



Sustainable investing:

fast-forwarding its evolution



February 2020

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Acknowledgments

This report is a joint effort, involving KPMG International, CREATE-Research, AIMA and CAIA.

It examines in detail sustainable investing and its impact on the alternative investment industry. Focusing on hedge funds and institutional investors, together with best practice from the asset management sector, the report investigates how sustainable investing is gathering momentum across the investment universe.

Our foremost thanks go to some 135 institutional investors, hedge fund managers, long only managers and pension consultants in 13 countries in all the key regions, who participated in the research on which this report is based.

We would also like to offer our special thanks to those CEOs, CIOs and board directors who participated in our face-to-face structured interviews. Their insights and foresights helped to produce a clear vision of the future of their industry.

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Anthony Cowell

Partner
Head of Asset Management
KPMG in the Cayman Islands

Amin Rajan

CEO
CREATE-Research

“

In the middle
of difficulty lies
opportunity.”

Albert Einstein



1

Executive
summary



2

The rise of ESG
in the hedge
fund industry



3

The rise of
sustainable
investing



Editorial board

Darina Barrett (KPMG in Ireland)

Ravi Beegun (KPMG in Luxembourg)

Ben Blair (KPMG in the Cayman Islands)

Tom Brown (KPMG in the UK)

Jack Inglis (AIMA)

Dmitriy Loselevich (17 Communications)

Tom Kehoe (AIMA)

William J. Kelly (CAIA Association)

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1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



Geographical coverage of research participants

- | | |
|------------------------|-------------|
| Australia | Luxembourg |
| Belgium | Netherlands |
| Canada | Sweden |
| Denmark | Switzerland |
| France | UK |
| Germany | US |
| Hong Kong (SAR), China | |



Executive summary	1
Introduction and aims	
Report highlights	3
Headline findings	4
Part I. Hedge funds: a progress report	
1. Institutional investors are driving the ESG agenda	4
2. ESG investing faces various obstacles	6
3. Perfection cannot be the enemy of progress	8
4. Best practice can shift the needle	10
Part II. Early adopters: their story	
1. Sustainable investing is about creating businesses of enduring value	13
2. Capital markets are slow to price in sustainability risks	15
3. Best practice is emerging	16



The rise of ESG in the hedge fund industry	19
How are managers advancing?	
1. Key drivers	21
2. Key constraints	27
3. Emerging best practice	30



The rise of sustainable investing	36
What lessons can be learned from early adopters?	
1. Progress along the Spectrum of Capital	38
2. Factors slowing progress	43
3. Developing best practice	48



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



1

Executive summary

Introduction and aims



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



The EU set out its landmark legislative plans to deliver carbon neutrality by 2050: yet another defining moment when one of the three key global regions became the first to make such a bold legal commitment.

Before then, in the last decade, various governments worldwide had enacted over 500 new measures to promote environmental, social and governance issues (ESG).

Given the magnitude of the task, various players are involved: governments, regulators, capital markets, businesses and consumers; and they are aided and abetted by green technologies and business model innovations.

This survey report focuses on capital markets in general and sustainable investing in particular.

The latter can best be described as an evolutionary investment journey ABC: (A) avoid harm and mitigate ESG risks; (B) benefit all stakeholders; and (C) contribute solutions to societal problems. This definition embraces approaches that variously come under the generic headings of ESG, responsible investing and impact investing. Throughout this report, sustainable investing is based on this definition, except where ESG has been more prevalent. Both are now widely viewed as smarter ways of investing.

Institutional investors were the original early advocates of sustainable investing, working initially with specialist asset managers. While some hedge funds were early adopters, the overall hedge fund industry's advance has been incremental thus far. This is now changing as: their investors demand the adoption of ESG into the investment process; the industry recognizes the potential for alpha generation through ESG factors; and regulators force hands through new rules.

This research report highlights the lessons learned so that others can benefit from them. In the process, it explores three issues.

- What is the current state of progress in implementing sustainable investing?
- Why is the pace of progress being held back by various barriers?
- How are these barriers being tackled on the ground by evolving best practice?

Focusing on North America, Europe and, to a lesser extent, Asia Pacific, our research method has targeted two separate constituencies.

- **Hedge fund managers and their institutional clients:** via two separate electronic surveys, bolstered by structured interviews. This group accounted for US\$1.65 trillion of assets.
- **Early adopters:** via a structured interview survey to hear the story from C-suite executives from a sample of large institutional investors, and global hedge fund and long only asset managers, with US\$4.6 trillion of assets.

The geographical coverage of respondents in the two constituencies is given in the table on page ii.

Detailed results are given in Sections 2 and 3, respectively.

In the rest of this section, our headline findings are organized under two distinct parts, covering two distinct questions.

- How far have hedge fund managers progressed along the ESG journey?
- What are the key lessons they and others can learn from the early adopters?

“

Globalization has been the engine of global growth. But it has, as a side effect, inflicted much damage on certain communities and their environment.”

A US pension plan



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



Report highlights



Hedge fund managers' survey — Key data points



85%

Institutional investors are the biggest drivers of demand for ESG-oriented hedge funds

55%

ESG-oriented hedge funds continue to target alpha returns, while managing fat-tailed far-off risks

15%

Hedge fund managers have embedded ESG factors across their strategies

63%

Progress hampered by lack of robust templates, consistent definitions and reliable data

Institutional investors' survey — Key data points



44%

ESG-oriented hedge funds can deliver alpha and also manage fat-tailed far-off risks

34%

ESG is material to the financial performance of investee companies

75%

Too early to decide whether sustainable investing delivers double bottom-line outcomes

49%

Lack of consistent quality data is a challenge in the adoption process

Early adopters' narrative — Key messages



Markets are slow to price in sustainability risks due to their excessive focus on short-termism

A new infrastructure of skills, data and technology is creating tailwinds for sustainable investing

Active Ownership 2.0 is emerging as the best practice model for effective engagement

Savvy implementation of sustainability factors is vital for achieving the expected outcomes

1
Executive summary



2
The rise of ESG in the hedge fund industry



3
The rise of sustainable investing



Headline findings

Part I. Hedge funds: a progress report

1 Institutional investors are driving the ESG agenda

Having established a good track record in promoting good governance among their investee companies, hedge fund managers are advancing in other areas of ESG. Some are leading, others are catching up. The advance is principally driven by institutional investors and their consultants (Figure 1.1).

Until fairly recently, these investors have been mostly focused on uncorrelated absolute returns. They now want their investments to target double bottom-line benefits: do well financially by doing good socially and environmentally, while promoting high standards of governance and avoiding reputational risk.

Specifically, they want their hedge fund managers to not only screen out activities such as tobacco, defence weapons, poor labor practices, and environmental pollution but they also want them to target positive environmental, social and governance outcomes, on top of the financial ones.

Thus, the traditional risk–return equation is being rewritten to include ESG factors. This, in the belief that it is now becoming material to investment returns, as our societies tackle environmental and social challenges such as climate change, water scarcity and loss of biodiversity.

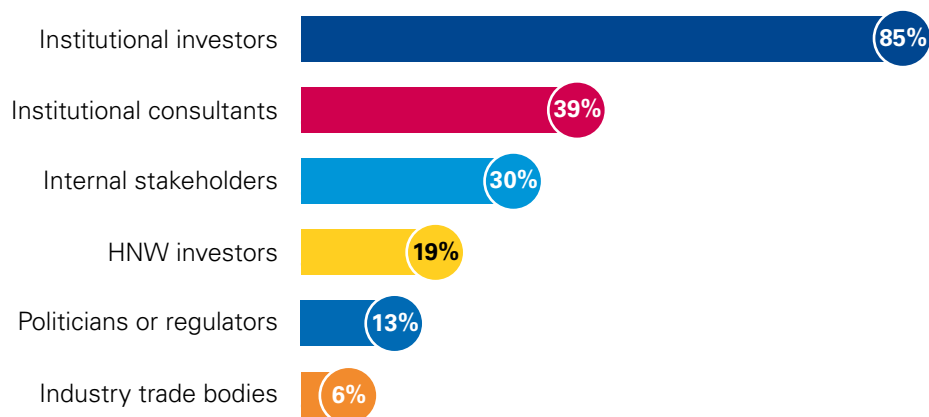
For their part, hedge fund managers are well placed to respond on account of their deep talent pool, technological capabilities, nimble investment strategies and activism track record. Their short-selling expertise has always been valued in encouraging their investee companies to up their ESG game.

The transition is a double-edged sword, however. It offers opportunities by promoting new ‘green’ industries, but it is also fraught with fat-tailed far-off risks that are hard to model statistically, for lack of historical precedence.

“
ESG is no longer a nice-to-have; it’s a must-have.”

A global alternative investment firm

Figure 1.1 Who is driving interest in ESG investing?



Source: KPMG–CAIA–AIMA–CREATE Survey 2020

4 Sustainable investing: fast-forwarding its evolution



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



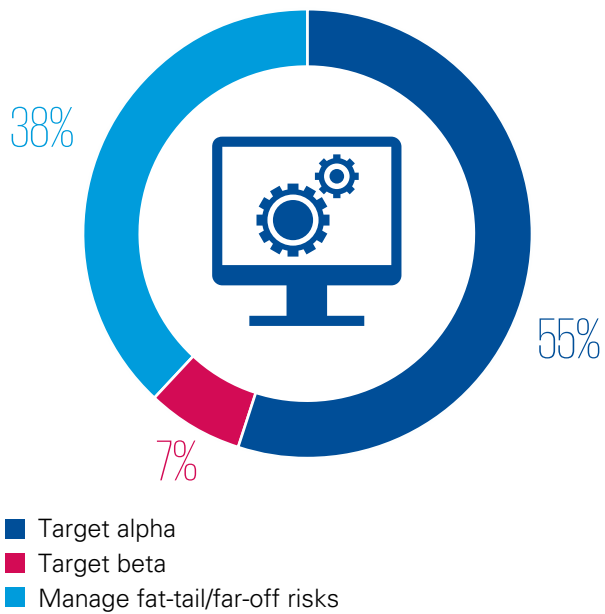
In our surveys, 35 percent of hedge fund managers and 34 percent of their institutional clients support the materiality argument — as shown in Section 2.

Indeed, 44 percent of institutional investors go a step further and base their investments in ESG hedge funds with the view that they offer

opportunities to generate alpha, while offering a more defensive portfolio by looking beyond the blind spots as markets are slow to price in ESG risks.

In response, hedge fund managers are deploying ESG factors to target three goals: alpha returns, beta returns and risk management (Figure 1.2).

Figure 1.2 How are ESG factors being used?



Source: KPMG–CAIA–AIMA–CREATE Survey 2020



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



2 ESG investing faces various obstacles

a. Data problems

In terms of the familiar life cycle, hedge fund managers' advance into ESG is happening incrementally (Figure 1.3).

Currently, 15 percent of our surveyed managers define themselves as at the 'mature' stage, where ESG is implemented across the firm via appropriate policies, committees, research and data.

A further 44 percent are at the 'in progress' stage, where implementation is piecemeal across the business, while a significant 31 percent are still at the 'awareness-raising' stage, leaving the remaining 10 percent at the 'no implementation to date' stage.

A number of factors have conspired against progress thus far.

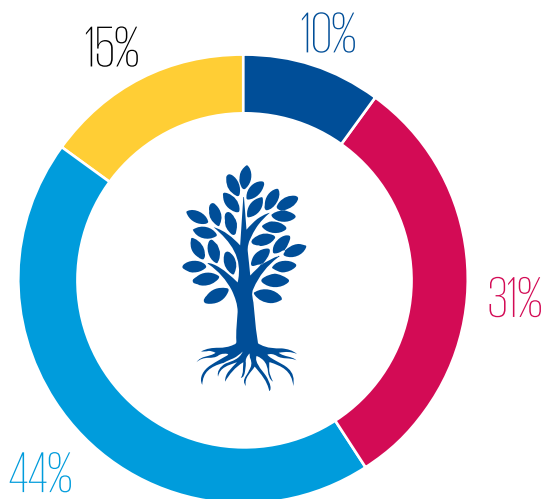
Far and away, the most important one is the lack of quality and consistent data on ESG factors, as cited by 63 percent of our hedge fund respondents in Section 2. Another notable one has been confusion over industry terminology (36 percent).

While there is widespread acceptance that the currently available data suffer from many shortcomings — such as inconsistent company disclosures, voluntary reporting, opaque research methodologies and unreliable ratings — there is also recognition that the quality of the available data is improving constantly.

“ ESG should come with a story. It can't just be about financial performance. ”

A US alternative investment firm

Figure 1.3 Where is your organization currently in the ESG-implementation life-cycle?



- No implementation to date
- Awareness-raising
- In progress
- Mature already

Source: KPMG-CAIA-AIMA-CREATE Survey 2020



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



b. Divided views

When it comes to the quality of ESG data, hedge fund managers' views differ (Figure 1.4).

On the plus side are managers who take an opportunistic or inquisitive stance in the belief that the data problems are nothing more than disguised opportunities to deliver alpha by exploiting the resulting market inefficiencies. Unstructured data sets provide an opening to employ machine learning and other quantitative solutions to better understand the market.

Indeed, many of their institutional clients believe that such inefficiencies will be a key source of alpha, which hedge fund managers are well placed to harvest on account of three inherent advantages: their deep talent pool; their widely acclaimed expertise in shareholder activism; and their sophisticated trading and machine learning algorithms, which are geared towards real-time investing.

On the opposite side are managers who are either skeptical about the

available data or overwhelmed by the challenge of filtering out the noise. Inconsistencies in data and company disclosures make it difficult to incorporate them into research and investment processes. Extracting meaningful alpha signals from them remains a herculean task for some managers.

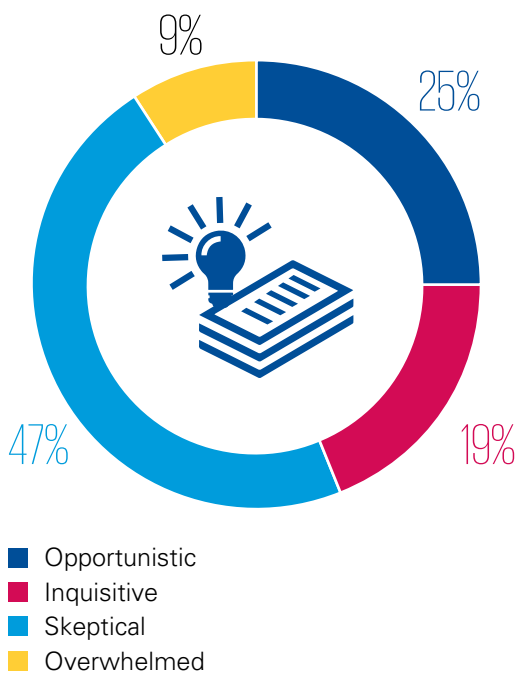
Hence, they are cautious about making bets on strategies not tested by time or events over extended periods.

Finally, apart from the data issues, two other factors were also identified by a minority of surveyed hedge fund managers as slowing progress.

Shown in Section 2, the factors are: ESG is not relevant to the investment strategies being pursued (25 percent) and lack of quality investment opportunities (21 percent).

The implications are clear: not all hedge fund strategies are created equal from an ESG perspective because not all managers see ESG in the same light.

Figure 1.4 Which of the following best describes your organization's attitude towards ESG data?



Source: KPMG-CAIA-AIMA-CREATE Survey 2020



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



3 Perfection cannot be the enemy of progress

a. ESG approaches

That ESG is coming into the hedge fund space is not in doubt; nor that it is coming on the back of a variety of approaches, reflecting the heterogeneity of hedge fund strategies (Figure 1.5).

