 71 billion into ESG funds between April and July 2020 alone – we saw little published research on the hedge fund industry and its approach to ESG.

In this special report, we combine these two themes to examine how hedge funds are adapting to the global rise in ESG as an investment framework. We also study how the particular traits and attributes of hedge funds mean they are following a different ESG path than was trail blazed by the traditional asset management industry some years ago.

We hope that the report furthers your understanding and interest.

Sandrine Ferdane

Global Head of Financial Institutions Coverage, BNP Paribas



INTRODUCTION

ESG principles have become an increasingly important part of the investment universe for all types of managers, including both hedge fund and traditional asset managers. Many institutional investors are looking to their investment managers to help drive positive outcomes in this area. For hedge funds, the path to integration has started in some areas, but has yet to find wholesale adoption.

The hedge fund industry prizes its ability to create alpha across a wide range of investment strategies. In this report, we examine the drivers for incorporating ESG principles and the constraints, real and perceived, to better integration. For a broader understanding of the organisational context, we look at the management company approach to corporate sustainability, traditionally known as corporate social responsibility (CSR).

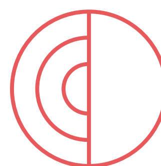
This report is based on primary research – an online survey of 53 hedge funds and some deeper qualitative interviews. These organisations represent a broad cross-section of manager styles, geographies, and sizes. As a group, their combined assets under management (AUM) are well over half a trillion US dollars, or approximately 20% of the hedge fund industry.

To better understand how to categorise hedge funds, this report centres around a framework we call the ESG Spectrum. We will look at the drivers that might shift organisations across the Spectrum towards integration – such as regulation and trading solutions.

This report is based on primary research – an online survey of

53

Hedge funds



Representing a broad cross-section of manager styles, geographies and sizes

AUM

>$0.5t

As a group, their combined assets under management (AUM) are well over half a trillion US dollars

20%

or approximately 20% of the entire hedge fund industry

EXECUTIVE SUMMARY

HIGHLIGHTS

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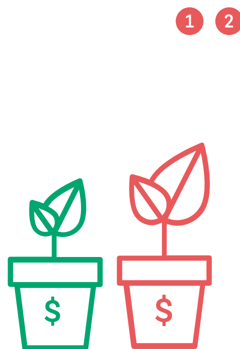


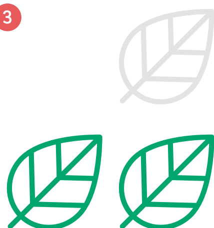
40%

of participants integrate ESG into their investment process

60%

of our participants do not integrate ESG

3



By mid **2022**

there will be more funds integrating ESG into their investment process than not

1. 40% of participants integrate ESG into their investment process, primarily driven by their investors. While investor demand is crucial, there is also growing internal commitment from senior management. As a result, a variety of ESG investment styles have been added to traditional hedge fund strategies.

2. 60% of our participants do not integrate ESG. Although some of them are actively planning to do so, a core group has yet to be convinced that ESG-related products and data sets can improve the risk-return profile or be successfully integrated into their trading strategies.

3. By mid-2022, there will be more funds integrating ESG into their investment process than not, primarily driven by client demand.

Those integrating ESG today are generally larger (by AUM and number of employees) than the non-integrators

4

of participants incorporate sustainability into the operations of their management companies

5

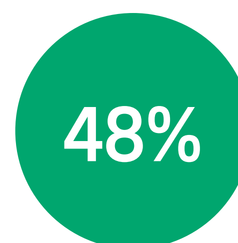
6

of respondents say their organisation measures the carbon footprint of their operations

7

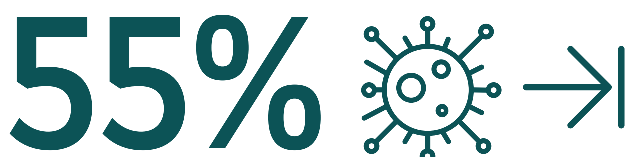
of respondents integrating ESG cite social factors as the most difficult to analyse and integrate into investment decision-making

8



of funds that are integrating are driven by the belief that it will improve their risk-return profile

9



of respondents believe we will see increased demand for ESG-integrated investments post-COVID

10

85%

of funds that are integrating expect increased ESG disclosure requirements in the next 12 months

4. Those integrating ESG today are generally larger (by AUM and number of employees) than the non-integrators.

5. 55% of participants incorporate sustainability into the operations of their management companies. However, not one respondent tied sustainability and CSR targets with the remuneration of its investment professionals and/or senior management.

6. 62% of respondents say their organisation measures the carbon footprint of their operations.

7. Hedge funds rank the 'S' of the three pillars (E, S, G) as the biggest challenge. 67% of respondents integrating ESG cite social factors as the most difficult to analyse and integrate into investment decision-making.

8. Only 48% of funds that are integrating are driven by the belief that it will improve their risk–return profile.

9. 55% of respondents believe we will see increased demand for ESG-integrated investments post-COVID.

10. 85% of funds that are integrating expect increased ESG disclosure requirements in the next 12 months.

THE ESG SPECTRUM

While ESG trends are driven by similar forces across all forms of investment management, hedge funds have always forged their own path due to the diverse and specific characteristics of their strategies. This, coupled with the complex and qualitative nature of many ESG issues, means hedge funds are finding a variety of paths in navigating these trends. We look at defining this activity in three different areas: magnitude, philosophy, and focus.

The ESG Spectrum is a way for hedge funds to categorise or map their approaches to integration.

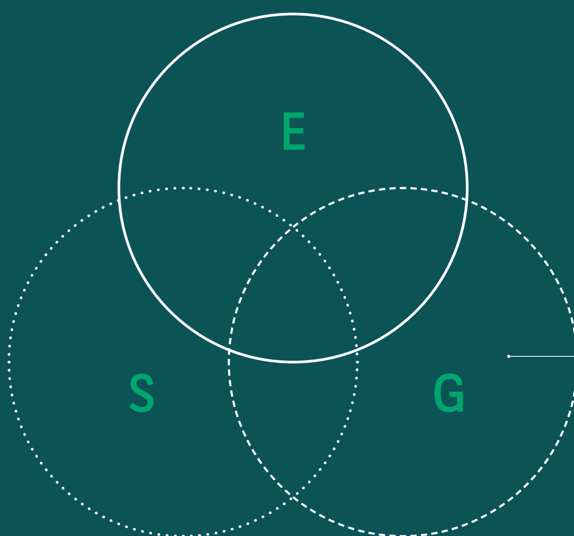
VARIATION IN MAGNITUDE

Essentially, all hedge funds, by definition, must sit somewhere along a band from complete adoption to complete indifference. In practice, this represents myriad levels of integration, from refraining to extensive involvement. The basic separators on the scale are whether ESG forms part of the investment process, how quickly it is being adopted, and how integrated it is.

VARIATION IN PHILOSOPHY

Often, ESG is driven by principles alongside profits. Here, a strategy will forego a potential benefit to the risk-return profile because its investment instructions preclude involvement with the asset (e.g. with negative screening). As we will see, in certain cases, hedge funds also use their influence as shareholders to engage with companies to take greater responsibility. They may also become more profitable, resilient, or competitive along the way, but the ESG motivation sits alongside risks and returns at the heart of the investment decision. Another point on this Spectrum is occupied by pure alpha-seeking funds.

THE ESG SPECTRUM



VARIATION IN FOCUS

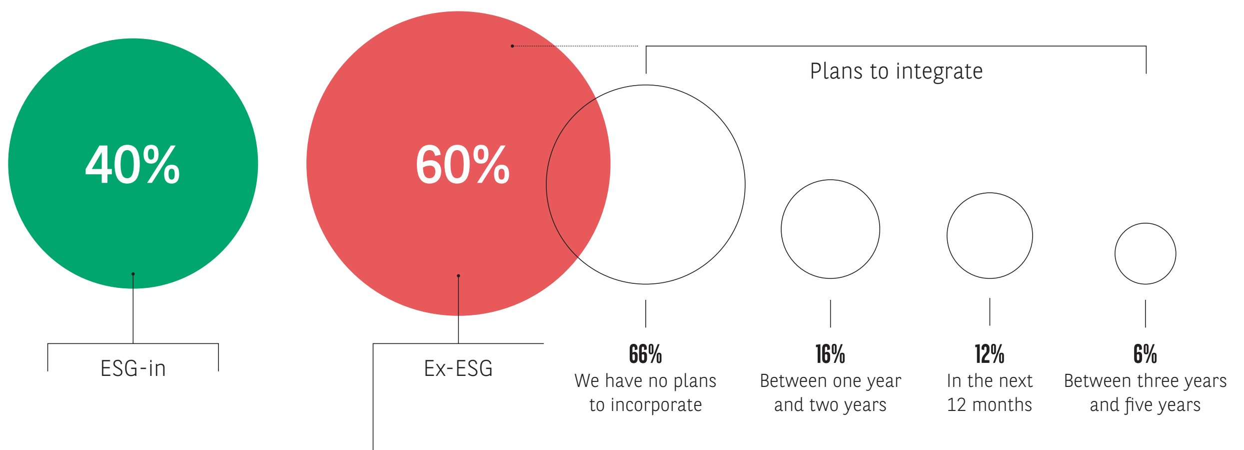
There are also different levels of attention given to each of the ESG components. This can be determined by many factors. For example, the practicality of implementation could mean that 'G' gets more attention than 'E' and 'S' because it is a traditional metric and easier to integrate. It could also be determined by what the manager and asset owner believe is most important including principles, risks, and returns. In contrast, a fund may take an ESG agnostic approach.

