ESG Reporting in Long-Short Portfolios

An assessment of fund reporting approaches for ESG & climate metrics for long-short portfolios, with recommendations on best practices for ensuring the greatest level of transparency for fund ESG reporting.

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April 2022

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Executive Summary

ESG reporting frameworks to date have mainly focused on long-only portfolios, which allows for straightforward portfolio ESG aggregation that is easy to understand and interpret. Short positions have typically been excluded from ESG analysis to date. With heightened regulatory and client scrutiny and wider adoption of ESG integration by long-short portfolio managers, the question of how to report ESG metrics for long-short portfolios is becoming increasingly urgent, however.

At present there is no clear global market consensus or regulatory guidance on how short positions should be treated when aggregating the ESG attributes of long-short portfolios. This paper therefore seeks to lay out some fundamental principles and best practices for ESG reporting of short positions at a portfolio level, based on the results from MSCI's consultation in Q2-Q3 2021 with over 20 market participants globally (asset owners, asset managers and hedge funds), and our own in-house research.

We also explore related issues that influenced market participants' views on this topic, including cost of capital, shareholder ownership, engagement and regulation.

Key Takeaways

- **The most important principle for long-short portfolio ESG reporting is transparency**. Transparency allows both regulators and clients to more accurately assess the ESG risks and opportunities to which the fund is exposed on both the long and the short sides of the portfolio.
- The main difference in investor views on reporting short positions was whether the investor was assessing **a company's real-world impact (i.e., double materiality) or if they were focused solely on its ESG risk/return metrics (i.e., financial materiality).** Real-world impacts in this context refer to tangible, measurable outcomes such as emissions released, wastewater produced or controversial weapons sold. Their significance lies in the ability to measure these as outcomes in the physical world, and not just in accounting terms.
    - **For real world ESG metrics** which consider a company's external impacts, such as business involvement in controversial weapons or child labor, asset owners and most asset managers preferred complete transparency through separate reporting on both long and short positions.
    - **For positive impact metrics**, such as investments in renewable energy or healthcare, asset owners preferred consideration of just the long leg,

representing directly financed positive impacts, but views among asset managers and hedge funds did vary.

- **For carbon emissions**, asset owners generally placed the highest priority on reporting their climate impact, which would imply reporting actual emissions from just the long-only (owned) positions. They also wanted to understand their reputational exposure to high carbon emitters, which suggests separate reporting of both long and short positions. By contrast, some hedge funds put the highest priority on reporting their overall net carbon price risk, and their relative economic exposure to carbon emissions, and so preferred a netting approach.

- In general, asset owners, asset managers and hedge funds agreed that reporting for **ESG transparency is different from reporting for ESG risk exposure**, with both being important in meeting different ESG investment reporting objectives.

We therefore recommend that **long-short portfolios report ESG and climate metrics separately for both the long and short legs,** in addition to any preferred aggregation schemes, as this allows the greatest transparency and flexibility for aggregate portfolio reporting under both a double and financial materiality assessment

Long-Short Positions & ESG Reporting

At present, the main ESG reporting frameworks, such as TCFD,[1] EU sustainability regulations, SFDR disclosure requirements,[2] and various sustainable finance labels, provide little guidance on the treatment of short positions, leaving unanswered questions over the reporting of ESG metrics at a portfolio level.[3]

Long-only portfolios have generally been considered to be the norm for ESG investment, enabling straightforward approaches for most ESG reporting needs. Long-short portfolio managers are increasingly looking to align their strategies with such reporting standards, however, and face significant challenges, as the treatment of ESG metrics for short positions has not been clearly defined.

In this paper, we discuss ESG reporting options for long-short portfolios with the primary goal of improving transparency for investors. The focus of this report is on physical short positions, and the topics and treatments discussed are in the context

[1] Task Force on Climate-Related Financial Disclosures.

[2] The Sustainable Finance Disclosure Regulation.

[3] Shorting as a market practice refers to taking a position in financial security (e.g., a stock or bond) either by physically borrowing it, or obtaining it through synthetic means (derivatives) and then selling it. The security is later repurchased (preferably at a lower price) and returned to the lender, where a net positive price difference is the core motivator.

of all long-short strategies, regardless of whether or not they have an explicit ESG focus. Topics for further exploration in follow-up research include 1) long-short carbon accounting; 2) the treatment of derivatives, leverage, other non-cash positions; and 3) aggregate fund ESG scores for long-short portfolios.

Client Consultation

To help establish what the market regards as intuitive, meaningful, and transparent in the context of ESG reporting for short positions, MSCI conducted 20+ consultations across the US, Europe and Asia with a variety of market participants, including major asset owners, asset managers, and hedge funds, to gather their views on how short positions are currently reported, and their function as a tool for implementing ESG in different portfolios.