Three approaches have been used by at least three in every 10 surveyed hedge fund managers with many of them adopting more than one approach.

The first one is ESG integration (52 percent). This has involved identifying material factors and incorporating them into traditional investment processes. In most cases, such factors are treated on a par with financial factors.

The second approach is negative screening (50 percent). This involves excluding stocks that sit uncomfortably with the value system of investors as mentioned earlier. Given the clarity of exclusion criteria, this approach has been the easiest one to implement.

The third one is shareholder engagement (31 percent), which has been gaining

traction lately as management teams have been slow to react to both ESG challenges and opportunities.

While implementing ESG factors into the investment process, portfolio managers make various assumptions about their relevance, weight and intercorrelation. These may or may not be correct. The underlying relationships they seek to establish may or may not remain stable. The forecasts they seek to build on may or may not be viable.

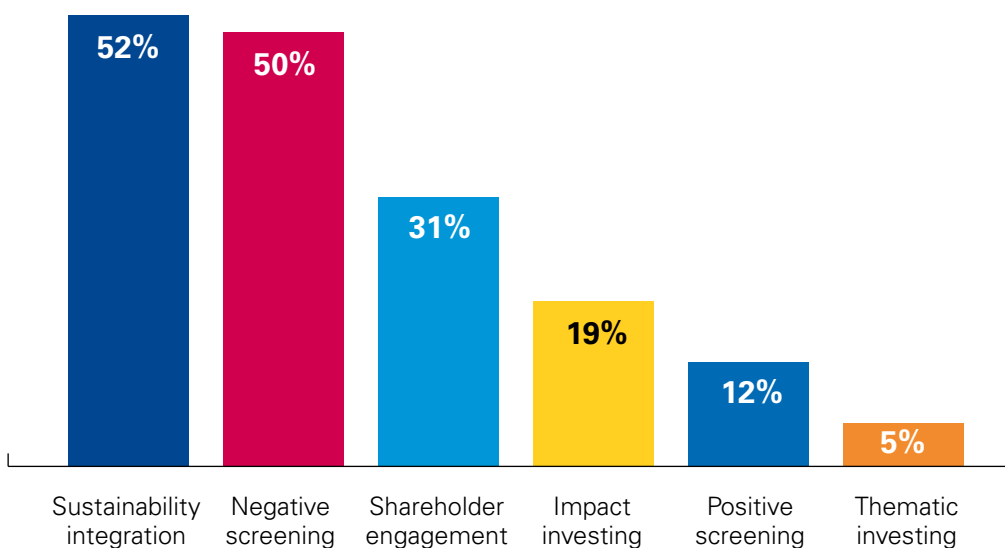
To complement the exercise, therefore, shareholder engagement is seen as a vital tool that serves two purposes: to enrich the investment process with firsthand knowledge about the investee company; and to steer the investee company into the ESG space via discussion, dialogue and proxy voting.

For their part, investee companies need to have a clear ESG policy as well as mechanisms for monitoring outcomes.

“
ESG takes time,
patience and skill.”

A global alternative
investment firm

Figure 1.5 Which of the following best describes your organization’s strategy when it comes to ESG?



Source: KPMG–CAIA–AIMA–CREATE Survey 2020



1

Executive
summary



2

The rise of ESG
in the hedge
fund industry



3

The rise of
sustainable
investing



b. ESG outcomes

Against this background, when asked to describe the performance outcomes of their organization's ESG-oriented investments so far, the verdict from both our surveys is broadly similar (Figure 1.6).

Taking them in turn, 29 percent of hedge fund managers in our survey report 'positive' outcomes and none report 'negative' outcomes; leaving the remaining 71 percent saying it is neither positive nor negative.

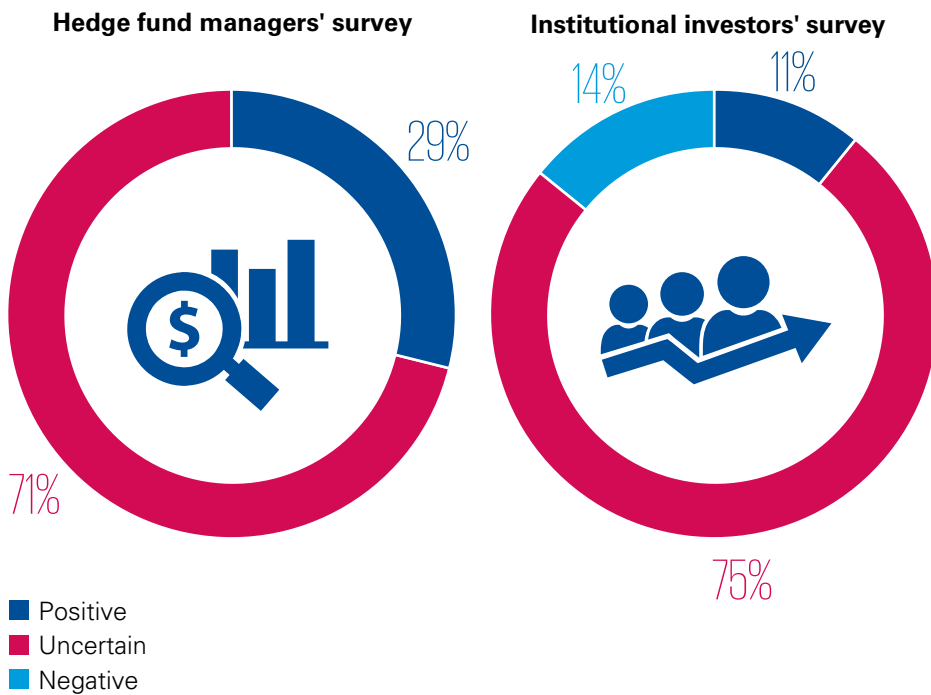
As for their institutional clients, they appear less sanguine so far: 11 percent

report 'positive' outcomes; 14 percent report 'negative' outcomes; and the remaining 75 percent saying neither.

In both cases, the implied message is simple: it's too soon to tell, given the rather short track record of these investments.

However, our post-survey interviews also indicate that the managers who took an early lead are not only meeting performance expectations via prime mover advantage, they are also emerging as the 'best in class' across the entire investment spectrum.

Figure 1.6 Which of the following best describes the outcome of your organization's ESG-oriented investments so far?



Source: KPMG-CAIA-AIMA-CREATE Survey 2020



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



4 Best practice can shift the needle

Best practice in the ESG space is a moving target. It's no longer enough for a hedge fund manager to rely on exclusion screens. Increasingly, there is an expectation that investments should generate a positive (and measurable) ESG impact, while managing the inherent risks.

Additionally, as the hedge fund industry becomes ever more institutionalized, its ESG practices are likely to attract much greater scrutiny.

The business model of hedge funds will likely be dependent on delivering decent financial returns (and thus generating performance fees). But it may be expected to deliver nonfinancial outcomes too, over time.

To fast-forward the ESG implementation cycle, our survey identified four key enablers.

a. Guard against greenwashing

The template of taxonomy and data that sit at the heart of sustainable investing is evolving, while institutional investors' interest in green issues has skyrocketed. Hopes have run ahead of expectations.

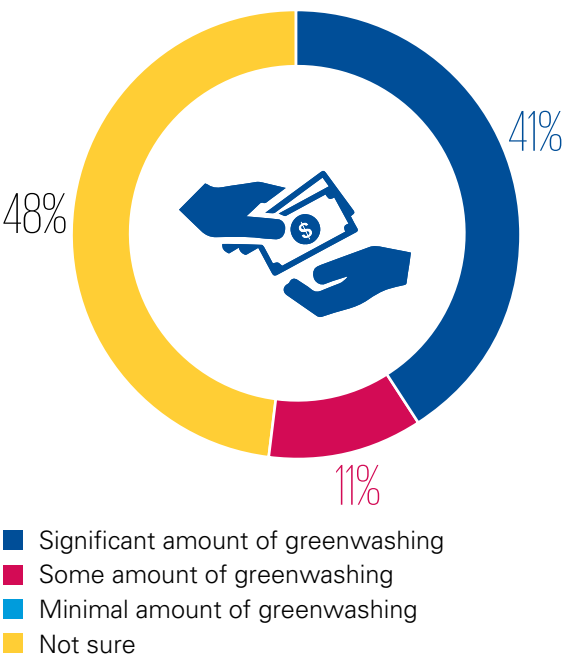
The result has been greenwashing: shortcuts taken by some managers to repurpose their old funds with an ESG label without rejigging the underlying investment process. The problem is widespread right across the entire investment industry. It is largely attributed to the data problems mentioned earlier.

As for hedge funds, 41 percent of respondents in our institutional investor survey report a 'significant amount of greenwashing'; 11 percent report 'some greenwashing'; and 48 percent are 'not sure'. Those reporting a 'minimal amount' is zero (Figure 1.7).

“As a firm, we have a strong view that ESG integration is at the core of sound risk management.”

A global alternative investment firm

Figure 1.7 From the investor perspective, which of the following best describes your views about the extent of 'greenwashing' in the hedge fund industry at this early stage as it embraces ESG investing?



Source: KPMG-CAIA-AIMA-CREATE Survey 2020

Home icon

Navigation arrows

1 Executive summary

2 The rise of ESG in the hedge fund industry

3 The rise of sustainable investing

The concerted action now in progress by data vendors, index providers, asset managers and listed companies to improve data quality and their definitional consistency is expected to ease the problem over time. The tighter regulatory oversight on greenwashing is hastening the process, especially in Europe.

For their part, some institutional investors also take a pragmatic view. As an investment elixir, ESG's advance requires them to accept that at least a part of today's greenwashing reflects the teething problems of a better form of investing. Progress may come at a price. In the meantime, they are getting better at separating winners from spinners.

b. Comply with industry codes and principles

The UN-sponsored Principles for Responsible Investment (PRI) are now widely adopted as an industry wide standard — by asset managers and their institutional clients alike.

Thirty-five percent of hedge fund managers in our survey are a PRI

signatory, 17 percent are in the process of becoming one and the remaining 48 percent are not planning to do so in the near future — as shown in Section 2.

Currently, 56 percent of managers have a policy of embedding PRI into the cultural fabric of the business. This is essential if managers are to enhance credibility, authenticity and transparency.

The numbers in both cases leave significant scope for increase in the next few years for strategies that are amenable to ESG investing.

c. Improve ESG reporting

Measurement and reporting on the nonfinancial impact of investments represent the next frontier for sustainable investing, as investors and regulators are stepping up demand for timely and fuller disclosures. Hedge fund managers need to stay ahead of the curve to remain relevant in a world where best practice is a moving target.

Currently, more than half (57 percent) of the surveyed hedge fund managers do not report on ESG performance at

all. Of those who do, 23 percent use the PRI framework and 11 percent use customized metrics — as shown in Section 2.

Yet, from the perspective of institutional investors, the problem seems far more widespread: 85 percent of them state that their hedge fund managers do not report on nonfinancial impacts.

Once again, the numbers indicate huge scope for improvement if hedge fund managers are to attract the rising tide of institutional money.

“ Integrity is critical. If you're going to call yourself an ESG investor, it's vital to have the right processes in place. ”

An impact investing consultant



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



d. Adopt Active Ownership 2.0

Hedge funds are ideally suited for shareholder activism that targets companies underperforming on sustainability issues. Our interviews show that there is a return premium in helping an ESG laggard among investee companies to become a leader.

The emerging model shows that responsible ownership is an important part of the ESG toolkit that must be taken seriously. Indeed, 74 percent of

the surveyed hedge fund managers are already relying on shareholder engagement to advance their ESG agenda — as shown in Section 2.

However, except for high-profile proxy cases, end-investors do not as yet have a clear idea on what value is being generated by engagement activities due to the lack of fuller details. Engagement reports need to carry far more granularity than seems to be the general practice currently.

“

Is this a magic moment to remake our business?”

A US hedge fund manager

To conclude this subsection, therefore, the overriding message from the surveyed hedge fund managers and their institutional investors is simple: ESG investing will likely continue to gain traction in the hedge fund industry, duly taking into account that some hedge fund strategies are more amenable to ESG than others.

ESG investing is not about jumping on the bandwagon; rather, it is about seeking to deliver financial and nonfinancial outcomes while managing the inherent risks.



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



Part II. Early adopters: their story

1 Sustainable investing is about creating businesses of enduring value

The ecosystem of capital markets is evolving gradually towards sustainable investing. But it remains a slow process. Large institutional investors have been at the vanguard, according to the three groups who participated in our interview survey for this section: institutional investors, large hedge fund managers and large long only managers. Their approaches extend beyond ESG and cover sustainable investing in its broadest sense, as defined in the introduction to this section.

a. In the beginning

For early adopters, the journey started with the exclusion of 'sin' stocks: shares in companies associated with activities deemed unethical.

Over time, it was recognized that exclusion reduced the scope for diversification somewhat. In any case, dumping 'sin' stocks yielded handsome profits to those who bought them without doing anything to pressure or influence the 'sinners'.

As a result, early adopters have augmented their approaches by integrating key sustainability features into their investment processes to achieve a double bottom-line: do well and do good, according to our interviews with early adopters. Over 80 percent of their sustainability assets are at this aspirational stage.

A minority have also ventured into private markets — private equity, infrastructure and private debt — to target measurable societal outcomes on top of the financial ones.

In all cases, progress is driven by large institutional investors who are moving well beyond a green 'do-gooder' image, duly taking account of the multidecade nature of their future liabilities.

In deference to enlightened self-interest, these investors are seeking to future-proof their portfolios against hard-to-model risks that are inherent in secular forces — like global warming, governance lapses, inequalities — that could pose existential threats to investee companies.

“
There are no shortcuts
to sustainability.”

A Swedish institutional
investor



1

Executive
summary



2

The rise of ESG
in the hedge
fund industry



3

The rise of
sustainable
investing



b. Current journey

As a result, such investors are now increasingly embedding sustainability into the DNA of their own organization and enjoining their asset managers to do the same in the emerging model of sustainability that focuses on a number of critical areas and their interlinkages (Figure 1.8).

The model perceives capital markets as an essential bridgehead to a more purposive capitalism that delivers businesses of enduring value for their four key stakeholder groups: shareholders, employees, customers and wider society.