PART 1: THE CURRENT STATE OF INTEGRATION

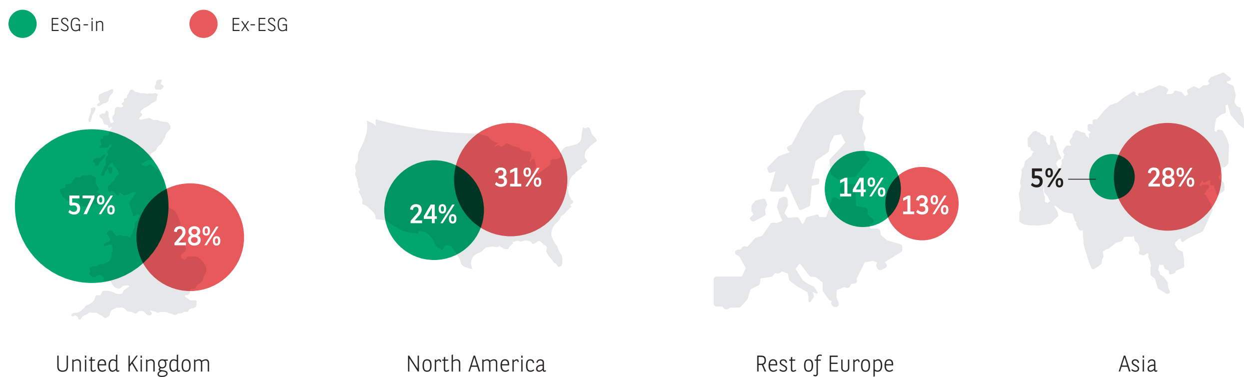
Our survey found that 40% of hedge funds incorporate ESG into their investment decision-making processes (hereafter: **ESG-in funds**), while the remaining 60% do not (hereafter: **ex-ESG funds**).

While at face value ESG proponents may view this as low, there is more than meets the eye. As we detail below, the lack of current or planned integration is not a simple matter of choosing to be agnostic.

ESG INTEGRATION



LOCATION OF RESPONDENT HEADQUARTERS



UK and European funds are almost twice as likely to be ESG-in as North American funds

TIPPING POINT 2022 (OR SOONER)

Just a few years ago, ESG-in funds were rare, so much of the adoption we see today is relatively recent. In fact, of the ESG-in funds we surveyed, 67% had only started integrating ESG since 2018.

This adoption looks set to continue. Some 28% of ex-ESG funds are planning to begin incorporating ESG within the next two years.

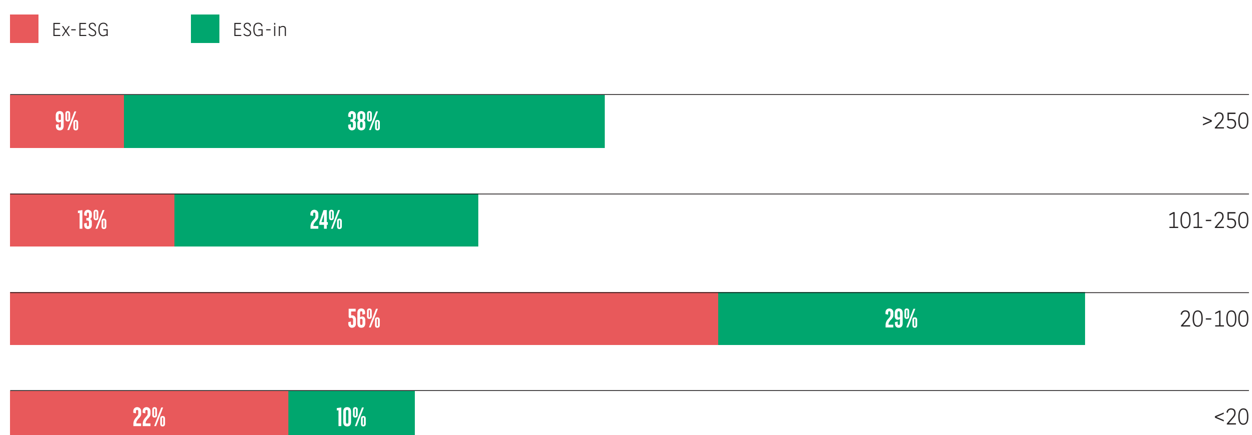
Based on these intentions – and with all things remaining equal – by mid-2022, the majority of funds we surveyed this year will be ESG-in funds (57%), with the ex-ESG proportion falling to 43%. Given the accelerating uptake of ESG in the context of the wider investment landscape, it is reasonable to suggest that this tipping point might come sooner than the data currently predict.

GROWTH OF ESG INTEGRATION IN THE HEDGE FUND INDUSTRY

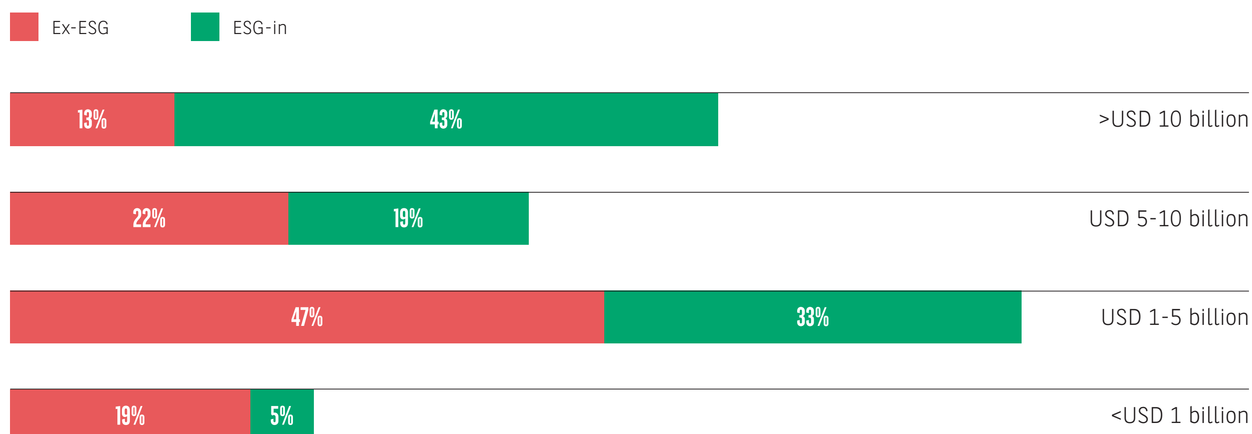
SIZE MATTERS

One of the noticeable factors separating those who integrate ESG from their refraining counterparts appears to be relative size and scale. Today's ESG-in funds are generally larger in terms of both the number of employees and AUM than ex-ESG funds.

ORGANISATIONAL SIZE: NUMBER OF EMPLOYEES



ORGANISATIONAL SIZE: AUM



There are two explanations. First, the largest institutional clients (which, as we shall discuss, are the primary drivers of ESG adoption) tend to favour bigger, more institutionalised hedge funds that can better meet requirements around longevity, transparency, reporting, and operational risk management.

Second, additional resources are needed to build an ESG-in operation. There is a common misconception that hedge funds are high-margin businesses. However, the truth is that many are lean operations that cannot easily devote resources to building a new ESG capability, particularly when proof of the alpha-generating potential of ESG factors is just emerging.

Consequently, hedge funds are looking to expand their ESG capabilities using cost-effective measures. Approximately 62% of ESG-in hedge funds plan to train incumbent teams in ESG principles over the next 12 months as opposed to the 38% who plan to hire specialists.

BUILDING THE CAPABILITIES

Only 10% of ESG-in funds have any in-house ESG analysts. Some larger hedge funds have built significant capabilities. For example, one manager has a 50-person team that spends some of their time on ESG across four different groups: research; reporting and communication; stewardship; and company activities (including carbon offsets, energy efficiency, reducing waste), according to their head of responsible investment.

While some organisations on the ESG Spectrum might lean towards a principles-based approach, the additional resourcing required could be prohibitive. It should therefore come as no surprise that hedge funds looking to expand their ESG capabilities are using cost-effective measures.

