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Hedge Funds Push Deeper Into ESG as More Products Come Online

By Lydia Tomkiw   November 27, 2019

Hedge funds are pushing further into environmental, social, and governance (ESG) investing, adding policies and building tools. And more products and ESG-integration efforts are likely to come in the next year, experts say.

Firms are taking different paths into the ESG investment space. For Inherent Group, ESG investing has been core to the firm's mission since its start five years ago. Other firms, such as **Waratah Capital Advisors**, have built separate ESG strategies to gain a foothold in the space. But they are part of a growing movement.

"We definitely think there is a sharp uptick in the number of managers adopting ESG policies as well as products, and it's being driven by client demand," says Jamie Kramer, head of the alternatives solutions group at J.P. Morgan.

Of the approximately 100 hedge funds that J.P. Morgan works with, 50 have now adopted policies on ESG – a sharp jump from earlier this year, Kramer says.

J.P. Morgan is currently working on developing an offering for clients to access via a pooled vehicle, with five to 10 underlying hedge funds whose investments are targeting assets with an ESG lens, Kramer says. Hedge fund managers are going about ESG in "very different ways" and that means having to ask, "How are they measuring it how are they thinking about it?" she says.

An Inherent Part of Investing

For Tony Davis, the route to ESG investing came after a successful run as the co-founder of Anchorage Capital Group. Hailing from a family that instilled the values of service, Davis started New York-based Inherent Group with his own capital and began investing in 2014 and 2015 in companies with a traditional impact purpose, many of which were early stage growth firms.

Davis describes his firm as an opportunistic investor looking for mispricings with two guiding missions. One is “to show when you incorporate sustainability into your investment process in the right way, it leads to better investment outcomes,” he says. And the other is “to demonstrate to companies when they lead on sustainability, they can lower their costs of capital.”

The firm opened up to outside investors in 2018 and had over $551 million in assets under management as of Dec. 31, 2018, according to its Form ADV 2 filing in March with the Securities and Exchange Commission.

Inherent looks at its investable universe in two buckets. The first focuses on businesses that are aligned with the United Nations Sustainable Development Goals (SDGs) and that will benefit from multi-year trends in areas such as decarbonization, electrification, value-based reimbursements in health care, and smart cities. The firm will also short companies it feels are on the wrong side of these trends. The second bucket focuses on dislocations, investing in the equity or credit of a company that is undergoing a change and finding mispricings.

“How do we engage with companies that have legal license to operate to make them the best they can be in their space?” Davis says. “We call it really engaged ownership, not activism, but it’s working with these companies to help them lead on these issues. And by these issues, I mean what are the material sustainability factors in their space?”

Most of the firm’s engagements will take a couple of years to bear fruit, Davis adds.

“The biggest surprise maybe for me has been the willingness of management teams and companies to engage with us,” he says.

Some of the companies Inherent has invested in with don’t have ESG departments, but the C-suite leaders want to lead on sustainability issues, Davis says.

“It’s too early to say whether we’re going to see companies adopt all the things that we are suggesting. But the early indications are really positive that at least we are having constructive conversations and they want to improve,” he says.

Adding a New Product

One of the newest ESG products on the block comes from **Waratah Capital Advisors**, a Toronto-based asset manager that specializes in alternative strategies, with 1.5 billion Canadian dollars under management.

The firm was already investing in areas such as decarbonization, battery technologies, and electric vehicles that opened portfolio managers' eyes to secular themes that would fit broadly under ESG, which led them to begin thinking about a dedicated ESG product.

"We were increasingly developing the view that integrating ESG both into the investment process and the risk management process was a better way to do it. And you couldn't just do it by applying third party data to an existing portfolio," says **Blair Levinsky**, co-founder and portfolio manager at Waratah.

The firm spent two years developing a proprietary scoring methodology that was consistent with its approach, and launched the global long/short equity Waratah Alternative ESG fund a year ago, seeding it with internal capital and just opening it to outside investors last month, he says. The firm declined to comment on the fund's current size.

Waratah, which gets its name from an Australian flower that can grow in inhospitable environments, looks at all three categories of ESG when it engages with companies, using ESG factors to better manage risk.

"A good company – making it a little bit better is good thing to do," Levinsky says. "But taking a poorly scoring company and making it better can have a much better impact on society in general… The only way we thought you could do that is through a long/short approach."

While already looking at sectors they had been investing in, the firm has added new sectors, including water technology, real estate from an energy efficient lens, and surface remediation rehabilitation with mining.

"We are looking at ESG change, or ESG delta – how a company is changing over time so that changes our score," he says.

The Future of Hedge Funds and ESG

Over the course of 2019, a few more thematically oriented strategies that have a climate change or sustainability orientation have cropped up in the hedge fund space, says Max Messervy, a responsible investment consultant at Mercer. And some new funds and firms could come to market next year that are currently seeking seed funding.

But hedge funds still represent a small number of the strategies Mercer rates from an ESG perspective and very few are receiving top scores. "This absolutely could shift over time," Messervy says. “We expect there to be a greater engagement with ESG in the hedge fund space.”

Firms will need to proceed in a way that avoids charges of greenwashing, he adds. “[T]aking a thoughtful approach to integrating those factors into their strategies is a good way to find clients or come back to existing ones and share what you are doing. You might also find new clients through the approach,” he says.

An inflection is taking place where social and profit motives are no longer opposing but instead complementing each other, Levinsky says.

“There is a general shift in assets and we are seeing the next generation care more about the way they invest and also be more open minded about opportunities in these new sectors,” he says.

The current moment in time is also playing a role in the rise of ESG investment and the willingness of companies to engage, Davis says. “Is the world really changing and embracing this?... I think so.”

He predicts there will be more discussion around climate change and related pricing and the impact that will have on securities.

“I think you will see more and more firms, hedge funds, integrating ESG into their business. I think the allocators are driving it in most cases,” Davis says.