ESG and Hedge Fund Investing

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AETOS AT-A-GLANCE

Firm Overview
Aetos Alternatives Management, LP ("Aetos") is an independent firm that, since its inception, has been a leader in providing investment advisory services and constructing fully customized hedge fund solutions for a broad range of institutional clients.

Founded
2001

Firm AUM[1]
$11.2 billion

Leadership
Anne Casscells
Co-President & Chief Investment Officer

Michael Klein
Co-President & Chief Risk Officer

Locations
New York, New York
Menlo Park, California

EXECUTIVE SUMMARY

In recent years, sustainable investing approaches have moved from a small niche of the investment universe to the mainstream, as many different types of investors express the desire to have their investment portfolios reflect their values by incorporating non-financial considerations into how they are managed. The term ESG has increasingly gained prominence as it defines three major areas relevant to sustainable investing: environmental, social and governance.

Although these three broad areas provide a useful framework, sustainable/ESG investing faces challenges because investors often have different values that matter most to them and because there is no universal definition of what qualifies as an ESG approach. Another significant challenge is a lack of well-defined corporate reporting standards and third-party verification protocols, as already exist for corporate financial information (i.e., GAAP accounting and third-party verification by certified public accounting firms).

To date, most of the assets that define themselves as ESG are in traditional strategies including long-only equities and, to a lesser extent, long-only credit. While there is much potential for effective adoption of ESG approaches in many hedge fund strategies, only a small number of hedge fund managers have done so. However, this is likely to change as more managers consider the potential benefits of expanding their research processes to include sustainability assessments and as investor demand for sustainable investing approaches continues to increase.

ESG OVERVIEW

While a comprehensive history and review of ESG approaches is beyond the scope of this white paper, a brief background on the subject is outlined below:

- ESG is one of many names for an approach that integrates non-financial considerations into an investment strategy. Other nomenclature under this general umbrella includes sustainable investing, responsible investing, values-based investing, SRI, impact investing and mission-based investing.
- Values-based investing has a long history, dating back to at least 1928 when the first responsible investment fund (US Pioneer Fund) was launched that excluded "sin" stocks (e.g. alcohol and tobacco) from its portfolio.
- Notably, in 1986, under pressure from shareholders including many faith-based organizations, General Motors, IBM and Coca-Cola ceased doing business in South Africa in protest of the Apartheid system of institutional racial segregation and discrimination.

[1] As of December 31, 2018.

- An important trend in sustainable investing has been the evolution from approaches that rely on negative screening (for example, by excluding certain industries from consideration) to approaches that actively integrate ESG consideration into the investment process. Active ownership is another major ESG approach that involves publicly influencing companies to improve specific areas of corporate activity via the shareholder proxy voting process.
- The evolution to more active approaches to ESG is viewed as positive by many since it creates a more dynamic mechanism for investors to influence corporate behavior. Compared to the static approach of negative screening, ESG integration creates the incentive for investors to identify those companies that are using sustainability factors to improve shareholder returns and/or reduce certain risks associated with their business. Thus, investors are no longer limited to just those companies that are already outstanding from an ESG perspective and which may already be incorporated into their share prices / cost of capital—but rather, can identify companies that are in the process of utilizing sustainability to improve their business' risk/reward profile before the broader market recognizes this.
- Starting in the early 2000s, academic research began exploring the question of how the incorporation of ESG considerations impacts investment results. Although the research is by no means conclusive, there have been a number of studies that suggest ESG integration need not detract from investment returns and may actually improve long-term financial results.[2] In addition, a 2013 review of equity returns in Harvard Business Review concluded that "stocks of sustainable companies tend to outperform their less sustainable counterparts." As with other studies related to stock price returns, however, the time period chosen can have an enormous impact on the results. Thus, one should probably avoid ascribing too much weight to any individual study.

For those who would like to research this topic further, several excellent primers are freely available. Notable are materials on the websites of The Forum for Sustainable and Responsible Investment (www.ussif.org) and Principles for Responsible Investment ("PRI") (www.unpri.org).

IMPLICATIONS FOR HEDGE FUND STRATEGIES

A reasonable question to ask is whether ESG approaches are relevant to hedge fund strategies. The answer seems to be that it depends on the type of strategy, since hedge funds pursue a wide spectrum of different approaches to generating returns in the capital markets. Long/short equity, the largest single category within hedge funds, seems naturally suited to the incorporation of ESG factors. Both fundamental and quantitative approaches to long/short equity could potentially benefit from the skillful application of ESG-related research to the investment process to help managers better gauge the potential returns and risks associated with stocks.

Conversely, there are other hedge fund strategies, including fixed income arbitrage, where ESG considerations hardly seem relevant, either due to the underlying securities that the strategy trades or the time frame involved in the security selection process. For example, what possible insights could ESG research yield to an arbitrageur searching for pricing anomalies in G7 yield curves? Similarly, since ESG/sustainable research is focused on the medium- to long-term implications of the choices companies make, it hardly seems relevant for hedge funds that focus on short-term strategies, such as high frequency trading.

