Unigestion's 2015 hedge fund and private equity ESG survey

July 2016

More and more institutional investors are acknowledging that taking into account environmental, social and governance (ESG) criteria in the investment process can have a positive effect on a portfolio's risk-return profile, both through its ability to identify opportunities and to help avoid risks.

As a signatory of the United Nations-supported Principles for Responsible Investment (PRI), at Unigestion we take our responsibilities as an investor very seriously, and consistently incorporate ESG criteria in our direct investments. But we also invest in funds run by external managers, and it can be difficult to assess third parties' approaches to ESG.

With this in mind, every year we send the hedge fund and private equity managers we invest with a questionnaire to assess their approach to ESG as part of our regular due diligence process. In this document we highlight some of this year's most interesting findings and report on some of the anecdotal evidence provided by individual hedge fund managers.

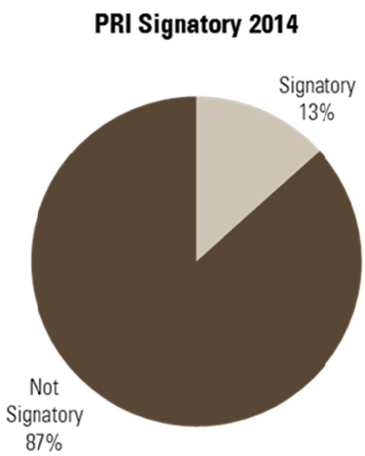
Eric Cockshutt is the firm's Responsible Investment Coordinator

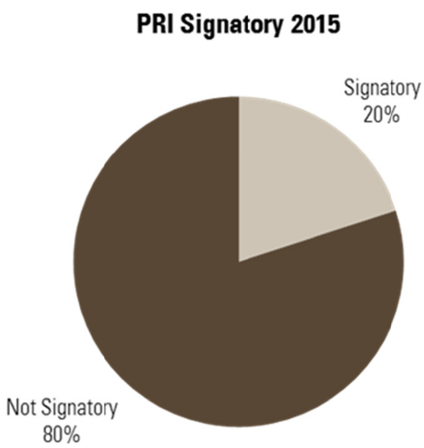
Hedge funds

91% of our invested hedge fund managers replied to our survey.

Signatories of the UN-backed PRI

A large majority – 80% – of the hedge fund managers we surveyed have chosen not to sign the PRI, designed to encourage investors to incorporate sustainability principles in their investment decision-making and ownership practices.





Based on the results of our survey, it was clear that large hedge fund managers (those with USD 10 billion or more of assets) were significantly more likely to be signatories of the PRI than small (under USD 2.5 billion) and medium-sized (USD 2.5–10 billion) managers: 44% of large managers had signed the PRI, compared with just 9% and 10% for small- and medium-sized managers respectively.

Summary

1. Although 80% of hedge fund managers have not signed the PRI, nearly half stated that they cared about ESG matters.
2. The PRI is spearheading a working group charged with creating a standard ESG due diligence questionnaire for hedge funds; Unigestion is proud to be invited to participate.
3. European private equity managers remain significantly better positioned than those in the US and Asia.

A long way to go for some hedge funds

One of the hedge fund managers stated that it did not sign the PRI as it considered that this would not have a positive social impact and because it was not the main reason for investors to allocate to their fund. When asked what might motivate it to implement an ESG policy, it highlighted that it would be for "marketing purposes".

In a similar vein, another manager stated that it sees ESG principles as an additional burden that involve a lot of filing and represent yet another layer of constraints in addition to the already heavy regulatory environment.

