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STRENGTHENING ESG IN ALTERNATIVE INVESTMENTS

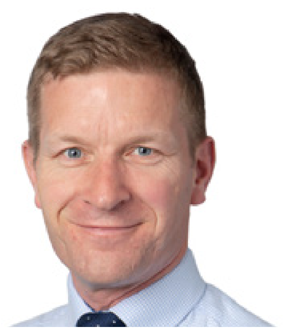
INDUSTRY INSIGHTS ON ALIGNING INTERESTS, REPORTING, AND BUILDING A TRUE ORGANIZATIONAL COMMITMENT TO ESG

IN PARTNERSHIP WITH

HEDGEWEEK

PARTICIPANTS

TOBY BELSOM, DIRECTOR, UN PRINCIPLES FOR RESPONSIBLE INVESTMENT (UNPRI)



Toby Belsom spent 17 years at two of the UK's leading investors – Aviva Investors and Henderson. He primarily worked as a UK equity manager – managing almost GBP£1 billion, specializing in small and mid-cap equities for retail and institutional clients. He started his city career as an analyst as part of the Aviva & NPI Socially Responsible Investment team in the '90s and early '00s. After leaving Aviva, he spent time at Edison Investment Research and Progressive Asset Management – founding a governance focused investment fund. He also spent two years managing the 12-strong climate and data/ranking team at ShareAction – a global capital markets advocacy group. He joined UNPRI in 2019 to manage the Investor Practices team. His team produces guides and tools for fixed income, listed equities, private markets and asset owners to help them integrate ESG issues into policies, processes and practices. Recent work has covered strategic asset allocation, EU Taxonomy, TCFD in PE and private markets, passive investment strategies, PRI reporting framework review, sovereign credit & selection, appointment and monitoring of asset managers. He is also currently a member of the CFA's ESG Working group and an Advisory Panel member to CEN Advisory.

STEFFEN DIETEL, PORTFOLIO MANAGER AT ALTANA WEALTH

Steffen Dietel is the Portfolio Manager for the Altana Distressed Opportunities Fund, which is currently pursuing unique opportunities in offshore Oil and Gas. He also has extensive experience in developing and financing renewable energy having served as sole MD for companies owning offshore wind farms Deutsche Bucht and Veja Mate in the German North Sea from 2012-15. Steffen has over 19 years experience in finance. Prior to Altana, Steffen was an Investment Director at Laidlaw Capital Management where he was responsible for a cross asset portfolio of around $1 billion. He was previously a Portfolio Manager at Schadeberg Family Office and Dresdner Bank AG. Steffen has been a CFA charter holder since 2003.

COLIN ETNIRE, HEAD OF ESG AT BC PARTNERS

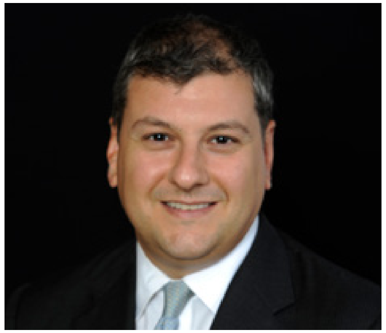
Colin Etnire joined BC Partners in New York in 2020. Previously, Colin spent 4 years at The Carlyle Group as an ESG analyst where he worked under the Chief Sustainability Officer to implement an ESG program across Carlyle's $221 billion AUM platform. Prior to this, Colin worked for the New Hampshire Democratic Party and interned at the White House. He holds a BA in Politics from Bates College.

