OQAM – a quantamental approach to responsible investments

ESG and Responsible Investments – development and insights 2020

OQAM was founded, not only to help our clients invest successfully, but also based on a desire to positively impact and strengthen the financial ecosystem and especially the ecosystem of financial research and innovation.

2020 was an extraordinary and challenging year caused by the pandemic. Still, it was an important year for OQAM. Our first product, the algorithm-based human hedge fund ia, celebrated its second anniversary by delivering positive returns in the turbulent markets. Despite the circumstances, we managed to intensify our fruitful collaboration with Lund University and student-led organizations. Moreover, we finalized v.1.0 of our framework for responsible investments and integration of ESG factors in the investment process.

OQAM started developing the framework in early 2019. This article shall therefore not be understood as indicating that OQAM has a fully developed framework. Rather, it should be read as an indication of what our aim is and what we believe can be achieved with limited resources but with a dedicated team and a quantitative approach. Nevertheless, the ESG framework v.1.0 enables us to integrate ESG factors alongside commercial and technical considerations and demonstrating our methods.

In the following, we highlight our approach to responsible investments and shed some light on our insights and the challenges facing us as a quantitative asset manager. OQAM not only needs to consider responsible investing regarding single stocks but also regarding other asset classes and investment products. To really understand the different challenges regarding responsible investing for a cross-asset quantitative asset manager, outlining the concepts is a good starting point.

Concepts under development

Concepts of responsible investing and Environmental, Social, and Governance (ESG) considerations play an increasingly important role in numerous investors' and asset owners' investment processes. The development of regulatory frameworks for sustainable investments has taken great steps forward, especially in the EU. These include measures to re-orient investments towards more sustainable technologies and businesses, financing of growth in a sustainable manner, and contributing to the creation of a low carbon, climate-resilient, and circular economy.[1]

There are various rationales behind responsible investments. The UN-supported PRI defines

[1] https://ec.europa.eu/info/business economy euro/banking and finance/sustainable finance/eu taxonomy sustainable activities_en, 2020-12-23

responsible investment as "[…] *a strategy and practice to incorporate environmental, social and governance (ESG) factors in investment decisions and active ownership."*[2] Today approaches such as portfolio tilting based on "best-in-class" approaches, sustainability goals, risk management and strict ethical considerations are used. There are also diverging positions on the definition of ESG, what to include in ESG investing, and how responsible investment approaches affect performance. OQAM also recognise the issue that ESG-integration not per se lead to sustainable outcomes in line with the temperature goal of the 2015 Paris Agreement.

As discussed above, responsible investment practices are applied in a variety of ways. In short, this is indicating the development of the ESG landscape.[3] The discourse and norms but also the standards are evolving rapidly.

OQAM's approach to an ESG framework

The development and relevance of ESG bring challenges and possibilities. We are strong believers that an investigatory, systematic, and transparent approach is important.

The aim is that OQAM's framework for responsible investments is managed based on efforts to always apply best practice in the fields where responsible investing is applicable. We therefore aim to always adopt industry best practices in both derivatives trading strategies and for the portion of portfolios represented by listed equity and other company or government-related assets. The latter part includes ESG data analysis, screening, as well as active ownership. Due to the size of ia at the time of writing, active ownership is something that is not deemed relevant and effective.

At OQAM we believe that an investigatory and systematic approach where objectivity, reliable data, transparency, and the minimization of human interaction is of fundamental value once investment strategies are implemented. We also believe this is true for a responsible investment framework and this is based on our belief that such approach may enable us to deliver the returns we aim for. These principles are therefore guiding OQAM in the development of our framework.

Investment universe and ESG challenges

Despite the broad definition of ESG as outlined above, the notion of responsible investing and especially integration approaches, are, in practice, mainly applied and discussed in the context of long-only investments in company-related assets. Generally, the strategies also apply a relatively long-term investment horizon. These strategies are not necessarily essential or common for quantitative managers.

Today, OQAM's investment universe includes Nordic stocks ranging from large-cap to small-cap but also includes several non-company related assets, such as equity indices, commodities, fixed income, and currencies. These are essential for our investment strategies. OQAM may not only invest in a vast number of instruments, but the holding periods of investments can vary from being short term in nature to long term. Hence, not only do the instruments diverge, but the typical holding periods are also shorter than the one implemented within common ESG integration approaches. The results of employing ESG approaches in this context may also be more complex to evaluate than when used in more traditional approaches.[4] Based on these facts, it may be questioned if responsible investing is applicable within OQAM's investment processes and, if so, how responsible investments shall be employed.

The instruments used may also be inconsistent with the applicable ESG considerations. Given the instruments construction the issue is arguably theoretical and not relevant from a ESG perspective, but the fact is that our investments strategies may trade an equity index future which

[2] https://www.unpri.org/an-introduction-to-responsible-investment/what-is-responsible-investment/4780.article, 2020-12-23

[3] https://www.pwc.lu/en/sustainable finance/docs/pwc esg report the growth opportunity of the century.pdf, 2020-12-23

[4] https://www.unpri.org/download?ac=4155, 2020-12-22

includes stocks that would otherwise be excluded based on the ESG considerations. As stated, equity indices accessed via futures constructed with or without consideration to different ESG factors may be traded. The ESG indices hold the potential to solve the inconsistency. However, the ESG indices are still highly illiquid instruments making them impossible for OQAM and many asset managers to trade. The ESG indices are also constructed with the ESG integration methods of the provider. They may therefore be constructed without respect to specific criteria applicable within the strategies integrating ESG considerations. The question is complex and unless asset owners to a larger extent demand it and market participants agree to a migration to ESG indices or indices with ESG factor integration, in some form, a change will most likely not be seen soon.

