December 2021

The Hedge

A look back at the month's news, views and a little more

NEWS, ACTIVISM , CRYPTO , ESG...

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A Brodie Consulting publication in conjunction with RQC Group

HEDGE FUNDS STRUGGLE TO NAVIGATE NOVEMBER HEADWINDS

November was considerably more difficult for hedge funds than previous months as Omicron, hawkish comments from **Fed** Chair ***Jerome Powell*** and energy concerns, alongside an increasingly truculent ***Putin***, all added to fund headwinds.

Equity indices generally fell during the month having hit highs early in the month. By the end of November, although the tech heavy **Nasdaq** was up, the **MSCI World** was down 2.2%, **MSCI Emerging Markets** down 4.1% and the **S&P 500** down 0.8%.

Looking at the **HFRI** numbers and only a few fund strategies closed the month in positive territory, with the HFRI Fund Weighted Composite Index declining by 2.2%, taking the year-to-date performance to 8.7%.

Equity Hedge was the worst performing strategy, with the HFRI Equity Hedge (Total) Index down 2.7%. Healthcare focused funds, in particular, weighed on this space, down 6.6%, followed by Technology/ Healthcare funds down 4.7%.

Macro performance was marginally ahead of equities, as the HFRI Macro (Total) Index dropped 2.4% for the month. This was largely driven by Systematic funds, with Systematic Directional down 3.2% and Systematic Diversified down 3.5%; while Discretionary funds were down 0.8%.

Event Driven was down 1.5% for the month, with Activist down 2.8% and Special Situations down 2.4%.

Relative Value was also down 0.7%, with Yield Alternatives the worst performing, down 4.9%, and Fixed income Convertible Arbitrage the best performing, up 0.5%.

Looking at **regions** and Western Europe focused managers were the worst performing, down 5.3%. The best performing were Middle East and North Africa, where the HFRI Emerging Markets: MENA Index rose 0.44%. All other regions were in negative territory, with North America down 1.9% and Japan down 1.7%.

UPCOMING EVENTS

18-19 January 2022
Investor Relations and Fundraising (BVCA)

19-21 January 2022
Gaining the Edge - Alternative Investment Cap Intro 2022

20 January 2022
HFM US Technology Summit 2022 (NYC)

24-25 January 2022
MFA Network 2022, Miami, Fl (MFA)

Click here to see other events in 2022

$1.75 trillion

Assets of GPIF, the largest SWF in the world

Source: GlobalSWF (November 2021)

$1.33 trillion

Assets of NBIM, the 2nd largest SWF in the world

Source: GlobalSWF (November 2021)

CALPERS INCREASES ALTERNATIVE EXPOSURES

In November **CalPERS board** announced that it will adjust its asset allocation over the next four years. This follows a year-long review into its existing portfolio and liabilities. The new look portfolio will see a smaller allocation to equities and a higher allocation to private equity and private debt. The board also approved adding five per cent leverage to increase portfolio diversification. According to ***Theresa Taylor***, chair of the Investment Committee, this move will *"help us achieve our investment return target of 6.8%. And by adding 5% leverage over time, we'll better diversify the fund to protect against the impact of a serious drawdown during economic downturns."*

MASSPRIM LAUNCHES EMERGING-DIVERSE PROGRAMME

MassPRIM's Committee has approved a $1 billion programme for 'emerging-diverse' managers.

This year alone, the Massachusetts $95.7 billion state pension fund has allocated $2 billion to established diverse managers, including as much as $1 billion to **RhumbLine Advisers**, a female and minority-owned asset manager. Chair of PRIM's board, ***Deborah Goldberg***, said that the program *"is taking important steps in addressing the inequalities endemic in the financial services sector"* and will "*reduce barriers and expand opportunities for diverse investment managers.*"

Five firms have been chosen to source, conduct due diligence and monitor managers. These are **Hamilton Lane** (private equity), **Bivium Capital** (fixed income), **Cambridge Associates** (real estate), **Xponance Inc.** (equities) and **PAAMCO** to invest in emerging-diverse hedge fund managers for PRIM.

Earlier this year the PRIM board voted to increase diversity on the boards and employees of those companies it invests in.

NEWS (CONT.)

CARBON CREDITS AT NEW RECORDS

Carbon has been one of the best performing commodities this year. In November the European market hit €75 per ton for December delivery, which set yet another record. In comparison, at the start of this year, the figure was just over €30 per ton.

This has been an increasingly popular market for a wide variety of funds and with a new framework in place there is expected to be even greater interest in schemes that generate credits. This framework has taken six years to finalise and is designed to make the market more transparent and regulated.

FUNDS PROFIT FROM RIVIAN IPO

According to the **Financial Times**, *Dan Loeb's* **Third Point** made $300 million from its stake in **Rivian**, the recently listed electric vehicle start-up. Third Point and 'several hedge funds' made significant profits from the IPO as the EV firm's shares soared from its offer price of $78. Even with the market turbulence over recent weeks Rivian's market cap is still around $100 billion, more than Ford and General Motors, but still a long way behind Tesla's $1.0 trillion valuation.

FUNDS BUILD LARGE STAKES IN TESLA

From having been the most shorted stock for a number of years and having burnt multiple hedge funds, funds are now building large stakes in **Tesla.** According to data from **WhaleWisdom,** 211 hedge funds and asset management firms took new positions in Tesla during the third quarter of this year. **Reuters** includes several names to this list, including *Jim Simons'* **Renaissance Technologies,** which according to **Business Insider has** quadrupled its holding in the firm, as well as **Aristides Capital** and **Adage Capital Partners**. Timings for these managers has been good, with Tesla shares up over 40 per cent in October alone, which was its best month this year and took the firm through the $1 trillion marker.

NEWS (CONT.)

