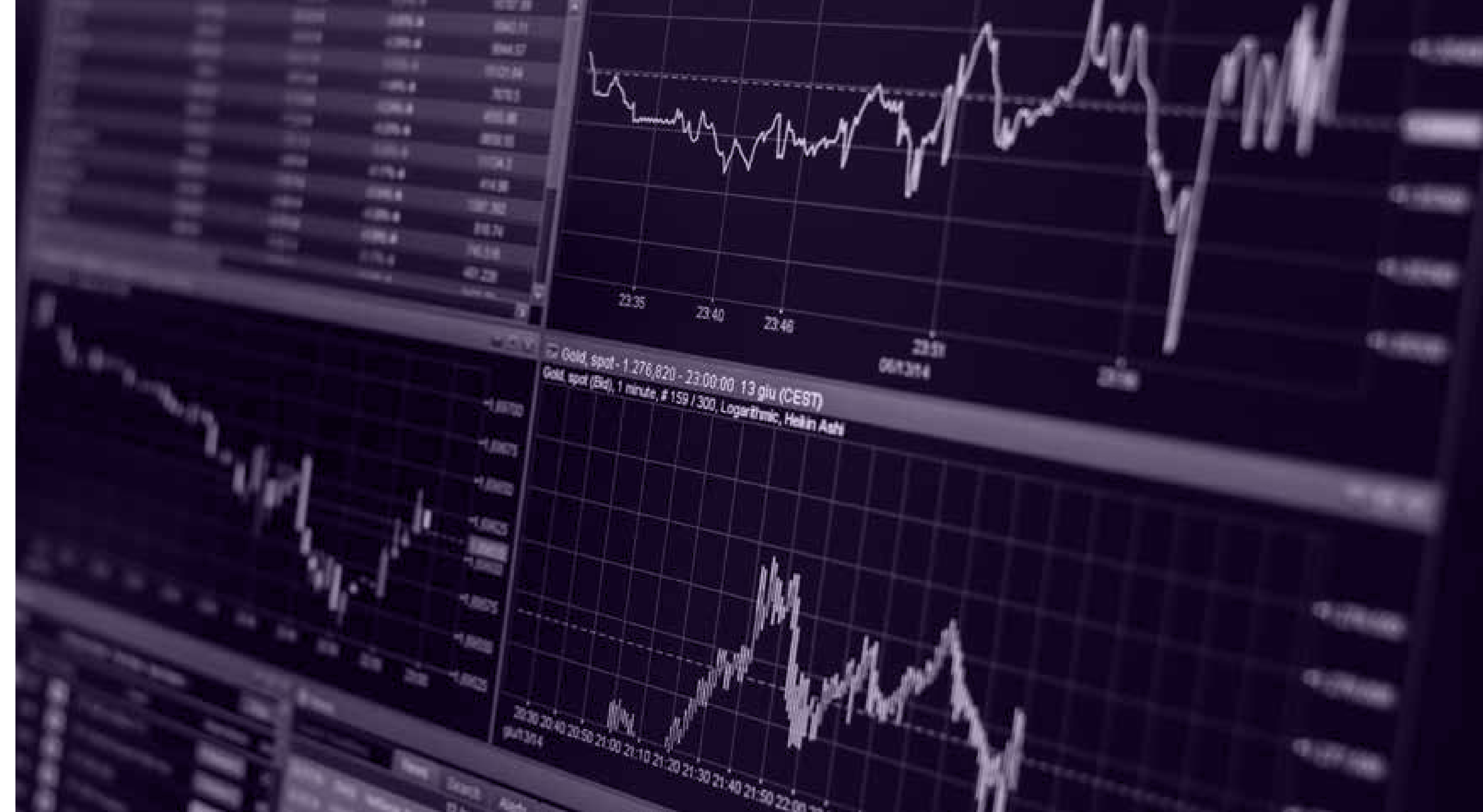

Lessons learnt from a challenging year and ESG-integration trends

In December, **Tell Media Group**, in cooperation with **Aberdeen Standard Investments** and **AXA IM Chorus**, invited investors to a roundtable discussion on hedge funds. Tell Media Group founder Niklas Tell and FBNW editor Janina Sibelius moderated the discussion.

