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Alternative Investment Group

**ESG and Sustainable Hedge Fund Investing: Observations**

**September 2016**

## Sustainable Investing at an Inflection Point

We believe sustainable investing has reached an inflection point. After years of talking about it, investors are finally starting to put their money behind this approach. According to US SIF, U.S. investments incorporating ESG (Environmental, Social, and Corporate Governance) principles, in whole or in part, increased from $1 trillion to approximately $4 trillion between 2012 and 2014. This growth is being driven by multiple factors:

- There is a genuine desire by a growing class of asset owners to invest responsibly, to support a clean environment, and to use their capital to help solve global problems related to economic inequality and access to resources such as healthcare and clean water.

- "Millennials," generally regarded as those born in years 1980-2000, are playing an increasingly influential role in the investment landscape. This group of young adults has identified "the improvement of society" as the primary purpose of business[1], and they are projected to be the beneficiaries of $40 trillion wealth transfer from baby boomers[2].

- From an investment standpoint, sustainable investing has been gaining momentum with the realization that investors can "do well by doing good." Companies solving global problems can be huge economic winners and may offer significant returns to shareholders. Several firms that emphasize sustainability have significantly outperformed their benchmarks.

- In addition, an increasing number of investors have recognized that integrating ESG factors into company analysis can be a source of competitive advantage. A recent study published in the Harvard Business Review found that firms with better ratings on material sustainability issues see their stock prices outperform companies with poor ratings by 5% per year.[3] The best companies recognize that to grow over the long-term, they need to consider the overall sustainability of their business practices.

## Expanding Investment Manager Universe

The universe of sustainable investment managers has grown at a rapid pace to meet investor demand. Investment approaches have evolved from a basic SRI (Socially Responsible Investing), or negative screening approach, to a more proactive approach that incorporates sustainability and ESG factors to identify winning companies and generate better returns. According to Morningstar Inc., a leading provider

[1] World Economic Forum (2013). "From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors."
[2] John J. Havens and Paul G. Schervish (2003). "Why the $41 Trillion Wealth Transfer Estimate is Still Valid: A Review of Challenges and Questions," Boston College Social Welfare Research Institute.
[3] Khan, Mozaffar N., George Serafeim, and Aaron Yoon (2015). "Corporate Sustainability: First Evidence on Materiality." Harvard Business School Working Paper.

of independent investment research, socially conscious investment funds have had on par or better risk-adjusted performance ratings than Morningstar Inc.'s global investment fund universe.

A growing group of investment managers self-identify as sustainable-themed or ESG managers. At the same time, some managers incorporate these principles into their investment strategy to enhance performance, but may not want to pigeonhole themselves into a sustainability bucket for fear it will alienate certain segments of investors that continue to believe that sustainable and ESG investment strategies require a return concession. At the other end of the spectrum are managers that claim to be sustainable or ESG, but are simply "greenwashing" their marketing message and, upon further inspection, do not meet the criteria most sustainable investors would find acceptable. It takes an experienced team with a deep network to identify the right managers for a sustainable portfolio and to ensure that the managers are integrating the appropriate considerations into their investment process.

**Continuum of Responsible Investing in Public Markets**

| SRI | ESG | Sustainable Themed |
|---|---|---|
| **Exclusionary investment approach** | **Considers sustainability of companies** | **Investments in companies addressing global challenges** |
| **Screens for investments like fossil fuels, tobacco, alcohol, weapons - primarily for ethical reasons** | **Evaluates impact on environment, examines fair labor practices and corporate governance** | **Sectors of focus include renewable energy, energy efficiency, food, water, shelter, healthcare** |
| **Potential concessionary returns** | **Market rate returns** | **Market rate returns** |

## ESG, Sustainable Investing and Hedge Fund Strategies

While ESG and sustainable investing are widespread in private investing and long-only equity strategies, they are less prevalent in hedge fund strategies. However, we believe the same benefits apply to hedge funds that employ these strategies. In fact, because of their ability to sell short, hedge funds can benefit not only from investing long in winning companies, but also from shorting companies on the losing end of the shift to sustainable business models or companies with high levels of ESG risk. We expect hedge funds to be an increasing area of emphasis as investors transition to a holistic, risk-managed approach to ESG and sustainable investing.

At Alternative Investment Group, we have been constructing and managing hedge fund portfolios on behalf of our clients for 20 years. We spent the last four years developing our approach to ESG and sustainable investing through hedge funds and believe there are five key points to consider when constructing a sustainable hedge fund portfolio:

- Sustainable themes, such as renewable energy and global healthcare solutions, are focused on areas of the equity market with significant stock dispersion, making them excellent areas for long/short investing with strong potential for alpha generation.

