Beyond Good versus Evil:

Hedge Fund Investing, Capital Markets and the Sustainability Challenge

A Personal Reflection

By

Jed Emerson

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Author's Preface

My professional journey has taken me from founding director of a homeless youth program, to founding director of the nation's second venture philanthropy fund, to working with a foundation exploring how best to execute strategic philanthropy, to strategic development with a sustainable ranching enterprise, to affiliating with a global public equities firm to this past year working with a fund of hedge funds firm in New York City. Throughout this process I have also held faculty appointments at Harvard, Stanford and Oxford business schools where I have used my writing to organize my thoughts, understand more about the work in which I was engaged and frame that work within the larger world of which it is a part.

In 1993, I published my first "thought piece" exploring the practice of investing for multiple returns—by which I mean the pursuit of some level of financial performance with the generation of social and/or environmental impact—a document that discussed the experience of a Roberts Foundation initiative to expand economic opportunities for formerly homeless people. In the years since, I have widely promoted the notion that capital could—and should—be structured on terms which generate multiple returns. I have also promoted a vision of "the firm" founded upon an understanding of both for-profit and non-profit organizations as having the potential to simultaneously create financial, social and environmental corporate performance. When taken together, structuring capital for multiple returns and managing firms for total performance allows one to pursue the creation of total, Blended Value, about which I have also written extensively.

Since drafting my first document on these themes, I have edited three books and authored over 30 additional papers. In each case, as I prepared these texts, I have relied extensively on the good criticism and suggestions of many colleagues to help me sharpen my thinking and improve my understanding of the issues I was exploring. There have been times when people disagreed with some of my notions and points where my efforts to integrate social and environmental perspectives with financial analysis were challenged—but for the most part the responses from those reviewing my ideas have always been measured, balanced and supportive of my inquiry.

Until this paper.

While I received extremely helpful feedback and excellent comments for improving this document, I also (indeed, often at the same time!) received heartfelt suggestions that perhaps I had taken things too far; that hedge fund investing was, at its core, mercenary capitalism at its worst and that to promote any aspect of hedge fund investing as being socially or environmentally redeemable was, well, just wrong on so many levels as to be absurd. With the best of intentions and my future professional career at heart, several of those reviewing this paper even suggested it might actually be best not to release this one and to simply leave well enough alone. I did have my reputation to consider, after all...

To simplistically paraphrase their perspective, these reviewers felt shorting and other practices in which hedge fund managers engage are destructive of social value and that is all there is to it. In part, the reasoning of those reviewers was that those asset owners (whether individuals or institutions) lulled by the siren song of high returns simply have to accept that their returns will be soiled by the hands of greedy fund managers who equate financial performance with success and view social/environmental anything as a weakness. Whether or not they would say it in quite these terms, the message was, "Hedge funds are fundamentally evil and there is no way to view them in any other light. You're a great guy, but let's not be ridiculous!"

Which is exactly why I wanted to write this paper.

When I first joined Uhuru Capital Management (an investment firm which offered a fund of hedge funds product and intended to allocate 25% of its performance compensation through a foundation funding nonprofits working to build the field of social entrepreneurship) we were focused upon making a commercial return for our limited partner investors and then using some of the Firm's returns to make impact investments through our Foundation. While interested, we were not focused on Sustainability.

But as the firm staffed up and fully launched in 2008, a funny thing happened on the way to the capital markets—well, actually, not so funny in that those markets imploded! Suddenly institutional and individual investors who had been making consistent returns had lost twenty, thirty and forty percent of their assets; while some portfolios of "social investments" returned four to six percent (which was a bit of a shock for mainstream investors now being told the new "up" was a 20% loss!).[2] Last fall, the financial world as defined by traditional measures of risk and return was rolled on its head—and we saw how intricately social capital was woven through supposedly "objective," rational markets with the rise of investor panic, market uncertainty and, in some cases, a betrayal of trust shutting those markets down.

As Uhuru Capital Management was a start-up, we were not yet invested in the 3rd quarter 2008. While we waited for the dust to clear, our CIO and I began a dialogue regarding the nature of Fundamental hedge fund investing practices, described later in this paper. As we explored those practices and I learned more about how he approached hedge fund investing, I was struck by how many of the aspects of Fundamental investing (as described to me) were similar to investing practices of Sustainable finance. Not the same, mind you, yet quite similar nevertheless. Simultaneous to this internal dialogue, an external dialogue evolved with investors Uhuru was engaged with around our work. These investors raised a related question: While they appreciated the attributes of our core Fundamental strategy, they asked if we couldn't create a truly "sustainable" fund of hedge funds product. What they sought was a "Long/Short"[3] investment strategy pursued in a manner consistent with an investor's commitment to Sustainability. Was such a thing possible?

These conversations became the genesis of this current paper—a basic exploration of that question. I do not believe Fundamental hedge fund investing alone meets the sustainability bar for many investors. I do not believe Sustainable investing alone will save capital markets and asset owners from their worst inclinations as either individuals or investors. Yet I continue to believe it is worth exploring the various ways sound mainstream investing practice and Sustainable investing are in fact two parts of a single, evolving pursuit of Value. What I seek to present in this document is not "an answer" to the challenge Sustainable investing poses to hedge fund investors, but rather a set of questions and issues I believe worthy of our attention.

The reader will quickly see that this paper has a large number of "moving parts." In relatively modest length, I attempt to review Sustainable investing, Fundamental Long/Short hedge fund investing practices, the concept of shorting, issues of capital market development and so on. While I have made a real effort to present each of these in concise, jargon-free language, the reader may find it necessary to absorb the detail, while keeping the larger flow of the discussion in mind—a need that reflects both the

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[2] While it is true micro-finance bond funds and other sustainable investment products did quite well through the crisis, it should also be acknowledged that accurately comparing performance of various instruments in differing asset classes is a challenge and a formal "cross comparison" may be needed before we can reach final conclusions regarding relative performance of various investments during the course of the crisis. Having said that, what remains intriguing is the potential sustainable products demonstrated over this past year to act as a non-correlated hedge within a larger portfolio of investments. This is also an area worth further exploration in the months to come.

[3] A definition of "Long/Short" hedge fund strategies is explored below. Simply put, it may be understood as an investment approach which takes a combination of "long" and "short" term positions within a single, public equity investment fund strategy.

complexity of the topics being addressed and the limitations of my own writing abilities. This document is not offered as a bullet-proof academic or professional article, but rather as a thought piece; a personal reflection on the state of both current Traditional and Sustainable investing practices and future promise. As such, I would ask you to focus on the flow of ideas presented, on the forest, more than on the particular detail of a given tree.

Furthermore, the reader will also find a lack of examples to illustrate the points I'm making. This intentional absence is the result of two factors:

First, the hedge fund arena—especially that of privately held, "Long/Short" funds—is notoriously competitive and non-transparent. Most of the funds in this category do not market or promote their specific strategies and investment practices beyond a limited set of qualified investors and trusted peers. In those cases where I did ask permission to profile certain funds on an anonymous basis, the offer was politely declined. In the future, my hope is to profile funds in order to give readers a better handle on how the ideas presented in this paper are being executed by an emerging group of fund managers—but for the purposes of this initial effort that was simply not possible and I apologize to the reader in advance.

Second, in many ways what I present in this paper is not an analysis of current practice, but rather a reflection on future potential. My core argument is that while Fundamental, Long/Short hedge fund investing contains within it various elements of Sustainable investing practice that connection is not readily apparent to many, whether investor or fund manager. What I seek to identify is what I feel is the reality of subtle links and connections between these two approaches to asset management and value creation. While there are a growing number of funds executing *aspects* of the type of Integrated investment approach I describe (Climate Change Capital in the UK; Highwater Fund and one other firm in Boston; a new fund of Mission Point Capital in Norwalk and a few other European funds come to mind, among others…) examples of this hidden reality are by definition in short supply.

This lack of examples means much of the following text explores on a theoretical level what is best demonstrated in practice. And this lack of examples means the reader may have to work harder to connect my ideas and the trends described with what she already "knows" about either Traditional investing practice or Sustainable investing approaches. Almost by definition, what I explore in the following pages does not fully exist in capital markets, so identifying funds which intentionally operate in the manner I envision is, as yet, a fool's errand. Having often looked beyond the curve to describe a vision of capital's future, I am comfortable with such a role, but it makes the reader's task all the more challenging. Again, I offer my apologies to the reader for making what is already a tough sell all the more difficult.

Finally, this is an extremely challenging topic to explore in that hedge fund investing and Sustainability are both complex topics to discuss in lay terms while still satisfying the interests of experts in each field. Much of the feedback I received from reviewers came from folks in either camp who felt their particular area was not addressed with enough detail. The reader is forewarned that my audience is less that of experts than the broad class of individuals with some working knowledge of and a general interest in capital investing *and* sustainability. Indeed, my ideal reader may be someone with a sharp mind, an acquaintance with Finance and Sustainability, but a lack of expertise in either!

Accordingly, this paper is offered as simply a discussion document in an attempt to contribute to each of our efforts to explore the belief that our pursuit of financial return should not be inconsistent with our broader efforts to create sustainable, Blended Value over the trajectory of our lives.

Jed Emerson
Greenwich, CT

Document Overview

Hedge Fund investing and Sustainability are two terms not often used in the same sentence. This paper presents an introduction to core elements of both practices, while making the argument that aspects of Fundamental hedge fund investing may be consistent with, though distinct from, Sustainable investing. Specifically, practices such as adoption of a long-term investment horizon, consideration of off balance sheet risk represented by environmental and social factors, heightened transparency, a focus on governance and other investor considerations are reviewed.

More specifically, while Fundamental investing practices are used across a host of investment strategies, the focus of this discussion is Bottom-up, Fundamental investment practices as executed by hedge funds making use of "Long/Short" investment strategies, which is described in the following pages.

A framework of Traditional, Integrated and Pure-Play investing is presented, along with a discussion of how hedge fund firms that engage in Fundamental investing may come to represent a form of Integrated firm which promises to expand the core aspects of Sustainable finance into mainstream markets—while not being branded as Pure-Play sustainability funds. Issues such as sustainable growth, shorting as a positive investing practice and short versus long-term investment horizons are also addressed.

Over time, as increasing numbers of funds and investors advance these practices, there is also the promise that mainstream capital markets themselves will evolve into new arenas for integrated, Blended Value creation. While there are those who would claim that this mainstreaming of sustainability practice within capital markets has already taken place and its integration within mainstream corporate practice is, in fact, clearly well underway, I would argue that its full integration into traditional investment practices within global capital markets has yet to occur. The promise of such integration within what is, together with fixed income and derivatives, a "final frontier" of investing (that of "Long/Short" hedge funds) is the focus of the closing discussion of this document.

The paper concludes by affirming that Fundamental fund of hedge fund investment strategies, when managed appropriately, may represent an emerging though as yet not realized opportunity for investors to pursue both full, commercial rate returns and affirm relevant aspects of Sustainable investment practice.

Introduction

Generally speaking, Hedge Funds[4] are viewed as opportunistic investment vehicles and Sustainable investing seeks to generate profit by integrating social and environmental factors into financial investing practice. The two are seldom considered together.

Dropping off its 2008 peak of $1.9 trillion, the hedge fund industry remains an active area for many investors, with $1.3 trillion under management in the first quarter of 2009.[5] While many funds posted negative results over the last year, many funds performed well relative to their major market indexes—and in previous years, some funds' financial returns have been virtually astronomical. Nevertheless, the number of hedge funds has declined substantially during the recent crisis as managers shut down business in the wake of in some cases large losses and substantial investor redemptions. While financial performance of many hedge funds has been good during much of 2009, since the crisis of 2008 they have come under increased scrutiny for their general lack of transparency, high fee structures and what has been portrayed in the media as the perceived arrogance of their fund managers.

