ESG Insights Vol. 6

Accounting for ESG factors: What to do with short positions?

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1. Introduction

There is strong consensus within the investment management industry that hedge funds – given their sophistication and the range of responsible investment tools at their disposal – can be agents for real-world change and should have a prominent voice in the debate about how to transition to a more sustainable world.

However, standard setters all too often approach their work with a focus on responsible investment tools and techniques associated with buy and hold equities investing. We believe that rules and standards can only be effective if they accommodate a range of investment strategies and techniques, including those employed by alternative investment managers.

AIMA has previously explored how short selling in particular can be an excellent tool for achieving two common goals of contemporary responsible investment: mitigating undesired ESG risks, and, when taken in aggregate, creating an economic impact by influencing the nature of capital flows through 'active' investing.

In our prior work, we used the example of carbon footprinting to illustrate how investment managers could use short selling to limit their exposure to carbon risks. We also acknowledged that investors might be interested in the carbon footprint of a portfolio not just for the sake of gauging its carbon risk, but also to measure the degree to which it is funding carbon emissions. We suggested that managers would need to determine a way of communicating the fact that they may be providing funding to carbon emissions with their long positions, while arguably increasing the cost of equity capital for other carbon emitters through their short positions.

The debate continues about what approach to investor reporting would best achieve this. This note revisits the topic to highlight areas of industry consensus and areas of ongoing discussion, focusing on the treatment of short positions. The Annex to the note provides further information regarding the mechanics of short selling.

2. Key issues when accounting for short positions

The following represent the key points that tend to underpin industry discussions of short selling and responsible investment:

i. There is a broad acknowledgement within the hedge fund industry that **the goal associated with reporting on ESG factors can vary**. In particular, reporting might seek to present: (1) exposure to financially material risks or opportunities; or (2) the real-world impact associated with portfolio-level positions. This distinction is sometimes referred to as single versus double materiality, particularly in the European context. The focus for individual investment managers will reflect the preferences and needs of the underlying investors in the funds they manage, but there is general agreement that both are important.

ii. Any **formal reporting approach for ESG factors needs to respond to these different underlying drivers.** This holds for both regulatory and industry frameworks and leads to challenges in terms of determining the best way to deal with particular types of exposures – including short positions and derivatives – given the different needs that reporting serves. As noted above, too often these points are neglected by standard-setters and our members emphasise the importance of taking a considered approach to the design of reporting frameworks to ensure that they accommodate a range of investment strategies.

iii. There is a **strong industry consensus that disclosure to investors of both long and short exposures to ESG risks is important**, enabling investors to decide how to analyse the information that is presented to them. This may well suit investors that have allocations to multiple managers, allowing for more sophisticated review of ESG exposures.

iv. There is a **strong industry consensus that short positions have the ability to drive change in the underlying economy** – i.e. achieve impact. Attributing impact to short selling can be challenging, particularly where issuer cost of capital is used to measure impact, but this same challenge exists for investing in general and for other elements of responsible investment. Firms have generally found that investors are open to discussing in a nuanced way the positive contribution of short selling to managing ESG risk and achieving impact.

v. Views differ on how to deal with shorts in the context of reporting on portfolio emissions in the context of net zero alignment. There is broad agreement that this in an important point to address – while allowing sufficient time for industry debate and consensus-building – given the increasing focus by investors on the externalities associated with their investments.

3. Ongoing standard-setting discussions

Many standard setters are actively considering how to deal with short positions from the perspective of ESG reporting. Notable examples are highlighted below:

- **November 2021: FCA Discussion Paper DP21/4: "Sustainability Disclosure Requirements (SDR) and investment labels"**

  The FCA notes that the debate over the role of derivatives in ESG investing is ongoing. It highlights the fact that certain ESG derivatives are being launched where the payoff or the underlying reflect certain sustainability-related performance criteria or characteristics. By contrast, others might consider 'traditional' derivatives to be more appropriate for managing sustainability-related risks. The FCA encourages stakeholders to provide feedback on whether the use of derivatives in pursuing sustainability strategies should have a bearing on the classification of relevant investment products. Similarly, the FCA invites views on the use of short-selling strategies in sustainable investing, both to mitigate risks and to achieve sustainability-related goals.