Interest in ESG matters

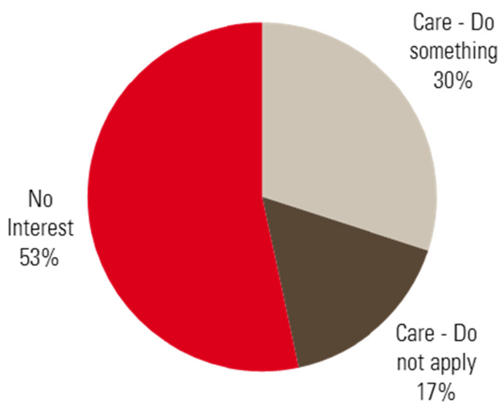
This year we ascertained our hedge fund managers' interest in ESG by asking them a number of questions about their approach to ESG and, based on their answers, assigned them one of the following grades:

1. Care about ESG and put it into practice in their investments: managers that have an ESG policy in place and include ESG criteria in their investment processes.
2. Care about ESG but do not put it into practice in their investments: managers that believe that ESG is important and have either a formal or informal ESG policy in place but do not take ESG criteria into account in their investment processes (possibly because it is simply not possible for them to do so because of the nature of their investment strategy).
3. No interest: managers that are unwilling to implement an ESG policy, take ESG into account in their investment processes or become signatories of the PRI.

"Nearly half of our hedge fund managers stated that they cared about ESG matters."

As the chart below shows, nearly half of our hedge fund managers stated that they cared about ESG matters, with close to a third actually implementing ESG criteria in their investment processes.

Interest in ESG 2015



Again, large managers were more likely to have in place a formal ESG policy than small and medium-sized managers.

Size doesn't have to matter: all firms can embrace ESG

While large hedge funds are more likely to have put in place an ESG policy than smaller funds, it doesn't have to be this way. Arrowgrass Capital Partners, a hedge fund with USD 5.9 billion of assets under management, showed the extent to which it is possible for smaller firms to embrace ESG.

The Manager explained how it has partnered with Sustainalytics, a leading ESG data provider, to ensure that it uses the latest ESG information in its investment process.

The Manager also explained how it works closely alongside Kukua, a responsible investment firm, to help with the implementation of an ESG policy and to further improve it over time. Arrowgrass has also formed an ESG committee, consisting of the firm's CEO, Co-COO and General Counsel, Head of European Compliance and Head of Investor Relations. Kukua (which reports to the committee) also attends each monthly meeting and presents Arrowgrass's ESG reports.

Interest in ESG matters by hedge fund type

Of the managers in our survey, it was clear that tactical trading managers (including commodities, managed futures and global macro) find it very difficult to implement ESG policies because of the nature of their strategies, with just a third of such managers implementing one. Equity hedge managers (including those involved in long / short credit, distressed, long / short equity and event-driven) were more likely to implement ESG criteria, which is intuitive because trading the equities or debt of individual companies provides a manager with considerable scope to incorporate ESG criteria in its investment process. But it was arbitrage managers (including convertible, equity, fixed income and multi-strategy arbitrage) who were the clear leaders in this respect, with 67% applying ESG criteria in their investment processes and a further 11% stating that they care about ESG matters.