As hedge fund investing continues to regain its balance in the ongoing aftermath of the crisis, many investors are re-examining a specific type of hedge fund investing which is the focus of this paper: Bottom-up, Fundamental Long/Short fund managers. These funds tend to make greater use of investment practices which "make sense" to your average investment committee and should be of particular interest to those asset owners interested in "knowing what you own" as well as to those focused on exploring how their investment of assets might be aligned with other goals they seek to advance either through their institutional mission or as a legacy for their lives. Anecdotally, interest in hedge fund investing has grown among mission-aligned/impact investors seeking to align commercial, market-rate investing with their interests in advancing more sustainable business practices in both investing and general corporate arenas.

Over recent years, Sustainable investing has moved from short-term fad to long-term trend, becoming a profitable and, more importantly, possibly positive force for change within capital markets. Investors in Sustainable funds seek to use their capital to generate financial returns with consideration of social and environmental factors. Despite numerous studies documenting a null or positive relation between sustainable investing and financial returns,[6] there has been much debate regarding the financial performance of Sustainable investing over recent years and whether such an approach would require one to accept a lower market rate risk adjusted return. We will leave that discussion to others. The critical point to be made in discussing Sustainable investing is that it is an investment practice and set of strategies—not a single silo or category of investment. Sustainable investing is not "green" or stock screening or renewable investing as a single investment approach, but rather it is an approach to investing *across* categories which might then include, for example, Renewable Energy or Clean Tech as allocated areas of investment.

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[4] A discussion and definition of hedge funds as used in this paper begins on page 11.
[5] http://finmanac.blogspot.com/2009/05/hedge-fund-industry-size-falls-sharply.html
[6] http://www.haas.berkeley.edu/responsiblebusiness/MoskowitzResearchProgram.html

And it is an investment approach that is growing. One reviewer of this paper commented that, "…(your) incorporation of social/environmental externalities in the investment models behind 'sustainable growth' seems very optimistic— "X" firm was set up to address this market failure…and hasn't proved its case yet or been widely copied…". Yet, in truth, the integration of environmental, social and governance considerations into investment strategies *has* grown significantly in recent years, at the same time that such practices have become increasingly mainstream. For example, a recent survey of investment practices conducted by Mercer Co. found that "sustainable investment in emerging markets has grown to over US$300 billion in assets under management," and that is just in emerging markets.[7] Depending upon how one defines Sustainable investing, the US market for sustainable investing is defined as totaling $2.7 trillion out of a total capital market of $25 trillion.[8]

Regardless of this debate regarding current market size, there is little debate that not only the general interest in this investment category, but the actual amount of capital moving through it, has grown and continues to evolve. Many investment professionals are exploring various aspects of these investment strategies and researchers are working to document its various forms, but there seems little question both believers and skeptics are engaged in a long term process of understanding the positive potential and possible limits of Sustainable investing practices.

With these framing comments in mind, the central question for investors interested in drawing upon all the tools of investing remains:

Can a Wall Street hardened, "the only thing that matters is the dollar" investment structure find happiness with
a "have my cake and eat it, too" capital investment strategy?

As presented in this paper, we would argue that "Long/Short," Bottom Up hedge funds managed with a Fundamental (not Technical) investment approach engage in a variety of investment practices which are in many ways consistent with, though distinct from, those of Sustainable investment funds.

In the following pages we present a definition of Sustainable investing focused upon the concept of how consideration of social and environmental factors may act as a sophisticated risk mitigation strategy. We present the central elements of Fundamental investing. And we assert that an integrated or long-term informed approach to Long/Short Fundamental hedge fund management, while potentially sharing certain characteristics of both Traditional and Sustainable investing should not be thought of as "un-sustainable." Rather, Fundamental investment practices *do* have the potential to advance certain elements of a Sustainable investing agenda within mainstream capital markets.

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[7] Gaining Ground: Integrating Environmental, Social and Governance factors into Investment Processes in Emerging Markets, March 2009, Mercer and Co., www.ifc.org. This question of market size is an irritating one for many—I included. Within that $2.7 trillion figure are numerous "rolled-up" amounts and divergent approaches which would more accurately be represented in discrete categories of investment. At present, however, it is the figure used by many and the best we have access to. Please see also Responsible Investing: A Paradigm Shift and the various reports from the UN Program for Responsible Investing.

[8] http://www.socialinvest.org/resources/professionals.cfm

Components of Sustainable Investing

In what is the most current and comprehensive discussion of Sustainable Investing, entitled *Sustainable Investing: The Art of Long-Term Performance*, Krosinsky and Robins (together with a host of chapter authors) present perhaps the best analysis of current thinking and practice within the field. The scope of issues and approaches addressed in their book is beyond our ability to fully review in this brief paper; however, their definition of Sustainable investing is worth referencing.

The authors use the term *"sustainable investing to describe 'an approach to investing driven by the long-term economic, environmental and social risks and opportunities facing the global economy'. What distinguishes current practitioners of sustainable investing from the other approaches is the conviction of their commitment to systematically integrate environmental, social and economic factors within the valuation and choice of assets and the exercise of ownership rights and duties."*[9]

Furthermore, Dr. Harry Hummels has observed that there are four aspects to sustainability criteria when applied in an investing context:

a. Sustainability criteria at no material cost to the investment. An example would be increased transparency

b. Sustainability criteria that are not likely to add value to the investment, but bring costs with them if they are going to be applied. An example would be the prevention of child labour, forced labour, facilitation payments, corruption, etc. Applying these criteria might be relevant to enhance the company's reputation but they may not positively impact the financial bottom line in the short term.

c. Sustainability criteria likely to add value to the investment. Reduction of CO_2 emissions, cradle to cradle processes, environmental technology, etc. will lead to a higher cost load, but are also likely to result in improved returns.

d. Financial criteria that have a sustainability component to it adding value to the investment. These are the criteria financial analysts already look at (For example, PwC's valuation reporting surveys or Ernst & Young's research in this area) such as good corporate governance, the quality of management, innovation, retaining key personnel, etc.[10]

Various groups and networks exist to assist those working to apply the concepts of Sustainable investing and finance to actual investment practice,[11] however we would argue that in the end the core concept is really quite simple. As presented on the web site of the International Finance Corporation which, it should be noted, pursues sustainable investing through project—not public equity—investments,[12]

Sustainable Finance integrates financial, social, and environmental considerations into decision making, facilitating improved risk management and higher return on investment. Financial institutions can potentially be affected by social and

[9] *Sustainable Investing: The Art of Long-Term Performance*, Edited by Cary Krosinsky and Nick Robins, Earthscan: London/Sterling, VA., 2008.
[10] Quoted from an email to the author.
[11] For example, see the Sustainable Finance Forum web site
[12] A distinction addressed in the next section of this paper…

environmental issues through the operations of their clients. Social and environmental issues within a financial institution's portfolio may translate into business risks for the financial institution. There are three types of risk a financial institution could be exposed to arising from the social and environmental issues of their clients: credit risk, liability risk and reputational risk.[13]

When taken together with the definition of Krosinsky and Robins, Sustainable investing may be viewed as an enhanced approach to risk mitigation for those investing in companies.

In addition to the risk side of the equation, a sustainability orientation may also be used to inform how one understands "Reward Opportunities" within markets, positioning managers to adjust business strategies to take advantage of such opportunities. The basic premise is that long term asset owners need to make use of not simply quantitative, financial analysis of firms, but must also assess factors which are "off balance sheet," extra-financial considerations that may positively affect investment returns over time. In this way, public equity investors may use sustainability factors in seeking to avoid risk while attempting to gain unique insights and generate financial return. Together these two aspects of risk and reward combine to create financial returns for fund managers and their investors.

Defining the Broad Concepts of Hedge Fund Investing

While it has only been in recent years that hedge funds have attracted significant attention from mainstream investors, they have actually been an option for other investors for decades. Alfred Jones (a business journalist) left his position at Fortune in 1949 to launch his money management firm and it was that same magazine which in a 1966 article first used the term "hedge fund" to describe Jones's fund strategy—and the term stuck.[14]

Hedge funds are often seen by your average investor as opaque, esoteric investment firms generating magical returns. However in broad terms, a hedge fund is simply a lightly regulated[15] investment partnership that uses a range of investment techniques and invests in a wide array of assets in an attempt to generate a higher than market return for a given level of investment risk.

These funds were originally intended for investment only by sophisticated investors (those the SEC defines "accredited investors and qualified purchasers") who are thought to have enough experience in investing to understand the possible risk of

[13] IFC Web Site for reference

[14] A solid reference on hedge fund investing is *Absolute Returns: The Risk and Opportunity of Hedge Fund Investing*, Alexander Ineichen, 2003, Wiley. And, at the risk of losing all credibility with the reader, we should state that the following paragraphs on the history of hedge funds are based upon the very helpful book, *Hedge Funds for Dummies*, Ann C. Logue, Wiley Publishing, 2007.

[15] Presently, serious debate is taking place regarding the degree to which hedge funds should be regulated and required to report on their holdings and activities. Stay tuned for possible changes in the regulatory environment for hedge funds…

hedge fund investing and who are viewed as having enough money to lose on such investments should those risks be realized.[16]

To "hedge" means to take steps to reduce risk—to "hedge one's bets." However, while many hedge funds make use of the practice of shorting stocks[17] (discussed at length later in this paper) to manage their risk exposure, other hedge funds do not engage in shorting or the use of derivatives to hedge their positions. Such funds may still be referred to as hedge funds since strictly speaking it is the structure of a hedge fund as an investment partnership—not its investing strategy—which defines any given firm as a "hedge fund."

What is critical to understand when discussing hedge funds, then, is that technically speaking hedge funds are an investment structure—and *not* an asset class. This point is often lost in popular conversations regarding hedge funds and serves to confuse discussions regarding their role in the market. "Assets" refers to the spectrum of investments which range from cash and cash equivalents, to bonds and other debt instruments, to various public and private equities, and then, finally, to various alternative investments. In their most basic form, these are all various types of assets, each of which constitute its own class with shared characteristics.[18] By contrast, hedge funds should be thought of as a structure or perhaps vehicle—but, again, until more recently investors did not view them as an asset class unto themselves.

However, one may create a hedge fund that invests in virtually any asset class or mix of strategy; hedge funds trade in private equities or take "long only" positions or, as in the case discussed in this paper, may pursue a combination of both "long" and "short" investment positions in public equity markets.

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[16] Parenthetically, there are many professional fund managers who would argue that part of what lead to the recent turmoil in the hedge fund market was the incredible growth in the numbers of hedge funds. Despite the stricture that they be marketed to accredited investors, increasingly many of those who invested in hedge funds did not fully appreciate—or in the case of Madoff-type experiences, were not informed of—the degree of risk carried by their investments or understand how those investments were actually structured. As growing numbers of investors and fund managers came to chase both management fees and investor returns, the field was subject to "overcrowding" whereby increasing numbers of managers were chasing fewer truly unique investment opportunities/strategies and, hence over time, these risks came home to roost in a variety of ways.

[17] Defined as: "The sale of a security or derivative, or the state of having sold one or the other. It is important to note that a short position is not closed, and is applied only to sales where further action may be required. For example, one who has borrowed securities and then sold them is said to be have a short position with respect to that security because he/she must eventually return an equivalent amount of the borrowed securities. Likewise, one who has sold (or written) an option is in a short position because the option may be exercised at a later date." As defined by the Financial Dictionary: http://financial-dictionary.thefreedictionary.com/Short+(or+Short+Position)

[18] What is perhaps most interesting is a point raised by Alan Kaufman in discussing this question with the author, which is that the true definition of an asset class is really one shared by each of what has been traditionally defined as discrete asset classes: They are each simply a single leap of faith that a given investment product will behave in the future in a manner similar to how it has behaved in the past—by which one assigns projected returns to *any* given asset under consideration. For example, one invests in public equities in order to assume a projected level of risk in exchange for a projected amount of financial return. But if one were invested in public equities between 1972 and 1982—a period of extremely poor performance—than the expected return would have been completely different from what actually occurred. Depending upon the make-up of an asset and its terms, actual performance may look completely different from whatever claim may have been made in marketing the product to potential investors. In this regard, *all* asset classes may simply be defined as being grounded within various leaps of faith concerning projected future performance—faith as informed by history, but faith nevertheless.

