STANDARDS BOARD FOR ALTERNATIVE INVESTMENTS

Practical Implementation of Responsible Investment in Systematic Strategies

SBAI Toolbox

1. Introduction

Systematic or quantitative strategies typically refer to the use of algorithms and models within the investment process. The strategies may rely on electronic trading and tend to invest in relatively more liquid instruments.

Discussion on Responsible Investment ("RI") within alternative investment strategies has historically been centred on traditional long only equity portfolios. However, with RI rising in both importance and prominence across all asset classes and strategies, systematic portfolios are now also in focus. Some systematic strategies rely heavily on data and can have relatively shorter holding periods. These, and other process differences, mean there may be nuances in systematic strategies when integrating RI into investment decisions or running a dedicated product with stated RI objectives.

As discussed in our Toolbox Memo on a Responsible Investment Policy Framework (SBAI Policy Framework) we have defined the spectrum of approaches to RI as follows[1]:

- **Responsible Integration:** Including financially material RI related risks in the investment process but not pre-defining an investment universe using RI criteria
- **Responsible Asset Selection:** Dedicated RI approaches such as exclusions, inclusions, and impact strategies.
- **Responsible Asset Ownership:** Voting, engagement, and activism.
- **Responsible Corporate and Market Citizenship:** Organisational initiatives, market behaviour, and carbon offsetting. These practices are strategy agnostic and therefore not covered within this memo[2].

This memo will assess each of these as they apply to systematic strategies and the instruments traded.

> This memo forms part of a series of SBAI Toolbox memos helping institutional investors and asset managers increase their understanding of how RI can be applied to different alternative investment strategies including equity long/short, macro, credit, systematic, and insurance linked strategies.
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> The memos are designed to be used in conjunction with the SBAI Policy Framework.
>
> Please see our SBAI Responsible Investment Toolbox for further information.

[1] Fuller explanations of these categories can be found in Appendix A

[2] See the SBAI Toolbox Memo on an RI Policy Framework within the SBAI Responsible Investment Toolbox for further information.

2. Executive Summary: Responsible Investment in Systematic Strategies

There are nuances to both the availability of data and the practicality of implementing different RI approaches to the four broad types of investments traded in systematic strategies[3]:

FX	**Data:** Country level data is typically available (with a bias towards more developed markets) through vendors and other publicly available information. **RI:** Integration and dedicated approaches are practical, providing the relevant data can be sourced, but there can be challenges with engagement at a sovereign level.
Derivatives	**Data:** For derivates based on single name listed equities data is likely to be available. Where this is not the case additional data sources or research may be required. **RI:** RI approaches can be used, although engagement may prove more challenging, but consideration should be given to ensuring any stated RI objectives are met.
Equities	**Data:** Data is typically available for listed equities (with a bias towards large cap securities in developed markets) through third party vendors and disclosures. **RI:** RI approaches are relatively straightforward using public equities although additional research may be required where vendor data is not available.
Baskets and Indices	**Data:** There may be challenges with transparency of data. Managers should give consideration to whether the weighting of the position requires a look through to the underlying securities. **RI:** The practicality of applying a dedicated approach using these instruments may depend on the level of transparency to the underlying holdings

Strategy Considerations

In all alternative investment products, there may be additional complexities to implementing RI depending on the characteristics of the strategy. Asset managers running dedicated RI products should consider some of the following things to ensure the product meets any specified RI objectives:

Long vs Short Positions

Whether a position is held long or short could have an impact on whether the investment satisfies any RI objectives. For example, managers may want to consider whether exclusion lists would apply to both the long and short book of the portfolio.

Time Horizon

Positions held for a longer period of time may increase opportunities for meaningful engagement with issuers on RI related issues. However, strategies with a shorter time horizon could consider engagement at a sector or industry level rather than an individual security level.

Portfolio Concentration

Concentrated portfolios typically have larger positions, meaning engagement and any exclusions or inclusions could have increased impact. Asset managers with concentrated portfolios may also have more resources per position than more diversified portfolios. For more diverse portfolios thematic exclusions and industry or sector level engagement may be able to achieve any specific RI objectives.

Hedging

Asset managers have a fiduciary duty to manage the risk in the portfolio appropriately and may be required to hedge certain risks. This may mean that instruments not necessarily aligned with RI objectives may be present in the portfolio. Engagement remains possible regardless of the reason the security is being held in the portfolio.