MSCI's consultation discussions focused on the following topics:

- Different portfolio aggregation options for long-short positions for **transparency:** netting, grossing and other variants.
- Different portfolio aggregation options for reporting on: 1) **business involvement** exposures (such as controversial weapons and child labor); 2) **positive impact** (such as revenue exposure to clean energy); and 3) **carbon emissions**.
- Different portfolio aggregation options for ESG and climate risk pricing and hedging purposes.[4]

Key Considerations

As a starting point for considering ESG metrics of long-short positions in a portfolio, it is important to delineate between economic interest and ownership, and consider what the implications of shorting are and are not in an ESG investment context. For example:

What shorting a company could mean in an ESG context:

- Possible portfolio upside from price declines associated with ESG risks.
- Signaling a view on poor company practices that could be improved.
- Initiating an activist campaign against a company on a specific ESG-related issue.

[4] Discussed at a conceptual level and not at the detail of aggregation techniques for portfolio construction and risk management.

What shorting a company does not mean in an ESG context:

- Complete removal of exposure to a company's ESG risks and opportunities. Divesting removes all portfolio exposure to a stock's ESG risks, while short selling retains an economic exposure.
- Formal shareholder engagement, voting rights or any form of stewardship to influence future company practices as part of a responsible investment strategy.
- Compliance with existing sustainable finance labels.[5]

Financial vs. Double Materiality

The main distinction between approaches to portfolio level ESG reporting is whether the asset owner or investor is considering ESG investment using just financial risk/returns (financial materiality) or also considering impact (external materiality). This distinction is becoming increasingly important as ESG becomes more widely adopted among hedge funds and long-short portfolios, with carbon emissions becoming the most contentious ground for how ESG & climate is reported.

Financial Materiality: This approach considers ESG integration and adoption purely from a risk/return perspective, with the main focus being the potential impact of ESG & climate metrics on a company's own financial performance. As each ESG & climate metric can therefore, in theory, be quantified as a unit of risk or opportunity to that company, this risk can be expressed through either a long or short position and the total risk netted off in quantitative terms the same way as currency, sector or other, more conventional, systematic risk exposures.

Double Materiality: This approach considers ESG integration not just from its impact on the company but also on its external environment/stakeholders. As this is not purely financial risk but is measured in 'real world' impacts of diverse units, it cannot be simply netted off, as the exposure to this risk remains in the portfolio. For example, the impact of business involvement in controversial weapons or the destruction of a biodiverse habitat cannot be offset through short positions.

The most high-profile examples, although they cannot be explored comprehensively in this report, are climate change and, most pertinently, carbon emissions. While the risk/return of carbon emissions, and their market pricing through carbon taxes or explicit carbon prices, may be susceptible to expression in purely financial terms, this is not the case for real-world physical units of carbon emissions. With investors under increasing pressure from clients, stakeholders and regulators to disclose and quantify their absolute carbon emissions, and their targets to reduce these to net

[5] At present and to the best of our knowledge, short positions have unclear status with sustainable finance labels.

zero over the long term, it is unlikely to be acceptable to report solely on the associated net financial risk, but rather to require the reporting of the fund's total financed carbon position at a portfolio level.

Long-Short Portfolio Reporting Options

The netting aggregation approach has traditionally been used in long only and long-short portfolios to measure portfolio characteristics.[6] Aggregation enables investors and market participants not only to assess portfolio level characteristics, but to compare different portfolios as well. In this section we go through the ESG metrics aggregation schemes considered during our consultations, use examples to showcase their attributes, and discuss their tractability for portfolio level application.

Net and Gross Portfolio Aggregation

Traditionally there have been two ways to calculate a portfolio's exposure to financial markets: net and gross market exposure. Net exposures measure a portfolio's sensitivity to price risks, while gross exposures measure the total amount of money the portfolio transacts in the market through both long and short legs. Metrics are thus offset between long and short legs to derive the net portfolio level attributes, and summed across long and short legs for the gross attributes.

As gross exposure relates to the total dollar impact of a portfolio on financial markets, it may be considered reasonable to apply this aggregation scheme to certain metrics for transparency. For example, when calculating the credit rating of a portfolio of bonds which includes short positions, gross weights are applied. The gross credit rating of a portfolio in this case serves as a good indicator of aggregate credit quality across both long and short legs.

Gross weights do not consider ESG characteristics of long and short legs separately, but rather flag all of them and may support investors' capital allocation decisions. Gross metrics aggregation can thus inform investors about ESG metrics of the entire amount of capital a strategy injects into financial markets.

Other Options

Other potential candidates for aggregating ESG metrics for long-short equity portfolios included:

[6] In fact, in portfolio construction and risk management net weights are predominantly used. Netting enables finding an optimal hedging position, for example, which is a technique that finds the optimal investment needed (usually short selling) to set a particular risk (usually instantaneous price risk) to zero at the portfolio level (but not to eliminate this risk for the entire financial system or the planet).