And this is where it gets really interesting:

While not technically an asset class, hedge fund investing has evolved over the past two decades, with a growing complexity of strategies. These strategies often include various mixes of assets and investment practices within individual funds. The result is that hedge funds actually *perform* as if they were their own asset class. And many investors are now allocating a percentage of their portfolio to "hedge funds" in the same way as one would seek an allocation to public equities or fixed note instruments.

For the major asset owner, one may invest in hedge funds as part of an overall risk/reward diversification strategy. What this means is that while on a legal basis hedge funds are simply a form of investor partnership, on a practical basis for investors managing capital, when their performance is viewed in relation to other allocations of capital within an overall investment strategy, hedge funds may be viewed as their own asset class.

This debate regarding whether hedge funds are or are not an asset class is summarized in the following narrative from one investment firm addressing the topic:

> *"….In the traditional sense, hedge funds are not an asset class, but a dynamic collective of alternative strategies that derive their return from the active management of other asset classes….(at the same time) hedge funds constitute an asset class because they are bound together by a common regulatory/legal structure, are treated by investors and managers alike as a separate market segment, require a specialized risk management approach, and in particular distinguish themselves by their collective dissimilarity with other asset classes. From this perspective, hedge funds are a separate asset class because fiduciaries feel the need to account for hedge funds explicitly in policy portfolios, to monitor explicitly their actual allocation to the funds and to control related portfolio risk."*[19]

While there is obviously a great deal more to be said regarding hedge fund investing, we will leave that discussion to others. For our purposes it is important the reader understand this basic concept of hedge fund structure[20] and how hedge funds are at one and the same time simply a legal form and have, over past years, also come to be viewed by many as an asset class.

In addition to the diverse forms hedge funds may take, two dominant investing strategies within the Long/Short hedge fund industry are Fundamental and Technical. Fundamental investing is discussed at length in this paper. Technical investing is largely based upon the use of complex, quantitative mathematical models which are structured to take past trends into account while projecting future anticipated performance based on probability ratios, technical scenario mapping and so forth.[21] It is diverse and complex. A complete discussion of Technical investing lies beyond the

[19] http://www.2strategic.com/05_Library/Fiduciary_Insights/FI_fiduciary_insightsInvstRisk.htm

[20] …which is to say, it is often used as a strategy to pursue higher risk-adjusted returns, primarily through investing in public securities that can be marked to market and made liquid—at the fund level, not necessarily for those investing in hedge funds—in a relatively short period of time as compared to private equity or venture capital investments.

[21] http://en.wikipedia.org/wiki/Fundamental_analysis#Top-down_and_Bottom-up

scope of this paper. Suffice it to say that Technical hedge fund investing is informed by some level of qualitative market analysis but relies primarily upon numeric analysis to identify investment opportunities.[22] This is all in an effort to predict future movements in the market—and to take advantage of such movements to generate "alpha" or returns on capital investments which outperform those of the market as defined by a benchmark or the performance of other investment managers.

In addition to the distinction to be made between Fundamental and Technical investing, a second "cut" one may make regarding investment strategies is referred to as "Top Down" versus "Bottom Up" investing. As one might infer, a Top Down approach begins with an assessment of global economic trends (such as country economic growth rates, interest rate movements and so on), may then advance to identification of market segments which are affected by those trends and then, finally, to analysis of individual companies within those segments. A Bottom Up investor most often begins by looking at specific companies and assessing their strategy, management team and position within a larger market. The challenging aspect to discussing hedge fund investment strategy is that often fund managers may have a core strategy which is then informed by other approaches. For example, a "macro" fund manager could have a Top Down approach to investing in short-term currency trades, yet a Bottom Up approach to taking long-term positions in public equities. And in truth, there are most likely very few Technical managers who look only at price trends without at least a broad consideration of the larger market dynamics which may be having an effect upon those trends. This fact makes a simple discussion of hedge fund investing challenging at best.[23]

Hence, for the purposes of this document, when we refer to hedge funds and hedge fund investing we are *not*, broadly speaking, referring to all hedge funds, the variety of assets they may hold or the various types of specific investment strategies they might pursue. And we are not talking about Technical hedge funds which make use of esoteric algorithms to identify possible arbitrage opportunities in capital markets and then make use of leverage to enhance the investment returns of those opportunities. What we *are* referring to would be that family of "Long/Short" funds wherein fund managers are investing in public equities and make use of Fundamental Bottom-Up investment strategies to guide their management of the assets they hold.[24]

[22] Often these are arbitrage opportunities, a description of which is also beyond the focus of this paper!

[23] At the risk of throwing yet one more set of terms at the lay reader, there is another "cut" at this worth considering: that of Systematic versus Discretionary. Some investors would argue that while a Fundamental versus Technical and Bottom-Up versus Top-Down framing is helpful, the key question is the degree to which any fund manager executes her analysis in a systematic manner as opposed to a discretionary manner. One could well be a Fundamental fund manager who reduces qualitative factors to numeric analysis and is therefore a Technical investor who could also be called "Systematic." Consideration must therefore be given to the degree that any given manager holds themselves to a disciplined, systematic approach to investing versus informs their analysis with Fundamental research, but then invests on the basis of their discretion and "sense" of market trends and opportunities.

[24] And now, after that lengthy effort to define my terms, one must at least acknowledge in passing that while my colleagues who have spent their lives committed to advancing various discrete and well considered investment approaches and to defining the unique strategy and approach taken by various fund managers of high integrity and regard…well, much of this comes down to marketing and a sense of what various investment strategies are in current high regard and vogue with potential investors. If you doubt this, consider the difference between calling oneself an "investor" as opposed to being known as a "speculator"—a term which was popular years ago. More specifically, this year's "Long/Short" hedge fund may be honestly marketed as next year's Global Macro fund; and the core strategy could well be the same both years. The real issue here may not be how a fund or investment

In many ways, when we describe elements of Fundamental investing, we are simply outlining aspects of what sound investment practices in *any* asset class might entail. The focus of this particular paper concerns Fundamental investing in a hedge fund context for those interested in Sustainable investing practices, however I would also argue that Fundamental investing (as opposed to Fundamental *hedge fund* investing) is a necessary but insufficient component of sustainable investing itself.

This is true for two reasons: first, Fundamental investing is inherently longer term because it requires the market to recognize the value over a longer time horizon than the manager sees today; and, second, in taking longer term investment exposure to realize value, the investment manager must incorporate longer term risk factors, many of which are extra-financial, including environmental, social and governmental risk. None of this, however, on its own ensures a sustainable investment. As presently constituted, these analytical factors primarily exist to increase financial return over time, and yet say little to nothing about creating positive social or environmental *impact* aside from their relation to financial risk and return. Finally, the necessary factors of Fundamental investing identified herein are not specific to hedge funds. Long-only public equity investors as well as various private and venture capital investors are also essentially practitioners of many aspects of Fundamental investment strategies. It is this intersect between concepts and practices of Sustainable investing, traditional Fundamental investing across various asset classes and the intriguing evolution of mainstream capital markets which I address in the latter sections of this text.[25]

We are exploring those practices as they relate to the management of Fundamental hedge funds investing in public equities on a "Long/Short", Bottom Up basis. It is this point—<u>that within the hedge fund arena there are fund managers executing Fundamental "Long/Short" strategies for investing in public equities and that these practices may be understood as sharing certain characteristics with sustainable investing practices</u>—which is most intriguing in a world where hedge funds (as a broad set of market investors) are often popularly portrayed in mainstream media and elsewhere as the "bad guys" of the recent capital market crisis.

Before turning to a discussion of Fundamental investing itself, one additional introductory point needs to be made regarding the practice of public equity hedge fund investing: managing a portfolio of public equity investments is uniquely different from managing either project finance or direct investments in privately held firms. As Pamela Hartigan of Oxford University observed when commenting on this paper,

> *"…There is no comparison between direct project finance and portfolio investment. Investors that back a project are far more likely to stay on till it matures enough to deliver; in fact, key actors all are covenanted to do so. Hedge funds operate in the free-flowing, usually well-oiled, portfolio finance world of*

product is defined, but rather the factor risk to which that fund or product is exposed. One may have what is presented as a conservative, bond fund, yet how the fund is structured and whatever additional strategies are joined with that fund, may actually be of greater interest than the fact that it is marketed to investors as a "bond" (and therefore, what is thought to be a conservative or safer investment) fund. Sustainable investors, take heed…

[25] The Author thanks Andrew Kassoy for teasing out these issues in his review of this document and the feedback he offered regarding the various points being made in this text. This language is taken from his emails to the Author.

short-term opportunism in capital and money markets where, rightly or wrongly, future potential and failings are priced and traded well ahead of the delivery of results. There is no commitment in those markets to delivery of good or better results. If outcomes ultimately prove positive—not at all assured—it is at high cost to losers, usually the poorer or weaker players, and include entire nations in some cases (as was the case in the Asian financial crisis).”

Direct investing is, indeed, quite distinct from managing a portfolio of investments in public equities or investing with funds which in turn invest in other market opportunities. And it is true that as mainstream capital rapidly moves out of one set of investments and into others the reality that “winners and losers” are created is a real one—a reality Sustainable investors with their interest in advancing sustainability practices through their market activities, may well not change. If one believes in efficient markets theory, perhaps this is a reality investors should not seek to alter, but should certainly be aware of. The question of whether investment practices have an effect upon how markets might integrate sustainability into their investment strategies is addressed later in this paper. However, the point remains that for significant asset owners with large portfolios of investments to manage, direct investing is seldom a realistic option for the management of the majority of their capital. Such large asset owners must invest through others and in funds operated by others. And it is the possibility of doing so in a manner which fulfills fiduciary responsibility as well as a Sustainability vision which is the focus of much of this paper.

In recent years, many such investors have placed their funds with hedge funds in the hope of both diversifying their exposure to risk and securing financial returns which outperform the market. For investors whose only concern is financial performance, with the exception of this past year, such investments have provided solid financial returns. Yet for investors interested in financial performance generated through exposure to a wide range of investment products/vehicles including hedge funds *and* the integration of environmental, social and governance considerations into their investment approach, the options are at present fewer than their “financial only” peers. How should these investors think about the management of their investments on a Sustainable basis? Is it possible to use mainstream investing tactics in a sustainable manner or must they only invest with managers who are clearly branded as “Sustainable”? These are several of the many questions to be explored in the following pages.

Key Practices of Fundamental Investing

With a most basic definition of Sustainable investing on the table together with a definition of the broad arena of “Long/Short” hedge funds we are reflecting upon, what, then, are the core elements of a hedge fund investment strategy based on a Fundamental approach? As we respond to this question, we should again note that the Fundamental practices presented below hold true for investors looking at investment opportunities at the firm, fund *and* fund of fund levels. While the specific details of the strategy as applied to a company will shift from those used in managing a fund of funds approach, the core aspects of Fundamental investing are constant.

First and foremost, it still pays to do one's homework. Through engaging in Bottom Up *deep research*, fund managers are positioned to drill into the core elements of a company, seeking to fully understand its strategy, customers, market environments and elements of performance. There is no short-cut to this process; no "magic mathematics" or analyst report upon which one may rely to generate the proper equation between firm, management, market investment opportunity and projected (and ultimately realized) financial returns.