By: **Niklas Tell**

The discussion started with Niklas Tell asking the participants to list the biggest surprises, good or bad, when it comes to the hedge fund space over the past year.

TEEMU AHONEN: "This has been an extraordinary year in terms of how we invest and also with a surprising macro environment that nobody has experienced before. We're obviously still in the ex-post analysis phase but I think the past year has really showed how different styles and variations of taking risk actually perform. And it really dispelled the myth about historical high Sharpe-ratio strategies, which really underperformed, and it showed the inbuilt fragility of these strategies. However, in the end central bank activity bailed out a lot of these strategies. For me, the biggest observation is that you really have to split your strategy groups into what is mean-reverting or non-mean reverting and if it's long convexity or short convexity. You really have to be 100 per cent clear about what type of strategy you run when you're exposed to these funds. On a positive note, active management made a comeback and you've been able to make very good returns while having a consistent approach to taking a risk. I think cheap convexity was massively rewarded but on the other side of the coin was every type of carry game, which people had leveraged or over-leveraged. That didn't perform at all. The conclusion is that your manager selection and the style you select is becoming even more critical. A final point is that we need to ask what role hedge funds serve in a portfolio construction framework. Does your hedge fund allocation really enhance your efficient frontier in asset allocation terms or is it more esoteric risk you take on? These are questions that we had already thought about deeply but, if anything, that debate is even stronger now."

AUGUSTIN LANDIER: "It has, of course, been an eventful environment to say the least. I think one of the big lessons for me as a quant is that there's really no vaccine against crowding if you trade factors. For us, concern about crowding was a very big theme and we had decided pre-crisis to work on being uncorrelated to factors such as momentum and value. We were successful navigating this environment with our equity market neutral strategies because we had decided to pivot away from trading such classic factors. Another takeaway of the year is that, contrary to what many people believe, even in times of market turmoil, there's still a lot of structure and predictability in stock returns and behavioural economics offers a great lens to look at this. It's not like the market just does crazy random stuff – even in panic times there are lots of structure in the cross section of returns. As an economist, I must say I was surprised by the speed of adaptation of the economy to the Covid shock during the spring. If you take a country like France, for example, the economic cost of the second lockdown was much smaller compared to the first because people had found ways to adapt production and consumption to the constraints. My last point relates to ESG. I was happily surprised that all ESG themes basically came out reinforced from this crisis and I think it's really interesting to think about why that is. I was very involved in ESG before the financial crisis and wrote a book in 2006 on the ESG factors and how they could be used by quants. However, just after the financial crisis, the ESG themes sort of lost their traction. It was like a long winter for these themes but it's exactly the opposite effect with this crisis. Now these themes have been reinforced, probably because the crisis emphasises the importance of externalities."

MIKAEL HAGLUND: "It has been a very interesting year, as described already. We basically had a mini-cycle with a good start to last year, a huge crash and then a recovery. We've also seen violent and quick sector and factor rotations, so it has been a testing year for many strategies and it has also resulted in a larger degree of return dispersion. For us, it has been a year of alpha opportunities and, except for the crash in March, it has also been a market where a fundamental analysis and security selection have played a bigger role than in the past. We've also seen a continuation of the narrow market with the tech sector leading the way. The big question, of course, is what will happen going forward and if there are structural factors behind the speed and the magnitude of the March sell-off and also the rotations we've seen. One explanation might be that we have more systematic players, which are also to some extent dictating liquidity. To us, there's less market liquidity, or at least less market liquidity in the way that most players want to have liquidity. When everyone is de-risking, we see a very large gap in liquidity. That will probably continue going forward."

DUNCAN MOIR: "I agree on what has already been said. If we look at the second half of last year, a big positive for us has been that stockpickers and long/short equity hedge funds have really captured this move up in equities. We've also seen a rebound among relative value managers, which have been able to adapt in order to capture the turnaround. I also think that Augustin had an interesting point regarding crowding in factors. This is something we've observed for several years with outflows from well-known big players but you also have a lot of traditional mutual funds that follow a similar approach of taking exposures to certain factors. We're talking about tens of billions of dollars coming out of these strategies in the last couple of years. In the last few months, we've noticed a pause in the outflows from the products that we track and we've seen some sort of stabilisation. I'm not calling a turnaround by any means. I'm not going to call the value turnaround in the academic value factor but we're definitely seeing some sort of normalisation, which is a good thing."

