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The notion of responsible investing has been rapidly gaining currency among investors in recent years, and ESG is gradually becoming a potential differentiator for hedge funds.

For many in the industry, though, such non-financial data might be viewed as an extraneous field which they are unlikely to focus on.

And often when hedge funds do get involved in ESG, they do so with a myopic focus.

As the contributors in this report show, ESG investing requires commitment, and to cement such commitment, an understanding of the underlying assets is just one critical part of the process which still lacks a common reporting approach.

Furthermore, there are some misconceptions about ESG – its purpose, value, and overall aim.

Contributors to this report dispel some of the myths surrounding ESG, and outline how it should be viewed and managed.

Overall, this report is sure to give readers sitting on the fence about ESG a clear insight into whether responsible investing is something for them.

Ross Law
Report editor
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DOES ESG MAKE SENSE?
Ebel Kemeling of MJ Hudson Spring distinguishes the scenarios in which ESG makes good sense for hedge funds

Fund services

STANDARDISE TO SUSTAIN
Will Bryant of Albourne reflects on beneficial changes that would help evolve ESG and give greater value to the field

Investment services

GREENING THE HEDGE FUND INDUSTRY
Amara Goeree of Apex considers how hedge funds can best approach ESG investing

Fund services

THE GLOBAL STANDARD
Philippe Jordan of Capital Fund Management (CFM) dispels some of the common misconceptions around ESG and reflects on the steps the industry must take to improve the value of data over time
Do ESG strategies make sense for hedge funds?

Quite frankly if you think about ESG, hedge funds are not the first category you think about. The reason is that the strategies are very often very mixed and the speed of transactions is sometimes very high. Also, the level of control that hedge funds can exercise over the investments is not always obvious. And why should they be taking responsibility for a strategy if they are shorting the company?

Overall, the value of ESG investing for a hedge fund will really depend on what their relationship is to a given company. Obviously, hedge funds fall into a broad category so there are definitely strategies that make a lot of sense to have an ESG lens – those will generally be the strategies wherein the hedge fund is relatively close to the management of the company, or at least communicating with them and trying to influence and taking some type of position.
on their strategy in general. This also means the hedge fund will be interested in having a position of a certain substance; there is no specific rule in this regard, but at least the intention to communicate with management would be one criteria. Another factor for a hedge fund would be that the ESG lens can help the strategy or your view of the company – so there has to be some relevance to the valuation of the company of applying the ESG lens.

There is then the further question of whether it is a public or a private product. If it is a private product, a hedge fund will have to be more responsible because in this case they will be directly invested in the company. Just trading a public asset has no influence on the company. If I were buying a share from you in an arms trader, for example, my trade does not touch the company. But if I were the private equity majority owner of an arms dealer, then I would of course be responsible. It therefore really depends on the hedge fund’s overall strategy.

If you for instance have a lower-mid market long only more or less activist strategy, then ESG would make a lot of sense. We have many examples where applying the ESG lens does enrich the conversation with management on value creation, and obviously is also very much appreciated by many LPs.

**The value of ESG investing for a hedge fund will really depend on what their relationship is to a given company**

**Q** Why do people even get into these short situations? 
**A** It depends on the trading strategy, and there are many ways to make money. If I am a high frequency trader, there is no need to be deeply invested in a company or their strategy. I am just pricing out the inefficiencies in the market. ESG only becomes relevant if you have a certain relationship with the underlying asset.

**Q** What does a good ESG relationship look like? 
**A** First of all, it means that the long-term strategy of the company is, in some form or way, aligned with the public good. Whatever the company does today, if you look at it in 15 years’ time and it still exists, it must be ready for all of the conditions that are relevant in the market today. If you’re in the energy markets, for instance, you will have to align with the transitions that are being made at this very moment. If you are in utilities in England, then your carbon exposure by 2040 will need to be very low because that is the public strategy as published by the government and signed in the Paris climate accord. The firms within these systems will need to remain in alignment with such dictates and the current trends such as low emission housing initiatives.

The question a hedge fund manager should be asking themselves is ‘how is my investment intending to align itself with the current strategies and issues within this industry?’ Not just now but in the longer term. Thus, it’ll be the responsibility of the hedge fund manager to ascertain how the short-term valuation will match with one in the longer term. ESG is always about strategy and the valuation of the underlying asset. If it’s not part of that, then it isn’t part of the investment. And therefore not part of the job of the hedge fund manager.
Standardise to sustain

Will Bryant of Albourne reflects on beneficial changes that would help evolve ESG and give greater value to the field

Plenty has been written over the recent months and years regarding the increasing amounts of capital being allocated to Environmental, Social and Governance (ESG) investment strategies. This has come about on the back of increased investor focus due to several different drivers, including a shift of capital to younger generations and increased public and media pressure.

