SEPTEMBER 2017

Sustainability in asset management

THE KNOWLEDGE FOUNDATION'S ASSESSMENT OF ALTERNATIVE ASSETS

Written by Ulrika Hasselgren, ISS
and Emma Sjöström, NUWA

Knowledge Foundation

MAIN SPONSORS:

SPONSOR 1

Skandia Fonder

SPONSOR 2

Amundi, AP7, BlackRock, Franklin Templeton Investment, Goldman Sachs Asset Management, Infranode, Mittkap

REPORT AUTHORS

Ulrika Hasselgren, Institutional Shareholder Services Inc. (ISS) and Emma Sjöström, NUWA

Content

Inspiration for quicker incorporation of sustainability

The Knowledge Foundation funds research and advanced level skills development at Sweden's new higher education institutions. As of August 2017, close to SEK 10 billion has been granted and the current capital base is around SEK 9 billion. By tradition, the Foundation has most of its capital invested in Swedish shares.

As the Knowledge Foundation is a long-term financier of research and education environments, we have, step by step, increased the weight of alternative assets in our portfolio to balance the large proportion of Swedish bonds with bank loans, private equity, micro loans and several forms of hedge funds. All told, alternative assets constitute close to 40% of the total capital.

In the report published in 2014 we evaluated the external asset managers the Foundation at the time had investments with, most in the form of hedge funds. Our questions dealt with how they approached the issues of sustainability and responsibility themselves, in their own organizations and in the investment process. This time around, the issue remains the same but the variety of assets has increased. With variety of assets comes a need to map the different processes and explain where in the chain the responsibilities start and end, for different actors, and where client demands and changes in perspective will have to play a stronger role if change is to be brought about.

I would first and foremost like to extend a warm thank you to everyone who has been involved in the project and open-heartedly shared their knowledge and their experiences with us – Amundi, AP7, BlackRock, Franklin Templeton Investments, Goldman Sachs Asset Management, Infranode, Mittkap, OPM, SEB and Skandia Fonder. We are especially grateful for the frankness and sincerity we have encountered, as well as the desire to reflect on current practices in order to develop. It is only through courage, self-reflection and open discussion that the development and furthering of sustainability in the financial sector will reach new levels.

I must confess up front that our habit of asking straight-forward questions has not changed over the years. But there is no intention of judging: the report is very transparent and open-minded. Different results from different forms of investments are shown, and good results and changes are explained. The aim with this study is to contribute to market development by encouraging active efforts and inspiring quicker incorporation of sustainability into asset management.

The Knowledge Foundation is glad to continue the collaboration with Ulrika Hasselgren, Global Head of Responsible Investment Strategy at ISS, who wrote the first report together with us, and who, together with Dr. Emma Sjöström, Founder and Director at Nuwa, conducted this study and wrote the report.

Madelene Sandström
CEO, Knowledge Foundation

Why are we doing it again?

In 2014, the Knowledge Foundation launched its assessment on how its contracted external asset managers, mainly hedge funds, viewed and managed sustainability and responsibility in their investment processes and organizations. The purpose was to initiate a constructive dialogue with asset managers with a focus on the forward-looking efforts and the dynamics in the process. This resulted in the report 'Sustainability and Responsibility in Asset Management: Focus Hedge Funds'[1].

Over the past years, we have seen noticeable progress by investors and asset managers to further integrate sustainability into investment policies and strategies, build knowledge, and demonstrate that it makes both business and investment sense to incorporate corporate governance, environmental and social factors into the investment process. This time around, we have taken a step to study how sustainability, corporate governance, environmental, and social issues are managed within the broader spectra of Alternative Assets.

As with the first study, we have focused on the forward-looking efforts and the dynamics in the process, while seeking to also understand the challenges that may exist within Alternative Assets. We have done this from the perspective of the investor, who may or may not have the knowledge about – or the ability to grasp – the "full investment chain" of

1 http://www.kks.se/app/uploads/2017/06/sustainability-and-responsibility-in-asset-management.pdf

Dr. Emma Sjöström, Founder and Director, NUWA and Ulrika Hasselgren, Global Head of Responsible Investment Strategy, ISS

the different assets. Some of these assets are complex, including several investment chain levels, such as the fund company, the holding company, the general partner, the portfolio manager, the project, the constituent, the borrower, the joint venture, the partner company, and the supplier.

We know that transparency is a challenge for many investors looking into Alternative Assets. And we know that asset owners are increasingly asking their external managers to present and describe their products and how sustainability is incorporated and managed within their investment process. Christina Backman, CEO of the Hasselblad Foundation highlights this well: “The big challenge is to sort out what alternative assets are, as it is complex. There are also many actors of varying quality which makes it even more difficult to understand and see what the product is about. One might think that the big players can be given a stamp of quality approval due to its size but it is perhaps not always so."

In light of this, we have been seeking to understand the managers' perspectives, and their approaches taken to address the increasing expectations from asset owners for integrated sustainability solutions within Alternative Assets.

This is why we are doing it again. We are grateful to the asset owners and asset managers participating in the study, contributing with their valuable experience and insights.

We are also grateful to Märtha Josefsson and Christina Backman, two Swedish board and investment committee professionals for their support and insights into what asset owners – small or large – are expecting from their asset managers within this space of Alternative Assets. One of the aspects they highlighted as striking was that "there are relatively few Swedish players on the market with sustainability solutions, although sustainability is now a 'hygiene factor' for institutional investors, and alternative assets are often seen as the only alternative to fixed income investments".

Stockholm in September 2017

Ulrika Hasselgren, Global Head of Responsible Investment Strategy, ISS
Dr. Emma Sjöström, Founder and Director, NUWA

Note on terminology

In this report we use the term ‘Sustainability’ as an overall description of:

- Sustainable Investment
- Responsible Investment
- ESG (Environmental, Social, Governance)
- SRI (Sustainable & Responsible Investment or Socially Responsible Investment)

These are all terms for a variety of practices that investors and asset managers apply and refer to when they incorporate corporate governance, environmental, social factors and perspectives into their products and investment process. For further reading on the characteristics of the market we recommend 2016 Global Responsible Investment Review[2], Eurosif SRI Study 2016[3], and reports provided by the UN-backed Principles for Responsible Investment.[4]

2 http://www.gsi-alliance.org/wp-content/uploads/2017/03/GSIR_Review2016.F.pdf
3 https://www.eurosif.org/sri-study-2016/
4 https://unpri.org

Sustainability and Alternative Assets

Several studies point to institutional investors' expectations that allocations to Alternative Assets will increase the coming years, with private equity and infrastructure to receive the highest new allocations.[5] In the current environment where investors are looking for higher yield and lower volatility, alternative investments play an increasingly important role, whether it be infrastructure, private equity, hedge funds, micro loans, or credit funds.

The focus on the incorporation of corporate governance, environmental and social factors into the investment process is also increasing, and the trend that asset owners ask for more of their asset managers continues to evolve.

Sustainability, responsible investment, ESG, impact investing, and more – the terms and the definitions are many, and there are a number of different approaches currently employed by investors and their managers. Taking into account sustainability factors has undoubtedly become a widespread phenomenon, the market is growing globally. But the focus has, until recently, been mainly on listed equities and corporate bonds, and for these categories there are a number of established frameworks, method-

5 See for example Mercer (2015) Global insights on alternative investments. https://www.mercer.com/content/dam/mercer/attachments/global/investments/responsible-investment/Global-Insights-ESG-in-Alternative-Investing-2015-Mercer-LGT.pdf

ologies, and approaches available. However, when it comes to Alternative Assets, there is somewhat new territory and less established approaches.

It has been noted that transparency can be a challenge within the sometimes complex investment chains of Alternative Assets. Some have also expressed views that sustainability does not make sense for some of the Alternative Assets categories. There are other views, however, arguing that it makes absolute sense, not the least for Private Equity. These and other matters relating to sustainability and Alternative Assets have been the focus for our study, as the Knowledge Foundation – alongside its peers of asset owners – is seeking to understand trends and to support the further development of integrated sustainability in asset management.

As with our first study, focusing on hedge funds, our dialogue with managers within the Alternative Assets space, and with members of boards and investment committees of some of the Swedish institutions, has been a key component of this study.

We have also been keen to understand why the participants have chosen to include a sustainability perspective, and what sustainability and responsibility actually means for them in terms of managing assets in the Alternative Assets categories.

