

# MANAGING THE FUTURE

Exploring responsible investing and the ability of CTAs to effect positive change

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**In the beginning**, socially responsible investing (SRI) was based primarily on the ethical and moral value systems from organized religion. To this day, the term “sin stocks” commonly refers to companies engaged in gambling and the production of alcohol, tobacco, pornography and weapons. However, over time, SRI expanded to encompass broader societal issues. In the latter part of the 20th century, apartheid and the Vietnam War heightened the awareness of sociopolitical and human rights concerns, while manmade disasters such as the Bhopal gas tragedy, Chernobyl and the Exxon Valdez oil spill significantly increased the focus on the environment. More recently, mounting scientific evidence of global climate change has exacerbated environmental concerns while the COVID-19 pandemic has highlighted some of the inequities relating to women and underrepresented populations in society as well as the growing economic divide between classes.<sup>1</sup> These issues have captured the public’s attention and are increas-

ingly being considered when investment decisions are being made.

Today, many investors consider environmental, social and governance (ESG) factors – and the concept of sustainability – when evaluating the non-financial performance of their investments. As companies financing their business operation using equity or debt have an obligation to deliver on their stakeholders’ expectations, ESG has facilitated the establishment of a broad framework for them to address their environmental impact on the world, ethical and moral behavior (relating to their employees, suppliers, customers and communities), and governance practices (including accounting methods, communication with stakeholders, and potential conflicts of interest). Independent organizations regularly screen and score companies based on their adherence to ESG principles, providing this service to many investors.

<sup>1</sup> United Nations Department of Economic and Social Affairs. The Sustainable Development Goals Report 2020. United Nations Publications, New York, NY. 2020. <https://unstats.un.org/sdgs/report/2020/>

ESG screening and scoring criteria are also used to classify sovereign and municipal securities, although the methods differ somewhat from corporate securities as does the ability of investors to directly influence management behavior. The results for both are open to interpretation and regional biases resulting in classification differences;<sup>2</sup> a company or country that may pass one screen may fail another.

Following are some evaluation methods currently employed:

- Negative screening – also known as “exclusionary screening,” this approach was one of the earliest methods used by socially responsible investors. The approach was designed to preclude investments in entities that are actively engaging in behavior that has a perceived negative impact on the environment and/or society.
- Positive screening – also known as “best-in-class selection,” this approach highlights entities perceived to be making a positive impact on the environment and/or society. Investing in these securities provides funding to support these entities’ continued operation. For those explicitly financing projects to generate environmental benefits using debt, “green bonds” are often issued.
- Scoring/rating – this method is an extension of screening and uses the same range of environmental, social and governance factors to quantitatively measure how entities are performing on those issues; leaders are generally rewarded, while laggards are penalized.

ESG integration is defined in the UN Principles for Responsible Investment (PRI) as “the explicit and systematic inclusion of ESG issues in investment analysis and investment decisions.”<sup>3</sup> Those screening and/or scoring investments based on ESG factors are attempting to assess and monitor the non-financial performance of their portfolios. There is empirical evidence that investments rating highly on ESG criteria have historically generated above-average returns leading many to believe that they will therefore likely outperform in the future. While this research has been scrutinized with various unrelated explanations offered as justification for the performance dispersion,<sup>4</sup> the consideration of ESG/sustainability factors when making investment decisions continues to gain momentum.

In addition to using ESG as an analysis tool, some investors attempt to make a direct ESG impact with their capital. Impact investments are made with a dual objective: generating a positive rate of return while producing a measurable benefit to the environment and/or society. Although most of these are made with the intention of realizing above-average results, capital is also available to those with “below market rate” expectations should the potential social or environmental benefit warrant.<sup>5</sup> However, for some, this blurs the line between impact investing and charity leading to criticism and controversy. Impact investors often build thematic portfolios to directly address one or more of the UN sustainable development goals (“SDGs”),<sup>6</sup> making investments to achieve a specific sustainability objective.<sup>7</sup>

<sup>2</sup> “Gratcheva, Ekaterina M.; Emery, Teal; Wang, Dieter”. Demystifying Sovereign ESG. Equitable Growth, Finance and Institutions Insight; World Bank, Washington, DC. 2020. <https://openknowledge.worldbank.org/handle/10986/35586>

<sup>3</sup> “Orsagh (CFA), Matt; Sloggett (CFA), Justin; Georgieva, Anna”. ESG in Equity Analysis and Credit Analysis. Principles for Responsible Investment (PRI) and CFA Institute, New York, NY. 2018. <https://www.unpri.org/download?ac=4571>

<sup>4</sup> “Bruno, Giovanni; Esakia, Mikheil; Goltz, Felix”. “Honey, I Shrunk the ESG Alpha”: Risk-Adjusting ESG Portfolio Returns. Scientific Beta Publication, Nice, France. 2021.