Our expectation is that equity-oriented hedge fund strategies—both fundamental and quantitative—will be the early adopters of ESG research approaches and the hedge fund category most likely to be successful in ESG fundraising. Other hedge fund categories where an ESG approach may be applicable include corporate credit-oriented strategies (including distressed credit) and activist equity strategies.

One important note is that, in our experience, many fundamental hedge funds already conduct some level of governance research as part of their diligence process on investments. For example, board quality, management quality, minority investor protections and employee relations are all significant topics that we see our managers already integrating into their investment approaches.

EQUITY HEDGE FUNDS AND ESG INTEGRATION

We thought it would be useful to outline our thoughts on ESG integration as applied to long/short equity strategies, as equity-oriented hedge funds are likely to represent the majority of ESG early adopters. Our thinking on approaches to ESG integration has also benefitted from my involvement as a member of the PRI's equity hedge subcommittee. We believe there are two primary approaches long/short equity managers can take in integrating ESG into their investment process. These approaches hold potential for achieving alpha and may influence corporate behavior by raising the cost of capital for poor ESG operators and lowering the cost of capital for good ESG operators:

1) A tool for playing better defense. It is well-documented that to "win the loser's game" of active equity investing, one must not only identify significant alpha contributors but also implement a strong risk management framework that avoids large losses through appropriately handicapping downside risks and effectively managing position sizes. At the company level, ESG risks often fall into the category of "low probability, high impact." Certainly, with respect to environmental factors,

[2] "ESG and Corporate Financial Performance" by Deutsche Bank and University of Hamburg, 2015.

there have been numerous companies over time that have faced significant, and sometimes catastrophic, deterioration of their business' enterprise value due to environmental events. The most notable example of the past decade is the Deepwater Horizon oil spill that resulted in BP paying fines of over $20 billion and suffering a nearly 50% peak to trough decline in its share price. Other companies may face similar impacts when it becomes clear that their products cause significant harm (e.g., asbestos, DDT, opioid manufacturers, etc.). Savvy investors who recognize these risks and avoid those companies where the market has underestimated the potential for catastrophic tail-risks may be more successful at avoiding significant losses and may also realize lower volatility in their portfolios.

2) A tool for playing better offense. Public awareness around environmental sustainability and social policies is the highest it has ever been, and consumers are making buying decisions based on their values in these areas. In addition, the pace of global regulatory change related to environmental impacts is high and is impacting more and more industries. For instance, new emissions regulations on the shipping industry (that produces 90% of global sulfur dioxide emissions) are coming in 2020 and have significant implications for that sector and its supply chain. The plastic industry will also face substantial disruption in the years ahead as many countries, including China and the EU, change their policies with respect to the production of ethylene-based products and recycling requirements (including the elimination of many single-use plastics). These factors create the potential for significant winners and losers within specific industry value-chains, which is fertile ground for active managers to source alpha, as the companies that adapt and innovate to respond to these changes may realize significant market share gains and/or better pricing power than their competitors.

   Conversely, those companies that are slow to adapt to changing consumer preferences and/or are likely to face increased regulatory costs (for example from environmental abatement) may be fertile areas for managers to source short positions. This is notable as it represents a unique advantage for an ESG long/short equity strategy versus a long-only ESG approach. Not only do long/short equity managers benefit from the potential to generate alpha from shorts, but this more active approach may represent a more direct transmission mechanism to penalize those "bad actor" companies via a higher cost of capital. Of course, as with any shorting strategy, timing is critical to success. In an ESG context, getting the timing of a short correct may be particularly challenging if a thesis hinges on a bad actor being called to account for their misdeeds.

Importantly, these two approaches are not at all mutually exclusive and could be theoretically applied to both fundamental as well as systematic long/short equity strategies.

ESG AND FINANCIAL RETURNS

The topic of how ESG approaches may impact financial returns has been fiercely debated, with strong views on both sides. Over the past dozen years, there have been a number of academic studies concluding that there is evidence that taking corporate sustainability considerations into account may lead to better returns. Outlined below are our thoughts:

- Negative screening is the ESG approach most likely to decrease financial returns as it narrows the investable universe formulaically. This is particularly true within a long-only, benchmark-sensitive context. For instance, excluding "sin stocks", such as alcohol and tobacco, can be costly as these companies are in the benchmark and often have strong free cash flow characteristics and strong brands which create competitive moats allowing them to earn higher than average returns on capital. In addition, since it is already widely known that these companies have troublesome societal impacts, many value-minded investors already avoid these companies and these companies already face a higher cost of equity capital. Within a hedge fund context, however, where portfolios are much more concentrated, and returns are driven by alpha rather than beta, negative screening may be less of a headwind to returns.
- We are skeptical of those who would claim that ESG incorporation de facto leads to better returns, but we also think it is likely that some managers who integrate ESG considerations into their process should be able to enhance their risk-adjusted returns by adding an additional tool to their investing toolkit. To us, saying that ESG strategies will outperform in aggregate is akin to saying that small-cap or value will outperform. While it may have been true over some historical periods, often when these factors are discovered and publicized, they do not persist. In the event these factors do still have some "factor alpha" associated with them, this alpha is usually very lumpy and may suffer years or even a decade of negative alpha at a time, as we have seen with the value factor over the past decade.