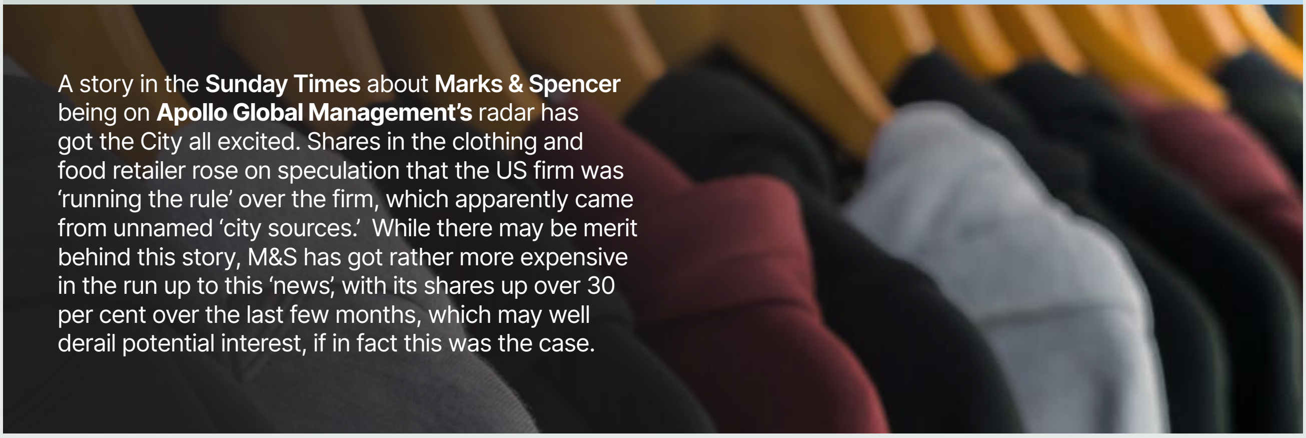
ANOTHER BEAR BITES THE DUST

An equity long/ short manager we have known for a number of years is ***Russell Clark*** who has sadly decided to close his fund and return capital to investors. Clark, who is a 'permabear,' has for the past decade been calling the peak of the equity market rally. According to **Bloomberg**, the fund's assets fell to $200 million from $1.7 billion in 2015 and through to the end of October was down 2.6 per cent. Clark himself blamed the closure on the irrationality of QE and China. Back in 2010, Clark took over ***John Horseman's*** fund, who himself decided to step down due to concerns about the investment environment. It was only last year that the fund was renamed **Russell Clark**.

CREDIT SUISSE FAVOURS ILLIQUID ASSETS

Credit Suisse's recently released Investment Outlook for 2022 is largely about change, writing that the next year is likely to see *'a meaningful economic and financial transition.'* One part of this *'transition'* will be more emphasis and focus on sustainability.

From a fund strategy perspective, the house view is a preference for yield alternatives and lower market beta strategies. In particular, the bank likes some of the more illiquid assets, including private infrastructure, real estate and consumer loans. However, they also believe that hedge fund returns in the coming year will be more challenging, with returns closer to the mean.



A story in the **Sunday Times** about **Marks & Spencer** being on **Apollo Global Management's** radar has got the City all excited. Shares in the clothing and food retailer rose on speculation that the US firm was 'running the rule' over the firm, which apparently came from unnamed 'city sources.' While there may be merit behind this story, M&S has got rather more expensive in the run up to this 'news,' with its shares up over 30 per cent over the last few months, which may well derail potential interest, if in fact this was the case.

ACTIVISM

ACTIVISTS CONTINUE TO FOCUS ON THE US

According to **Lazard's** third quarter review of shareholder activism, it is the US that leads global shareholder activities. In total, there were 123 new campaigns this year through to the end of the third quarter, a similar figure to last year.

The US is where the bulk of the activities have been taking place, accounting for 54 per cent, an increase from 45 per cent in 2020. **Elliott**, perhaps unsurprisingly, is the most active of all activist managers, with 12 situations to its name and six alone launched in the third quarter, including **Toshiba, Citrix** and **SSE**. European activists have however slowed down during this quarter, with only 13 campaigns.

This year activists have won 73 board seats, which is below the historical average, and only two were won in the third quarter. Interestingly, **Ancora, Elliott** and **Starboard** were the most successful managers on this front, responsible for a quarter of board seats.

Looking at the end of the third quarter and start of the fourth, there are reports of 'elevated new campaign activity… potentially portending a busy end to 2021.'

Another report, this time from **Alvarez & Marsal,** looks ahead at 12 months of shareholder activism in Europe. Their analysis points to what they describe as a *'golden age'* in European activism, with 148 companies at risk, of which 21 are UK based.

ACTIVISM (CONT.)

PENNER TO LEAVE ENGINE NO 1

Having only written last month about the hard-hitting success of **Engine No. 1** against **Exxon** and its head of active engagement, ***Charlie Penner***, it has been announced that he is set to leave the firm. Timing is unfortunate, or particularly good (if it was planned), but there is a lengthy article published on 1 December about Penner and the Exxon campaign in the latest edition of **Bloomberg's Businessweek**, entitled *'Charlie Penner, the Investor Reshaping Exxon from the Inside.'* Penner even makes the **Bloomberg 50**, their annual look at people and ideas that 'defined global business' in 2021.

IS JANUS HENDERSON TO MERGE WITH INVESCO?

Nelson Peltz's pressure on underperforming **Janus Henderson** appears to be paying dividends with change at the top as ***Dick Weill*** announces he will be retiring as Chief Executive. Peltz who has a 15 per cent holding in the asset manager has been seeking changes to the Board and wants the firm to look for deals.

Interestingly, Peltz also has a 10 per cent stake in **Invesco** that has led to stories that he wants the two to merge, a situation that Investec's Chief Executive ***Marty Flanagan*** has tried to scotch. According to Barron's, Peltz has met with the board and CEOs of both firms to discuss additional ways to increase their value.

Should the two firms merge, the combined business would have total assets of more than $1.5 trillion.

Another small activist looking to shake a large tree is **Bluebell Capital** Partners, who has written to **Glencore,** calling for the commodity giant to spin off its thermal coal business. In a letter that the **Financial Times** has seen, it describes this side to the business as *'morally unacceptable and financially flawed,'* with Glencore aiming to run down this business over the next 30 years. Furthermore, they believe that without this business, Glencore shares could rise 40-45% over the medium term.

As the largest exporter of thermal coal in the world, such a move is unlikely to happen anytime soon, particularly as current prices are at high levels. **Lex** argues that Bluebell's case is flawed given Glencore's business model *'benefits from having a wide range of commodities to deal in'* and would hurt shareholders in the short-term.

CRYPTO

US BITCOIN FUTURES ETFS SHAKY START

US bitcoin futures ETFs have had a lukewarm start, with the new products not being quite as popular as the market had expected. While there were plenty of flows into **ProShares'** ETF, given its first mover advantage, the second wave to the likes of **Valkyrie** and **VanEck** ETFs have proved to be rather stickier with limited flows.