Scope and participants

The study covered the following Alternative Assets categories, identified as of particular interest for the Knowledge Foundation: **Private Equity**, **Hedge funds**, **Micro Loan**, **Infrastructure**, and **Bank Loan/Credit Fund**.

The study is not comprehensive, nor have we ranked or scored the participants, their products and approaches. Rather, the aim has been to understand views, perspectives, preparedness, and approaches, that managers within this segment have, given the increasing interest and expectations from asset owners such as the Knowledge Foundation and other asset owners. Our hope is also that the study and this report can provide a platform for constructive dialogue between asset owners and asset managers with focus on the forward-looking efforts and the dynamics in the process.

We reached out to Swesif (Sweden's Forum for Sustainable Investment)[6] and the Knowledge Foundation's contracted external managers with an invitation to participate in the project. The following members joined the project: Amundi, AP7, BlackRock, Franklin Templeton Investments, Goldman Sachs Asset Management, Infranode, Mittkap, OPM, SEB, and Skandia Fonder.

The participants have generously shared their knowledge and competence within each of their respective areas of expertise in relation to a chosen product/solution as outlined in the table below.

---

6 www.swesif.org

Participant	Category	Product/solution
Amundi	Private Equity	Private Equity Funds
AP7	Private Equity	Private Equity Manager Selection
BlackRock	Infrastructure	Renewables within Infra-structure
Franklin Templeton Investments	Private Equity, Infra-structure	Private Equity Funds
Goldman Sachs Asset Management	Bank Loan/Fixed Income, Manager Selection	Bank Loan / Fixed Income, Alternative Investments and Manager Selection
Infranode	Infrastructure	Infrastructure Funds
Mittkap	Hedge Funds	Hedge Funds
OPM	Hedge Funds	Fund of Hedge Funds, Multi-Strategy Managers
SEB	Private Equity, Hedge Funds, Micro Loan	Private Equity, Hedge funds, Micro Loan
Skandia Fonder	Bank Loan, Private Equity	Bank Loan / Credit Fund, Private Equity Fund

Methodology

As for the hedge funds study, this study also contained two parts: a questionnaire with seven questions, and a follow-up dialogue with all participants.

The questionnaire was used to gather a general understanding of each participant's view of and approach to sustainability and transparency within the scope of their Alternative Assets. The follow-up dialogue was used to obtain a deeper understanding, and to give the participants an opportunity to expand on their answers in the questionnaire.

The following seven questions were answered by each of the participants in relation to their chosen product/solution:

1. How do you define sustainability and responsibility as it relates to your assets/product?
2. How do you evaluate and consider sustainability and responsibility in your investment process?
3. How do you determine which sustainability factors or areas are essential?
4. How do you manage sustainability risks that are found throughout the investment chain?
5. What knowledge and competence do you have regarding sustainability and responsibility?
6. Can you please describe the process of ongoing monitoring of sustainability in your investments?
7. Can you please provide a concrete example where you have integrated / considered sustainability and responsibility in your investments?

Overall findings from the survey and the dialogue

For both the survey and the follow-up dialogue, the participants provided substantial answers and openly shared their perspectives. They also showed an encouraging level of competence and a commitment to integrating sustainability within the investment processes of their respective strategies and products.

At the first question, 'how do you define sustainability and responsibility as it relates to your assets/products', all participants described their view of sustainability in terms of risk and value creation, and/or as part of their fiduciary duty, i.e., it is part of their financial commitment to the beneficiaries. In other words, sustainability is here defined as a financial matter rather than a values-based matter.

"Environmental, social, and governance (ESG) issues can have a material impact on the value of companies and securities ... We believe these issues should be considered alongside traditional financial measures to provide a more comprehensive view of the value, risk and return potential of an investment."

Simon Reinius, OPM, Ulrika Hasselgren, ISS and Hans Hellenborg, SEB.

This confirms a general tendency among financial market actors, where many seem to motivate their sustainability efforts on the basis of financial arguments. At the same time, few participants can show evidence of this based on the results of their own investment management. Rather, it is based on conviction and general insight.

It also appeared in the conversations that there is a tension between financial value and values. One participant noted that decisions on values-based exclusions are not taken by portfolio managers, as “he or she would never make such a decision. It must be taken by a separate committee.”

Overall Survey findings

The table below summarizes the survey findings according to the seven questions asked.

Question	Survey findings
1. How do you define sustainability and responsibility as it relates to your assets/products?	**All participants** state that it generates financial value and/or that it is a fiduciary duty to beneficiaries.
2. How do you evaluate and consider sustainability and responsibility in your investment process?	**Most participants** work in a structured way, e.g. in-house sustainability tool or framework, in-house sustainability team. Participants with few employees tend to work more ad hoc. **Many participants** state that sustainability is integrated into financial analysis.
3. How do you determine which sustainability factors or areas that are essential?	**Most participants** are using an internal or external framework or an established process to do this.
4. How do you manage sustainability risks that can be found throughout the investment chain?	**All participants** express that they have a continuous evaluation of sustainability risks, and manage them e.g. through dialogue with management, action plans, or contractual obligations.
5. What knowledge and competence do you have regarding sustainability and responsibility?	**All participants** refer to long experience with sustainability. **Most participants** have their own sustainability teams, some offer internal education for all staff, while respondents with fewer staff depend mostly on a committed CEO.
6. Can you please describe the process of ongoing monitoring of sustainability in your investments?	**All participants** describe a continuous process for monitoring. Some rather refer to "engagement" which connotes a more interactive approach than monitoring.
7. Can you please provide a concrete example where you have integrated/considered sustainability and responsibility in your investments?	**Several participants** witness that the sustainability perspective allows for additional or different risks to be identified. **Some** can even point to how their own sustainability focus is influencing the next actor in the investment chain to work more with sustainability. The nature of the examples varies widely.

Overall Dialogue findings

This section summarizes the dialogue with reference to the participants' Alternative Assets categories: Private Equity, Hedge funds, Infrastructure, Micro Loan, and Bank Loan/Credit fund. The follow-up dialogue with the participants showed both commitment and capacity to incorporate sustainability into the investment process, and capacity to monitor and action throughout the Alternative Assets Investment Chain of their respective products as illustrated below.

Alternative Assets Investment Chain				
Product	**Level 1**	**Level 2**	**Level 3**	**Level 4**
Private Equity	General Partner (GP)	Fund	Portfolio company	Portfolio company suppliers, clients, partners
Hedge fund	Multi-strategy manager	Underlying manager	Constituents: equity, bonds, currency, etc.	Supply-chain
Micro loan fund	Fund company	Consulting company	Micro finance institute	Borrower
Infrastructure fund	Fund company	Investment advisor	Project within infrastructure	JVs/Partner company within project
Bank loan	Fund company	Fund	Constituents	

THE USEFULNESS OF FRAMEWORKS, METHODOLOGY, AND PROCESS

Most participants described that they work with sustainability in a structured way, based on a framework or method they have developed. Many of them have internal sustainability teams, have developed their own analysis models, and integrated sustainability into the financial analysis.

> *"Our embedded ESG approach is led by our portfolio teams, who work in partnership with a dedicated team of ESG specialists to help ensure that ESG issues will be fully integrated across our global platform."* **Private Equity**

If this is not the case, it is mainly because the fund company has a small team of employees and therefore works a bit more *ad hoc* and outsources the sustainability analysis to service providers.
One participant described that the sustainability manager for a fund company reviews all portfolios, and has a conversation with the managers at least twice a year. It helps the managers themselves begin to include sustainability in their work. The level of interest of managers varies and personal qualities can influence how open individual managers are to take in new perspectives. The burden of proof on the part of the head of sustainability for showing the financial relevance of the sustainability is perceived to be heavy. Something that may affect the internal managers' motivation to engage, according to one participant, is the extent to which he or she is exposed to the customer.