10%

Only 10% of ESG-in funds have any in-house ESG analysts

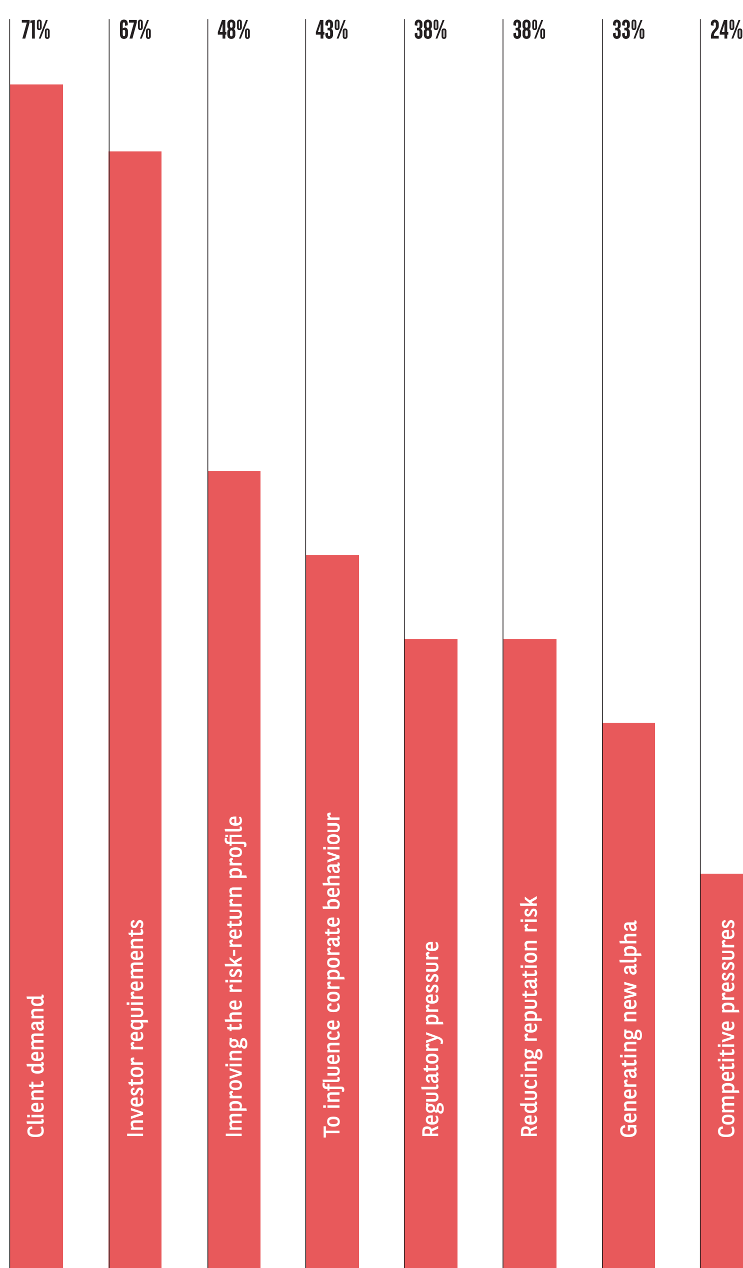
THE KEY DRIVERS OF INTEGRATION

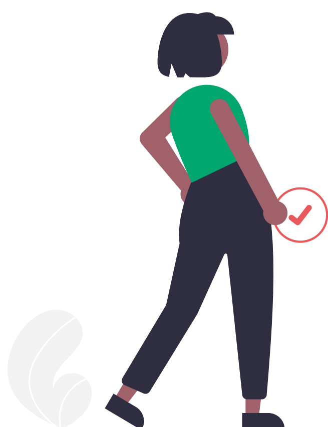
In line with other segments of the asset management industry, client demand is driving the hedge fund industry towards ESG integration. Among the ESG-in hedge funds in our survey, 71% say client demand is the primary driver for implementation, followed by investor requirements (67%).

Similarly, among the ex-ESG funds that are planning to integrate ESG within the next two years, 89% say client demand is the primary driver.

PRIMARY DRIVERS FOR ESG INTEGRATION AMONG ESG-IN FUNDS

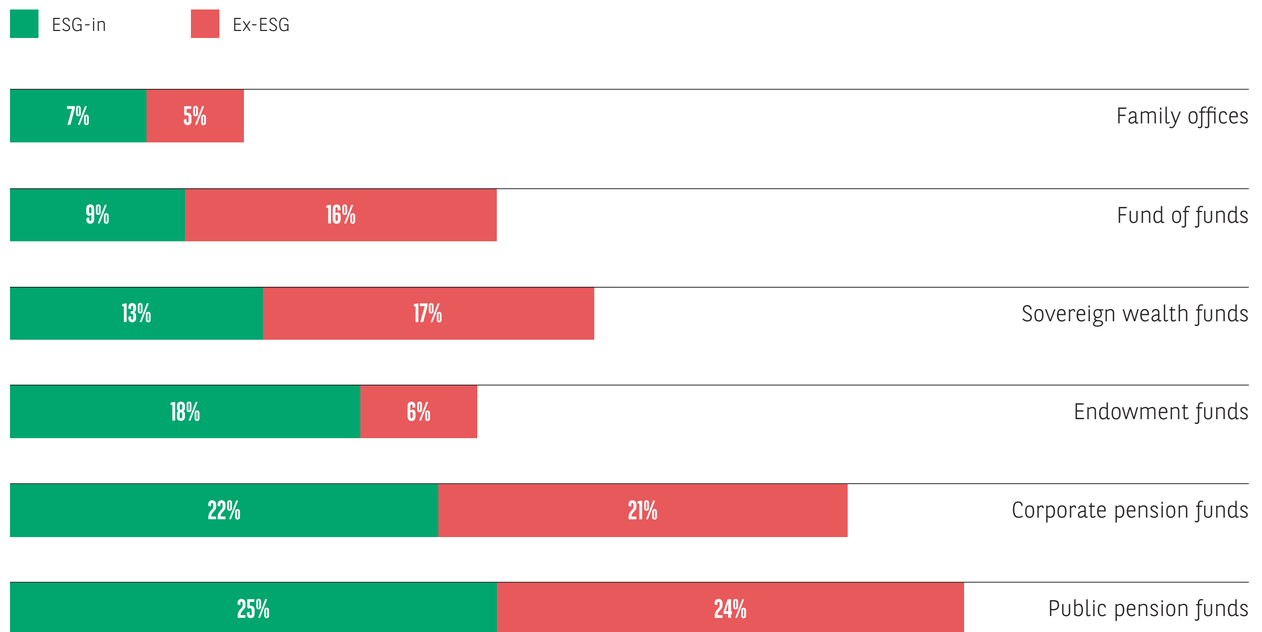
Is the glass half full or half empty? Almost 50% see improved risk-return as a driver to ESG integration





Many funds are seeing a significant increase in the proportion of requests for proposal (RFPs) that ask ESG-related questions. Some of our qualitative interviews confirmed that this trend differs more by region than by investor type. Anecdotally, RFPs from countries such as Switzerland, the United Kingdom, and the rest of Europe are more likely to have an ESG component compared to the Middle East and the United States.

CLIENT PROFILE FOR ESG-IN AND EX-ESG HEDGE FUNDS



THE KEY BARRIERS TO INTEGRATION

EX-ESG FUNDS – TOP THREE BARRIERS TO ADOPTING ESG

31%
Weak client demand

56%
Suitability of asset classes and/or time horizon

25%
Lack of evidence that ESG improves risk-return profiles

Over half of ex-ESG hedge funds say they have strategies that currently preclude ESG integration

Here are some of the explanations (56%) ex-ESG hedge funds provided for not yet integrating ESG:

ASSET CLASS SUITABILITY/DATA

“The firm does not currently consider ESG be substantially relevant to our investment activities; we invest in a variety of asset classes but primarily in government fixed income products in G3 markets.”

“The limited relevance of ESG to investment decision-making in implementing an Asian macro strategy.”

“We don’t invest in corporate securities, just government securities.”

“It is not clear how to incorporate ESG into trading macro products such as FX, rates, futures (in indices), or government bonds.”

“ESG is not relevant to the securities/asset classes we trade.”

“We trade FX and rates derivatives, no credit, no single-name equities – our application would likely be in a sovereign context for local currency bonds and is a much smaller part of our portfolio.”

“Given that our trading strategies are focused on developed markets’ government bonds and related derivatives, ESG issues are generally not applicable to our fund.”

“There are difficulties incorporating ESG matters into instruments traded by our strategies (e.g. commodities and derivatives).”

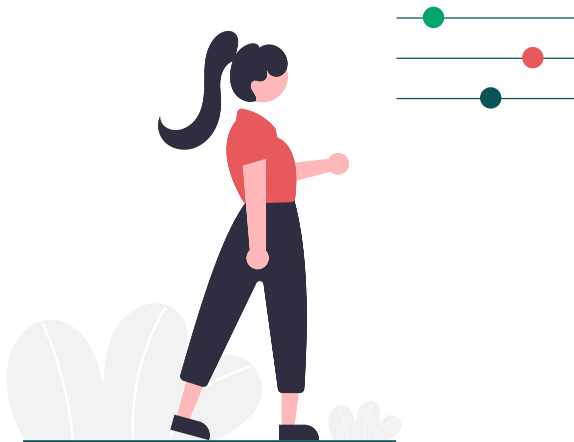
TRADING STRATEGY/ HOLDING PERIOD

“ESG is not relevant to our trading strategy.”

“It is difficult to limit our investment universe because we have partially quant-driven strategies.”

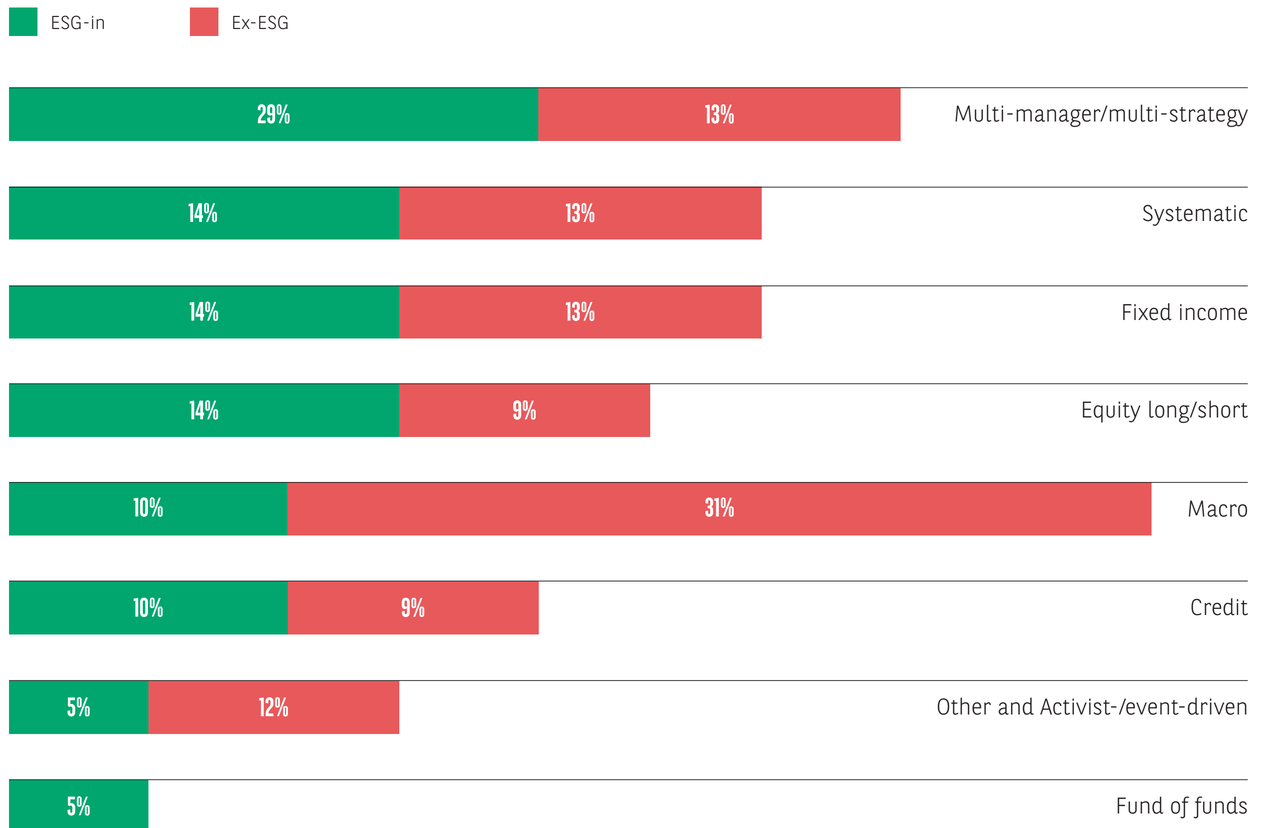
“We are an actively traded fund where the timescale of our holding period does not lend itself to ESG factors being a dominant determinant of security selection.”

