STANDARDS BOARD FOR ALTERNATIVE INVESTMENTS

Practical Implementation of Responsible Investment in Macro Strategies

SBai Toolbox

1. Introduction

Macro hedge fund strategies typically invest by taking a view on the overall economic and political outlook of a country including its macroeconomic principles. Trading is typically via instruments related to countries such as sovereign bonds, currencies, or interest rates.

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, macro portfolios are now also in focus. RI in this space has many nuances in terms of the instruments traded, the individual jurisdictions issuing the instruments, and political considerations that may be encountered either when determining a "good" or "bad" RI investment or using engagement to try to drive RI related change.

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 including 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 macro 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.
>
> 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 Macro Strategies

There are nuances to both the availability of data and the practicality of implementing different RI approaches to the three broad types of investments in macro strategies:

Sovereign Debt **FX** **Rates**	**Data:** For many developed markets country level data is available either through vendors or public sources such as The World Bank. Some of this data may have a short history and will likely be inconsistent across jurisdictions. Sourcing data for emerging markets may prove more challenging. **RI:** Where data can be sourced, financially material RI related risks can be integrated into the investment process. Exclusion and inclusion lists can also be practically applied. Engagement, although possible, poses more challenges than engagement with corporate issuers both in terms of impact and political sensitivities when pushing for change.

Macro strategies may also invest through commodities, this is covered in more detail in the Responsible Investment in Systematic Strategies memo

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.

3. Practical Implementation of RI in Macro Strategies

Data

Data is an important component for both integration of financially material 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.

Data for sovereign assets can typically be obtained through data vendors and publicly available information such as the World Bank's Sovereign ESG Portal[3]. Credit rating agencies are also starting to incorporate RI related factors into sovereign credit ratings, The availability of this data is in its infancy and as such does not have a long history and data on sovereigns can remain static for some time.

Developed vs Emerging Markets:
In general, data may be more widely available in developed markets. Emerging markets tend to have less publicly available data, and this may result in relatively poor ESG scores due to lack of transparency. In addition, emerging markets often lack resources for dedicated initiatives, such as those relating to climate and carbon emission reduction, which may mean vendor ESG ratings do not appear to improve as much as more developed markets.

Corporate vs Sovereign Bonds:
While corporate bonds can be scored using similar ESG ratings to equities, there are challenges with assessing government debt in the same way. This assessment can tread a fine line between RI assessment and political commentary – particularly in developed markets. This presents challenges for ESG rating agencies to provide vendor data and as such independent research or frameworks by asset managers may provide a view that is more in line with the managers' RI objectives.

For the reasons above, asset managers looking to integrate RI related risks in their investment process, or run a dedicated RI product, will need to take time to understand both the financial materiality of each RI risk factor to the country they are focused on, and the limitations of the data that is available.

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.

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

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

understood process to ensure that time and resources are spent on the risks that are financially material to the strategy.

Importantly, there is a lack of consistency in data and analysis required to define and measure the materiality of RI factors in different jurisdictions. Resources will therefore need to be dedicated (and trained) to understand how different RI risks will be financially material in different countries and the interdependency of the risks.

Short vs Long Time Horizons

Governance has traditionally been the key risk factor for sovereign assets. Governance issues that may impact a countries ability to repay its debt, or the value of its currency, are already present in investment analysis for these assets. Social and environmental risk factors are also important. The productivity of a country is often dependent on its human capital, and human rights issues can potentially lead to sanctions or boycotts that could impact economic performance. In recent years, climate has become a focus area and an increase in natural disasters, such as fires and floods, may lead to increased environmental risk for certain sovereign states. Each of these risks will play out over different timeframes with governance and social risks being potentially more short-term issues and environmental risks playing out over a relatively longer time horizon.

Emerging Markets

RI integration may be more intuitive in emerging markets as some of the specific RI related risk factors are more differentiated. For example, in general, governance related risks in emerging markets have a higher correlation with credit risk than the same risks in developed markets.