At this early stage, the model also envisions sustainability as an evolutionary journey of experiential learning where ideas beget ideas. It enjoins business leaders at asset management firms to set the 'tone at the top' by:

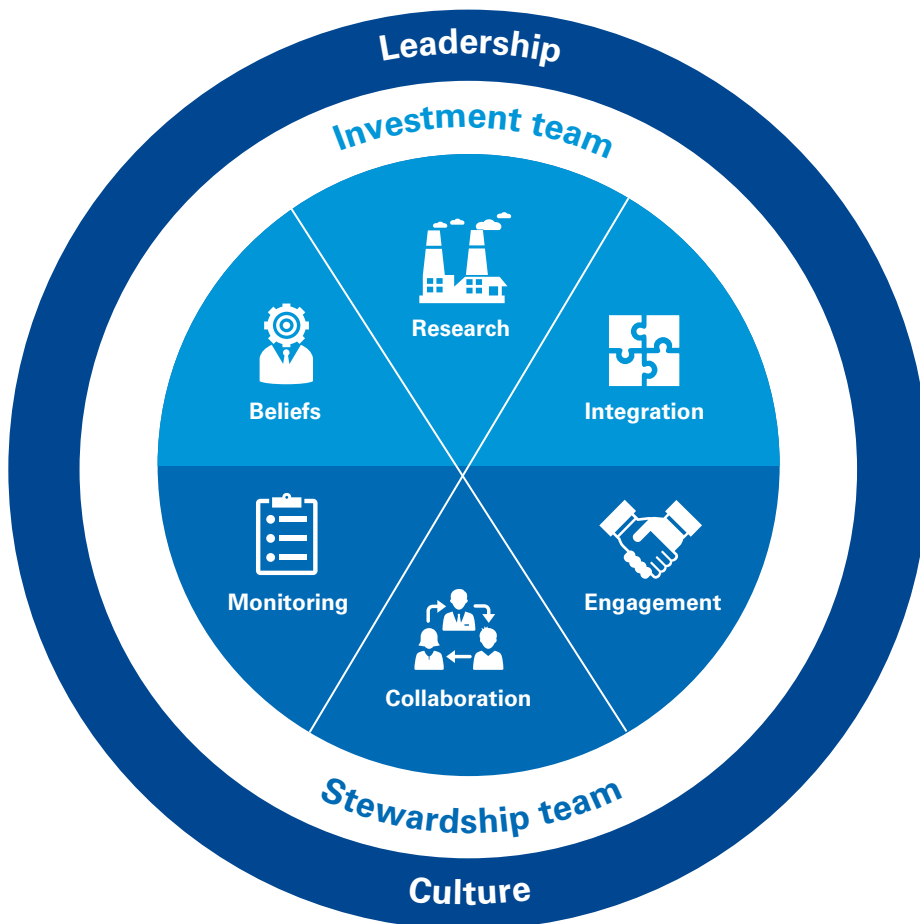
- creating a culture and belief that sustainability is not just another fad, but a sea change in the way investing is to be done
- harnessing the collective memory of the business via joined-up thinking between the investment team and the stewardship team
- ensuring that their portfolio managers and research analysts develop the requisite expertise into the dynamics of sustainability factors
- encouraging regular engagement with investee companies, setting realistic expectations and continuously monitoring progress.

These requirements impact on all vital activities in the investment value chain. So, the process is necessarily evolutionary.

“ Sustainable investing requires a joined-up business. ”

A large US fixed income manager

Figure 1.8 Creating sustainability DNA in business models



Source: KPMG–CAIA–AIMA–CREATE Interview Survey 2020



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



2 Capital markets are slow to price in sustainability risks

Three forces inherent in capital markets are slowing progress. Each is expected to weaken over time, as ever more investors switch from the old ways of investing that solely targeted financial returns.

a. Steep learning curve of data

Currently, investors are enjoined to climb a steep learning curve because of a lack of the requisite data on three foundational concepts in sustainable investing: materiality, intentionality and additionality.

Respectively, they seek to assess:

- how material are various sustainability factors to a company's financial performance, such that their inherent risks are managed?
- does the company intend to act on them and 'do good' via its products, services and interactions with wider society?
- does it generate societal benefits in addition to financial benefits?

For asset managers, while their sustainability policies are evolving rapidly, the requisite infrastructure of data, skills and technology has yet to catch up.

The problem is exacerbated by the fact that there are no generally agreed upon guidelines on what constitutes a 'good' or 'bad' company. The result is twofold: greenwashing, as asset managers repurpose their old funds with sustainability labels; or whitewashing, as investee companies overstate their green credentials. Both are widespread in developed markets.

b. Quarterly capitalism

The second force slowing down progress is the rise of 'quarterly capitalism', as identified by some

institutional investors who are at the vanguard of sustainable investing.

Under it, listed companies are incentivized on short-term profits at the expense of long-term growth. Some institutional investors believe that equity markets have, as a result, morphed from a source of raising investment capital for growing companies to a vehicle for cash distribution and balance sheet management.

Markets are no longer effective conduits between savers planning for a decent retirement nest egg and borrowers deploying savings to create wealth, jobs, skills and innovation.

In the 'new economy', capital formation is mainly happening in the private markets where transparency is low. Companies are staying private longer and are mostly outside the public purview.

There may be other, deeper, causes that may lead to the perception or manifestation of increasing short-termism in the developed economies. These could include: the move away from industries depending on fixed capital expenditures to more service-oriented businesses in mature economies; increased market power of individual companies in certain industries leading to excessive profits and underinvestment; and the deepening of global trade or an increasing rate of the underlying technological change.

All these factors could lead to changes in the way our economies function that are either harmless and a simple manifestation of reaching another stage of economic development, or potentially harmful but not necessarily related to capital market or financial institutions' behavior.

c. Tentative evidence of success so far

Evidence suggests that the early generation of investors in sustainability are satisfied with their returns so far. But as the new wall of money has arrived, a critical question has come to the fore: Is sustainability a risk factor?

Early adopters fall into two camps: believers and pragmatists.

Believers advanced three arguments.

- Sustainability is a risk factor for sure; except that, so far, it is a compensated factor in Europe, but much less so in the US and Asia Pacific.
- The compensated element has varied over time and between the three individual components: environment, social and governance.
- The huge collective push from governments, international agencies and investors worldwide will reshape investor behaviors overtime. It is hard to believe that nothing will change after all that is happening now.

“

On the data front, progress may be exponential, but it is still not enough.”

A Danish institutional investor



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



Pragmatists, in turn, think that it is too early to say, for two reasons.

- For any return driver to be treated as a risk factor, it needs a long performance history over multiple cycles in multiple regions, within a replicable investment process. Data on sustainable investing thus far fall short of these criteria.
- Capital markets have enjoyed the longest bull run in history, thanks to the easy money policies of central

banks. Asset valuations have been lifted indiscriminately. Hence, the true test of sustainability should not be judged by the assets it has attracted so far, but by how resilient these flows will be when the next downturn comes.

Both camps agree on one point, though: given the powerful tailwinds from institutional investors, sustainability will be the new frontier of innovation in the 2020s.

“

Just as it is foolhardy to drive a car by looking in the rearview mirror, so must investors look forward and factor in change. The world does not stand still.”

A UK asset manager

3 Best practice is emerging

The challenges outlined above have intensified efforts to develop best practices that can put sustainability at the heart of investing. Progress is evident in three areas.

a. Data: room for improvement

Different constituencies are being encouraged in a concerted action to tackle what is now sustainability's Achilles' heel: the lack of a robust template with consistent definitions and reliable data on how companies score on various sustainability factors.

From the investor perspective, for example, climate change is an inexact science. Various risks identified by the Task Force on Climate-related Financial Disclosures have made it hard for investors to establish a direct line of sight between climate science and investment outcomes. They are fraught with as many unknowables as unknowns.

Both institutional investors and asset managers are collaborating with over 150 data vendors to up their game. They

are also collaborating with not-for-profit institutions globally to develop methodologies on how to measure, report, benchmark and improve sustainability performance.

For their part, data vendors are experiencing rapid consolidation and innovation, as competition has intensified. Asset managers, too, are developing their own proprietary methodologies in order to gain an information edge on the mispricing of assets. Learning-by-doing remains a powerful tool of progress.

b. Engagement: the new alpha behind alpha

Best practice in sustainability involves enriching the current infrastructure of data, skills and technology with shareholder activism that targets real-world outcomes at scale.

For those investment strategies that can do so, their principal tool is direct engagement.



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



It rests on the belief that sustainability only works if company boards are not only called to account but also held accountable. They must:

- justify their decisions and be responsible for their outcomes
- create an agenda for change and acceptable standards that are consistent with its delivery
- engage in proxy voting to ensure that investors’ voices are heard in board-level deliberations
- foster year-round dialogue with investee companies beyond shareholder meetings.

The days when engagement was a box-ticking exercise using a boilerplate narrative are over.

Asset managers are increasingly expected to act as agents of change

by seeking progress in three mutually reinforcing related areas: communication, learning and internal politics (Figure 1.9).

These approaches seek to promote new learning in the belief that ideas breed ideas and only improved collaboration can deliver the goals of all stakeholders.

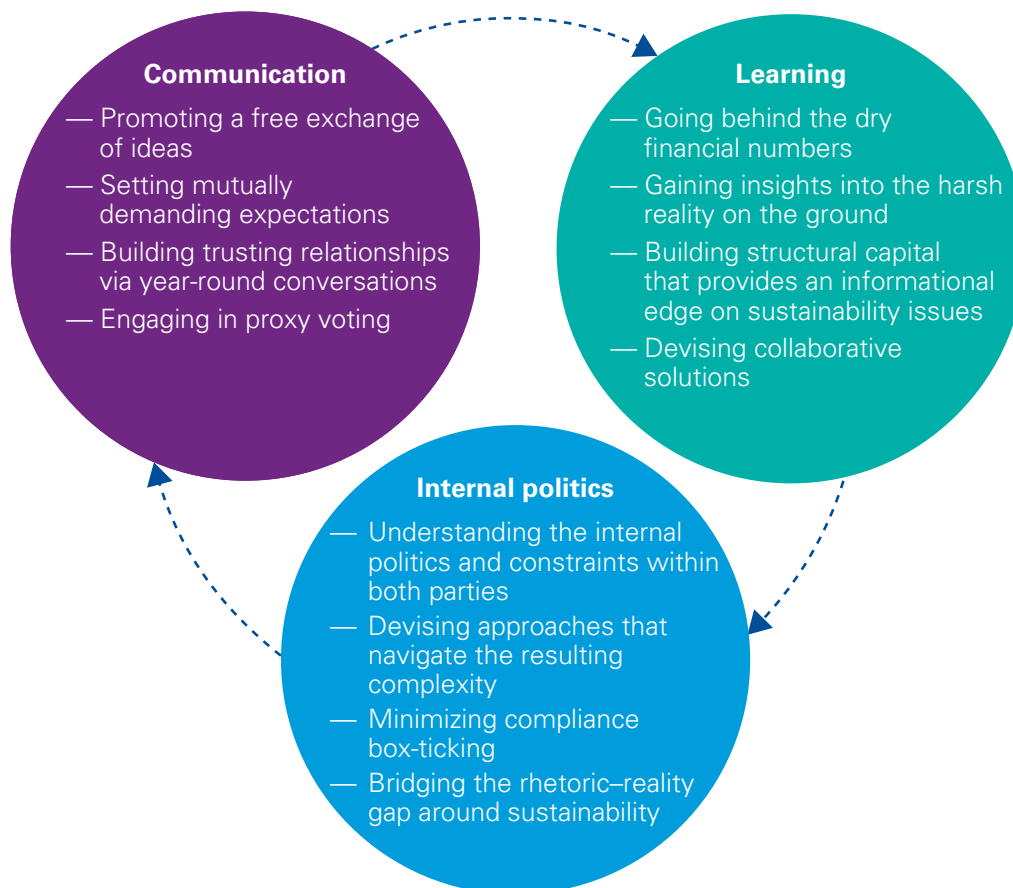
Indeed, some investors believe that engagement enables them to develop structural capital that offers an informational edge: ever-deepening knowledge about how sustainability is actually being implemented on the ground via positive feedback loops.

Indeed, as they have moved up the learning curve, asset managers have realized the power of engagement — often in collaboration with other investors who have, for example, worked closely with energy giants on plans to reduce their carbon emissions.

“
Effective engagement requires deeper communication, continuous learning and minimal internal politics.”

A large German asset manager

Figure 1.9 Engagement that goes beyond the hype of sustainability



Source: KPMG–CAIA–AIMA–CREATE Survey 2020



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



A more pragmatic ‘carrot and stick’ approach to engagement is coming into view. Under it, if engagement does not work, asset managers will resort to the nuclear option — divestment.

c. Implementation: upping the game

Except for large institutional investors, their peers do not as yet have the resources to do in-house investing and/or engage directly with their investee companies — they rely on their asset managers. Hence, sustainability capabilities are the most important criteria in manager selection.

Asset managers are thus enjoined to seek continuous improvements in five areas:

- **Data:** step up pressure for quality improvements in the supply chains of sustainability data

- **Integration:** develop an integrated core–specialist portfolio to give investors greater choice and diversity
- **Clarity:** deliver transparency that sets a direct line of sight between the sustainability policy of the manager and its activities
- **Articulation:** demonstrate how sustainability is integrated into covenants that currently disallow voting at AGMs or meaningful engagement
- **Interest alignment:** have an equitable sharing of pain and gain with clients, as well as common beliefs and time horizons.

“
By the end of the 2020s, sustainability will be the gold standard of investing.”

A Belgian asset manager

To conclude, therefore, early adopters see sustainable investing as serving their own long-term enlightened self-interests as much as those of wider society.

Progress so far confirms that sustainability is a long journey of experiential learning in which a series of small steps will add up to a giant leap by the end of this decade.



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



2

The rise of ESG in the hedge fund industry

How are managers advancing?



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



As in the long only space, so in the hedge fund industry: there is no one-size-fits-all approach to ESG. Different strategies and fund sizes demand different approaches. This is not a flaw: it is an important characteristic of ESG. There is room for everyone, including short sellers.

But this range of approaches brings its own challenges: a lack of quality data; a lack of uniform disclosure criteria; a shortage of knowledge or expertise; difficulty in finding the right investment opportunities; and lack of internal consensus. These and other challenges are all surmountable, with enough time and effort.

Advancing in the implementation cycle requires time, patience and skill. Hedge fund managers must learn by doing, but fortunately, they tend to be fast adopters and quick learners. Hedge fund managers should seek to collaborate with peers, competitors and specialist global networks to catch up in the ESG space.

Best practice is a moving target. Data are getting better. Shareholder engagement is getting stronger. ESG metrics and reporting frameworks are becoming standardized. Talent is becoming more accessible. Tailwinds are gathering behind the adoption process.

Information in this section is based on two electronic surveys carried out for this report, involving hedge fund managers and their institutional clients, and is bolstered by post-survey interviews. Their focus was on ESG investing.

When it comes to ESG, hedge funds were an outlier. Whereas their peers in other investment sectors were moving apace, the hedge fund industry was a relative latecomer.

There are a variety of contributing factors, ranging from skepticism about the value of ESG, to confusion over industry terminology, to legitimate challenges incorporating ESG factors.

The Spectrum of Capital, discussed in Section 3, is an appropriate parallel for the wide diversity of strategies in the hedge fund industry. Indeed, even the term 'hedge fund' is not a particularly useful identifier for what a hedge fund is or does. No two hedge funds are the same, and therefore, no two approaches to ESG either should or will be the same.

Yet, our post-survey interviews identified several potential advantages that hedge

fund managers can offer ESG-oriented investors, especially when compared with many of their long only peers.

- **Talent:** hedge fund managers are well known for the breadth and depth of their talent pool, whether it's portfolio managers, traders, researchers or, increasingly, computer scientists
- **Technology:** they have long harnessed the power of technology by building sophisticated trading and machine-learning algorithms that permit real-time investment decisions
- **Flexibility:** the legal structure of a hedge fund makes it one of the most flexible investment vehicles, investing across asset classes and using derivatives, leverage and shorting, as needed
- **Activism:** many hedge fund managers made their name by engaging in public proxy fights and other shareholder battles, and have extensive experience in the art of shareholder engagement.

“
We are seeing the hedge fund industry evolve from a mindset of resistance to one of adoption on ESG.”

An institutional consultant



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



However, these advantages will only come to the forefront if hedge fund managers take concrete steps to embrace ESG across the organization.

Accordingly, this section seeks to answer three key questions.

A. What are the key drivers of the increased interest in ESG?

B. What are the key constraints preventing its faster adoption within the hedge fund industry?

C. What are the emerging best practices that hedge fund managers can adopt to fast-forward their progress in the implementation cycle?