MARIA LONG, RESEARCH AND CONTENT DIRECTOR, STANDARDS BOARD FOR ALTERNATIVE INVESTMENTS (SBAI)

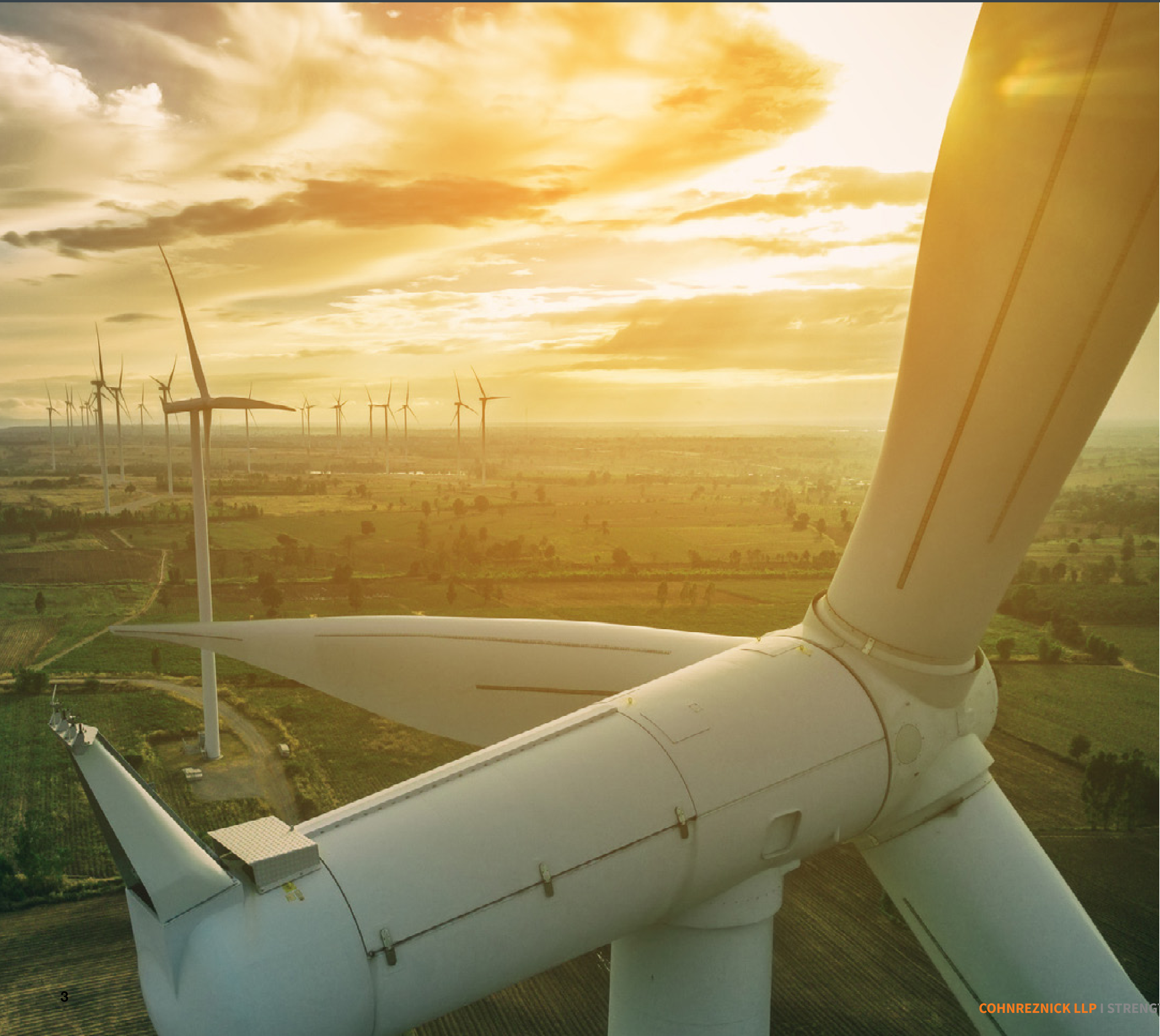
Maria Long joined the SBAI as Content and Research Director in August 2020 and is responsible for the SBAI's Working Groups and Toolbox publications. Prior to joining the SBAI, she was an Operational Due Diligence Analyst at Man FRM ('FRM') a Fund of Hedge Fund and Managed Account Provider based in London. Prior to joining the Operational Due Diligence Team in 2015, Maria was the Head of FRM Middle Office. Her responsibilities included oversight of valuation production, expense payments, FX hedging and reconciliations. Prior to joining FRM in 2008, Maria worked for Northern Trust Hedge Fund Services in Dublin running the Fund of Hedge Fund Accounting Team and also held operational roles at Unigestion SA and Thames River Capital (UK) Limited, both hedge fund managers based in London.