The fund manager must maintain a deep connection to the investment under consideration and cultivate a sound understanding of how that investment will most likely function over time in dynamic markets. Fundamental fund managers are those who use this deep research to "look beyond the numbers," to see aspects of both risk and opportunity not readily apparent to others.[26] By virtue of this deep knowledge of the markets and specific companies in which they seek to invest, such Fundamental hedge fund managers are best positioned to see the traditional risks visible to many—yet also take into consideration what may be thought of as *"off balance sheet" risk* to future financial performance. Off balance sheet risk is represented by environmental or social liabilities present in a market or company but not explicitly accounted for in traditional numeric valuation or mainstream investor analysis. Making use of what is still an evolving set of enhanced analytics, these managers seek to understand how understated or unidentified liabilities may negatively (or positively) affect financial performance and the ability to generate consistent, year over year returns.

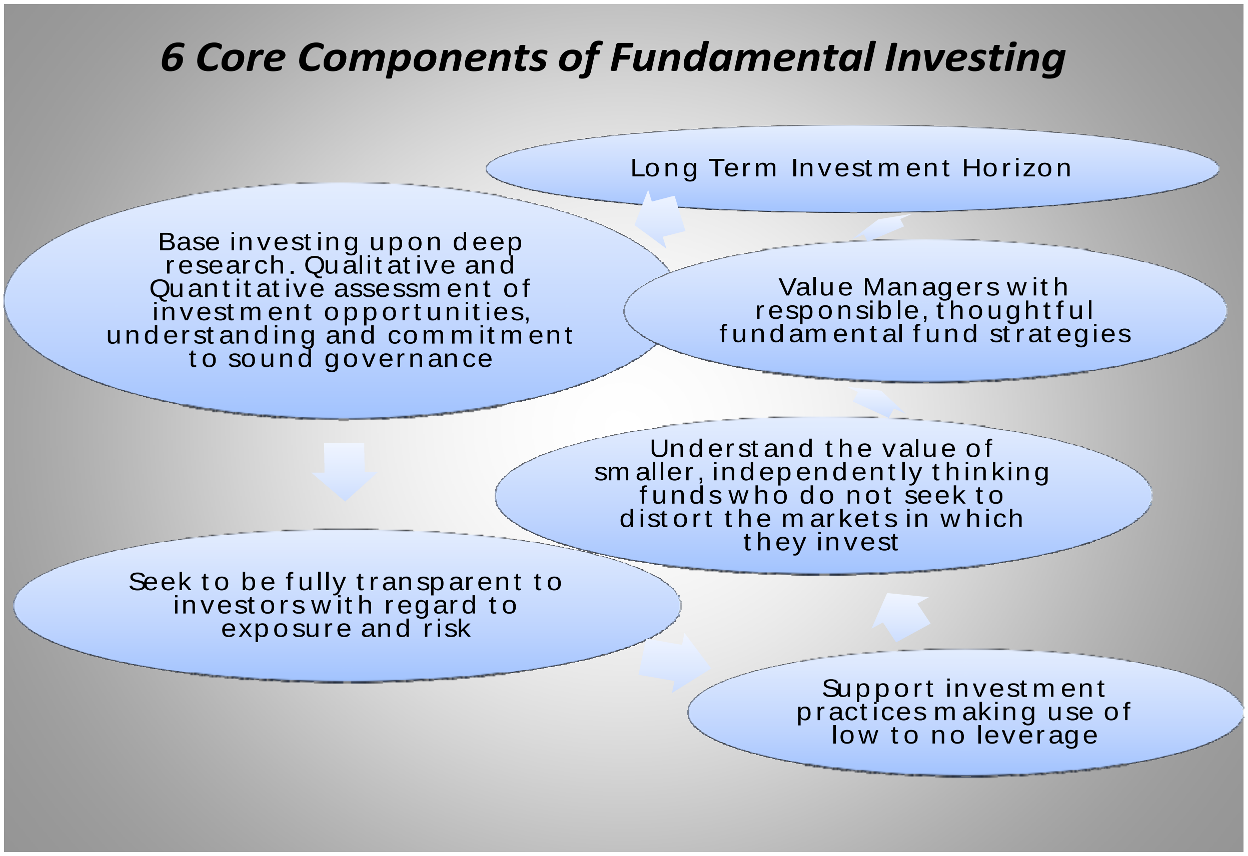
Off balance sheet risk is, however, more than environmental and social factors—Fundamental investors also look to understand shifting public policy and regulatory trends, including changes in governmental priorities and funding initiatives. For example, the institution of carbon "caps" on industry could represent both real risk and opportunity for companies as well as those who invest in them. An increasingly active regulatory posture on the part of the Environmental Protection Agency and other government actors will also affect the larger operating context of firms. And new tax structures to encourage one type of activity while putting in place disincentives for others will also have important impacts upon corporate business models, revenue streams and profitability.[27]

As ancient wisdom states, *Fortune favors the prepared mind.* Before being able to take successful steps forward in uncertain times, one must first understand where one has been, where one is headed and what core resources are available to move investors where they seek to go. One must truly know, as much as humanly possible, how any individual investment is positioned relative to the total market within which it operates. And one must maintain a firm grasp of that investment's fundamental structure and prospects. As one fundamentally focused hedge fund manager stated, "We can never know enough. Every fund manager is always seeking out new

[26] Naturally, this interest in using one's research to more fully understand the "risk" of a given investment opportunity is not limited to hedge fund managers—it is an issue *all* investors seek to address through their investment approach. However, we are primarily focusing on how that fact plays out within the realm of Fundamental, Long-Short hedge fund investing.

[27] Shifts in investor preference and interest also represent a type of "off balance sheet" risk as well. Today's hot, "must have" investment approach or promising sector may rapidly be played out through the creation of bubbles or emergence of new thinking with regard to investing itself—such as the growing trend of Sustainable investing.

information on both the specifics of the firms they are considering and the markets within which they operate."[28]



Commitment to deep research cannot be realized, however, in the absence of *solid organizational practices and corporate management*. Real transparency, meaningful reporting metrics and solid governance must each be in place to ensure the correct—and accurate—information is being converted to knowledge by fund managers and those who invest with them.

As we have recently seen, even in developed markets with active third party rating agencies it is incumbent upon investors to place funds only with those companies and firms committed to accurately representing past performance and future potential. In developed markets, this means analysts must be positioned extremely "close" to a real or potential investment and its managers. In emerging markets, this means the investor must also maintain a regular presence in country—touring factories, interviewing suppliers, assessing the future appetite of customers and the overall context within which the firm operates. One reviewer of this paper (a highly

[28] In many ways, what is being described here could be thought of as a private equity approach to public equity investing—the difference being that one does not have direct influence or control over how decisions are made at the firm level, and therefore have very limited if any capacity to affect corporate practice aside from shareholder activism or public advocacy.

experienced investor) commented that the notion that 3rd Party rating agencies are "objective" actors in the market is "laughable" and that may well be the case; however, if so, then it is even more critical investors engage in deep, Fundamental research.

While Fundamental fund managers do operate with a unique idea or perspective of market opportunity, cultivation of sound knowledge of markets and market actors means such managers do not need to identify a single insight and then make use of significant leverage in order to generate financial returns. In general terms, hedge fund managers making use of quantitative data available to all investors may end up participating in momentum investing as that information becomes available to increasing numbers of competitors, all of which contributes to a piling on effect or "overcrowding." By contrast, the Fundamental fund manager overseeing a smaller fund with fewer holdings is often one who makes use of extremely *low leverage* (often only two or three times their combined short/long position in an investment category where a dominant practice has often been to pile on the leverage, with some hedge funds building up five, ten or even 15 times aggregate in their leveraged positions). Generally speaking, smaller, Fundamental managers should be able to generate attractive returns using limited leverage.

Leverage can be a slippery thing since in some ways it is less a question of "leverage" than the real risk of the underlying asset one should be concerned about. On balance, by being low leverage in a high beta stock one will have more risk than if one were highly leveraged on a low-beta stock. Therefore, one must keep in mind that while in general terms less leverage is "better" than being highly leveraged, leverage itself must be viewed within the context of the underlying asset which is being levered.

This practice of making use of appropriately low leverage has the added benefit that the best Fundamental asset managers do not attempt to gain short-term advantage by creating *market distortions* within the very markets they are investing in. Their close proximity to the market means they understand the deeper trends of those markets and take advantage of both running with and at times against those trends—taking short and long positions that capture long term value for their investors yet not at the risk of creating negative effects and distortions within the markets they seek to create value within.[29]

Having attained this deep perspective of the investment opportunity, the fund manager must then have the patience and type of capital required to operate within a *longer-term investment horizon*. As further discussed below, depending upon the asset class under discussion, the definition of what constitutes "long-term" will shift from investment to investment. For example, Fundamental investing in the Long/Short hedge fund category could mean analyzing a company's prospects not for a day or a quarter, but for one or more years. Regardless of asset class, such a perspective helps one better understand when an investment opportunity is either well priced given the market environment or is overvalued or a mispriced asset.

As a reflection of the complexity of hedge fund investing practices, the question of a long term investing horizon may be viewed differently within the same hedge fund

[29] This interest in not engaging in market distorting activities becomes critical to our discussion of shorting practices by hedge funds, explored later in this paper.

depending upon the practices of any given manager. For example, there are certainly macro global fund managers who would make use of Fundamental analysis and a longer term approach to equities, but within the same fund apply a Fundamental analysis and *short*-term approach to how they manage their investments in commodities and currency trades.

Having acknowledged this fact, consistent value creation (at either the company or investment fund level; and for many types of investing—hedge fund, private equity, venture and so on) is ultimately not the result of capturing a single moment in which to "flip" an investment. Nor is it when a single point in time insight presents an opportunity to take on inordinate leverage in an effort to maximize the greatest possible financial returns from that single insight. Rather, *sustained* value creation—and therefore sustained profitability—is understood as the outcome of shepherding a consistent set of market opportunities to grow and create long-term value for customers and impact for communities operating within evolving markets. Successful Fundamental investing is the process of developing and maintaining an *idiosyncratic and well-informed perspective* on both where markets are and how they may evolve. Accordingly, asset owners and managers with fiduciary responsibility must also operate within a longer-term perspective with regard to both corporate performance and financial returns if they seek to benefit from unique market insights over the long term life of their fund.[30]

Furthermore, larger investment funds may be prone to partial dependence upon "rolled up" metrics that by their very nature dull sharp edges, eliminating nuance and masking deep market insight. For example, if one is considering an investment in AIG, the analyst is examining information representing multiple and diverse corporate holdings, whereas if an analyst is focused upon a "bricks and mortar" company the financial statements are typically more transparent.

For these reasons, many return-focused Fundamental hedge fund managers choose to maintain *smaller portfolios* with fewer holdings which allow them to remain closer to the investments they oversee and cultivate. This in turn positions them to be more responsive to the dynamics of the markets in which they invest—both readily identifying opportunities and being able to act responsively to unique market insights and dynamic shifts.

Certainly, while one does not necessarily have to be small to be either Sustainable or a Fundamental investor, maintaining a smaller investment portfolio can help fund managers more effectively track their holdings and stay connected with firms in which they are invested. If one is a "long only" fund, managers may create investment portfolios which are, in fact, quite large since positions are taken in firms and held for an extended period of time. A smaller, Fundamental hedge fund portfolio may be

[30] Interestingly, this long-term perspective on investing and value creation holds true regardless of whether one is in pursuit of financial return or community impact. Emergency relief programs, charitable gifts and short-term governmental aid may assist in keeping body and soul together for a day, but economic development, impact investing and strategic philanthropy with the offering of growth capital for social entrepreneurs are what is required if we are to position communities to attain true development and sustainability for a lifetime. A principled investing strategy based upon the Fundamentals of investing in real value creation is the foundation of *any* effective approach to capital management—regardless of whether one is in pursuit of competitive financial returns or meaningful community impact.

managed on more of a tactical basis, thereby limiting the overall size of the portfolio one maintains.