HOW WE DILIGENCE ESG STRATEGIES

Conducting diligence on investment strategies that utilize a negative screening approach to ESG investing is straightforward, as one must only confirm that the negative screens are appropriate to achieve the goal of the client. Approaches that involve integrating ESG considerations into a manager's investment process present much more complexity but, in our view, are ultimately what many investors will demand as they are more active and, in our opinion, provide greater potential for alpha. We have met with numerous managers pursuing some version of the latter approach. Below are some of our takeaways into how to diligence these strategies:

- Be skeptical, ask for detail. Much of how we diligence ESG strategies carries over directly from our customary approach to manager research. Since ESG is an emerging area that attracts news coverage and has piqued the interest of many different types of investors, there is the potential for managers to use ESG “branding.” That is, using ESG as a marketing and fundraising tool rather than an enhancement to their process that is supported by a rigorous and consistent discipline. As such, there is no substitute for engaging with a portfolio manager in detail as to the core tenets of their approach and reviewing multiple individual investment examples that showcase how their ESG diligence flows through to investment decision making.
- Look for managers who are investors first rather than social policy advocates for ESG. In our view, it is much easier for an experienced and talented investor to add an ESG toolkit to their process than for an ESG proponent to become a great investor. This is particularly important within a hedge fund context since, in order to harvest the lower-correlated returns we expect from the strategy (and to justify higher fees and less liquidity), our focus is on alpha generation with low market beta exposure. In our view, this requires a level of skill that generally is higher than for long-only strategies.
- Approaches that are well integrated into an investment process are preferable to a bolt-on approach. The diligence of ESG considerations should be well understood by the entire investment team at the organization, from portfolio manager to analysts. In particular, we look for evidence of these considerations during our initial on-site diligence with the investment team and our ongoing interactions thereafter.
- Similarly, a well-integrated approach to ESG means that ESG considerations must be balanced alongside all the other merits and considerations of an investment case. Therefore, ESG considerations alone cannot be a sufficient condition for an investment in the absence of compelling financial merits to an investment thesis.
- While the use of third-party ESG data and scoring reports (e.g., Sustainalytics) may be useful to a manager to leverage their research process, we believe that there is no replacement for in-house independent diligence—just as you would not want a manager to over-rely on sell-side research in a traditional active equity strategy.
- ESG managers should develop robust methods for reporting the ESG attributes of their portfolio to their investors. This can include qualitative assessments but should also ideally include appropriate quantitative reporting as well. Qualitative assessments should strive to be comprehensive rather than anecdotal and quantitative reporting should be relevant, consistent and transparent.

OTHER CONSIDERATIONS FOR POTENTIAL ESG INVESTORS

Although the application of sustainable investing approaches to hedge fund strategies is still nascent, our research to date has led us to several important takeaways regarding appropriate approaches for LPs interested in this area:

- Investors who are contemplating ESG/sustainable investments should take the time to define their values and goals first. If the goal is simply to avoid those industries that are not in sync with their values, then a negative screening approach may make sense. If an investor desires to only have exposure to those companies widely recognized as leaders in sustainability, that is also a valid approach. However, investors should realize that both of these approaches may involve performance tradeoffs. In our view, a third alternative—full ESG-integration into an investment process as a risk mitigator and/or additional source of alpha—is the most sensible approach within a hedge fund context, as it offers the best potential to both influence corporate behavior and realize greater alpha. Of course, hybrid approaches are also possible that may exclude certain undesirable industries while still giving a manager the flexibility to invest in companies that are improving but have not yet achieved best-in-class ESG practices.
- Within the context of ESG as applied to hedge fund strategies, long-term success depends heavily on a robust process to select outstanding managers that possess the necessary expertise and skill to generate superior results.
- Like other active management strategies, one must evaluate and select managers with a medium- to long-term view, recognizing that even the best managers will experience periods of time when they underperform their benchmark and peers.

ESG INVESTING WITH AETOS

We believe that incorporating ESG factors through absolute return strategies can accomplish the twin goals of providing diversification through less correlated assets while meeting a client’s socially responsible objectives. As a firm, we have developed a robust process to assess hedge fund managers’ level of ESG integration and screen portfolios on ESG factors. Leveraging this capability, along with our experience in building customized portfolios, the depth and skill of our team, and our deep infrastructure, we can create customized portfolios designed to meet clients' specific ESG criteria/objectives. We have the capability to design portfolios based on a client’s preferred approach, whether through incorporating ESG factors, sustainability/thematic-focused investment approaches or more straightforward negative screening.

DISCLOSURES

Hedge fund investing involves substantial risks, including the risk of loss of invested capital. Hedge fund investments are typically made through investments in illiquid, unregulated investment funds that employ sophisticated investment techniques, often involving derivatives and leverage, in a wide range of financial instruments and markets. These investments entail a wide variety of risks, which remain substantial notwithstanding the risk management practices we employ in selecting and monitoring the funds in which we invest. Past performance is not indicative of future returns.

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