> *"If you meet institutional clients who have this in their investment policy, you'll be forced to do it whether you like it or not; you understand there's a world outside that thinks this is important. If you are just managing funds and never have any customer contact and do not have to answer the questions or be accountable, then the road is much longer."* **Bank Loan/Credit fund**

All participants described that they have a continuous or recurring monitoring and follow-up process in place. However, the monitoring processes differ among the participants depending on their investment process, approach, and organization. For the Alternative Assets categories included in this study, some participants described direct access to the Level 1 in the investment chain only, such as the fund manager, and referred to indirect access to Level 2 or Level 3. However, for Bank Loan/Credit fund and Infrastructure, the situation was described as much more simple:

> *"Loans are much simpler to manage, as we have full control over what we buy. We know which company it concerns. We can ourselves get out of a position if we are not comfortable. This has also been the case." B***ank Loan/ Credit fund**

“The prerequisites for transparency are good. We invest directly, we make few investments and they are long-term.” **Infrastructure**

THE IMPORTANCE OF DUE DILIGENCE

Several participants emphasized the importance of due diligence, i.e. to make a thorough assessment of a company, a sector, or a project, before the investment is made. As an example, for Infrastructure, Micro Loans, and Hedge funds, investors cannot easily sell their holdings. Hence, it is critical to make an accurate sustainability analysis before the investment is made.

“In contrast to private equity, the infrastructure investor does not have an exit strategy, but rather a buy-and-hold approach.” **Infrastructure**

“What we’ve learned, is that bringing up ESG practices early on in the process is better, most importantly to mitigate risk and identify potential opportunities along the investment period.” **Infrastructure**

“For micro financing, the whole investment chain is screened for relevant risks. These, and how they are managed, are documented for each investment decision. The conclusions regarding the risks is a part of the assessment of whether or not to make the investment, or how they may impact the overall investment.” **Micro Loan**

Another dimension relating to due diligence and Hedge Funds, is that “not only is it difficult to get out of an investment – you also do not know exactly what you are getting into”. A Hedge Fund participant described that their due diligence process as very thorough, taking at least six months.

When investing in Private Equity, the investor, the Limited Partner (LP), makes one commitment with a certain amount of capital, but the LP cannot choose what the General Partner (GP) invests in. In other words, the LP trusts the GP to invest and manage the capital responsibly or in line with the LP’s Sustainability policy. Therefore, it is crucial for the LP to get to know the GP and to establish a constructive dialogue on sustainability issues in the investment chain and over time. According to the Private

Equity participants, there is frequent follow-up on sustainability matters from the GPs to the LPs.

For Private Equity, large managers (GPs) are often experienced in the area of sustainability. Participants shared that in general, sustainability issues seem to be quite mature with the managers. But this is not the case with all managers. Therefore, one participant has developed its own 'best-practice document on sustainability in private equity investment' which they provide to their Private Equity managers, especially for those who do not directly understand what the LP means when asking for e.g. sustainability monitoring and reporting. The document has proved to be both useful and appreciated by Private Equity managers.

The Private Equity participants shared that it is rare to avoid or exit an investment for sustainability reasons. The majority have never done so. To a certain extent, this is linked to the fact that it is difficult to discard

CASE EXAMPLE:

SEB Micro Loan Investment Process and Result

SEB's Micro finance investment chain starts with the institutional investor and includes 'SEB Microfinance Funds', the 'Microfinance Institutions' (MFIs), and ends with the 'Micro entrepreneurs' in low- and middle-income countries (currently more than 18 million in the institutions that SEB finances).

Mrs. Chandrikamanya Prerea is 43 years old, is married and has two children. The family lives in Divulapitiya, a village in western Sri Lanka. A couple of years ago the husband's income was not enough to support the whole family. Mrs. Prerea then wished to contribute more directly to the family revenues, and approached LOMC (the largest microfinance company in Sri Lanka) with a view to obtaining a microloan to start her own business. She received her first loan of LKR30,000 (approx. USD230) from the MFI (Micro Finance Institution) in 2012, with which she opened a shop selling daily utilities like soaps, toothpaste, and spices.

During 2013, she applied for a second loan, to buy additional stock for the shop. This new financing was also used to expand the family's kitchen in the backyard. The extra contribution to the household that Mrs. Prerea provides has not only improved the family finances, but also allows her children to gain access to better education. Mrs. Prerea believes that further credits from LOMC will allow for her to expand her product offering to her clients.

an existing investment for technical reasons. It appears that the number of sustainability-related issues is also low. A challenge mentioned by the participants is that there is less information and disclosure about the holdings of Private Equity, compared with listed equity. The number of holdings in a buyout fund is generally smaller than in a listed equity fund, they are less covered by the major analysts, and are therefore not as 'well-framed' from a sustainability perspective. On the other hand, sustainability lends itself to Private Equity as the GP and the portfolio companies are so close and the active ownership is embedded in the structure, hence a dialogue on sustainability matters is easily organized.

CASE EXAMPLE:

OPM Fund of Hedge Funds Due Diligence

OPM's investment process starts with a due diligence of the hedge funds, which may take around six months. In this process, we communicate that sustainability is important to them. As hedge funds tend not to be so advanced in their sustainability approach, we take on the role of an educator: We will explain why sustainability is important to the hedge fund, and that it is not 'green wash' but something they can actually use in their investments. A conversation on sustainability is relevant only for a limited number of hedge funds we speak with, as it is difficult if not impossible to apply sustainability to e.g. currency trading, index futures, or if the investment horizon is very short.

We have found the sustainability competence level of the hedge fund managers to be reasonably good. In our DD process, hedge fund managers will not oppose to the idea of sustainability, but they will typically say that, even though sustainability is important it is difficult for them to include due to the short investment horizon. This, of course, raises the question of whether we can really include sustainability to any significant extent in our offering towards clients. We are not saying that we are doing an enormous lot, but we do what we say. One of the most important things is that we promote this. Our efforts, together with like-minded investors, have moved some of the hedge funds in the right direction.

According to us, the fact we show an interest for sustainability in relation to the hedge fund manager, and that we point out risks and opportunities and how the hedge fund manager can approach these issues, is a big ESG contribution in itself. We perceive that while clients' interest sustainability is rising, their interest in transparency throughout the investment chain is low. It is rare that a client asks questions about that.

THE VALUE OF MONITORING AND DIALOGUE

As regards the monitoring and follow-up dialogue with portfolio companies, one Private Equity participant noted that smaller companies are often not as 'well-polished' as the larger ones, but on the other hand they are often 'more sincere'. For smaller companies with low sustainability risks, it may not be desirable for them to add resources to spend on report writing and disclosure. Of the larger companies, one can demand more, a participant said.

> *"How comprehensive communication about sustainability should be, depends not only on the size of the company but also on their industry. In a business with higher risks, it is natural to communicate more clearly with investors."* **Private Equity**

CASE EXAMPLE:

AP7's ESG Program for Evaluating Private Equity Managers

In 2014, AP7 decided to increase the ESG integration of its Private Equity investments. The purpose was to develop a methodology to increase the communication on and integration of ESG factors into their investment process: From AP7 (Limited Partner/LP) to the Fund (General Partner/GP) to the portfolio company (Private Equity).

At the beginning of 2015, AP7 invited PE managers to participate in a first evaluation by responding to a questionnaire. The response was followed up with a meeting in order to increase AP7's understanding of the manager ESG processes. AP7 also agreed to annual targets on how to improve the managers' ESG performance.

For 2016, AP7 upgraded its questionnaire in line with the PRI guidelines: The Limited Partners' Responsible Investment Due Diligence Questionnaire. AP7 sent the updated questionnaire alongside the agreed targets to each manager, and followed up in meetings. The project to develop this ESG Program for Private Equity aimed at developing tools for deeper integration of sustainability perspective in their PE management and to provide a methodology that can be used by the industry. The tools and the processes are now an integral part of AP7's annual evaluation of its Private Equity managers.

Within the investment chain for Hedge Funds, interest in sustainability is often quite limited, one participant said, but "it has increased over the years, and greenwashing has been replaced by real work based on our own insights". This indicates that sustainability has moved from the public relations department through to management and the board with the backing of a growing number of mainstream investors.

At the same time, many Hedge Funds have such an orientation that it is not possible to consider sustainability matters, such as derivatives or high-frequency trading. One participant, referring to alternative investments and the value of monitoring specifically for Infrastructure said:

> *"This whole process is really very clear where everyone has their tasks, and monitoring and reporting is established. Compare this with buying individual stocks, where each company has thousands of employees. With infrastructure, we know the local manager, and we have his phone number."* **Infrastructure**

Several participants across the categories testify that their questions and follow-up on sustainability throughout the investment chains of their respective products have helped raise the level of awareness and efforts.

