

Responsible Investment Primer

May 2019

Contents

Introduction	1
Key Concepts	2
Regulatory Principles	4
FAQ	6
Glossary	8
Additional Resources	9

Max Budra
Associate, AIMA
mbudra@aima.org

Lucian Firth
Partner, Simmons & Simmons
lucian.firth@simmons-simmons.com

Sarah Crabb
Managing Associate, Simmons & Simmons
sarah.crabb@simmons-simmons.com

Introduction

Responsible investment is one of the most significant and fast-growing trends in the hedge fund industry today.

Certain components of responsible investment (RI) are not new. Hedge fund managers (referred to in this primer as 'managers') have been concerned about the governance of their investments for a long time, while some institutional investors have historically demanded investment products that exclude certain assets, such as the manufacturers of cluster munitions. However, RI has never been as important to investment managers and their clients as it is today.

The growing interest in RI is set against a backdrop of global change. The 2015 Paris Agreement, for example, gave new international impetus to combatting climate change, and this has been followed by a raft of regulatory initiatives in the European Union (EU). As a generational shift in asset ownership begins, younger investors are increasingly demanding that their assets be invested in accordance with RI principles.¹ Meanwhile, the greater availability of environmental, social, and governance (ESG) data, while still far from perfect, is enabling managers to build more sophisticated models to identify inefficient markets in which ESG risks are not accurately priced.

RI is a broad term that encompasses a range of choices. At one end of the spectrum, a manager could practice RI simply by screening a handful of securities out of a portfolio. At the other end, a manager could decide to run a fund entirely dedicated to investing in assets that generate social goods.

The form of RI a manager chooses is determined by the reasons why they chose to implement RI in the first place. Broadly, those reasons can be divided into two categories. Some may adopt RI primarily for ethical reasons, while others may adopt it primarily as a means of controlling risk or generating outperformance. While one manager,

for example, may elect not to invest in arms manufacturers on moral grounds, another might seek to use ESG to limit their portfolio risk.

Many questions, however, still surround RI. For some hedge fund strategies, it may simply have little relevance. Trading interest rate futures, for instance, may offer little scope to implement RI. Moreover, managers have traditionally been wary of anything that might restrict the investments they can make. As such, some managers may face challenges when investors question them on their RI practices, while others may be unsure whether they can implement RI in a cost-efficient manner, given challenges such as the difficulty in obtaining the necessary ESG data.

Despite this, however, significant numbers of RI funds are being launched, and assets are flowing into RI strategies.

This primer provides a high-level overview of RI, and outlines some of the more common RI policies adopted by managers. It also seeks to answer some frequently asked questions about RI in the context of hedge funds, and outlines a series of AIMA principles for effective regulation in this space.

Please note, however, that RI is a dynamic field and the terms used can vary from region to region. While the content of this primer represents the best efforts of AIMA and the individuals involved in its preparation, the views expressed and the information provided are not necessarily those of all AIMA member firms and may evolve through time.

We hope that this primer will:

- Help investors understand RI and its applicability and relevance to hedge funds.
- Assist regulators with the key issues currently faced by managers as they develop regulation in this area.
- Provide some clarity around the language of RI, to facilitate meaningful conversations between managers, investors, and other stakeholders.

¹ US Trust, 2018 *U.S. Trust Insights on Wealth and Worth*, pp. 21-22
https://ustrustaem.fs.ml.com/content/dam/ust/articles/pdf/insights-on-wealth-and-worth-2018/Detailed_Findings.pdf

Key Concepts

Socially responsible investment

Socially responsible investment (SRI) is a screening process in which certain securities or industries are excluded from an investment portfolio. Despite its name, the screening process does not need to be based on 'social' factors.

SRI is, therefore, one of the simpler forms of RI, and has been practiced by investment managers for some time—generally in response to demands from large institutional investors linked to religious, public, or charitable organisations. By way of example, a manager may invest in accordance with an SRI policy which prohibits it from investing in tobacco companies, or arms manufacturers. Managers can also offer an SRI version of an existing strategy.