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[3] Systematic strategies may also have some cross over with macro or equity long/short strategies. Both are discussed in more detail in separate memos within the SBAI Responsible Investment Toolbox.

3. Practical Implementation of RI in Systematic Strategies

Data

Data is an important component for both integration of financially material RI-related risks and dedicated RI approaches. Typically, data is either purchased from a vendor or sourced by an internal research team. The SBAI Policy Framework discussed the following considerations about ESG data in general:

- Inconsistency of data and ratings across vendors,
- Data may be delayed and not reflective of recent events,
- Differences in methodologies for aggregation of E, S and G scores and weightings,
- Lack of consistency in issuer disclosures globally,
- Risk of cherry picking by selecting the vendor that produces the best portfolio scores, and
- Thorough due diligence being required to ensure that the vendors methodologies align with the portfolio's objectives.

For many of the instruments traded within systematic strategies such as commodity futures or indices there is a significant lack of ESG data.

FX:

Data for sovereign assets can typically be obtained through data vendors and publicly available information such as the World Bank's Sovereign ESG Portal[4]. The availability of this data is in its infancy and as such does not have a long history and can remain static for some time.

Equities and Single Stock Derivatives:

In general, data for equities or single name equity derivatives is the most established within the alternative investment asset classes. Many jurisdictions mandate that listed issuers produce RI related data (although there is a heavy focus on climate related disclosures versus other ESG data points). This data can be biased towards large market cap issuers in more developed jurisdictions. This happens for a combination of reasons, including regulatory frameworks and the availability of resources to provide reliable and consistent data. Equity strategies focused on small or mid cap issuers or emerging markets may find sourcing data in a systematically consumable format is less straight forward. For other single name derivatives based on non-equity assets, for example commodity futures, the data availability of the underlying asset is the key driver for data availability for the derivative.

Indices and Baskets:

These instruments are typically linked to multiple underlying instruments. It can therefore be difficult to source data as it would be required on a look through basis. That said, given the automated nature of systematic strategies, if the data can be sourced for the individual underlying components, then this should be able to be factored into the investment process.

Responsible Integration

The inclusion of RI-related factors into investment and risk management processes, where they have financial materiality. This involves the use of all relevant financial and non-financial information to aid asset valuation and risk assessment, but RI factors are not used to pre-define an asset universe.

[4] https://datatopics.worldbank.org/esg/

As the focus on RI related risks has increased, these risks have begun to feature more prominently in the investment process. In the SBAI Policy Framework we highlighted the importance of a flexible and well understood process to ensure that time and resources are spent on the financially material risks to the strategy.

Whilst systematic and discretionary portfolios have the same outcome i.e., a portfolio of assets in line with the investment mandate of the product, the decision-making process for a trade will differ. Systematic strategies rely heavily on data that passes through rigorous research processes involving data validation techniques amongst others, whereas discretionary strategies can rely more heavily on fundamental research involving interactions with the underlying issuers. There are some nuances for RI integration in systematic strategies that include:

- The potentially higher number of line items in the portfolio,
- The typically shorter holding periods, and
- Potential requirements to look through indices and baskets where they are material to the portfolio.

Short vs Long Time Horizons

In general, it may be G factors that are more likely to cause an event which could financially impact the portfolio as these factors are more likely to lead to an "event" of some sort at the issuer (although there are examples of short-term E issues such as oil spills). E and S factors are typically seen as more long-term risks. This means the financial materiality of some RI-related risks may be limited in certain cases for example when the security is held for a matter of hours or days as opposed to months. Price impacts, however, do not necessarily happen at the same time as real-world impacts and so-called long-term issues such as climate change could become financially material reasonably quickly.

Discussion Points for Asset Managers and Investors

Discussions should be held on how different RI related risks are factored in over the time horizon of the portfolio.

Investors may also wish to discuss with managers both the process for assessing materiality of these risks and the experience of the investment team in the relevant jurisdictions.

Responsible Asset Selection

A dedicated approach where RI factors are used to pre-define the investment universe using tools such as exclusions, inclusions, or impact strategies.

Exclusions and Inclusions

In general, systematic strategies can be designed to include or exclude based on sectors, region, industries, and the like. Issuances of "ESG" instruments such as indices, futures, or green bonds are increasing and could potentially be used within an inclusion-based strategy – but data history and liquidity is often lacking which can make these difficult to base a systematic strategy on.