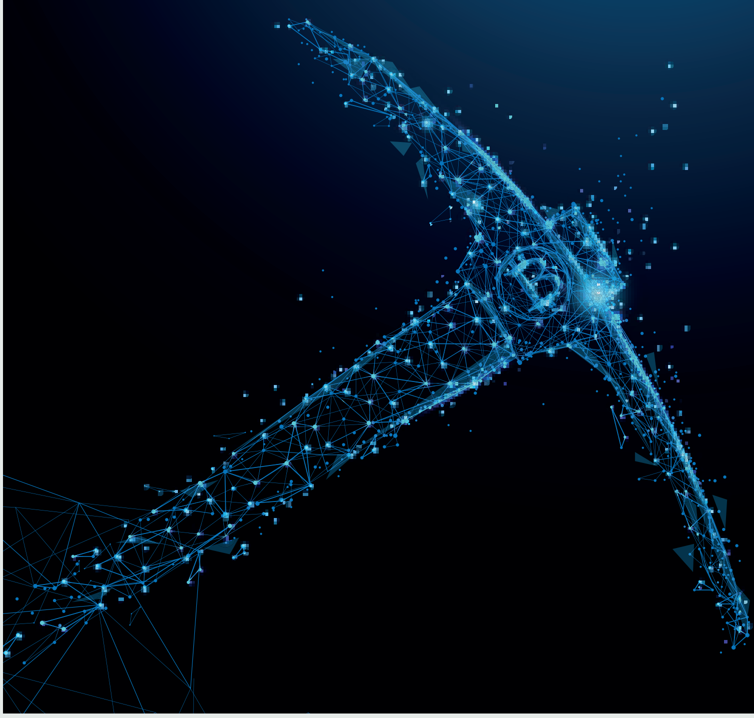
Since then, big players including **Invesco** and **Bitwise** have pulled their applications over concerns about the SEC's insistence on 100 per cent exposure to bitcoin futures. *Anna Paglia*, global head of ETFs at Invesco, said that the *"cost of rolling the futures produced a drag of 60-80 BPS [a month]"* on the fund as well as citing higher than anticipated operational costs.

BINANCE COMES OUT FIGHTING FOR ITS LIFE

To fight off what appears to have been a calamitous onslaught of critical press coverage and to placate global regulatory concerns, **Binance**, the cryptocurrency exchange, has come out with all guns blazing, with what is supposedly an appeasing global PR campaign. This includes waves of press releases and interviews with *Changpeng Zhao*, CEO, talking to **Bloomberg TV, CNBC, AP** and **Financial Times**. There has even been an advert in the Financial Times, which is never the cheapest route to take.

On CNBC, Zhao said he is trying to pivot the company from being a decentralised technology company to a centralised financial services company, which is a position he believes will sit better with regulators. Yet, after all this work, following a Dogecoin 'technical hitch', the #1 Twitter influencer, ***Elon Musk***, tags Zhao to ask *'what's going on with your Doge customers? Sounds shady.'*

CRYPTO (CONT.)



According to **Forbes**, billionaires today own four per cent of all cryptocurrencies through their family offices. In North America alone, around one-third of family offices have invested in cryptocurrency. Citing **Campden Wealth** research data, Forbes adds that family offices on average have one per cent invested in crypto and over a quarter are looking to increase their holdings, some by 'substantial margins.'

In a memo to employees, **Citigroup** has announced that it is adding 100 new employees with digital assets expertise in London, Singapore, New York and Tel Aviv. This follows news that the bank has appointed ***Puneet Singhvi*** as head of digital assets. The push into digital currencies as well as blockchain and comes at a time when several other global banks are building out their digital resources.

ESG

OVERBLOWN ESG CLAIMS ARE THE NEXT BIG SCANDAL

We have made ESG the theme for this edition, which is picked-up by our guest writers. With COP26 there has understandably been far greater awareness in recent weeks and for us it has served as an important reminder that we should be giving this topic considerably more column inches. So going forwards, this will always have a place in our publication.

Historically, the alternative space has not exactly built a reputation for being strong on the E, S or G. Times are however changing with managers aware that they need to adapt. This should be about aligning good works with good investments. Importantly the sharp end, who are the investors, from family offices to high-net-worth individuals, have really started to grasp the nettle. Many of their portfolios are still locked into their longer-term real assets, but there is a desire to change the more liquid aspects of their portfolios. Family offices by their very definition are there to maintain and build wealth for future generations. They fully understand that with no change to how we live our lives and invest, there will be no future generations. Importantly, helping to drive this is the pressure and influence brought to bear by influential institutional investors, such as the **BlackRock's** of this world.

As the asset flow numbers show, there is significant investment heading into this space, which unsurprisingly is making its way to the big brands that have the strongest ESG credentials. This is not only mainstream investment management, but also names in the alternative space, such as **TCI** and **Bridgewater.**

As things stand there are still too many hurdles and too many varying standards at play. Under a light regime, you can claim to be ESG compliant, which you will be, but under more rigorous criteria many funds do not stand up to scrutiny and the case for investing falls apart. Down the line there will undoubtedly be misselling problems and this will probably be the next big scandal.

For investors, this world is too convoluted and is increasingly difficult to navigate - it is like a crypto investor trying to work out which of the 7,500 coins they should invest in. Ultimately, as an investor, you want to compare apples with apples.

In my mind, the only way forward is to have centralised rules, definitions and regulations. These are fundamental to building a proper and usable framework, which investors know and trust. It is down to the regulators to combine their thinking and pull together a common set of standards that all managers can adhere to.

Alastair Crabbe, Editor

ESG (CONT.)

FLOWS ACCELERATE INTO PASSIVE ESG

Investment flows into US ESG funds were $54.7 billion at the end of the third quarter, which is higher than the total figure for 2020, according to recent data from **Morningstar.** Total assets in US ESG funds stands at $330 billion, of which $200 billion is in active funds, although the trend flows this year have largely favoured passive funds. The largest beneficiary of this flow of new money has been **iShares ESG Aware MSCI USA ETF** that saw $3.4 billion inflows, while the most popular active strategy was the $6.4 billion **Brown Advisory Sustainable Growth Fund**. In comparison, total Asia Pacific ESG funds was $93 billion at the end of September, spread over 500 sustainability funds in the region, according to data from **Morgan Stanley.** Similar to the US, active funds also dominate this market, representing around 70 per cent of total assets, although like the US, the bulk of the recent flows have been heading to passive funds.

PENSION FUNDS COMMITTED TO NET ZERO BY 2050

According to **Aviva**, pension funds are heading in the right direction to hit net zero targets, although they still have what appears to be a long way to go. This is taken from the **Aviva Investors Real Asset Assets Study 2021** that surveyed 584 insurance funds and 535 pension funds globally. The report found 52 per cent of insurers and 50 per cent of pensions are committed to hitting net zero by 2050, which is a 12 per cent year-on-year increase. Breaking through the 50 per cent marker is seen as a *'tipping point'* by the report's authors, with 92 per cent of insurers and 93 per cent of pension funds now committing to net zero at some point in the future.