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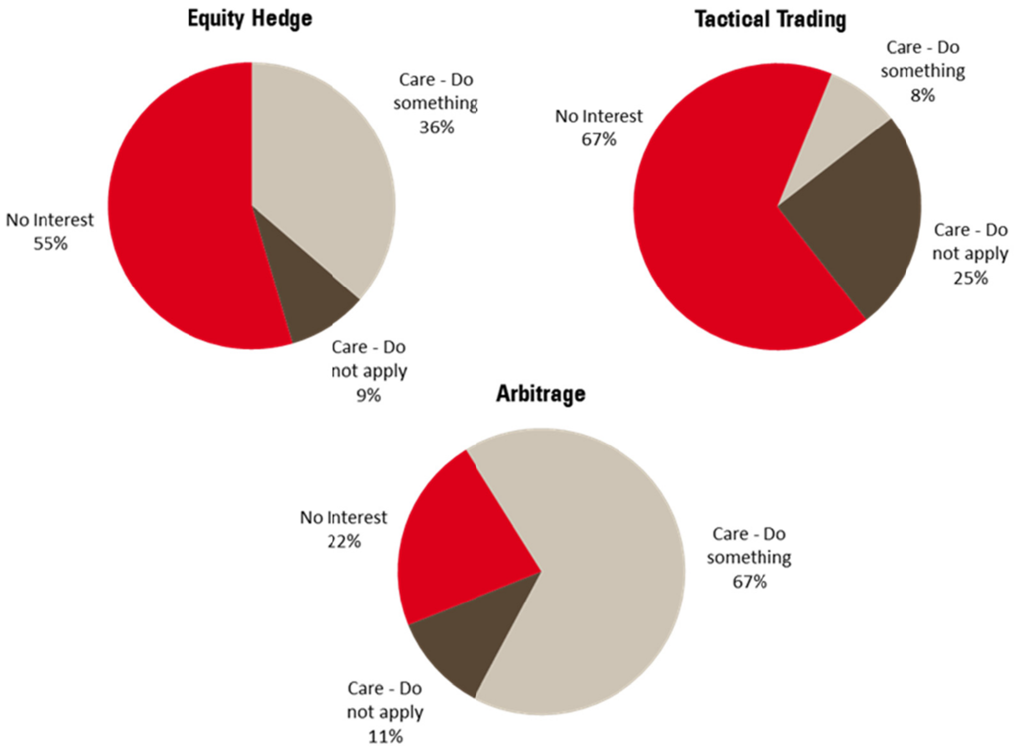
Hedge funds can meet their responsibilities in a variety of ways

It is difficult for some hedge funds to adopt ESG criteria in their investment processes because of the nature of their activities. For example, one of our managers is a purely systematic, quantitative fund that invests only in futures contracts rather than taking direct stakes in companies or physical assets. This makes it difficult to adopt ESG criteria in the traditional sense. However, it confirmed that it supports the PRI's definition of responsible investment and is currently looking into ways to incorporate the principles in its investment process.

But taking ESG seriously can encompass activities other than investment processes. In terms of giving back to society, Winton Capital Management explained how it has established the Winton Research Prizes Programme which recognises first class research and aims to facilitate further research by scientists whose work has already been recognised at an international level and whose future contributions are expected to be of similarly high achievement. On an environmental front, Winton's London headquarters, Grove House, is a certified Low Carbon Workplace, one of only 8 in the UK.

2015: interest in ESG by manager type



Helping hedge funds to embrace ESG

In order to provide hedge fund managers with a clearer way to integrate ESG practices in their investment approaches in the future, the PRI is spearheading a working group charged with creating a standard ESG due diligence questionnaire for hedge funds – something that does not currently exist. The PRI is working in concert with the Alternative Investment Management Association, the Hedge Fund Standards Board and a select group of asset owners and asset managers on this project. Unigestion is proud to be one of the asset managers that has been invited to participate.

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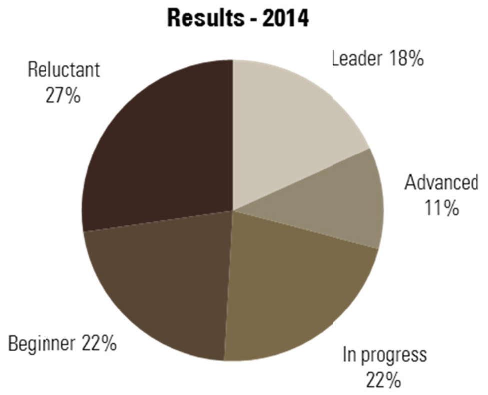
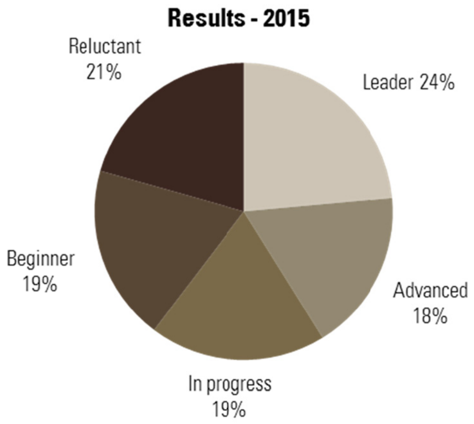
Private equity

In January we sent ESG questionnaires to 79 private equity managers that we invest with, 85% of which have responded. In the questionnaires we asked them a series of questions based on which we assigned each manager an ESG grade – "leader", "advanced", "in progress", "beginner" or "reluctant".

