ESG Hedge Fund Classification Framework

By: Gregory Neal

ESG is one of the hottest topics in the investment industry today. ESG adoption has been years in the making, and hedge fund managers have finally started to take notice. We have spent the last three years working with investment managers to understand their ESG approach. As you might imagine, the application of ESG in hedge funds is just as varied as the investment strategies they employ. The wide range of ESG strategies has created complications for investors. Until now, there hasn't been a common language to aid investors, managers, and other stakeholders in their conversations about their ESG hedge fund investments.

After meeting with many hedge fund managers, it is clear that understanding the application of ESG by an individual manager requires in-depth due diligence and ESG expertise. Complicating the matter, there is no silver bullet for allocators to quantify how a given hedge fund uses ESG. There is not a single score or rating system that can comprehensively relay all the information needed to assess a strategy. While many hedge funds claim to incorporate ESG, it may be difficult to determine how well they do so versus their peers without doing the work.

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HFR Investments focuses on hedge funds and other public markets investment managers by offering a range of multi-manager products and single manager seeding options.

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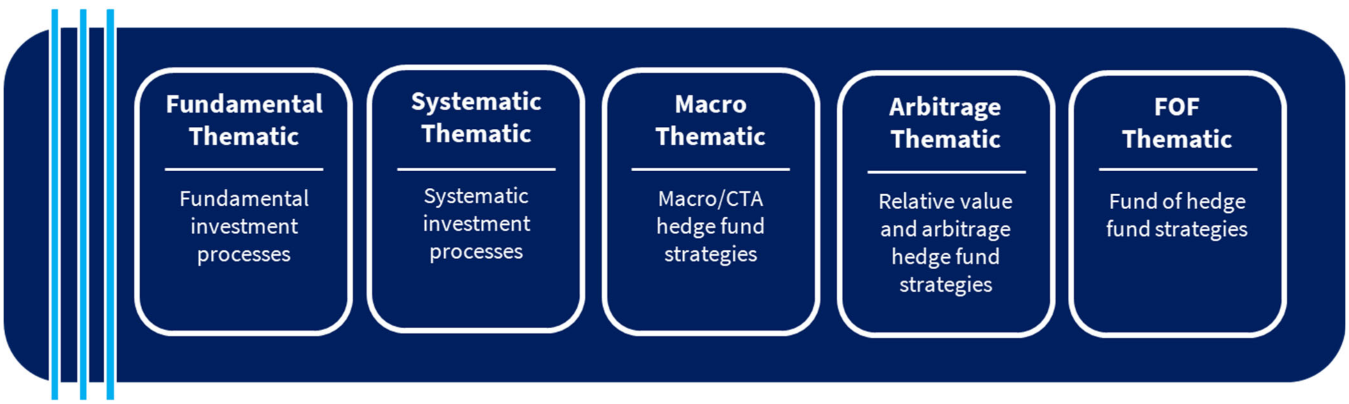
There are managers that may invest in so-called "dirty" or "brown" companies. These companies have high carbon intensity according to publicly reported measures, but the manager has done their own due diligence and can see that the company has taken steps in reducing its carbon intensity, which has not been reflected yet in the data. This is just one example of how contemporary scoring systems cannot capture the whole picture.

Instead of a scoring system, we developed a classification framework to assist allocators in categorizing ESG hedge funds based on their investment process. The classification framework is meant to be used as a starting point and in combination with ESG and investment due diligence. By making funds classifiable and comparable, we aim to facilitate communication – between asset managers and their clients, asset owners and their boards and stakeholders, and fund managers and their investors.

Hands-on due diligence is required to truly understand and quantify how an investment manager integrates ESG, so we do not attempt to grade or opine on how well a manager integrates ESG. The framework is not designed to measure or rank a manager based on their impact on the world. Instead, it was created to assist in the initial categorization of funds, which then allows ESG investment professionals to explore and determine a manager's level of ESG sophistication.