When all is said and done, long-term investors with deep knowledge of any given portfolio or watch list must ultimately rely upon the *integrity and talent of the leadership* in which they are investing. Furthermore, in some cases, confidence in leadership may be less a function of past financial performance and current economic trend projections than investor faith in the *future* leadership demonstrated by a CEO and management team of a firm. This can only be assessed as a function of perceived personal integrity and knowledge of how that leadership functions in the day to day reality of running a company as well as within those exceptional market moments which test the full mettle of fund managers. Together with good governance practices, transparency and other factors, such confidence in leadership and talent may only be built upon the principles of Fundamental investing outlined above. One may debate whether that confidence comes as a result of such investor inquiry or must exist from the start, however a central premise of Fundamental investing is the seemingly self-evident knowledge that a company or fund is only as good as its leadership and people—its social capital.

In this regard, the notion of what could be called "principled investment managers"—whether at the level of an individual investment fund, a fund of funds or, for that matter, at the level of individual corporations—is of real interest from a Fundamental investing perspective. By this we refer to the integrity and principles of fund managers as being key to making sound decisions with regard to investing with such funds. In the realm of Sustainable investing, one also hears investors raising questions with regard to a firm's values and integrity. And this area would appear to be one more place where Sustainable investors find common ground with Fundamental investors.

Finally, each of these elements of Fundamental investing practice may be understood as creating the opportunity to pursue unique ideas. Hedge fund managers with the best idea are often viewed as unique individuals with depth in a given market and insight into how that market—and the actors within it—function. "Best Idea" fund managers may act to bring integrity to their investing practices and frequently have the talent to manage "across a market," in contrast to many others with a greater potential to "run with the market." By applying the seven core components of Fundamental investing presented above, Fundamental hedge fund managers seek to consistently manage risk while capturing upside reward.

In concluding this section, the perspectives of two reviewers of this paper are of interest. One stated that, "There is nothing particularly distinctive about how you are framing your definition of Fundamental investing. At the end of the day, it is simply a question of good, common sense investing that would hold true for any investor." The second, however, stated that the whole notion of Fundamental investing within the hedge fund space was questionable—and that <u>none</u> of the fund managers he knew would recognize themselves in the previous description of Fundamental investing!

Both comments are correct. And that is exactly the point.

Fundamental investing as envisioned by a new set of principled investors is simply about sound investment practices which pursue returns while effectively seeking to manage risk—practices which are shared by various actors within Traditional investing *and* Sustainable investing alike and is a significant factor in Fundamental investing whether through hedge funds or other strategies. In many ways, both types of investors share more in common than we have acknowledged to date—with the challenge for the informed investor being to identify and invest with fund managers who do, in fact, recognize themselves in such Fundamental practices and who embody these central aspects of and approaches to the execution of their investment strategies.

Financial sustainability as a Sustainability component

Financial sustainability is core to any discussion of the fundamentals of sustainability in that without an organization being financially viable that organization (regardless of whether it is a for-profit or non-profit corporation) will cease to exist—the ultimate state of being unsustainable! The form this financial sustainability takes (commercial rate returns or subsidized returns) will determine the long term life of the organization as an organism, ultimately determining whether that organism lives or dies.

Accordingly, if an investment product does not generate a financial return, that product is not competitive and will ultimately lose its investors. But generating a consistent financial return should not be confused with short term spikes in share price or corporate valuation. Capital markets witness periods of what are in essence asset flow driven shifts where a "hot" fund or investment category rises in financial valuation, but isn't truly sustainable since it is simply the individual share price or broader market index that is getting bid up. A company's current share price may look financially promising separate and apart from any core fundamental analysis of its longer term prospects—which may be much less promising!

It is interesting to note how questions of true financial sustainability and expected return are tied directly to investors' understanding of expected market level, long term performance. This past year witnessed the abrupt end of what was the longest, highest growth period capital markets have ever experienced. As we enter this next period of market activity and grapple with the evaporation of literally trillions of dollars of global capital market value, we must ask ourselves what our future expectation of long term financial performance should be. In this new environment with the real possibility of lowered long term growth expectations, understanding how investment managers may create alpha in a consistent manner is a key challenge for all market participants.

In addition, the question of what constitutes financial sustainability is also a function of asset class. Today's investors looking for Sustainable investing options may select from a host of investment products ranging from fixed note offerings to public and private equities.[31] The area of "Long/Short" hedge funds, however, remains a challenging one in which to identify products which are consistently sustainable while offering investors competitive financial returns for a Long/Short strategy. As described above, the "trick" here is not to confuse sectoral funds that are "green" with either Fundamental or Sustainable investing practices. While various managers are working

[31]Krosinsky and Robins present a current overview of the breadth of these emerging sustainable investment products. And a new report published by Rockefeller Philanthropy Advisors, entitled "*Solutions for Impact Investors*" (Pomares, Kleisner, et. al.) is also very helpful in presenting investment products across asset classes.

to construct hedge funds which invest on a sectoral basis directly in what might commonly be thought of as "green" investments (bio-fuels, water, infra-structure, renewables, etc.), the return on many of those funds has to date been uneven and highly volatile. Integrated investment funds[32] within the hedge fund space hold future promise of offering strategies which are fully sustainable on financial terms while exploring related aspects of sustainability such as those described in this paper.[33]

At the level of the individual (and not institutional) investor, ultimately the question of how much "weight" investors place on the goal of financial sustainability is a key consideration. One expert in wealth management observed that at the individual, retail investor level she suspected sustainable investments are often given a "pass" on the financial sustainability question, with some investors actually opting to accept a lower level of financial performance in exchange for the pursuit of defined social impact. A second advisor, Kathy Leonard, observed that clients *do not* have to sacrifice financial return to invest sustainably and other factors are at play as well. For example, a client's perception of an advisor's commitment to sustainability, their personal relationship with their advisor, inertia to change advisors and so forth may all play a role in how individuals value financial performance as an issue. Yet a third wealth advisor, Max Rutten, frames the discussion of financial performance within the context of a client's overall life goals. In that conversation financial return and performance are one part of a larger discussion regarding the "life footprint" clients seek to leave as a legacy to a family's next generation.

In this way, individual investors operate in a somewhat shifting context that differs between investors when it comes to assessing the importance of financial performance in defining the overall success of their investment approach and, specifically, financial returns.

On the other hand, due to considerations of ERISA[34], institutional investors (for example, pension fund trustees) could not tolerate below market rate, risk adjusted financial returns on their investments. They are mandated to pursue whatever overall investment approach holds promise of the best financial return possible. What is interesting to note is that in recent years ERISA has allowed that while fiduciaries must pursue full financial performance for the assets under their management, fiduciaries must also consider how various "extra-financial" factors may impact future financial performance. And it is under this provision that many state pension funds have been taking the lead on the issue of climate change.[35] However, it should be

[32] The terms "Integrated," "Traditional" and "Pure-Play" are specifically defined in the Capital Markets section of this paper, beginning on page 24.

[33] An interesting comment was also made in this regard by Alan Kaufman who pointed out that "hot new" areas of investing may also attract less skilled managers. A manager who is meeting with great success in an "old" area of investor interest will be satisfied with that and not look for a new approach or area in which to invest. While there are no doubt many skilled managers drawn to the opportunities of a new investment arena, Alan cautioned that there is also the likelihood that managers who have not done well in existing areas of investing may be drawn to a new area in order to have a fresh start.

[34] ERISA stands for the Employment Retirement Income Security Act and is the governing law trustees of pension funds must operate within. Other fiduciaries (for foundations, endowments and so forth) also tend to use ERISA as the legal framework within which they must operate.

[35] Harvard University, the United Nations and this author have each produced documents on this critical issue. These reports may be found at: http://www.unepfi.org/fileadmin/documents/fiduciaryII.pdf , *The Prudent Trustee* at

understood that this directive to consider extra-financial factors is relative to the risk they may represent to the investment—and not the possible positive social impacts such factors may generate or capture as an investment opportunity.

This discussion of individual versus institutional investor perspective is of interest since in many ways the question of whether one must give up financial performance in order to be "responsible" is reflective of previous years of socially responsible investing practice wherein negative screening and the limiting of investment portfolios was the dominant approach and is negatively viewed by many Traditional investment managers.[36] With that history in mind, many of today's Sustainable investors and investment products seek to attain both financial performance *and* sustainable value creation. The fact is one may opt to modify the terms of investing (accepting a longer-term structure, taking on greater risk or accepting a lower risk adjusted return) however one does not have to do *any* of those things to engage in and benefit from a Sustainable investing strategy.

Either the perspective of the individual investor or the institutional investor is not necessarily more correct or "right." Rather it is up to the investor to decide what level of financial performance and returns is acceptable in the pursuit of his or her overall investment goals—which will also include financial and other considerations, such as risk and volatility, as well as overall Sustainability.

Considering the Fundamentals of Sustainability

Assuming a commitment to attaining full financial sustainability is a shared attribute of Sustainable and Fundamental investing, there are other areas of consistency as well. As previously discussed, these may include:

- ✓ A Long-Term Investor Orientation
- ✓ Engagement in Deep Research
- ✓ A Commitment to Sound Financial Stewardship Through Investment Strategies that Operate with No or Low Leverage practices
- ✓ A Focus upon Sound Governance Principles and Practice
- ✓ Identification of "off balance sheet liabilities" represented by social and environmental factors
- ✓ A Commitment to Transparency
- ✓ Affirmation of Fund/Firm Managers who are responsible, thoughtful and executing Fundamental investment strategies

A long-term investment orientation appears to be the key practice which allows Fundamental investors to connect with their Sustainability counter-parts for as soon as one makes the shift from "short term flip and profit" to longer term value creation one moves beyond simply crunching numbers to an exploration of how to augment such financial analysis with deeper manager insight and perspectives gleaned from sound, Fundamental research. In the same way that a Risk Metrics, TruCost, or KLD

www.blendedvalue.org and http://www.hks.harvard.edu/m-rcbg/CSRI/publications/report_3_Sustainability%20and%20Risk%20Report.pdf .

[36] This discussion of performance raises the issue of the business case for Sustainable investing addressed further in a future paper to be released by Veris Partners.

differentiate themselves through their research capacities, Fundamental hedge fund managers must cultivate an understanding of investment mandates and markets which go beyond what traditional quantitative analysis may offer.

Since the investor orientation is to long term value creation and sustainable financial performance, limiting or eliminating use of arbitrage opportunities enhanced with the use of leverage (debt) helps many Fundamental Long/Short hedge fund managers engage in what they feel will be better financial stewardship than their Technical counter-parts. When further enhanced with considerations of "extra-financial" factors (such as fund culture, management team and so forth), Integrated firms move beyond Traditional investor practices and align more closely to those of the Pure Play firm, (as those terms are defined in the Capital Markets section of this paper below).

In exploring a discussion of the need to assess off balance sheet risk and extra-financial factors which will have an impact upon financial sustainability, one is struck by the organic nature of Fundamental Long/Short hedge funds in particular, and all Fundamental firms in general. This is because what is ultimately under analysis is the management of *social* capital. In their analysis of any investment opportunity, Fundamental investors must drill deeply into a firm's core characteristics: the worldview of its managers, the firm's history, culture, and collective experience.