- **Long only reweight:** This treatment ignores the short leg of the portfolio and recalculates asset weights according to the amount of capital invested in each asset. A variant of long-only reweighting can be used to calculate carbon emissions ownership. This uses enterprise values to calculate the percentage of the company an investor holds, and therefore the percentage of the carbon emissions of the company that the investor directly owns, rather than the dollar amount invested as a proportion of the total portfolio.
- **Long only gross reweight:** This treatment starts by calculating gross weights of all assets, however ESG metrics for only the long leg are considered, meaning that the short leg's ESG metrics are forced to zero.
- **Long and short legs reported separately:** ESG metrics are reported separately for the long and short legs. This provides full transparency for both the long and short legs' ESG risks in the portfolio, as well as the total portfolio ESG risk. The disadvantage is that it does not provide a single portfolio-level aggregated ESG metric.

Portfolio Reporting Options & ESG

During the consultation, these treatment options were discussed for long-short ESG aggregation in the context of 1) business involvement; 2) positive impact; and 3) carbon emissions. Each option presents different pros and cons along with varying implications for portfolio level ESG metrics, which are discussed here further on.

A key challenge for ESG reporting is that ESG data types can vary significantly in nature; for example, they can be qualitative, quantitative, discrete, or continuous. They can also be in the form of revenue exposures, binary associations or ties, tons of emissions, intensities expressed per million dollars of sales, etc. Different metrics also behave differently when aggregated, and such differences must be factored into weighing schemes.

A summary of the key attributes of each weighing approach is outlined below, along with their application in a simplified two asset portfolio.

Exhibit 1: Potential Long-Short Portfolio ESG Weighting Schemes

NETTING

- The net weight is used, considering directionality (positive for long and negative for short).
- Both positive and negative weight values therefore apply.
- This can be problematic for bounded metrics such as MSCI ESG scores (0-10)

	ESG Metric	Net Value $	Net Weight	ESG Metric Portfolio Contribution
Long Equity	10	1,000,000	200%	20
Short Equity	4	-500,000	-100%	-4
Portfolio		500,000	100%	16

GROSSING

- The gross weight is taken by looking at the absolute value of all positions.
- All weights are positive values, and effectively the short leg's contribution is positive.

	ESG Metric	Gross Value $	Gross Weight	ESG Metric Portfolio Contribution
Long Equity	10	1,000,000	67%	6.7
Short Equity	4	500,000	33%	1.3
Portfolio		1,500,000	100%	8

LONG-ONLY GROSS REWEIGHT

- Gross weights are calculated and then ESG attributes of only the long leg are considered, ignoring the short leg and effectively setting ESG attributes of the short leg to 0.
- This aggregation shrinks the ESG metric in the long leg by the size of the short leg compared to netting, because it disregards the short leg.

	ESG Metric	Gross Value $	Gross Weight	ESG Metric Portfolio Contribution
Long Equity	10	1,000,000	67%	6.7
Short Equity	4	500,000	33%	Force to 0
Portfolio		1,500,000	100%	6.7

LONG-ONLY REWEIGHT

- Considers only the long leg of the portfolio.
- Reweighting is based on the market value of the long leg and ignores the short leg.[7]

	ESG Metric	Long Only Value $	Long Only Weight	ESG Metric Portfolio Contribution
Long Equity	10	1,000,000	100%	10
Short Equity	4	500,000	-	-
Portfolio		1,000,000	100%	10

[7] Long only reweight with ownership approach is used in calculating portfolio carbon footprint.

Portfolio Weighting & Key ESG Metric Examples

1. Controversial Business Involvement

Many ESG portfolios globally apply screening approaches on business activities such as alcohol, tobacco and controversial weapons. Investors care about association with such activities and may prefer to minimize or remove exposure to certain business involvements entirely. Such association metrics can be binary in nature linked to direct or indirect activity/revenue exposure.

Applying netting to business involvement metrics can result in negative exposures of the short leg offsetting those of the long leg, implying that these ties are removed from the portfolio.

In the simplified example portfolio below where company A is a short position, and B, C are long, the controversial weapons tie of each asset is denoted by Y/N. Netting results in this association being removed, while long-only reporting removes the association with controversial weapons in the short leg. Grossing shows the association from both the long and short legs.

Exhibit 2: Controversial Business Involvement Weighting

Asset Name	Controversial Weapons Tie	Net Market Exposure (USD)	Gross Market Exposure	Net	Gross	Long Only Gross Reweight	Long Only Reweight
A	**Y**	-600,000	600,000	-60%	**27%**	**0**	**-**
B	Y	1,000,000	1,000,000	**100%**	**46%**	**46%**	**63%**
C	N	600,000	600,000	**0**	**0**	**0**	**0**
Portfolio		1,000,000	2,200,000	**40%**	**73%**	**46%**	**63%**

Source: MSCI ESG Research.

2. Positive Impact

Positive impact metrics differ from business involvement in the sense that investors may prefer to know what positive activities or solutions they are directly financing. Such metrics are typically in the form of revenue exposure to defined business activities.