Sovereign vs Corporate

Sovereign bonds typically have a longer maturity than corporate bonds and in addition have fewer enforcement mechanisms. Importantly for RI integration, the assessment of the financial materiality of the relevant RI risk cannot always be completed in the same way. Corporations typically have narrow objectives aligned with profit maximisation and other economic goals. Whilst economic goals may be part of a sovereign state's objectives, there are many other factors that also need to be considered.

The PRI report on ESG integration in sovereign debt contains some further details specific to this asset class[4].

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.

[4] https://www.unpri.org/fixed-income/a-practical-guide-to-esg-integration-in-sovereign-debt/4781.article

Exclusions and Inclusions:

Exclusion lists for macro strategies can be applied using criteria such as sanctions, countries that engage in certain activities, reputational issues, and wars in the region as examples, but this approach has a high degree of subjectivity. A simpler approach may be to base exclusions or inclusions lists on more binary regulatory considerations such as whether countries have ratified certain conventions or legislations that meet the RI objectives of the strategy. This has an advantage of removing some elements of subjectivity.

Dedicated inclusion strategies have historically focused on assets such as “sustainable” and “green bonds” issued by various sovereign states. Thematic bonds can allow sovereign issuers to communicate their RI related commitments, such as those related to the reduction of carbon emissions or progress towards the UN Sustainable Development Goals[5]. Asset managers should complete the same due diligence on any bonds issued with a “green” label as they would for other investments within a dedicated RI strategy to ensure they align with the RI objectives of the portfolio.

For FX and rates strategies there is potential debate as to whether the use of exclusion or inclusion lists with these asset classes would meet any stated RI objectives. This depends on the reason for any exclusions being applied i.e., are they intended to make an impact on the sovereign (which may be limited in effectiveness) or to reflect an “ethical” view that profit should not be made from countries that either breach specific rules or 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 counterparties used.

As discussed above, the link between governance and credit risk is less pronounced in developed markets versus emerging markets. For a dedicated RI approach that focuses on exclusions in developed markets, asset managers would need to carefully consider how any exclusions would impact the risk/return profile of the product given the relatively fewer number of developed markets.

Discussion Points for Asset Managers and Investors:

Exclusion lists using criteria that are wider than sanctions-based exclusions can be challenging. The range of criteria for exclusions is both broader than the corporate space and has more elements of subjectivity built in, particularly in more controversial areas such as human rights. This will mostly come down to a decision on what an asset manager (or investor) views as acceptable. Investors and asset managers should discuss the criteria used for these selections to ensure that any RI objectives are aligned.

There are additional considerations when looking at developed markets versus emerging markets. On one side the impact of a dedicated approach may be higher in emerging markets, but exclusionary strategies may risk depriving funding from countries that arguably need it more. This can lead to a cycle where emerging markets that are not as progressed on, for example, environmental initiatives find it harder or more expensive to access funding and therefore harder to implement the required environmental initiatives. Asset managers and investors should discuss whether exclusions in emerging markets are aligned with the RI objectives of the fund.

Applying any tilt or exclusion list to developed countries can have a bigger impact on the risk/return profile of the portfolio. There is a limited number of developed market sovereigns, and any exclusions limit this further. It is also not clear whether there is a direct link between RI and credit risk in these markets. Investors should discuss with asset managers any such impact on the portfolio.

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

For FX or interest rate asset classes it is important to discuss the intention of any exclusion or inclusion based dedicated approaches. Discussions may focus on the effectiveness of strategies that aim to impact a sovereign state versus those designed to reflect the ethical views of the investors.

Impact:

Dedicated impact approaches with a goal of societal or environmental improvements may be challenging when investing in sovereign assets. Many of the reasons for this have already been noted in this memo including the relative size of investments and the political considerations involved. Some of the thematic sovereign bond issuances noted above could potentially be considered impact investing; however, it may be challenging to measure the impact achieved through the investment.