<sup>5</sup> Global Impact Investing Network. 2020 Annual Impact Investment Survey. <https://thegiin.org/assets/GIIN%20Annual%20Impact%20Investor%20Survey%202020.pdf>

<sup>6</sup> United Nations Sustainable Development Goals – <https://www.un.org/sustainabledevelopment/>

<sup>7</sup> Principles for Responsible Investing – <https://www.unpri.org/investment-tools/thematic-and-impact-investing/>

## UNITED NATION SUSTAINABLE DEVELOPMENT GOALS



Source: <https://www.un.org/sustainabledevelopment/>

Below are examples of less conventional responsible investing approaches:

- Short-selling negatively screened securities – this approach is relatively controversial as some consider short-selling an irresponsible activity that promotes financial market instability. However, the PRI acknowledged the potential ESG utility of the approach<sup>8</sup> and the Alternative Investment Management Association (AIMA) outlined its practical application in equity impact investing.<sup>9</sup>
- Building activist stakes in companies to directly influence management actions – this approach (popularly employed in private equity, venture capital and private debt) has perhaps the greatest direct impact, but also requires the greatest commitment from investors.

In some regions, governments and regulators have begun to establish standards for their constituency to follow.

The adoption of the 2030 Agenda for Sustainable Development by the UN in 2015 and the introduction of the SDGs provided a framework around which nations could directly address sustainability issues. In Europe, the EU taxonomy for sustainable activities was enacted in July 2020 to clarify which investments are environmentally sustainable and to mitigate “greenwashing.”<sup>10</sup> In March 2021, the European Supervisory Authorities enacted the Sustainable Finance Disclosure Regulation (SFDR) as a tool to hold financial market participants accountable for contributing to the objectives laid out in the Green Deal.<sup>11</sup> However, the focus of these efforts has generally been on the company level and the acceptance, adherence, and policing of these standards has not been fully developed nor is the approach homogenous across regions.

Further, while many view the problems that ESG confronts as global, nationalist and economic pressures have resulted in different approaches being employed to tackle them. For example, Donald Trump controversially pulled the United States out of the Paris climate accord arguing that the agreement disproportionately disadvantaged US businesses.<sup>12</sup> Critics also argue that responsible investing may encourage institutional money managers to act against their fiduciary responsibility to clients, particularly when their decisions differ from those that would otherwise be supported by traditional fundamental and technical analysis.

<sup>8</sup> “Hernandez, Marisol; Jones, Jonathan; Belsom, Toby”. Technical Guide: ESG Incorporation in Hedge Funds. PRI, UNEP Finance Initiative and the UN Global Compact, New York, NY. 2020. <https://www.unpri.org/download?ac=11344>

<sup>9</sup> “Fox, Darren; Budra, Max”. Short Selling and Responsible Investing. The Alternative Investment Management Association Limited (AIMA). 2020. <https://www.aima.org/sound-practices/industry-guides/short-selling-and-responsible-investment.html>

<sup>10</sup> EU taxonomy for sustainable activities – European Commission.

<sup>11</sup> European Green Deal. [https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal\\_en](https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en)

<sup>12</sup> <https://trumpwhitehouse.archives.gov/briefings-statements/statement-president-trump-paris-climate-accord/>

## RESPONSIBLE INVESTING IN PRACTICE – MANAGED FUTURES

As active participants in the global futures markets, CTAs contribute to efficient and reliable price discovery and provide liquidity to the benefit of hedgers. Consequently, many have highlighted their activities as supporting the UN PRI, specifically the belief that “an economically efficient, sustainable global financial system is a necessity for long-term value creation.”<sup>13</sup> Further, as the trend-following models employed by most CTAs are likely to participate in – and support – ESG trends created by other responsible investors, they could indirectly contribute to enhanced sustainability over time. This section explores whether there are other opportunities for CTAs to incorporate ESG principles in their approach.