> *"If we and some others had not been there and pushed them, they would not have done very much. We have moved them in the right direction."* **Hedge Fund**

UNDERSTANDING MARKET AND CULTURAL DIFFERENCES AMONG INVESTORS

A few participants expressed the perception that Sweden is relatively far ahead with the fund managers' understanding of sustainability. From an 'outside' perspective, Sweden and the Nordic region can be viewed as being in the forefront of sustainable investment, however, it is important to consider the differences in market characteristics and culture between countries and regions.

From a global perspective, there is a strong growth of investors incorporating sustainability into their investment policies and processes across asset classes. However, the differences between regions and countries play an important part of how sustainability is incentivized, defined and incorporated. Several countries have government requirements and legislation in place which sets out frameworks that shape each market and guides investors and fund managers. Some of the public pension funds in several countries are transparent and disclose their policy and procedures and therefore naturally impact both their local markets and across regions.

In addition, even though demand from institutional investors is increasing, it varies with regards to approach. One participant described that their institutional clients can submit long questionnaires for them to fill out before they decide to invest. Several participants also experience that clients are generally not interested in streamlining the entire investment chain, and one participant even said that: "to get questions about this is the exception".

The level of focus and knowledge surrounding sustainable investments can also vary greatly between clients.

> *"Most Swedish institutional investors historically have been focused on traditional asset classes, mainly due to a limited access of suitable products and investment policy restrictions within alternative assets. This has, however, shifted tremendously during the last couple of years and the same will probably happen within sustainable investing. With increased focus and interest, knowledge will also increase."* **Bank Loan/Credit fund**

Reflections on the findings

Today, institutional investors are in a situation where they need to achieve meaningful returns with limited risk. Listed equity, fixed income, and alternative assets, are the three available asset classes. While listed equity funds are well-assessed and documented in terms of investment processes and methods, and fixed income are fairly assessed and documented, alternative assets are less so. Thus, they represent completely new challenges for many institutions. Some of the challenges may include:

- the fundamental understanding of the product and its investment chain,
- what the risks are and where in the investment chain they may arise,
- how sustainability is incorporated,
- how to address unexpected sustainability issues.

As alternative asset classes are a heterogeneous group, knowledge is required in a number of investment areas. These assets represent different challenges and issues regarding an integrated approach to sustainability, transparency, and risks. For example, can a Responsible Investment policy applied to listed equity also be applied to hedge funds with exposure to derivatives and currency trading, or to infrastructure and credit funds?

Sustainability integration and transparency of Alternative Assets products, are in general viewed as more limited, as compared to traditional listed equity products. For example, hedge fund managers will not oppose the idea of sustainability, but will typically say that, even though sustainability is important it is difficult for them to consider it due to the short investment horizon. Another aspect is the fund managers' level of client interaction. According to one participant, credit managers are more open to external input and sustainability matters. The reason for this is that they often meet the clients. Fund managers that regularly meet with clients and potential investors tend to be more open to external input. If you meet institutional clients who expect sustainability to be managed, then you are forced to deal with it. Portfolio managers who don't interact with clients and who don't need to answer questions, are much more reluctant to consider sustainability and non-financial factors.

"Portfolio managers who don't interact with clients and who don't need to answer questions, are much more reluctant to consider sustainability and non-financial factors."

There is growing interest in sustainability from institutional clients. This has implied that asset managers are expected to include more details on sustainability in their commitment towards the client. The participants express that their clients are only going in one direction and that is, increasing their focus on sustainability. They work in a sector that has a certain exposure to sustainability issues, so we may be at a point now where it is even hard to survive for actors who do not address these issues. Many asset owners have only had ESG policies for listed companies earlier and now they are in the process of restructuring and focus on unlisted. Sometimes they will transfer it on to the external fund manager and work together with them to design a suitable approach.

We are noting that by forwarding asset owners' expectations on sustainability to the fund manager, institutional clients may set a ball in faster motion, which is confirmed by the participants having received questions from their investors. The fund managers perceive that these questions can influence their investments and how they work, and can thus play an important role in advancing the sustainability focus in asset management.

On manager evaluation/selection, the matter of resources for asset owners, depending on their size, is important to consider:

- Larger asset owners have for some years developed routines and processes for assessing external managers and understanding what the transparency or sustainability issues may be;
- Mid-sized investors have taken some initiatives to develop and implement procedures but are not fully up to speed; and
- Smaller asset owners, which often lack resources and own competence and thereby make investment decisions on their own or through investment committees with mainly external competence, often feel uncertain about both transparency and sustainability, even though they may have a policy or a commitment to address it. Smaller investors are also often 'too small' to be interesting for the large specialists within Alternative Assets.

We believe there is an opportunity for smaller investors to learn from both the participants in this study, from actors across the broader spectrum of Alternative Assets, and from larger asset owners. As we encourage asset owners to develop their responsible investment policy and test it internally, we also encourage dialogue with their external asset managers, and in particular to not shy away from the sometimes difficult or complex matters within Alternative Assets.

From the dialogue with the participants but also in general, we have noted that many are using similar statements on the incorporation of sustainability into the investment process and products using the wording of the UN-backed Principles for Responsible Investment (PRI). However we have also been encouraged by a diversity of approaches and unique views on beliefs, what matters, and what is less relevant. A reflection is whether asset owners should encourage asset managers to define and describe their own perspective, process, and procedures, or if they should support the development of a 'one description fits all' standard?

Also, is sustainability considered in the initial part of setting the strategy, or further into a strategy in the selection of sectors, companies, or projects? And, how is a factor such as political risk taken into account?

With regards to transparency throughout the investment chain for the different categories, we were encouraged to hear from several participants that, for them, transparency is not an issue. Several participants described with good levels of detail what happens at each stage of their respective investment chain, and how they are able to manage risk or deal with matters of potential concern. The challenge as we see it, is that even though this may be the case for the fund managers, it is not as easy for an asset owner to understand and grasp a product including its investment chain unless they get involved in detail with a potential or a contracted manager. This is particularly so for smaller asset owners. In other words, there is a discrepancy in the perceived level of transparency of the investment chain depending on whether one is situated in the asset owner or fund manager position.

We encourage asset owners to ask as many questions as needed in order to understand the products they plan to invest in, and to continue a constructive dialogue with the managers they select. And, as one of the Swedish hedge funds said: "We encourage KK-stiftelsen and other investors to assess not only the investment process but also the organization itself when they evaluate asset managers and sustainability."

Further details of sustainability within each alternative asset category

The following section provides further details on sustainability and transparency matters for each of the categories and the participants' respective products and investment chains, as described overall below.

Alternative Assets Investment Chain				
Product	**Level 1**	**Level 2**	**Level 3**	**Level 4**
Private Equity	General Partner (GP)	Fund	Portfolio company	Portfolio company suppliers, clients, partners
Hedge funds	Multi-strategy manager	Underlying manager	Constituents: equity, bonds, currency, etc.	Supply-chain
Micro Loan	Fund company	Consulting company	Micro finance institute	Borrower
Infrastructure	Fund company	Investment advisor	Project within infrastructure	JVs/Partner company within project
Bank Loan/ Credit fund	Fund company	Fund	Constituents	

PRIVATE EQUITY

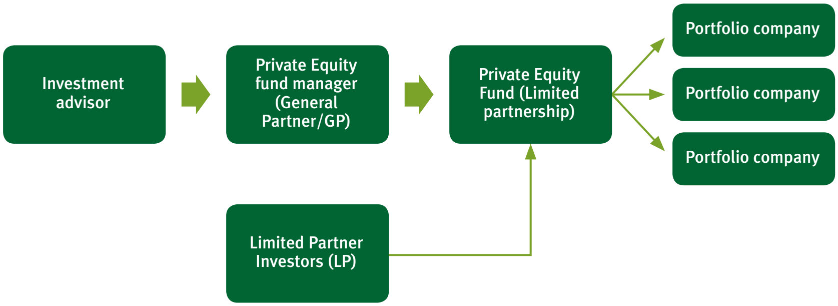
Participants: Amundi, AP7, Franklin Templeton, SEB, Skandia Fonder

Private equity is capital that is not noted on a public exchange. Private equity is composed of funds and investors that directly invest in private companies, or that engage in buyouts of public companies, resulting in the delisting of public equity. Institutional and retail investors provide the capital for private equity, and the capital can be utilized to fund new technology, make acquisitions, expand working capital, and to bolster and solidify a balance sheet.