Alongside this there have been several articles on the different approaches to ESG investing. These range from simple screens and tilting strategies, whether exclusionary or positive targeted methods, to integrated approaches where ESG factors are embedded within the investment process, using active engagement as an added tool to further enhance positive change. Thematic and impact investing are included in this spectrum, where measurement of the environmental and social goals is a key output.

These different approaches to the inclusion of ESG or ‘non-financial’ data into the investment process will vary based on the characteristics of the investment strategy or the portfolio manager’s belief in the efficacy of ESG integration. Whatever the approach, one thing that has become increasingly clear in conversations with investors and managers, is that the integration of ESG data in the investment space is here to stay. Investors are increasingly demanding ESG inclusion, asset managers are developing ways to integrate ESG into their processes, and corporates are beginning to grasp the potential long-term security valuation benefits of embedding ESG into their business.

Despite the demand for ESG, one key area is holding back further integration. The lack of standardised non-financial data provided by corporates is the main hurdle for many fund managers to be able to easily integrate ESG into their investment strategies; the proliferation of questionnaires with different approaches is also a growing burden for corporates.

Albourne sits at the intersection of investors and alternative asset managers. From this position we have seen the development of the trends for ever increasing ESG integration and the issues that fund managers and investors face when focusing on ESG in their processes. Along with the rigorous investment, quantitative and operational due diligence Albourne currently completes on alternative funds, Albourne conducts a review of their ESG capabilities. Albourne has integrated ESG into its operational due diligence of fund managers to complement its existing ESG questionnaire, and subsequent report, through which Albourne has been gathering and conveying a manager’s approach to ESG integration for over eight years.

To further widen ESG integration, Albourne is looking to promote and support efforts to move towards a standardised approach to data production as part of Albourne Investor Manifesto II, launched in 2018.

Current situation with ESG data

One of the key issues around non-financial or ESG data is that it can be difficult to directly correlate this data to security valuation or performance. Much has been written about the impact of ESG data on financial performance. In the 2015 paper by Deutsche Asset Management and the University of Hamburg they reviewed over 2,000 empirical studies from the 1970s to present day, finding that ‘roughly 90% of studies found a nonnegative ESG-CFP (corporate financial performance) relation’, with the majority of studies finding a positive relation.

What remains unclear is how long it may take for this relationship to play out in the underlying securities price. For the hedge fund space, the timeframe for recognition of the ESG characteristics may not be compatible with their strategy or may get swamped by other characteristics for which the security is in the portfolio. This leads many investors to focus on the inclusion of ESG data from the perspective of risk mitigation.

At present the reporting by corporates of non-financial data is voluntary and non-standardised; this often sits within a separate Corporate Responsibility or Sustainability
report. The fact that the output is not standardised unlike the reporting of financial data, makes it hard for investors to be able to easily compare companies with reference to these data points.

The increased demand for the inclusion of ESG data within the investment process has led to an increase in third-party ESG data and ratings providers. Many investors, asset managers and other stakeholders are increasingly reliant on the reports and ratings of third-party ESG agencies to assess, compare and measure ESG performance of their investment universe. Given that the inclusion of ESG data into the investment process is in the nascent stages, there is ongoing development, evolution and even debate around methodology and principles for best practice among providers.

Each of the rating agencies have different methodologies in how they arrive at their scores. This has led to a dispersion of overall scores dependent on the provider, a general lack of clear understanding by many consumers of the differences and ultimately, in our view, a slightly confused landscape. It is estimated that the correlation between credit ratings issued by S&P and Moody’s stands at about 0.9, while the correlations between MSCI and Sustainalytics (two the most widely used ESG rating agencies) is roughly 0.3.

It is also worth noting that banks are advising corporates on how to improve their ESG ratings and benefit from positive screening in investor strategies.

Over recent years several initiatives have come about in order to create common reporting frameworks, such as the Global Reporting Initiative, the UN Global Compact and the Carbon Disclosure Project. These sorts of initiatives can lead to companies being more focused on how they perform relative to the criteria of the framework, rather than focusing on optimising their ESG impact within the framework of their business model.