These questions are separately considered in the next three subsections in order to highlight how hedge fund managers are progressing towards a sustainable future.

“ We see growing evidence of immediate or short-term value creation in sustainability rather than just long term. ”

An institutional consultant

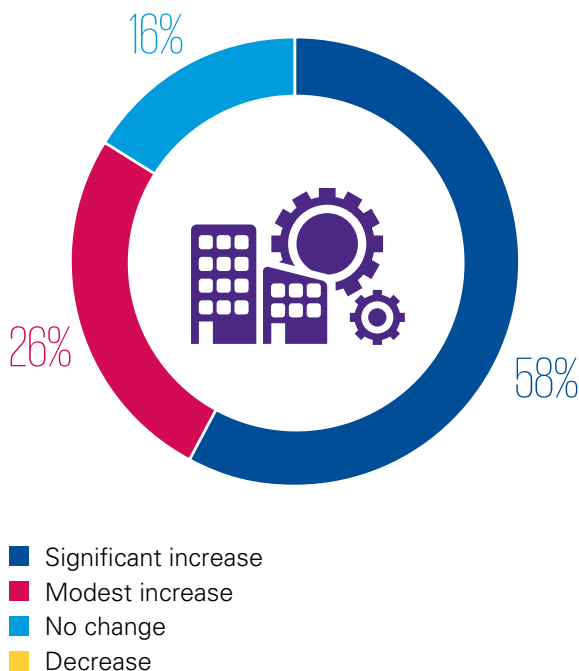
1. Key drivers

It is clear that there is growing interest in ESG-oriented strategies, products and funds across the hedge fund industry, according to our survey of hedge fund managers (Figure 2.1): 84 percent of them reported an increase in interest over the preceding 12 months, with more than half (58 percent) citing it as a ‘significant increase’. The remaining 16 percent said that there was

‘no change’ in interest. Not a single survey respondent reported decreased interest when given the choice: a clear sign that sustainability is a credible phenomenon in the hedge fund industry.

Further analysis revealed two key drivers to be at work: growing investor demand and growing evidence of the materiality of ESG, as shown in Figure 2.2.

Figure 2.1 How would you describe the change in interest or demand in your organization’s ESG capabilities or strategies over the last 12 months?



Source: KPMG–CAIA–AIMA–CREATE Survey 2020

21 Sustainable investing: fast-forwarding its evolution



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



a. Growing investor demand

Like in other parts of the asset management industry, the initial wave of interest in sustainability in the hedge fund industry has come from institutional investors and their consultants, as cited by 72 percent of surveyed hedge fund managers (Figure 2.2).

These institutional investors — and their consultants — have been vocal in demanding that their portfolios not be exposed to the so-called ‘sin’ industries like fossil fuels or weapons manufacturing, with a growing number of them also seeking to use their capital to generate positive social and environmental outcomes.

Hedge fund managers, accordingly, have begun to respond by making their investments more ESG-oriented. Some of our survey respondents have

launched dedicated ESG funds, while others have crafted policies that clarify how sustainability factors were taken into consideration as part of their investment processes.

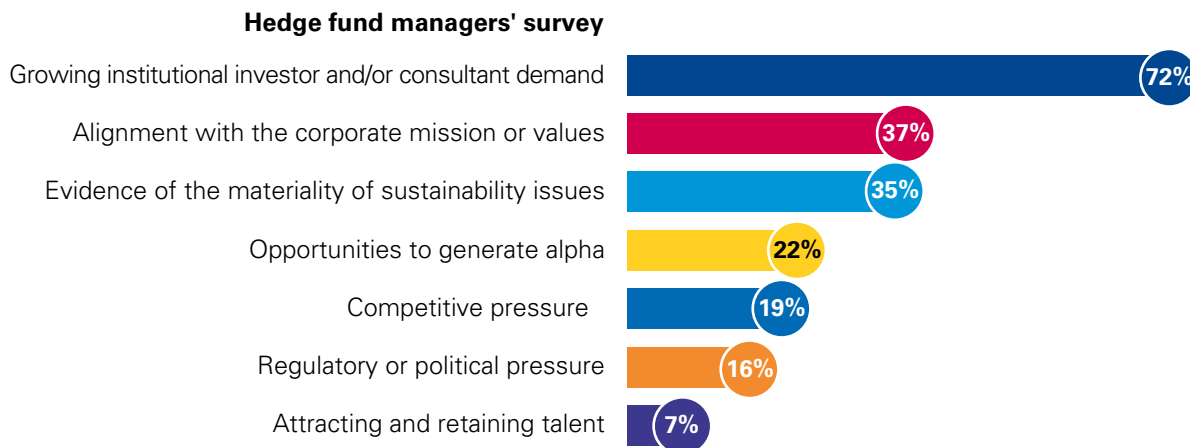
While the scope and scale of the response to investor demand seems to vary widely across the hedge fund industry, the speed of the response has been notable. Almost every hedge fund manager who participated in our post-survey interviews had made improvements to their ESG programs (or started them from scratch) in the last 12 months, potentially signaling a coming sea-shift across the industry.

This is further corroborated by a recent survey of over 600 institutional investors, evenly split among the US, the UK, Canada, Germany, Japan and the Netherlands, with US\$9 trillion in combined assets. The survey provides further insights into investor thinking¹.

“Hedge fund managers should focus on the economics of ESG, not its morality.”

An institutional consultant

Figure 2.2 What are your organization’s biggest drivers when making ESG-oriented investments?



Source: KPMG–CAIA–AIMA–CREATE Survey 2020



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



It showed that:

- **84 percent** of respondents agree that maximizing shareholder returns can no longer be the primary goal of the corporation: business leaders must commit to balancing the needs of other stakeholders
- **87 percent** of respondents say their organizations have changed their voting and/or engagement policies to be more attentive to ESG risks
- **86 percent** would consider investing with a lower rate of return, especially if it meant investing in a company that addresses sustainable or impact investing considerations
- **61 percent** have increased their investment allocation to companies that excel in ESG factors and more than half of investors believe that ESG practices positively impact trust
- **99 percent** of respondents expect the board of directors (of the companies in which they invest) to oversee at least one ESG topic.

b. Evidence of the materiality of ESG

There is a growing body of academic literature and industry research that supports the double bottom-line proposition: an investor can do well financially by being good socially. That is, ESG is not only a part of the risk–return equation, it could potentially also generate additional benefits for the wider community, as discussed in Section 3.

For instance, a meta-study of more than 2,000 research papers on equity returns found that 63 percent of studies reported

a positive correlation between ESG and financial performance, and just 8 percent reported a negative correlation².

Of course, there is not yet conclusive evidence that there is a positive correlation between ESG and performance. Some have even vocally argued that there is a negative correlation, and that sustainability considerations may actually hurt portfolio performance — at least when applied over shorter time horizons.

While there may be some validity to these arguments, there are clearly a growing number of hedge fund managers who have bought into ESG as a way to generate outsized returns. The materiality debate has also turned the spotlight on the role of shorting in ESG investing (case study 2A).

c. Other factors

There were two other notable drivers cited by hedge fund managers that also influenced their increased adoption of ESG. While these paled in comparison to the top two drivers mentioned above, they are important to keep in mind as the industry evolves, for they have the potential to act as catalyzing forces in the years ahead.

i. Regulatory changes

Currently, hedge fund managers seem relatively unperturbed by regulatory or political pressures when it comes to ESG for a simple reason: its rise so far has largely rested on voluntary or self-regulatory initiatives. But it is highly likely that this bottom-up momentum will be complemented by new regulation in certain parts of the world.



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



In the past 2 years alone, there has been a dizzying array of proposals across different jurisdictions that would, if implemented, rewrite the rules of finance — as described in Section 3. Initial indications are that, like their long only peers, most hedge fund managers have yet to take proactive steps in preparation for policy changes, likely since most of the proposed rules are still at the outline stage and months and years away from enactment.

As an additional resource, hedge funds should familiarize themselves with the PRI's report on the 'Inevitable Policy Response'. While governments are clearly behind actions to address climate change, there is growing

consensus that there will eventually be a dramatic policy response that will up-end global financial markets³.

To take one example, consider the issue of stranded assets. The Carbon Tracker Initiative estimates that as much as US\$2.3 trillion of oil and gas assets may become stranded as the world shifts to a low- or zero-carbon economy. Already, major fossil fuel companies have written off billions of dollars' worth of oil and gas assets from their balance sheets. The stranded asset problem may also eventually apply to plastics companies, manufacturing companies, agricultural companies and even some food companies, which would force a broad repricing of their market valuations over time⁴.

“
Regulation is coming to give sustainability more teeth, with the EU leading the way.”

A global alternative investment firm

Case study 2A: The ethics of shorting

A philosophical debate has erupted over the last couple of years on whether shorting has a place in ESG-oriented portfolios.

The latest salvo came from Hiro Mizuno, chief investment officer of Japan's Government Pension Investment Fund (GPIF).

In December 2019, the GPIF announced that it would stop lending its global equity stocks out to short sellers, arguing that short selling promotes a short-term mindset and is therefore contrary to the idea that sustainability should be a long-term game.

We have heard opponents of shorting cite a number of reasons for why short selling is 'bad'.

One of the key arguments is that short selling, if successful,

involves potentially profiting from job losses if a company has to lay off workers or even goes bankrupt. Another is that it requires holding 'sin' stocks if betting against a company in a sector like tobacco, which is an issue for investors with strict exclusion lists.

But we take a different view, which is that short selling has an important place in the investment industry, especially in the broader sustainability context.

Short selling can increase the cost of capital for sin stocks, especially if shorting bonds within a fixed income strategy.

Short selling, if done successfully, can generate a positive financial return, which

can then be used to help fund additional investment, research or engagement activities.

Shorting can also be a source of differentiated returns, particularly in down markets.

We don't think there's a simple answer to the shorting question. There should be nothing wrong with hedge fund managers profiting from the sunset of certain carbon-intensive industries, as long as they are clear about their intended approach.

Ultimately, it should be the prerogative of the investor to decide whether or not to invest in a fund manager that engages in short selling.

A long-short equity manager



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



ii. Alignment with the corporate mission

Many hedge fund managers are also looking at the ESG rise from a mission-driven mindset. After all, it stands to reason that if hedge fund managers believe in the positive relationship between ESG and long-term value creation, then they would also agree that having strong requisite practices internally is also a recipe for long-term success.

Many managers have always known that having a diverse team, strong corporate governance and fair compensation schemes are all key to running a well-functioning business. Those managers that best articulated a corporate mission and a set of values beyond just generating strong financial returns also tended to attract and retain the best talent, according to our post-survey interviews. It confirmed the point in Section 3 that ESG is as much about mindset shifts as about physical changes in business models.

As the hedge fund industry becomes ever more institutionalized, these practices are likely to attract greater scrutiny. This is true of the broader

investment management industry, which is being held to a higher ethical standard. The business model of hedge funds will always be dependent on delivering decent financial returns (and thus generating performance fees). But although that will be necessary, it won't be sufficient. Implementing ESG factors where they are relevant will be essential for attracting institutional money.

d. Investor perspective

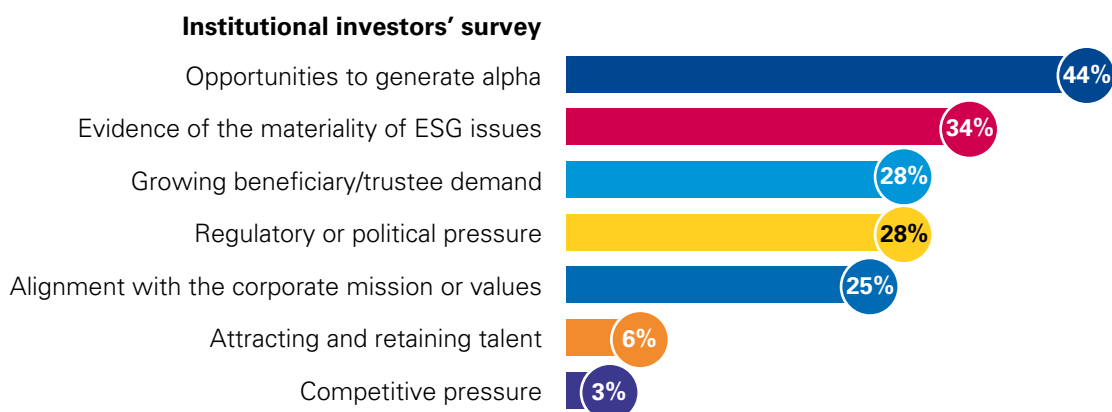
We also surveyed institutional investors to ascertain the key factors driving their allocations to ESG-driven hedge funds. We found several parallels between what drives hedge funds and what drives investors, with materiality at the core of the decision-making processes of both groups (Figure 2.3).

Nearly half (44 percent) of surveyed investors said their allocations to ESG-oriented hedge funds were driven by 'opportunities to generate alpha' and 34 percent were driven by 'evidence of the materiality of ESG issues'.

“ We see some hedge funds write off sustainability as an exclusionary approach and continue to peddle misconceptions about it to investors. ”

An institutional consultant

Figure 2.3 What are your organization's key drivers of ESG-oriented investments?



Source: KPMG-CAIA-AIMA-CREATE Survey 2020



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



In contrast, relatively few investors (28 percent) were driven by ‘growing beneficiary/trustee demand’ or by ‘regulatory or political pressure’. Interestingly, investors didn’t seem any more or less mission-driven than hedge funds, with only a quarter (25 percent) of investors saying they were motivated by a desire to make investments that were aligned with the corporate mission or values.

These figures are supported by our post-survey interviews with investors. They revealed overwhelming recognition that at least some aspects of ESG are clearly material and therefore should be incorporated into the investment process. It should come as no surprise, then, that investors base much of their due diligence around ESG and how well their underlying fund managers are able to use the appropriate data and insights to make better-informed investment decisions (case study 2B).

“The lack of industry standards has given hedge fund managers permission to not take sustainability seriously.”

A US quant manager

Case study 2B: ESG as a risk management tool

As fiduciaries, we look at anything that may materially affect the financial returns of our funds. We believe that ESG factors clearly belong in this conversation, particularly as a risk mitigant.

While we recognize that the ESG data out there can be very noisy, we have found success by combining fundamental analysis with select data sources to create a more holistic picture

about each investment in our portfolio. This picture allows us to more proactively identify and monitor risks, both before and after an investment is made. This is by no means easy to do, but we do think there are material signals out there waiting to be found for investors willing to do the work.

At the end of the day, ESG factors should be treated just like other risk factors. With more and

more of a company’s value now tied up in so-called ‘intangible assets’ like brand recognition and goodwill, it seems inevitable that ESG components like employee diversity and environmental stewardship will take on increased importance in future investment decision making.

A European fund of hedge funds



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



2. Key constraints

When asked to identify the constraints that are slowing down the adoption of ESG, the surveyed hedge fund managers singled out a number of them, of which two are particularly noteworthy. These are considered separately below.

a. Lack of quality ESG data

If there's one thing that the hedge fund managers participating in our interviews agreed on, it's that there isn't enough reliable ESG data to clearly identify risk or alpha signals (Figure 2.4). As we shall see in Section 3, this challenge is also pervasive across the investment landscape, including for long only asset managers, institutional investors and other alternative investment firms.

While it is true that the current ESG data suffer from many shortcomings — like inconsistent company disclosures, opaque research methodologies and unreliable ratings — it is also true that the quality of the available data is improving every day.