Private equity comes primarily from institutional investors and accredited investors, who can dedicate substantial sums of money for extended time periods. In most cases, considerably long holding periods are often required for private equity investments, in order to ensure a turnaround for distressed companies or to enable liquidity events such as an initial public offering (IPO) or a sale to a public company.[7]

7 http://www.investopedia.com/terms/p/privateequity

THE INVESTMENT CHAIN



PRIVATE EQUITY AND SUSTAINABILITY

Each of the participants have established procedures, teams, and competence to incorporate sustainability as part of their investment processes. AP7, as an asset owner, has implemented its sustainability program for evaluation of PE managers, which is described on page 23.

> *"Sustainability is part of our risk process and a rational part of our investment process – this is our starting point."*

Another participant said that "it is an investor's responsibility to consider the social and societal function of the companies it supports in an eco-system. Efforts should be made to ensure that investments create economic and social value in the long term."

This triggered a question on how this is done within private equity. One of the participants said that they carry out a thorough sustainability due diligence for all potential deals. Depending on the size of the investment, the due diligence is carried out either by internal teams or by a third party as defined by the participant.

In comparison with listed equity, private equity is viewed as "uniquely placed to directly influence the ESG practices at the investee level given the nature of the investments and governance structures."

It was further described that they have a thorough due diligence and that they do background checks on the management and assess information picked up on the market, such as information from former employees.

> *"When we read or hear about issues, we will investigate those in the due diligence process. In addition, we have a lot of local boots on the ground, and for every company, we visit many of their sites, we meet the teams, and we can assess if there is a good working place, enough safety, good labor standards, or, conversely if it is not. All of this will be key issues for us."*

Another example:

> *"Corporate governance is one main factor within private equity, and for Japan for example, we carry out a dialogue with the executive team before we make an investment. We talk about potential changes we would like to see with regards to corporate governance. If the management team is not perceptive to our views, then we will not invest. If you cannot have an open dialogue with people who are willing to listen to our input, then there is no reason for us to take a large risk. This is a natural part of our process, but when it concerns private equity, it is even more important that collaboration and dialogue with founders or the management team is good."*

TRANSPARENCY IN THE INVESTMENT CHAIN

The participants described that they actively oversee and manage sustainability matters throughout their investment process and that it is "key to mitigate risks as they can have a material impact on the value of companies and securities".

As shared by one participant, sustainability considerations are incorporated and evaluated throughout the investment process. Prior to any investment, material issues are identified at the initial review and are evaluated during the due diligence phase. During their due diligence, project-specific matters are considered, along with legal (regulatory and anti-corruption), accounting, market and environmental review. Once the investment has been made, material sustainability matters become part of the monitoring phase through board representation and constant review.

Similarly, another participant described a thorough sustainability due diligence for all their potential deals. Depending on the size of the investment the due diligence is carried out either internally or by a third party in a format defined by their own sustainability team.

There is clear focus on the management with regards to handling risks in relation to sustainability which may occur during the investment process. “If the management is aware of the upcoming risk and the company is adequately prepared, the residual risk will be low and the company will likely be eligible.”

Participants shared that regarding Private Equity, “clients are mainly interested in understanding how the investment teams are managing risk, and how their investments are protected. They are less concerned about reputational risk, and focus more on understanding the actual investment”.

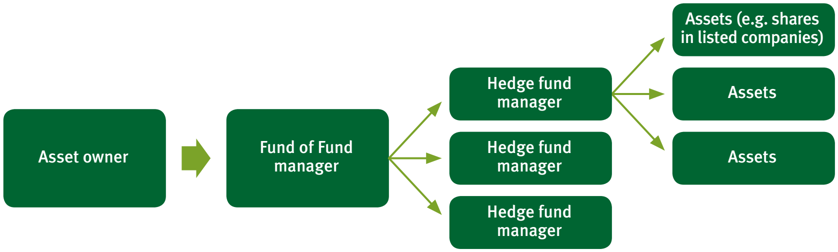
HEDGE FUNDS

Participants: Mittkap, OPM, SEB

Hedge funds are an investment orientation – rather than an asset class – that can use numerous different strategies to earn absolute returns. Hedge funds face less regulation than mutual funds and other investment vehicles, and are free to invest in any way they want, as long as they disclose the strategy upfront to investors. A hedge fund may for example invest in land, real estate, stocks, derivatives, and currencies, and strategies range from equity market neutral to convertible arbitrage, fixed income arbitrage, distressed securities, global macro, or emerging markets, to name a few examples.[8]

8 Investopedia ”Hedge fund” http://www.investopedia.com/terms/h/hedgefund.asp

THE INVESTMENT CHAIN



HEDGE FUNDS AND SUSTAINABILITY

The participants have established procedures, teams, and competence to incorporate sustainability as part of their investment chain. One participant is using a fund of funds (FOF) strategy. The fund invests in a number of underlying hedge funds. This investment chain is thus one tier longer than for those who manage their own hedge funds. For the FOF strategy, the fund manager will offer asset owners to invest in fund units in a variety of hedge funds. The next tier is thus the managers of the actual hedge funds, followed by the last tier which is the assets in which hedge funds invest. If the hedge fund is investing in corporate shares, this will be portfolio companies.

Many hedge fund managers attest that it is generally challenging to include sustainability, not least due to the short-term nature of hedge fund investment, but also because of the different techniques and instruments used, such as derivatives or high frequency trading, which do not really lend themselves to incorporating sustainability. Some strategies, such as long/short equity or M&A styles, may however be well positioned for including sustainability, for example by going long in companies that are excelling in terms of material sustainability issues and shorting companies with high risk exposure.

One participant said that hedge funds have a lukewarm interest in sustainability:

> *"The thing is that sustainability is not a huge factor for them. You still have a reasonable short-term investment horizon. The longest funds may have a two-*

year investment horizon. ESG are factors that may play out over 30 years. That is when it becomes a factor. It is likely going to be less than one percent excess returns per year for that factor. So it's not a dominant factor in their work."

The risk perspective is also not a huge concern, according to the participant:

"Let's say another Volkswagen incident happened. If we have, say, eight percent in that fund, and that fund has three percent in Volkswagen, and VW takes a hit, and drops to half. Then they lose 1.5 percent, and we have 8 percent of it, so we lose 15 points in a product that may move 0.5 to 1 percent per month. It is not of any significance. Maybe if there was a more systematic effect, like the one we saw in oil. But that wasn't for environmental reasons. So, I do not think there are any relevant risks to worry about."

A reflection is that the hedge funds are sharing their views on sustainability in relation to return, but what about their views on sustainability in relation to client demand/expectations?

"We have seen an increasing client interest and demand for sustainability in the last few years. The topic has become more mature and sophisticated so we are having a lot more detailed discussions with our clients."

TRANSPARENCY IN THE INVESTMENT CHAIN

One participant explained that their communication is only with the hedge fund managers, not with their underlying portfolio companies or other entities, and that transparency is limited.

"We only communicate with the hedge funds. We do not know exactly what they are doing, so we have to try to explain to them that they should think about this as risk and opportunity, and that they should take some responsibility. So we are trying to influence the investment chain."

According to the participant, the hedge fund managers' response to the sustainability expectations from them has improved over the years.

"I think it was very slow for the first 20 years, but in the last two years I think it has really improved."

This may, according to the participant, in part be due to the downturn in the oil industry ("oh, I should have seen that one coming") and to public scandals such as Volkswagen and BP, which had many financial actors thinking about the links between sustainability and financial performance.

Another factor is that as hedge funds are keen to attract capital, they will listen to the fund manager for that reason, too. The challenge for the fund manager, then, is to judge to what extent there is any substance to the sustainability claims of the hedge fund.

"Time horizon is a difficult factor since it can be hard to predict when the investment might be affected. Our experience is that clients consider how hedge funds work with sustainability as one way of judging quality of management and risk control. Sustainability is not "non-financial" is it "future-financial" so it will have an impact on investments."