One has to not only understand the social capital of a given fund or company, but also the eco-system within which it operates and its relative position to other, competing funds within its market. The investor must understand how various fund managers think, what they feel in a shifting environment and how they will respond to complex market dynamics. One looks for low personnel turnover (which speaks to a stable system) as well as for a culture of humility and passion for the life of the firm—namely a passion for the firm's future existence and understanding of its place in economic markets. These are not terms or analytics used by all Traditional market investors, however they are phrases often used by both Integrated and Sustainable investment managers.[37]

Such off balance sheet considerations matter a great deal to both Sustainable and Fundamental investment analysts—as do political and regulatory factors which will affect how those environmental and social issues come to be priced in the market. Using these off-balance sheet factors to more effectively assess risk and opportunity becomes a cornerstone of both investment processes. The IFC and such groups as The Enhanced Analytics Initiative offer a set of initial thinking and tools for use by Sustainable investors.[38] In coming years, Integrated investment groups must work to create analytic tools and processes which may be put to use in their investment practices as well. Firms which fall into the Pure-Play realm may have specific types of environmental and social factors which they want to see their investments manifest,

[37] However, while this is true in the broad sense and fund of fund managers may include "humility" as one of the many factors they look for in the hedge fund managers with whom they invest, several reviewers of this paper commented that precious few of the hedge fund managers they knew could be said to be "humble," and in fact, what investors often seek out are managers with "attitude" and conviction which sometimes looks little like the characteristic of humility.

[38] As of early 2009, the Enhanced Analytics Initiative became part of the United Nations PRI. http://www.enhanced-analytics.com/portal/ep/home.do; http://www.future500.org/sustainability-toolkit/

whereas for the Integrated firm the simple fact that fund and corporate managers are asking the "right" questions (and effectively anticipating off-balance sheet risk) may be of greater importance than those same firms pursuit of a specific "green" investment strategy or that they have the "right" answer.

Finally, Traditional investors seek to maximize shareholder value and returns. Integrated and Sustainable investors certainly seek to provide shareholders with financial returns—yet they both understand the role of and accountability to shareholders and stakeholders in generating those long term, consistent returns. Increasingly, a growing number of Fundamental Long/Short hedge fund managers do not function within an understanding of accountability which places these two sets of actors in conflict, but rather view such conflict as reflections of a misalignment between society and shareholder—a misalignment which may often be a reflection of unsustainable corporate or capital market practices. This bifurcated worldview is in tension with the reality that full, Blended Value integrates various components of value into a single whole.[39] And in this way, Fundamental and Sustainable investors both affirm a future of sustained stasis whereby the long-term value for investors is a reflection of long-term value created for all stakeholders, whether employees, individual investors, pension funds or local communities.

Shorting As a Social Act?

A majority of Sustainable funds (whether they hold public or private equities) invest on a "long-only" basis. In contrast, the types of Fundamental hedge funds we have been discussing take both long and short positions. While shorting practices have been the center of many debates regarding the need to regulate certain hedge fund investment practices, before we review such a debate it must be acknowledged that the practice of shorting by investors is not new—indeed, investor shorting has been a common tool for many since the mid-1800s.

In the most basic definition, taking a short position simply means investors sell shares of companies which they do not actually own but are borrowed from long holders and promised to be delivered in the future. An investor takes a short position in order to bet that a company's share price will decrease over time. If the stock price decreases in value, the investor has the ability to close the position by buying back the shares, also known as "covering the short position." In this way, Long/Short hedge fund managers are able to bet against companies whose value they believe will decrease over time and thereby make a profit. Some Fundamental long/short managers will use shorting to pursue financial return in and of itself, while others view it as a tool in risk mitigation in order to "cover" long positions they are carrying. As is true of all investing, investors take short positions as informed by their belief that either market movements will run against a firm or that the firm's business model and practices are not competitive (i.e. financially sustainable) and will lose value over time.

The effect of shorting on markets and even on society is often framed in strictly negative terms—with investors who short being portrayed as driving companies'

[39] For a collection of writings on Blended Value and research regarding the development of strategies which seek to generate multiple returns (financial performance with social and environmental impacts) please see www.blendedvalue.org.

valuations down, potentially creating volatility and profiting from failure. Beyond the practice of shorting individual companies, it must be acknowledged that shorting can indeed have a negative effect upon national currencies and economies. Where shorting may certainly be viewed in a negative light is in the practice of using shorts to actively distort a given market, driving value down and allowing a handful of investors to profit in a way that is unfair not only to other investors holding stock or national currency in those markets, but to society at large. And, of course, the practice of "naked shorting" is illegal and not condoned by any of those who affirm the positive aspects of shorting practices. Either way, the issue is one of whether investors are engaging in activities which contribute to market distortion and turmoil from which they seek to gain unfair advantage over other investors in the market.

With all that in mind, from another perspective shorting may also be viewed as a social good. While investment professionals debate its relative merits, shorting can create greater liquidity for investors, may be useful in indicating a "bottom" to market pricing, can be used to control general equity market risk and may also serve to actually decrease overall volatility within a market. Within the context of Sustainable investing, shorting also has the potential to act as a signal to markets and society at large that an industry or company within an industry group are at risk—either as a result of poor corporate management practices, engagement in "unsustainable activities" or simply due to larger market trends such as having a business ill-suited to the demands of an increasingly carbon constrained planet.

For example, when investors decide clean tech is a "good investment," increasing numbers of investors may move into the segment, bidding up the value of all companies to levels unsupported by the underlying fundamental valuation of individual clean tech firms. This may contribute to the creation of bubbles within favored industry segments which when they burst have a negative effect on all—good and bad company alike. Accordingly, companies operating in what may be viewed as a "good" industry segment may see their valuations increase even if they are "bad" companies (either due to management issues or poor business models which will ultimately impact their financial prospects and therefore make them "bad" in financial terms—not bad in the normative sense of the word). Shorting bad companies within a good industry offers the potential to improve the efficiency of those markets, punishing the poor performers in a segment within which many would like to see greater growth and expansion.

In these ways shorting may actually act as a fiscal "canary in a coal mine" to warn of impending problems and the potential for decreased future performance. When viewed in this light, shorting is the process by which a stakeholder group (in this case, investors) is allowed to punish managers and governing boards for poor operational decisions in running a publicly traded company—something that will be of benefit to the individual investor, hedge fund investors and, ultimately, the overall capital market.

When understood in this way, shorting itself is value neutral. And shorting may be viewed as not necessarily antithetical to Sustainable investing. It is only when used in efforts to distort markets or when shorting leads to a piling on, momentum effect among traders in the market that such practices can be damaging to firms, capital markets and nations. Shorting, as is true of any widely embraced investment practice, ought to be viewed as an available investor tool, but it is a tool which should be monitored and, in some cases, effectively regulated in order for it to maintain its value to both investors and society. In this way, shorting may be understood as a positive "social act" in that it's judicious use as an investment tool can both reward investors and protect the larger market by signaling poor management or corporate prospects.

For Sustainable investors interested in making use of short strategies there are at least two challenges, one having to do with the issue of timing and, secondly, transparency. With regard to timing, the challenge for Sustainable investors is the same one shared by *all* investors: while one may be aware of poor performance or potential future for a company, how does one gauge when—exactly—in the future that company will be held accountable by the market for poor performance? There were investors who moved to short Enron in the months prior to its complete collapse—but some held those shorts for a relatively long period of time prior to the company's demise. Furthermore, since many sustainability investors manage "long only" strategies, shorting moves such investors into what could be thought of as a "trading posture" which may be contrary to their core operating practices and a commitment to being "long only" as an investment strategy.[40] Understanding when to short a company and how long to hold that position are critical aspects of successful shorting practice—and would also be critical to successful shorting as a Sustainable investor.

Some hedge fund managers do promote their short positions as part of their overall strategy since they ultimately want the market to move in the direction of their short position, but for others to promote the short positions they take in the market is to telegraph those unique insights to others and, thus, risk losing their investment edge and uniqueness in advance of executing their particular strategy. For shorting to fulfill its potential as a tool in advancing sustainable investing, managers would need to embrace shorting as part of a sustainability agenda, encourage others to short the same company and allow the market to move to "punish" poorly performing companies. While socially responsible investment groups have acted to make use of the power of the proxy to raise issues with corporate management, it is not clear hedge fund managers would act collaboratively in the same way, with the same intent until after they have locked in their position—if ever.

The following comment, from one Sustainable investing Long/Short hedge fund manager offers insights into how one manager views shorting as a useful instrument of both finance and sustainability:

> *"…shorting is a tool and not a moral or ideological statement. It is a risk management vehicle providing for exposures to be managed in a given sector or category and allowing the manager to hold on to high conviction "long" investments in times of market duress. It is also a moneymaking tool organically arising out of the fundamental research, understanding of value and overall*

[40] Again, as discussed in a previous footnote, the issue of how various investment practices are actually marketed and understood by investors is key here. One could conceive of a "long only" manager maintaining a long term conviction with regard to market dynamics and opting to use a set of "shorts" to trade around that conviction. In this way, short term trading around a long-term conviction could be viewed as having a long-term investment horizon. And while one of our reviewers referred to this notion as "BS", the fact remains there are hedge fund managers who view their investing practices in this manner…which, of course, is exactly the point.

knowledge base a manager has of a given sector. It should never be moralistic; shorting oil companies because they are exploitive is a failed financial strategy, shorting one because its reserves are overstated and dwindling is not. However, in the context of a sustainability portfolio, shorting an oil company against any alternative energy company does not reflect either exposure management or risk mitigation. While pair trades are a flawed approach, it is generally useful to think of longs and shorts as thematically as well as quantitatively correlated bets."[41]

It should be noted that several active investors and reviewers of this paper argued that, in fact, pair trades are not a flawed approach and could be tools in advancing a sustainable approach to shorting practice within the hedge fund arena. Their perspective was that by shorting "bad" companies and going long on "good" companies (again, recognizing all the limitations in using the normative terms of good and bad in this sentence!), shorting could be used to play the role of activist shareholder within capital markets for the benefit of both shareholders and the larger society as well. And, again, in that sense, shorting should be viewed as simply a tool to advance one's interests as an investor—whether those interests are simply financial or financial with consideration of how social and environmental factors may impact financial returns.

Which brings us back to that intriguing possibility:

For many Sustainability investors, the practice of shareholder advocacy is a widely embraced one which has demonstrated real effectiveness in not only raising issues with management, but securing meaningful changes in corporate practices—advancing change that is both good for shareholders and community. These shareholder activists include a growing number of pension funds, foundations and endowments—each of whom is driven both by a financial interest in seeing that companies in which they invest operate with greater efficiency and compliance with best thinking of how sustainability factors are fundamentally material to the long term success of corporations. They work to raise issues with management regarding a host of environmental and social issues—and they agitate to replace managers who don't recognize the risks present in a carbon-constrained world or the threat to corporate value represented by poor employee retention practices, among other investor concerns.

And guess what?

A common practice among some hedge fund managers who engage in shorting is to stake out a position and then engage in activism against either the managers or boards (sometimes both…) of companies they target. One wonders whether there isn't a real opportunity for both approaches to be linked in a powerful manner wherein "short shareholder activism" executed by an emergent set of capital market revolutionaries couldn't help advance the shared agenda of both Sustainable investors and more traditional hedge fund managers. This prospect of altering how capital markets move through executing Sustainable hedge fund strategies is further addressed in the following section of this paper.

[41] Excerpt from an email exchange with the author.

In sum, the question of whether shorting could ever be viewed in a positive light by Sustainable investors was perhaps the most contentious topic among this paper's reviewers. There were those reviewers who felt shorting was always negative and to say anything else was to act as an apologist for the worst aspects of capital investing and management. Others felt shorting plays a critical role in advancing efficient capital markets by punishing poorly performing firms and acting as a control on over-valued companies. In the end, it is probably best to acknowledge that shorting itself may not be the issue and shorting in certain instances can indeed have negative effects. However, the potential of shorting to function as a positive tool in advancing the interests of investors should also not be ignored and could be turned to the advantage of a Sustainability agenda if mobilized as part of an intentional strategy by a significant number of investors.