Although the survey focused on illiquid real assets, it highlights the direction of travel and institutional commitment to ESG. Ultimately, short-term, it is the more liquid fund world that has to be providing new ESG solutions and products to pension funds, otherwise they are never going to be sitting at the table. As for those managers with no ESG policy, or even a clear ESG policy, don't even try for pension fund investment. One fund speaking to **Pensions Export** said that they are *"favouring asset managers who have an emphasis on ESG investing - [who] cannot move fast enough in our view."*

UN Sustainable Development Goals

- Goal 1. No Poverty
- Goal 2. Zero Hunger
- Goal 3. Good Health and Well-Being
- Goal 4. Quality Education
- Goal 5. Gender Equality
- Goal 6. Clean Water and Sanitation
- Goal 7. Affordable and Clean Energy
- Goal 8. Decent Work and Economic Growth
- Goal 9. Industry, Innovation and Infrastructure
- Goal 10. Reduced Inequalities
- Goal 11. Sustainable Cities and Communities
- Goal 12. Responsible Consumption and Production
- Goal 13. Climate Action
- Goal 14. Life Below Water
- Goal 15. Life On Land
- Goal 16. Peace, Justice and Strong Institutions
- Goal 17. Partnerships for the Goals

Source: United Nations

REVIEW

THE MANAGER THAT IS ALWAYS SPOILING FOR A FIGHT

The activist manager that truly puts the fear of God into the C-suite is **Elliott Investment Management L.P.** Its very name makes even the toughest of CEO's quake in their bespoke boots. Shares rise and fall, regardless of Elliott fact or rumour.

New York based Elliott was founded in 1977 by **Paul Singer**, who has been described by **The New Yorker** as the *'Doomsday Investor'* and has *'developed a uniquely adversarial and immensely profitable way of doing business.'*

Like many activists, Singer's background is more legal than finance. At Rochester he studied psychology and then went onto Harvard Law School. After Harvard he worked at various law firms before landing at investment bank, **Donaldson, Lufkin and Jenrette** (DLJ) within their real estate division. After a few years he left to launch Elliott Advisors - Elliott being Paul Singer's middle name - with $1.3 million in seed investment from friends and family.

Speaking to the **Wall Street Journal**, Paul Singer said he is looking for firms that have taken the wrong path, be it inadequate R&D in core products, or just general misdirection into projects that don't work out. Incredibly articulate, detail orientated and never shy of a fight, Singer was described by the **Financial Times** in 2012, in appearance, as more Ivy League professor than a Gordon Gecko figure.

Elliott Investment Management is now 44 years old and is one of the oldest funds under continuous management. Only a handful of other funds, such as **Bridgewater** and **Soros Fund Management,** pre-date Elliott that are still operating today. As of 30 June 2021, the firm had 472 employees, including 168 investment professionals, and managed assets of $48 billion.

The London office (**Elliott Advisors (UK) Limited**) has been operating for almost 30 years (opened in 1994) from where the firm originates and runs many of its activist campaigns. This is run by Paul Singer's son, **Gordon Singer**, who went to Williams College in Massachusetts and spent a year at Exeter College, Oxford. He has been in charge of this office since 2009 and has been described by the **Financial Times'** *Laurence Fletcher* as *'Elliott's quiet man making noise in Europe',* who has been *'schooled by his father… and is willing to be involved in hostile situations.'* Junior Singer is also a fan of Arsenal Football Club.

The firm has other offices in Hong Kong and Tokyo, and since Covid has opened-up new offices in West Palm Beach, Florida, and Greenwich, Connecticut.

Elliott's investors include pension plans, sovereign wealth funds, endowments, foundations, funds-of-funds, high net worth individuals and families, and employees of the firm. Its minimum ticket size is $5 million, according to **Smart Asset.** Since inception, **The Times** wrote in September 2021, the firm has annualised returns of 14 per cent, with only had two down years, which is a stellar record for a firm that has 44 years under its belt.

Elliott takes a highly analytical opportunistic trading approach to its global investments, which are on the whole focused on the US, although the portfolio has some very sizeable European and Asian holdings.

One of the firm's more famous battles was against the Argentinian government, which it forced to pay on its default sovereign debt. This fight took 14 years to win but ultimately resulted in a $2.4 billion payout, showing that the firm has few boundaries.

As things stand, today Elliott is going head-to-head with **Dropbox, SoftBank, GlaxoSmithKline, SSE** and most recently **Ahold Delhaize**. And these are just a few of the names…

With shorter attention spans, strong brands today are about simplicity and telling a compelling story.

Branding
Building and strengthening a firm's identity to tell a clearer story.

Marketing
Developing and updating collateral to enhance a firm's offering.

Writing
Editing and writing materials, commentaries, thought pieces and more.

Design
Designing PPTs, documents, infographics, adverts and imagery.

Website
Scoping, design, development and SEO for websites.

Comms
Reactive and proactive, external and internal communications.

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This newsletter is a selection of the previous month's sector news, trends, regulatory developments and best practices. Any opinions expressed are those of the author only and the newsletter does not constitute personal advise or a personal recommendation. We always seek to maintain tight editorial standards. If you have any comments on this content, please do not hesitate to get in touch with the team.

GUEST ARTICLES

ESG IN EMERGING MARKETS THERE ARE NO SHORTCUTS

Olivia Seddon-Daines, Head of Engagement at Somerset Capital Management

As investors in Emerging Markets for over 25 years, we have long sought to identify high-quality companies with the ability to generate sustainable returns over multiple business cycles. This has always entailed doing extensive due diligence when it comes to corporate governance which we have come to call a 'circuit breaker' after a handful of very bad experiences with unscrupulous majority shareholders, corrupt CEOs etc – you name it, we've seen it all.

Many Emerging Market investors will share these experiences and have their own battle scars from governance blow ups. As such we are not the only ones who are well versed when it comes to the 'G' of ESG (environmental, social and governance), but the 'E' and the 'S' are much more nascent in our markets. Just like assessing governance, these two categories require a truly tailored approach, one we at Somerset have evolved and adapted as a result of our experience.

Olivia Seddon-Daines

ESG has become a fundamental component of our investment philosophy and process at Somerset; we know from many years of investing in Emerging Markets that uncovering the true characteristics of a business, and assessing how minority shareholders will be treated, requires a long-term perspective and crucially, entails looking beyond traditional financial data points. We were early to the party in EM and began to assess ESG factors within our assessment of Business Risk (one of the key fundamental risks that we analyse when looking at companies, the others being Financial Risk, Governance Risk and Valuation Risk) back in 2016. This was in recognition of the impact non-financial factors such as Environmental Impact of Production, Treatment of Labour and Product Responsibility & Safety could have on core business profitability and by extension on investment returns.

While conceptually attractive, truly integrating ESG into our investment decision-making in practice is not without its challenges. Like many investors, we have found the data landscape challenging to navigate especially with more issues being thrown into the ESG mix to try and get us closer to assessing how 'good' or 'bad' a company is on ESG. This coupled with the fact that we are operating in an environment with so many informational asymmetries, owing to poor disclosure of non-financial factors or excessive disclosure of immaterial factors, has led us to think long and hard about what purpose we really want ESG to serve in our investment philosophy and process today and in the future.