- **April 2022: MSCI ESG Research: Reporting in Long-Short Portfolios**

  MSCI ESG Research draws on consultation with owners and managers of long-short portfolios to recommend best practices for fund-level ESG and climate reporting. MSCI's analysis concludes that:

  - Reporting just net ESG and climate metrics for long-short portfolios potentially conflates, and may obscure, investors' intent, impact, ownership and risk management.
  - Investors may therefore wish to separate the ESG and climate disclosures for the long and short portions of their portfolios, to be as transparent as possible.
  - In theory, it is possible to create ESG risk-neutral strategies, but the involvement, impact and emission attributes of such strategies would not be considered as neutral in the real-world sense.
  - Reporting for ESG and climate transparency should be treated differently from reporting for ESG and climate risk exposure, but both are important requirements.
  - There is limited evidence that shorting is similar to or a better tool than divestment, for ESG purposes. MSCI research suggests that, on average, stocks with high short-selling demand have not had a higher cost of capital, and so short selling has had limited influence on companies' management to adopt ESG and climate-related best practices.

- **May 2022: Institutional Investors Group on Climate Change (IIGCC) Discussion Paper on Derivatives and Hedge Funds**

  IIGCC has published a discussion paper to address the challenges raised when considering incorporating derivatives and hedge funds into the Net Zero Investment Framework. The discussion document sets out the analytical issues to be considered when incorporating derivatives and hedge funds into the Framework in a way that is germane to all investors. Consistent with the approach for other parts of the Framework, the intention is for the recommendations to be practical, setting out steps that investors can take now. The paper considers how investors' strategies towards net zero can be enhanced through the use of derivatives as well as discussing possible solutions to the challenges of reporting. It also offers potential recommendations for how hedge funds could approach setting net zero targets and how multi-asset portfolios can incorporate allocations to hedge funds into existing net zero commitments.

4. How to deal with short positions in the context of net zero alignment

As noted above, AIMA members have different perspectives on how to report on carbon exposures for the purposes of assessing the degree to which a portfolio aligns with a net zero commitment. The following represent the two distinct approaches that firms tend to adhere to.

Arguments in favour of an approach that includes only long exposures to carbon emissions in the context of net zero alignment

- Tackling the climate emergency requires action by investors to reduce carbon emissions in the underlying economy; reporting of long-only exposure to carbon emissions provides the clearest view of the real-world emissions that will need to be eliminated in order to achieve net zero.

- Any netting of short positions in this context could suggest that short positions can be equated with carbon offsets; it is generally agreed that this should not be the case.

- Netting of short positions is more appropriate in the context of financial de-risking, rather than in the context of reporting on a fund's exposure to real-world emissions.

- Arguing in favour of netting of short carbon exposures could be perceived as being motivated by self-interest rather than the desire to make a meaningful contribution to transition in the underlying the economy; this could lead to the perspective of alternative investment managers being side-lined in future ESG discussions.

Arguments in favour of an approach that permits a degree of netting for short exposures to carbon emissions in the context of net zero alignment

- Reporting only long carbon exposures associated with physical and derivatives holdings leads to a fundamental disconnect between the real-world carbon footprint of a company and the sum of all individual reporting of “owned carbon emissions”, given that short positions only exist by virtue of corresponding longs. This would put investors in a worse position in terms of being able to properly aggregate exposures across different portfolios, whilst exaggerating the carbon intensity of certain hedge fund strategies.
- A more sophisticated approach to carbon accounting would instead focus on the investor’s willingness to allocate capital to carbon, taking into account both short and long positions and derivatives (while factoring in the delta of the derivative relative to the underlying).
- It is generally understood that short selling has the potential to prompt change on the part of issuers by virtue of its cost of capital impact, indicating that short positions should be accounted for in the context of reporting on carbon exposure.
- Arguing for more sophisticated carbon accounting is not to suggest that short positions are equivalent to carbon offsets and the two concepts should not be confused.

Whichever approach a manager ascribes to, it is important to ensure that the way in which it reports to end investors provides sufficient detail about the methodology used and any relevant limitations. As noted above, the approach taken ultimately needs to reflect the preferences and needs of investors.