While futures normally track the price of the underlying asset, they do not convey any legal ownership or control of that asset. Arguably, to have an ESG impact, one party must be able to motivate another currently engaged in socially or environmentally damaging behavior to change. In equities and credit, the goal of responsible investors is to create economic incentives and disincentives to encourage a company’s management to embrace sustainability and ESG principles. This objective is not easily transferable to managed futures and, in fact, applying the same approach could even produce unintended negative consequences as we will explore later in this document. Some futures exchanges have introduced contracts incorporating ESG factors – such as screened stock indices and sustainably sourced commodities<sup>14</sup> – and new contracts are being developed. However, the liquidity of these is generally lower than traditional futures markets which has resulted in a relatively slow adoption by larger CTAs.

### Classification

To start, there is no consensus regarding whether or not futures markets should be classified based on ESG or sustainability factors given their unique structure. As exchange traded derivatives, many believe that they play an important role in achieving long-term sustainability objectives by enhancing transparency and allowing businesses and investors to hedge their risks efficiently,<sup>15</sup> so the underlying asset is almost irrelevant. However, regulators have yet to provide a definitive opinion on this issue.

Unlike traditional securities, there is no established classification framework in place for futures. For financial contracts, employing a similar methodology to one that is already applied in cash equities and bonds is likely the most logical place to start. Determining the constituency of the stock indices underlying the associated futures contracts is a straightforward endeavor, although deciding how to classify each company and subsequently what to do with that information is somewhat more complex. While there is an increasing number of ESG-screened index futures being developed as mentioned earlier, their composition is based on someone else’s evaluation criteria and not an individual’s own value system. Should this matter? If so, even one company included in the screened index failing to meet an investor’s unique criteria might preclude long investments in that contract (although, perhaps it could be shorted, as we will explore later). Scoring or rating indices based on an aggregate assessment of their constituency using personal ESG-related criteria is significantly more inclusive, but also more open to scrutiny.

<sup>13</sup> United Nations Principles of Responsible Investment – <https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment>

<sup>14</sup> <https://www.cmegroup.com/markets/esg.html#overview>; <https://www.theice.com/energy/environmental>; <https://www.theice.com/equity-index/msci/esg-derivatives>; <https://www.lme.com/en-GB/About/Responsibility/Responsible-sourcing>

<sup>15</sup> “Derivatives in Sustainable Finance”, CEPS-ECMI Study, Centre for European Policy Studies – [www.ceps.eu](http://www.ceps.eu)



To date, there has been less ESG-related attention paid to fixed income and foreign exchange by global futures exchanges and, therefore, fewer options are available than in equities. However, credit rating agencies have long been incorporating governance and social factors in their models and have recently been integrating environmental elements such as natural resource availability, physical risk from climate change and other natural disasters, energy transition risk and energy security.<sup>16</sup> Investors could use consensus evaluations from these agencies – or develop their own – to screen or rank countries based on ESG criteria. CTAs could potentially apply this same approach to both fixed income and currency futures.

Arguably, commodities are the most challenging markets to evaluate based on ESG criteria due to idiosyncrasies in production and subtleties regarding their utility. For example, classifying copper as “green” (ecologically responsible) or “brown” (detrimental to the environment) is not as straightforward as categorizing a casino operator as a “sin stock.” Copper mining and processing are undeniably harmful to the environment, so it should be an easy call on the commodity: “brown.” Not so fast. Copper is also highly conductive making its usage instrumental in the expansion of electricity grids across the globe as well is in the production of electric cars. So should that make it “green?” At this point, it all depends upon your perspective.

Given the existential risk of global warming and the scientific evidence supporting the connection between greenhouse gas (GHG) emissions and rising atmospheric temperatures, investors have increasingly been using carbon footprint to quantify an investment’s negative environmental impact. Carbon footprint is the total GHG emissions caused by the burning of fossil fuels and other biological materials; livestock and other agricultural practices; land use and the decay of organic waste; and a wide variety of industrial practices and processes.<sup>17</sup> Theoretically, carbon footprint could be utilized by CTAs to measure the environmental impact of the commodities underlying the futures contracts in their portfolios, although there are considerable issues with this approach.

First, as explained in the copper example earlier, the environmental benefits of certain commodities in some cases can balance out their detrimental impact making the net effect challenging to calculate. Next, while delivery grades are defined by exchanges, production methods are not. For example, sustainably and responsibly farmed agriculture produces a markedly different carbon footprint than legacy methods and new technologies are being explored to reduce the impact even further.<sup>18, 19</sup> Accurately quantifying the environmental impact could be challenging. Finally, for virtually indestructible commodities such as precious metals and recyclable industrial metals, a vast portion of the global inventory referenced by futures contracts has already been produced. For example, an estimated 197,576 tons of gold has been mined throughout history, while only between 2,500 and 3,000 tons of new supply is added every year.<sup>20</sup> Should the aggregate historical environmental impact be considered or only what is produced today?