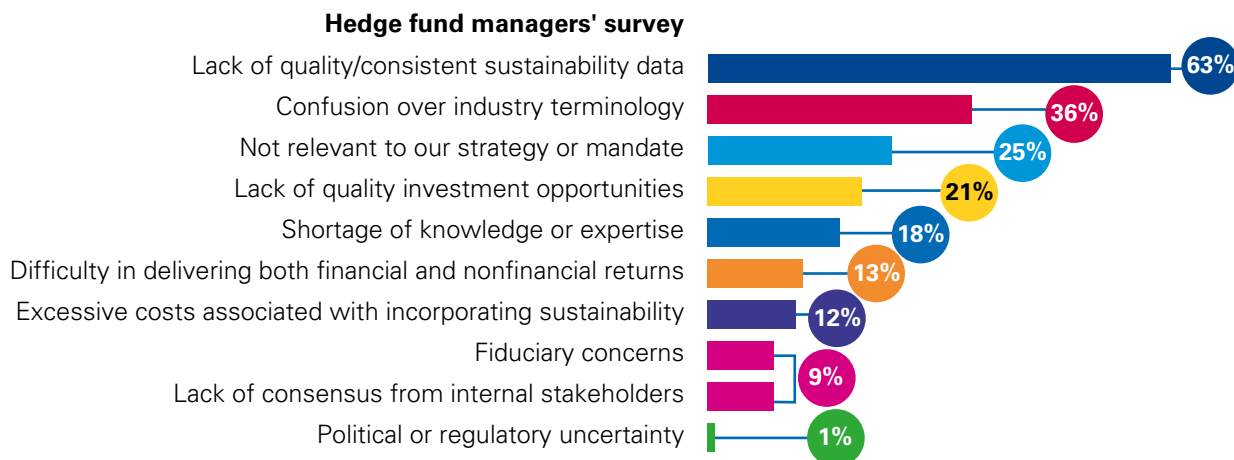
In contrast, some of our interviewees took the view that the lack of quality

sustainability data should be viewed as an advantage — rather than a disadvantage — for hedge funds, which typically rely on market inefficiencies to generate outperformance. In other words, hedge funds shouldn't be using the lack of ESG data as an excuse not to pursue sustainable investments. Instead, they should do the difficult work of identifying which signals are material and which are not, whether through existing data sources or by developing proprietary approaches (case study 2C).

b. Shortage of ESG expertise

Indeed, there were several other challenges that emerged from the survey. They could all be traced back to education and/or awareness problems. More than a third of hedge funds (36 percent) said there was 'confusion over industry terminology', 18 percent cited a 'shortage of knowledge or expertise' and 9 percent were beset by a 'lack of consensus from internal stakeholders' (Figure 2.4).

Figure 2.4 What are your organization's biggest challenges in making ESG-oriented investments?



Source: KPMG-CAIA-AIMA-CREATE Survey 2020



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



Just as different hedge fund managers may have divergent views on ESG, so too do different employees within each of these individual firms. This disconnect — whether between the investment team and the research team, or between the C-suite and the compliance team, or between investors and the investor relations team — is a major barrier to the adoption of ESG and prevents some hedge fund managers from agreeing on a single approach.

In the early days of ESG there was a noticeable shortage of investment professionals who could combine financial expertise with ESG experience.

However, several organizations have stepped up to fill the implied education and talent gap, whether through conferences, trade associations, academic research, third-party consulting or even specialist recruitment agencies.

Many long only managers have hired ESG specialists or have even built dedicated ESG teams; other firms have joined advisory committees at one of the many not-for-profits and standard-setting organizations engaged in the ESG space. Most of the managers are upskilling rather than creating new teams, however.

“
Small hedge fund managers face excessive costs in implementing sustainability, while large ones have a marketing machine to help greenwash.”

A Nordic hedge fund manager

Case study 2C: Turning noise into signal

We've heard all of the complaints about the low quality or unreliability of sustainability data, arising from the inconsistencies in company disclosures and differences in the methodologies used by various data providers.

While the quality of the data is getting better every day, it's still nowhere near the level of traditional financial data. But that

doesn't mean that the data are irrelevant or unusable.

For our part, we've looked at many of the third-party sustainability data providers to determine which data points generated a clear alpha signal. We couldn't find one. Instead, we have devised our own methodology, which goes a layer deeper beyond

a company's financials or sustainability reports.

It mines vast amounts of unstructured data in near-real time, and gives us greater and faster insights into both the risks and opportunities in our investment universe.

A global quant manager

c. Other challenges slowing down adoption

There are two other challenges worthy of note. The first one is the high costs involved in implementing ESG across the organization. These costs can be broken down across several areas: investments in talent (hiring ESG specialists for the investment, research and shareholder engagement teams), investments in data (purchasing datasets and data-mining technology from third-party providers) and investments in marketing (sponsorships, PR and thought leadership to build credibility in the market).

These costs can easily pile up and may therefore be prohibitive for some small- or mid-sized hedge funds. It's no surprise that the hedge funds doing the most on ESG tend to be those with the most operational resources. Alongside, however, new firms are also emerging that specialize in ESG.

The second challenge cited by about a quarter of the hedge fund managers we surveyed said that ESG was 'not relevant to their strategy or mandate'. They believe that ESG could lose its materiality powers for trading strategies that rely on short



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



holding periods or in an asset class like currency that is extensively traded daily.

This may be true for high-frequency trading strategies, but our interview research suggests that while a longer holding period makes it easier to incorporate ESG into the investment process, ESG factors could still potentially generate relevant signals over a short time frame, especially as the pace of news and the speed of data continues to increase.

d. Investor perspective

We also asked institutional investors to highlight the challenges they faced in making ESG-oriented investments in hedge funds. They cited many of the same challenges as hedge fund managers, suggesting that there are common issues across the investment management value chain (Figure 2.5).

The challenges identified by institutional investors are similar to those singled

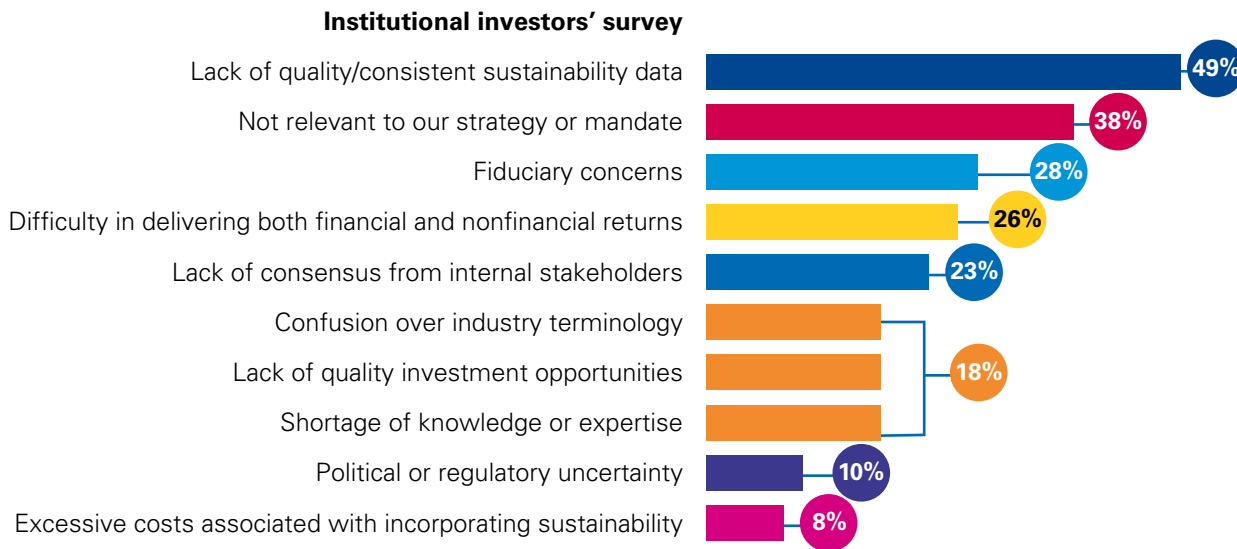
out by hedge fund managers, except in one crucial area: the ‘lack of consensus from internal stakeholders’. While only 9 percent of hedge funds cited this as a challenge, a much larger percentage of investors (23 percent) struggled with this issue.

This could be explained by the nature of most institutional investors, which must answer to a wide range of stakeholders with potentially diverse needs and objectives. For example, a pension fund must meet the needs of its beneficiaries but is ultimately only answerable to its board, which may have widely different views on ESG. This exact issue played out in 2018 at an American retirement organization, which elected a new President who took a very different view of sustainability to that of his predecessor⁵. Pension plans with low funding levels and fast maturing liabilities have faced a similar challenge.

“The minimum bar for hedge funds is to have a robust ESG policy with buy-in from the top. ESG should be part of the DNA of the firm.”

An impact investing consultant

Figure 2.5 What are your organization’s biggest challenges in making ESG-oriented investments?



Source: KPMG–CAIA–AIMA–CREATE Survey 2020



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



3. Emerging best practice

Our post-survey interviews identified four sets of practices that could potentially speed up the adoption of ESG and generate improved outcomes for hedge fund managers and their institutional clients alike.

a. Avoid greenwashing

Best practices in the ESG space are a moving target. Whereas negative screening may have historically been the dominant approach, today the bar is clearly being raised. It's no longer enough for a fund manager to just avoid 'sin' stocks; increasingly, there is now an expectation that investments should generate a positive (and measurable) social, environmental or economic impact.

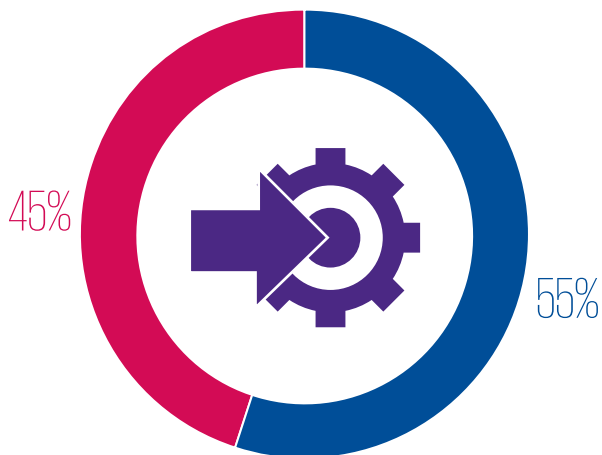
This is easier said than done. For many hedge fund managers, the idea of ESG

is a challenging one to incorporate into their funds, just as it is across the entire investment management industry.

But, as in all fields of human endeavor, the challenges are all surmountable with enough time, patience, persistence and diligence.

Those firms that fall short of best practices are likely to fall victim to the investment management industry's new 'G' word — greenwashing. Our research suggests that, as in the long only space, there is still a greenwashing problem in the hedge fund industry. However, institutional investors are getting more savvy in how they approach ESG in their due diligence, duly separating the leaders from the pretenders and the winners from the spinners.

Figure 2.6 As an institutional investor, do you include ESG considerations as part of your due diligence prior to making an allocation to a hedge fund manager?



■ Yes
■ No

Source: KPMG–CAIA–AIMA–CREATE Survey 2020



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



Indeed, more than half of the institutional investors (55 percent) reported that they include ESG considerations as part of their due diligence prior to making an allocation to a hedge fund manager (Figure 2.6).

However, early indications suggest that investors were concerned with what they found, as we saw in Figure 1.7 in the Executive summary. It reported that 41 percent saw a 'significant amount of greenwashing', with a further 11 percent reporting 'some greenwashing'. The remaining 48 percent said they were 'not sure'.

To minimize the problem, hedge fund managers are developing the necessary practices (Figure 2.7). These take into account the fact that investor expectations vary when it comes to hedge fund firms practicing ESG investment. For many investors, this may be as simple as expecting their managers to screen certain assets out of their portfolios — particularly those assets that might cause the investor reputational harm. Other investors, however, may expect a manager to implement ESG analysis, or even to measure the environmental footprint of its investment activities.

“
We’re seeing a snowball effect in the hedge fund industry now that sustainability is becoming mainstream.”

An institutional consultant

Figure 2.7 What do institutional investors expect?

Investor expectations	
Policy	Firm has a policy on responsible investment and has thought through the implications thereof for its investment strategy and operations.
Talent	Relevant investment staff have been trained in responsible investment; accountability for responsible investment policy does not only sit in compliance/legal.
Investment strategy	Firm has a screening policy, and has demonstrably thought through the impact of responsible investment and sustainability concerns on its investments.
Engagement	Firm engages with investee companies where possible, and reports on the outcomes of those engagements to its investors.
Reporting	Firm has internal controls to ensure its responsible investment policy is properly enacted.

Source: KPMG–CAIA–AIMA–CREATE Survey 2020



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



b. Comply with industry codes and principles

As mentioned previously, there is no one-size-fits-all approach when it comes to ESG. This is also true of implementation efforts⁶.

ESG is not a race but rather a unique journey, with unique challenges and unique opportunities for individual hedge fund managers. It is a journey based on experiential learning; questioning what works, what doesn't and why, and applying the resulting lessons going forward.

As we saw in Figure 1.3 in the Executive summary, only 15 percent of hedge fund managers would define themselves as being at the 'mature' stage of the implementation cycle, where ESG is implemented across the firm via appropriate policies, committees, research and data. The rest of the managers are either at the 'in progress' stage, where implementation is piecemeal (44 percent) or the 'awareness raising' stage (31 percent), with the remaining 10 percent reporting 'no implementation to date'.

Hence, as they advance into the implementation cycle, hedge fund managers should consider good practices enshrined in the PRI. Currently, 35 percent are already a signatory to these Principles, and a further 17 percent are in the process of becoming a signatory (Figure 2.8, left-hand panel).

As for embedding the PRI policies into the cultural fabric of the firm, 56 percent of hedge fund managers currently have a policy to do so, and a further 36 percent are in the process of developing one (Figure 2.8, right-hand panel). This shows significant progress when compared with a November 2018 Preqin survey on the same question, which found that 20 percent of hedge fund managers have an ESG policy in place, 15 percent don't have a policy yet but are working on one, and 65 percent aren't actively working towards a policy at all⁷.