Maria received first class honours for a BSc in Physical Sciences from the Open University in June 2017.

JEREMY SWAN, MANAGING PRINCIPAL, COHNREZNICK



Jeremy Swan is the National Director of CohnReznick's Financial Sponsors & Financial Services Industry practice and also leads the efforts of the firm's M&A Consulting Services practice. Jeremy is responsible for management of CohnReznick's Financial Sponsors and Financial Services Industry practice, which includes all work conducted at the firm level, fund level, and across portfolio companies. Jeremy serves as the lead and/or relationship partner for many of CohnReznick's largest private equity firm and portfolio company engagements, managing teams across service lines and maintaining a single point of contact at the private equity firm level. With more than 20 years of experience advising financial sponsors and emerging private and large, multinational portfolio companies, Jeremy has extensive experience working with financial sponsors as both an investment banker and a consultant. He has expertise in mergers and acquisitions, IPO readiness, financing transactions, post-acquisition integration, and operational and financial due diligence.



As environmental, social, and governance (ESG) factors continue to grow in importance in hedge funds' and other asset managers' investment processes, a recent CohnReznick-hosted discussion explored ways the alternative investment industry is rising to meet the challenges of evolving investor demands and expanding regulatory scope in this space.

Participants considered how firms can successfully adapt to the rapidly changing standards and the ways in which operational processes are shifting. They also explored how best to align manager-investor interests, and tackle the ongoing headaches surrounding data.

ESG standards, expectations, and regulations are becoming much more stringent. How can you adequately prepare for initiatives like the Sustainable Finance Disclosure Regulation (SFDR)?

Understanding what the aims and intentions of regulations are – as opposed to what managers and investors are trying to achieve – remains key for industry participants, according to Maria Long, research and content director at SBAI.

"We talk about ESG as if it's one thing and it's really not – there are many different flavors to it," Long says.

Jeremy Swan, managing principal, CohnReznick, observes how there are increasingly competing standards in the US, adding that the US is slightly behind

Europe and certain other regions in terms of understanding what standards are relevant.

"We're advising our clients to really look at what's most meaningful to their business and what's most relevant to their investors," Swan says of this ongoing challenge.

SBAI, which is an active alliance of around 150 asset managers and 90 institutional investors, now has a large responsible investment working group, comprising some 160 industry professionals.

For Long, though the assortment of guidance and regulations each differ slightly, they all tend to center around investor protection, and "making sure that what you are selling is what you're actually selling to avoid greenwashing," she adds.

"If you can sit and work through what it is you're trying to achieve, and what you can do with the resources that you've got, and what you can actually evidence, then that's a good start in preparing for these regulations."

Steffen Dietel, portfolio manager at Altana Wealth, a $500 million London- and Monaco-based manager specializing in niche strategies and alpha-generating ideas, explains how his fund – the Altana Distressed Opportunities strategy – focuses on offshore oil and gas services, putting it in the "crosshairs" of the debate.

Part of its investment approach has been to explore areas - such as carbon markets - to determine whether it can use certain instruments to improve a company's carbon footprint. This, Dietel explains, has been driven less by regulatory pressure and more by investor demand and discussions over how best to approach the next 10-15 years, and the transition away from fossil fuels.

"We spend a lot of time, both with our companies but also on the fund level, trying to figure out if there is something we can do to help with the emissions picture," he explains. "This may be a very narrow part of the whole ESG debate, but it's one that's been very close to the fund I'm managing."