JANINA SIBELIUS: JARKKO, WOULD YOU AGREE WITH AUGUSTIN THAT THE ESG TREND HAS BEEN REINFORCED OVER THE PAST YEAR?

JARKKO MATILAINEN: "I do. We've seen over the last couple of years that ESG factors have meaningfully affected the pricing of the securities, especially in the equity markets.

PARTICIPANTS

- **TEEMU AHONEN**
  Head of absolute return, Ilmarinen
- **MIKAEL HAGLUND**
  Head of manager research, SEB
- **JARKKO MATILAINEN**
  Co-founder and director, NorthPeak Governance
- **DUNCAN MOIR**
  Senior investment manager, alternative investment, Aberdeen Standard Investments
- **AUGUSTIN LANDIER**
  Head of research lab, AXA-IM Chorus

ROUNDTABLE – HEDGE FUNDS

TEEMU AHONEN
Ilmarinen
Head of absolute return at the Finnish pension company Ilmarinen. He previously worked as a portfolio manager at the hedge fund Nektar Asset Management for four years and has also been head of alpha and a portfolio manager at Ilmarinen.

MIKAEL HAGLUND
SEB
Head of manager research at Sweden's SEB since 2015. Prior to that, he was head of portfolio solutions at SEB where he focused on portfolio construction in a multi asset and multi manager environment. In 2013, he also became responsible for selection and analysis of hedge funds across all strategies.

JARKKO MATILAINEN
NorthPeak
One of the co-founders of NorthPeak Governance. Prior to that, he was head of hedge funds at the Finnish pension company Varma. He has served as a member of the PRI hedge fund advisory board since 2014.

As that's becoming more visible for portfolio managers – they pay attention. I would also just like to add to the good and bad of the recent past. If this had happened some ten years ago, I think we would have seen meaningful business disruptions. It has been amazing how smoothly hedge funds been able to operate in this new environment. On the negative side, I must mention how we again and again seem to fall into the same asset liability mismatch problem. There's basically too much leverage in illiquid assets, which causes a lot of problems for managers and then for investors. And I think we were lucky in this instance that the rebound was sharp and quick because if this would have continued for a bit longer, I think we would have seen liquidations or problems within the funds holding illiquid assets. Now, the market saved these structures. This seems to be a continuing story that happens every now and then and I think we probably haven't learnt the lessons yet."

JANINA SIBELIUS: WE'VE TOUCHED ON THIS BRIEFLY ALREADY BUT WHICH TYPES OF STRATEGIES HAVE DONE WELL OVER THE PAST YEAR AND WHICH ONES HAVEN'T?

MIKAEL HAGLUND: "For us, it was discretionary strategies that fared better, while some systematic players have been more effected by the March selloff and also by the large rotations. This means that strategies such as global macro and relative value have been more fruitful. Long/short equity funds have also been good, especially the ones having some sort of beta exposure to the US and to the tech sector."

TEEMU AHONEN: "I think it's important to go back to what was happening during the crisis and what the crisis correlations looked like and ask yourself where the fire was burning. It was obvious in our books that anything related to relative value and mean reversion, such as value strategies and long-short, were under significant stress. Now we know, of course, what happened but you have to analyse and know how these strategies behave in a crisis. It's different to analyse the situation now. You have to analyse what happens during the time of stress – when correlations flip or when you have a big drawdown. You could argue that without a central bank intervention, the situation might be completely different. On the positive side, I think discretionary macro performed well during the crisis and we were also very happy with volatility strategies. Volatility strategies and long convexity products, which are hard to source, did extremely well also during the crisis. It's very important during a crisis when your whole asset allocation is under stress to know which strategies gives you breathing space and allows you to actually increase the risk taking. Another thing that I think proved its risk management capabilities were the platform funds: the larger hedge fund combinations that run multiple trading teams. Although it's seen as expensive, I think it paid off in this crisis."