While SRI is relatively straightforward, it comes with several potential challenges. The first is that investors may have different views as to what assets are acceptable in an SRI product, making it difficult to offer a single comingled SRI fund. Some investors, for instance, may not want their capital invested in companies that produce alcoholic beverages, while others may only be concerned with ensuring that their capital is not invested in arms manufacturers. This problem can, however, be overcome through the use of separately managed accounts.

Another challenge is that SRI may inadvertently increase the profits to be gained from investing in excluded securities, a market effect which has been noted by several prominent figures in the financial services sector.² To illustrate this, take a (fictitious) company, Nicotine Inc. As more investors adopt SRI policies which forbid investment in tobacco companies, the demand for Nicotine Inc.'s stock will decrease. To remain attractive to investment, Nicotine Inc. may need to add a premium to its stock, making holding it more profitable and thus rewarding those who still invest in the company. The corollary of this, however, is that the cost of Nicotine Inc.'s capital would increase.

Many managers have informal conventions around the securities in which they invest, such as an

unspoken agreement not to invest in landmine manufacturers. However, a manager is only practicing SRI when those conventions are codified into a formal policy. As such, many firms may be able to practice SRI simply by formalising the conventions by which they already abide.

Environmental, social, and governance factors

The use of environmental, social, and governance factors when investing (a process generally referred to simply as ESG) is an increasingly common form of RI. ESG calls for the evaluation of investment opportunities based on environmental, social and governance factors. So, given the choice between two otherwise equal energy companies, an ESG portfolio would include the energy company which derives more of its energy from renewable sources.

ESG integration is predicated on the notion that ESG factors can be financially material to investment performance and can, moreover, lead to superior financial performance. The notion that a well-run company tends, on balance, to deliver better financial performance than one which is run poorly is relatively uncontroversial. ESG factors can also be thought of as risk factors, such as the risk that a company's practices may not be sustainable in the long-term due to the environmental degradation they cause.

Some managers argue that ESG can be integrated into pre-existing strategies to enhance a portfolio's performance, either by minimising risk or helping identify securities with the potential to outperform. Because of this, some have argued that the integration of ESG is not driven by morals, ethics or beliefs but is, rather, simply a matter of portfolio efficiency. One manager of a specialist RI hedge fund describes it as "value even if you don't believe in the values." On this basis, ESG could even be a source of alpha, although the research on such claims remains inconclusive. It should also be noted that, as the use of mainstream ESG factors becomes more popular, any outperformance that they may provide could be eroded.

² See, for instance, the comments of Cliff Asness, CEO, AQR, on this topic: <https://www.aqr.com/cliffs-perspective/virtue-is-its-own-reward-or-one-mans-ceiling-is-another-mans-floor>

Crucially, one of the greatest challenges managers face when implementing ESG is gaining the necessary data. Issuers are generally not required to disclose information on their performance on most ESG factors; such data is even more difficult to source for private assets. Third-party ESG data, meanwhile, can be expensive, limited, and inconsistent. As such it can often be very difficult to gather the data necessary to reliably integrate ESG into investment decisions.

Impact investing

Impact investing is the most rigorous form of RI: it calls for deliberately investing capital in order to create measurable social or environmental goods. In many ways impact investing bridges the gap between traditional investing and philanthropy, by deliberately creating public goods while also generating profits. Impact investing is closely linked to the phenomenon of social entrepreneurship, in which for-profit companies work to solve social and environmental problems.

At present, impact investing is relatively uncommon in the hedge fund industry; it is seen more typically in the private equity and private credit sectors, where closed-ended funds may invest in infrastructure such as hospitals and schools. Hedge funds prioritise their ability to protect and grow the capital of their investors, and some argue that impact investing is simply too restrictive to be able to meet that goal. In addition, the implementation of impact investing may require a retooling of expertise within a firm, as many managers lack the in-house talent needed to measure long-term social and environmental impact. As such, impact investing tends to be offered either by larger firms which have the resources to overcome the difficulties, or by smaller firms which have opted to specialise in this type of investing.

Responsible behaviour outside of the investment mandate

Some managers are adopting the ESG ethos outside their investment mandates, in respect of their internal processes and governance, for example by focusing on the gender balance and diversity of their own staff (particularly within their portfolio management teams) or by seeking to diversify the composition of the directors on their fund boards.

