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TRANSCRIPT

The Long and Shorting of ESG

Featuring:

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Bentley Kaplan:

Hello, and welcome to the weekly edition of ESG Now, the show where we cover how the environment, our society and corporate governance affect and are affected by our economy. I'm Bentley Kaplan, your host for this episode. On today's show, we're going to take a look at one of the tricksier tools in an investor's toolbox: shorting, or short selling. Shorting has made its way more and more into popular media of late, being featured in movies like The Big Short and, more recently, in highly publicized short positions at companies like Tesla, Valeant and GameStop. On this episode, we're going to take a look at the Venn diagram of where short selling and ESG investing overlaps. First, we'll cover the 1-0-1 of short selling for those who haven't yet seen Ryan Gosling smashing down a tower of Jenga blocks. From there, we'll put down some initial markers about how investors can think about short selling in the context of ESG investing and, in doing so, we'll tease apart how the differences between financial and double materiality are right at the center of this.

What is super great is that the material for this show is publicly accessible on MSCI's website, in the paper entitled Long-Short ESG Investing: Best Disclosure Practices, authored by my colleagues, Rumi, Miranda, Yulia, and Yu. So, if you want to get a little further into the details, do check it out after this episode. In the meantime, thanks for sticking around. Let's do this.

Okay. Let's start off with a simple idea that very quickly gets complicated: short selling. Now, if you are too cool for school and don't need short selling to be explained to you, well, then, great, skip ahead to around three minutes and 50 seconds. But here's how it works. You've got a nagging feeling that something's wrong at your favorite takeout franchise. Maybe the French fries are getting a little soggy. Maybe the milkshakes are watery. Yelp reviews are getting catty. Whatever it is, you just have a feeling it's going downhill along with its share price. While it totally sucks that your no-cook nights are going to get worse, you can turn that frown upside down by shorting that company's stock. The way you do that is to borrow shares in the company from a broker.

You sell those shares on the stock market today, and then you wait for the stock’s price to plummet and when it does, you buy those same shares back for much less money and hand the borrowed shares back to your broker. Minus premiums and any other administrative fees, you can pocket the difference between the stock price and use it to buy yourself, I don't know, better burgers. So, seen in one way, shorting is a bet at the price of a company's share or, indeed, a wide range of financial instruments, from equity to debt to currency, and much more complex things, are going to drop, channeling cynicism into investment strategy.

There are probably two main reasons for taking short positions. One is to speculate, when you're really trying to benefit from a fall in price, and this speculation is often the short selling approach that makes splashy headlines or Hollywood movies, when the speculator rarely needs that price to fall. Some investors have turned gutsy short positions into very big returns by shorting companies like Valeant Pharmaceuticals, Lehman Brothers, Enron, Wirecard, or even a whole currency like the British pound. Putting aside the sexier speculation type short positions, investors also use shorting as a way of hedging their existing investment risks, and that's to help offset some risk that you take on by, say, buying shares in a company.

You see, if those shares rise in value, then great, but if they drop, you can help stem those losses by holding short positions that have complementary risk profiles or characteristics; not so much needing a specific price to fall, but rather using it as a kind of back-up plan.

Okay. So that was your roughshod, whistle-stop tour of short selling. I hope you enjoyed yourselves. But now we're going to try and crack a truly complex nut. How do we understand or talk about the ESG-ness of short selling? In the maturing world of ESG investments and reporting, ownership of shares or debt is something that's been a lower hanging fruit. If you hold company shares or debt, it's not philosophically complicated to figure out how your investments are ultimately tied into the ESG impacts of those holdings, like, say, the volume of carbon emissions or the sales of controversial weapons. But having a short position is kind of the opposite of that direct holding, but also not really the opposite. You don't own shares or debt in a company, so your investment isn't directly linked to the ESG impacts of that company, but you do remain bound to the price of those investments, their financial performance, whether they go up or down. Now, if you want to start adding up the total ESG impacts, like carbon emissions, of a portfolio that does include both short and long positions, you need to figure out a way of adding apples to oranges. We at MSCI aren't the only ones thinking about this challenge.