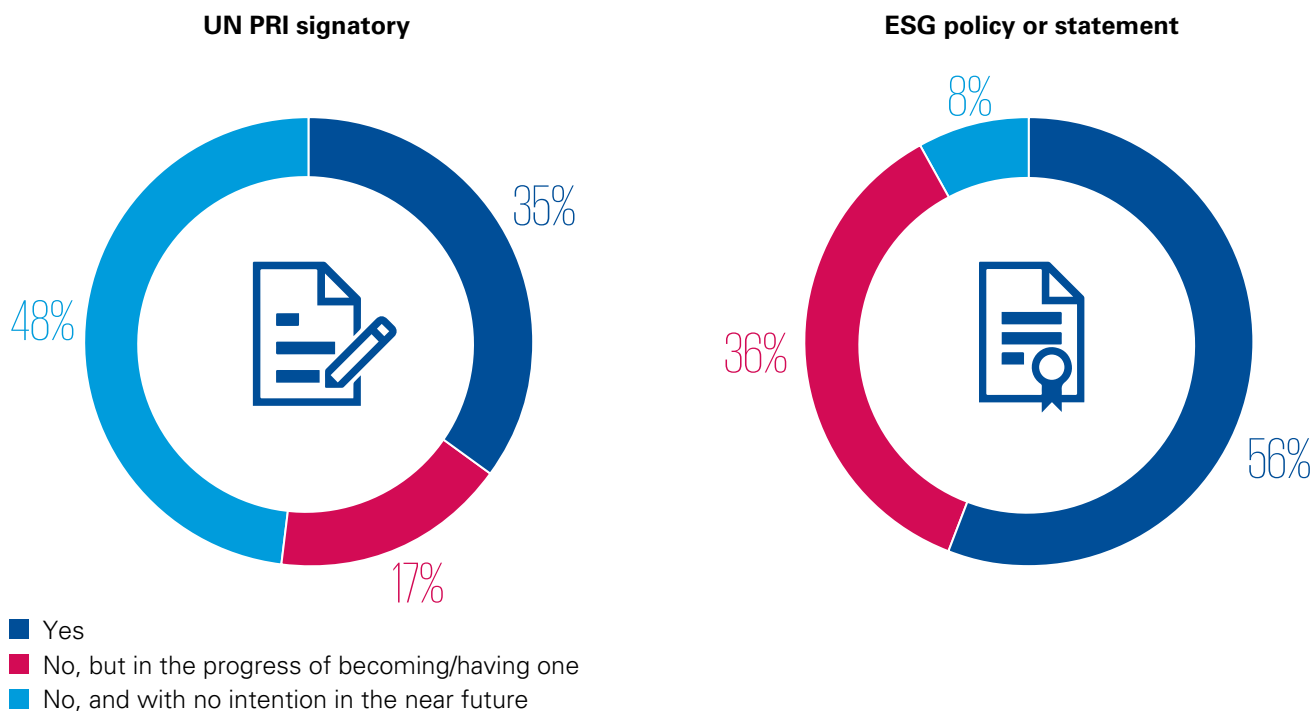
These data invite a caveat, however. As mentioned previously, not all hedge fund strategies are amenable to ESG investing and, by extension, to UN PRI.

“

Active ownership and responsible stewardship are a critical part of sustainability, regardless of whether you are active or passive.”

A US quant manager

Figure 2.8 Is your organization a current UN PRI signatory? And does your organization currently have an ESG policy or statement?



Source: KPMG–CAIA–AIMA–CREATE Survey 2020



1

Executive summary

2

The rise of ESG in the hedge fund industry

3

The rise of sustainable investing

Implementation progress is evident with regard to those that are, in order to enhance the credibility, authenticity and transparency required by institutional investors (case study 2D).

Where the PRI are less relevant, the industry needs to work together to create a set of its own harmonized principles.

“

Integrity is critical. If you're going to call yourself a sustainability investor, it is important to have the right processes in place.”

An impact investing consultant

Case study 2D: Embedding ESG into corporate DNA

We look for hedge fund managers that clearly have ESG in their DNA. We evaluate these managers for how well they integrate it into their research and investment processes, how committed they are to responsible ownership, and the quality of their approach to sustainability data and nonfinancial reporting. An ESG policy is the absolute bare minimum and it is not usually enough to earn a recommendation from us.

We also want hedge fund managers to show that they

are willing to 'walk the walk' of ESG by asking themselves the same sorts of questions that they would ask of portfolio companies. That means a hedge fund should have a commitment to employee diversity, equitable pay, appropriate fees and fund structures, and strong corporate governance. If a hedge fund truly believes in ESG as part of its core investment philosophy, then it follows that it should be seamlessly integrated across the organization.

An institutional consultant

c. Improve ESG reporting

Measurement of and reporting on the nonfinancial impact of investments represents the next frontier for ESG investing. Investors and regulators are increasingly demanding information on the nonfinancial performance of all investments. In response, there has been a growing list of standards, frameworks and principles developed to create a shared language for investors who wish to report on ESG. While no single standard has emerged as universal, there is an expectation that best-in-class managers will report using one or more of these standards — or develop proprietary ones.

When asked what different approaches were used in their ESG reporting, more than half (57 percent) of the surveyed hedge fund managers said they do not currently report on ESG performance

at all, as mentioned in the Executive summary. Of those who do, 11 percent use customized metrics and 23 percent use PRI, with other standards far behind in terms of adoption.

Of all the data points we looked at, we expect this one to change the most year on year. Reporting is no longer seen as a nice-to-have by most investors; it has become a must-have. While there may not ever be a single reporting standard that satisfies a range of conditions for different types of investment strategies, that doesn't mean hedge fund managers can get away with no reporting of any kind.

It is essential for them to focus on reporting what is most material and relevant to a particular strategy. There are plenty of tools available that can be used to come up with standardized reports or feed into a customized reporting mechanism.



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



d. Publish the outcomes of shareholder engagement

The final area to improve current practices is shareholder engagement. It's not enough to just invest in ESG-friendly securities; hedge fund managers must also engage with the underlying portfolio companies and make the case for improving their ESG outcomes. Indeed, this is, in fact, already being done in significant numbers (Figure 2.9).

The most dominant approach to shareholder engagement is also the most opaque: nearly three-quarters of managers (74 percent) said they privately engaged with companies on ESG issues, compared with 25 percent of managers who engage publicly and 34 percent who vote their proxies. But the most active form of engagement — proxy fights or activist battles (6 percent) — were rarely

used, owing in part to how resource intensive activist battles can become. On the other hand, collaboration with other managers and external networks is on the rise (case study 2E).

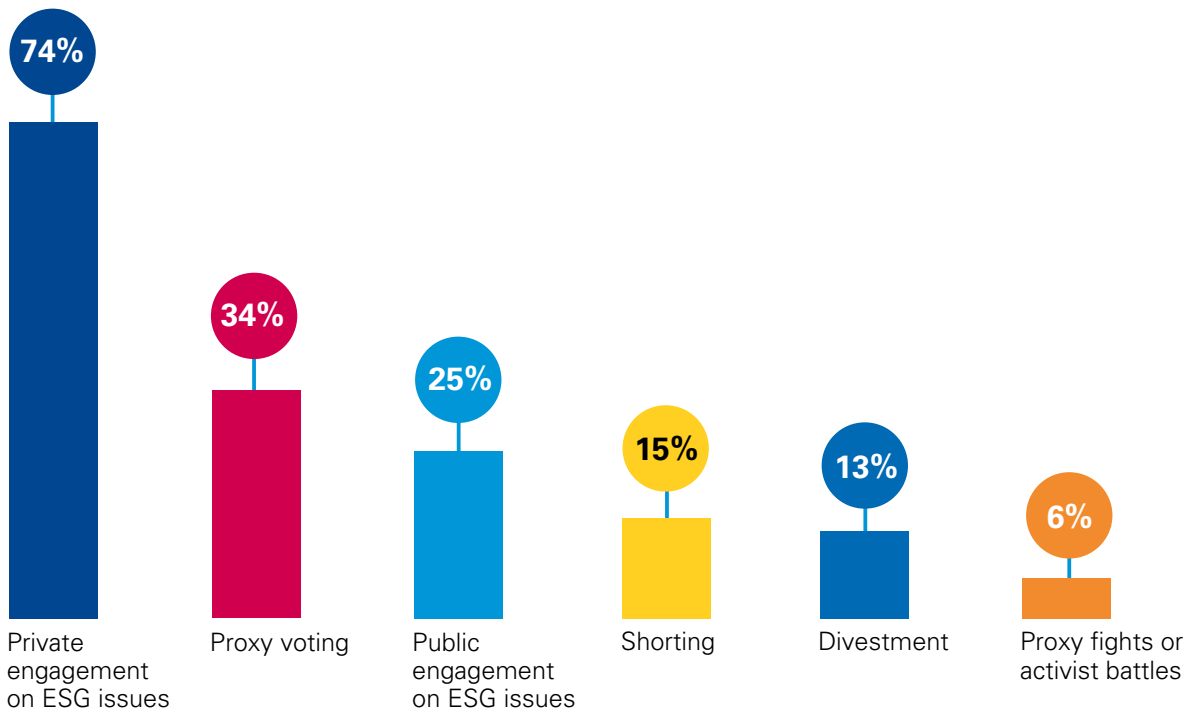
Hedge funds are ideally suited for activism that targets companies underperforming on ESG issues. Our interviews show that there is a return premium in helping an ESG laggard to become a leader. It also shows that responsible ownership is an important part of the ESG toolkit and must be taken seriously.

Above all, the outcomes of all engagements must be transparently conveyed to end-investors. Except for high-profile proxy fights, end-investors do not as yet have a clear idea on what value is generated by engagement activities due to this lack of transparent reporting.

“Sustainability is a great opportunity for hedge funds to rebrand and show their commitment to inclusivity and sustainability.”

An institutional consultant

Figure 2.9 What approach does your organization bring to shareholder engagement when it comes to ESG?



Source: KPMG–CAIA–AIMA–CREATE Survey 2020



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



Case study 2E: Progress requires collaboration

Adopting best practice can be rather expensive for some fund managers, especially when it comes to shareholder engagement. We know that we're too small to gain much traction on our own, so we look for opportunities to collaborate with other asset managers through organizations and initiatives like Climate Action 100+, Ceres and the Institutional

Investors Group on Climate Change.

We think this is best practice for other smaller or mid-sized managers that want to engage on ESG issues but don't have the right expertise or resources. Engagement looks different depending on the company, jurisdiction and culture, so there's no one-size-fits-all approach.

Companies are learning too, and they want to work with their shareholders to understand what investors are looking for on ESG. It's become much more of a dialogue or conversation. Not all engagements have to be combative. Indeed, the best conversations are discreet and behind closed doors.

A boutique ESG manager

Best practice in the years ahead

What may seem like a non-starter today could easily emerge as best practice over the next few years. That is why one area that bears watching is a better alignment of interests via fee and incentive structures that reward hedge funds for both financial and nonfinancial performance. While such fee structures are still in their infancy, hedge funds that show a clear alignment of interests when it comes to ESG — especially in their remuneration schemes — will have a distinct competitive advantage. Some niche players are already setting the trend.

We may also see hedge funds and long only managers exploring innovative lock-up structures that would allow them to tie up investor capital for prolonged engagement campaigns or specific thematic investments. Since most research suggests that ESG factors become more material over longer-term horizons, it would make sense for fund managers and investors to mutually agree on seeing an investment through to its natural conclusion, even if it takes years.

To conclude, therefore, on ESG, hedge fund managers are moving up the implementation ladder.

They must also embrace best practice and take control of their own narratives — proactively making the case for how and why ESG is material to their strategies rather than passively reacting to external demands — whether those demands come from investors, consultants, policymakers, regulators or even employees.



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



3

The rise of sustainable investing

What lessons can be learned from early adopters?



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



Sustainability is evolutionary in nature but revolutionary in potential. It envisions a key role for capital markets — alongside governments, consumers and green technology. Neither capital markets nor individual countries alone can deliver results. Transnational co-operation is essential.

Sustainability is set to reshape the ecosystem of capital markets and the behaviors of their participants. It requires mindset shifts as much as physical changes from the way investing has been done historically.

Barriers persist. Creating the necessary infrastructure of data, skills and technology is proving challenging. Progress has been exponential but the task remains huge. Pragmatism has been all too evident. Future demand prospects look promising. Regulatory pull remains strong. Early results are encouraging.

Future success critically hinges on three factors: a new model of shareholder engagement that enjoins investors to go from distant owners to vocal change agents; savvy implementation of sustainability into investment portfolios; and business leadership that is keen to capitalize on the opportunities arising from the transition.

This section presents the results of a stand-alone interview survey, which involved large institutional investors, alternative investment managers and global asset managers who are early adopters of sustainable investing, as defined in the introduction to Section 1. The survey aimed to shed light on three key issues:

A. What is the current state of progress in the adoption of sustainable investing?

B. Why is sustainability facing headwinds from different sources?

C. What best practice is being developed by these global players to overcome these challenges?

Each issue is covered in the three subsections below.

“

Markets usually price in inflection points when they are in the rearview mirror.”

A Canadian pension plan



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



1. Progress along the Spectrum of Capital

a. Adoption so far

Currently, there are over 80 different terms used to describe a mind-boggling array of approaches that have emerged under the umbrella of ‘sustainable investing’.

To chart the way forward, many early adopters in our interview survey for this section use the schematic entitled the ‘Spectrum of Capital’, which was developed by *The Impact Management Project*⁸, as shown in Figure 3.1.

It envisions sustainability as a progressive journey that focuses on the

financial and nonfinancial goals targeted by investors as they advance in different stages. These two sets of goals are accorded separate and varying weights in investor portfolios, as they progress from left to right in the figure.

The term ‘sustainability’ is used broadly to describe the journey along this spectrum.

In the last decade, the journey mostly involved the exclusion of ‘sin’ stocks: shares in companies associated with activities deemed unethical — like tobacco, weapons, fossil fuels, abuse of human rights and poor labor standards.

Figure 3.1 The Spectrum of Capital

	1	2	3	4	5	6	7	8
Investment approach	Traditional	Responsible	Sustainable	Impact-driven			Philanthropy	
Financial goals	Deliver competitive risk-adjusted financial returns				Tolerate higher risk	Tolerate below market returns	Partial capital preservation	Accept full loss of capital
Impact goals	Avoid harm and mitigate ESG risks							
	Benefit all stakeholders							
	Contribute to solutions							
	Don't consider; may have significant negative outcomes for people and the planet	Avoid harm; try to prevent significant effects on important negative outcomes for people and the planet	Benefit effect; important positive outcomes for various people and the planet	Contribute to solutions; have a material effect on important positive outcomes for underserved people or the planet				

Source: The rise of impact — five steps towards an inclusive and sustainable economy; UK National Advisory Board on impact investing 2017 & Impact Management Project 2017



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



The process of negative screening narrowed the investment universe somewhat and reduced the scope for diversification. Thus, exclusion and diversification were not always compatible.

Hence, most of the large institutional investors have been advancing towards the right end of the Spectrum into illiquid markets — infrastructure, private equity and private debt — to target societal as well as financial impacts, while still generating market-rate returns (Levels 4–5). In part, this is because these asset classes have customized vehicles of much longer duration with clear metrics and monitoring.

In contrast, in public markets, the same investors' interest in sustainability has largely progressed to Levels 2–3 due to a variety of challenges, such as the lack of reliable data on sustainability issues, as we shall see below.

There are regional differences, of course. Overall, in all asset classes, Europe leads the pack, followed by the US and then Asia Pacific.

These regional differences reflect the stance of public policy and regulatory responses, as well as cultural differences. These are well documented⁹. Among them, far and away the most ambitious program promoting sustainable investing has been enshrined in the EU's *Action Plan: Financing Sustainable Growth*.

Most importantly, the EU Council of Ministers has recently committed to convert its *Green Deal* into law by March 2020, which envisions the EU achieving carbon neutrality by 2050 in line with the Paris Agreement.

The ambition envisions a significant role for asset managers in its delivery. It also envisions intergovernmental co-operation on a scale far bigger than now. Acting alone, neither asset managers nor individual nations can make a big impact.

b. Root causes of the problem

The central thrust of the emerging policy framework is directed at one overriding aim: to tackle negative externalities resulting from those day-to-day corporate activities that inflict uncompensated costs on wider society.

They include environmental damage, governance lapses, poor labor practices, stagnant incomes, the hollowing out of the middle class and rising inequalities.

These have ignited a powder keg of resentment in the West and fueled the rise of populism.

Markets have been slow to fully price in these risks — especially climate risk — while quarterly capitalism continues to retain a decisive influence. Under it, investors are overly influenced by quarterly earnings.

Over time, sustainability will likely have a growing impact on company valuation and cost of capital. Thus, by not acting to future-proof their businesses now, many listed and private companies risk harming the interests of their shareholders as well as those of wider society, not to mention their own long-term financial viability. This much was clear from our interviews.



With governments, regulators, asset owners and asset managers seeming to pull in the same direction, it is hard to believe that we are not in the midst of something profound.”