- There are growing areas of opportunity in sustainable credit strategies, such as expanding access to credit to underserved segments of the population, funding for hospitals and schools, and community development through small business lending.

- A multi-manager portfolio, integrating multiple sustainability approaches, provides important diversification and risk mitigation benefits to maximize risk-adjusted returns, particularly given the high volatility of certain sustainable sectors such as renewable energy.

- Avoiding investments in carbon-related energy companies that are part of The Carbon Underground 200[4] avoids risks associated with potentially stranded assets and reduces climate change-related tail risks.

- Active ownership through oversight and corporate engagement can achieve positive outcomes.

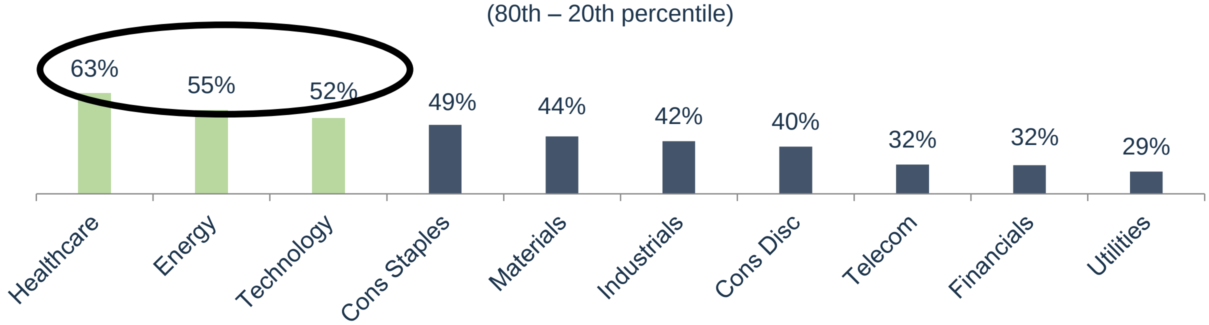
In the next section, we address each of these points in greater detail.

**Higher Alpha Potential for Equities**

Long/short equity strategies rely on high stock dispersion to generate returns. Managers employing this strategy generate a significant portion of their performance from the return differential between their longs and shorts. The higher the stock dispersion, the more potential for alpha generation. Sustainable business models are a natural driver of dispersion because they are often industry disruptors. For example, over the last ten years, we have witnessed the tremendous growth of renewable energy in areas such as wind and solar and the shrinkage of heavily polluting energy sources, such as coal. Managers can invest long the winning technologies in renewable energy and short the losing coal companies to capture the performance differential between the two. For example, NextEra Energy is an electric utility company that has been successfully transitioning its business to cleaner energy sources, such as wind and solar, with its share price more than doubling over the last five years. On the other side of the spectrum, more than half of the assets in the global coal industry are now held by companies that are either in bankruptcy proceedings or don't earn enough money to pay their interest bills.[5] In general, sustainable investing tends to have a bias toward high dispersion sectors such as energy, healthcare, and technology.

Complexity can also be beneficial for knowledgeable active equity managers and the areas of the economy related to sustainability are driven by a complex mix of factors. Whether it is energy, healthcare, agriculture, or water, these areas are impacted not only by technological improvements, but also by regulatory policy, government intervention, and even commodity prices. The advantage goes to managers that can correctly analyze all these factors to determine the likely outcome of a stock investment.

2015 Russell 3000 Sector Stock Dispersion
(80th – 20th percentile)




Source: Bloomberg

[4] The Carbon Underground 200™ identifies the top 100 public coal companies globally and the top 100 public oil and gas companies globally, ranked by the potential carbon emissions content of their proven reserves.
[5] David Fickling - Bloomberg Columnist (2016). "Coal Stranded Assets"

**Credit Opportunities**

While long/short equity is an effective strategy to express views on sustainability and ESG, we believe there are a variety of credit strategies just as appropriate in supporting sustainable and ESG objectives.