Dietel says: "Perhaps the privilege of being in a sector that is under a lot of scrutiny is that, for us, it's clearly not something we can delegate away to the operations team or the compliance team. This is at the heart of the portfolio management."

Building on this point, he continues: "These discussions have become a crucial part of the interaction with management teams – in our set-up, it's a genuine portfolio manager discussion and not something that is only a compliance function or something directed towards the regulator. It's become a real core part of the portfolio management exercise."

Toby Belsom, director, UN Principles for Responsible Investment (UNPRI), suggests that hedge funds as an asset class have often lagged behind private equity and infrastructure assets when it comes to thinking about ESG publicly.

The UNPRI, which was founded in 2006 initially with 26 signatories, has since grown to some 3500 signatory members, spanning asset owners, asset managers, and service providers across the globe.

Belsom – who leads the investor practice team which provides tools and guides to help signatories deliver on principles such as ESG integration, incorporation, and stewardship – notes there are various ways, in terms of long/short strategies, of thinking about the incorporation of ESG into investment practices. These include the asset selection process in the construction of a portfolio, how a strategy might use hedges as a tool to avoid climate-related risk, and the utilization of leverage.

"How do you combine long/short investing with an RI approach? How do you utilize some of the really advanced mechanisms about analyzing data, about utilizing different asset classes and financial instruments? If you have a short position, you're probably unable to engage with a management team. It does make it difficult to improve practice within that business."

However, he highlights how the hedge fund industry has also often been at the forefront of ESG in other ways, pointing to the impact of activist manager Engine No. 1 in 2020 in effecting board-level changes at ExxonMobil. "There are some really different and very active approaches that are being developed within the hedge fund industry."

Weighing up the competing ESG requirements across investor, regulatory, and investment management spheres, Colin Etnire, head of ESG at BC Partners, outlines that although voluntary and regulatory standards have evolved markedly over the past decade, they continue to be driven by the core principle of making sure firms deliver on what they are promising.

"In the US the regulatory regime is very explicitly just on that principle: the SEC will audit claims you make to investors – make sure you have backup for it," says Etnire.

"The UK and EU are heading in a little different direction, but similarly are more on the lines of having particular things that they want to have disclosed. The UK is very climate-focused, while the EU is more of, quite frankly, a tangled web of different indicators, taxonomies, and frameworks."

Moderating the discussion, Swan reflects on how hedge fund firms and other investment managers in the US are able to offer more bespoke reporting of ESG metrics, rather than following a cookie-cutter approach.

Long explains that SBAI opted not to produce ESG standards, noting there are already a raft of competing standards in this space which she says does not help the marketplace. It's also something that is quite difficult to do globally, she adds, with ESG remaining a large, sprawling topic with many areas of focus when it comes to reporting and discussion.

Europe is heavily focused on the SFDR requirements, she says, while Asia has certain climate regulations, but remains "a little further behind" Europe. The US continues to be "very LP-driven" in terms of asset manager reporting.

Etnire – whose firm is primarily buyout-focused, and also runs credit and real estate platforms, and has focused on ESG standards since signing the UNPRI in 2009 – cautions against allowing the "tail to wag the dog" in terms of reporting.

"If we try to design our process to accommodate each [LP], it would be completely unmanageable and it would get further away from the core goal, which is focusing on material issues," Etnire says.

Describing ESG as a "broad tent," he indicates that not all LPs have the same set of interests and explains how there are "trade-offs" between managers and investors.

"As long as you are transparent about the decisions that you're making, I think that it's generally defensible and something that people can get on board with."

How can you collaborate in the reporting process to align manager and investor interests on ESG, and what are the operational headaches?

Talk turns to ESG-related operational challenges, with the discussion hearing how, despite LPs and managers collaborating closely on criteria, there are often very different questions and concerns raised by, for instance, public pension funds compared to insurance companies, or endowments or family offices.