Capital Market Catalysts Becoming Revolutionaries

With these broad and general understandings of the key aspects of both Fundamental and Sustainable investing practice in mind, it is intriguing to further consider intersects between the two—as well as the limits of such a comparison. In exploring this notion of the common aspects of Sustainable and Fundamental investing practice, it is helpful to have a sense of the landscape within which they rest as ultimately both are part of a larger capital market—a market the transformation of which may be viewed as the ultimate goal and end game for Sustainable investors. This landscape may be thought of as consisting of three related sets of actors: Traditional Investment Firms, Integrated Investment Firms and "Pure-Play" Firms.

These may each be broadly defined as follows:[42]

- *Traditional* firms may be thought of as the vast majority of mainstream investment firms which pursue financial returns without consideration of sustainability factors.

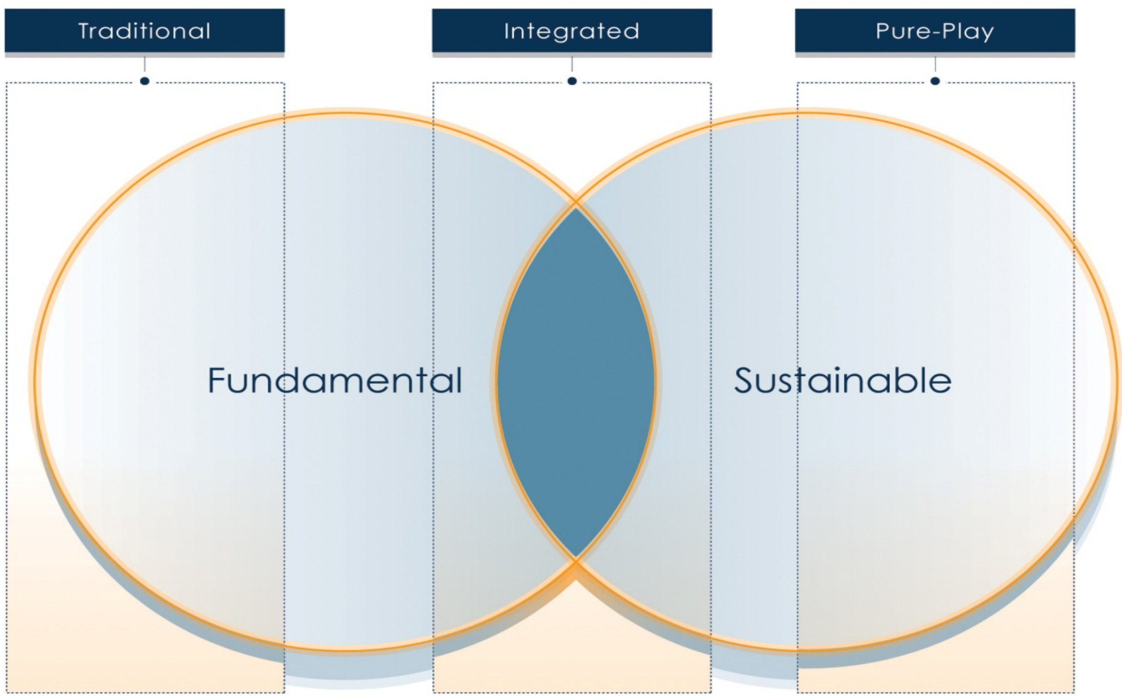
- *Integrated* firms are that growing number of investment groups which consider potential financial performance as their central criteria for investing, yet which in various ways also seek to actively integrate various aspects of sustainability into their investment strategy because they believe them to be material to the business and play a function in long-term performance/returns.

- *Pure-Play* firms may be thought of as those firms which are clearly branded as sustainable and socially responsible investment groups. These firms may or may not use screens or other tools to construct their portfolio of investments, but however defined they view their approach in terms of sustainability as *the* driving consideration for their investment philosophy and practices.

In assessing the intersects between Fundamental and Sustainable Investing, it is important investors be clear on how directly they would like to have their investment strategies framed in terms of sustainability language and direct practice. This is what

[42] These terms were conceived and framed in the context of this paper. However, the terms themselves have been used by others and may not be unique to this discussion—accordingly, others may have assigned them specific definitions which may vary in usage from that presented above.

Mathew Kiernan, Founder of Innovest, has referred to as the "Sustainability Quotient"—namely, from the client perspective, how green is green enough?
The answer to this question will be different for different investors. Some will want to invest only in Pure Play funds which limit themselves to investing in Renewables, Sustainable Forestry or other clearly defined "green" or socially responsible investments. Others will want to see consideration for sustainability integrated into an overall investment approach, but are less interested in being able to clearly "brand" their investing as wholly sustainable or in using their investment approach to advance specific economic activities, for example within the areas Green or Clean Technology investing.



And still other investors may accept such investments within a diversified asset allocation strategy as part of a Traditional portfolio of capital holdings—but would not actively seek to include sustainability factors as a part of their overall investment strategy.

For those hedge fund investors with an interest in Sustainable investing, the challenge is that many current Long/Short investment approaches focus on investing in a "sustainable" market segment—but do not necessarily drive sustainability analysis down within a set of investments to ensure the underlying holdings of a fund are themselves truly sustainable. One may be investing in a sustainable category (Clean Tech, for example) while within that category there may be companies that are not being managed in a sustainable manner. As is discussed in this paper's section on shorting, the ability to invest long with "good" firms while also having the capacity to go short on "bad" firms is one intriguing aspect of a Sustainable Long/Short investment strategy that has appeal to many exploring how best to advance a sustainable investing approach within a volatile, still evolving investment market.

Another aspect of how different investors view the investment landscape consisting of various firms and their degree of sustainability will have to do with the issues of what may be thought of as “original intent.” For many investors who have an interest in advancing the practices of sustainable investing and finance, the original intent of firms making use of such approaches is an important, if not critical, consideration. For example, Paul Hawken’s firm, Highwater Research, is premised upon the idea that a company’s intent to be sustainable should be the defining factor, the starting place, for any investment strategy which claims to be Sustainable. And the IFC definition of sustainability, with its focus on risk mitigation, may simply not be viewed as having a strong enough sustainable intent for some investors. While those investors may be interested in seeing Sustainable investing enter the mainstream, they have a specific, perhaps more “green” understanding of what sustainability means and would want the central purpose of the managed funds they invest in to advance that understanding.

By contrast, other investors (for example, fund of funds investing in hedge fund managers with various strategic mandates) may choose not to engage in “reaching through” fund managers’ portfolios to dictate that fund managers only hold positions in firms with “original intent,” preferring to opt for managers who generally apply practices which could be viewed as broadly consistent with a sustainability agenda focused upon the goal of risk mitigation or other desired investing attributes. In this way, Fundamental investors (whether by default or design) may seek to incent sustainable fund management practices among other fund managers by affirming such approaches through how and where their funds are invested—and where they are not. From the perspective of the asset owner or CIO, the goal is to create a portfolio of fund managers executing what could be thought of as positive practices and opting not to invest in fund managers who make use of investing practices which do not create consistent, sustainable returns for their investors.

A Matter of Time

Let’s return to our previous discussion regarding an additional factor considered by many investors, that of time horizon. A central argument of this paper is that Fundamental hedge fund investing, as defined herein, holds long-term investing as a central aspect of a Fundamental strategy. However, simply saying one is a long term investor is not enough and such a term needs further exploration.

Some investors may view “long term” as a question of years and not months. For such investors, any holding not undertaken with an eye to maintaining that investment for one or more years is simply not viewed as a long-term investment—regardless of the asset class or other considerations of investment strategy. In contrast, we would argue that a determination of whether an investment may be considered “long term” should not be made in the abstract or by each individual investor, but rather should be made by individual investors with reference to the specific type of asset class and investment strategy under consideration.

With this perspective in mind, many Fundamental Long/Short hedge fund managers (as opposed to Technical fund managers) may be thought of as taking a long term perspective since their core positions are often held for numerous months—when the average hedge fund investment is sometimes made for a matter of days or perhaps weeks. While this is true, those same managers may take a long position yet opt to "trade around" that position—shorting other companies in the same market which they view as poorly managed (or not financially sustainable). These short positions are, for the most part, held on a short-term, trading basis as opposed to a long term, "Buy and Hold" basis—yet in either case the intent is to capture increasing value and benefit from decreasing performance.

Specifically, one Long/Short fund manager described his perspective on time horizon as follows:

> *"Long/Short hedge funds tend to have higher turnover. And a fairly concentrated fund like ours will see the short book turnover 3X per year on a name basis, while the long book turns over at half that rate; this is in part driven by exposure management and in part by the setting of stops. It is more important to think of turnover as related to the large positions in the book. The key is the holding period of the conviction bets, and all the effort surrounding the portfolio construction is driven toward developing and maintaining conviction in an investment and seeing it to its conclusion. With this in mind, the lower end of the portfolio has (or should have) a different turnover profile than the upper end."*

At this time, the determination of what ultimately constitutes "long term" is one each investor must weigh. For some investors, long term is quite simply a matter of taking positions for a year or more and so any hedge fund investing that is not "long only" will never be viewed in a favorable light by those investors. But if an investor is looking to diversify beyond "long only" into a "Long/Short" hedge fund strategy, then the understanding of an appropriate investment time horizon will have to adjust to accommodate the specific strategy being considered—or the asset owner should opt not to invest. And it is for this reason historically many Sustainable investors have tended to focus primarily upon "long only" investment strategies.

In addition, the investor's time horizon influences not only how she views returns and investment time periods, but also how she comes to view the overall market trends and conditions within which those investments will play out. Such a long term perspective may support fund managers' deployment of tactical tools which assist in executing more effective approaches to risk management—tools which will assess factors such as the leadership capacities of management or the capital structure of the firm, as well as factors such as how environmental trends and corporate practices serve as potential "off balance sheet liabilities" which could have an impact upon the firm's potential to generate consistent financial returns for investors.

For many Sustainable investors, long term means they will exclusively take "long only" positions in companies they believe to be offered at a good price and are well managed for multi-year performance—however, for many Fundamental "Long/Short" hedge fund managers having a long-term perspective on investing does not necessarily translate to maintaining long term holding periods for all investments. Rather, as is true for the previously quoted fund manager, such managers will seek to map the long term expected path of a market and its actors, attempting to use that assessment to inform when to buy, when to sell and when to short.

A critical component to this discussion of time horizon and long-term perspective is that the asset owners—those investing in hedge funds—are often themselves driving for <u>short term</u> returns. Those investors may invest in hedge funds as a way to diversify their exposure and therefore the pressure on hedge fund managers to significantly outperform other investment strategies each and every quarter is high. This is one reason most hedge funds maintain "gates" on investor assets, in order to ensure they have the funds on hand to manage long term strategies effectively. In some ways, of course, this is a "chicken and egg" problem since the rationale for hedge fund firms earning such large management fees is that they offer the promise of extremely competitive returns on a regular basis—positioning themselves as "Absolute Return" funds which, over the long run, will seek to do well in both up and down markets.

The Activity and Outcome of Investing

Within this discussion, a central question becomes whether one views the *outcome* of one's investment approach as defining sustainability or the *activity* of investing itself which promotes sustainability. For example, Pure Play firms may be more clearly branded as "sustainability"-oriented but may hold positions in individual firms which are not always viewed as sustainable.[43] Integrated firms may also act to advance sustainable investing practices within mainstream capital markets but may not do so with the "original intent" to be Sustainable investors. And financial markets, together with the diverse actors within them, by operating in various ways may function to either advance or detract from the ultimate "sustainability" of their investments (the outcome) as opposed to managing their investment process in a sustainable manner (the activity).