NIKLAS TELL: HAS THIS CRISIS MADE YOU REASSESS YOUR LONG-TERM HEDGE FUND STRATEGY?

TEEMU AHONEN: "I think you always have to question your current portfolio. Do you think that macro is in some sort of a secular break or will this mean-reverting, central bank-driven and liquidity-driven investment environment go on from here to eternity? Then, the decisions you need to take will be different than if you think we're on the verge of a secular cycle where, for example, the deflationary or inflationary frameworks become a bit more volatile. Those are different types of environments. We obviously don't know the answer. Nobody knows but what we're trying to avoid is getting into stupid strategies and taking bets that we really don't want to take. What does it mean from a portfolio allocation view? Allocations into strategies like momentum and long volatility can be justified. As I said, we're making changes constantly to reflect our thoughts and I think this has definitely been an eye opener of how to construct the portfolios. We might also use hedge funds as a tool to have less correlation between our assets, which would allow us to take more equity risk. You don't have to do it via the hedge fund asset class but if you have a well-built hedge fund portfolio, you can actually use it to increase your risk-taking capability in other asset classes."

AUGUSTIN LANDIER: "What I would emphasise is that the market is not becoming erratic and random. There's a lot of structure and as quants, we try to exploit that structure. We try to take advantage of the fact that there's predictability coming from the structure. One example is economic linkages. You could think of the economy being companies and people, which are linked to each other in different ways. If I'm Air France and I can't fly my planes, that's obviously bad news for all the suppliers of Air France and strategies based on exploiting these supply chains have worked pretty well. A second example relates to flows. There's a lot of structure when it comes to flows and their impact on prices that helps predict future stock returns."

NIKLAS TELL: DUNCAN, WHAT ARE YOU HEARING FROM CLIENTS? ARE THEY CONTINUING WITH WHAT THEY HAVE BEEN DOING OR ARE THEY RETHINKING THEIR ALLOCATION?

DUNCAN MOIR: "If we look at the more classic hedge fund allocations from clients, I genuinely think that they're pleased with the performance. For clients that have sought more liquidity and lower cost and have moved towards alternative risk premia and liquid alternatives over the last few years, there's a little bit of a rethink. I don't think that desire for low-cost and liquidity has changed, so they need something to fill that space. We could call it alternative risk premia 2.0, which is more hedge fund risk premia strategies as opposed to the academic risk premia. In general, we feel that clients are thinking much more about what their hedge fund allocations do in the total portfolio context. It's not just about alpha anymore but more about total value added to the portfolio and they think more about total portfolio construction."

NIKLAS TELL: HAVE YOU INVESTED WITH ANY NEW MANAGERS THROUGHOUT THIS PERIOD OR HAS THE INABILITY TO TRAVEL MADE THAT MORE DIFFICULT?

TEEMU AHONEN: "Yes, we have. We have a surprisingly active list of new managers. As I said earlier, different environments put the spotlight on who has the skill in which environment. In every macro environment, a certain skill set will flourish and we've had a bit of a shakeup. There have been strategies that have behaved differently compared to what would have been expected. Then we need to take active decisions and for some of the strategies we believe in, we've needed to add new managers. And yes, that process has been made a lot more difficult as we've not been able to travel."

MIKAEL HAGLUND: "We've added managers across asset classes and also within the hedge fund space during this period. We do the fund analysis and also the due diligence in-house and for us, onsite visits are normally a very important part of our process, which has been a challenge for several reasons. I think we've handled it well but it was a transformational event when we couldn't travel anymore and needed to switch to a digital business model. A video call is not the same as visiting a manager as you don't get the same understanding of team dynamics, for example. How are people working together and how are different responsibilities feeding into each other? How's the mood in the office? These areas are much harder to analyse, as is the operational due diligence. Another area that we added to our process about a year ago is behavioural analysis and that's also much harder to conduct digitally. We still do it but the quality of the work is not where we want it to be, so we're looking forward to things normalising."