We also acknowledge, in the context of efforts to develop more universal approaches to reporting, that these views are not easily reconciled. However, we believe that ongoing dialogue between industry participants is important in order to ensure that different perspectives are raised and discussed. Without constructive engagement of this nature, it is less likely that standard setters will be able to arrive at an approach to reporting that has full industry buy-in, leading to a suboptimal outcome for investors.

Annex: The mechanics of short selling

In simplistic terms, short selling is the act of borrowing an asset and selling it to a third party, with the intention of buying the asset back once its price has decreased. The difference between the higher price at which the asset is initially sold and the lower price at which it is repurchased and returned to the lender—minus the fees paid to borrow the asset—represents the profit of the investor doing the short selling.

The most widespread use of short selling is to mitigate losses, sacrificing potential returns in order to do so. The risk-mitigating (or 'hedging') potential of short selling was pioneered by Alfred Winslow Jones in the 1950s. By combining long positions and short positions, Jones realised that he could limit the risk to his portfolio. His fund was thus 'hedged' against risk, and the first hedge fund was born. By hedging, hedge fund managers can choose the risk they take: they can ensure that the major risks to their portfolios are idiosyncratic, rather than driven by the general movement of the markets. For instance, in a long-biased hedged portfolio, an investment manager may allocate 60% of its capital to long positions, and 40% to short positions. Their total market exposure is thus only 20% of their capital. In a downturn, an investment manager will suffer losses on their long positions. However, they will generate positive returns on their short positions, thus mitigating their losses. There is, however, a trade-off. When markets are doing well, the short positions an investment manager establishes will generate losses that offset the gains their long positions generate. As such, a hedge portfolio will not capture the entirety of a market upswing. Conceptually, passive short selling can be compared to the act of purchasing insurance. Investment managers will 'pay' during good times by way of not generating the returns they could with a portfolio that was not hedged. This insurance will, however, 'pay out' when markets correct downwards, as the short positions an investment manager has been paying for in good times will limit its losses when markets experience a downturn.

The mechanics involved in short selling involve five principal parties. First, the asset owner. This is the party that owns the asset to be sold short, and from whom it is borrowed. Today asset owners tend to be large investment managers with long (as opposed to short) positions, which are also generally long-term in nature. Such investment managers—often pension schemes or insurance companies—will operate asset lending divisions, tasked with lending their assets and thus generating additional returns. For instance, rather than simply holding an equity and waiting for its value to increase, an asset owner may choose to loan that equity out, thus generating interest on it in addition to any increase in value it may experience. Without asset owners willing to lend their assets short selling would not be possible.

Second, the short seller itself. Under most regulatory regimes, short selling can only be performed by specific forms of investment managers. Short selling is generally limited to those investment managers who work for 'professional' investors and is often synonymous with hedge fund managers.

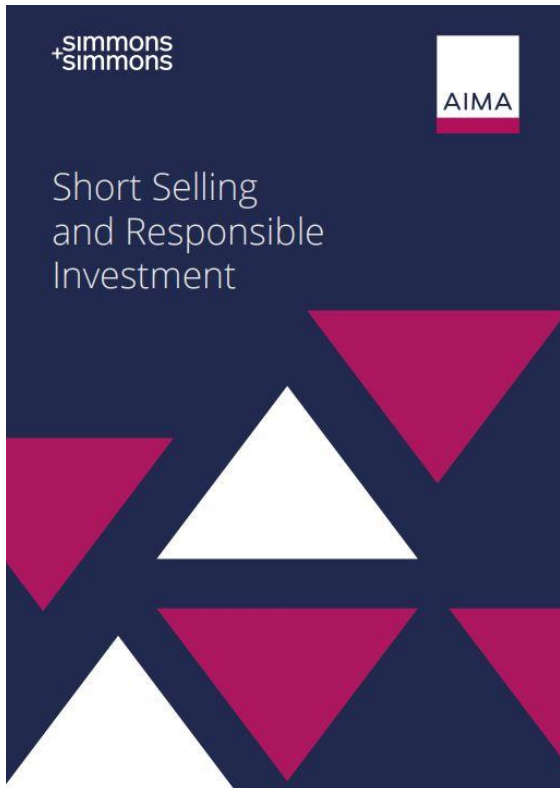
Third, there is the prime broker. This party acts on behalf of the short seller, locating the assets to be sold short for them and providing them with a margin account. Per regulation in the United States of America, for instance, short selling positions must be held through margin accounts, which must hold capital to the sum of at least 150% of the value of the initial transaction (i.e., if one wanted to take a short position of $10,000 in value, one would need $15,000 in the margin account). Margin accounts are also subject to 'maintenance margins,' in which the investment manager must maintain a certain percentage of the value of their position with the margin account as collateral.