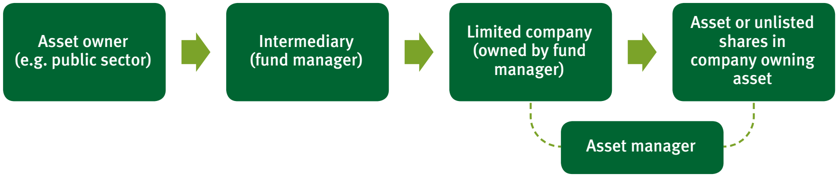
INFRASTRUCTURE

Participants: BlackRock, Infranode

Infrastructure is attracting increasing attention in the global investment community, as it offers inflation protection and stable yields. Private investment in infrastructure also has a key role in achieving the Global Sustainability Goals. Infrastructure assets are the facilities and structures essential for the orderly operations of an economy. This may include transportation assets such as toll roads, airports, ports, bridges, tunnels and rail; utility and energy assets such as water, power generation, electricity and gas networks, and fuel storage facilities; communications infrastructure such as transmission towers; and social infrastructure such as education, recreation, waste management and healthcare facilities.[9]

9 Source: UBS (2011) "An introduction to infrastructure as an asset class"

THE INVESTMENT CHAIN



Investing in infrastructure would require a large in-house team, why many asset owners instead choose to use an external intermediary. The second level in the investment chain, therefore, is typically an intermediary, whose role is to act as fund manager. In our study, Infranode and BlackRock represent intermediaries.

The intermediary performs direct investments into infrastructure projects, via a fully-owned limited company. That company, hence, is the third tier in the investment supply chain. The company would invest either in unlisted shares of a company that controls physical asset, or in the physical asset itself, such as wind turbines, solar panels or a district heating plant. That physical asset or the shares in the company that owns the asset, is the fourth tier in the investment chain. Once an assets has been acquired, a project asset manager (employed by the fund managing company) is engaged to manage day to day operations and report on performance.

A reflection is on the role of the project's asset managers and the challenges around transparency for this function.

The intermediary can own 100 percent of the asset, or it may use a partner strategy and invest alongside other investors or the original developer of the asset. Sometimes a municipality that has its own limited company may only want to sell 30% of its shares. Hence, the ownership structure and share in the asset may vary.

In contrast to private equity, the infrastructure investor does not have an exit-driven strategy, but rather a buy-and-hold approach. The investor may commit to a time horizon of 25 years. The technical lifetime of a bridge, for example, may be 100 years, so long-term thinking comes natural to the infrastructure investor, one participant shared. A reflection is about sustainability and political risk, and the participants' perspective on this.

Political risk, and in particular regulatory and policy risk, is an important factor to consider in both the due diligence process as well as during the holding period, as one participant describes it. Before they make an investment they describe the need to get comfortable that the assets' essentiality is sufficiently secured through law, regulation, contract or its inherent characteristics. In most cases long-term success is dependent upon specific regulations, which in a situation where adverse policy decisions are made could have serious negative effects on the risk and return profile of the investment.

> *"In a situation where we co-own an asset with the public sector it is very important to consider potential changes in the political environment as it would most likely have an effect on how the business is governed in the future. In sum, political risks play a natural part in our day-to-day work and we strive to be as informed as possible during the investment process as well as in the asset management phase, in order to avoid negative exposure."*

Developing countries have experienced political risks via nationalization or retroactive changes in laws. Some of this risk is mitigated by political risk insurance or by involvement of multilateral agencies. One participant evaluates political risks and possible mitigating factors by tapping into both in-house and external expertize. With offices around the world, investment decisions are taken in close coordination and consultation with local and regional teams and with the input from sovereign analysts and portfolio managers dedicated to a specific country or region.

Apart from inputs provided by local and regional experts, the participant seeks the highest degree of disclosures from sponsors in order to assess a full picture. As an example, their investment professionals recently analyzed and reviewed the procedure under which certain toll road concessions were awarded to the winning bidder. The focus of this exercise was to ensure that the projects were awarded under a transparent procedure, ensuring that there were multiple bids within close proximity to the winning bid.

"To help mitigate political exposure, we have the ability to selectively invest globally after a thorough analysis. They expect the support for infrastructure investments to continue, globally, along with the drive to attract private capital for local investments. Developed markets in North America and Europe have demonstrated a strong track record of honoring underlying contractual obligations."

INFRASTRUCTURE AND SUSTAINABILITY: BATS, BIRDS AND WATER VOLES

Within infrastructure, the sustainability issues tend to center on how the physical asset will impact flora, fauna and the local community. Issues such as noise, water, quality of the natural environment and protection of biodiversity may be relevant. This is often regulated through permissions.

"Infrastructure is so asset heavy, there is always something that is built or to be built. All sectors have some kind of link to the environment, so that is probably the most important question."

One participant, who invests in wind turbines, explained that they have constant monitoring of birds and other animals to make sure that the turbines will not have a negative influence on their habitat. Sustainability issues tend to be quite hands-on:

"On two of our wind projects in Iowa, due to our ongoing monitoring, we became aware of emerging concern about impacts on northern long-eared bats. As a result, on advice from our Project Asset Manager, we instigated a delayed cut in wind speed on the wind turbines from dusk to dawn to mitigate any impact that we might have during the sensitive months."

The same participant described how they identified water voles in a watercourse on the site where a transport crossing was planned. This was unexpected as the watercourse was not classic water vole habitat. In order to mitigate risk, the investor constructed a substantial bridge over the watercourse which preserved the water voles habitat whilst enabling the investor to continue with deliveries of turbine components to the site.

Another important aspect related to physical assets is health and safety in the construction phase. Local communities may also be affected by the asset, such as having the views from their home obstructed by wind turbines. Even with permits in place, asset managers will typically try to find a way to compromise. As one participant put it: “Angry neighbors is never a good thing.”

TRANSPARENCY IN THE INVESTMENT CHAIN

Our participants have not experienced that transparency in the investment chain is a major challenge. On the contrary, the nature of infrastructure investment is rather facilitating transparency.

> *“The prerequisites for transparency are good. We invest directly, we make few investments and they are long-term.”*

The project asset manager will report periodically, e.g. on a monthly basis, on sustainability metrics which may include clean energy production, environmental management, health and safety and community engagement. This will also be reported back periodically to the client, i.e. the asset owner.

As the infrastructure fund manager will typically have board representation, it will sit in the midst of the flow of all relevant information. One participant therefore has a two-tier approach, and explains their approach to influence in terms of sustainability:

> *“We may be majority or minority shareholders. If we are majority owners, we can influence. If we are minority owners, we can try to influence. We have developed two ESG packages, for majority and minority ownership respectively. It’s about over time helping this company that we are invested in getting better and better in its approach to ESG. We evaluate the activities every year.”*

When probed about whether the fund manager is satisfied with the level of transparency in the investment chain, and whether they meet any resistance, one participant said:

> *"This [our sustainability framework] is so new to us. (...) What we can say is that due diligence advisors have not been complaining [that we ask for transparency]. The company that I have done a first study on has not been complaining; they have done well. Everyone seems to share the perception that this is important. What may come down the road, though, may be if we make an investment in a company that doesn't tick so many boxes for us, where we have more of a job to do as an owner. It will put a lot of demands on us as an owner, and management may not be too happy about our requirements. But that is what we are here for."*

Something very helpful, according to one participant, is standardization on how to follow up on sustainability.

> *"We are part of international efforts to do this in a more standardized way, which makes it a little easier when we discuss it with companies and other stakeholders, to say that this is what the standard should be."*

One participant said that asking for transparency on sustainability in the investment chain is also a bit challenging. Investment opportunities are not abundant, and anything that limits the opportunities to do business is a risk. It is a balance act to follow up on sustainability but not scrutinize the company too much.

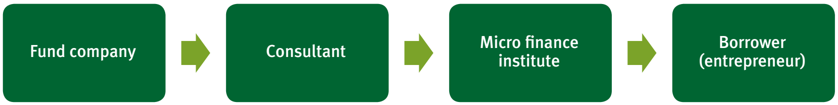
MICRO LOAN

Participants: SEB

Microcredit refers to lending practices intended to empower the poor by making funds available to entrepreneurs and small businesses whose financial resources, economic status or credit history would preclude their eligibility for traditional business loans. Microcredit may be categorized in a number of ways, including the loan applicant and the business segment served. For example, the applicant for the microcredit may be a group or one entrepreneur. The granting of credit to a group is known as group lending. In this case, each member of the group may offer collateral or a group pledge to secure the loan. In turn, individual lending extends a loan to only one client who is responsible for the loan repayment. In addition, microcredit may be categorized according to the activity the business performs to earn revenues. For example, microcredit obtained from specialized banks may be referred to as agricultural credit or handloom credit.