A Danish pension plan



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



Thus, sustainable investing is first and foremost about future-proofing businesses against secular forces that can cause existential threats, while generating positive spin-offs for the wider society (case study 3A).

Hence, in their role as allocators of finance, capital markets are viewed as an essential bridgehead to a more purposive capitalism, as institutional investors seek to future-proof their own portfolios against the looming risks in the separate areas of environment, social and governance. The fiduciary responsibility currently enshrined in their articles of memorandum tend to

focus narrowly on shareholders and their financial interests.

Of course, capital markets alone cannot tackle the negative externalities: in the area of global warming especially, intergovernmental co-operation is vital. But markets are viewed as the strongest link in a mutually reinforcing chain involving three other sets of partners: governments, using their supportive tax and trade policies; technology, delivering innovations in cost-effective green energy; and consumers, favoring pro-sustainability products.

“Sustainability is the biggest leadership challenge of our age. Leaders can make a huge difference.”

A Canadian asset manager

Case study 3A: Sustainability is a leadership issue

Our sustainability initiative started some 15 years ago, with a sole focus on ethics: We screened out shares in companies associated with activities deemed undesirable like weapons, fossil fuels, tobacco and human rights abuses.

Not only were these activities morally wrong in themselves, but they also imposed negative externalities — uncompensated costs — on the whole of society, hurting future growth and prosperity.

Our belief was that the rise of sustainability would, over time, change the ecosystem of markets that had long relied primarily on financial metrics to value individual companies.

Hence, we focused on companies that were enhancing

their own sustainability, so as to deliver decent risk-adjusted returns.

Our initial forays into ethical funds were not successful because dumping ‘sin’ stocks yielded handsome profits to those who bought them. All that happened was a change in share ownership.

Markets had not woken up to the fact that investors were expressing their personal values via investment choices.

As CEO of the company, I persuaded my colleagues that, as a mid-sized player, we could only differentiate ourselves by pioneering sustainability at the heart of our business model.

We have evolved a culture that links it to our core business values, our leadership

competencies, our business behaviors, our talent pool, and our systems and processes.

Our sustainability DNA has reoriented our business to ‘do good and do well’ by continuous improvements in our capabilities and track record over time.

Around 80 percent of our assets now cover sustainability funds of one variety or another. Of these, around a third rely on specific ESG themes that target financial and nonfinancial outcomes. Our total assets under management has doubled in the last 5 years.

Our people are excited to work for us because they believe in our core value that finance has to give something back to society as well as making a profit.

A Benelux asset manager



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



c. Setting the tone at the top

This laudable aim marks a sea change from the traditional way of investing, which has long targeted risk-adjusted returns, assessed mostly on financial criteria.

For individual asset managers, the implied shift has huge implications in a number of areas in the value chain: research, investment process, stock selection, portfolio construction, talent pool, staff incentives, fund pricing, distribution, client engagement, and performance reporting.

It all adds up to combining the best of old and new in order to re-anchor markets in the transition to a low-carbon future.

In this context, our discussion with early adopters identified two related salient points.

First, sustainable investing is essentially a leadership issue. It requires a strong belief that the old ways of investing that ignore negative externalities are self-defeating: they will increasingly harm shareholders and society over time, while undermining the role of markets in the efficient allocation of capital.

Leaders must question the purpose of a modern corporation in order to give it better social expression. They must set the tone and lead by example, as they face what is veritably a new foundational trend that is reshaping investing as we know it today.

But, as case study 3A shows, it's the long haul that requires vision, passion and persistence. Transition to a low-carbon future is likely to have a jagged trajectory owing to various barriers.

Second, sustainability investing is primarily driven by institutional investors. Worldwide, total sustainable investing assets under management was more than US\$30 trillion in 2018, representing around a third of the investment universe, according to recent estimates¹⁰. It has been influenced by a large body of trans-Atlantic research that shows that sustainable investing works².

As for emerging markets, data are sparse. But significant changes are afoot on the corporate governance side, which is vital for the efficient allocation of capital that delivers long-term growth and sustainability. Good corporate

governance can also translate into lower overall corporate risk, as governance can set standards for environmental and social goals. This is especially the case in emerging markets (case study 3B).

There, transparency is a big slow burn issue because of the unique concentration of corporate ownership in the hands of individual families or government bodies; further complicated by a myriad of cross-shareholdings that often compromise the interests of minority shareholders.

“
Rising short-termism
has turned investing
into a game of chasing
the next rainbow.”

A UK asset manager



1

Executive
summary



2

The rise of ESG
in the hedge
fund industry



3

The rise of
sustainable
investing



Case study 3B: Emerging markets face a stiff test

Over the past 40 years, breakneck industrialization has lifted over 750 million people out of poverty in emerging markets (EMs).

But as an unintended consequence, environmental, governance and social issues have been seen as the responsibility of governments, not companies.

However, corporate governance has come under the spotlight, especially as EMs' share of global stock market capitalization has more than doubled so far in this century to around 30 percent in 2019.

Our experience shows that checks and balances between a company's board, its management and its shareholders are weak in most EMs.

Internal systems and controls that help the board to effectively incentivize and monitor management in the best interests of shareholders and wider society are not so well developed — as of yet.

Lately, however, with the worldwide rise in passive investing, a big positive push has come from many large listed companies, as they up their governance game to qualify for entry into major EMs' indexes.

A majority-independent board, meritocratic executive incentives, robust capital allocation criteria and an engagement mechanism that focuses on reducing financial and nonfinancial risks — these imperatives have come to the fore, as index funds have taken off.

To reinforce these requirements, index providers are also increasingly demanding accessibility, efficiency and transparency of capital markets in emerging economies, all of which requires a robust regulatory framework.

Such efforts reinforce what many regulators worldwide are trying to do in earnest: reorient markets towards sustainability risks.

As in developed markets, so in EMs, all the moving parts in the sustainability revolution are pulling in the same direction. Progress is slow but the direction of travel is clear.

A global US asset manager



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



2. Factors slowing progress

Three sets of barriers were most frequently cited by early adopters in general and institutional investors in particular.

a. Coping with shorter investment horizon

Over the past 20 years, what has passed for active asset management has largely been the second-order trading of existing assets, the main focus being trying to anticipate the behaviors of other investors.

Under this argument, some institutional investors suggest that financial markets are no longer a conduit between savers planning for a decent retirement nest egg and borrowers deploying their savings to create wealth, jobs, skills and prosperity.

i. Trading vs. investing

The result of this, as per the view of some investors, has been shorter time horizons, unrealistic expectations, more momentum trading, a higher velocity of trades and the constant search for hot products. Long-term investing has come to be full of opacity, such that commitment to it exists at the outset until investors resolve is tested by time and events.

A decade of zero-bound interest rates has enabled companies on both sides of the Atlantic to inflate their share prices via borrowings that have mostly gone into stock buy-backs and outsized dividends. As per the view of some investors, companies seem to have been under pressure to distribute cash to shareholders rather than invest it to improve their long-term prospects, resulting in lower growth in the future.

Such practices haven't gone unnoticed. Large institutional investors with liabilities stretching out over decades have been their most vocal critics. They are forming coalitions that promote climate action and better sustainability methodology by, amongst other things, fostering long-term investing.

Climate Action 100+ and the Impact Management Project are just two of the most prominent examples. That apart, individual pension plans have been discouraging activities that promote a quick-buck mentality. Other asset owners have been petitioning regulators to codify rules on sustainability disclosure to promote long-term investing.

The foundational short-term problem is not that stock market pressure dislodges firms from the right technological path, but that it forces faster and deeper change than before, which induces a negative reaction in corporate, employment, judicial, and political circles. More people feel vulnerable. Sharper technological shifts and enhanced global competition are the cause; stock markets are the messenger.

ii. Regulators flexing their muscles

For their part, regulators, too, have been responding.

The EU's Second Shareholder Rights Directive, effective from June 2019, sets out to remedy the situation by strengthening the role of shareholders, enjoining them to act like active owners, rather than distant holders of paper assets; and demanding commitment to sustainability in reporting requirements. Similar aims are deeply embedded in the latest governance codes in Japan and the UK.

Indeed, the regulatory tempo has increased. Over 500 separate measures have been enacted worldwide in the last decade, according to the PRI responsible investment regulation database.

Among others, these rules and regulations seek to escalate new disclosure requirements from companies, securities issuers, asset owners and asset managers. They also enhance the definition of the fiduciary duty of a pension plan to include societal considerations. In the past, its focus was solely to maximize the financial gains that can provide a regular decent retirement income for their members.

“

Guidelines on how to assess what is 'good' and 'bad' are rare. There are no agreed definitions.”

A US asset manager



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



b. Climbing a steep learning curve

Another key barrier is data challenges. At the heart of sustainability sit three foundational concepts that have proved hard to quantify: materiality, intentionality and additionality (case study 3C).

Respectively, they seek to assess how material sustainability factors are to a company's financial performance and the risks that can affect it; does the company really intend to act on them and 'do good' via its products, services and interactions with wider society; and does it generate societal benefits in addition to financial benefits?

So far, each of these areas have relied on blending existing data with judgment calls.

Learning-by-doing remains the principal vehicle for climbing what looks like a steep learning curve.

i. Heart of the matter

The crux of the problem is that there is no universal acceptance of what a 'good' company is in practice. With rare exceptions, therefore, governments do not mandate companies to provide data on the aspects that matter for sustainable investing.

Article 173 in the French 2017 transition law broke the mold by requiring mandatory carbon reporting for listed companies as well as pension investors. Other EU jurisdictions have followed suit.

“

Materiality is hard to ascertain with the current generation of data. We are forced to make judgment calls.”

A Dutch asset manager

Case study 3C:

The Achilles' heel of sustainability

Far and away the biggest barrier to sustainability investing so far has been the lack of a robust template with consistent definitions and reliable data on how companies score on various sustainability factors.

Worldwide, there are over 150 major data vendors, each with their own proprietary definitions and data sources.

The result is that companies in the same investment universe end up with radically different scores from different vendors.

But we are a long way from having real-time reliable data that can enhance market depth in sustainable funds.

Data coverage, on the whole, is far better for larger companies that

typically have better disclosure procedures than the rest. The rise of big data has been a major boost for all data vendors.

But information challenges persist on three of the most pertinent issues for investors: materiality, intentionality and additionality.

It is hard to ascertain these issues because most of the data are self-reported, raising questions about reliability and consistency. The implied volunteerism has given rise to whitewashing on the part of corporates: selective focus on good scores and ignoring the rest.

Their coverage is mostly limited to this decade such that their time series are not long enough to facilitate statistical modeling that typically underpins asset

selection. The data are updated annually so it is hard to assess progress on sustainability scores more frequently.

For now, we are making do with what data we have. Our experience shows that it is not the sustainability scores themselves, but the rate of change in them — in either direction — that moves their share prices.

Markets seem to have rewarded those who have improved their game the most, including carbon polluters.

A key contributory factor is the media publicity generated by shareholder engagement with the companies involved.

A Dutch pension plan



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



Even so, four problems persist in all fund jurisdictions.

First, currently, there is no universally agreed upon terminology that can help to create a common language and mental models about sustainability at a statistical level. Trade associations and advocacy groups worldwide are collaborating extensively to bridge the gap.

Climate change, being an inexact science from an investor perspective, presents formidable challenges in measuring the carbon footprints of companies. The task of establishing a clear line of sight between climate change and investment outcomes is fraught with as many unknowables as unknowns.

Second, getting consistent data on sustainability scores and performance measures remains a difficult task even with the presence of more than 150 major data vendors, each with their own proprietary definitions and methodologies on materiality, intentionality and additionality. In the absence of a standardized format, the result is often a radically different assessment of the same company from different sources. The problem is compounded by the fact that most of the required data is self-reported, selectively focusing on good news and filtering out bad. As a result, many asset owners prefer to pursue sustainability via passive funds that require least governance oversight and data demands on them.

Third, when it comes to avoiding 'sin' stocks, it is unclear at what threshold a company is to be classified as 'bad'. For example, many conglomerates have a small exposure to defense weapons. Any ceiling is bound to be arbitrary¹¹.

Similarly, when it comes to ESG investing, it is unclear how much weight should be accorded to each of the three disparate components, without invoking value judgments.

Finally, in the area of climate change, two data challenges have proved daunting. One is having to factor in physical risks like forest fires and rising sea levels that are hard to predict. The other challenge is to measure a company's carbon footprint, which is defined to include emissions from its own operations as much as emissions from its supply chain at the upstream end and its customers at the downstream end.

Yet, these problems have not detracted from two parallel developments, according to the participants in our interview survey.

ii. Winds of change

The first one is that we are indeed witnessing the emergence of a new infrastructure of data, skills and technology on the ground. Data vendors are experiencing rapid consolidation. The rise of big data and machine learning is improving the quality and timeliness of the information. Progress may not be enough but it remains exponential. For example, the Impact Management Project alone has involved over 2,000 investment practitioners globally on how to measure, report, compare and improve impact performance.

Second, for smart investors, the identified problems give rise to all manner of informational inefficiencies in financial markets. As such, they are nothing more than concealed opportunities to generate alpha for those who are progressing fast up the learning curve.

“

Engagement will become the alpha behind alpha.”

A German asset manager



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



c. Partial evidence of success

With ever more money flowing into sustainable investing, a big question has come to the fore: Is sustainability a risk factor? Our interviews identified two groups: believers and pragmatists.

i. Believers

Believers argued that it is — but with one difference. It is a compensated

factor in Europe but probably less so in America or Asia Pacific (case study 3D).

Regionally, the environmental aspect was most evident in asset valuation in the US during 2014–17 but has since turned negligible¹².

Case study 3D:

Is sustainability a risk factor?

The rise of sustainability has naturally raised the question: Is it a risk factor — on top of the traditional ones like value, quality, low variance, size and momentum?

The main problem is that most risk factors are not readily observable. So, our portfolio managers are forced to use their proxies.

For example, value factor is associated with cheap stocks. But the evaluation of 'cheap' relies on metrics such as book-to-price or PE ratios.

In contrast, as yet, there is no agreement on the proxy metrics for environment, social and governance; nor on what weights to assign to each of them.

Traditional risk factors have gained credence over time as

more data have emerged to confirm their validity.

In contrast, being a relatively new phenomenon, sustainability lacks the database to underpin its status as a risk factor. But that does not make it unimportant.

First, there is a concerted regulatory push towards sustainability, as investors have earmarked some US\$30 trillion worldwide towards sustainable investments. It is hard to believe markets will not take note.

Second, the history of other risk factors shows that, once discovered, they remain uncompensated until they have been tried and tested by events.

We have been witnessing dramatic climate events in this

century as well as related high-profile corporate disasters — like the recent abrupt bankruptcy of Pacific Gas and Electric Company.

So, sustainability is gradually transitioning from being an uncompensated risk factor to a compensated one.

Third, our own research shows that sustainability is correlated with the traditional quality factor that relies on proxies that are broadly similar.

Even so, we use sustainability as a factor to deliver — at the very least — a more defensive portfolio by taking account of long horizon risks that are statistically hard to model.

A global French asset manager



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



Overall, governments and consumers in Europe have become stronger supporters of sustainability, especially after the 2015 Paris conference, which attracted widespread attention in the mass media.

Unsurprisingly, five European countries have made most progress in implementing carbon pricing, according to the latest OECD data. They are Switzerland, France, the UK, Italy and Germany. Capital markets have duly noted.

