Responsible Investment, Hedge Funds, and Short Selling

Short selling is a defining aspect of hedge fund management. Short selling is what gave the first 'hedged fund' its name, and it continues to be used across the industry to hedge risk and generate profit from overvalued assets. However, despite the benefits it provides both to investors and to capital markets, short selling (or 'shorting') remains subject to criticism in some quarters.

This has led some to question whether short selling is compatible with responsible investment. Responsible investment—an umbrella term for the integration of non-financial factors into investment decisions—is still nascent in the hedge fund industry, and like short selling is often the subject of misunderstanding. In fact, short selling is entirely compatible with responsible investment.

In order to understand why short selling and responsible investment are compatible we must look at the objectives behind the use of both techniques. We should also be clear on what short selling and responsible investment are not.

Short selling

Simply put, short selling is the act of borrowing a security, selling it to a third party, waiting for the price of that security to correct, then repurchasing and returning it—keeping the difference as profit. Short selling is, as such, a way of generating profits from the price of an asset correcting downwards. It is most commonly used as a risk mitigation tool; some managers use it to profit from identifying overvalued assets.

To begin with the former, by taking both long (buying and holding) and short positions, hedge fund managers can limit their exposure to market risk. In so doing they can ensure that the major risks in their portfolios are idiosyncratic—risks unique to the individual assets in which they invest. This limiting of market exposure allows hedge fund managers to protect and grow the capital of their investors no matter which way the broader markets are moving.

Some managers also use short selling in a more active way. These managers adopt an investment strategy of identifying assets that are overvalued, taking short positions on them, and waiting for the market to correct. For instance, a hedge fund manager may conclude that a widget manufacturer's profit expectations are overoptimistic, and as such so is the price of its equity. The manager could short that company's equity and profit if their conclusion turns out to be correct.

Short selling is not a tool for idle speculation. Many criticisms of short selling seem to be premised on the belief that it is a technique used to profit from the pain of companies or industries, or that hedge fund managers stoke misguided fears about sound companies in order to profit from the subsequent market reaction. This is not accurate at all. First, such behaviour would in many cases be illegal. Second, it would be a profound breach of professional ethics. Third, doing so would not be a sustainable investment strategy, as the market would quickly realise what was happening. Short selling is simply a means of investing; it is no less moral than any other investing technique.

The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,000 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2 trillion in hedge fund and private credit assets.

Responsible investment

Responsible investment is a very broad term, but it can best be understood through a teleological lens. Broadly speaking, all forms of responsible investment aim to generate alpha, manage investment risk, create positive impacts, or express an ethical or religious belief (or all four). A manager's or investor's primary goal will determine which form of responsible investment they will implement.

It should come as no surprise to anyone familiar with the hedge fund industry that the most common goal of responsible investment amongst hedge fund managers is risk management. Many managers see the analysis of environmental, social, and governance (ESG) factors in the investment process as a way of mitigating risk. ESG integration, as this process is generally known, is rapidly gaining in popularity in the hedge fund industry. For instance, by examining the environmental factors to which a company is exposed a hedge fund manager may be able to avoid the risk of that company's assets being stranded by a shift away from the use of hydrocarbons.

Those managers wishing to actively create social or environmental good, meanwhile, are more likely to engage in impact investing. This is a niche strategy in the hedge fund industry, and it involves pursuing a strategy of deliberately investing in companies that create social or environmental good. For instance, a hedge fund manager could invest in a for-profit company that offers water purification solutions to rural communities. Conversely, a manager could also theoretically look to promote environmental or social change in order to affect the price of an asset.

Finally, a hedge fund manager wishing to reconcile the ethical or religious beliefs of their investors with their investment portfolios may opt for the use of 'socially responsible investment.' This is a screening process by which specific assets or asset classes are completely excluded from a portfolio. This form of responsible investment is very old, and has historically been driven by religious investors who may, for instance, not wish to see their capital allocated to a company producing arms and munitions.

Short selling and responsible investment

From the descriptions above it should be clear how short selling and responsible investment align. Short selling can be used as part of a responsible investment strategy to mitigate risk, and also as part of a strategy to create social and environmental goods. Some managers also short assets they have screened from their portfolios, further increasing the cost of capital for the issuers of those assets.

To begin with risk, short selling can be used to hedge out more than just market risk. It can be used to narrow a portfolio's exposure to any kind of systemic risk. Environmental and social factors are often systemic (governance factors tend to be idiosyncratic).

They affect a variety of assets in different ways. This opens the possibility for their effects to be hedged. For instance, a hedge fund manager wishing to protect against the risk of natural disasters occasioned by climate change could take short positions on a handful of insurers to hedge their exposure.

Those managers wishing to create social or environmental goods, meanwhile, may wish to use short selling in a more active manner. Rather than simply going long on assets that create positive impacts, such managers could short assets that create social or environmental harms, operating under the assumption that those harms have not been priced into the asset's market valuation. This allows hedge funds to be far more flexible, and potentially far more impactful, than traditional impact funds. For instance, rather than simply investing in companies that clean chemical spills, an impact hedge fund could short companies that cause those spills in the first place—increasing their cost of capital. Similarly, a hedge fund could short companies that fail to improve their environmental or social practices.

The interaction between short selling and socially responsible investment, meanwhile, will depend on the goals underlying the latter. Some investors may wish to screen certain assets from their portfolios in order to increase the cost of capital for those assets. In such case, it would make sense for a hedge fund firm to short those screened assets. Some investors, however, may take the view that deriving any profit from proscribed assets is unacceptable, even if that profit is derived from shorting. This is a maximalist position, and tends to be relatively rare, but managers would be well advised to consult with their investors before shorting screened assets.

Short selling is not about speculation, and responsible investment is not about avoiding financial innovation. Combining short selling and responsible investment is a powerful way to limit systemic risk and drive social and environmental objectives. Short selling and responsible investment are not only compatible—they strengthen each other.

AIMA will continue to do its part to support those hedge fund managers wishing to implement responsible investment, and will soon publish a paper exploring the confluence of short selling and responsible investment in greater depth.

Those wishing to learn more about AIMA's work on responsible investment should contact Max Budra at mbudra@aima.org

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