Thoughts on ESG Integration for Alternative Solutions

Established in 2004, Fulcrum Asset Management LLP ("Fulcrum") is an independent asset manager with a single, cohesive investment team founded on an inquisitive, thoughtful, and research-oriented culture. To help our clients meet their objectives, our aim is to remain innovative, identifying the trends reshaping markets and driving investment performance.

From the ongoing energy transition to the growing concerns around labour rights in the 'gig economy', environmental, social and governance (ESG) risks and opportunities are already shaping capital flows around the world, with consumer preferences and regulation accelerating this trend. We see it as part of our fiduciary responsibility to consider all factors that affect investment performance; incorporating ESG considerations thus helps us make better, more informed investment decisions.

We recognise that the allocation of capital can affect society and the environment, and we aim to play a positive role in this evolution. Climate change represents a strategic area spanning investments, engagement, data provision, and the sustainability of Fulcrum's own operations, with a growing share of our long-only equities invested in companies that help accelerate the world's low-carbon transition. The establishment of our Diversified Liquid Alternatives Fund (with a clear ESG focus), and of our first impact-focused fund (the Fulcrum Climate Change Fund) have been important milestones in our journey to strengthen responsible investment integration across asset classes, and we are pleased to have received an "A" overall rating in our latest assessment from the UN Principles for Responsible Investment (UNPRI). We value having an integrated approach, with responsibility for the management of ESG risks and opportunities sitting inside the investment team.

Through our affiliation with organisations such as the Institutional Investors Group on Climate Change or the UNPRI, we collaborate with issuers, other investors, and policy-makers to push for market-wide progress on ESG issues.

We also regularly engage with our investee companies, using our votes to express our beliefs and hold companies accountable.[1]

At the same time, we will withhold capital from sectors that we believe do not provide any clear potential societal benefits – this includes companies involved in predatory lending, tobacco, and controversial weapons.

Average level of support during 2020-21 proxy season	Environmental proposals	Social proposals	Overall
Fulcrum AM	**70%**	**67%**	**66%**
Average – 6 largest asset managers	39%	29%	32%

Sources: ShareAction, Fulcrum, Glass Lewis.

We pay close attention to our own internal processes, recognising that good governance is the foundation for responsible investment. We invest our clients' money alongside our own and in the same way, which helps to align incentives and minimise conflicts of interest. We are developing ESG performance indicators for our portfolio managers, increasing the levels of ESG resources for training and data, and establishing centralised oversight to make sure we deliver on our ESG ambitions, with a Responsible Investment Committee overseen by our Management Board.

And we also pay close attention to our external partners: we are increasingly engaging with prime brokers and data providers on ESG themes, and our Alternatives Solutions Team have developed a sustainability scoring framework for third-party asset manager selection (as detailed below).

Responsible Investment in Alternatives

Within the Alternative Solutions Team, our investment process is driven by an Impartial Implementation approach. This is our framework for selecting the most suitable implementation route (internally or externally managed, passive or active) for a particular idea, taking into account trade-offs between returns, risk,

1 Sources: ShareAction ("Voting Matters", 2021) Fulcrum AM, Glass Lewis

sustainability considerations and costs. Not only do we score each investment's sustainability characteristics using a proprietary system (see steps 2 and 3 of our investment process below for more detail), but we also adjust our return and risk assumptions based on our extensive due diligence. This process results in two key benefits:

- It prompts us to proactively seek out investment opportunities with positive scoring sustainability characteristics (e.g. clean energy and recycling companies, or third-party managers who themselves have strong sustainability characteristics).
- It provides a very clear audit trail for marginal decisions, where our sustainability scores can be very influential.