Ultimately, it circles back to the

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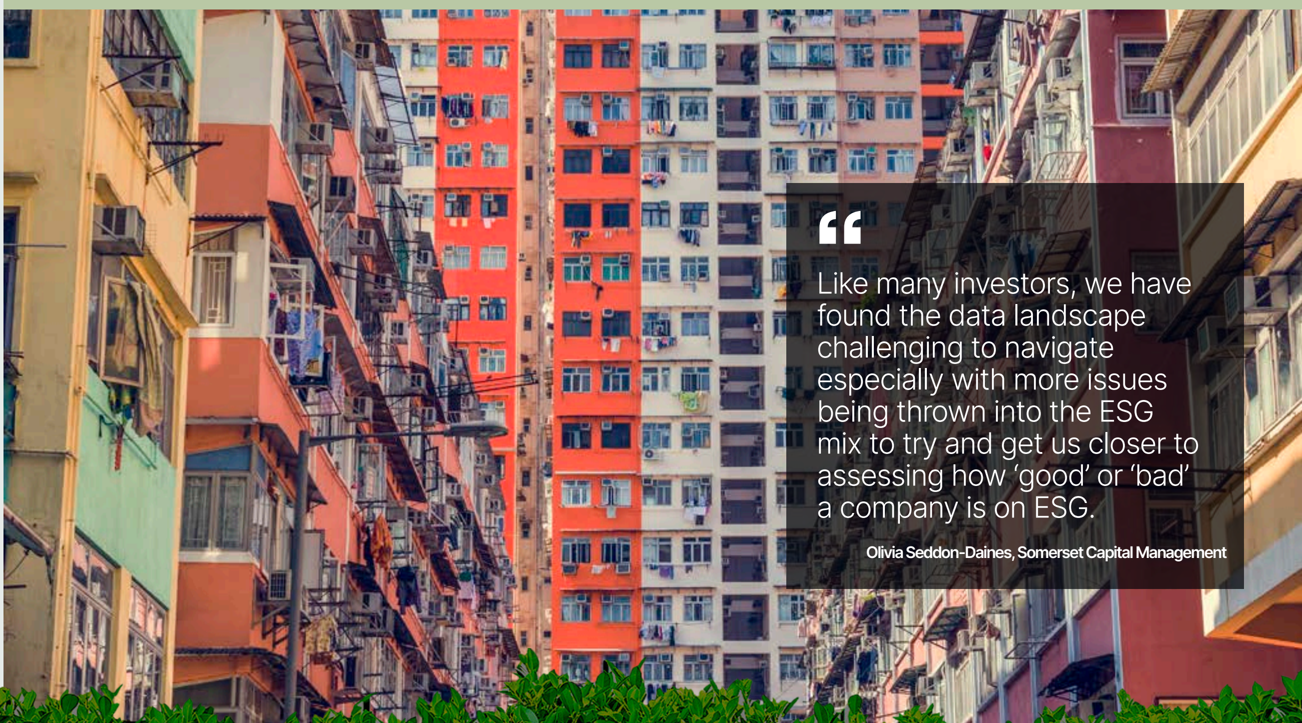


GUEST ARTICLES (CONT.)

Continued from previous page

opening premise: identifying high-quality companies with the ability to generate sustainable returns over multiple business cycles. We have not redefined what a sustainable return is, rather, we have come to understand how environmental and social factors can threaten or aid a company's survival. Namely, we have seen how government regulation and shifting consumer preferences in relation to 'E' and 'S' issues such as climate change, worker treatment, supply chain transparency, data privacy, etc., can affect a company's durability or become a source of competitive advantage.

With approximately 50% of the carbon data in our seven Emerging Markets Strategies being 'estimated' by a third-party ESG data provider, we have to do the majority of the analysis ourselves. This challenge is exacerbated as we move down the market cap spectrum with approximately 3 in 5 small cap companies not disclosing their greenhouse gas emissions, something that seems so fundamental for our counterparts investing in developed markets. This is especially relevant for Somerset given that we specialise in smaller companies EM investing and have numerous funds focused in this area including our EM Small Cap Strategy which has sizeable exposure to sub-$1bn companies.

In practice, this means we have come to understand the non-financial criteria of our investee companies much better, as we cannot rely on data providers as easily nor can we rely on quick and dirty ESG scores – since the underlying information is not disclosed. As a result, our focus has been on developing our bottom-up approach and analyst intelligence (AI) allowing a truly tailored approach to integrating ESG in our investments in Emerging Markets. It's difficult, it's time consuming, where there is data we draw on it but the truth is there aren't really any shortcuts - analysts and fund managers just have to do the legwork.

About Somerset Capital Management

Somerset Capital Management was founded in 2007 as a specialist Global Emerging Markets investment management firm. Over time the firm has grown to c.$7bn under management with more than 50 members of staff including +20 investment managers and analysts based in London and Singapore.

> ... our focus has been on developing our bottom-up approach and analyst intelligence (AI) allowing a truly tailored approach to integrating ESG in our investments in Emerging Markets.
>
> Olivia Seddon-Daines, Somerset Capital Management

INVESTING IN SUSTAINABILITY

Myles Watkiss, Senior Analyst, Stenham Asset Management

At the core of sustainable investing is the necessity to decarbonise the world to avoid temperatures rising by more than 2°C, in line with the Paris Agreement. This requires, at a minimum, achieving net zero global emissions by 2050, and to do this the world needs to undergo an energy transformation, which focuses on three core areas:

- Decarbonisation of power generation
- Electrification of energy use
- Increased efficiency of consumption

This transition is a megatrend that we believe will represent the largest investment cycle in technology, energy and industry of our generation, spanning multiple decades and leaving almost no sector untouched. The Intergovernmental Panel on Climate Change (IPCC) has estimated that the economic damage from a 2°C rise in temperatures could be as much as $69tn. What is more worrying is that global temperatures have already risen by 1.2°C and even the most "ambitious" current global initiatives are projected to limit heating to 2.4°C.

> "... at Stenham we work extensively to identify true specialists in a broad range of strategies, from energy and utilities all the way through to growth equities, carbon markets and commodities.
>
> Myles Watkiss, Stenham Asset Management

The energy value chain will witness the biggest disruption and, while we see a need for renewables generation capacity to increase by around 14x, there are even more exciting opportunities deep within the value chain, including transmission, distribution and storage. It is not all about energy though, and we see interesting investments in clean mobility, circular economy and changing consumer habits. Sustainable agriculture and forestry will play a key role, with the industry currently accounting for 18.4% of emissions, as will efficiency of all kinds from resource efficiency to the efficiency of renewable generation and storage. We also see opportunities in uncorrelated assets and strategies. Carbon credits will play an important role in encouraging companies to decarbonise and commodities, such as copper, lithium and nickel, are seeing hugely increased demand while extra supply can be hard to come by as quickly.