What the future might look like

Currently, the biggest hurdle standing between the mass adoption of ESG, possibly after an (increasingly shrinking) investor belief that integration of ESG factors is not relevant, is the lack of consistent data.

What is required is a consistent global approach covering a range of different topics under the ESG umbrella, ideally with some level of third-party audit of this data. One standardised reporting protocol, with strict (and possibly regulated) definitions around the different metrics, would be simpler for corporates to produce rather than the plethora of existing reporting frameworks, which are currently the burden of corporate management.

The standardisation of the information would allow for simple collection, collation and comparison of relevant data points

Over recent years there have been isolated efforts to gain this standardised data in individual areas within ESG. Efforts include the Greenhouse Gas Protocol and the UK Gender Pay Gap reporting, both examples provide standardised, well-defined ways to explicitly show data in an objective, quantifiable manner.

There is still very much a place for corporates to provide their own corporate responsibility or sustainability report or integrate this information within their annual report. This demonstrates to their stakeholders how they view their activities from an ESG perspective and how it fits within their own specific business model. However, this should sit alongside a standardised display of objectively defined data.

The auditing of this data is also a key step in the confidence that investors can take when using the output. As with the provision of traditional financial data, non-financial data should be treated to the same level of oversight and verification.

Conclusion

The requirement for the reporting of non-financial data is increasing, and what is currently voluntary is going to become required by many stock exchanges and regulators. There needs to be a coordinated approach across national agencies to avoid a fragmented reporting landscape. Ideally the industry needs to avoid the adoption of more than one approach as is seen in accounting standards (whereby investors need to be proficient in both US GAAP and IFRS methodologies).

Within the EU there is a will to create regulation around the standardisation of reporting on ESG topics, whereas in the US the approach seems to be to let the market naturally encourage companies to make adequate disclosures. This is likely to lead to a wide variety in quantity and quality of data as corporates can report in different formats. Currently corporates in the US must disclose material items, however what is material is currently at the judgement of directors.

A standardised approach would maintain a place within the industry for the existing ratings providers who are taking that data and using their own proprietary methodologies to distil the data into an actionable approach.

From Albourne’s perspective, the above outline for the future of ESG data provision looks very similar to the creation of the Open Protocol. That is because the aim and need are very similar, both are looking to standardise the reporting of information. The standardisation of the information would allow for simple collection, collation and comparison of relevant data points.

The use of standardised comparable ESG data by investment managers would then be defined by their interpretation of materiality and applicability within their relevant strategy, with the aid of frameworks such as SASB. Allowing managers to continue to evolve their investment approaches and to be able to factor in all information that is relevant and material to an investment is the key to any investment strategy.

1 www.tandfonline.com/doi/pdf/10.1080/20430795.2015.1118917?needAccess=true
2 www.ft.com/content/a5e02050-8ac6-1e8b-bf9e-8771d5404543
3 ghpprotocol.org/
5 theopenprotocol.org/
6 www.sasb.org/standards-overview/materiality-map/
What role should hedge funds play in sustainable finance?

Over the past decade, asset managers have been focused on ‘long-term investing’, which is probably one of the reasons why a lot of shorter-term return-driven investors have stayed away from investing with environmental, social and governance (ESG) sustainability in mind. The legacy view has been that most investors don’t want to buy stock X and keep it for 10 years; they want something more liquid. Looking at the state of ESG in the industry today, I would say that hedge funds currently only play a minor role in ‘greening the financial industry’. A potential explanation for this could be that hedge fund players will often argue that they do not see a match between their management strategy and ESG, thinking that there might not be alpha in ESG strategies. On top of that, often not knowing where to start, i.e. where to find the opportunities, plays a role.

However, hedge funds can, and should, play an important role in helping address global goals and challenges such as those stipulated in the Paris Climate Agreement and the United Nations Sustainable Development Goals. There are estimates out there that look at needed investments of over $300bn for a 2°C global temperature increase and nearly $500bn to limit temperature rises to 1.5°C. That is to combat climate change alone; it doesn’t include the investment into sustainable development.

Hedge fund investors have long been experts in finding market inefficiencies, leading shareholder activism, and they also have the risk appetite to invest in the types of innovations that other investors might not be able to support. What we tend to forget is that that includes a lot of climate change mitigation and adaptation solutions, for example.

How should long/short ESG be approached?