Derivatives such as futures can typically use data from the underlying asset where it is available to support exclusion or inclusion-based strategies. Commodity futures can present interesting dilemmas that need careful consideration such as the alignment of exclusion-based strategies to any stated RI objectives.

Whilst on the surface it may appear easy to categorise some commodities as “bad”, for example fossil fuels or mining based products, this may not be the case. Commodities may have more than one use, for example a mined product that may be detrimental to the environment during the extraction process could also be used to support renewable or green technology. Oil is another example, divesting entirely from the industry before there are suitable alternatives could be detrimental to emerging markets that rely on fossil fuels for essentials such as hospitals and water sanitation. Futures based on scarce commodities may reference an asset that has already been produced, therefore, thought needs to be given to whether excluding (or including) this commodity future for RI related reasons would achieve any stated RI objectives.

Outside of the alignment of RI objectives point above, for FX, futures, and other derivatives there is potential debate as to whether the use of exclusion or inclusion lists would contribute to any stated RI objectives. This will depend on the reason for any exclusions being applied i.e., are they intended to make an impact on the issuer or underlying issuer (which may be limited in effectiveness) or to reflect an “ethical” view that profit should not be made from issuers that do not meet required standards (likely to be effective). In the case of the former, it may be more practical to assess the RI related practices of the counterparty for the asset.

Portfolios that trade indices or baskets based on multiple underlying issuers may have practical challenges excluding (or including) certain issuers, sectors, or industries. Low levels of transparency may generate a requirement for additional research which is both outside of the investment team’s expertise and potentially unsuitable for the holding period of the position (i.e., the research would take longer than the position will be held). Asset managers may also consider whether the relative weighting of this position means a look through to the underlying assets should be considered, particularly if reporting any RI related metrics to investors.

For a systematic manager wishing to run a dedicated RI product, using a thematic or tilt approach based on sectors or industries rather than individual securities may be more practical, particularly in portfolios with shorter holding periods. Alternatively, fundamental data about the issuers, such as carbon footprints could be factored into the investment selection process. By consistently holding securities with higher ESG ratings, securities from “green” sectors, or other RI based criteria, the portfolio will have a bias over time regardless of the duration the individual securities are held for.

Discussion Points for Asset Managers and Investors:

Where an RI approach is chosen to influence external parties as opposed to reflect an investor’s view, an important question is whether there is a difference in terms of an effective RI approach between holding a physical or a synthetic asset. Discussions should include whether holding a derivative of a security has the same desired societal or environmental impact as holding the cash equity, and whether applying an exclusion list to options or futures has the same potential impact on cost of capital for the issuer as excluding an equity.

Asset managers and investors should discuss any stated RI objectives and how derivative instruments are being used to meet these objectives.

Impact

Dedicated impact approaches with a goal of societal or environmental improvements may be challenging for shorter term trading strategies. Achievement of goals of this kind typically needs a longer holding period.

Impact strategies are generally most effective when investing into small businesses where there is an operational role to play or companies that align with specific objectives that you wish to support such as the UN Sustainable Development Goals[5]. This requires a different skill set than most systematic based investment teams would have and is also a fundamentally different approach to investing than is typical in most systematic strategies.

Responsible Asset Ownership

The use of engagement to drive improvements or changes in RI related practices using tools such as voting, engagement, and activism

Holding single stock equities in systematic strategies theoretically offers the same engagement opportunities as more fundamental equity strategies. Voting is possible and asset managers can choose to implement proxy voting policies aligned with RI related objectives. In faster trading strategies, not all securities will be held over voting periods, but by applying this strategy to those that are, overall voting records would be aligned with the RI objectives.

Outside of single name equities, other instruments offer more limited opportunties for direct engagement with issuers and do not have voting rights attached. This does not, however, mean that engagement on RI related issues is not possible in systematic strategies.

In the SBAI Policy Framework we outlined several forms of engagement outside of direct engagement with companies. Engagement such as with regulators, exchanges, investor collectives, and industry organisations such as the SBAI can all be used by asset managers running systematic strategies.