We believe that now is the time to act for three reasons: 1) renewable energy is now cost competitive to fossil energy on a levelized basis, meaning that this transition makes economic sense and hence is inevitable; 2) regulation will become an important tailwind, penalising legacy companies and incentivising sustainable companies; and finally 3) the financial and societal costs of inaction are building every year and if we delay too long, mitigation may become impossible.

We are still early in this transition and the opportunities/risks of being on the right/wrong side are still great, but the complexity involved in technological innovation, together with the high pace and breadth of disruption, makes specialist knowledge a necessity. For this reason, at Stenham we work extensively to identify true specialists in a broad range of strategies, from energy and utilities all the way through to growth equities, carbon markets and commodities. We are also finding that the insights gained from these specialist managers is helping to inform the investment decisions across our broader portfolios. It is becoming increasingly evident and inevitable that understanding ESG and energy transition is critical to achieving investment success in the coming decades.

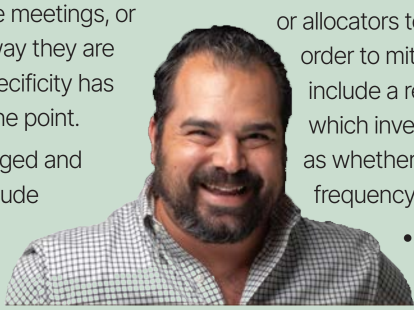
GUEST ARTICLES (CONT.)

SIX LETTERS EVERY FUND MANAGER SHOULD KNOW... E-S-G AND O-D-D

Vincent Molino, Head of Risk and Risk Management Solutions, Northern Trust Front Office Solutions

Whether you're a hedge fund or private equity manager, you've likely noticed a pick-up in questions about your Environmental, Social and Governance (ESG) business model. Often these questions are coming from investors or their consultants via RFPs, face to face meetings, or part of an ongoing process. Whichever way they are arriving, the number of questions and specificity has surely caught your attention, and that's the point.

Your clients' ESG prerogatives have changed and the range of inquiry has expanded to include the operational aspects of a firm's ESG governance, policies, procedures and compliance… areas of focus for an operational due diligence (ODD) process.



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The expansion of ESG ODD scope, and the determination as to whether your operations are acceptable for investment, is borne from a number of expanding influences on investors' decision making:

- **Benchmarking and Measurement:** As common standards do not exist for ESG investment screening, many investors attempt to rely upon data providers to assist in sorting the underlying factors which contribute to portfolio performance. Unfortunately, due to differences in vendor methodology, one may not get the desired apples to apples comparison. Investors often rely on ODD to analyze what is the documented and repeatable investment process used by portfolio managers, to formulate a benchmark among peers. An example of this is requesting policies or documentation from the manager on their ESG research and allocation process, and conducting comparative scrutiny.
- **Transparency and Reporting:** As is common, some hedge funds and private equity funds generally lack high levels of transparency, creating a challenge for investors or allocators to understand their own exposures. In order to mitigate risks, an ODD process could include a review of the technology and means by which investment firms disclose information, such as whether they offer client data portals and the frequency of data transmission.
- **Fiduciary and Regulatory Requirements:** Certain clients, like institutional investors, may be subject to governance or regulation that requires them to report on how they conduct due diligence of an underlying manager, or may be subject to mission mandates that require adherence to the ESG precepts to which they are holding you (i.e., a foundation, family office or sovereign wealth fund). A fulsome ESG ODD process would include analyzing a manager's compliance both internally (per policies) and externally (adhering to newly defined regulations).

As the industry continues to refine how ESG due diligence is implemented, it is important for investment managers to understand their clients' perspectives. Thinking you have an acceptable and marketable ESG process will likely fall short if you do not consider the needs of your clients. Presenting a sound process, being transparent and adapting to a fluid environment will allow your firm the opportunity to stand out in an increasingly competitive ESG investing landscape.

GUEST ARTICLES (CONT.)

ESG TALENT WAR SPREADS TO FAMILY OFFICE

Tanya Lutyens, co-Founder, Lutyens Advisory

Family offices have been slow to embrace ESG, but new hiring trends suggest they are finally waking up to the material risks and the commercially compelling opportunities to integrate sustainability into their portfolios.

Main drivers include the Next Generation controlling more of the family capital, more female investors and entrepreneurial NextGen family members for whom sustainability particularly resonates. This cohort is also increasingly keen to allocate capital towards the outcomes and areas they care most about like climate, health and education.

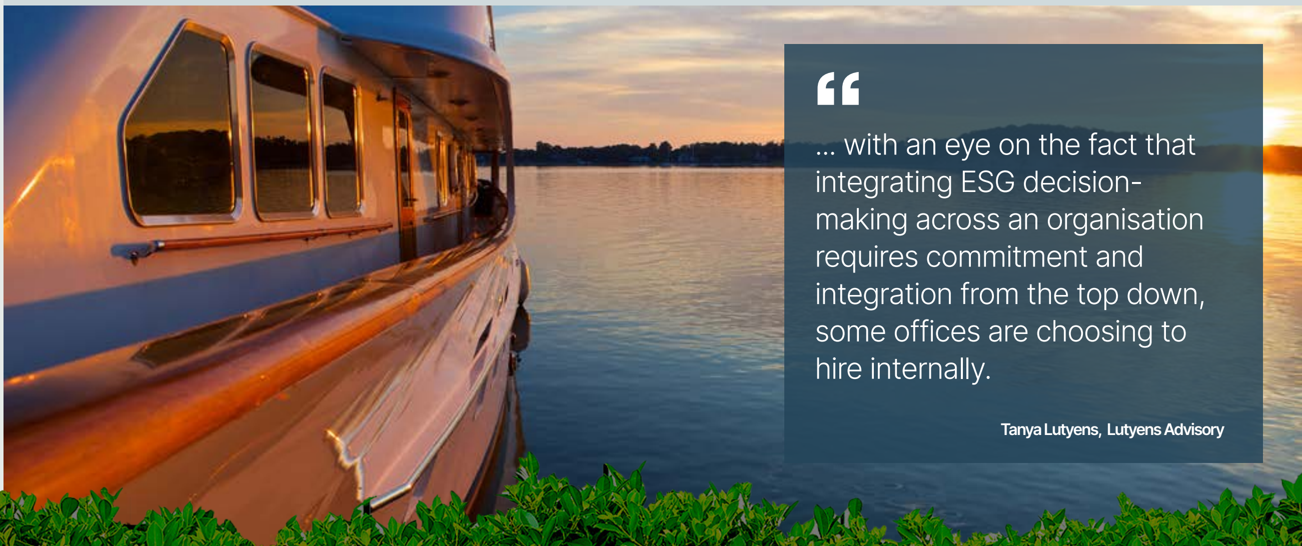
The desire to invest for both impact and returns runs deeper with impassioned and driven millennials than amongst older generations. Add in the realisation that from a risk return standpoint, sustainable portfolios compare to conventional portfolios and have potential for outperformance, and it's fair to say the family office has joined the competition for ESG talent.