This is, at least partially, driven by demands from investors, who are increasingly evaluating the managers to which they allocate against ESG factors, including good governance, diversity and inclusion.

Regulatory Principles

The regulatory environment surrounding RI is nascent. At present, one of the most high-profile initiatives in this area comes from the European Commission, which recently adopted an action plan to increase capital flows to 'sustainable' investments. This plan has formed the foundation of recent proposed EU regulations. At the same time, there has been a significant regulatory push around RI elsewhere, such as in the People's Republic of China, where the China Securities Regulatory Commission has announced plans to require issuers to disclose the environmental risks associated with their operations by 2020.

Given the dynamism of this topic it is vital that regulation does not end up stifling innovation. In conjunction with our members, AIMA has formulated the following key principles to help inform the debate on effective RI regulation.

Investor-led

Managers exist to serve the needs of their investors. Any regulation on RI must take into account the fiduciary duty managers owe their investors; ultimately managers are the agents of their investors, and are beholden to their demands. As such, the implementation of RI should be a product of investor demand. Managers are best positioned to know what their investors want from an RI product, and indeed whether their investors want such a product at all. It may therefore be unwise to require all investment managers to adopt RI principles.

Principles-based

RI is still a nascent phenomenon and is evolving rapidly. Any RI regulation must allow the field to develop naturally and sustainably, and not unduly stifle or constrain it. Accordingly, AIMA recommends that any RI regulation should be high-level and principles-based. Managers need flexibility to adapt their strategies and asset allocations in response to the evolution of RI. For instance, biomass wood chips were once seen as 'sustainable' products, but they are now avoided because of their high carbon emissions. RI regulation must permit managers the flexibility to adapt and respond to such changes.

Proportionate

Regulators should be mindful that RI may simply not be applicable to certain investment strategies, such as those based on short-term sovereign bonds. Rather, regulators should take into account the diversity of strategies used by managers. Failure to do so would increase the risk of 'greenwashing' and make it more difficult for investors to determine which managers were practicing RI in a meaningful way.

Non-duplicative

Regulation that seeks to embed RI practices into various aspects of investment management, such as risk management, may end up being redundant or self-defeating. Managers take their role as guardians of the capital of their investors seriously, and exercise thorough risk management and asset selection processes. These already take into account such things as sustainability risks, where they are material. As such, regulation requiring managers to account for such issues may be redundant. There is also the danger that regulation might create a situation where RI processes are regarded as separate from more 'traditional' aspects of investment management, thereby preventing RI from becoming an everyday part of investment management.



Consistent

RI is a broad term that can mean different things to different people. It is therefore imperative that regulators ensure consistency in the terms they use across different pieces of regulation. This is likely to require cooperation between market participants, policymakers, and regulators to create a common vocabulary which has an appropriate level of flexibility.

Practical

Regulators should be aware that the data necessary to implement many forms of RI can be expensive, inconsistent, or simply unobtainable. Compelling managers to use certain forms of data could create an artificial market in which the managers are forced buyers. As such regulators should avoid requiring managers to use specific types of data. Further, regulators should be mindful that mandating the use of a specific form of data can risk distorting the concept of RI by artificially defining its parameters.

Broad-based

Regulating managers alone is unlikely to achieve the goal of any RI regulation. To be effective, a regulatory framework must be broad-based and must encompass the behaviour of issuers. This is related to the problem of data scarcity. In many jurisdictions, issuers have few obligations when it comes to disclosing ESG data, and a strong incentive not to do so voluntarily. Any RI regulation should ensure a proper foundation of data is available before mandating specific action on the part of managers.

FAQ

Is responsible investment compatible with the concept of a hedge fund?

Yes. Hedge fund managers are, by definition, unconstrained and active. As such some have argued that RI represents a constraint that is antithetical to the premise of hedge funds. However, as explained in this primer, not all forms of RI are based on constraints—some of the most popular forms are based on factor weighting, the calibration of which can be determined by the manager deploying them. In many cases, RI is simply a means of using data to make more informed investment decisions.

Further, hedge fund managers (and active managers more broadly) may actually be more capable of implementing RI than their passive counterparts. Passive, indexed funds are compelled to own certain securities in order to avoid tracking errors, and thus do not usually have the ability to selectively exclude securities from their portfolios. Further, passive managers often do not engage with the companies in which they invest. Many hedge fund managers, on the other hand, have a long history of engaging with the management of the companies in which they invest.