“As a global macro strategy, trade horizons tend to be short (1–3 months), and assets tend to be equity indexes, government bonds, currencies, and commodities.”



Integrating ESG into an investment process does not appear to be a simple matter of whether a firm should integrate but often more a question of if it can be done. Questions of philosophy become less relevant: many managers feel that the choice to integrate, or not, is out of their hands. More than half (56%) of ex-ESG funds say that the asset classes and/or short holding periods they use make ESG integration irrelevant, immaterial, or impossible to quantify.

THE TRADING STRATEGIES OF HEDGE FUNDS



Hedge funds focused only on public equities and corporate debt find it more straightforward to integrate ESG considerations. As shareholders, they can behave similarly to any long-only manager, investing or divesting as they choose, to influence the investee company.

But things become significantly harder when managers do not have a theory about how the asset is quantifiably linked to ESG. "With some assets, for example government bonds, it is less apparent how to make a direct translation to ESG for those investments. There is some applicability, but it gets weaker the further away you get from traditional equities and corporate debt. There are a lot of different things to think about and we have not seen any consensus arise in this area," says one manager.

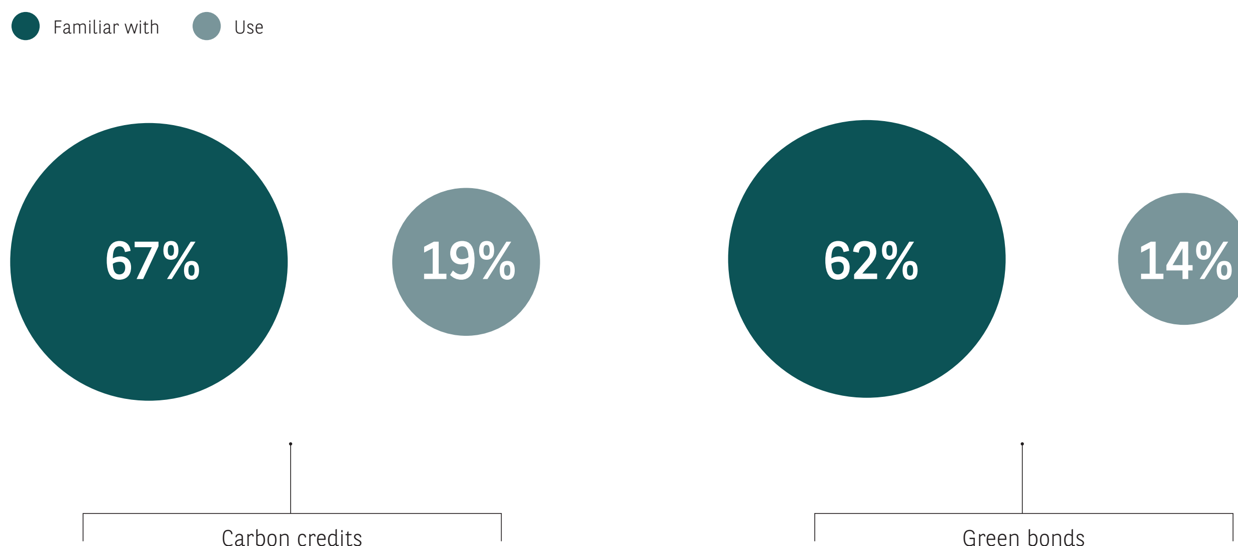
A MATTER OF TIME

It is a similar story with higher-frequency trading strategies, where it is debatable whether assets are held long enough to either benefit from ESG-driven alpha or materially impact the corporate behaviour of underlying companies. However, hedge funds committed to a principles-based philosophy are finding ways to implement partial solutions. "There are some strategies, such as statistical arbitrage, where holding periods are a matter of days or weeks, not months or years," says Jason Mitchell, Co-Head of Responsible Investment at Man Group. "It is hard to make the case for ESG integration there, so we reweight our scoring methodology that focuses on the organisation, rather than the strategy."

Macro strategies in general appear especially challenging, with many restricted to currencies, interest rate derivatives, and government bonds. As a result, we found macro strategies are significantly more common (as primary strategies) among ex-ESG funds (31%) than ESG-in funds (10%).

There is potentially scope for macro strategies to make more use of green bonds and other ESG-related instruments within their portfolios, but this practice is not yet mature. Among our survey respondents, awareness of these is high, with 67% of ESG-in funds aware of carbon credits and 62% aware of green bonds. However, usage is low, with just 19% and 14%, respectively, in use within the investment strategies of ESG-in funds.

GREEN PRODUCTS – FAMILIARITY VS UPTAKE



SPOTLIGHT ON DATA

In our survey, we found that data, or a lack of the right data, impacts both ESG-in and ex-ESG hedge funds. In fact, this remains a reason why one in five ex-ESG funds has not yet integrated ESG. One major fund made it clear that without standard industry metrics, it feels it is impossible to engage in a non-random way in ESG investment, where it can measure its success. The fund prefers to wait for greater clarity on the definition and limits of ESG, as well as industry standardisation, before it integrates.

Hedge funds are also looking for new data providers. Approximately 81% of our ESG-in respondents use external research vendors as their primary source. However, there appears to be no one pre-eminent data provider. Our funds identified 10 different vendors as sources for their ESG data. A consequence of this is that 48% of ESG-in funds are still looking for an external provider to supply a central data hub to feed their internal systems, with a further 43% looking for a self-service portal with an ESG reporting suite.

In-house innovation is being applied to the lack of standardised industry metrics identified as a key barrier. While for some, this is cause to delay implementation, others have responded by investing in their own ESG rating tools. LGT Capital Partners, for example, has built a model that helps them achieve the kind of standardisation that data providers cannot provide currently. “An ongoing standardisation in regards to data would be appreciated. It would make scores more transparent and comparable,” says Davide Zanichelli, a senior member of the firm’s risk management unit. “If, like us, you believe in active management and fundamental analysis, then having only one score will not reach far enough. Data should be comparable and the methodology should be transparent, to enable managers to understand how a score comes about and base their decisions on this, rather than on a single score.”

While ESG-in hedge funds report a range of early successes, the lack of required data remains a key challenge. It hinders the ability of funds to quantify the characteristics of their strategies. Only 19% of ESG-in funds measure the impact of ESG on risk-adjusted returns, while only 24% measure the climate risk of their portfolios. For an industry that prides itself on its analytical skills, those are low numbers and may be why, on the Spectrum, they find themselves still at a development stage and not accelerating the process.

MIXED MESSAGES

Other challenges, primarily for equity and credit strategies, relate to discrepancies between the ESG ratings used by various data vendors and between the various proprietary methodologies used by hedge funds. This can make it challenging for a fund to determine where to focus its efforts and how it can make the most impact. The question of where on the Spectrum to focus is not easily answered.

“You have to decide whether E, for instance, is more important than S or G,” says LGT’s Zanichelli. “What is the relative weight? There are many different methodologies.”

Another equity fund we interviewed focused not on the complexities and difficulties of data collection or the suitability of ESG to its strategy but, rather, to the compact it had made with its investors. In that case, the fund felt it had committed to a management style that never mentioned ESG as a factor in the investment process. Its goal is to produce a risk and volatility adjusted return stream, and including external factors that could detract from that, or even become predominant goals in themselves, would break that compact.

funds do not integrate due to lack of data

PART 2: HOW TO INTEGRATE

In the previous section, we looked at the rate of ESG adoption among hedge funds. In this section, we turn our attention to how hedge funds are integrating, or can integrate, ESG into their investment processes.

NO ONE-SIZE-FITS-ALL APPROACH

Beyond the complexities of trading strategies and asset classes, ESG itself means different things to different people.

"There are two accepted and potentially appropriate investment approaches for companies with poor environmental records," says one manager. "You could exclude that company, or you could buy more of it. You would exclude it because you believe this will drive up their cost of capital, leading to less of the negative activity. You would buy more of it to have a bigger say in company decisions in order to drive positive change." The Children's Investment Fund (TCI), for example, actively engages on ESG to help them understand, quantify and influence a company's exposure to climate change-related risks, and the way it is managing those risks.

Other activist hedge funds go even further. They tend to hold concentrated portfolios and employ specialists to continuously engage with companies on issues like greenhouse gas reduction and environmental risks. This is an even starker contrast to a strategy that simply excludes a company. These examples sit at the top level of engagement on our Spectrum: high levels of commitment and accelerated interaction.