A microloan is a small loan granted to the poor entrepreneur in addition to training and other resources, which is meant to fund and best ensure the success of the small business. Unlike individuals who may be recipients of financial aid that is funneled into poor communities by governments and charities based on need alone, a small business owner is granted a microloan on the premise that he will repay both the loan principal and interest to the lender over a specific period of time. A microloan may be as small as $100 in size and the interest rate as much as 35 percent.[10]

THE INVESTMENT CHAIN
MICRO LOAN AND SUSTAINABILITY



Microfinance is the provision of access to capital and financial services in low income economies. Microfinance institutions (MFIs) finance micro- and small enterprises (MSMEs) and low income households. Micro-enterprises have up to five employees, small enterprises have up to 50 employees. Microfinance investment vehicles (MIVs) invest in MFIs and more broadly in microfinance markets. Investors invest in MIVs, with an aim to maximize shared value creation.

Microfinance is mentioned on several occasions within the UN Sustainable Development Goals framework, as a prerequisite for achieving the goals by 2030. Microfinance in itself has an inherent positive impact, in that it implies that people who are otherwise excluded from the main-

10 http://smallbusiness.chron.com

stream financial system get access to basic financial services. This has positive results for the individuals, their families, and society as a whole.

The participant for Micro Loan has an established process, a team with competence to incorporate sustainability throughout the investment chain. Through investing in microfinance institutions, the Micro Loan participant provides financing for entrepreneurs and low and middle income households in emerging and frontier markets. Over 4 billion SEK has been invested through microfinance institutions reaching more than 17 million micro-entrepreneurs in 33 developing countries.

> *"Micro finance is a necessity to reach the Sustainable Development Goals. The social side effects of making capital available for small entrepreneurs and to help them grow their business is having a large impact both on the entrepreneurs and society at large."*

TRANSPARENCY IN THE INVESTMENT CHAIN

Sustainability within Micro Loans is described as an integrated part of the investment process, where each individual investment object is evaluated according to how well they take care of the end customer, i.e. the micro-entrepreneur, as well as what efforts are in place to make a positive contribution to the development of society.

There is a general view of opportunity (and risk) for companies that manage (or not) sustainability and responsibility matters, and that those who do have a greater possibility to create added value, i.e. they reduce risk and cost, they attract capital, and they take care of the sustainability-related business opportunities.

For Micro Loans, it is described that they whole investment chain is thoroughly screened regarding relevant risks and sustainability matters. "These matters and how they are managed, are documented and included in each and every investment decision. And the conclusions are included in the overall assessment leading up to whether or not an investment will be made, or how they may impact the overall assessment of the investment."

"It is crucial that there is full transparency all the way from the investor to the entrepreneur. It gives the investor not only financial return but also the benefit of seeing the difference the investment is making."

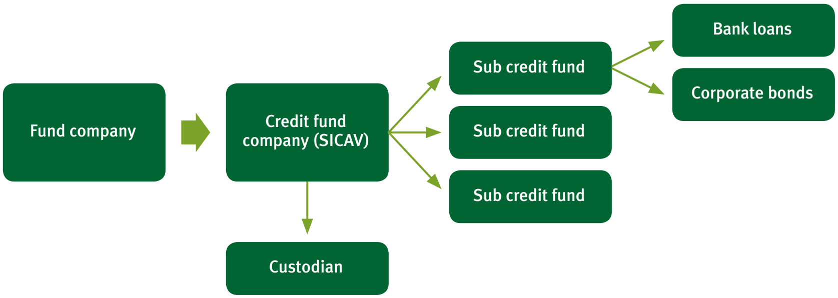
BANK LOAN/CREDIT FUND

Participants: Goldman Sachs Asset Management, Skandia Fonder

Bank Loan and Credit funds essentially invest in loans by banks and other financial firms to companies with large debt. They are also known as floating rate funds because their yield fluctuates based on an index rate to which they are tied.

The investment chain below illustrates a fund of fund structure, as compared to a manager who invests directly into bank loans, i.e. the portfolio manager selects and invests in the loans directly rather than via a sub-credit fund.

THE INVESTMENT CHAIN



BANK LOAN/CREDIT FUND AND SUSTAINABILITY

For credit research, one participant shared that they have fundamental analysis; a team of credit research people who do nothing else but look at credits across different sectors, and their focus is on risks, such as sector risk, business risk, or financial risk.

With a set of developed key drivers they identify companies that will fit within these key drivers. There are multiple areas and it is a reiterative process, founded in models.

When thinking about sector risks, one participant looks at the attractiveness of a sector. As an example, the water treatment sector is considered attractive. Other sectors, polluters, are viewed as a sector that will have to disappear. Geopolitical risks are certainly part of this assessment, as well as labor relations, health and safety, in essence all of what makes a good company sustainable. However, this is not necessarily labelled ESG or sustainability. When talking about fundamental analysis, and the sector risks, the companies can have red flags. If any of those red flags refers to a particular governance issue, it could lead to not investing in a certain issuer.

With the high focus on risks, identifying a particular sustainability risk for bonds as compared to listed equity, the materiality that is factored in with an equity company is much quicker, according to one participant.

> *"If you buy a bond with a maturity of five to six years, and something happens, what is the materiality? Of course, if the company is bankrupt, that would be bad, and the bond goes down. But let's say – talking about the Walmart or the Volkswagen issues – is it really going to destroy the credit and the cash flow? If it is not, as a bond investor you are fine. But as an equity investor, reputational risks can be linked to more volatile returns and you get impacted more heavily. A bond is just getting your money back and that in a certain period."*

One participant shared that, for fixed income, there are particular sustainability areas they consider:

- Within Environmental, asset and product mix such as carbon intensity and emissions profile operations such as safety performance and potential risk mitigation, and regulations of the risks embedded in products or emissions.
- Within Social, safety performance such as the management of safety protocols around operations, employees and stakeholders. In addition, stakeholder relations and the license to operate and employee relations, morale, turnover, and the ability to attract talent and appropriate skill-sets.

- Within Governance, transparency and disclosure, capital and risk management such as balance sheet management and debt tolerance, legal risks and exposures, board structure and composition, management incentives, and ownership structures.

Another participant shared that there is no one formula to identify which sustainability factors are material.

> *"There is no recipe. That would have been handy. But it can be material from different perspectives. It can be material based on us as a company, for our brand, or for the fact that we don't want to be associated with certain aspects. It can also be material not to provide our services to a certain client group depending on what their investment policy looks like. But materiality is most common in relation to a company that we hold. What matters then is the actual company, its sector, its corporate governance, etc. Good sustainability standards within a company is often an indication of a good management."*

TRANSPARENCY IN THE INVESTMENT CHAIN

> *"As part of our investment process, we regularly communicate with company management teams on all topics that impact credit risk, including ESG-related factors. We believe that the act of raising these factors, where relevant to credit quality, risk management or credit spreads, serves as an important signal to management teams about the relevance of ESG to our investment approach."*

One participant described that their analysts are responsible for assessing sustainability risks and incorporating them into their overall research and evaluation process. To supplement their internal knowledge, the fixed income team also leverages the expertise of several external providers of sustainability research. The external sustainability research is viewed as one of many inputs into the overall credit research process. Where appropriate, a dialogue-based approach to engagement with management takes place to understand how management acknowledge and mitigate sustainability-related risks.

For bank loans, one participant shared their process for monitoring their portfolios. Based on a sustainability assessment, conducted by their internal teams, they initiate a dialogue with the portfolio manager, at least twice a year. Based on those dialogues, issues are raised and discussed. It varies how susceptible the portfolio managers are to external input on sustainability matters.

> *"Bank loans are much easier to deal with, as we have full control over what we buy. We know the company, and we can get out of the position if we are not satisfied. This has happened."*

Credit managers are said to be more open to external input. The reason as described is that they often meet the clients.

> *"If you meet institutional clients who expect sustainability to be managed, then you are forced to deal with it. Portfolio managers who don't interact with clients and who don't need to answer questions, are much more reluctant to consider sustainability and non-financial factors."*

Closing remarks

Our working hypothesis when planning our study was that transparency would likely be low, as information has farther to travel in the alternative assets investment chain than it has for listed equity. We had also hypothesized that larger actors may be farther ahead in terms of transparent investment chains compared with their smaller peers.

Each product has its unique features which either lend itself easily, or not, to transparency. In infrastructure, transparency is less of an issue due to the nature of the investment chain, where e.g. the fund manager may fully own a physical asset and have fewer intermediaries. In hedge funds, PE-funds or credit funds, transparency can be more of an issue for investors due to the often more complex investment chains.