Recruitment trends vary depending on the size of the organisation, investment focus and existing ESG knowledge: few are hiring internal ESG leads, and some are calling on external advisors. Family office investment teams are typically only three or four-strong, characterised by a CIO, a couple of portfolio managers and a junior. But with an eye on the fact that integrating ESG decision-making across an organisation requires commitment and integration from the top down, some offices are choosing to hire internally. Demand for skills to meet the reporting burden inherent in ESG, due diligence and help with portfolio construction are most prevalent.

Historically, the family office has tended to integrate sustainability via exclusions and removing exposures through a values lens. Today, integration is moving to the next level as more investors align to leading ESG corporates. Family offices also want to shape thematic exposure and lean into the themes and issues they hold most important. Meeting the growing trend in impact investment also requires new expertise like measuring impact through both the course of an investment and on exit.

Slow out of the blocks, the family office has only just started building its ESG expertise. But once begun it is not a process easily flipped into reverse and nimble family offices will scale up quickly. Expect demand for more ESG expertise as their sustainability objectives change, and different themes become more investable.

Tanya Lutyens is the co-founding partner at Lutyens Advisory, a leading consultancy that advises boards and executive teams on all human capital related matters.



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REGULATION — Presented by RQC GROUP

FCA CONFIRMS CHANGES TO MIFID II RESEARCH AND BEST EXECUTION OBLIGATIONS

Earlier in 2021, the **FCA** proposed amendments to the **MiFID II** research rules and the removal of the best execution disclosure obligations. On 30 November, the FCA confirmed the amendments, which take effect on 1 December 2021 (best execution disclosure) and 1 March 2022 (research).

Research

Since 2018, under the MiFID II inducements framework, subject to certain exemptions, research services are either paid for by the firm itself or by agreeing a separate research charge with its clients. 'Bundling' of research and execution services – which was hitherto conventional for certain asset classes - is not permitted.

This significant change arose out of a policy objective to improve accountability over costs passed onto clients and to improve price transparency vis-à-vis both research and execution.

However, the FCA has concluded that these benefits are outweighed by costs regarding small-cap firms. In particular, the changes have caused research coverage of such firms to decline and become lower in quality.

Therefore, research with respect to firms with a market capitalisation of less than £200 million will be classified as an 'acceptable minor non-monetary benefit.' In other words, it will be possible to either receive research for free, or to bundle (or, re-bundle) the research and execution costs. This exemption also covers 'corporate access' i.e. where a broker introduces an asset manager to an issuer.

The FCA will also introduce an exemption where the research relates to fixed income, currencies and commodities ('FICC'). Such transactions are not typically paid for via commission payments but on the basis of a bid-offer spread. Therefore, re-bundling research and execution does not carry the same opacity risks as – for example – is the case for equities.

Finally, the FCA is creating exemptions regarding research provided by independent providers (i.e. where the provider does not also provide execution services) and where the research is openly available.

Best execution

MiFID II aspired to improve investor protection and transparency in how firms execute client orders. The solution was to introduce publicly available reports focussing on the quality of execution. For execution venues the reports are known as 'RTS27' reports. For investment firms, the 'RTS28' reports have been an annual requirement for each calendar year from 2017 onwards.

The FCA has found that the policy goal has not been achieved. In particular, the reports are viewed by a very small number of market participants.

The FCA has therefore removed the requirement to produce these reports. Firms are able to remove these reports from their websites from 1 December 2021 onwards.

Due to Brexit, there are now two versions of MiFID II – the UK and the EU. As at 1 January 2021 the respective regimes were almost identical. The aforementioned changes were implemented by the UK unilaterally, and the EU has also tinkered with their version of MiFID II, including the so-called 'quick fix' amendments intended to support Covid-related economic recovery. Commentators will continue to speculate on whether there will be further divergence in 2022 and beyond.

EU COMMISSION PROPOSES AIFMD UPDATES

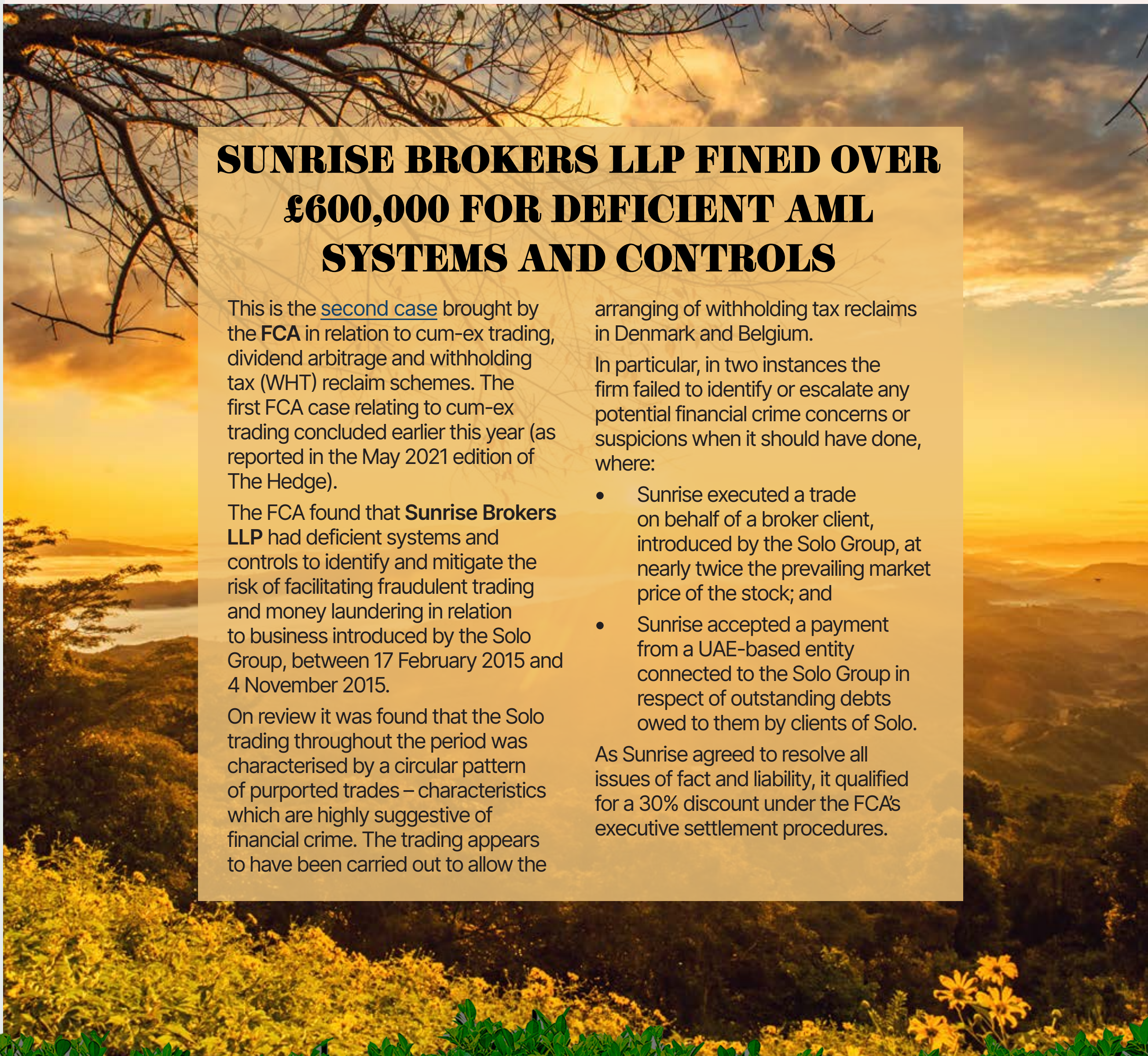
On 25 November 2021, the **EU Commission** published a set of proposals that deliver on several key commitments in the EU's ***'2020 capital markets union (CMU) action plan'.*** This includes a proposal to update certain aspects of the AIFMD (Alternative Investment Fund Managers Directive) framework.