Applying netting to positive impacts can distort portfolio level exposures, through offsetting between the long and short, as illustrated in the following simplified example portfolio where companies A (short), B and C (long) have varying exposures to clean technology revenue.

The grossing approach can risk overstating the exposure, as investors would not be directly financing any clean technology through the short leg. The long-only gross reweight approach in this case captures the percentage of the portfolio invested that is directly exposed to clean technology revenue.

Exhibit 3: Positive Impact Weighting

Asset Name	Clean Tech Revenue	Net Market Exposure	Gross Market Exposure	Net Weight	Gross Weight	Reweight	Net	Gross	Long Only Gross Reweight	Long Only Reweight
A	40%	-600,000	600,000	-60%	27%	0	-24%	11%	0	-
B	10%	1,000,000	1,000,000	100%	46%	63%	10%	5%	5%	6%
C	40%	600,000	600,000	60%	27%	37%	24%	11%	11%	15%
Portfolio		1,000,000	2,200,000	100%	100%	100%	10%	26%	15%	21%

Source: MSCI ESG Research, LLC.

3. Carbon Emissions

Carbon emissions are becoming one of the most important ESG & climate metrics for portfolio reporting. In this case the different weighing schemes are applied on the basis of ownership, where owned emissions are calculated relative to the fraction of owned market cap.

Applying the netting approach results in offsetting of emissions between the long and short legs, implying that the short position reduces real world emissions "owned" through the long leg. The grossing approach results in overstating of portfolio level owned emissions, as the emissions of the short leg are counted as adding to real world emissions "owned" by the investor. In this case the long only emissions reporting approach captures the portfolio's emissions over which there is direct ownership and engagement rights.[8]

[8] Complexity can arise when portfolios engage in securities lending leading to potential double counting of the same emissions between portfolios. Carbon accounting in this regard will be addressed in more detail in a subsequent analysis.

Exhibit 4: Carbon Emissions Weighting

Asset Name	Company Carbon Emissions, metric tons CO2e	Market Cap (USD)	Net Market Exposure	Gross Market Exposure	Ownership	Net Carbon Emissions metric tons	Gross Carbon Emissions metric tons	Long Only, Emissions metric tons
A	1000	6,000,000	-600,000	600,000	-10%	-100	100	-
B	2000	10,000,000	1,000,000	1,000,000	10%	200	200	200
C	1000	6,000,000	600,000	600,000	10%	100	100	100
Portfolio			1,000,000	2,200,000		200	400	300

Source: MSCI ESG Research

Client Consultation Feedback

The landscape of investor types is varied, and perspectives across the investment value chain vary accordingly. Priorities and motivations for ESG reporting are therefore diverse and nuanced. For asset owners such as public pension funds, for example, stakeholder and end beneficiary ‘buy in’ is significant. For hedge funds that typically face lesser reporting requirements on portfolio holdings, the emphasis lies more on risk and return. To account for such differences, we grouped feedback by three major investor types: pension funds, sovereign wealth funds and endowments (Asset Owners); diversified asset managers, wealth managers and fund providers (Asset Managers); long-short portfolio managers, alternative investment managers, hedge funds and fund-of-fund allocators (Alternative Investment Managers).

Asset Owner Views

1. Business Involvement

Asset owners generally preferred the grossing approach on the basis that the business involvement exposure of all sources of return should be made transparent. For example, an investor may short a company that engages in child labor, but this still implies a portfolio exposure to child labor, regardless of the position's directionality. It certainly would not imply that shorting that company 'removes' child labor associated with a long exposure to another company in the portfolio that is implicated in child labor. Asset owners' views illustrated that the concern for business involvement is about association, and whether the investor is benefitting from the price performance of a firm engaging in specified negative business activities.

2. Positive Impact

Asset owners generally preferred long-only attribution for positive impact metrics and considered that shorting positive impact stocks should not be considered in ESG aggregation. For example, in a situation where a firm involved in significant clean energy investment is being shorted, the aggregation scheme should not record this as being a negative exposure. For positive impact metrics, the main focus was on what the portfolio is directly financing through long positions.

3. Carbon Emissions

On carbon emissions, asset owners considered that directly owned emissions in the "real world" are most important for portfolio reporting, reflecting the portfolio's total carbon footprint, and that emissions should not be netted between the long and short legs of a portfolio. While in certain portfolios short positions can be used to manage carbon price risk, the question of netting actual carbon emissions for reporting purposes was viewed as fundamentally different to that carbon price risk.

Among asset owners there were concerns that netting emissions would imply the real-world removal of the shorted company's emissions from the atmosphere, which is not the case. Some further expressed strong views that netting emissions to claim net-zero portfolios would be firmly stepping into the territory of greenwashing. Overall, asset owners expressed the view that mitigating real world emissions is not the same as mitigating economic exposure to emissions.

Summary

Asset owners predominantly expressed the view that ESG & climate reporting should focus on transparency and real-world impacts. Moreover, they firmly delineated between ESG transparency reporting for clients and ESG risk reporting for portfolio managers, and considered that the two require separate reporting frameworks and should not be conflated.