Believers cited two other arguments. To start with, their own analysis shows that sustainability has been a factor overall in this decade. But the time period for environmental, social and governance components has varied: they have not moved in tandem. This argues for a more granular approach when assessing sustainability as a risk factor.

Furthermore, together, these three components have served to provide

downside protection and much lower drawdowns in the pronounced risk-on/risk-off cycles of the last decade. In other words, sustainability has so far already proved a good capital conservation strategy in periods of volatility.

ii. Pragmatists

On the other hand, pragmatists argued that, for any return driver to be treated as a risk factor, it needs a long performance history over multiple cycles in multiple regions. So far, data on sustainability have been sparse, covered a short time horizon and been beset by various caveats. This relative sparsity of data creates problems for many among the current generation of research analysts and portfolio managers. They are trained skeptics: Their craft blends data with personal judgment — cultivated over years of chasing financial returns via in-depth research. For them, investing is a bet on an unknown future.

Hence, they need evidence that something has worked well in the past within a replicable investment process, backed by a clear thesis. For many of them, sustainability is a nascent phenomenon. They remain to be convinced about its upsides. After all, their own incentives favor consistent returns year on year.

“Unless asset managers act like active owners on our behalf, sustainable investing will not meet our expectations.”

A Hong Kong institutional investor



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



3. Developing best practice

The challenges outlined above — namely, short-termism, data shortcomings and lack of robust impact evidence — have only intensified efforts to develop practical solutions. Two areas have been prioritized: active ownership and smarter implementation, as described separately below.

a. Active Ownership 2.0

It is now widely accepted that sustainability best practice involves enriching the current infrastructure of data, skills and technology with shareholder activism that targets real-world outcomes at scale.

Its principal instrument is direct engagement with investee companies that seeks to understand the reality on the ground and be a change agent in reshaping it for the better. More than that, it's about gaining an informational edge via positive feedback loops in which ideas beget ideas and information begets information. Such loops blend

data about a company from a diverse set of sources with information emerging from direct engagement with it as shown in Figure 3.2.

Notably, some pension plans see engagement as a source of what they call 'structural capital': knowledge about how sustainability is playing out on the ground and where alpha opportunities are likely to arise, as companies improve their sustainability credentials. After all, it is widely accepted that it is the increase in sustainability score — rather than absolute levels — that drives performance. The aim is to identify companies, via engagement, with a virtuous trajectory, as opposed to those exposed to controversy.

i. Pragmatism presides

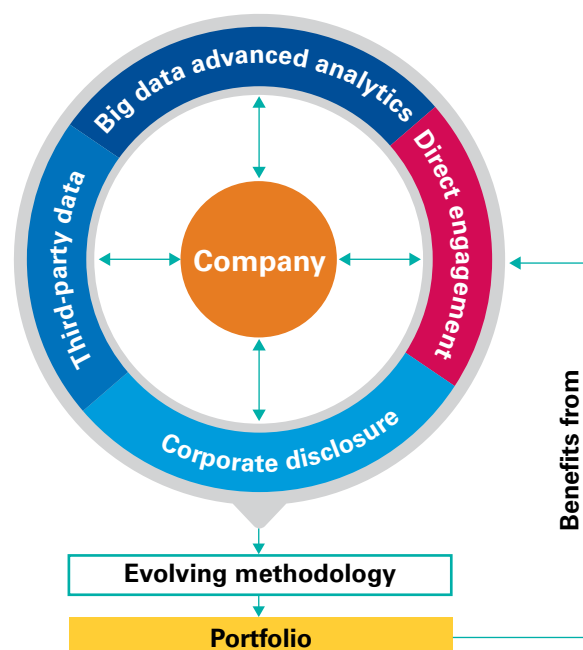
In this context, investors face two choices: divest or engage.

The former is appealingly simple: Cut off the flow of funds to society's corporate 'villains' and they will collapse from capital

“ Our neglect of socio-environmental issues will shock future generations, just as our predecessors' neglect of slavery shocks us today. ”

A French institutional investor

Figure 3.2 Active ESG



Source: Neuberger Berman, 2019



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



starvation and sacrifice the diversification benefits as a trade-off.

Instead, there is growing preference for a pragmatic 'carrot and stick' approach. Selling 'sin' stocks, for example, to others without similar concerns often ends up with the latter buying shares at less than the prevailing market price and pocketing the profits; while the business models of the villains remain unchanged.

Besides, when it comes to fossil fuel companies, voting with your feet does not work, since most of them now sit on a large free cash flow, with much less reliance on capital markets.

Hence, the more effective channel for changing corporate behaviors is direct

engagement with investee companies — often in collaboration with other investors to exercise maximum leverage. It is based on the belief that those who are part of the problem can also be part of the solution.

Engagement can be an intensive drawn-out process. But if all else fails, then our interviewees have been unafraid to exercise the nuclear option: divestment.

In sum, data provide the breadth of information, engagement provides the depth. Together, they make a powerful combination as investors and their asset managers progress up the learning curve, via collaboration with their peers within various global networks (case study 3E).

“
The days when
stewardship was a
box-ticking exercise
using a boilerplate
narrative are gone. We
are mandated to be
agents of change.”

A UK pension plan

Case study 3E: An owner, not a trader

Engagement is not a 'once and done' exercise but a long haul. It seeks to wean investors off a deeply ingrained addiction to quarterly numbers.

Our research shows that, on a 5-year view, companies with poor sustainability scores have higher idiosyncratic risks and higher beta. We have such companies in our portfolio.

That leaves us with two choices: One is to dump them; another is to encourage these laggards to up their game. We have done both.

Principally, we require them to use the reporting framework of the Task Force on Climate-related Financial Disclosures, with a strong focus on carbon footprint and the actions taken to reduce it.

We are also demanding regular reporting on various governance aspects such as board independence, executive compensation, risk dashboard, employment practices, gender diversity and community-related activities.

We vote at AGMs and back that up with year-round conversations with top executives, in order to deepen our relationships in the targeted companies. In 2019, we engaged with over 800 major companies, via face-to-face meetings, conference calls and emails.

We enhance our leverage by subscribing to the UK Stewardship Code, the Japanese Stewardship Code, the US Forum for Sustainable and Responsible Investment, the Carbon Disclosure Project, the Sustainability Accounting

Standards Board, and Climate Action 100+.

The UK Stewardship Code, hailed as one of the best globally, is being refined this year.

The previous one asked for policies, procedures and basic disclosures from institutional investors. In contrast, the new one requires evidence-based disclosures from us as to how these policies are actually implemented on the ground.

More notably, it also enjoins our board and C-suite executives to receive and approve the stewardship reports and put their money where their mouth is.

The new code has shifted the burden of proof to us by mandating us as the agents of change.

A UK pension plan



1

Executive
summary



2

The rise of ESG
in the hedge
fund industry



3

The rise of
sustainable
investing



ii. Progress is slow

In general, though, positive investor action is the exception rather than the rule so far, according to a recent report from the PRI¹³. Many investors do not — as yet — have policy advocacy functions that could move the needle on some of these issues.

To cynics, therefore, engagement may smack of box-ticking. Not so, according to a previous paper from the PRI¹⁴.

Its research shows that engagement can and does promote a constructive dialogue that facilitates the exchange of information, sets expectations, seeks specific actions and builds trusting relationships on the ground.

It promotes new learning in the belief that ideas breed ideas and collaboration can devise solutions that meet the requirements of both parties.

Finally, it navigates internal politics within both parties that have often promoted the box-ticking that has long undermined genuine catalysts for change.

b. Smarter implementation

Templates for improving the effectiveness of sustainability have been produced by various national and international bodies.

One that was widely used among our interview survey participants was from *mallowstreet Insights*, a research center providing pivotal inputs to pension trustees and their asset managers¹⁵.

Its own research shows that, for pension plans, sustainability capabilities are the most important factor in manager selection because the majority of plans do not as yet have the requisite resources. Hence, they tend to rely on their asset managers to make all the key decisions on sustainability.

So, asset managers should concentrate on four areas to achieve best practices in implementation: data, integration, clarity and articulation.

i. Data

Taking them in turn, the ability to measure sustainability impact is central to its reporting. As regulators in the West step up their efforts towards disclosure guidance in line with the Task Force on Climate-related Financial Disclosure recommendations, asset managers should step up pressure for quality improvements in their data supply chains.

Lack of requisite data remains a major impediment — what cannot be measured cannot be reported. The current situation provides ample scope for greenwashing — repurposing of funds to give them a green label as a marketing gimmick. It also gives rise to whitewashing at the investee company end — massaging the data to overstate improvements. Both are detrimental to the sustainability brand. Investors are especially keen to know how reliable sustainability scores are, how they are changing over time and whether they are reflected in the value of assets they hold.

“Sustainability will have its own version of the core-satellite model.”

A UK asset manager



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



ii. Integration

The second area is integration. Asset managers need to have an integrated approach to sustainable investing, embracing at least one of two levels that are meaningful to investors: core and specialist (Figure 3.3). Data problems dictate pragmatism in the core portfolio by including only those securities that rate high on both their alpha potential and their sustainability potential in the short and medium term. That way, poor data will not undermine performance, nor will the investment time horizon — if the portfolio includes securities currently underpriced on both criteria.

On the other hand, investors who wish to pursue specific sustainable themes should have access to thematic funds, with longer time horizons and variable performance. In other words, the core portfolio should embrace Levels 2 and 3 in the Spectrum of Capital (Figure 3.1) and the specialist should cover Levels 4–6. Investors are especially keen to see sustainability investing evolve along this dual line.

iii. Clarity

Asset managers should provide explanations at a more granular level on how implementation is done at the fund or mandate level. This includes seven components: the statement of its investment policy; its link with international standards; the data sources used; their real-time tracking; the definitional templates used; corporate engagement policy; and resources dedicated to engagement practices and their outcomes.

Investors are especially keen to know that there is a direct line of sight between sustainability policy and the practices that deliver its impact on the ground.

iv. Articulation

Asset managers should provide better sustainability articulation in the fixed-income space. Currently, attention is centered on equities where data availability is less constrained and engagement is a lot easier via proxy voting, attendance at the AGM and year-round conversations. In contrast, fixed-income instruments are perceived as overly quantitative, relying on interest rates, inflation, credit quality and liquidity risks.

“Actions on climate change are no longer equated to tree-hugging and back-door socialism.”

A Swiss institutional investor

Figure 3.3 How ESG is evolving



Source: QMA, 2019



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



There is a perception that lenders do not have the right to engage because their investments come with protections at the expense of voting rights. Hence, investors are especially keen to know how effective sustainability criteria are currently exercised at two stages: the initial screening when the investment is first made and the refinancing stage when a bond matures.

Some asset managers already do this by adopting the approach set out in Figure 1.9 in the Executive summary. And the pace is set to accelerate as more sustainability funds flow into the fixed income space.

In addition to the above four areas, institutional investors in our interview survey also identified a fifth one where the needle needs to shift significantly.

v. Financial and nonfinancial alignment of interests

Worldwide, fee compression is the norm in the asset industry. It is most evident in new mandates, while legacy assets remain locked into the age-old fixed percentage fee linked to assets under management. While encouraging asset gathering, this asymmetric structure rewards asset managers irrespective of outcomes. It also generates windfall gains in rising markets as the icing on the cake.

As more assets go into sustainability funds, a meritocratic fee structure will have to be the norm in the active space. In contrast, in passive investing, where price wars have been fierce lately, stewardship has to be a key point of competition.

Furthermore, alignment is no longer just about having fees that offer equitable sharing of gain and pain with clients. It is also about having alignment of investment beliefs and time horizons over which investment goals can materialize.

The current approach — often influenced by herding and past performance — is fraught with ‘wrong time’ risk and ‘regret’ risk: Investors buy high and sell low, only to lament later on. Many of them have not been too clear about beliefs on which their investments are based; nor about the time horizon over which their goals are expected to materialize.

Accordingly, an essential element of engagement between asset managers and their clients is to align beliefs and time horizons when it comes to sustainable investing. Fee structures are moving in the right direction as alignment deepens.

To conclude, therefore, the challenges identified in this section are the teething problems of a better form of investing.

Sustainability is set to morph into the new gold standard, as our societies seek to overcome the side effects of the turbocharged capitalism of the past 40 years.

Before then, sustainability is beset by its own challenges. But early movers see it as no more than a concealed opportunity to create businesses of enduring value — and profit from them.

Institutional factors are fast driving change. Pragmatism has been all too evident, with concerted action now in progress. There is an increasing realization that finance must give something back to society as well as making profit. Early results are encouraging.

Only responsible ownership and savvy implementation will deliver sustainability. They will also differentiate the winners from the losers.



1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



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1

Executive summary



2

The rise of ESG in the hedge fund industry



3

The rise of sustainable investing



Contacts

Regional contacts:

Andrew Weir
Global Head of
Asset Management
E: andrew.weir@kpmg.com

Greg Williams
Head of Asset Management
North America Region
E: gregorywilliams@kpmg.com

Darina Barrett
Head of Asset Management
EMEA Region
E: darina.barrett@kpmg.ie

Linda Elkins
KPMG Australia
E: lindaelkins@kpmg.com.au

Simon Townend
KPMG in the Bahamas
E: stownend@kpmg.com.bs

Mahesh Balasubramanian
KPMG in Bahrain
E: bmahesh@kpmg.com

Gary Pickering
KPMG in Bermuda
E: garypickering@kpmg.bm

Lino Junior
KPMG in Brazil
E: lmjunior@kpmg.com.br

Peter Hayes
KPMG in Canada
E: phayes@kpmg.ca

Anthony Cowell
KPMG in the Cayman Islands
E: acowell@kpmg.yk

Steven Hunt
KPMG in the Channel Islands
E: stevenhunt@kpmg.com

Bonn Liu
Head of Asset Management
ASPAC Region
E: bonn.liu@kpmg.com

Tomas Otterström
Global Leader
Sustainable Finance Services
E: tomas.otterstrom@kpmg.fi

Jon Mills
Global Leader
Asset Management Audit
E: jon.mills@kpmg.co.uk

Vivian Chui
KPMG China
E: vivian.chui@kpmg.com

Jan Hove
KPMG in Denmark
E: jahove@kpmg.com

Gerard Gaultry
KPMG in France
E: ggaultry@kpmg.fr

Hans Volkert Volckens
KPMG in Germany
E: hvolckens@kpmg.com

Frank Gannon
KPMG in Ireland
E: fgannon@kpmg.com

Russell Kelly
KPMG in the Isle of Man
E: russellkelly@kpmg.co.im

Giulio Carlo Dell'Amico
KPMG in Italy
E: gdellamico@kpmg.it

Ryuichi Murasawa
KPMG in Japan
E: ryuichi.murasawa@jp.kpmg.com

David Neuenhaus
Global Leader
Asset Management Tax
E: dneuenhaus@kpmg.com

John Cho
Global Leader
Institutional Investors Group
E: johncho@kpmg.ca

David Capocci
KPMG in Luxembourg
E: david.capocci@kpmg.lu

Jeroen Van Nek
KPMG in the Netherlands
E: vannek.jeroen@kpmg.nl

Andrew Thompson
KPMG in Singapore
E: andrewthompson8@kpmg.com.sg

Francisco J. Muñoz Neira
KPMG in Spain
E: jmunozneira@kpmg.es

Markus Schunk
KPMG in Switzerland
E: markusschunk@kpmg.com

Rachel Hanger
KPMG in the UK
E: rachel.hanger@kpmg.co.uk

Jim Suglia
KPMG in the US
E: jsuglia@kpmg.com



1

Executive
summary



2

The rise of ESG
in the hedge
fund industry



3

The rise of
sustainable
investing



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