So to try and figure out how all of this might work, we did some canvassing or, to be more honest, some of my colleagues did some canvassing. Rumi Mahmood, out of our London office, is one of those colleagues. To start with, Rumi broke down exactly why this consultation is needed.

Rumi Mahmood:

So, ESG reporting frameworks to date have mainly focused on long-only portfolios and short positions have typically been excluded from ESG analysis to date, but 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 short positions is becoming increasingly urgent. A key issue underpinning investor views on reporting short positions is whether the investor is assessing a company's real-world impact, that is double materiality, or whether they are focusing solely on ESG risk-return metrics or financial materiality.

So, real-world metrics in this context refer to tangible, measurable outcomes, such as emissions released in the air, wastewater produced, or controversial weapons sold, and their significance lies in the ability to measure these as outcomes in the physical world and not just accounting terms. On the financial materiality side, this approach considers adoption of approaches purely from a risk-return perspective, with the main focus being the potential impact of ESG and climate metrics on a company's own financial performance.

Bentley Kaplan:

So, here is the rub. Broadly, you can look at ESG through two lenses. One is through so-called financial materiality. Here what matters is how ESG impacts a company's financial performance. If a company is pumping out carbon emissions and then regulators implement carbon caps or taxes, what financial implications does that have for the company? The other lens that Rumi talks about is double materiality. This includes the financial impact on a company, but it also adds a new dimension, a company's externalities, its impact on society or the environment. As an illustrative example, in double materiality, a company's physical carbon emissions not only represent a financial risk to the company but also the risk of exacerbating climate change. For some stakeholders, it's all about double materiality, but for others, it's only about financial materiality. The problem is, when you zoom out from a single company and you want to scale this up into a portfolio level report, the way you do it for double materiality could be very different to the way you do it for financial materiality. With this in mind, Rumi then took us through two potential routes for portfolio reporting.

Rumi Mahmood:

How they report these typically can be done in two main ways. So that's net and gross market exposures. The net exposures measures a portfolio sensitivity to price risks, while gross exposures measures the total amount of money that a portfolio transacts or injects in the market through both the long and the short legs. So it's the absolute value of capital going both through the long and short legs. The metrics at a portfolio level can thus be offset between the long and the short legs to derive the net portfolio level ESG attributes, or financial metrics if you will, and they can be summed across the long and short legs, so the gross attributes. The gross weights in this case don't consider the ESG attributes of the long and short legs separately, but rather flag all of them and may support investors' capital allocation decisions; whereas the net can give a sense of net risk exposure between the long and short legs.

Bentley Kaplan:

Okay. Rumi is a truly cool customer, and he's dropping those swanky financial terms like honey off a spoon. But if you're not an investor, don't panic, here are the crib notes. If you're taking a whole portfolio of investments that includes both short and long investments, to get an overall picture you kind of have two options. One is to net your investments. Simplistically, what happens here is that you offset your exposure on long positions with those on short positions. The other option is to use a grossing approach. Here you take a total exposure on long positions and you add them together, and then you do the same for those on short positions. Now, one area where the difference between netting and grossing becomes really important is when you look at a company's externalities, its impacts on the world, because holding a short position in a company does not create any connection between you as the investor and that company's actual impact on the world, like its carbon emissions. Your connection stops at the price of that investment. So when it comes to something like carbon emissions across a whole investment portfolio, how can an investment manager with long and short positions report? How should they report? Can short positions be used to net out long positions? This is basically what we wanted to get to the bottom of, and how stakeholders answered those questions is what Rumi told me about next.