Asset Manager Views

1. Business Involvement

Asset managers varied in their views on business involvements aggregation and there was no prevailing opinion. Generally, business involvement exposures of short positions was not something asset managers currently report for their long-short relevant strategies.

2. Positive Impact

Asset managers considered that there is merit in treating different ESG metrics separately. Some disagreed with the idea of not reporting the short leg (e.g., using the gross weights and only reporting the long leg, or ignoring the short leg completely) as they felt this missed out reporting the full ESG exposure of the portfolio. They further acknowledged that aggregation has little value if multiple pieces of information are required to put the numbers into context, and in such scenarios reporting on long and short leg separately is the sensible choice for transparency purposes.

3. Carbon Emissions

Asset managers echoed asset owners in expressing that netting emissions is not appropriate, but netting carbon price risk is acceptable and can be reported separately.

Other Issues

Some asset managers shared internal proprietary methods used in accounting for short leg ESG attributes, such as inverse scoring of MSCI ESG Scores. In this treatment, using an ESG scoring scale of 0-10, a company's ESG score is inverted if shorted, e.g., a company with an ESG score of 2 is given an ESG score of -8 when shorted. It was acknowledged that this treatment has limitations due to the fact that the ESG score distribution for investable companies is not symmetrical (both universally and intra-sector).

On the question of whether short positions had any role in company engagement and investor influence, some asset managers viewed engagement as a spectrum, acknowledging that while shorting doesn't involve any formal engagement rights, it may have an impact through public announcements and activist campaigns as a 'de-facto' form of engagement,

Summary

Asset managers did not express any strong views in the aggregation of business involvement and positive impact, but considered that for transparency and ESG risk purposes, the long and the short legs should be reported separately. They also considered that absolute carbon emissions and carbon price risk are separate concepts, with different reporting approaches required for each purpose.

Alternative Investment Manager Views

1. Business Involvement

Shorting was considered by hedge funds to be the best way after divesting to "punish" companies involved in controversial activities by raising their cost of capital (addressed in more detail in the next section). As business involvement was usually perceived as an ESG risk, and therefore a price risk, the view was that it can and should be managed and netted. Consequently, hedge funds largely did not agree with the grossing approach for business involvements. Some agreed that ESG transparency reporting of the return sources and hedging demand of priced risks can and should be separated. Some hedge funds expressed the view that assets in the short leg are usually an important return source for a strategy and should not be excluded from reporting.

2. Positive Impact

Hedge funds generally did not express any strong views on positive impact metrics aggregation and thought both gross and net aggregations could be a possibility to inform investors.

3. Carbon Emissions

The majority of hedge funds surveyed favored the netting emissions approach on the grounds of being impactful through "economic disinvestment" in shorted companies and generally viewed price risk exposure and real-world emissions impact to be part of the same reporting framework. Moreover, carbon risk was often considered to be a priced risk factor, thus allowing for netting for risk reporting, where absolute emissions was bucketed under risk. Some hedge funds agreed, however, that investors have limited transparency when comparing two portfolios where both have seemingly zero net carbon emissions, even though one has high emissions in both legs, and the other has low emissions. They agreed that such portfolios are different and thus, in the interest of transparency, both net and an alternative aggregation might be considered.

Other Issues

Some hedge funds ascribed double counting of emissions as a rationale for netting. Double counting can arise in different scenarios, for example when long only investors engage in securities lending, the stocks and their ESG metrics can be counted in multiple portfolios. It was acknowledged however that current regulations across jurisdictions do not stipulate that emissions of a given company held across portfolios globally require summing to the total company level emissions. Further analysis on the topic of carbon accounting may be required in follow up research.

Summary

Overall, hedge funds were in favor of netting ESG metrics including carbon emissions and felt that shorting poor ESG performers should result in some reward at the aggregate level. Hedge funds generally approached the ESG reporting discussion through a lens of risk management and net economic exposure, with the implicit assumption that ESG metrics are akin to accounting metrics that are comparable rather than denoting different units of diverse 'real world' impacts.

Key Question 1: Does Shorting Raise the Cost of Capital?

One of the key arguments for the benefits of using short positions as part of an ESG investment strategy was that shorting a company "punishes" the company through raising its cost of capital and so can be used to influence the company management to adopt ESG best practices. It could therefore be considered more effective than simply divesting from a company from a responsible investment perspective. We found limited evidence to support the view that shorting raised the cost of capital on a consistent basis, however, so this may only apply in certain individual cases.