How can investors be sure that a manager is really performing responsible investment?

There is always the risk of so-called ‘greenwashing,’ in which an investment manager will label a product as environmentally sustainable in order to attract business, without actually implementing RI in any substantive way.

At present, the onus is on investors to properly research managers and their products. However, in the future, national regulators may regulate the use of such terms as ‘ESG’ and ‘sustainable’ more strictly. In 2018, the European Commission adopted proposals which, if ultimately implemented, would create an EU classification system (or taxonomy) for sustainable investment. Further, verifications performed by third-party labelling agencies can provide some comfort to investors as to the nature of the products in which they are investing.

Is responsible investment compatible with the practice of short selling?

Yes. Short selling is neither irresponsible nor unethical, and it can form a critical tool in RI. For instance, a manager could short a company with poor environmental practices that were hidden from the public and which the market had failed to price in. However, it should be noted that some of the most stringent responsible investors may prohibit short selling for a variety of reasons.

Can responsible investment considerations go beyond the portfolio investments?

Yes. At the level of the fund, the effectiveness and the quality of governance provided by the fund’s board of directors can be an RI concern. Prospective investors in a fund may raise a variety of issues: is the board comprised exclusively of independent directors? What is the board’s gender balance? What do its members bring in terms of diversity of backgrounds, skills and experience?

At the level of the manager, similar consideration may be given to the composition of the investment team and senior management. Investors may also examine the degree to which certain functions within the manager, such as compliance and risk, are independent from the investment decision makers.

Is responsible investment compatible with the use of offshore fund structures?

Yes. Investment funds use offshore fund structures to meet the challenges of accommodating investors and investments located in multiple jurisdictions. Offshore jurisdictions provide expertise and a concentration of fund servicing businesses in a cost-efficient manner. A wide range of international initiatives, including the OECD’s Base Erosion and Profit Shifting (BEPS) project, seek to address deficiencies in the international taxation system and create a fair tax system. These measures, combined with the expertise offered by offshore jurisdictions, promote responsible and ethical investments across the globe. In spite of this, certain investors—such as

Northern European investors, who have historically been very significant allocators to ESG strategies—may prefer onshore structures.

Is responsible investment compatible with a public pension mandate?

In some jurisdictions, pension plan trustees or other investing fiduciaries may not use plan assets to promote social, environmental or other public policy causes at the expense of the financial interests of the plan's participants and beneficiaries. A fiduciary may not accept lower expected returns, or take on greater risk, in order to secure collateral benefits. Since every investment necessarily causes a plan to forego other investment opportunities, plan fiduciaries are not permitted to sacrifice investment return or take on additional investment risk as a means of using plan investments to promote collateral social policy goals. However, when competing investments serve the plan's economic interests equally well, plan fiduciaries can use such collateral considerations as 'tie-breakers' for an investment choice.

How does responsible investment affect fund performance?

The evidence is inconclusive.

Modern portfolio theory would suggest that narrowing the range of securities held in a portfolio, such as through the use of SRI, will increase its volatility and risk. On the other hand, the use of ESG factors may allow a firm to account for long-term risks which have not yet been priced.

Is divestment the answer?

There are currently a number of high-profile divestment campaigns, such as one targeting fossil fuels which is supported by many academic institutions.

The counterargument, however, is that divestment means the loss of a voice or voting rights. As such, it can be argued that it is responsible to maintain an investment and engage with the relevant issuer's governing bodies in order to encourage them to

improve their ESG practices.

By way of example, the Church of England is widely credited with having pressured Royal Dutch Shell to make firm commitments to cut its carbon footprint.

How are managers dealing with investor demands to demonstrate responsible investment?

Many managers are reporting an increase in questions from investors about their RI practices. Managers who may not have considered RI may find that, through becoming an engaged asset owner, they are able to demonstrate positive practices without the need to significantly change their investment approach. This usually involves, at a minimum, systematically exercising voting rights, but may extend to interactions between the manager and the governing bodies of issuers within the manager's portfolio. Through ownership of a small percentage of a listed company's equity, a manager may be able to demand the attention of the company's governing bodies and pressure them to improve their ESG practices.