<sup>16</sup> “Georgieva, Anna; Sloggett, Justin”. A Practical Guide to ESG Integration in Sovereign Debt. PRI, UNEP Finance Initiative and the UN Global Compact, New York, NY. 2020. <https://www.unpri.org/download?ac=9696>

<sup>17</sup> <https://www.epa.gov/ghgemissions/sources-greenhouse-gas-emissions>

<sup>18</sup> “Benbi, DK”. Carbon footprint and agricultural sustainability nexus in an intensively cultivated region of Indo-Gangetic Plains. *Sci Total Environ.* 2018. [pubmed.ncbi.nlm.nih.gov/29990911/](https://pubmed.ncbi.nlm.nih.gov/29990911/)

<sup>19</sup> “Advancing sustainability and efficiency: Are you prepared for the future of agriculture?” – <https://www.bayer.com/>

<sup>20</sup> <https://www.gold.org/about-gold/gold-supply/gold-mining/how-much-gold>

## Implementation

As was the case with classification, there is no broadly accepted consensus on how CTAs can better incorporate ESG considerations into their approach – if they can at all. For those futures contracts that are not cash settled, CTAs avoid taking physical delivery of the underlying assets by exiting contracts prior to expiry, so their ability to have a direct impact on environmental and/or social issues is limited. However, there are potentially opportunities for CTAs to have an indirect impact by creating financial incentives and disincentives for hedgers to influence their behavior. The following table explores the pros and cons, in our view, of adapting different strategies used in equities and debt to the managed futures industry.

APPROACH	DESCRIPTION	PROS	CONS
<b>ACTIVIST INVESTING</b>			
<b>Activism</b>	Futures contracts convey no legal ownership or control of the underlying asset and regulators/exchanges limit positions; cannot be realistically applied short of illegally “cornering the market”		
<b>NEGATIVE SCREENING</b>			
<b>Exclusion</b>	Exclude contracts perceived to have a negative impact on the environment and/or society from the asset allocation	<ul style="list-style-type: none"> <li>+ Lower volume and open interest make hedging relatively more expensive for producers/issuers</li> <li>+ Precludes investors from capitalizing on price moves which support perceived detrimental behavior</li> <li>+ Inspires the development and inclusion of “green” contracts</li> </ul>	<ul style="list-style-type: none"> <li>– Increased hedging costs could be transferred to consumers, creating disproportionate financial hardship for challenged economic groups</li> <li>– Less efficient price discovery could lead to market volatility and instability</li> <li>– Reduced opportunity set for money managers, potentially contrary to their fiduciary responsibility</li> </ul>
<b>Shorting</b>	Only take short positions in those contracts perceived to be negative	<ul style="list-style-type: none"> <li>+ Lower market prices reduce the profitability of producers/issuers over time creating a financial disincentive to continue their activities</li> <li>+ Investors capitalize on these market moves creating a virtuous cycle and exacerbating ESG trends</li> <li>+ Price discovery remains relatively efficient, minimizing market impact</li> </ul>	<ul style="list-style-type: none"> <li>– In the case of commodities, lower market prices could encourage increased production to overcome tighter margins</li> <li>– Similarly, consumers may be discouraged from conserving or transitioning to more sustainable alternatives</li> <li>– Reduced opportunity set for money managers, potentially contrary to their fiduciary responsibility</li> </ul>
<b>Penalties</b>	Underweight long (and/or overweight short) signals in contracts perceived to be negative	+ All of the above, but with less market impact	– All of the above, but to a lesser degree
<b>POSITIVE SCREENING</b>			
<b>Inclusion</b>	Expand the asset allocation to include contracts perceived to have a positive impact on the environment and/or society	<ul style="list-style-type: none"> <li>+ Higher volume and open interest make hedging relatively less expensive for producers/issuers</li> <li>+ Increasing volume attracts additional market participants</li> <li>+ Investors able to capitalize on price moves which support perceived beneficial behavior (virtuous cycle)</li> <li>+ Increased opportunity set for money managers to the financial benefit of their investors</li> </ul>	<ul style="list-style-type: none"> <li>– Many contracts are relatively new with currently limited volume and open interest; liquidity risk can be significant and transaction costs high</li> <li>– For newer contracts, limited price history makes robust modeling and forecasting relatively challenging</li> <li>– For markets traded on less trafficked exchanges, the operational burden and counterparty risk can be high</li> </ul>
<b>No shorting</b>	Only take long positions in those contracts perceived to be positive	<ul style="list-style-type: none"> <li>+ All of the above, plus...</li> <li>+ Higher market prices increase the profitability of producers/issuers over time creating a financial incentive to continue their activities</li> </ul>	<ul style="list-style-type: none"> <li>All of the above, plus...</li> <li>– In the case of responsibly produced commodities, higher prices could create disproportionate financial hardship for challenged economic groups</li> <li>– Similarly, consumers may be discouraged from transitioning to sustainable alternatives</li> </ul>
<b>Rewards</b>	Overweight long (and/or underweight short) signals in contracts perceived to be positive	+ All of the above, but to a lesser degree	– All of the above, but to a lesser degree