We identified several studies that examined how an increase in stock shorting demand impacts corporate behavior. Short sellers usually are skilled and efficient market participants, and academic studies have shown that high short interest signals issues of concern with stock fundamentals[9] or company governance.[10] Divesting is often seen as an approach to influence ESG laggard companies and is believed by some market participants to have a negative effect on the cost of capital of a company. It is expected that if market participants start divesting from ESG laggard companies, their cost of capital should increase and more so often it is argued that shorting stocks will have a similar effect on the company's cost of capital.[11]

During the client consultation, hedge funds in particular expressed that they were having a negative effect on companies by raising their cost of capital. While in

[9] Engelberg, J. E., Reed, A. V., Ringgenberg, M. C. 2012. "How are Shorts Informed? Short Sellers, News, and Information Processing. " Journal of Financial Economics. Akbas, F., Boehmer, E., Erturk, B., Sorescu, S. 2013. "Short Interest, Returns, and Fundamentals. " Working paper.

[10] Campello, M., Matta, R., Saffi, P. A. C. 2020. The Rise of the Equity Lending Market: Implications for Corporate Policies. Working paper.

[11] Budra, M., Fox, D. 2020. "Short Selling and Responsible Investment.", Alternative Investment Management Association.

principle shorting has the potential to raise the cost of capital by raising volatility in stock price, empirically we could not find the support for this statement, except in cases of coordinated mass scale shorting by numerous investors, which is generally not the market norm (see below) Also, long-short strategies with an ESG focus commonly refer to the raising of cost of capital in fund objectives documentation, but from our assessment of 100+ long-short funds globally (including ESG integrated ones) we found no evidence of any funds providing evidence of the degree to which they raised the cost of capital through their short positions for individual companies.

Shorting and Cost of Capital: Empirical Evidence

Recent work[12] studied the effect of divesting on the cost of capital of companies. Berk and Binsbergern argued that for divesting to affect the cost of capital, the new potential buyer of a divestment stock should be incentivized to buy it, which is usually achieved by lowering the stock selling price, which then leads to an increase in the cost of capital of that company. The fraction of impact investors in the market is important and is part of their model. Based on data from US markets between 2015 and 2020, they found that effect of divestment on a firm's cost of capital was less than 1% and therefore lacks economic significance. The authors concluded that engaging with the 'bad' companies may be a better and faster way to have impact.

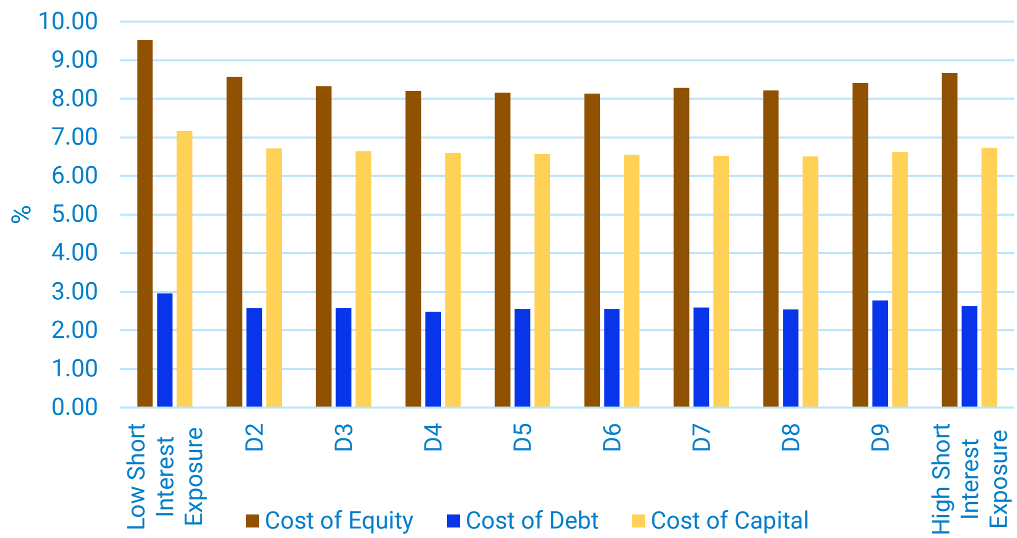
To understand if shorting stocks is the next step in divesting and a potential vehicle to impact the cost of capital of a company, we analyzed the relationship between stock shorting demand and cost of capital for constituents of the MSCI World Index between August 2015 and December 2021.[13] We found that the difference in the weighted average cost of capital (WACC) between highly shorted stocks (with a short ratio 9.2%) and those with the lowest short interest (0.08%) was 1.29%. For the cost of equity, we found a difference of 1.43%, and for the cost of debt, 0.45%.

To measure the effect of short interest, after controlling for stock characteristics, such as size, momentum, value, etc., we performed the same exercise after neutralizing short interest to the style factors of the MSCI's Barra Global Equity Total Market Model. We found that the cost of equity, debt, and capital for the stocks with the highest short interest were lower compared to the stocks with lower short interest by -0.85%, -32%, and -0.43% respectively.

[12] Berk, J. and van Binsbergen, J. H. 2021. "The Impact of Impact Investing". Stanford University Graduate School of Business Research Paper , Scalia Law School Research Paper Series No. 22-008.