Reporting standards have improved "dramatically" in recent years, not only regarding major issues such as carbon disclosure, but also around reportable incidents of job safety, Dietel says.

Delving into the potential challenges and headaches, he maintains that one of the worst unintended consequences currently is troubled assets moving away from public players into the private sector.

"That's a real problem because it massively affects the reporting quality. Especially on the oil company side. You see a lot of divestment decisions that put very, very problematic assets into the hands of private players," Dietel adds. "That's a real negative, and something that has to be dealt with."

Long, meanwhile, points to the contrast between, on the one hand, a fund without ESG objectives that aims to integrate financially-material ESG risks, and on the other, a fund that has dedicated ESG objectives.

"Your reporting is really going to be based on the metrics the LPs want to capture. And a lot of LPs will have determined their own objectives that they may need data to feed into. It could be something as simple as trying to measure their carbon footprint.

"If you look at an actual fund with a dedicated ESG objective – an impact fund; something that's looking to make some sort of real-world change, or even just one that's excluding certain industries or including certain scores – the collaboration here should start way before the reporting side," Long says.

Expanding further, Long explains how reporting was among

the first things SBAI was asked to look at when it launched its Responsible Investment working group, before pushing it back and starting off instead with a policy and framework, then later moving on to different asset classes.

"Now we are starting to look at reporting, because for a dedicated ESG objective, you need to know what those objectives are, and whether the strategy and asset class aligns with them," she says. "But the actual collaboration between managers and investors has to start way before agreeing on what the report is going to look like."

Reflecting on the evolving reporting landscape, Belsom predicts an "increased responsibility on asset managers, whatever their investment strategy, to report coherently."

"How do you report truthfully and transparently in a timely manner to clients, stakeholders, public at large?

"How do you report the impact of a long/short strategy in terms of greenhouse gas emissions, its carbon footprint? How do you evidence that with a long/short portfolio? Do you take away the longs from the shorts? Do you just report the longs? Do you do something else? I don't know the answer to that, and neither does the industry, I think," Belsom adds.

Elsewhere, the evolving reporting landscape heralds greater scrutiny among regulators over the risks of greenwashing, with Belsom acknowledging that such critical voices "are to be expected as this industry grows and matures."

He observes how the EU has made considerable strides in this area, leading the way with initiatives such as SDFR and EU taxonomy, and points to developments such as the CFA Institute's Global ESG Disclosure Standards for Investment Products.

How do you set up your business to be ESG-focused? What changes do you need to make, and what should a head of ESG be responsible for?

The discussion zeroes in on how hedge funds, private equity, and private credit managers continue to face pressing issues relating to ESG, and how a firm's head of ESG can take the lead on such challenges – whether this is in daily operations, diligence processes, the relationships firms have with service providers, or the industries in which they invest.

What's really important is that everyone owns it collectively, rather than it being a siloed, specialist function within a firm, says Etnire. Underlining this point, he says the specialist ESG function helps establish good standards and oversee training throughout the organization.

"It is valuable to have someone whose entire life is focused on ESG within these organizations, but ESG doesn't substantively occur within an organization unless it's infused throughout; where investment teams are taking ownership of these issues in their diligence process, and when they're making a decision on information presented to an investment committee, managing it in their portfolio, reporting on it."

Long, meanwhile, reflects on the pitfalls of separating the investment team from the ESG function, and emphasizes the need to have a dedicated firm-wide ESG objective in place, starting with a policy, which she explains is much more than just a piece of paper.

"It's a thought process; it's a roadmap for what you want to do," she advises. "Even if you don't have a dedicated ESG objective, that policy could contain details about which ESG risks you consider to be financially material to your strategy, and how you're going to account for those, and what you're going to do as a firm. It will really help solidify your thought process."

Offering the portfolio manager's perspective, Dietel says this process cannot be simply outsourced to an ESG manager.