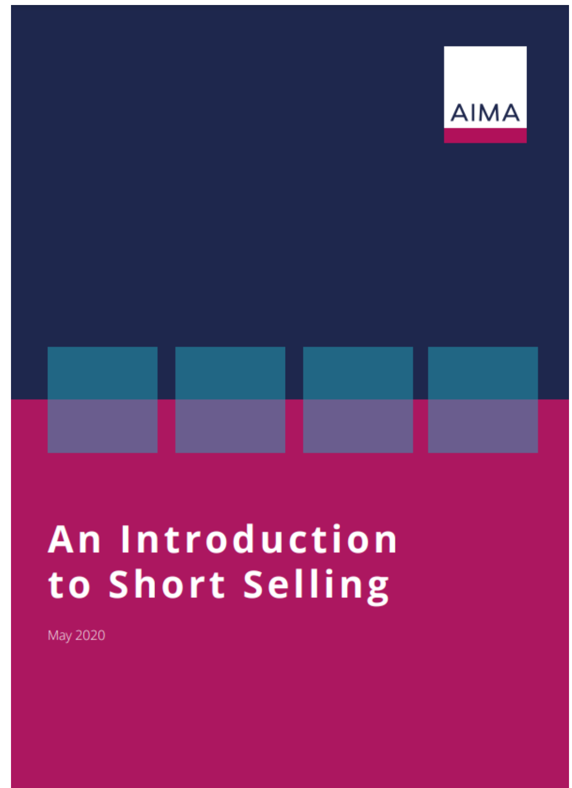
Fourth, the underlying entity to which the asset being shorted is attached. This party, often a company that has issued the equity or bond being sold short, plays a passive role in the process, but is nonetheless important. As a general rule, companies do not enjoy having their equity or bonds sold short, given that it tends not to be seen as a vote of confidence in one's company.

Finally, there is the asset buyer—the party that buys the asset being sold short. Selling short the equity of a company offers a good example of the typical way short selling works. To begin with, the underlying entity, in this case a company, issues a round of equity, a portion of which is bought by the asset owner. The short seller, after reaching the conclusion that the price of the company's equity will decrease, decides to sell short $10,000 worth of that equity. The short seller contacts its prime broker, who arranges for an asset owner to lend that amount of equity. The equity is then sold to the asset buyer, generating $10,000 in revenue for the short seller. The short seller then waits, say, six months, after which the equity has lost 50% of the its value. The short seller then purchases $5,000 worth of the equity it sold short, before returning it to the asset owner. Assuming the short seller had to pay a monthly fee of $100 to borrow the equity, their total profit after closing the position would be $4,400.

Additional resources

Please visit www.aima.org to access our past papers on short selling and on short selling and responsible investment.





About AIMA

The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than US$2.5 trillion in hedge fund and private credit assets.

AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides**.** AIMA works to raise media and public awareness of the value of the industry.

AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

About ACC

The Alternative Credit Council (ACC) is a global body that represents asset management firms in the private credit and direct lending space. It currently represents 250 members that manage over US$600bn of private credit assets.

The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council.

ACC members provide an important source of funding to the economy. They provide finance to mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure as well the trade and receivables business.

The ACC's core objectives are to provide guidance on policy and regulatory matters, support wider advocacy and educational efforts and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits.

Alternative credit, private debt or direct lending funds have grown substantially in recent years and are becoming a key segment of the asset management industry. The ACC seeks to explain the value of private credit by highlighting the sector's wider economic and financial stability benefits.

About this note

This note draws on a member roundtable that took place on 10 May 2022. It does not constitute formal guidance and AIMA does not endorse any of the approaches described. If you have any questions about the content or AIMA's work on responsible investment, please contact Adam Jacobs-Dean (ajacobs-dean@aima.org) and Kate Boulden (kboulden@aima.org).