Whilst a majority of the original AIFMD (2011) would remain unchanged, certain revisions are proposed that would address perceived deficiencies, including with respect to delegation, liquidity management, depositary services and data reporting for market monitoring purposes.

Regarding delegation, the practice of an EU AIFM delegating a function such as portfolio management or risk management to another entity (which could be in or outside of the EU) is expected to continue, albeit with some adjustment to the delegation requirements. This is perhaps a positive development for non-EU asset managers who access EU investors via a third-party EU AIFM management company.

The proposals will be debated and fine-tuned by the EU law-makers. It is envisaged that the proposals would take effect in 2024 or early 2025. The proposals relate to the EU version of AIFMD, and not the UK version that was onshored post-Brexit.

The EU's published proposals also cover reviews of the European Long-Term Investment Funds (ELTIFs) Regulation and the Markets in Financial Instruments Regulation (MiFIR), and the European Single Access Point (ESAP) that will offer a single point of access to public information about EU companies and EU investment products.



SUNRISE BROKERS LLP FINED OVER £600,000 FOR DEFICIENT AML SYSTEMS AND CONTROLS

This is the second case brought by the **FCA** in relation to cum-ex trading, dividend arbitrage and withholding tax (WHT) reclaim schemes. The first FCA case relating to cum-ex trading concluded earlier this year (as reported in the May 2021 edition of The Hedge).

The FCA found that **Sunrise Brokers LLP** had deficient systems and controls to identify and mitigate the risk of facilitating fraudulent trading and money laundering in relation to business introduced by the Solo Group, between 17 February 2015 and 4 November 2015.

On review it was found that the Solo trading throughout the period was characterised by a circular pattern of purported trades – characteristics which are highly suggestive of financial crime. The trading appears to have been carried out to allow the arranging of withholding tax reclaims in Denmark and Belgium.

In particular, in two instances the firm failed to identify or escalate any potential financial crime concerns or suspicions when it should have done, where:

- Sunrise executed a trade on behalf of a broker client, introduced by the Solo Group, at nearly twice the prevailing market price of the stock; and
- Sunrise accepted a payment from a UAE-based entity connected to the Solo Group in respect of outstanding debts owed to them by clients of Solo.

As Sunrise agreed to resolve all issues of fact and liability, it qualified for a 30% discount under the FCA's executive settlement procedures.

REGULATION (CONT.)

FINAL NOTICE ISSUED TO COLIN BERMINGHAM

The **FCA** has issued a final notice, prohibiting Colin Bermingham from performing any function in relation to any regulated activity from 27 September 2021.

Mr Bermingham was head of the cash desk at **Barclays.** He was previously been given a warning notice in relation to a charge to defraud in 2014.

On 28 March 2019, Mr Bermingham was convicted at Southwark Crown Court on one count of conspiracy to defraud in respect of fixing EURIBOR. This was in relation to criminal activity between January 2005 and December 2009. Mr Bermingham conspired with others to procure or make submissions of rates into the EURIBOR setting process by Barclays which were false or misleading in that they intended to create an advantage to Barclay's trading positions, while disregarding the proper basis for the submission of the EURIBOR rates.

SEC ANNOUNCES ENFORCEMENT RESULTS FOR FY 2021

The **SEC** recently announced that it brought 434 new enforcement actions during its 2021 fiscal year, a 7% increase over 2020, and obtained judgments and orders for nearly $3.9 billion.

The new actions cover a wide variety of topics and include the emerging threats in the crypto and SPAC spaces.

'Big names' subject to SEC action included **General Electric, Kraft-Heinz, AT&T, Ernst & Young**, the former CEO and Chairman of **Wells Fargo, BlueCrest Capital Management, Goldman Sachs, Deutsche Bank** and **WPP.**

At the other end of the spectrum, actions were brought against wrongdoers targeting affinity groups including police officers and firefighters, and members of the South Asian American, Orthodox Jewish and Venezuelan-American communities.

"The SEC's Enforcement Division is the cop on the beat for America's securities laws," said Chair ***Gary Gensler.***

If you have any questions about **The Hedge**, or would like to have a colleague added to our distribution, do please contact the team at **thehedge@brodiecg.com**

This document has been produced by Brodie Consulting Group in conjunction with RQC Group.

Brodie Consulting Group is an international marketing and communications consultancy, focused largely on the financial services sector. Established in 2019 by Alastair Crabbe, the former head of marketing and communications at Permal, the Brodie team has extensive experience advising funds on all aspects of their brand, marketing and communications.

Founded in London in 2007 and with a dedicated office in New York, **RQC Group** is an industry-leading cross-border compliance consultancy specializing in FCA, SEC and CFTC/NFA Compliance and Regulatory Hosting services, servicing clients with AUM in excess of $580 billion.

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