To provide further context, below we outline the four stages of our investment process and how Responsible Investing is considered at each stage:

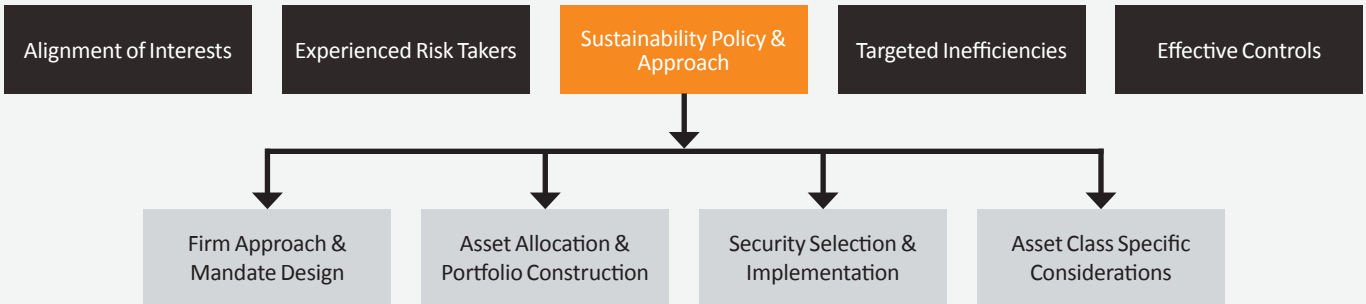
1. Strategic Asset Mix

This sets out the baseline asset allocation framework that underpins our solutions and considers long-term secular trends, market size, investment efficiency and a range of other factors. It is at this stage where we may consider the potential sustainability of an asset class and debate whether the opportunity to invest remains attractive over the long term. We ask ourselves questions such as "Is there a future for the oil and gas industry within Natural Resources?"

2. Dynamic Idea Generation

For all potential investments, we develop views on the above five 'Key Ingredients for Competitive Advantage', which includes our primary decision-making tool for Responsible Investment. We make a qualitative assessment based on the granular details of how an idea is designed, constructed and implemented with sustainability in mind, and whether this could lead to improved risk-adjusted returns.

An investment or manager's sustainability policy and approach is one of the key ingredients, assessed across four main areas, illustrated below:



Firm Approach & Mandate Design: This includes business commitment, ESG philosophy, current and evolving ESG credentials, approach to stewardship, diversity and inclusion, as well as the overall level of experience in implementing ESG considerations. We are also very interested to learn how and why a particular mandate has been designed the way it has, and we will explore in detail the specific business rationale for the launch of a particular product or solution.

Asset Allocation & Portfolio Construction: We discuss adjustments that may be needed to capital market assumptions or climate-factored scenario analysis, which can in turn help us to make our own adjustments too.

Security Selection & Implementation: We review materiality assessments, engagement prioritisation, voting records, linkage to UN SDGs and data provision.

Asset Class Specific Considerations: Finally, we consider factors specific to a particular asset, which we discuss later in this paper.

Each of the aspects above is scored on a scale of 1-4 (1 represents poor and 4 represents a leading score) and aggregated to form an overall Responsible Investment view on any given idea in our research pipeline

3. Portfolio Construction

It is here that we apply our Impartial Implementation approach, and we do this by applying 'Four Key Factors' in order to enable holistic investment decision-making.

All potential investments are scored across these four factors, and this enables us to assess the relative trade-offs between ideas, as illustrated below:

Four Key Factors	Description
Target Net Return	Long term house asset class assumptions for major markets Return boost from strong fundamental/behavioural traffic lights
Diversity Factors	Holistic risk assessment including target volatility, factor exposures, geographical exposure Target volatility informed by house assumptions and nature of investment idea
Sustainability	We evaluate company, mandate, investment process and asset class components of an investment opportunity to arrive at an aggregate score for ESG policy and approach. Each is scored 1-4: 1 represents a poor score and 4 represents a leading score. In addition to impacting return and volatility assumptions, ESG scores influence marginal decisions
Implementation Considerations	Assess implementation costs Scrutinise idea and portfolio level liquidity

Idea	Sub- Strategy	Target Net Return	Diversity Factors		Sustainability	Implementation Considerations	
			Target Volatility	Geography	Aggregate Score	Total Fees	Min Market Cap/ADV
Theme Basket 1	Clean Energy	6%	15%	Global	4	0bps	$1bn/$5mn
Theme Basket 2	Residential REITS	5.5%	12%	US and Germany	2	0bps	$1bn/$5mn
Manager 1	Securitised Credit	5%	5%	Global	3	59bps	Daily
Objectives	**15-20**	**Inflation + 4%**	**8-12%**	**Diverse**	**Aim to improve average scores over time**	**Meet overall cost limits. Highly liquid**	

Source: Fulcrum Asset Management LLP. For illustrative purposes.