Our study showed that there is generally a low explicit interest from asset owners for greater transparency throughout the full investment chain. The push for transparency comes from a select number of investors. However, the participants had a high level of knowledge of their respective investment chains and solid processes in place for managing not only risks and opportunities, but also questions and expectations from investors with regards to sustainability and transparency. It was made clear that the process of seeking to improve transparency, most notably through questions asked by fund managers, is spurring a greater interest in sustainability further down the investment chain.

As we know, Alternative Assets are heterogeneous, and one should not generalize or make conclusions about "alternative assets" as one piece or in general. An infrastructure investment where the fund manager holds

100 % of the physical asset themselves would likely have a different experience in terms of transparency in the investment chain than e.g. a hedge fund of fund manager, where it is unknown what the hedge funds invest in.

Some Alternative Assets categories are even quite heterogeneous themselves. Hedge funds, for example, have a broad range of strategies which may have different implications for what the challenges in terms of transparency may be.

A key take-away from this study, is for asset owners, the investors, to ask questions and engage through constructive dialogue with their asset managers, all categories, but crucial for Alternative Assets. Learn from the participants in this study and from actors across the broader spectrum of Alternative Assets. We encourage dialogue between asset owners and asset managers, also focusing on the sometimes difficult or complex matters within this important asset class.

A view from the Knowledge Foundation with regards to what is needed to improve transparency is that knowledge, competence, and incentive systems need to be upgraded. We are keen to understand and follow how the participants and the market in general will respond to this.

In closing the dialogue with the participants, we asked where they believe the market for sustainable investment will be in three years. Everyone foresee growth and development of sustainability within the asset management industry, and some shared some specific views as stated below:

- ESG will grow in general and mature in Alternative Assets.
- The hedge fund industry will see no major changes.
- There will be greater interest of ESG in the U.S. (currently behind Europe), leading to more friction-free dialogue, and more proactive GP's in the U.S. (not waiting for the LP's to ask).
- Tax issues will be seen as a sustainability issue to a greater extent.
- There will be greater emphasis on reporting and metrics to be disclosed to investors.
- The financial world is small. If you get enough people who think this make sense, behavior will change.

Our first study... what happened with the hedge funds?

One of the hedge funds in our first study three years ago, commented: "It's good that you're doing this and that we get a kick in the right direction. Even if the questions are difficult to quantify, we can see in several areas of the survey that we can do certain things to improve the overall level. Even though we are not an ethical hedge fund, we notice that investors, and in particular foreign investors, are now starting to place demands in this area. In our company research we will also try to differentiate more between companies that have genuinely introduced a CSR policy of substance and those who just talk the talk."

Curious to understand what progress has been made since then, we reached out to the hedge funds, and asked them. Here are some key points shared:

Alcur: "Sustainability is highly important, it will affect the whole industry, and it pushes our thinking. Since your first report and our discussions then, we have developed our approach including a sustainability document. We support the PRI principles and live by them, but we do not sign up as we cannot guarantee compliance, something we believe is important to do. There is a risk that these large initiatives focus on short-term issues that in the long-term may not be sustainable. Take electric cars as an example, and the batteries´ production resource consumption – relative to a traditional gasoline car. Or wind power's total production cost relative to the clean energy saving, the environmental liability is there long after the car or windmill is built. We believe solar energy inventions will change the game.

We encourage KK-stiftelsen and other investors to assess not only the investment process but also the organization itself when they evaluate asset managers and sustainability. We would also like to see the large, global asset managers define their own sustainability strategies rather than streamlining alongside PRI and its followers. Last but not least, we think it is important to engage with the real subject-matters experts, such as environmental organizations with strong public support, to get their insights into what investors need to do across the variety of important matters." **www.alcur.se**

Brummer & Partners: "Since the previous evaluation took place our experience is that the mandate given to us by our customers has widened. The mandate is still the same though; to generate returns. But in doing so, consideration should be given to ESG (environmental, social and governance) factors in order to make better-informed investment decisions. However, including all risks in the investment analysis is part of the role description of a portfolio manager and even though they were not classified as E, S or G risks earlier, many of the factors labelled ESG were taken into account. Also, companies with ESG issues are typical short cases for long-short equity strategies. Since the last evaluation took place we have been formalizing our responsible investment practices and articulated an approach to responsible investment that fits our organization. It is however a continuous learning process and we joined the PRI last summer in order to learn more and improve but also to share our experiences and act as a role model in areas where we believe we are at the forefront. For more information about our responsible investment activities, please see our website." **www.brummer.se**

Catella: "Catella signed UN Principles for Responsible Investment in 2009. The sustainability efforts has since then been deepened on a number of areas. Each portfolio manager for all equity products were made individually responsible for the ESG assessment, evaluation and decision-making around norm breaching companies. Infrastructure and processes around screening, yearly reporting and filing to meet the UNPRI criteria were put in place. Catella has also selectively engaged with companies in ownership discussions which often touches the sustainability area. In these dialogues Catella has always worked to encourage holding companies to increase transparency and performance regarding sustainability.

Catella decided to take the next step in sustainability 2015, backed by a more mature sustainable finance industry, apparent opportunities and threats evolving from sustainability issues alongside customer demands that pivoted towards sustainable investments. The goal was set to introduce a more tangible sustainable product offering and investment strategy. Since then Catella has hired dedicated ESG resources, re-launched one of our long-only funds as a sustainability mandate with a new investment process and philosophy. For this product we have enhanced our screening to also involve controversial product and services and bought access to external sustainability research. This knowledge is accessible to all PMs and is to be considered as a part of the UNPRI and general fiduciary duty. We have conducted internal workshops and will keep increasing the internal know-how in the area. Catella's ambition is to further improve in the sustainability area whilst keeping focused on companies and portfolio performance. **www.catella.se**

Gladiator: "We have implemented a sustainability policy, and our efforts are monitored by our management team and board on a regular basis, and decisions for revisions is taken at least annually. We base our analysis on principles of international standards for human rights, labour rights, the environment, and corruption.

Through the analysis we highlight corporate responsibility for human rights, employees' working conditions and rights, and climate and business ethics. The analytical work within our asset management is based on the view that an active sustainability work in companies is not only regarded as a cost, but a way to improve and develop the companies for the benefit of shareholders and therefore a component that contributes to better future returns for shareholders in the fund Gladiator.

The goal for us is independent analysis and objective decisions based on ascertainable facts. We will not let ourselves be governed by emotions, rumors or pressure groups. We believe that each investment opportunity must be valued independently and on the basis of its individuality, and we attach greater importance to a company's intentions and current documents than its history. If we discover that we, despite our intentions and goals have invested in a company that violates our approach to managing sustainability issues, the holding will be sold." **www.mittkap.se**

RAM ONE: "During 2015, RAM ONE signed the UN-backed Principles for Responsible Investment, and thus formally integrated responsible and ethical guideline as part of our investment decisions. In addition, we provide an annual report of the results of our ESG efforts. Through this commitment, we are also able to encourage the portfolio companies to improve their own performance within these areas.

Regarding the ESG analysis, RAM ONE has both intensified and formalized our analysis process, where each analyst and portfolio manager is individually responsible for making sure that each portfolio company is evaluated form an ESG perspective. When there are areas or risks we do not fully understand, we educate ourselves gather relevant external information. Within certain circumstances this may lead to the conclusion that a company will no longer be approved for trading. Our Head of Research is responsible for ensuring the quality of the ESG analysis and for ensuring that knowledge and insights are communicated to the investment team.

Our investment universe is revised yearly and we put great emphasis on a companies' efforts on creating sustainable business model and their attention to environmental, social, and governance (ESG) factors. Only if ESG issues are handled in a credible manner a company can be included in our investment universe." **www.ram.se**

Graphic design: Sinfo Yra
Photo: Johan Olsson, iStock
Print: Elanders 2017

The Knowledge Foundation funds research and competence development at Sweden's new universities and university colleges with the purpose of strengthening Sweden's competitiveness.

We provide funding when activities are conducted in collaboration between academic staff and business sector partners. The aim is to build internationally competitive, integrated research and education environments. Our mission is to strengthen Sweden's competitiveness, and we know that collaborative projects between academia and industry create great benefits for both parties.

The Foundation was established in 1994 with a founding capital of SEK 3.6 billion, and has now invested some SEK 9.3 billion in over 2,500 projects.

Knowledge Foundation

Birger Jarlsgatan 16, SE-114 34 Stockholm
www.kks.se