JANINA SIBELIUS: DUNCAN, HOW HAS IT BEEN TRYING TO EXPLAIN TO CLIENTS ABOUT YOUR FUNDS AND COMMUNICATING WITH THEM WHEN YOU HAVEN'T BEEN ABLE TO MEET THEM?

DUNCAN MOIR: "My travel is very much client facing and one of our offerings now is a new sort of passive hedge fund. A lot of the initial work, potentially over several years, is more educational. That's much harder over Zoom or a conference call compared to a conversation face-to-face. A lot of what we've been trying to do is to produce more material, such as papers, recorded video and podcasts. So small bits of information that investors can digest more easily over a longer period of time, rather than just having constant Zoom calls. However, the team I'm part of are also allocators to hedge funds and what I hear from the research team is that they're big fans of online conferences, for example the capital introduction-type conferences run by third party marketers. The response has been really good and the attendance is very high. It's just far more efficient for the research team as they can cover many more funds in their own time. The only difference is you don't have the eye-to-eye contact with a hedge fund and part of investing in a new fund is obviously about trust. And it's difficult to build that relationship with someone just over the screen. Mikael talked about behavioural research earlier and it will be interesting to see if analysts are becoming more rational in their decision making when they have less face-to-face relationships. In order to know that, we obviously need a lot more data and we might find that only one year will just be a blip and that we're soon back to normality."

AUGUSTIN LANDIER: "We travel less and that makes it somewhat more difficult to create trust and personal relationships. I agree that online conferences have been very fruitful when it comes to starting new relationships but eventually, I think a physical meeting helps a lot creating trust and understanding the specific thought process of each investor. The pandemic has clearly been a negative shock to the ability to do marketing, to meet people and to create personal trust. At the same time, I think this change

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AXA-IM Chorus
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will have a long-lasting impact. Digital conferences can be quite fruitful. Since the cost of meeting is small, people explore larger sets of possibilities. It introduces a bit of randomness, which can make improbable matches crystallise. We're all looking forward to communicating as humans again and sharing a table but at the same time, I don't think we will go back exactly to our past habits, partly because of ESG concerns. Crossing the ocean for a few meetings was common practice before and that kind of behaviour is probably going to change."

JANINA SIBELIUS: JARKKO, HOW IS THE CURRENT SITUATION IMPACTING YOUR WORK ON THE HEDGE FUND GOVERNANCE SIDE?

JARKKO MATILAINEN: "The current situation hasn't impacted the essence of the governance work that much. For board meetings, you can typically dial in and participate remotely and we have all materials we need and so on. However, you do want to participate in person at the board meetings at least once a year, which will typically be in Ireland, Luxembourg or the Caymans and that's clearly not happening right now. Attending in person allows you to chat to your colleagues on topics that are not strictly on the agenda, which is valuable. We also want to understand what's happening with the managers that we're working with. We speak frequently with them to understand how things are on the operational side and to pick up on potential problems as early as possible. I personally want to meet our managers in person at least once a year in their offices, which is something we miss today under Covid restrictions."

NIKLAS TELL: MOVING OVER TO THE TOPIC OF ESG AND HEDGE FUNDS. IS IT FAIR TO SAY THAT HEDGE FUND STRATEGIES ARE STILL BEHIND ON ESG INTEGRATION COMPARED TO LONG-ONLY STRATEGIES, FOR INSTANCE?

MIKAEL HAGLUND: "This is a topic that we spend a lot of time and resources on. Some three years ago, we implemented a dedicated qualitative ESG analysis on the all the funds that we cover across all asset classes on the platform, including alternatives and hedge funds. On a broader level, it's clear that hedge funds in general are lagging behind when it comes to ESG and it has been other players driving the development. There have, of course, been a number of large players, especially on the traditional long-only side, that have done this for a long time but now I would say that all global asset managers are focusing on ESG and are enhancing what they do in various ways. This focus will increase further in 2021 with new regulation and it will become mandatory in a way that it hasn't been in the past. It will be a game of catch up for hedge funds. It's typically a knowledge curve that starts with focusing on avoiding ESG risks, which you can do in various ways, such as excluding things you don't like. When managers move along the knowledge curve, they focus more on combining ESG risk and ESG alpha opportunities and I think it will be important for hedge funds to also view ESG as an alpha source. When we analyse managers on ESG across asset classes and rank them from the strongest to the weakest, we typically find hedge funds at the bottom. It's very hard to find hedge fund managers that excel on the investment side, the operational side as well as the ESG side."