Overall, our private equity managers have continued to gradually develop and improve their ESG programmes over the past year. 42% of the managers achieved "advanced" or "leader" status (up from 29% in 2014), while only 21% are reluctant to address ESG issues.



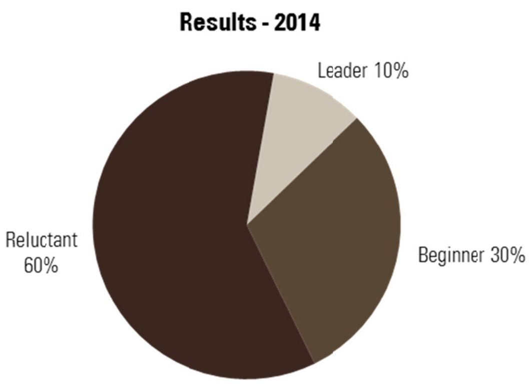


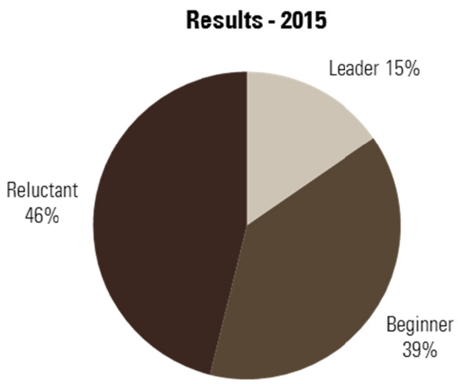
Similarly, there was a slight increase in terms of the proportion of managers who have signed the PRI, up from 27% in 2014 to 30% in 2015.

Approach to ESG by investment strategy

As was the case in 2014, venture & growth capital managers were still more reluctant to implement ESG policies than other kinds of private equity managers, although they have improved slightly in this respect over the past year. Again, there was a slight increase in how many had signed the PRI, up from 10% to 12%.

Venture capital / growth managers

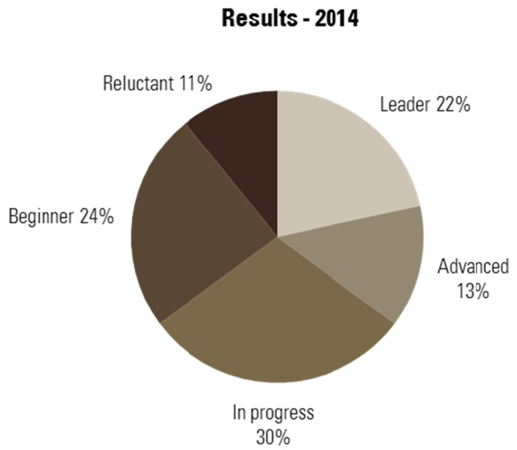


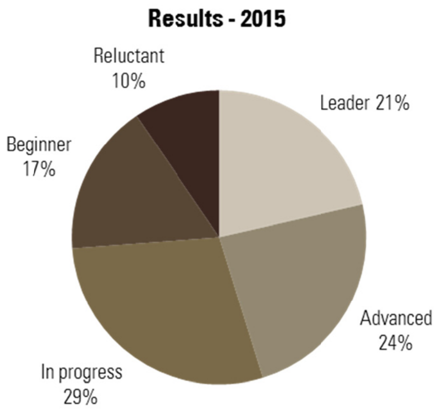


"Buyout managers remain the clear ESG leaders in the private equity market, and there has also been a significant improvement in their ESG performance over the past year, with 45% achieving either "leader" or "advanced" status."

Buyout managers remain the clear ESG leaders in the private equity market, and there has also been a significant improvement in their ESG performance over the past year, with 45% achieving either "leader" or "advanced" status – up from 35% in 2014. This is probably because buyout managers tend to invest in larger companies, which themselves have the resources to implement ESG programmes, than the firms that venture capital managers invest in. The proportion of managers that had signed the PRI rose from 35% to 38% over the year.

