'It is becoming increasingly clear that carbon emissions constitute an investment risk'

Carbon is everywhere. From Turner's paintings to the Battle of Blair Mountain, from the soot-stained buildings captured by the earliest newsreels to the advent of offshore oil rigs, the story of industrialisation has been the story of carbon, our dependence on it and our attempts to end that dependence.

Almost 80 years after the splitting of the atom birthed the first hopes of a post-carbon world, the end of the carbon economy has become a key objective for many developed states.

The effects of this are already being felt in the investment management industry. Investors are increasingly looking at limiting their exposures to carbon or even making their portfolios carbon neutral. Meanwhile, the members of the Net-Zero Asset Managers Initiative, who collectively manage more than $9 trillion, have pledged to make their portfolios carbon neutral by 2050.

A number of alternative investment managers are responding to this growing demand. By using short selling, hedge fund managers can both limit carbon risks and increase the cost of capital for the biggest polluters.

Over the past several years, it has become increasingly clear that carbon emissions constitute an investment risk. Countries around the world are beginning to implement carbon taxes, even countries as dependent on commodities as Canada. Even without taxes, however, many now assume carbon-intensive physical assets, such as coal-fired power plants, may one day become stranded assets. The fate of the Keystone XL Pipeline will be interpreted by some as a sign of things to come.

How to mitigate such risks to portfolios? If you are a long-only investment manager, you don't have many options. You can either divest entirely from companies with high emissions or you can purchase offsets. The former is difficult if you're chasing a benchmark. The bigger problem, however, is fully removing carbon emissions from a portfolio is effectively impossible.

Carbon is pervasive; the company in which you invest may be carbon neutral, but its suppliers, distributors and energy providers may well not be. Purchasing offsets, meanwhile, can cut into the returns passed on to investors.

Short selling offers a different way to limit carbon risks. As with market risk, hedge fund firms can use short selling to protect against carbon risk where they identify this to be a significant driver of future asset values. Short positions on carbon-emitting assets will generate positive returns should carbon risks materialise. Those returns should offset the losses created by holding long positions in carbon-emitting assets.

Hedge fund firms can thus hedge against carbon risks without the need for divestment or offsets. Indeed, given the practical impossibility of fully removing carbon emissions from a portfolio, the argument could be made that hedge fund firms are the only investment managers that can truly minimise carbon risks.

Using short selling, they could even achieve carbon neutrality without sacrificing any returns. They could even increase the cost of capital for heavy emitters. If carbon emissions are indeed a risk, it stands to reason companies which emit relatively large amounts of carbon should compensate investors for that risk.

This dynamic is already at play with divestments. The fewer the investors willing to purchase a company's securities, the lower the demand and thus, all else being equal, the higher the returns that company will need to offer to attract investors. By selling emitters short, hedge fund managers can accelerate this transition.

Finally, short selling gives hedge fund managers a strong incentive to closely investigate companies' stated emissions. As evermore money flows into issuers marketing themselves as "sustainable" or "environmentally friendly", markets will benefit from having sceptics on the hunt for greenwashing. Short selling gives hedge fund managers a good reason to help keep the markets honest.

Moving away from a carbon-based economy will create investment opportunities and drive innovation in risk management practices. Hedge fund firms stand ready to use their flexibility and dynamism to deliver superior risk-adjusted returns as we move towards a new industrial paradigm. ●

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