DUNCAN MOIR: "If I look at colleagues that run multi-manager long-only portfolios, they are miles ahead of the hedge fund industry when it comes to incorporating ESG into the processes. Obviously, the 'G' has been a part of most hedge fund investment processes for a long time. We've had an independent operational due diligence team since 2002 and the governance part is very important to the investment process. I think environmental and social aspects have really only come into focus over the last few years. In 2021, we will be surveying every single hedge fund that we have on all relevant ESG matters, which includes both the actively selected funds and all of the passive allocations that we make to hedge funds, to also make sure that we have a complete understanding of the hedge fund industry from an ESG perspective. We're really excited about the data that we're going to collect because we do believe that there could be positive things to learn from this as part of the investment process. The Yale Endowment recently said it will make decisions on manager allocations based partly on the diversity of the investment manager and if they don't see improvements in diversity, the managers will be cut. These things are clearly becoming more important and that includes the underlying portfolios as well."

> "I think the past year has really showed how different styles and variations of taking risk actually perform"
>
> *– Teemu Ahonen, Ilmarinen*

NIKLAS TELL: JARKKO, DUNCAN MENTIONED THAT GOVERNANCE HAS ALWAYS BEEN AN IMPORTANT PART FOR HEDGE FUNDS. DOES THAT MEAN THAT ALL IS DONE AND DUSTED OR ARE THERE MORE THINGS TO BE DONE AROUND GOVERNANCE AND HEDGE FUNDS?

JARKKO MATILAINEN: "There are still things to be done on the governance side. One example is the recent thematic review from the Irish central bank showing that diversity is still fairly bad when it comes to fund boards. When it comes to the overall ESG philosophy, there are several different areas to look at and one is, of course, how responsible a corporate citizen the manager is and how responsibly they run their business. Another important aspect is at their product or fund level and here, the composition of the board of directors is one important area. When it comes to the underlying portfolio, I still think there are a lot of misunderstandings in the marketplace because not all strategies are meaningful when it comes to ESG integration and I think we need to be honest about that. Finally, investors must also consider how hedge fund managers behave in the marketplace to ensure that they contribute to a responsible and efficient capital market."

TEEMU AHONEN: "This is obviously a priority for us and it's something we look at across all assets. I do agree that there's some catching up to do for hedge funds and the whole process is more integrated in the long-only space. I think one reason is that the hedge fund space is very diverse – a long/short equity manager is very different from a derivative or momentum player. It's clear that if you're in the business of having long volatility exposure to some index or to some macro variables, that's very different from having a long/short equity book. These are different businesses and how they implement an ESG framework would be different. The problem is how you acknowledge that one size doesn't fit all and how you implement this in practice. We have a team of three people dedicated to ESG and they help us to enhance all processes across all asset classes. I think it's a learning process, both for us as investors and also for the product providers. When it comes to hedge fund managers, size is obviously one important aspect because a smaller player will not have the same resources to produce all the disclosures we might be interested in."

JANINA SIBELIUS: HOW DO YOU THINK THE EU TAXONOMY WILL AFFECT THE HEDGE FUND INDUSTRY?

JARKKO MATILAINEN: "The EU regulation will be a game changer and managers need to be working on that right now. It doesn't hit all the asset owners directly but the PRI has introduced a new way of requiring disclosures from asset owners, which could cause some indirect consequences for asset owners over time. For managers, it will be a huge undertaking because some of the data required is not even available yet. They need to report on a company-by-company basis on sustainability factors in the future and there's a risk matrix of 32 compulsory sustainability factors plus at a minimum two voluntary factors per underlying investment. That's a lot of data for a manager running a big number of names in their long and short books. For managers investing in large blue-chip companies, I think that data will be pretty easily available over time but it will be more of a struggle for managers investing in small- and mid-caps and also in private companies. Even if this annual report on individual companies has been postponed, there are more imminent disclosures about processes that are expected already in March, focusing on ESG policies etc. Overall, it will be a lot of work for managers and it will be interesting to see how the industry tackles these new data requirements."