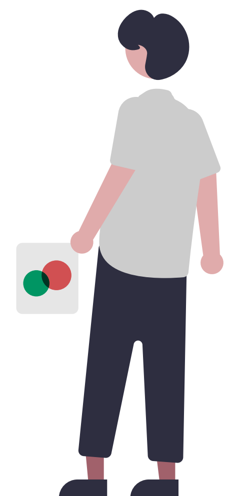
ONE COMPANY, MANY ESG STRATEGIES

Another approach, based on another interpretation, would be to use shorting as a kind of punitive measure against a company and a way to offset risk elsewhere in the portfolio. "We have a couple of strategies that use shorting with ESG," says one manager.

EMBRACING DIVERSITY

Some hedge funds are not forcing commitment to a unifying definition of ESG or a standard rating model – even internally. They choose areas on the Spectrum as appropriate. With the trend still relatively young in the industry, some are instead embracing the diversity of opinions and theories on ESG.

Man Group is one example: "We operate a wide range of strategies. While there's a unifying approach to responsible investment in terms of policy, stewardship, analytics platform and organisation – there is no singular approach to ESG integration across the firm," says Mitchell. "This is intentional. We want to maintain active debate about what ESG means. Is it a top-down factor? Can it be quantified? Or it is a bottom-up, fundamentals factor? How do you treat ESG in private markets? In a fund of funds approach, how do you go about manager selection? Our different businesses have generated a variety of approaches and expectations, and this has advanced our thinking across the firm."



TWO BROAD CAMPS

From these diverse approaches, we can create two broad camps on the ESG Spectrum:

1. **Profitable world-shaping strategies:** ESG is often driven by principles alongside profits. Here, a strategy will forego a potential benefit to the risk-return profile because its investment instructions preclude involvement with the asset (e.g. negative screening). As we saw above, hedge funds will also use their influence as shareholders to push a company to be more responsible. Companies may become more profitable, resilient, or competitive along the way, but the ESG motivation sits alongside risks and returns at the heart of the investment decision.

2. **Pure alpha-seeking strategies:** ESG signals are emerging as useful market factors, particularly among systematic hedge funds. This returns-led approach is neutral on values, principles, ethics, or the impact investors have on the wider world – it simply finds opportunity in ESG as a trend or force like any other, with quantifiable impacts on asset prices. Some may argue that this is not true ESG integration. We call it 'ethically neutral', and these funds sit in the right, or alpha-generating-only, end of the philosophy Spectrum.

ETHICAL INVESTING, ETHICAL NEUTRALITY

Whether a hedge fund is on a part of the Spectrum for values or alpha-driven reasons, how it expresses its focus will naturally be influenced by individual investment processes. However, it is important to remember that more than half of ex-ESG funds state that their asset classes and/or investment horizons render ESG non-applicable, immaterial, or impossible to quantify. Following a number of developments in 'green' finance products, we present an evolving list of options available to hedge fund managers, spanning asset classes.

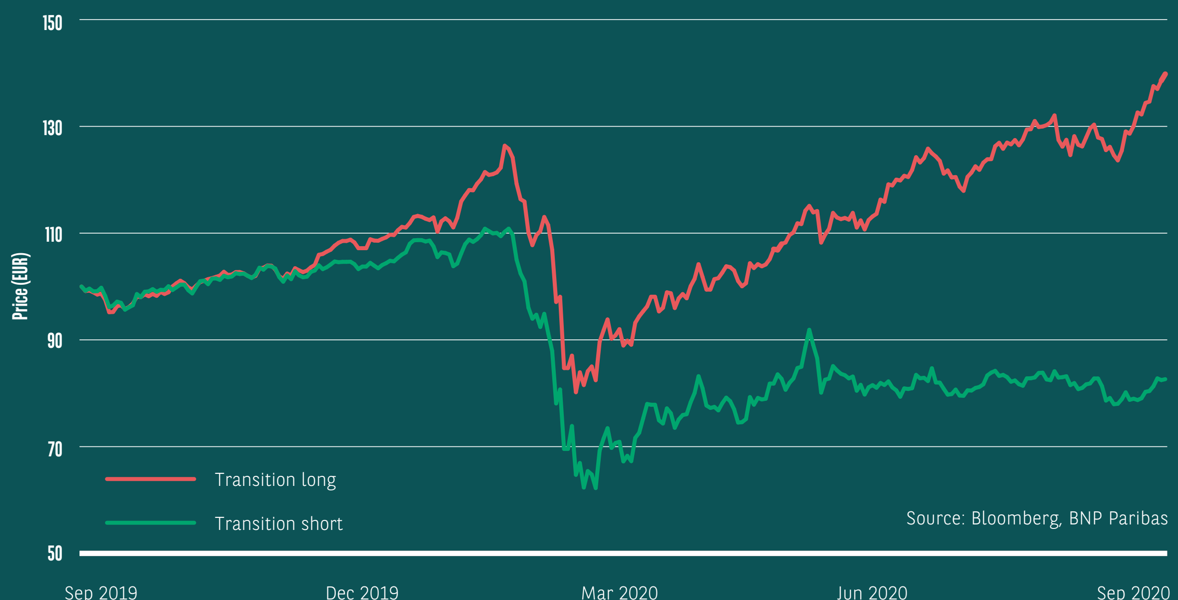
ESG EVOLUTION 1: THEMATIC TRADES

THEMATIC INVESTMENT

Equity hedge funds are already looking to allocate capital in thematic ways to target specific business activities. This is an essential transmission mechanism for influencing behaviour to effect an ESG outcome and is found at the principles-based end of the Spectrum. Shorting or ESG activism is a direct way for hedge funds to pressure corporates where they may be unable to influence them via other means. But what if some funds can't influence behaviour this way? If they are on the alpha-generation-only end of the Spectrum or can't trade single-name equities, can ESG products be included in their investment processes?

Thematic trade ideas and equity indices – Many macro funds do not trade single names but do trade equity indices. Thematic baskets and custom indices can offer long and short exposure to a specific business activity such as electric vehicles, renewable energy development, or companies that possess a minimum ESG score. An ESG-related basket with sufficient diversity could mitigate many funds' reluctance/prohibition against single-name trading while still being able to promote ESG values and generate alpha. Thematic baskets can have as few as 10 stocks or as many as a few hundred depending on the scope of the strategy and can be a way for macro funds to move towards the ESG-in space.

TRANSITION LONG PORTFOLIO VERSUS TRANSITION SHORT PORTFOLIO, 12 MONTHS REBASED TO 100



As stated, a large percentage (56%) of our sample population define themselves as unable to integrate ESG into their investment process, mostly because they feel government securities or foreign exchange do not lend themselves to ESG. Is there a middle ground though, between those who integrate, and those who don't, where firms could begin to use ESG related products for alpha generation in an "ethically neutral" fashion?

ESG EVOLUTION 2: FIXED INCOME, CURRENCIES, AND COMMODITIES (FICC)

FIXED INCOME

Green bond relative value – In fixed income, the world of green bonds is expanding. At the time of publication, the European Commission was preparing to issue over EUR 225 billion green bonds as part of its pandemic recovery fund. Germany is creating a green sovereign bond curve ranging from 2 to 30 years, starting with a heavily oversubscribed 10-year benchmark green bond issued in September 2020. There are a growing number of sovereign issuers, including France and Ireland, with the German curve potentially becoming the risk-free green benchmark. Diverse (and large) issuance creates spread and yield curve trading opportunities. More liquidity and the tighter bid offer spreads that come with increased transactions are the benefits hedge funds supply in return. Over time, this may make it cheaper to issue green bonds, ultimately benefitting the environment. As all German green sovereigns will be launched with a conventional twin bond with the same maturity, investors can trade the 'greenium' (green premium). The government green curve can also act to define credit spread levels, i.e. versus green bonds issued in the corporate sector.

Switching into green bonds and out of traditional bonds, or the reverse, or trading country spreads or yield curves represents a way to generate alpha on an ethically neutral basis, with increased liquidity offering a lateral green benefit. An increasing number of hedge funds are becoming involved in this space.

12-MONTH FRENCH GREEN OAT* YIELD VERSUS TRADITIONAL OAT YIELD

iTraxx ESG bond index – Recently, iTraxx launched a new index that focuses exposure on higher-rated ESG companies and excludes businesses involved in alcohol, armaments, and tobacco. Spread trading corporate names against this index would not be based on effecting beneficial ESG outcomes or selling the credit of target companies but, again, about generating returns and mitigating risk. In this sense, it is also ethically neutral for a hedge fund to participate.

* Obligations assimilables du Trésor (OAT)

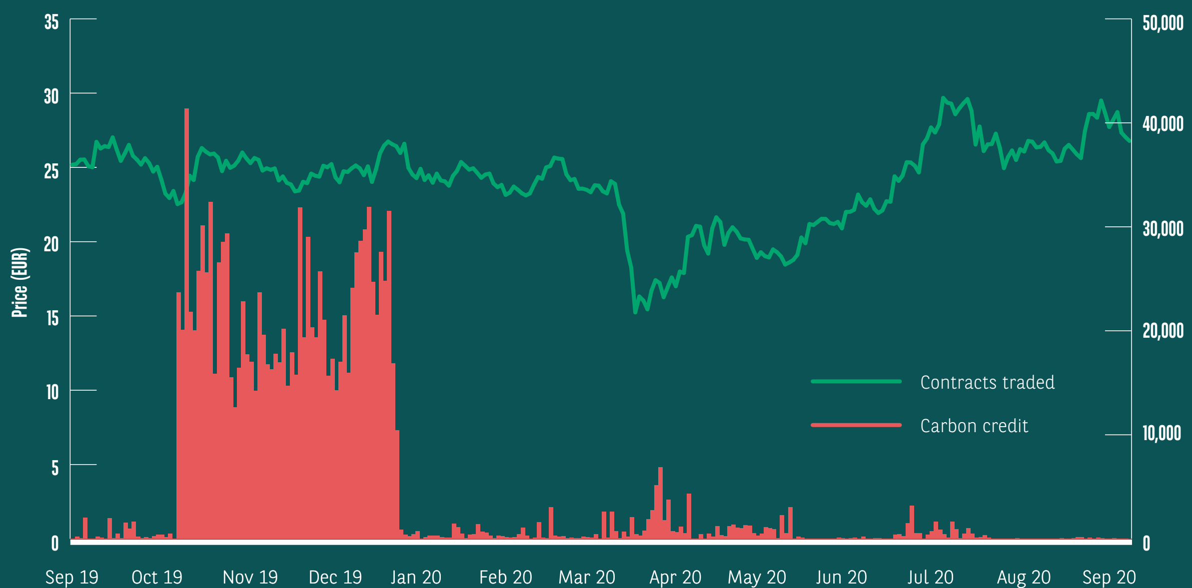
ESG EVOLUTION 2: FICC (CONTINUED)

Structured products – Customised products can provide hedge funds with niche exposure and expertise to highly specialised themes such as reforestation and bio-diversity, absolute-return long/short trades combined into one security, and emission reduction overlays to help mitigate carbon exposure to an existing portfolio. Continuing the ethically neutral theme, these highly bespoke trades take advantage of the strong momentum of other investors to invest in ESG-driven strategies and can be traded as a way to create additional returns.

