

‘Hedge fund managers are ensuring the companies in which they invest are safer, more environmentally friendly and better governed’

Responsible investment is no longer the sole purview of long-only investment management. An increasing number of hedge fund managers are formally integrating environmental, social and governance (ESG) concerns in their investment decisions. Given their flexibility and sophistication, hedge fund managers are well positioned to implement responsible investment; their ability to sell assets short and their experience in facilitating governance reforms in investee companies are of particular use.

Any discussion of responsible investment must first come to grips with the fact that responsible investment can mean different things to different people. Indeed, there seems to be little agreement on what to even call responsible investment. Alternative Investment Management Association (AIMA) North American members, for instance, tend to call it “ESG”, while our Continental European colleagues favour “sustainable finance”. Then, of course, there are the acronyms of which there are enough to make even a hardened government bureaucrat blush.

Luckily, the hedge fund industry is a practical place and we tend to see things through the prism of results. As such, when approaching responsible investment, we try to ignore the jargon and ask a simple question: what is the goal? In our experience, there are generally three answers: limiting unwanted risk, enhancing returns and creating a positive impact. Hedge funds, by their very nature, are well suited to accomplish each of those goals.

Let’s begin with the limiting of unwanted risks. One of the most important reasons to consider ESG factors when analysing an investment is that such factors can constitute risks.

A company with high carbon emissions, for instance, might be vulnerable to carbon taxes or an energy transition; a resource extraction company, meanwhile, may depend on the goodwill of the local community to carry out its business. These risks are every bit as real as those reported on a balance sheet and investors have every right to expect their investment managers to protect against them.

Hedge fund managers are uniquely well suited to do so. By using short selling, hedge fund managers can not only hedge against common market risks, but also against non-traditional ESG risks. Hedge fund managers can, for example, use short selling to hedge their exposure to carbon emissions and the attendant risks.

The flipside, of course, is such risks also present the opportunity to generate above-average returns, which is also something of a specialty for our industry. Hedge fund managers can use short selling to deliver returns to their investors by identifying issuers that perform poorly on ESG metrics or are unduly exposed to ESG risks.

For instance, a hedge fund manager might sell short the securities issued by a company with lax safety practices, on the assumption that the price of those securities will fall if the company is involved in an industrial accident.

Hedge fund managers can, however, go beyond simply dealing with ESG risks. They can also help mitigate them. The hedge fund industry has a proud track record of facilitating improvements in corporate governance and even in unmasking corporate malfeasance. The most recent example is the alleged fraud at Wirecard; were it not for the bravery and conviction of hedge fund managers taking action

against the company, the damage to investors would probably have been even more significant.

Managers of hedge funds are already leveraging this expertise to ensure the companies in which they invest are safer, more environmentally friendly and better governed. This is a win-win: society benefits and the companies become better investments.

Hedge fund managers, in summary, bring unique skills to the world of responsible investment. We at AIMA are supporting them, working with our members to create guidelines on responsible investment policies, corporate ESG considerations, and our upcoming paper on short selling and responsible investment, as well as several research pieces exploring the adoption of responsible investment in our industry. We will continue working to ensure the strengths hedge fund managers bring to responsible investment are not just recognised, but put to good use. ●



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