When it comes to adjusting our return and risk assumptions, based on sustainability considerations, we apply caution and are conservative with any adjustments given the difficulties inherent in measuring the impact of ESG factors in a quantitative manner. Any adjustments are based on a combination of statistical analysis and academic research. This step also allows us to have the option to veto any investments we may feel uncomfortable about, for example those investments with a Sustainability score of 1, and it enables the Sustainability score to be a powerful tool for tie-break decisions.

4. Monitoring and Risk Management

Our preferred approach to Responsible Investing is to engage with stakeholders. We believe this is critical in achieving a positive outcome for those involved, and therefore we do not automatically rule out a poor scoring direct investment or third-party manager, particularly if we can identify the right steps are being taken to innovate and improve. This is assessed on an ongoing basis, as part of quarterly updates and annual reviews.

Case studies

Investors often believe that sustainable investment options are more expensive or can be detrimental to returns though we have found that this need not be the case. The following two examples highlight leading innovators in their respective fields and having reviewed all implementation options, both scored highly when measured across our 'Four Key Factors' approach.

Sustainable Listed Infrastructure

Infrastructure has some of the highest carbon-emitting companies and we were keen to seek out a more sustainable, long-term approach. The strategy we invest in looks to combine long-term valuation and quality stock

analysis with an analysis of how sustainable the underlying companies are. We were the first external investor in a newly launched sustainable listed infrastructure fund, and as a result we achieved a compelling fee deal. This female managed strategy scores highly on diversity factors at both an investment and portfolio construction level, reflecting the importance we place on including a range of decision makers with complementary experiences and backgrounds in our portfolios.

ESG-integrated High Yield

High-yield debt is one of the sub-strategies in which underlying companies are more prone to lagging in the management of ESG-related issues, particularly in the traditional energy sector. As a result, our objective was to find a manager where individual companies were credibly assessed on ESG and more traditional valuation criteria. We were therefore a day-one investor in a new fund launch from a long-established, female-owned boutique manager that looks to explicitly integrate ESG considerations in all decisions.

Asset class specific considerations

The table below highlights some specific considerations we review for each asset class in our liquid alternatives opportunity set:

Asset class	Key considerations	Impact
Real estate	GRESB credentials	The GRESB ("Global Real Estate Sustainability Benchmark") credential is key in the Real Estate sector as it sets the tone for how these assets are developed, perform and managed.
Infrastructure	Climate scenario analysis	Climate scenario analysis is key to measuring transition and physical risk due to temperature impact, and the eventual risk of stranded assets, which in turn can lead to adjustments in position sizing.
Natural Resources	Engagement prioritisation	The philosophy and approach to working with energy majors is critical within natural resources and reflects how voting rights are used as a tool to enact longer-term change.
High Yield	Data quality	Active engagement with smaller companies to encourage greater consideration and transparency of ESG-related issues, particularly new issues where greater support is required.
Emerging Market Debt	Social & environmental policy	Government action and support for the financial and physical wellbeing of its population and environment is critical. Green bonds and engagement during the price discovery phase of new bond issues is a key mechanism to encourage improving behaviour.
Securitised	Lending and mortgage servicing standards	Engagement with lenders and servicers to reduce the prevalence of predatory lending practices.
Convertibles	Creditor rights	In the absence of voting rights, where a manager is reviewing a new issue, engagement on bond terms to encourage greater ESG transparency and improving practices, especially where they are made 'private.'
Quant Hedge Funds	ESG risk influence	ESG data availability and reliability are common issues that are improving. However, the ability to measure ESG impact quantitatively is in its infancy
Fundamental Hedge Funds	Shorting ESG laggards	Understanding the due diligence and reasoning behind the decision to short a stock vs. to engage is key in assessing the sustainability of returns over the long term
Event-driven	Transaction announcement threshold	Assessing minimum ESG thresholds in place to initiate a position could lead to improved risk-adjusted returns.

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