COMMODITIES

Carbon credits – Carbon has become a tradable commodity, expanding far beyond the practical requirements of utility companies and other heavy emitters. These companies are often mandated to offset their carbon footprint with the purchase of carbon credits. For some time, investors have sought to speculate on the price of carbon credits based on existing and perceived regulations, which could filter into regional arbitrage strategies. It is clearly ethically neutral for a hedge fund to speculate on carbon pricing, but it is also clearly an ESG-related asset class and would require an active trading strategy to become aware of and sensitive to excess carbon in the atmosphere.

12-MONTH CARBON CREDIT PRICES AND VOLUMES



Source: Bloomberg, BNP Paribas

PART 3: CORPORATE SUSTAINABILITY

FROM PHILANTHROPY TO SUSTAINABILITY

Hedge funds are becoming increasingly aware of their responsibilities to the environment and society. Our survey shows that even though the majority of hedge funds we surveyed do not integrate ESG in their investment processes, 55% of all respondents do use ESG principles in the management of their companies. Typically referred to as CSR, the goal is to provide long-term value for stakeholders without compromising people or the planet. Given that the typical hedge fund is privately held by a few founders, this move generally reflects the personal choice of the firm's founders.

The expectation from stakeholders is that companies should contribute to a more sustainable and inclusive future. Hedge funds are also aware of the public demand for corporate responsibility and might typically champion gender equality, environmental protection, better educational accessibility, poverty reduction, or something similar. The UN Sustainable Development Goals (SDGs) can be considered the pathway for achieving a better and more sustainable future for all. Currently, however, within the hedge fund industry, awareness of the SDGs remains limited, with only 27% integrating at least one into their day-to-day operations.

In at least four interviews, the anecdotal evidence has been for funds having a bespoke engagement, based on either committee oversight or dedicated employees driving a particular agenda. There are also indications that hedge funds are moving their CSR strategy from one that was traditionally charity- or philanthropy-based to one that integrates all aspects of corporate sustainability. TCI is an example of a hedge fund that has over time evolved to follow both these paths.

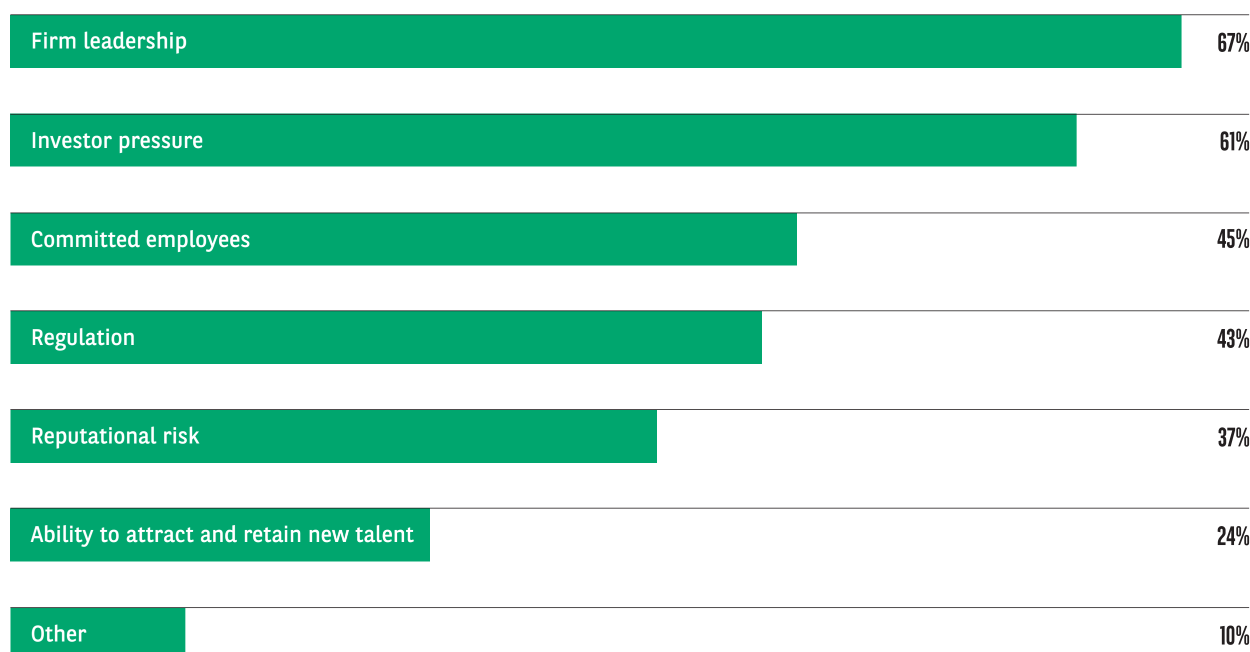
WHO IS DRIVING CORPORATE SUSTAINABILITY STRATEGIES?

Among the ex-ESG group, around two-fifths (42%) view the sustainability of their operations to be either very or extremely important, suggesting this has become a strategic management objective, even if they are not integrating ESG into their investment processes. The top three stakeholder groups driving these strategies are the organisations' leadership (67%), investors (61%), and committed employees (45%).

42%

Among the ex-ESG group, around two fifths (42%) view the sustainability of their operations to be either very or extremely important

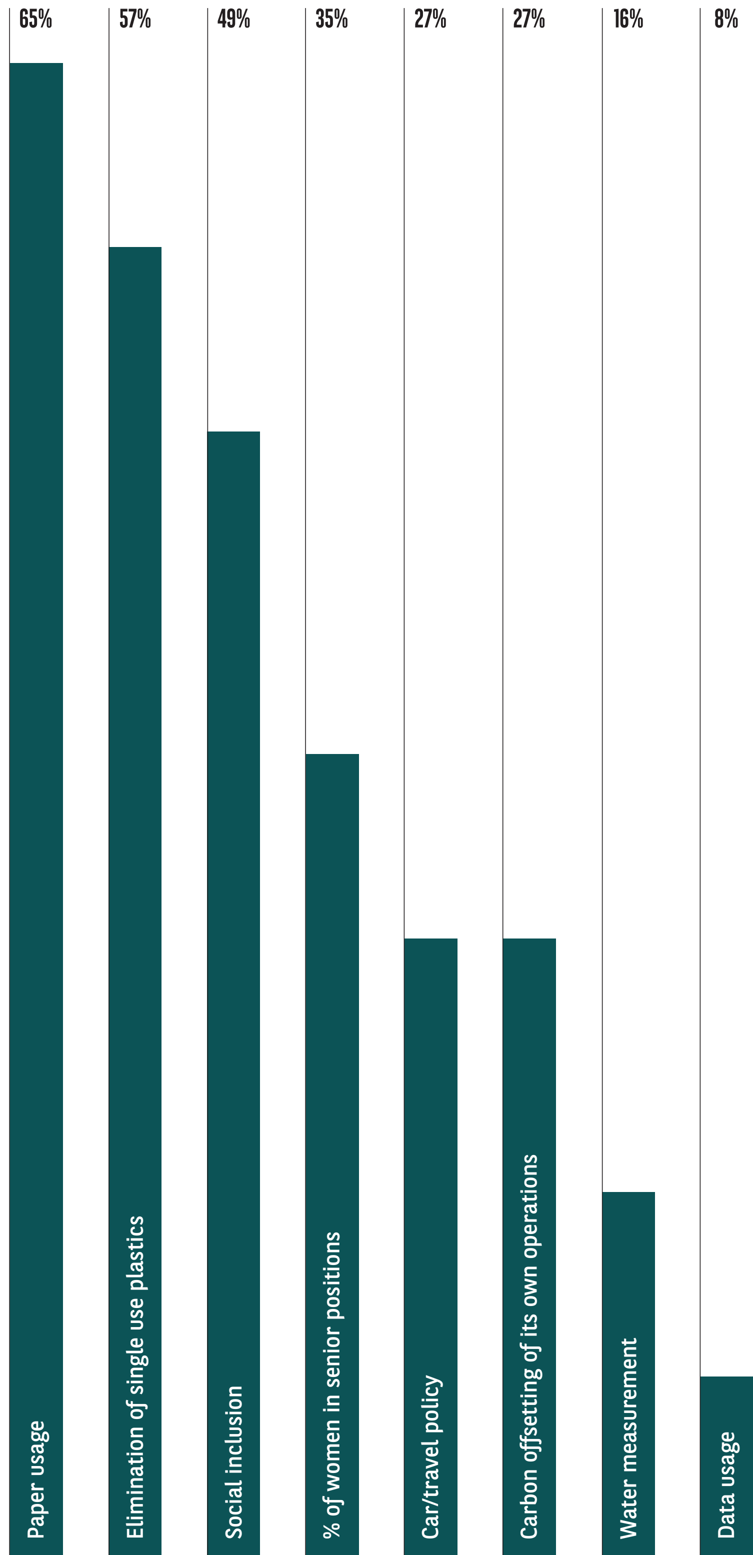
THE DRIVERS OF APPROACHES TO SUSTAINABILITY



The interviewees consistently said that CSR strategies are in place to support engagement with stakeholders including employees, investors, and local communities. However, we found a clear divergence when it comes to the perception of reputational risk as a driver. Over half (57%) of ESG-in respondents cite reputation as a driver of CSR compared to just over a fifth (22%) of ex-ESG respondents.