Discussion Points for Asset Managers and Investors:

Directly engaging with issuers outside of voting may not be practical in systematic strategies. Unlike fundamental research, research for these strategies is typically data-based rather than via interactions with the companies and utilises a different skill set. This coupled with potential short term trading strategies and a relatively larger number of positions means direct engagement outside of voting in these strategies may not be a suitable approach to RI.

Where an asset manager intends to use engagement on RI related matters within a systematic strategy, investors should discuss how this will be achieved.

4. Reporting

Investor reporting will be covered in more detail in an upcoming SBAI memo but the below highlights some systematic strategy specific elements that investors and asset managers should be aware of.

Data:
In systematic strategies the strength lies in data, this means that some asset managers in this space may be ideally suited to provide both transparency and attribution data for RI related factors.

[5] https://sdgs.un.org/goals

Investors should be conscious of the cost of data for reporting. If the data is not used in an alpha generating process, then the data costs (potentially being paid for by the fund) will be to facilitate investor reporting only.

Short Positions:
There are two ways that short positions can be reflected on RI related reporting:

- Gross – where long and short positions along with any associated scores or metrics are presented separately, or
- Net – where short positions are netted against long positions, and aggregated scoring or metrics are presented (i.e., long metrics minus short metrics).

Discussion Points for Asset Managers and Investors:

When choosing how to present (or receive) this information asset managers and investors should consider which way might be more appropriate based on some key considerations:

- If the fund is not a dedicated RI product with stated objectives, then the purpose of the reporting may dictate its format i.e., are investors looking for an aggregated portfolio score or position level transparency to be able to fully understand their exposure.
- For a dedicated RI product, the stated RI objectives will factor into how this is reported. For example, an objective to keep the entire portfolio above an average ESG score may better suit net reporting, but an objective to hold long positions in "good" scorers and short positions in "bad" scorers may be more accurately reported showing long and short positions separately.

Discuss with managers whether the cost of RI related data is borne by the fund or the manager and whether this data is used within the investment process or for reporting purposes only.

5. Investor Due Diligence Questions and Policy Disclosures

The SBAI Policy Framework contains a detailed list of disclosures that should be included in an RI Policy. The below list adds further systematic strategy specific disclosures that should also be considered.

Investors may also wish to use these points for discussions with asset managers on RI related practices.

Non-Dedicated RI Products
• What sources of data are being used for each instrument type traded?
• How is the data being used within the investment and risk management processes?
• How does the manager think about different types of ESG related risks in relation to the time horizon of the strategy?
• Is a look through completed to the underlying constituents of any indices or baskets when assessing RI related risks?
Dedicated RI Products and Engagement
• Do exclusion and inclusion lists apply to both long and short positions?
• How are short positions used (or not) to achieve any stated RI objectives?
• Are there positions in the portfolio that are not used to further stated RI objectives e.g., assets used for hedging purposes only?
• What is the objective of any exclusions or inclusions-based strategies i.e., intended to produce a real world impact or to reflect the views of the asset manager or investor?
• How do the investment choices – including asset classes – align with these objectives?

• Are exclusion (or inclusion) lists applied to derivative positions and if so, how do these positions contribute to the overall RI objectives of the fund?
• Does the manager apply any RI related tilts to the portfolio to achieve a general position over time?
• Does the manager exercise any voting rights for securities if held over voting periods and if so, do proxy voting policies align with the RI objectives of the fund?
• What forms of engagement on RI related issues does the manager participate in including those outside of traditional engagement with issuers?
• Is RI related data charged to the fund? If so, are any data sets used purely for reporting versus being used within the investment process?