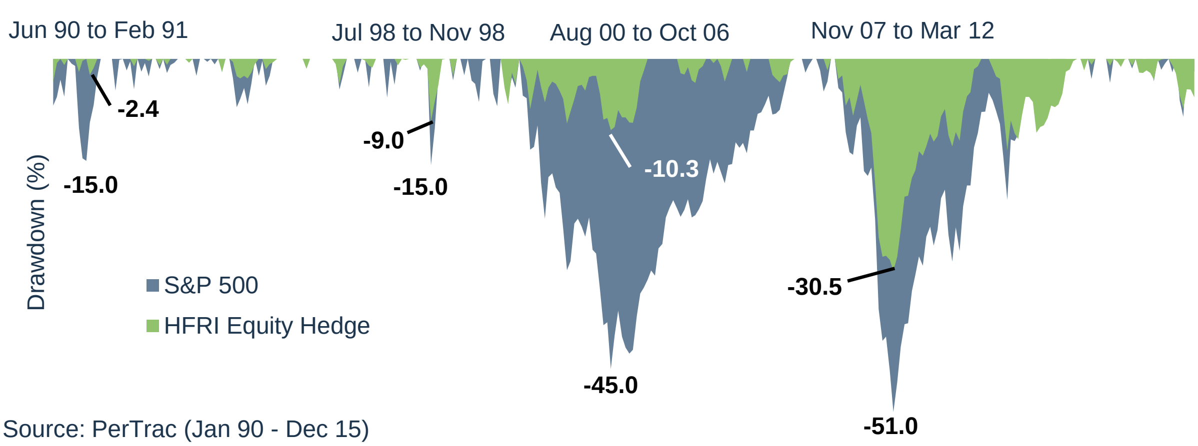
Mortgage credit, for example, has become much more restrictive post-financial crisis. While it is clear that credit standards were too lax pre-crisis, it can be argued that they have become too tight post-crisis. The average FICO score for a mortgage has increased from below 700 in 2006 to 745 today, while 44% of the U.S. population has a FICO score below 700[6]. Ben Bernanke, the ex-Fed Chairman, related that he was unsuccessful refinancing his mortgage after he left his post and acknowledged that certain lending standards are “probably excessive.” If Ben Bernanke could not get a mortgage, how about a middle-class worker with a dented credit history?

Savvy managers have identified mortgage strategies that provide credit access to those borrowers who are still good credit risks, but may not meet today’s stringent requirements. The same restrictiveness of credit applies in a range of sectors, including small business loans that can support community development and municipal loans to schools and hospitals that may be facing certain competitive challenges. It is harder than ever even for responsible borrowers to access credit and we believe that sustainable credit strategies can fill that gap to help build communities and support small businesses.

**Risk Mitigation**

Equities typically earn the highest long-term returns, but are volatile and sometimes lead to large losses. For example, the S&P 500 lost 51% and 45%, respectively, in the drawdown periods of 2007-2009 and 2000-2002. One of the main advantages of hedge funds over traditional long-only strategies is the ability to reduce market risk through shorting. This is evident through examining hedge funds’ volatility relative to equity markets. The HFRI Equity Hedge Fund index’s volatility of 8.9% since 1990 is only 60% of the S&P 500 Index’s 14.6% volatility during the same time period. We believe this is particularly important for certain sustainable investment strategies, since they tend to be concentrated in high volatility sectors such as alternative energy, healthcare and technology. For example, the Wilderhill Clean Energy index of clean energy stocks has an annualized volatility of 33%. This is 2.2x higher than the volatility of the S&P 500!

**Hedge Funds Historically Have Significantly Lower Drawdowns and Volatility than Equity Markets**



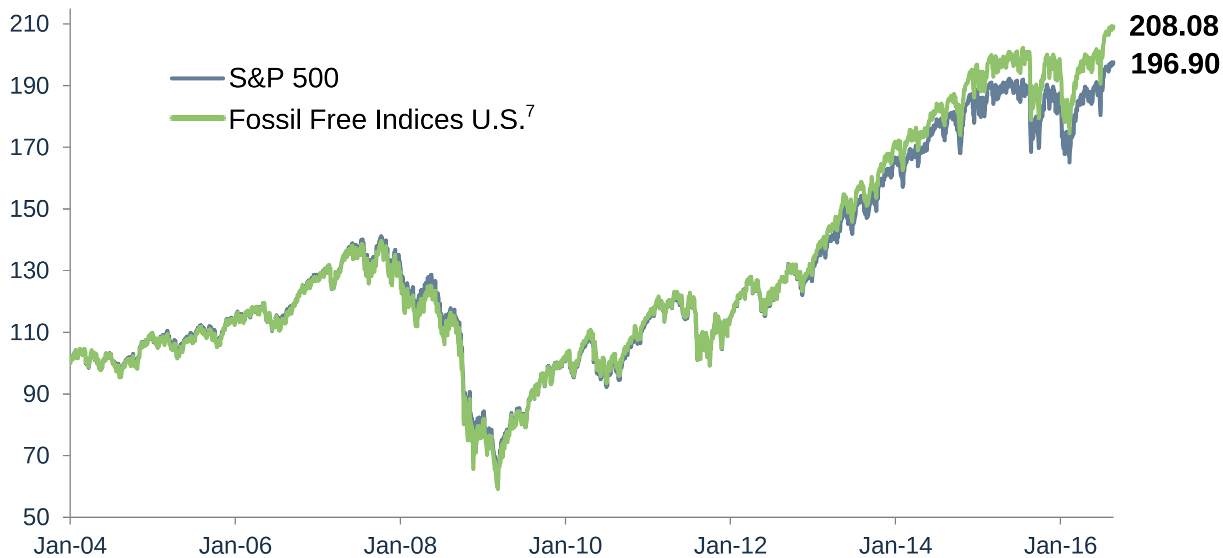

Source: PerTrac (Jan 90 - Dec 15)