AUGUSTIN LANDIER: "Regarding the discussion that hedge funds are late to the game when it comes to ESG, I would like to push back somewhat on that because maybe it's for a good reason. I think a lot of the marketing behind ESG has been a little bit lazy in the sense that it's too often around a

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>
> *– Mikael Haglund, SEB*

simple win-win rhetoric: namely that being green is always good for returns and good for the world. Hedge funds are right to be prudent about that sort of claim. We need to be very clear about what the alpha part is when you exclude companies and how the exclusion contributes to a better world. On this, we need much more intellectual backing because what economic theory says is that in the long run, there might be a risk premium associated with holding dirty assets. Then, the question becomes if we should refrain from collecting that risk premium and then we're no longer in the win-win argument that green is always good. We need to be clear about the alpha delivery and we must also be clear about the impact that we're aiming for. Do we think that we are changing the world for the better if we exclude dirty assets from the portfolio? Not if these assets are in the end going to be exploited by unscrupulous asset owners. We also have to be more disciplined about trying to deliver impact and trying to change companies and I think that's where a large fraction of hedge funds are indeed lagging behind as they're rarely active investors engaging with companies. But many of them are already big users of alternative data, or ESG data. They are trying to automatise and systematise fundamental analysis by going beyond what accounting data tells you. This requires use of alternative data, about employees, intangibles and regulatory risks, which you could call ESG."

NIKLAS TELL: WHAT ARE YOUR EXPECTATIONS FOR THE COMING YEAR? DUNCAN, YOU TALKED ABOUT THE DIFFICULTIES IN EDUCATING INVESTORS ON NEW STRATEGIES, SO I ASSUME THAT'S SOMETHING YOU'RE LOOKING FORWARD TO IN 2021.

DUNCAN MOIR: "I'm very much looking forward to hopefully getting back on the road and talking to investors again. One of the things we will be talking about is how ESG can be done passively. In terms of hedge fund strategies, I know that the team on the desk picking hedge funds are really positive on relative value and stockpicking hedge funds again. Also, we don't have a negative view on any hedge fund strategies, which is quite unusual. We usually have some sort of mix there but there are no areas we're particularly negative on right now."

JARKKO MATILAINEN: "Over the coming year, the ESG development will absolutely continue and we will move from ethically-based exclusions to ESG incorporation or integration. That's not limiting any of the choices but rather setting the hurdle high for those ESG sensitive names. Also, integrating ESG should not have a negative impact on returns but should be neutral or even positive because you just have better information. I agree that a coal mine will not disappear but good ESG integration should encourage transition and that's what the EU regulation is all about as well."

MIKAEL HAGLUND: "Looking ahead, we see that hedge funds will continue to catch up when it comes to ESG. According to the discussions we're having, I think a lot of hedge funds are a bit unfamiliar with how they want to approach ESG in terms of setting processes and that work will continue. I also think we will see more when it comes to hedge funds becoming more active owners in order to influence companies to transition in the right direction. We share the analyses we do on managers with them in order to provide feedback and it's clear that many hedge fund managers are a bit unfamiliar with how they should talk about ESG in a more structured way. I think that will also be a theme going forward where they are able to establish more defined processes and find ways to explain what they do more clearly. One area that we will see more on is climate change, which is also very much aligned with the new regulation that's coming."

TEEMU AHONEN: "In my opinion, hedge funds have shown that the alpha generation capabilities in times of volatility is there and that's positive going forward. It seems that the more volatility we have, the more alpha generating opportunities we get. I think the macro environment is going in a direction where we obviously have a very heavy monetary stimulus, combined with the fiscal stimulus, and that usually creates volatility as well. This type of environment does change a little bit the mix of assets you want to run. You basically want to pick up cheap convexity where you can get it and we're doing it internally. I think hedge funds are actually pretty well positioned to take advantage of this type of environment. For me, hedge funds are part of a total asset allocation, so I don't want to invest into hedge funds that pick up lazy equity beta at a high cost. I would rather pay for the alpha."