Further, the adoption of a firmwide prohibited securities screening list may be a relatively straightforward way by which to formalise a firm's existing informal RI practices. Many managers, for instance, may already not invest in so-called 'uncontroversial controversies,' such as manufacturers of cluster munitions. As such, creating a formal policy and a prohibited asset list to that effect can be a relatively straightforward way of demonstrating some degree of RI practice.

Glossary

Best-in-class: Assets or investments that are the best performers amongst their peers in terms of environmental, social, and/or governance factors.

Engagement: The practice of seeking to influence the behaviour of a company in which a fund is invested in order to improve their environmental, social, and governance practices. For instance, engaging with a company's board in order to improve that company's labour practices.

Environmental, social, governance (ESG) factors: Identifying traits of a security that may not have been taken into account by that security's price, but which may affect its desirability from both a non-financial and a financial point of view. For example, accounting for a company's carbon footprint when deciding whether to invest in that company.

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

Green investment: Investment activities that focus on companies or projects that are committed to the conservation of natural resources, the production and discovery of alternative energy sources, the implementation of clean air and water projects, or other environmentally conscious business practices.

Impact investing: Investments made in order to deliberately create social goods. For instance, investing in a for-profit company which makes affordable water purifiers for the developing world.

Responsible investment (RI): An umbrella term describing the formal integration of ethical, social, or sustainability considerations into investment decisions.

Socially responsible investment (SRI): A screening process which excludes certain securities from a portfolio based on perceptions of their moral worth, their environmental impact, or other non-financial considerations. For example, the exclusion of cluster munition manufacturers from an investment portfolio.

Sustainable investment: An investment approach that considers environmental, social and governance (ESG) factors in portfolio selection and management.

Sustainability risks: Risks to the value of an asset occasioned by environmental, social, or governance issues. For instance, the price of an equity declining due to fines levelled against the issuer for environmental damages.

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

Additional Resources

For more information about responsible investment and the hedge fund industry, please see the following sources:

- AIMA: *Due Diligence Questionnaire for Responsible Investment*
 - A DDQ on responsible investment in the hedge fund space produced in conjunction with the UN PRI
 - <https://www.aima.org/sound-practices/due-diligence-questionnaires.html>
- AIMA: *From Niche to Mainstream*
 - A research paper created in partnership with Cayman Alternative Investment Summit, examining the state of responsible investment in the hedge fund industry.
 - <https://www.aima.org/educate/aima-research/from-niche-to-mainstream-esg.html>
- AIMA: *Perspectives: Industry Leaders on the Future of the Hedge Fund Industry*
 - A research paper exploring the future of the hedge fund industry, which discusses how responsible investment might affect the industry.
 - <https://www.aima.org/educate/aima-research/perspectives-research.html>
- AIMA: *Responses to ESMA Consultation Papers on the Integration of Sustainability Risks and Factors in MiFID II; the UCITS Directive and AIFMD*
 - AIMA's responses to ESMA's consultations on how responsible investment precepts might be integrated in MiFID II, the UCITS Directive, and AIFMD.
 - <https://www.aima.org/resource/aima-response-to-esma-consultation-paper-on-integrating-sustainability-risks-and-factors-in-mifid-ii.html>
 - <https://www.aima.org/resource/aima-response-to-esma-consultation-paper-on-integrating-sustainability-risks-and-factors-in-the-ucits-directive-and-aifmd.html>
- AIMA: *Letter to IOSCO on Issuer Disclosure of ESG Factors*
 - A letter written by AIMA to IOSCO in support of its call for issuers to disclose materially relevant ESG factors.
 - <https://www.aima.org/resource/aima-response-to-iosco-statement-on-disclosure-of-esg-matters-by-issuers.html>
- Simmons & Simmons: *Sustainable Financing and ESG Investment microsite*
 - A microsite covering the key regulatory obligations for asset managers stemming from the European Commission's Action Plan on Financing Sustainable Growth.
 - <http://www.elexica.com/en/resources/microsite/sustainable-financing-and-esg-investment>



Disclaimer

The contents of this primer are not intended as legal advice. Due to this dynamism of this field the meaning of some key concepts may change over time.