Either way, capital may be viewed as a resource to create change or, as it has been referred to, as "trapped energy"[44] which may be applied to generate financial performance *with* multiple returns (i.e. social and/or environmental impacts). This energy may be used in a variety of ways. It may be targeted at helping build the assets under management of Pure Play funds. Or it may be structured to affirm positive investment practices of both Integrated and Traditional fund managers within the larger market. In either case, the intent is to use one's capital to create financial returns with various elements of social and environmental value embedded as part of a sustainable value proposition.

This notion that the activity and outcome of sustainable investing may be two parts of the same coin tweaked the ire of one reviewer of this paper. For him, the intent of the investment and the "branding" of investment as either Sustainable or Traditional were the only factors of interest. If a Traditional or Integrated investor happened to create or advance sustainability as a by-product of their investing this reviewer felt that outcome was simply incidental and that the fund manager should not be credited for creating positive, sustainable value in the market.

However, it would seem that, again, is exactly the point: value, at its core, is whole and non-divisible. There are some investment funds which create real, sustainable value through how they manage their investment approach, yet these Traditional

[43] Please refer back to the previous discussion on sustainable intent…
[44] James Jensen, along with others, have used this metaphor for the power of capital.

investors view their strategy as simply sound investment—not as "green" or sustainable. On the other hand, there are certainly funds which operate in a supposedly "sustainable" arena (as previously discussed, investing in renewable energy infrastructure or clean tech) and yet may be supporting practices at the firm level which are not themselves sustainable. One must ask, if a fund manager does not brand themselves as sustainable, yet creates sustainable impacts within a given market, shouldn't that be considered sustainable regardless of the language used to describe the value they create?[45]

Such a perspective underscores the idea that capital markets are, in the end, a means to an end. For the potential of its financial energy to be well managed, financial markets must themselves be managed and operate in a sustainable manner. It may appear self evident, but while there are certainly legal, regulatory and moral aspects to some of the recent destructive practices we have witnessed within capital and financial markets over recent years, as we have seen, the final outcome of questionable practices is that they freeze capital markets—shutting them down and making them unsustainable by any definition of the term. Specifically, governance considerations, which have been the center piece of many sustainable investing strategies and activists, have direct materiality for how mainstream capital markets function.

The question of whether or not one follows a banner of Sustainable investing is ultimately less important than that of whether sound governance is driven forward as a linchpin consideration for mainstream, Traditional investors. Our goal should not necessarily be to simply act as catalysts to create a larger investment community of "sustainable" investment firms, but rather to act as *revolutionaries* within Traditional capital markets to embed sustainable investment practices into the capital market mainstream.

Of course, it should be noted that inherent in this notion of capital market revolutionaries is the idea that one may use capital markets to actually have an impact on something—anything! And that "the Market" cares what you think. There is certainly a school of thought which believes that the act of investing with a commitment to advancing anything other than financial return is not "felt" by the market, that markets are at their core amoral and that buying a stock is simply the act of purchasing what is, at heart, a future—a derivative with a claim on the future earnings of an individual company. Short of engaging in shareholder activism, "the Market" simply takes note of that claim and little else. By this way of thinking, for public equity investors the only way to have an impact on markets is through individual firms which will respond to such factors as shareholder action and public relations threats to brand value.[46]

While there are a number of solid points to this perspective, modern sustainable investing theory is founded upon the emerging reality that social and environmental

[45] Furthermore, as observed by Andrew Kassoy in reviewing this paper, investing in secondary financial markets may create economic value for investors, but does not, at its core, create sustainable value at a firm or community level. This is an important comment worthy of future discussion as we explore sustainable investing in public equities versus private direct equity investing or impact investing.

41. Or by investing in private markets where one could have a more direct role in advancing sustainable business practices. However, the focus of our discussion is the public equity arena.

factors are directly material to the performance of companies and, by extension, their long-term share value. What we are arguing in this case is that as increasing numbers of investors move to allocate their capital with consideration of sustainability factors, this act will itself affect—indeed, has already initially affected—how capital moves and the aspects of performance it seeks to capture.

As we envision the continuous evolution of capital markets themselves, we must acknowledge that there is a role to be played by various types of investors—whether Integrated or Pure Play—in advancing the adoption of sustainable investing practices by Traditional investment firms which manage the vast majority of public market investment capital. As increasing numbers of Traditional firms continue embracing aspects of Sustainable investing, the leading edge work of financial firms more directly focused on "sustainability" as a differentiator will shift. By drawing upon the evolving practices of clearly defined Pure Play firms, those firms practicing Integrated approaches to investing and asset management may be the ultimate vehicles through which mainstream capital markets will be broadly transformed into more sustainable investment arenas for *all* asset owners.[47]

For example, is good governance a foundation for Sustainable investing? Yes.

Is it also critical to Fundamental investing practice? Definitely.

Could the two come together to drive better, more "common sense" and sustainable investing practices within global capital markets in the years to come?

Without doubt.

That said, it must be acknowledged that the current structure of global capital markets is grounded in a reality of intermediaries with a traditionally defined fiduciary duty to asset owners and, in the case of public markets, the obligation to mark to market and provide liquidity to those investors is paramount. One must ask whether and how Fundamental and/or Sustainable investment strategies can overcome that underlying structure of public markets. We would argue that as growing numbers of asset owners seek to manage their investments with regard to consistent financial performance *and* multiple impacts, mainstream capital markets will continue to respond to emerging investor demands for "more than money," just as the concept of fiduciary duty has itself evolved over decades.

While the role of investment funds within the clearly labeled, Pure-Play sustainability arena has been significant in pioneering new practices of investment and asset management, if we are to drive those emerging practices into the mainstream there is clearly a role for firms pursuing an Integrated approach to sustainability. As these firms advance their own investment strategies and develop longer track records of success, the field of Sustainable investing as a whole will be expanded, developed and

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[47] Parenthetically, it is also interesting to note that this notion may also be turned on its head: Instead of investing solely in one of the three categories presented above, investors and wealth managers might opt to invest *across* the three categories in an effort to gain advantage from the best aspects and merits of Traditional, Integrated and Pure Play investment strategies. While this is certainly true, I'm trying to make a point here, so will focus on a cleaner distinction for the moment!

made all the stronger—to the benefit of asset owners and fund managers alike. In this way, the practices of Pure Play and Integrated firms have already demonstrated and will continue to have the promise to radically transform global capital markets. In coming years such firms will themselves more fully evolve from the present role of catalyst to that of capital market revolutionary.

Concluding Thoughts on the Fundamentals of Sustainability

In the end, investors interested in advancing Sustainable investing practices within any asset class are confronted by three core questions:

- ✓ Is there a diverse enough investment universe from which to choose?
- ✓ Are the investment practices at the fund level *truly* sustainable and to what degree?
- ✓ Will the potential of Integrated firms to transform the mainstream investment community ultimately be effective in attaining that goal?

The first question is the starting place for the entire effort to advance Sustainable investing as an alternative for asset owners. If there are not an adequate number of investment options from which to choose, investors will not be able to diversify across a set of sound holdings with which to build their portfolio. Today, there are a variety of investment opportunities branded as "sustainable." For those interested in exposure to Long/Short hedge funds there are fewer funds from which to choose—and still effectively manage portfolio volatility.

Having said that, a growing number of Long/Short hedge fund managers are exploring how to create sound, sustainable investment offerings within this arena (whether through direct, managed accounts or funds which invest in Renewables or other segments which have traditionally been viewed as sustainable). Over time, these investment opportunities will only grow as increasing numbers of asset owners demand their investments reflect their financial interests as well as related elements of sustainable investing.

The second question, of whether Long/Short hedge funds may ever be considered truly "sustainable," is a moving target, based on the specific definition of sustainability used by both individual investors and fund managers. Getting to a right answer requires both that investors be clear with regard to their own definition of sustainability and that fund managers be truly transparent concerning their practices and overall strategy of investing in order for potential investors to be able to make an informed choice. We would argue that in the flow from Traditional to Integrated to Pure Play there is an increasingly wide array of options from which investors may choose—and in the process of their doing so, new strategies which actively integrate additional aspects of sustainable investing into the mainstream practices of Traditional investment firms will be advanced and tested within the overall capital markets.

The final question (Whether any of this will ultimately matter and have the larger impact many of us hope), will only be proven over coming years. If we are satisfied with the current state of Sustainable investing—a growing market, but a niche market nevertheless—then we need not concern ourselves with questions of how such practices enter the global capital market mainstream or the degree to which we steer that process. But if we hope to achieve the long term vision shared by many—a vision of sustainability and integrity within those same global capital markets—we have no choice but to challenge our thinking, to move beyond a small community of like minded actors to a larger, diverse community of investors, stakeholders and asset owners.

Through exploring how best to offer a variety of approaches, products and strategies, over coming years an ever evolving cadre of managers will pioneer these new approaches to fund construction and an equally evolving number of investors will vote with their assets. What is clear is that what was once a fad is now clearly a trend.

How that trend evolves is a future we have the potential to create.

Jed Emerson has been active in exploring how capital (whether philanthropic, below-market or market rate) may be structured to generate multiple returns (financial, social and environmental) for over 20 years. He is an internationally recognized thought leader and has founded or co-founded various social ventures and funds. Jed has held academic appointments at Harvard and Stanford Business Schools and is a Visiting Fellow with the Skoll Center on Social Entrepreneurship at Oxford University. His various writings on these topics may be found at www.blendedvalue.org and he may be reached at the following email address: jed@blendedvalue.net.

Appendix A:
A Key Question of Growth

Not to bury the headline, but the one issue within this discussion of Sustainable investing that is truly the 800-pound gorilla in the room is that traditional investing and popular economics are both predicated upon an assumption that growth is good and consistent over time. This growth is driven by a variety of factors, but four core assumptions of both approaches are that inflation will be present, consumption will expand, productivity gains achieved and new markets identified. If managed effectively, growth may be viewed as a positive process—but even positive processes have sustainable limits. The recent economic crisis raises significant questions regarding the wisdom of building national and international growth-oriented economies upon the sand of perpetual consumption and ever increasing leverage.

Fundamental hedge fund strategies, being longer term in nature, are executed by fund managers looking for consistent returns. As previously described, these returns are generated through holding both long and short positions in the market. The shortcomings of a consumer driven economic system confront <u>both</u> the Fundamental hedge fund manager as well as the investor seeking sustainable, long-term performance. In the end, all long-term investors are challenged by the same core issue of how to create and profit from economic systems which must over time become less leverage and consumption driven and more focused on sustainable economic growth. Ultimately, this core question centers upon the challenge of affirming and investing within a society that does not base its corporate valuations on simply attaining increasing levels of expansion.

In academic terms, a sustainable growth rate is defined as the maximum rate of growth a firm (and we would add, fund) can sustain without increasing financial leverage.[48] In the context of this paper, leverage is understood as both financial leverage as well as resource leverage within an economic system which borrows from the future in order to meet the consumption demands of the present. Sustainable growth—growth that reflects sound environmental stewardship *and* fiscal practices—is the goal of all long-term asset owners who seek to grow their holdings yet do not want to undermine the central foundation of the value they are committed to creating, for themselves, their heirs and the planet in which both live.

This issue has been the focus of a major report by the UK's Sustainable Development Commission, *Prosperity Without Growth*,[49] and will no doubt be a significant area of discussion for many over coming years.

[48] http://financial-dictionary.thefreedictionary.com/Sustainable+growth+rate
[49] http://www.sd-commission.org.uk/publications/downloads/prosperity_without_growth_report.pdf