The wheat and the chaff: Man Group's case study in rating an RI Fund

INTELLIGENT RI

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As responsible investing becomes default best practice, it is increasingly important that allocators can separate the wheat from the chaff, distinguishing genuine responsible investment managers from those that greenwash. Below, we provide a case study that sets out the best practices for allocators.

Let's assume that a discretionary trading hedge fund firm is demonstrating its RI credentials to the allocator using a recently traded buy position in an oil and gas company.

- While the portfolio is managed under a positive screening RI policy, it is explained to the allocator that this does not mean that companies in the oil and gas sector are automatically excluded. However, it does mean that the investment manager should be able to demonstrate the positive screening process, and how it seeks to invest in companies which lead on RI issues in the oil and gas sector.

- The hedge fund firm has recently enhanced its existing order management systems to require the investment analyst to enter a RI narrative as part of the investment thesis submission process; the firm is able to demonstrate this by walking the allocator through its system. (Note that if the investment manager operates a more manual process, then it is important for the allocator to be able to walk through this process with appropriate personnel at the hedge fund firm and understand any control features that formally embed the RI policy into day-to-day investment activity; engaging with a controller at the investment manager, such as the COO or CCO, should provide the allocator with a good insight into this embeddedness and arguably better manage potential conflicts.)

- The firm is able to demonstrate to the allocator that its investment committee challenged the analyst over the proposed trade's RI credentials before approving it (the committee meeting is minuted to provide a permanent record). The firm's analyst successfully argued that the oil and gas company's direction was positive: it had recently expanded its operations by buying windfarms, and its annual report had set a target that 50% of revenue would come from renewable energy sales by 2030. In addition, while the oil and gas company had below average ratings on ESG metrics compared to the broader indices, it was the best performing energy company within the oil and gas index. (Note that for higher volume discretionary trading strategies, or multi-portfolio manager firms who each may follow different RI strategies, investment decisions maybe made at a portfolio manager's desk. As such, it is important for the allocator to understand how the RI investment factor is formally presented in the research thesis document and that this written form is stored centrally in the firm's systems and is accessible by the firm's controllers.)

In summary, not only should the trade be justified on an economic basis, but the fund has a formal mechanism for decisions to be challenged (the investment committee or other formal process), with the CIO or portfolio manager taking a lead by acting as a 'red team'. Moreover, by keeping formal records of the initial analysis, the challenges presented and an ongoing plan to monitor the investment, the fund has a clear methodology which ensures that decisions are defensible on an RI basis. If the oil and gas firm does fail to make progress towards its target, this will become apparent, and the fund can either increase pressure on the management or exit the position – both actions would avoid a charge of greenwashing.

At this point, we would stress that the above case study is an example of best practice. Because of the relative novelty of RI investing, not all firms are likely to have such a process in place. Furthermore, for smaller funds, processes may be more informal: a fund with a team of two may have a robust level of challenge when researching positions, but it is likely that a lot of this may take place informally. As in all businesses, large funds have more resources to create formal procedures, and as such, investors should adjust their expectations accordingly. Note that this does not mean that investors should lessen their standards, but should instead recognise that smaller organisations are likely to have fewer resources (both personnel time and finances to enhance existing research databases) in an effort to formally embed the RI nuances.

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