There is also increased recognition that despite often occupying limited office space, hedge funds can play a role in minimising their environmental impact, and, in turn, many of the common CSR initiatives centre on environmental practices (paper usage, etc.). In conducting the interviews, we found that many of these initiatives are led from the bottom up, with these individuals acting as champions within the organisations.

CSR INITIATIVES



62%

of the funds are looking at and measuring the carbon output of their management operations

27%

are offsetting a proportion of their carbon output

12%

are achieving carbon neutrality

WILL THEY JOIN THE RACE TO NET ZERO?

Some 62% of the funds are looking at and measuring the carbon output of their management operations. Over a quarter (27%) are offsetting a proportion of their carbon output, and 12% are achieving carbon neutrality. A number of interviewees are measuring their carbon footprint with a view to future offsetting.

With many funds now measuring their carbon emissions, we could expect carbon offsetting to become commonplace over time. There is also an increasing focus on data usage and the carbon emissions associated with such activity. In contrast, we have yet to uncover much evidence of formalised carbon measurement of hedge fund investment portfolios.

SOCIAL INCLUSION

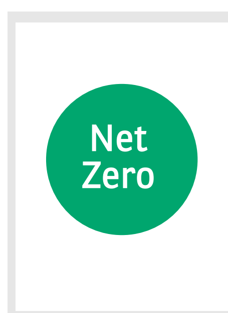
Social inclusion remains key for many hedge funds through their charitable and philanthropic activity, and some highlighted efforts during the COVID-19 pandemic such as retaining catering services while employees worked from home and ensuring the food supported local food poverty campaigns. Another hedge fund also used its money to help fight racial injustice in the wake of the recent protests against racial discrimination.

REMUNERATION

Despite 40% of funds incorporating ESG into the investment process and 55% incorporating sustainability into the operations of their management company, not one respondent tied sustainability and CSR targets with the remuneration of investment professionals and/or senior management. We could argue that this is one sure-fire way to accelerate progress in CSR/corporate sustainability. But in any event, we are also seeing more consistency and transparency about the progress hedge funds are making against their CSR objectives.

A ROLE TO PLAY

We expect that we will see increased reporting of hedge fund CSR activities as investors continue to ask the questions all institutions are being asked – what is your role and impact to help meet the two significant, interwoven challenges we are faced with, i.e. stopping climate change and reducing inequality? There is increasing recognition that everyone has a role to play, and hedge funds can be part of the solution using CSR strategies along with their investment ones.



PART 4: LOOKING AHEAD

Having assessed the current state of integration and the drivers and challenges to date, this section takes a forward-looking view towards two dominant forces we believe will advance hedge funds along the ESG Spectrum: society and regulation.

SOCIETY AND THE 'S' IN ESG

It is impossible to write in 2020 and not refer to the COVID-19 global pandemic. Needless to say, the pandemic has accelerated the focus on the economic, physical, and mental wellbeing of society.

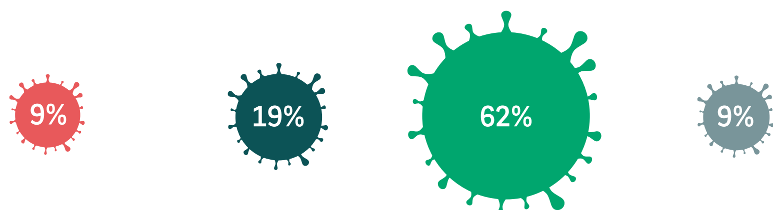
COVID-19 IMPACT

Disagree · Neutral · Agree · Dont know

When the world recovers from the COVID-19 pandemic, we will see increased demand for ESG-integrated investments

The COVID-19 pandemic will stall the hedge fund industry's progress on ESG integration

The COVID-19 pandemic has not changed our stance on integrating ESG factors into our investment process



The COVID-19 pandemic will change the hedge fund industry's approach to managing risk

Over half of our respondents (55%) see increased demand for ESG-integrated investments post-COVID. Two thirds (66%) do not see Covid-19 as stalling progress on integration.

SQUARING SOCIAL CIRCLES

If social welfare becomes a more important investment factor, what implications will this have for the social pillar (the 'S' in ESG)? Of the three, 67% of ESG-in funds say social factors are the most difficult to analyse and integrate into investment decision-making (with 29% selecting environmental and 5% choosing governance).

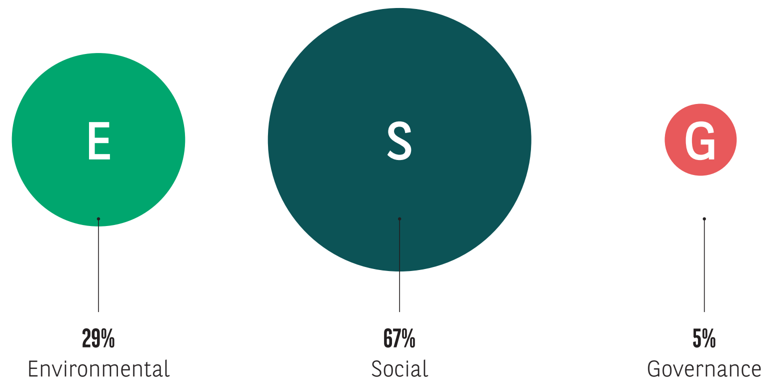
The difficulty is reflected by our respondents acknowledging that social factors have the least impact on their investment risk; instead, 71% chose governance factors and 29% environmental factors.

Governance has always been a key part of analysing individual companies, while focusing on environmental factors has always been about avoiding potentially disastrous outcomes for the planet. Increasingly, though, environmental factors are becoming positively linked to growth and competitiveness, shifting investor perceptions.

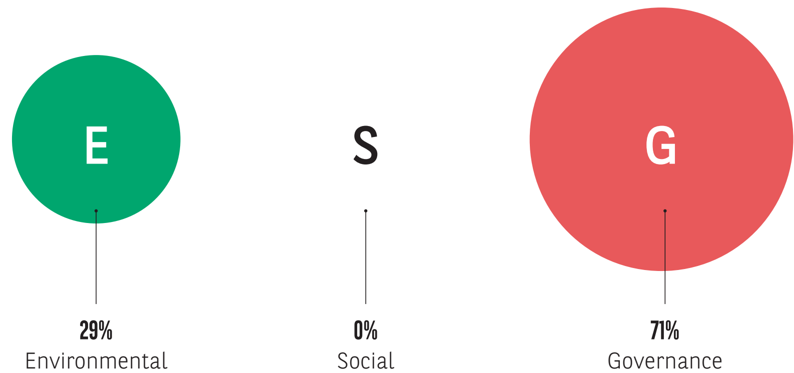
The social strand remains challenging because it covers a wide range of – often qualitative – issues. Companies are also less advanced in reporting social issues than environmental or governance issues.

However, several hedge funds are creating innovative solutions to either exploit or incorporate social factors. "We have always been big proponents of governance signals in our full alpha models," says one manager, "but up until recently, we had not had E or S signals directly in our alpha models because we had not found anything that was going to increase expected returns. Recently though, we have found things in the environmental and social category and begun rolling those out – that is a big change."

WHICH IS THE MOST DIFFICULT TO ANALYSE AND INTEGRATE INTO YOUR INVESTMENT DECISION-MAKING?



WHICH HAS THE MOST IMPACT ON YOUR INVESTMENT RISK?



REGULATION

Globally, ESG is becoming an increasingly important topic for policymakers. Multiple consultations are taking place on important topics such as disclosure and taxonomies, in support of new directives on sustainable finance. Hedge funds are well aware of this transition: 85% of our ESG-in funds think that policymakers will increase requirements on ESG disclosure over the next 12 months.

A key issue for hedge funds is the extent to which regulators follow a prescriptive rather than a principles-based methodology. Consequently, hedge funds are adopting a proactive rather than passive role in regulatory consultations, with over half of the ESG-in funds (55%) wanting a greater voice in regulatory/government consultations on ESG. They are also joining networks that advocate for progressive public policy development, including adopting sustainable investment goals such as the UN PRI.

"We are trying to help steer the regulatory bodies and explain our own methodologies. In general, we prefer some degree of flexibility in implementation, instead of adding prescriptive rules," says Zanichelli.

THE COST OF REGULATION

Approximately 80% of ESG-in funds say increased regulation will drive up costs, while 60% say their organisations will dedicate more resources to ESG in response to increased regulation.

A key area is reporting, where only 52% of ESG-in funds say they have been effective in keeping pace with client-driven ESG reporting requirements. "The idea of what is a base standard level of reporting, as recently as 18 to 24 months ago, is changing," says Mitchell. "We have clients that are not looking for ESG funds specifically but still need to see evidence of stewardship and reporting on ESG. They are often under pressure to do this – sometimes regulatory, sometimes statutory, depending on the region."

We have included a summary of the key ESG regulatory developments across each region at the end of this report.

VOLUNTARY CHANGE

A growing number of hedge funds are pre-empting legislation and recognising the importance of sound stewardship. "Over the last three years, we have been developing our approach to stewardship and building our team, and this is leading to major changes," says Mitchell. "We are now more vocal and actively searching for filing and co-filing shareholder resolutions on ESG issues. We also aim to be much more visible, in terms of public support or opposition."