Buyout managers





But it was special opportunities managers (those involved in areas such as turnarounds, distressed debt, renewable energy and natural resources) that made the most progress in terms of ESG over the year. This can be explained in part by the considerable efforts made by renewable energy managers. Every year our sustainability research partner sends the nine managers in our specialist sustainability private equity fund an in-depth ESG due diligence questionnaire, and this has acted as a strong catalyst for these managers to live up to their ESG responsibilities.

Meanwhile, 53% of our special opportunities managers achieved "leader" or "advanced" status in 2015 – up from 24% the year before – and the proportion of PRI signatories more than doubled, from 12% to 25%.

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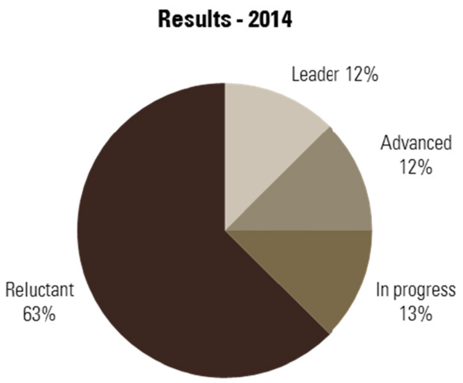
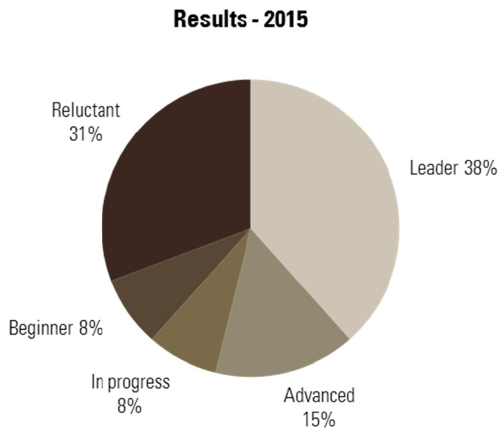
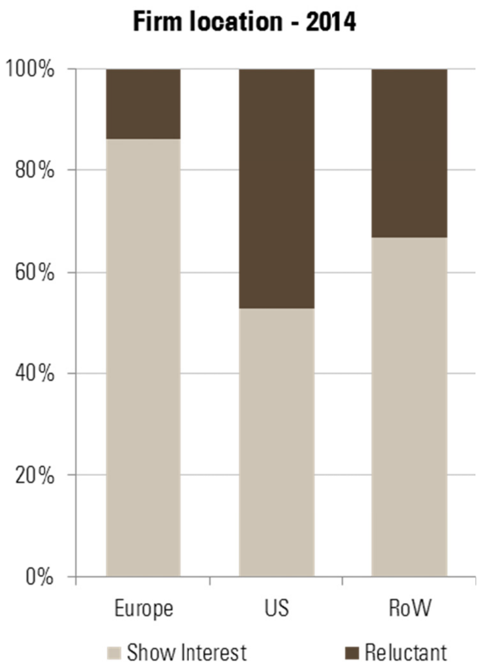
Special opportunities managers