[6] Fair Isaac Corporation, www.fico.com

Multi-manager portfolios are another buffer against volatility, particularly if they bring together a diverse set of uncorrelated investment approaches. Many investors' concept of sustainable investing revolves around renewable energy. However, we believe that, by creating a portfolio that incorporates multiple sectors such as healthcare, agriculture, water and consumer and by adding uncorrelated credit strategies, investors can significantly improve their risk-adjusted returns. Effective portfolio construction is a critical part of creating a successful hedge fund portfolio.

**Unfavorable Return-to-Risk Ratio for Carbon Underground 200 Companies**

Avoiding long holdings in companies that are part of the Carbon Underground 200 aligns with a sustainable long-term investment approach. We believe any short-term performance concession will be inconsequential compared to the long-term climate change-related tail risk. In fact, in the last few years, these companies have negatively contributed to the returns of the S&P 500 index as seen in the chart below, a trend that may persist as the shift to a low-carbon economy continues.




Source: Bloomberg

In addition, these companies have the potential to suffer from stranded assets. Stranded assets are fossil fuel-related resources on a company's balance sheet which, at some time prior to the end of their economic life, are no longer able to earn an economic return as a result of changes in the market associated with the transition to a low-carbon economy[8]. These include regulatory risks due to recent and potential changes in legislation or policy, physical risks due to environmental changes and inherent in the extraction process, and economic risks due to the cost of extraction relative to market price and demand. As a result, these assets may be worth far less than they are valued on a company's balance sheet.

[7] S&P 500 index screened for The Carbon Underground 200 TM by Fossil Free Indices US
[8] The Carbon Tracker Initiative www.carbontracker.org/resources

### Oversight and Corporate Engagement

Once an investment program has been initiated, it is important to monitor manager holdings to ensure the portfolio is consistent with expectations and managers are and stay true to their sustainable investment themes. Hedge fund managers should be willing to share their holdings on at least a quarterly basis. This transparency also allows investors to pursue a program of active ownership, or engagement.

We recognize there are certain “gray areas” in sustainable investing. Different investors may have a different set of priorities as to what constitutes a sustainable company. Even companies tackling major global issues may not be high performers in all areas of E, S, and G. For example, there is a well-known solar power manufacturer that has poor employee relations relative to peers. This company is solid on the environmental front (E), but an underperformer on the social front (S). Rather than exclude companies such as these from portfolios, a good engagement program can help move the company in the right direction and potentially lead to improvements in the bottom line. This involves having a detailed understanding of the true deficiencies within the company and developing a clear set of objectives for improvement. Once these are established, an effective engagement program involves initiating a dialogue with the company regarding these concerns and regular follow-up to see if management is moving in the right direction. In our experience of bringing concerns to management in a constructive manner, companies have shown themselves willing to listen to shareholder concerns and have responded appropriately.

It would take tremendous effort to evaluate from scratch each company in a portfolio. We, therefore, believe a good starting point is one of several third-party services, such as MSCI and Sustainalytics, which provide thorough, though not all-encompassing, ESG reporting metrics. We believe it is also critical to call these ESG deficiencies to the attention of the investment manager that owns the position. Since investment managers are frequently in dialogue with the management teams of their portfolio companies, they are on the front lines to address these issues. In our experience, hedge fund managers are very willing to discuss any ESG deficiencies in their portfolio companies, since it helps to identify a potential risk factor for the business of which they may not have been aware.

### Conclusion

We believe a confluence of investor demand and investment opportunity has brought us to an inflection point for sustainable investing. While much of the attention has been focused on long-only and private investment strategies, we believe hedge funds are an excellent way to express sustainable and ESG themes. Through a long/short approach, hedge funds can capitalize on the significant stock dispersion and mitigate the volatility inherent in certain sustainability sectors such as renewable energy. Investors can further improve their risk-adjusted returns by constructing a multi-manager hedge fund program, incorporating a diversified portfolio of equity and credit strategies. Avoiding the Carbon Underground 200 aligns with long-term investment objectives as the world moves to a low-carbon economy. Lastly, by being active owners, we can help ensure that companies are fulfilling their obligations as good corporate citizens.

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