There are also relative value strategies that could be employed to potentially harvest an “ESG premium.” For example, investors could maintain delta-neutral equity exposure by hedging long positions in ESG-screened stock index futures with short positions in corresponding non-compliant contracts. However, the relatively low expected outperformance and potentially significant liquidity and basis risks limit the attractiveness of this approach. Hedging techniques could also be applied to neutralize the aggregate negative perceived exposure in a portfolio, such as purchasing carbon credits to compensate for the estimated CO<sub>2</sub>-equivalent GHG emissions. However, a single hedge factor may not encompass all the ESG risks in the portfolio and determining loadings to that factor is a complex process with similar challenges as in classification and screening. Finally, hybrid approaches combining different elements of the methodologies outlined in the table and described above could be developed. However, based on the relatively significant arguments for and against utilizing these techniques, building consensus on the optimal implementation strategy will likely be challenging.

## Engagement

Unlike classification and implementation, engagement is much less controversial. Whether you believe that current ESG efforts are misguided or that significant advancements have already been made, engaging in open and honest discourse with others is important to effect real change. CTAs have the responsibility to engage with their investors on these topics to better comprehend those investors’ objectives. This dialogue could help establish a common understanding of the challenges and opportunities faced when attempting to incorporate ESG and sustainability principles in managed futures, and hedge fund strategies more broadly. Developing a framework for managers to communicate and report on the key performance indicators most relevant to their investors (and regulators) will necessarily be an iterative process. Transparency – as well as data quality and uniformity – are substantive issues that will need to be addressed to achieve a robust solution, but a robust solution is possible.

Additionally, engaging with exchanges can support the development of more ESG-focused futures contracts. Given some of the issues explored earlier, the binary classification of a commodity as “green” or “brown” may not be as critical as moving towards more sustainable production; exchanges have been actively coordinating with producers and consumers towards this end. Multiple solutions are being explored and implemented including redefining delivery specifications, verifying sourcing and production methods, and introducing new contracts explicitly meeting certain prescribed ESG standards. Similarly, the development of financial contracts – beyond screened stock index futures – will be influenced by market participants communicating the importance of environmental, societal and governance factors in their decision-making process.

Other than investors and exchanges, CTAs can engage with peers and industry groups to help build consensus on classification and implementation. Equally importantly, they can engage with regulators to communicate which reporting metrics are most relevant to the strategy and to influence policy as it relates to the managed futures industry. Only through this communication will CTAs be able to determine how best to make the transition to a more sustainable world.

## CONCLUSION

From all accounts, the increasing focus on ESG factors and sustainability is a trend that will not wane. Whether or not CTAs will be able to effectively classify futures contracts based on ESG criteria or implement strategies capable of generating a positive ESG impact is currently up for discussion. On that topic, the objective of this paper was to raise relevant questions, rather than draw definitive conclusions.

## LYNX SUSTAINABILITY FORUM

The Lynx Sustainability Forum was established to coordinate with senior management and other employees on sustainability-related matters. The Forum is responsible for setting and updating Lynx's sustainability framework, direction and project prioritizations and to ensure that resources are leveraged across the firm to drive these initiatives. The Forum includes representatives from different competences within the firm and provides the Executive Management Committee and the Board of Directors with regular updates on our sustainability efforts. In addition, Lynx coordinates with two full-time Responsible Investment professionals at Brummer & Partners to aid in our efforts.

## GET IN TOUCH WITH US

We welcome your feedback on this discussion paper; please contact our investor relations team at [ir@lynxhedge.se](mailto:ir@lynxhedge.se) with any comments or to schedule a call.

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