For equity hedging an example of how to get started is to change the mindset around some of the most pressing issues. Again, taking climate change as the example ESG topic, you could go long on a company that shows clear signs of high quality corporate governance and the ability to innovate and adapt in order to negate climate change risks. And then go short on a company which may not have as...
sound corporate governance (for example a lack of board diversity may result in less ability to innovate). There are always going to be some participants in any industry who are lacking in strategic renewal in comparison to their peers. Sure, they may just be ‘late movers’, but particularly in terms of climate change risks, we have reached a state where there is no place for late movers in the market.

By the way, if I were to transfer this approach to a short only strategy, I would start by looking at those firms lacking in terms of general corporate sustainability strategies versus their industry peers.

Q How could a more event-driven strategy apply ESG?
A I think that what is most important here is to be mindful of the overall macro-economic impacts event-driven strategies may have. I am not saying this strategy cannot be ‘ESG-proofed’, but it will take some adjustments beyond the underlying investment instruments.

For example, activist-wise, it is in fact important that issues are brought to light so they can begin to be dealt with. However in the past the strategies have, in many cases, been at the cost of the company and its key stakeholders such as employees and communities in which the target(s) operate(s) – stories of which appear in the media and give an unbalanced and poor reputation towards investing of this kind. With some simple changes there can be more positive activism strategies. A plan for the employees and communities that will be affected by the activist strategy would be a starting point. How are they taken care of?

In addition, I could see an ESG-friendly merger arbitrage or distressed strategy apply ESG?

Q Why do some firms get ESG wrong and what other factors should they be considering?
A An example I often use is Tesla. The company was the first to scale electric vehicles, yet to the surprise of many kept failing to make it into sustainability benchmarks. Yes, they created a product that will significantly reduce the environmental impact of automobiles during use. But, what many raters noticed was that the company often lacked quality corporate governance – you hear stories about costly repairs work for specific parts along with some labour concerns, too. It’s not only about having a sustainable product; it’s also about how the organisation in general is managed. If a product or service has a positive impact or less negative impact on the environment and/or society, does it outweigh the impact of the organisation itself? At times there is a thin balance.

Finally, how about climate change-related/event-driven strategies as a new category? Shorting those instruments that are not ready for anything less than a two-degree scenario?

Hedge funds can, and should, play an important role in helping address global goals and challenges such as those stipulated in the Paris Climate Agreement and the United Nations Sustainable Development Goals

Q So are you saying that there are sustainable alternatives for every hedge fund strategy?
A I cannot be certain of this. There are plentiful possibilities, but there are definitely also some ‘don’ts’. One of the biggest in my opinion is betting on currencies and other assets that could lead to economic instability of a country, region or even the world. No one will benefit from this and it will most definitely not lead to global sustainable development.

Other don’ts are more related to the governance, strategy and management of the fund itself. Avoid having controversial investors and investment into highly controversial business practices such as weapons and child labour. Exercise sound risk management and responsible lending. Avoid speculation and too large positions that could have a significant market impact that would make the result unsustainable unless it clearly only pushes the sustainable solution without harming the laggard too much. And again, maybe a firm lags in its ESG profile, but it usually still employees many people and has many communities relying on it. If that falls apart because of a hedge strategy, this is extremely unsustainable.

Finally, don’t adopt ESG practices for a single ‘green’ product, implement minimum standards for all your funds.
What do you feel are some of the common misconceptions surrounding the way in which ESG is dealt with?

There’s this perception that ESG criteria can be implemented as they’re presented, which I feel is quite problematic for disciplined quantitative firms who look at the underlying data and structure.

One perception that you hear often is that ESG broadly provides alpha on a wholesale basis. We have not found such assertions to be true when you look at the underlying data. We’ve found that the Governance factor (G) can largely be explained by the Fama-French inspired quality factor that many quantitative firms have been employing for years as an alternative risk premia.

But when you go to Environmental (E) and Social (S), it will be a very hard stretch to affirm that statistically those factors provide alpha. Whether you should be seeking alpha or not when implementing an ESG strategy is a different conversation; the mere statement that these factors provide alpha statistically does not seem to bear out.

Is this a case of people not committing to ESG as fully and putting the quest for alpha as ESG’s sole purpose?

I think there’s many different voices in the field and those voices have typically emanated from NGOs, which have different objectives from systematic quantitative asset managers. They’re advocating for a particular issue and have a particular agenda which is not always aligned or easily attainable with certain types of strategies.

I think it has produced an awful lot of noise that quant firms have had to sift through over the past 3-5 years in order to determine what is statistically robust, and what is plainly noise.