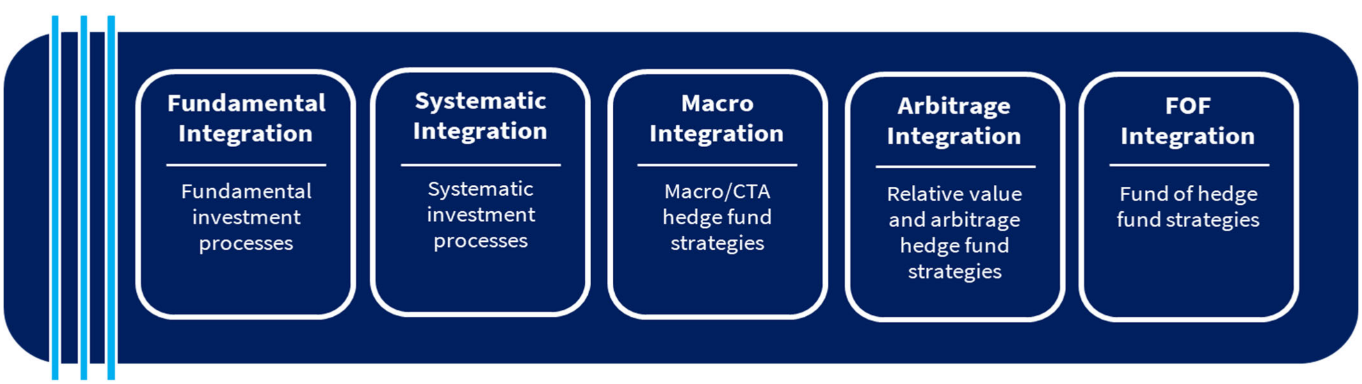
ESG Thematic Hedge Funds

ESG thematic hedge funds screen their investment universe based on specific predetermined themes, such as climate change, resource efficiency, sustainability, or energy transition, among others. Thematic managers may also use ESG integration techniques as a secondary factor.



ESG Integration Hedge Funds

ESG Integration hedge funds screen their investment universe using specific ESG criteria to conduct investment research. Some criteria include ESG scoring systems, positive or exclusionary screenings, or ESG risk management processes.



The framework initially divides funds into two main ESG categories – **Thematic and Integration**. The two categories allow us to understand if a manager is focused on investing thematically, aligned with specific environmental, social, or governance objectives, or if their strategy incorporates ESG factors throughout the investment process.

> **Thematic ESG hedge funds** tend to screen their investment universe based on specific predetermined themes, such as climate change, resource efficiency, sustainability, or energy transition, among others. Thematic managers may also use ESG integration techniques.

> **ESG integration** comes in all shapes in sizes. It can be as simple as negative screening for a company's product such as tobacco. Or it can be as complex as creating an in-house proprietary ESG scoring system that analyzes their investment universe across a variety of factors.

The framework's next level of classification organizes funds by their investment strategy. The second level is divided into five categories: **Fundamental**, **Systematic**, **Macro**, **Arbitrage**, or **Fund of Funds**. Coupling the ESG classification of Thematic or Integration with the above investment categories gives us the basis of our framework. We'll revisit Macro, Arbitrage, and Fund of Funds shortly, as understanding the delineation between Fundamental and Systematic fund strategies—the largest subcategories—is critical.

Fundamental strategies utilize core economic, financial, and ESG data to determine intrinsic values and make investment decisions. In contrast, systematic strategies quantitatively employ ESG and financial data to make trading decisions in a rules-based system.

> **Fundamental Strategy**: An investment strategy whose theses are based on firms' financial statements, in both absolute terms and relative to other similar securities, as well as market indicators. Generally, these funds are of a bottom-up and discretionary nature.

> **Systematic Strategy**: A rules-based, non-discretionary investment strategy that uses various advanced quantitative methods to implement trading and investment decisions.

ABC Long/Short ESG Example Fund

Investment Strategy Description: The Fund seeks superior uncorrelated returns with low beta by taking positions both long and short based on opportunity and insights within climate change related industries. The Fund selects investments via a bottom-up, fundamentally driven, research-intensive approach, leveraging the management team's firsthand market experience, network, and successful stock selection experience.

Hedge Fund Strategy: Equity Hedge

Hedge Fund Sub-strategy: Fundamental Growth

ESG Classification: Fundamental Thematic

1) Fundamental investment research
2) Climate change focused investment theme

XYZ Emerging Markets Long/Short Example Fund

Investment Strategy Description: The Fund employs a concentrated long and short emerging markets focused equity market neutral portfolio. Detailed fundamental research stock selection and active portfolio construction are employed. The strategy will integrate ESG factors based on a proprietary scoring system and considerations into the fund's investment analysis to reduce ESG-related risks as well as to identify ESG-related investment opportunities.