Trading some of the assets (for instance commodities or currencies) is not necessarily conflicting with ESG integration principles or factors. Arguably, this can also be the case if a manager may take both long and short positions in the relevant instruments. Still, short selling within the concepts of responsible investments is debated. There are views that short selling can constitute a useful method for both mitigating undesired ESG risks and influence capital flows to achieve ESG objectives. Recently, PRI has acknowledged the potential value of short selling when implementing responsible investment strategies.[5] As an example, if long positions at sufficient levels may decrease the issuer's cost of capital, short positions, in the same sense, should increase the issuer's cost of capital. Both methods may arguably have an impact from an ESG perspective and create positive outcomes related to the relevant ESG objectives.

Given the situation, acknowledging these questions and especially communicating positions and stating clearly what activities are included and to what extent ESG integration is or may be applied is important. Since greenwashing has emerged as an issue related to ESG investing and especially the question of sustainable investments, clear communication may also help mitigate the risk for accusations of misguiding information. Ultimately, this also allows customers to apply their preferences to their portfolios.

ESG data challenges

Based on models within our ESG framework, we started generating our proprietary ESG data sets on companies in our investment universe. Early we concluded that having the capability of creating our own ESG data sets and E, S and G scores would be the only way for OQAM to be in control of the data and enhance transparency towards investors in terms of methods applied. Using raw company data, as much as possible, instead of ESG scores from data providers, was also deemed important.

From what OQAM has concluded, ESG scores from ESG data providers to a large extent, rely on qualitative assessments that vary in methods applied. Attempts to quantify ESG metrics and especially ESG scores remain discretionary and heterogeneous. There are initiatives and the unified industry-wide movements and regulatory initiatives towards unification of ESG data may lead to a common standard.[6] This could also be a part of a solution to the debated issues related to data providers offering different types of ESG scores, their criticized methods, lack of standardization and low correlations between the vendors.[7] The ESG data from ESG data providers generally, and their ESG scores specifically, could also potentially be biased or outdated and, particularly, we would not to a full extent be able to explain the logic behind the data. We recognize the importance of focusing on ESG issues that are likely to be material. Hence, our models are built to generate data that we believe

[5] Ibid.
[6] See inter alia: https://www.sasb.org/, https://www.fsb-tcfd.org and https://ec.europa.eu/info/business economy euro/banking and finance/sustainable finance/eu taxonomy sustainable activities_en, 2020-12-23
[7] Escrig Olmedo, E. et al., "Rating the Raters: Evaluating how ESG Rating Agencies Integrate Sustainability Principles", MDPI, 2019

may enable us to reach genuine and relevant insights.

Despite the value of raw company data and proprietary methods, the use of ESG data has its constraints, especially due to the absence of a functioning governance framework and standard for company reporting. Adding complexity to these issues, as OQAM and many others have concluded, large-cap companies report ESG data to a much larger extent and tend to receive higher ESG scores, than small or mid-cap companies. This is essentially due to insufficient reporting by the mid and small-cap companies.[8] Hopefully, this is something that will also change over time.

Transparency and ESG outside of the investment process

Ultimately, addressing questions on responsible investing and ESG is also relevant related to company activities outside the direct scope of the investments process. A company culture demonstrating sound considerations to environmental, social and governance questions coupled with a contribution to, and presence in, discussions, debates and academia on responsible investment is an important part of the development of ESG related endeavours and best practices. During 2020, we initiated a research project together with a group at the Lund University Finance Society. The group is focusing on an investigation of methods for implementing ESG factors with a forward-looking, data-driven and systematic approach, evaluating companies based on their exposure to environmental risks.

As concluded above, transparency regarding the methodology is an important part of a responsible investment framework. Based on this, we have published a detailed methodology document describing our available methods for sector and norms screening and for generating our proprietary E, S and G scores. This document is available at oqam.se (only in Swedish). Furthermore, exclusion criteria and exclusion list on equity investments in ia is published on our website.

Conclusions

While concepts of ESG investing have been around for a long time, we believe that ESG investing is indeed in its infancy. Principles, technology and the markets have developed and will continue to develop rapidly. ESG issues can and will affect portfolios to a larger extent over time. Several questions need to be addressed and it is still too early to draw final conclusions on the future of ESG integration. Nevertheless, a proper understanding of what impact introducing ESG have on a portfolio is and will be of fundamental importance. A common understanding of what constitutes best practices for all asset classes would also ensure the application of sound responsible investment methods and clarity for customers. Striving for best practice, our approach is investigatory, systematic, and evolutionary in nature.

Stemming from the conclusion on the diverging ESG metrics and the potential of proprietary ESG data a proper understanding and relevant use of ESG data and in-house knowledge regarding ESG data analysis and concepts is highly valuable for OQAM.

Recognizing the need for research and the current constraints around accessibility and comparability of relevant ESG data, as well as lack of clarity in terms of best practice, our framework will be continuously reviewed and improved. The development will hopefully give us an important tool to help our clients invest successfully.

[8] https://www.sasb.org/wp content/uploads/2020/12/ESG Integration Insights 2020 112520.pdf, 2020-12-23

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