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The Socially Responsible Short

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As of this piece's publication, it's been a bad couple weeks for hedge funds in short positions; specifically, it was a *historically terrible* rout for some funds who were caught in short positions on brick-and-mortar retail, cinema, and legacy tech equities with extremely high short interest.[1] But despite monumental losses in a number of particular funds, hedge funds are going to keep on doing what they were originally invented to do: produce uncorrelated returns with the flexibility to express long or short investment theses.[2] Given that, if we are to expect widespread ESG adoption across the hedge fund industry, there needs to be a wider embrace of shorting from an ESG perspective.

The lion's share of assets managed worldwide with an ESG focus are driven by investment screens: According to the Global Sustainable Investment Alliance's biennial Global Sustainable Investment Review, assets managed through negative or exclusionary screens accounted for $19.8 trillion of the total $30.7 trillion sustainably managed assets worldwide in 2018.[3] In other words, a large majority of sustainably or responsibly managed assets are long-only, with securities that are selected (or rejected) based on how well they score on ESG metrics. While the 2020 GSIA Global Sustainable Investment Review has yet to be released, we expect a similar breakdown of assets.

For ESG to truly reach its maturity as a developing strategy, some investors—particularly hedge funds—need to consider incorporating ESG shorting into their portfolios. Broadly, ESG investors expect that in the long run securities well-rated by ESG metrics will outperform, while poorly rated ones will underperform. But by restricting the scope of ESG investing to long positions, ***we limit the ability of investors to express profitable bearish attitudes towards stocks with unpriced ESG risks.*** It also precludes investors from ***hedging against downside risk on an ESG basis***. Lastly, ESG shorting has the potential to enact positive transitions through debt and equity markets. As demonstrated by the highly publicized short battle over Valeant Pharmaceuticals (now Bausch Health), such pressure can prompt meaningful change.[4]

Capturing the Upside *and* the Downside of ESG

From an absolute return investor's perspective, ESG shorting is critical because it allows them ***to capture both the upside and the downside of their investments while incorporating ESG factors***. For example, many ESG investors point to increasingly stringent global climate initiatives, arguing that these changes will eventually create headwinds for the oil and gas industry. Should they not be able to capture positive returns from this thesis? Due to the plummeting cost of renewables alone, it's easy to imagine a somewhat near future where some energy producers who rely exclusively on extracting fossil fuels struggle

[1] According to Ortex, short sellers have lost $70.87 billion from their positions in U.S. equities as of January 28, 2021.
[2] Other hedgies made hundreds of millions riding the short squeeze alongside retail investors.
[3] http://www.gsi-alliance.org/wp-content/uploads/2019/06/GSIR_Review2018F.pdf
[4] Of course, in this case, the shorts need to produce *positive* meaningful change (e.g., pressuring a carbon intensive energy producer to transition towards renewables).

to compete: In this scenario, some firms will transition to survive, many will consolidate, and some even go under, drowning in stranded toxic assets such as extraction and refining facilities.[5]

According to a study by *Financial Times Lex*, if governments worldwide implemented stricter climate measures to limit the rise in temperatures to 1.5° Celsius above pre-industrial levels for the rest of this century***, it would amount to around $900 billion in stranded assets***. At the time, this equaled about a third of the market value of large oil and gas firms.[6] Investors always go where they can make money, so it's not hard to imagine that investors may want to take short positions in this circumstance, whether it's to make money, do "the right thing," or a mix of both.

ESG Hedging against Downside Risk

Unlike positive alpha, which is harder to consistently link to an isolated ESG factor, researchers have proven that worse ESG ratings correlate with increased default risk. According to a working paper published by researchers at the University of Giessen, "ESG score reduces firm risk, both for U.S. firms and for European firms."[7] Their analysis of 1-year and 5-year CDS spreads and distance-to-default also found that "ESG efforts significantly reduce market-based default risks in the U.S. sample." In the U.S. market particularly, increased ESG activity (i.e., social responsibility efforts) correlates with reduced default risk. Hence, going long on higher ESG scorers can lower risk, ***while going short on poor ESG scorers could potentially shield against downside risk.***

Firms with a track record of ESG issues, especially scandals and governance issues, have been shown to correlate with negative alpha. Simon Glossner of the University of Virginia constructed a "value-weighted U.S. portfolio of controversial firms with a known history of ESG incidents," and found that it had a "a four-factor alpha of negative 3.5% per year," even after controlling for other risk factors, industries, and firm characteristics.[8]

There are clear risks in ignoring the governance portion of ESG. Scandals, cover-ups, and fines are perhaps the easiest place to see the financial impact: It took over two full years for Volkswagen's share price to recover after its diesel emissions test cheating scandal; Wells Fargo paid billions to settle its fake accounts scandal, but its reputational damage was the real cost; and Enron's falsified earnings led a meteoric rise to a $70 billion market cap and dramatic fall to bankruptcy. Prominent short-seller Jim Chanos made a name for himself by shorting Enron the whole way down, netting his fund $500 million. Of course, uncovering such scandals is easier said than done, but paying attention to governance factors—particularly, a lack of transparency and accounting issues—is often the place to start.

Creating Positive Change by Shorting

Short positions can also be utilized to pressure executive boards to make strategic changes. While short position holders have no voting authority, management still pays

[5] CEOs of the U.S. behemoths Exxon Mobil and Chevron have reportedly discussed a merger.
[6] Alan Livsey, "Lex in depth: the $900bn cost of 'stranded energy assets'," *Financial Times*, February 3 2020.
[7] Christina E. Bannier, Yannik Bofinger, and Björn Rock, "Doing safe by doing good: ESG investing and corporate social responsibility in the U.S. and Europe," CFS Working Paper Series, No. 621, Goethe University Frankfurt, Center for Financial Studies, April 29, 2019.
[8] Simon Glossner, "The Price of Ignoring ESG Risks," May 18, 2018.

attention to them, even if it is out of ire: "Managers of firms don't like people who short sell their stock, especially if the short sellers are accusing the firms of fraud and even more especially when the fraud accusations are true," says economist Owen Lamont.[9]

While it's hardly a surefire strategy for friendly engagements with management, sometimes it works, especially in cases where the short sellers put reputational pressure the firm by uncovering issues management would rather hide. Short sellers played a key role in publicizing the nature of Valeant's drug pricing policy, which lead to Senate hearings where Valeant stood accused of price gouging sick and vulnerable people, followed by the ousting of CEO Michael Pearson.

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Even if these short sellers weren't necessarily coming from an "ESG perspective," the results were the same, and it's easy to imagine how these tactics could be used to pressure ESG bad actors (e.g., polluters, labor exploiters, etc.) to correct course. Socially responsible short selling could even be used to uncover "greenwashing" by supposedly well-rated ESG firms that are misleading investors about their environmental impact.

Conclusion

ESG has long been the domain of long-only investors. In fact, there's even some disagreement on whether taking a short position at all is compatible with ESG principles. However, shorting can be a viable strategy for achieving the goals of ESG investors: lessening carbon footprints, uncovering lapses in proper governance, and raising the cost of capital for ESG laggards, to name a few. Another goal of ESG investors is to encourage widespread ESG adoption across all asset classes, including hedge funds—it's Principle 4 of the UN Principles for Responsible Investment. It would be a disservice to the wider project of socially responsible and sustainable investing to exclude the bearish side of the market.

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[9] Owen A. Lamont, "Short Sale Constraints and Overpricing," in *Short Selling: Strategies, Risks, and Rewards*, edited by Frank J. Fabozzi, 2004, pp. 183-4.