6. Appendices

Appendix A: The Different Approaches to Responsible Investment

Different Approaches to Responsible Investment

Responsible Integration	The Inclusion of RI-related factors into investment and risk management processes, where they have financial materiality. This involves the use of all relevant financial and non-financial information to aid asset valuation and risk assessment, but RI factors are not used to pre-define an asset universe.	
Responsible Asset Selection	Exclusions	An "Exclusion List" or "Negative Screening" is used to pre-define an investment universe. Exclusions may be based on "damaging industries" such as gambling, fossil fuels, or tobacco, relatively low ESG ratings or other considerations such as faith-based investing.
	Inclusions	"Positive Screening" is used to pre-define an investment universe. Inclusions may be on a "best in class" basis, i.e., those with relatively high ESG ratings or on a "thematic" basis with investments in particular sectors or industries targeted.
	Impact	Investing with the specific goal of delivering meaningful societal and environmental outcomes, for example, reduction of carbon emissions, or more generally contributing to societal goals such as the UN's Social Development Goals (SDGs).
Responsible Ownership	Voting	A form of engagement based on participating in Annual Company Meetings and using voting rights to support RI-related initiatives or express a negative view on current practices.
	Engagement	Having a dialogue with underlying issuers or companies with a view to achieving improvements on RI-related practices. This can also be used for improvements in wider industries through collective engagement for example with regulators or investor groups.
	Activism	A more involved form of engagement where investors look to promote change through building up a significant holding within a company and potentially gaining a seat on the board. This may also be a more public form of engagement.
Responsible Corporate & Market Citizenship	Organisational Initiatives	Initiatives and policies put in within the Investment Manager's own firm to address environmental, social and governance issues for example, energy efficiency, diversity, and employee wellbeing.
	Good Market Citizen	Being a responsible market citizen by governing the firm's behaviour in the market and ensuring the maintenance of free and effective markets, for example, by having strong controls in place to prevent market abuse.
	Carbon Hedging	Offsetting carbon emissions either directly produced by the firm (for example via travel) or funded within the portfolio (for example by investing in high carbon emitters) using carbon credits or other forms of carbon hedging.

Appendix B: SBAI Responsible Investment Systematic Working Group

(Alphabetically by firm)

Pontus von Essen
Head of Fixed Income, FX & Alpha, *AP7*

John Springett
Director of Investor Relations & Marketing, *Aspect Capital Limited*

Alex Ball
Product Specialist, Systematic Active Equity Team, *BlackRock Investment Management (UK) Limited*

Lauren Hardardt
Chief Operating Officer for Sustainable Investing, *Bridgewater Associates, LP*

Pierre Lenders
Managing Director - Head of Sustainability, *Capital Fund Management S.A.*

Wai Leng Leong
Managing Director, Head of Asia Pacific, *CDPQ Asia-Pacific Pte Ltd*

Kenneth Kan
Managing Partner, *Dymon Asia Capital (Singapore) Pte. Ltd*

Thibault Nantes
Senior Associate, International Business Development, *EnTrust Global*

Rob Vanderpool
President, North America - Managing Director, *InfraHedge Limited*

Weber Hsu
Analyst, Global Markets, *Lakefront Asset Management (HK) Co. Ltd*

Peiying Li
Director, Global Markets, *Lakefront Asset Management (HK) Co. Ltd*

Haiwei Cao
Global Markets Research Analyst, *Lakefront Asset Management (HK) Co. Ltd*

Lu Lu
Analyst, Global Markets, *Lakefront Asset Management (HK) Co. Ltd*

Giselle Comissiong
Head of Brand and Communications, *LFIS Capital (LFIS)*

George Coplit
Managing Director, *Lynx Asset Management*

Despina Xanthopoulou
Director, Business Development and Sustainability, *Lynx Asset Management*

Pooja Fricke
Responsible Investment Director, *Man Group Plc*

Jason Mitchell
Co-Head of Responsible Investment, *Man Group Plc*

Carina Carvalhais
Responsible Investment Director & Sales Strategy, *Man Group Plc*

Rishab Sethi
Manager, Listed Mandates and External Partnerships, *New Zealand Superannuation Fund*

Scott Treloar
Chief Investment Officer*, Noviscient*

Robert Furdak
Chief Investment Officer for ESG, *Numeric Investors LLC*

Neil Messing
Head of Hedge Funds, *Office of New York City Comptroller*

Sushil Wadhwani
Chief Executive Officer, *QMA Wadhwani*

Nicolas Mirjolet
Chief Executive Officer, *Quantica Capital AG*

Grégoire Dooms
Product Manager, Head of Sustainability, *Systematica Investments*

Marc van Loo
Investor Relations, *Transtrend*

David Cohen
Global Head of Investor Relations, *Two Sigma Investments, LP*

Sara Razmpa
Director, Head of Responsible Investment Portfolio Manager, Equities, *Unigestion SA*

DeWayne Louis
Founding Partner, *Versor Investments*

Francois Chevallier
Portfolio Manager, *Welton Investment Partners*

Robert Sachs
Head Of Business Development, *Whitebox Advisors LLC*

Lucy James
Head of Client Services, *Winton Group Ltd*