Discussion Points for Asset Managers and Investors

As with any impact strategy both asset managers and investors should understand:

- The stated impact objective of the product,
- The assessment criteria of the investments chosen to be in the portfolio, and
- How these impact goals will be measured and reported.

Further detail on the governance and documentation of impact strategies in general can be found in the SBAI Policy Framework.

Responsible Asset Ownership

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

Investing into sovereign assets, as opposed to corporate or private companies, poses additional considerations for engagement. Sovereign states can be large and the size of individual holdings relative to these countries may limit the impact of engagement.

Engagement may also have potential political considerations i.e., at what point does engagement become diplomacy or political intervention – sovereigns are essentially accountable to their citizens rather than their investors or debt holders.

Holding sovereign debt, currency, or interest rate instruments means asset managers are not “owners” in the traditional sense and have more limited legal mechanisms to influence issuers. As such, engagement with sovereign states is more complicated than with corporate issuers and may require alternative methods for example non-governmental organisations (NGOs), lobbyists, policy makers, media outlets or public statements, sovereign investor roadshows, or credit rating agencies.

When dealing with organisations or individuals that have either access to or influence on foreign governments or policy makers, asset managers should ensure to have robust controls in place to prevent the receipt of material non-public information or the appearance of undue influence on governmental policy for the benefit of the portfolio. The SBAI Alternative Standards on shareholder conduct provide a robust framework for preventing these issues.

There have been examples of positive engagement in this space, for example, investor letters on Brazilian deforestation[6][7] which show that while it is challenging it is not impossible, but most positive examples tend to be in emerging markets rather than developed markets.

Discussion Points for Asset Managers and Investors:

Sovereign states are accountable to citizens and not investors or debt holders, this raises the question of whether it is "right" for foreign investors to try and influence policy decisions (however well intentioned). The other side of this argument is that the countries that can make the biggest difference in RI related areas and the countries that bear the most risks are not necessarily aligned. Therefore, there may be an argument to engage for the collective good on issues such as climate change and carbon emission reduction. Asset managers and investors should discuss the purpose behind any engagement to ensure it is aligned with any RI objectives in the product.

Governance and environmental issues may pose challenges, but social factors can be harder to address. There may be cultural differences between the investors and the citizens of the country and investors may need to be wary of appearing to force more developed market ideals on emerging markets. Any engagement on social issues for macro policies will likely require investment team members that understand local nuances and are perhaps based in the relevant locations. Asset managers and investors should discuss areas of engagement on social issues to ensure these are handled appropriately and in line with any RI objectives.

4. Reporting

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

Short Positions:

There are two ways that short positions can be reflected in 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 method 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

[6] https://www.actiam.com/49e60f/siteassets/4_verantwoord/documenten/en/open-letter-brazilian-embassy-202006.pdf

[7] https://www.reuters.com/article/us-brazil-environment-investors/global-investors-demand-to-meet-brazil-diplomats-over-deforestation-idUKKBN23U0L8v

in “bad” scorers may be more accurately reported showing long and short positions separately.

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 macro 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?
• What training (or relevant experience) has the investment team had to understand the local nuances to assess the financial materiality of RI related risks?
• For emerging markets-based strategies how is data sourced where it is not publicly available?
• How does the manager think about different types of ESG related risks in relation to the time horizon of the strategy?
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 an impact in the relevant country or to reflect the views of the asset manager or investor?
• How do the investment choices – including asset classes – align with these objectives?
• Is the due diligence process relating to RI any different for sustainable or green sovereign instruments versus those not labelled in this way?
• Is any exclusions or inclusions logic based solely on observable data such as the ratification of certain conventions or is the criteria more subjective? If subjective, what is the assessment and review process on these decisions?
• Has the choice to exclude any developed market materially impacted the concentration or risk/return profile of the portfolio?
• What type of engagement does the manager participate in and through which entities?
• Does the manager have robust anti-bribery and corruption policies and keep records of meetings with any person or organisation that has either access to or influence on foreign governments or policies?

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 Macro Working Group

(Alphabetically by firm)

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