This, however, is not to say that research into ESG does not hold promise, and that quant firms are not interested in or committed to ESG. Far from it. But they are ultimately going to commit to ESG from a quantitative perspective which relies primarily on finding statistically significant results – not based upon a belief system which is, generally, not subject to any statistical hurdles.

As stated, there’s a lot of promise in Governance which can largely be explained by alignment with the quality factor: using available data you really can show statistical significance for that particular factor. With the other two, E & S, we believe there are some real issues with the underlying data and the manner in which it’s being computed.
Q What can be done to remediate issues surrounding data quality? How can certain metrics be quantified in any meaningful way?

A You need to come up with standards in the same manner that we have standards in accounting, whether it be in Europe, the United States, Japan, or elsewhere. We need to develop standards for the likes of ‘E’ in particular.

Today, there are a multitude of data providers, many of whom use different data standards, and even inject heavy discretionary biases meaning that the goalposts can shift over time: they can view data through a particular lens for 4-5 years, and then decide to view the same data through another lens for the ensuing 4-5 years depending on the changing understanding and importance of the various issues. We need to develop standards that, over time, are not a moving target themselves, so that eventually the data will be more consistent and thus quantifiable. It may even be that we need a better fundamental understanding of the E and S issues to do such analysis.

Q Does sticking with the same data provider help in this regard?

A We can have different providers, but simply need the same shared standards. A broad ecosystem of providers is a good thing, but the same standards need to be applied. If a particular firm decides to view a firm through a ‘materiality mask’, and decides that a particular piece of data is important whereas the rest is not, but change their minds 3-5 years later, there ends up being no consistency in such data over a longer span of time, and the data is therefore not consistently valuable as it has morphed too many times over the years. This makes it very difficult to work with and is why we as an industry must derive a common understanding, and a common standard on emissions disclosures, for instance.

Q How may ESG become more integrated with HF strategies in the future?

A ESG initially gained traction with investors in the long-only space who were seeking certain exclusions. Not only did they allocate to long-only, but they did so with very long liabilities, meaning they were almost structural long-only holders. It’s one thing to take a view on ESG factors with a portfolio that has very little internal improvement, and it’s a radically different thing to implement any of the ‘E’, ‘S’ or ‘G’ factors to a portfolio that has higher turnover, under, say, three months, or even under a month. It’s a different thing to vote proxies on stocks if you’re going to have turnover every 30 days in your stock portfolio.

We’re advocating for better disclosure, more standardisation and less greenwashing. Arguably it means something different if you were going to hold that stock for the next 30 years.

Currently we need to figure out, within the hedge fund landscape, what makes sense in terms of implementation in view of the turnover of the strategies; what makes sense for a 30-year portfolio won’t always make sense for a 30-day portfolio.

Some pieces may make sense but others won’t; you need to pragmatically look at what something means in the perspective of what turnover is, and then you have to incorporate the cost of it if you do a have a high turnover portfolio – which is very different than if you have a low turnover portfolio. That’s not to say that nothing can be done, though; they just cannot be done in the same context as slow-moving, long-only portfolios.

Q What is CFM’s overarching narrative now and moving forward?

A We’re interested in finding the best way to implement ESG into the quant industry but we come at it from a disciplined quantitative perspective, which means we’re looking at the empirical evidence for what it is at this stage in time and we found that governance is indeed statistically robust and can be explained by the quality factor. ‘E’ is problematic at this time in terms of data, but we’re advocating for better disclosure, more standardisation and less greenwashing, and ultimately trying to find a path towards which we can ultimately lay our hands on standards that will enable us to look at homogenous data in a non-passionate way and be able to derive statistical meaningfulness from it and trying to evaluate the factors.

As an industry and as a firm, I think we have things to bring but our methodologies are slow because we’re based on data and stats and there’s a dearth of ESG data today.

Our overarching narrative is that this is a work in progress. We think the data will get better. As this happens and we advocate that it does, we will likely start extracting some information that is hopefully as statistically valid in ‘E’ as it has been in ‘G’ and we look forward to working on it further.

In terms of ‘S’, there are significant data issues and real heterogeneous differences between geographies – what is socially acceptable in one place may not be in another. The divergences here are very large so at this time we’re quite far away from reaching a standard of any sort. However, the good news is there is a global compact to a certain extent that has been at work in trying to derive global or at least regional standards, by which things can be benchmarked.

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