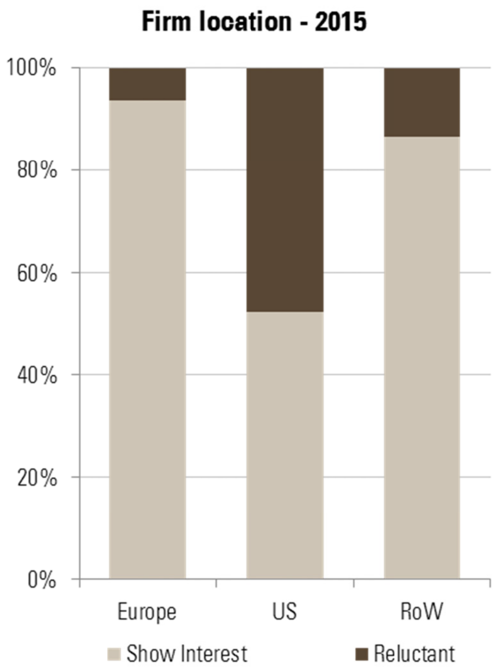




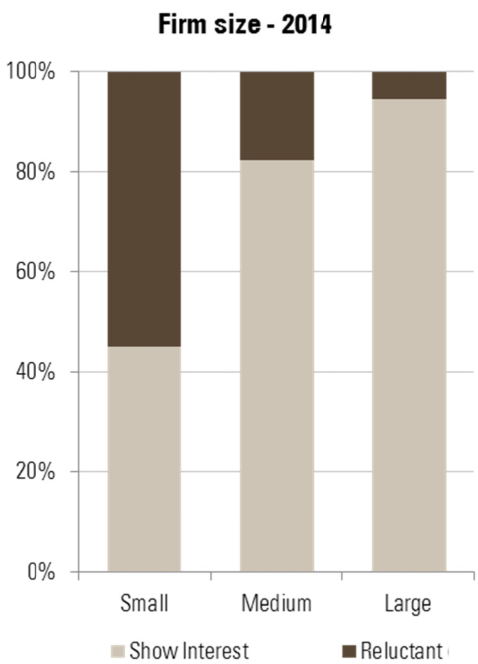
Firm location and size

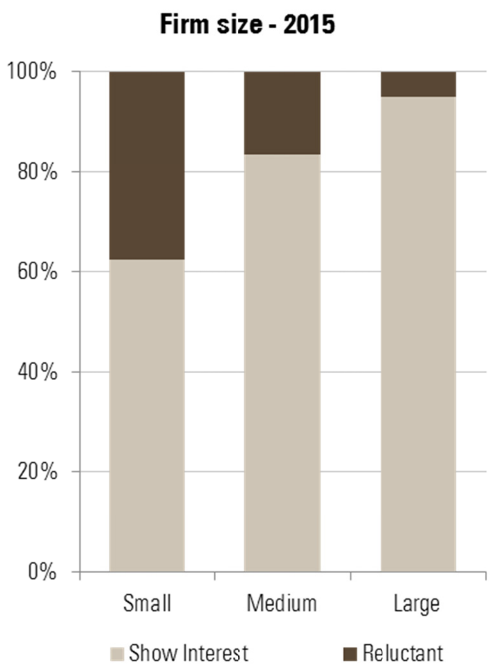
Our European managers remain significantly better positioned than those in the US and Asia. However, Asian managers started to catch up in 2015, with the proportion of Asian managers in the “reluctant” category falling from 33% in 2014 to 13% last year.





Meanwhile, larger firms continued to pay more attention to ESG issues than small- and medium-sized companies. Again, this is likely to be because they have more resources to devote to ESG programmes, and because they typically have bigger clients which themselves are more sensitive to ESG concerns.





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Conclusion

Our results suggest that 2015 was a year of steady but unspectacular progress in terms of how our hedge fund and private equity managers approach ESG – very much evolution rather than revolution. We expect further such progress over the coming years as awareness of the benefits of considering ESG becomes more widespread among the private equity and hedge fund communities, and also because of greater pressure from their investors.

Private equity managers remain more advanced than hedge fund managers in how they view ESG. While it is clearly difficult for some hedge fund managers to implement ESG in their investment processes, the anecdotal evidence provided by some firms shows how it is possible for any company to implement a wide range of responsible practices that cover their entire corporate activities, not just their investment processes.

For our part at Unigestion, we will continue to lead by example by implementing ESG criteria in our investment processes and adopting responsible behaviour in everything that we do. As well as integrating ESG scores in our private assets monitoring reports and hedge fund due diligence questionnaires, we will continue to help the managers we invest with develop their awareness of ESG matters, identifying areas for potential improvement and suggesting ways this could be achieved.

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Important Information