[13] Plyakha Ferenc, Y. 2022. "Implications Of Shorting On Cost Of Capital And ESG: Empirical Evidence". MSCI Research Insight.

Exhibit 5. Short Interest and Cost of Equity, Debt, And Capital (by Decile)



Source: MSCI ESG Research. D = Decile. Data from August 2015 to December 2021.

Results also indicated that the cost of equity, debt, and capital across all short interest decile portfolios did not show any specific patterns and the variation of the values of the cost of equity, debt, and capital across different short interest deciles was economically insignificant (Exhibit 5).

These results are in line with work by Asquith, Pathak, and Ritter,[14] who showed that there are several ways companies can influence stock valuations, particularly if a firm's management disagrees with short sellers or have positive insider information about the company. For example, when stock short interest increases, companies may trigger stock buybacks and stock price will eventually revert.

The above indicates that while shorting may be perceived as a similar or a better tool to divesting owing to the potential to influence the cost of capital, we could not find any economically significant evidence to support this hypothesis. We repeated this exercise and found similar results during 2021 and between 2020 and 2021, in a period of media spotlight on several cases of activist investor campaigns for large-scale coordinated shorting of certain companies.[15].

[14] Asquith, P., Pathak, A., Ritter, J. R. 2005. "Short Interest, Institutional Ownership, and Stock Returns", Journal of Financial Economics 78 (2), 243-276.

[15] Activist hedge funds launched 89 campaigns in 2021. Here's how they fared, CNBC 2022. Here are the biggest short squeezes of the stock market, including GameStop and AMC. MarketWatch 2021.

Key Question 2: How Effective is Shorting for ESG Engagement?

A key consideration for the treatment of short versus long positions is the role and influence of a shareholder in responsible investment and ESG engagement versus a short-seller. This not only covers the effectiveness of long-only engagement versus shorting, but also the wider implications of having an economic interest in a company rather than direct ownership.

In our consultation, there was general acceptance that a direct ownership stake (i.e., a long position) was the most effective method for ESG engagement,. But there were differing views on how much influence short-sellers had on a company's ESG policies and practices.

We consider that, while there are individual examples of short-selling being used as an ESG engagement tool, at a portfolio level and as a general responsible investment principle, an investor's economic exposure to ESG risk through long-short positions and the level of direct ownership should be disclosed and reported separately.

Engagement versus Activism

The importance of shareholder engagement and active ownership of companies is underlined by its position as the second principle of responsible investment in the UN PRI's signatories' commitment:

- **UN PRI Principle 2:** We will be active owners and incorporate ESG issues into our ownership policies and practices.
- This includes exercising voting rights, monitoring compliance with voting policy, development of an engagement capability, and filing shareholder resolutions consistent with long-term ESG considerations.

Implicit in this principle is the importance of direct shareholder rights in effective ESG investment and engagement, from the basic voting rights of every single shareholder to the greater influence that larger shareholders, or collaborative investor groups, have in terms of company strategy, board composition and persuading the company to adopt long-term ESG policies and practices.

This issue is becoming increasingly prominent given the wider use of collective shareholder voting action, particularly regarding the key issue of climate change, such as the Say on Climate campaign or the high-profile Engine No.1 campaign against ExxonMobil.

By definition, shorting a company does not provide this company engagement option, or any direct influence over the company as a shareholder. Instead, short-sellers have two options – public campaigns or indirect company engagement.

- **Public campaigns.** Publicly declaring a short position based on ESG or climate principles was seen to be an effective tool by some participants in the consultation, with high-profile cases, such as Oatly, being cited as key examples.
- **Indirect engagement.** Although short-sellers do not have a vote, they can still talk to the company management, using their short position as leverage to push ESG issues. This was seen as an important tool by some respondents in the consultation.

While public campaigns and indirect engagement by short-sellers may be effective for tackling ESG and climate concerns for individual companies, the issue of company engagement becomes more problematic at a portfolio level, however. While every long position has a *de facto* voting right which can be exercised, it is not the case that every short position in a portfolio will either be subject to a public campaign or indirect engagement with the company. This makes the argument for treating short positions as equivalent to long positions in terms of ESG engagement substantially weaker.

Economic Interest versus Ownership

In addition to engagement potential, there is the wider issue of an investors' economic interest in a company versus its ownership stake and how these can become decoupled. This topic came to prominence 15 years ago owing to concerns over 'empty voting', under which hedge funds could use long positions combined with short equity swaps to give them voting rights without any economic interest, or vice versa.[16]

As a short position reflects an economic interest in a company, rather than ownership, then any responsibility that is typically associated with owning a portion of that company does not apply. The investor may only be interested in the ESG risk, and subsequent price volatility, of the stock, and not in the underlying ESG issue itself in terms of how a company manages it. This is not, in itself, a negative, given that investors have multiple reasons and strategies for using ESG metrics for investment, but it is still an important consideration for reporting purposes.