Hedge Fund Strategy: Equity Hedge

Hedge Fund Sub-strategy: Equity Market Neutral

ESG Classification: Fundamental Integration

1) Fundamental investment research
2) Integrates ESG scoring in investment decisions – No specific ESG-focused theme

This distinction is made because of the ESG data that is used in systematic strategies. As the old adage states, “Garbage in, garbage out”—The ESG data currently available is still in its infancy and cannot always be relied on unconditionally. This is not to say the individual sets of data are bad but rather that consistency is lacking because of the varying ESG reporting and materiality standards across the world. To further muddle matters, the data is then collected and combined by rating agencies based on their own methodologies. The data companies have the same intention of producing reliable, consistent company-level ESG data and scores, but as research has shown, scores for the same company provided by two different rating agencies may be completely uncorrelated. This inconsistent and, at times unreliable data coupled with the systematic strategies' data dependence requires the funds to be separated from the more flexible fundamental strategies.

QRS Systematic Equity Example Fund

Investment Strategy Description: The Fund is a fully systematic equity market neutral program focused on US equities including single name securities, index futures, and ETFs. The Fund uses several commercial ESG ratings along with ESG data to determine the investable universe based on minimum qualifications set out by the manager. The Investment Manager will deploy a number of quantitative algorithms that analyze stock price movements and patterns to identify and exploit short- and medium-term investment opportunities.

Hedge Fund Strategy: Equity Hedge

Hedge Fund Sub-strategy: Equity Market Neutral

ESG Classification: Systematic Integration

1) Systematic investment strategy
2) Integrates ESG scoring and data in systemic process – No specific ESG-focused theme

On the other hand, fundamental analysis allows for nuance in ESG approaches, data, and scores. The facts and figures can be analyzed in context by the hedge fund manager for a tailored approach. This does not mean that a fundamental approach is better than a systematic approach but rather it demonstrates the flexibility of a manager to do their own ESG analysis.

There may be exceptions to the framework, but that is why the ESG due diligence team's knowledge and ability is critical to understand the nuances and expertise of a manager, no matter how they implement their ESG strategy.

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While dividing funds between **Thematic** vs. **Integration** and **Fundamental** vs. **Systematic** covers most ESG hedge funds (e.g., equity hedge, event-driven, quantitative equity, etc.), other hedge fund strategies, such as **Macro**, **Arbitrage**, and **Fund of Funds**, must also be considered. To address this, the Framework includes thematic and integration classifications specifically for macro strategies, arbitrage hedge funds, and fund of funds.

Macro Strategy: Macro managers trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency, and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top-down and bottom-up theses, quantitative and fundamental approaches, and long and short-term holding periods.

Arbitrage Strategy: Relative Value and other arbitrage strategies have an investment thesis that is predicated on realizing a value discrepancy in the relationship between related securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and securities range broadly across equity, fixed income, derivative, or other security types.

Fund of Funds Strategy: Fund of Funds invest in multiple hedge fund managers across strategies and may focus on investment strategies such as opportunistic, diversified, or defensive.

MNO Sustainable Convertible Arbitrage Example Fund

Investment Strategy Description: The Fund will seek to generate absolute returns achieved through realizing pricing inefficiencies by owning convertible securities and shorting the related equity securities. The Fund will invest primarily in global Convertible Securities focused on issuers that primarily focus on sustainable resources, energy efficiency and technology, water infrastructure, and recycling companies.

Hedge Fund Strategy: Relative Value Arbitrage

Hedge Fund Sub-strategy: Convertible Arbitrage

ESG Classification: Arbitrage Thematic

1) Arbitrage investment strategy
2) Sustainability focused investment theme

The HFR ESG Hedge Fund Classification Framework is designed to help hedge fund allocators and their stakeholders better understand how ESG fits within their hedge fund portfolio. We also hope that it allows hedge fund managers and their investors to compare and classify ESG hedge fund strategies. The framework does not grade a manager's ESG quality, since ESG hedge fund strategies are so varied, and assessing manager ability requires due diligence. However, these categories can provide a common language that facilitates communication and reporting across stakeholders. The classification framework is just the beginning, a starting point for deeper ESG due diligence and investment research, but we also hope that starts deeper conversations about incorporating ESG into hedge fund investments.