"It doesn't work like that," he says. "In theory, most of the concepts with ESG – the company that treats their employees properly, which has diversity in the workforce and leadership, and as a long-term business is good for the planet – will also be a good investment. There should not be this trade-off between ESG and returns.

"On the other hand, there's a limit to what the portfolio manager can do in the interaction. LPs have diverse agendas and are under significant pressure. I can have my portfolio manager commonsense approach to ESG, but if I don't have any investors because my LPs don't agree with my judgment then I don't have a business."

Dietel adds: "I would really emphasize that as a portfolio manager, these topics have to be part of the day-to-day operation, and only then can those standards be properly met and implemented."

Swan believes that for ESG to be successful, it has to become part of the culture of the manager.

Drawing a parallel with cybersecurity, he adds: "When you do

cybersecurity and treat it as a check-the-box process, you're not really protecting yourself. It has to become inherent in the culture of an organization to develop that protection.

"ESG is, in a lot of ways, the same thing – if it becomes prescriptive, and it's another check-the-box paper process, and you're doing it just because you have to do it, it's not going to be nearly as effective as when it's something the firm believes in. This is when it becomes part of the culture and is driven through the investment team, driven through the operations team. I think it needs to really permeate through the organization in order to truly be effective."

Making the case for the ESG specialty function, Etnire believes it is crucial to have a strategic hand guiding the process.

"If you don't have someone who understands ESG deeply helping you set that standard, you're going to be tracking the wrong things," he says. "You're not going to be able to adapt over time, which is a huge issue in a space that is moving as quickly as this one, and has such a diverse set of interests."

Dietel cautions that the outsourcing exercise is "a very dangerous one," pointing to the potential for greenwashing.

"Box-ticking doesn't do the job. You have to know where the problems really are; and they're sometimes in surprising places."

Turning to the adoption of net zero targets by asset owners in the aftermath of the COP26 climate summit, Belsom concedes that while certain benchmarks exist, putting these into practice is ultimately "a jump into the unknown" for many managers.

"That doesn't mean it's an impossible thing to do. It just means that asset managers need to be brave in their approaches. They need to be innovative and quick, because this is a challenge that is coming now," he adds.

"Asset managers able to be on the front-foot on that and meet those challenges will, I suspect, be the ones who grow and thrive in this new changing environment. That's just as true for alternative managers as it is for listed equity managers."

What data and analytics are required to drive value from ESG strategies? How do we track ESG metrics in earnest and achieve this?

As the discussion draws to a close, Dietel reflects on the "massive improvement" of the data quality, particularly in those sectors that have been under most pressure. He describes the strong data on carbon footprint as "a real success story" which has allowed for a "pretty substantive discussion" with companies compared to only two or three years ago.

For Etnire, data has become more of a project management challenge than one of having a highly technical solution.

"That being said, the drive towards greater importance on these pieces of data means more people are providing it, and more are giving us better data to work with. We're starting from a higher standard pretty much every year."

He adds there are certain ESG factors which are not suited to being "datafied," but for carbon footprint and ones that are very data-centric, the standard has markedly improved.

Long notes that while there is more data available in certain listed equities and developed markets and deal-based strategies, where there is more interaction and engagement, data is not necessarily improving in other asset classes such as emerging markets.

Underlining the challenge, she says: "Emerging markets tend to get penalized because there's less data available. Then you end up in a sort of vicious cycle where they get less funding because they're less well rated. Then they can't do anything about the issues which cause them to be less well rated.

"Even within listed companies, how do you split carbon footprint data between equity and debt and options and other derivatives on that between physical commodities and futures? There's a lot of data and data-related issues that are still really unsolved. Even with new regulation coming out now, it's not really clear how alternative asset managers are going to be able to account for this."

"There's a lot of vendor data out there for listed equities and increasingly for private markets. But there's a lot of proxy-based data, and their own estimates and not actual data they have sourced. Understanding the methodology of the data that vendors are using is absolutely key to this."

"I think we have to be careful to caveat the idea that data is getting better and better."

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