[16] Henry, H. and Black, B. 2006. "Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership." European Corporate Governance Institute Finance Working Paper No. 56/2006.

For example, take a company which is performing poorly on key ESG issues, such as climate change, or has a high number of controversies. If an investor only has an economic interest in the company through a short position, then they may benefit if the company continues to perform poorly on those issues, as this could contribute to a fall in share price, as opposed to their engaging with the company to try to reverse its poor ESG issue management.

This separation of economic interest and ownership does, however, highlight the importance of considering different requirements for reporting of short positions and ESG. **At a portfolio level, disclosing both the investor's economic exposure to ESG risk and its ownership stake of the companies** provides the most transparency and indicates the extent that the investor is adopting responsible investment principles in its portfolio.

Key Question 3: Will Shorting Align with ESG Regulations?

Globally, regulation on ESG reporting for short positions is scarce at present. In the UK, the Financial Conduct Authority (FCA) launched its proposals for a sustainable disclosure framework in 2021. A discussion paper was published soliciting feedback across a number of areas, including views on the role of short-selling strategies in sustainable investing.[17] More guidance may be forthcoming later this year. The UK Stewardship Code is yet to reference short positions, and in the U.S.A., Securities & Exchange Commission (SEC) guidance on ESG remains at a nascent stage.

In Europe, the European Securities and Markets Authority (ESMA), the financial regulator, launched a public consultation on short selling regulation in 2021. However, there was no specific mention or focus on sustainable finance or ESG.[18] The latest Regulatory Technical Standards report issued by European Supervisory Authorities on SFDR remained silent on how to treat short positions for the purposes of the Principle Adverse Indicators regime.[19] This is partly a result of process of policy clarification and enactment by order of priority.

European sustainable finance labels such as Febelfin, FNG, Greenfin and others are also yet to provide any clear reference to short positions and ESG. The absence of concrete guidance has not meant the absence of acknowledgement for its need by regulators, however. We expect that after the initial elements of SFDR

[17] DP21/4: Sustainability Disclosure Requirements (SDR) and investment labels (fca.org.uk)

[18] ESMA consults on the review of the Short Selling Regulation (europa.eu)

[19] Final Report on Draft Regulatory Technical Standards. 2021. European Supervisory Authorities. (europa.eu)

implementation become established into market practice in Europe (and equivalents elsewhere), regulatory attention could shift to pending matters such as short positions. The diversity of portfolio types means that a 'one-size' fits all template may be difficult to achieve. However, given that transparency has been a core focus of European financial disclosure regulations in recent years, we expect that eventual guidance on short positions could also follow suit

MSCI Recommendation

MSCI's position is that no single reporting or aggregation treatment can encompass all ESG & climate reporting requirements for long-short portfolios. The different ESG integration priorities and approaches required for different investors, including ESG strategy and intention, impact, ownership and risk management, can lead to a multitude of options for ESG reporting, as well as significant quantitative complexity. We therefore consider that, as a fundamental starting point, **long and short positions, alongside their ESG metrics, should be reported separately for maximum transparency.**

Some investment managers may prefer to show aggregated ESG metrics, and decide to place primacy on netting ESG risk. We believe in that case, the most transparent approach requires showing both the aggregated ESG metrics, **as well as long and short legs' ESG metrics separately**. While this creates additional reporting and interpretation burden, this approach would help mitigate the risks of misreporting and greenwashing allegations, and avoid potential conflation of intent, impact, ownership and risk management into any one aggregation scheme. We recognize that while in theory it is possible to create ESG risk neutral strategies, the involvement, impact and emissions attributes of such strategies would not be considered as neutralized in the real-world sense.

Potential Approaches by ESG Issue

We also consider that different aggregations for different ESG issues may offer solutions towards improving portfolio transparency for investors, and facilitate portfolio comparison on the basis of ESG metrics. These approaches are:

- **Business involvement**: gross reporting, as this demonstrates total portfolio exposure to the business activity and flags potential reputational or values-based risks.
- **Positive impact**: long-only gross reweight, as this demonstrates the directly financed and owned positive impact for the portfolio.
- **Carbon emissions**: long-only reweight, as this demonstrates the directly owned 'real world' carbon emissions.

It is also worth highlighting that across all market participant types, in addition to the potential approaches laid out during the consultation, there was strong support and some practices already in place for reporting ESG metrics for long and short legs separately.

We reiterate that reporting *ESG transparency* for clients is different from reporting *ESG risk*, and that the two are separate reporting frameworks. Portfolio managers may thus wish to be clearer on which they are reporting. Business involvements and positive impact metrics should be displayed to the extent that they are relevant considerations in the investment process, or firm-level ESG principles. On carbon emissions, we believe that netting absolute emissions towards claiming net-zero portfolios is at present inappropriate. Mitigating physical units of emissions in the real world should not be confused with mitigating economic exposure to emissions, and managing carbon price risk should not be confused with managing the carbon emissions that one owns through share ownership.

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