85%

ESG-in funds expect increased ESG disclosure requirements in the next 12 months

55%

ESG-in funds are taking a greater role in regulatory/government consultations

The time has come for the hedge fund industry to think about responsible investment beyond new products, increasing AUM or identifying new investment opportunities and risks. Market participants must now widen their perspective to consider their role and responsibility as stewards of assets

Fiona Reynolds, Chief Executive Officer, PRI

CONCLUSION

Our research finds the hedge fund industry nearing a tipping point on ESG adoption. Over the next two years the proportion integrating ESG will shift from the minority to the majority, representing an acceleration of the adoption rate and a fundamental shift in how hedge funds manage money.

It is fascinating to see how hedge funds – with their diverse and complex investment strategies – are tackling the diverse and complex challenges of ESG integration. This has led to a range of different approaches, representing all areas of our ESG Spectrum: from first steps to full-scale integration; from niche specialists to champions of all three pillars (E, S, and G); and from activist funds, to performance purists discovering new sources of alpha from ESG factors.

Around the industry, new products, services, securities and data are advancing ESG integration. These include green bonds, carbon credits, structured products, long/short strategies and more, which can allow hedge funds previously challenged to integrate to be able to do so. Previously excluded areas, including government fixed income and structured products, are evolving to include ESG variants.

To become a sustainable and persistent priority for hedge funds, ESG investing will need to make business and economic sense. In the past, there has been an expectation that responsible investments could be expensive to operate, attract fewer investors, and deliver inferior returns compared to similar non-ESG funds. Over the past few years, these assumptions are being challenged.

Today, hedge funds are increasingly creating ESG products, not only because they can drive positive change, but because it makes business sense to do so. Investors too, whether principled or not, invest in ESG products without expecting weaker returns. These shifts are changing the hedge fund landscape, and show no signs of slowing. They may end up representing a fundamental investment trend of this decade.

ESG REGULATORY ROADMAP

EUROPEAN UNION (EU)

As set out in its 2018 Action Plan on Financing Sustainable Growth, the European Commission wants private investing channelled towards climate and environmental goals.

Regulatory changes will therefore:

- Impact the disclosure obligations of investments funds marketed in the EU (including non-EU investment funds marketed under the National Private Placement regime as referred to in the Alternative Investment Fund Managers Directive (AIFMD)), their asset managers, and financial advisers in the EU

- Help investors identify genuinely sustainable investment funds through two broad regulatory initiatives:
  - Transparency obligations (information provided to investors, both institutional and retail)
  - Rules for EU financial advisers requiring them to assess investors' ESG preferences and to respond with a product range limited by regulatory requirements

- Require EU asset managers to consider sustainability risks and adverse impacts on sustainability factors resulting from investment decisions

These changes require new regulations and amendments to existing regulations within the next two to three years.

New regulations
- The Sustainable Finance Disclosure Regulation (SFDR)*
- The EU taxonomy regulation

Existing regulations
- MIFID II rules (new requirements for EU financial advisers of shares in investment funds)
- AIFMD and UCITS (new requirements applicable to EU asset managers only)

UNITED STATES

At the federal level, ESG disclosures by market participants are voluntary. Some nationwide ESG regulatory initiatives (materiality for disclosure, standards for labelling ESG funds, fiduciary definition, and ESG) exist, but these are in no way comparable to EU initiatives and, in some instances, stand in direct contrast.

At the state level, there is piecemeal regulation, with some legislatures addressing ESG risk and factor disclosure where the federal government has failed to legislate. Notable state legislation includes the 2018 California Senate Bill 964, which requires pension funds to assess the climate-related financial risks of their public market portfolios (beginning in 2020), and Illinois' Sustainable Investing Act 2019 (HB240). Other states have followed, either enacting or planning to enact ESG-focused legislation. These largely focus on restricting the investment of publicly managed funds or encouraging greater diversity within firms at the C-suite level.

It appears to be a matter of when, not if, federal regulations pertaining to ESG, particularly in the area of disclosure, look to be introduced. By way of example, the United States Commodity Futures Trading Commission's Climate-Related Market Risk Subcommittee report published in September 2020[1] set out a path to possible legislative and regulatory initiatives, including 53 recommendations such as developing a taxonomy and a higher level of disclosure of climate-related risks.

* The SFDR applies to hedge funds (any non-EU investment funds marketed in the EU are considered as AIFs).

1 Managing Climate Risk in the U.S. Financial System

ASIA-PACIFIC (APAC)

In APAC, regulatory requirements relating to ESG have taken a faster pace of development in recent years. In particular, interest in sources of systemic disruption to the financial system arising from climate change are now of heightened concern to banking and financial market regulators, notably the Hong Kong Monetary Authority and the Monetary Authority of Singapore.

Across investments, market regulators are keen to ensure that marketing claims in asset management around sustainable and ESG investments are indeed merited by suitable processes and disclosures of impact.

Many jurisdictions across the region – from Japan to India, China, Hong Kong, Singapore, and Australia – are putting roadmaps in place to promote green and sustainable finance 'hubs' in APAC. At the same time, there is a strong desire among financial institutions, whether investment- or banking-related, for consistency to be shown by regulators, as they consider the taxonomies that define 'green' economic activities for the purpose of ESG investment and assessments of environmental and social impact.

Australia and Hong Kong have already implemented mandatory requirements in terms of ESG disclosure, and Japan is encouraging asset managers to sign up to a code of good practice. Other countries, such as the People's Republic of China, have introduced non-mandatory guidelines, which we expect are only preliminary steps before a mandatory regime is adopted. In Singapore, the Environmental Risk Management Guidelines for Asset Managers have just been proposed and will be mandatory once adopted by the local regulator.

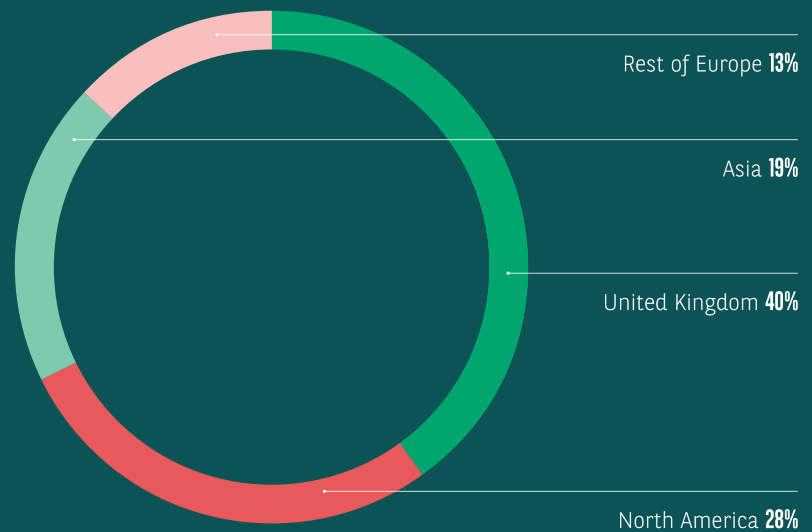
There is, however, some concern that an over-enthusiastic regulatory environment may lead to prescriptive individual country frameworks and metrics seeking to help assess the impact of climate risk. These may differ from those accepted globally, a concern found especially amongst those firms that have invested in their own in-house investment research capabilities and treat ESG risks the same as other fundamental risks to draw their own investment conclusions.

Where taxonomies differ, there are initiatives in place to harmonise the definitions of economic activities eligible for green investment. Differences could hinder regional economic investment for want of consistency between nations, for example, China and the EU. Hong Kong has established the Green and Sustainable Finance Cross-Agency Steering Group to co-ordinate the management of climate and environmental risks across the entire financial sector and to help accelerate the growth of green and sustainable finance in Hong Kong. One of the first tasks of the Steering Group is to develop a local green taxonomy for use by all financial regulators in Hong Kong.

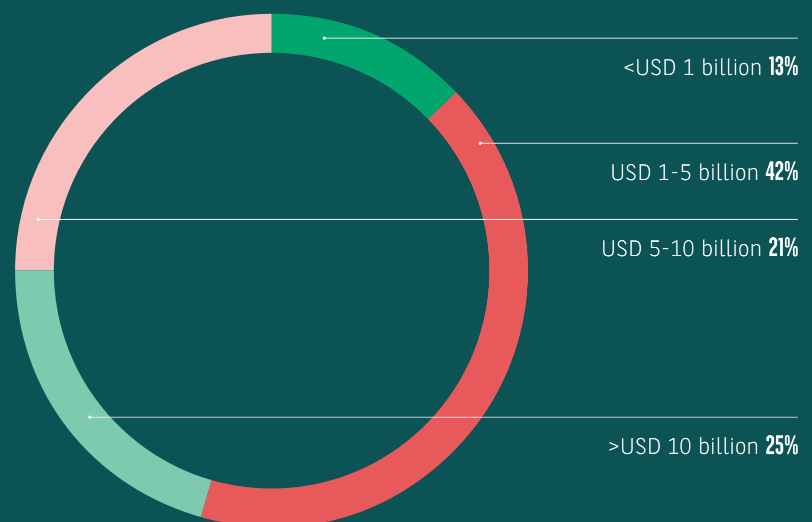
METHODOLOGY

The research is based on a survey of 53 individual hedge fund management organisations along with in-depth interviews with industry leaders conducted in spring/summer 2020. The survey sample represents a broad cross-section of hedge funds, in terms of sizes, primary strategies, geographies, and client types. As a group, their combined AUM is over half a trillion US dollars – approximately 20% of the total hedge fund industry's AUM.

LOCATION



AUM



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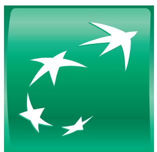

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