Rumi Mahmood:

So the landscape of investor types is quite varied, and their perspectives can vary quite a lot. Priorities and motivations for ESG reporting are, therefore, quite diverse and nuanced. To help establish what the market regards as intuitive, meaningful and transparent in the context of ESG reporting for short positions, MSCI conducted 20-plus consultations across 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 being reported and their function as a tool for implementing ESG in different portfolios. Asset owners predominantly expressed a view that ESG and climate reporting should focus on transparency and real-world metrics, and they firmly delineated between ESG transparency reporting for clients and ESG risk reporting for portfolio managers, and considered that the two require very separate reporting frameworks and shouldn't be conflated. Asset managers, on the other hand, didn't express any strong views in the aggregation of ESG metrics, but considered that for transparency and ESG risk reporting purposes the long and short legs should be reported separately. They also considered that absolute tons of carbon emissions and carbon price risk are separate concepts and therefore require different reporting approaches. Alternative investment managers, such as hedge funds, were pretty much in favor of netting ESG metrics, including carbon emissions, and felt that shorting poor ESG performers should therefore result in some credit at the aggregate portfolio level. Furthermore, hedge funds generally approached the ESG reporting discussion through a lens of risk management and net economic exposure rather than double materiality or real-world impact.

Bentley Kaplan:

Right. So the priorities and mandates of these different stakeholders fed into their views about how ESG and short position should be reported. Key differences emerged in whether ESG metrics should be netted, i.e. canceled out, or grossed, and this looked to fall along the lines between financial and double materiality. Holding short positions doesn't cancel out your investment in a company with a problematic externality or impact, like high carbon intensities or cluster munitions. Our respondents also expressed clear differences on whether long and short positions should be reported separately or together, and the views and mandates and opinions of these stakeholders is a key guide to our work at MSCI ESG Research and to MSCI as a whole. To be frank, a lot of the discussion around shorting and ESG is probably still to come. Regulators haven't really taken a firm line on shorting within ESG reporting yet, and this may change in time with authorities like the UK's Financial Conduct Authority, or the FCA, and the European Securities and Markets Authority both seeking feedback, holding consultations on short selling. But for now, only the FCA has included explicit reference to sustainable investing. Wherever these discussions will ultimately lead and how regulations on disclosure might unfold, the questions that sit at the core of current and future debates around ESG and shorting probably won't be changing all that much. To take us through these fundamental questions, I managed to snag one of Rumi's co-authors and a serial guest on the podcast, Miranda Carr, coming to us from MSCI's Singapore office. First Miranda laid out for me how ownership of a long-only investor creates a different set of engagement tools than it does for a short seller.

Miranda Carr:

Yes, because this comes to the heart of some of the key debates about is shorting appropriate for responsible investment, which has been a wider debate outside of what we concentrated on for our current position paper. The use of shorting and how effective it is in influencing a company's behavior, engaging with the company, and actually making some of your ESG objectives or goals over the long-term, particularly on the climate side, can you actually achieve that through shorting as effectively as you can with a long-only portfolio? This generated a huge amount of debate during the consultation, and there was quite a bit of disagreement between some of the asset managers and some of the hedge funds. Basically, as a shareholder in the company, you own a share. You have the right to engage with that company. You can go to the AGM. You can vote against the directors. If you're a big enough shareholder, you'll have meetings regularly with that company. So you can help influence that company's strategy, its climate targets and its overall ESG goals, and if it's underperforming, then you can put pressure directly on that company as a shareholder. This forms part of the UNPRI principles. The second principle is being able to engage. Obviously if you're a short seller, that's a lot more difficult. You don't have a vote. You don't have direct engagement opportunities. So the main argument for shorting is then the best way to influence a company's behavior is that you're punishing the company by shorting it, you'll put pressure on its share price, and potentially you will also be... The fact that the company knows that you're shorting it, and potentially that will become known in the public, that in itself will put a lot of less direct but still significant pressure on the company.

You do have some instances where there's been very, very good and very strong activist campaigns being mounted by short sellers and that has influenced a company's behavior. But the way we were looking at it from is, if you're looking at a portfolio level, and so you may have a most multitude of short positions and a multitude of long positions, you're not going to be taking an activist stance on every single one of those, it's only going to be on a selective basis. So once you get to the portfolio level and you're talking about a large number of positions, then some of those key arguments about directly targeting the company through shorting through activist positions, they start becoming less relevant. So there's a whole different argument about how shorting can be used, how long positions can be used around engagement, which is very, very different from even just the portfolio reporting level.

Bentley Kaplan:

Right. So being a short seller does not mean that you cannot affect the behavior of a company. The role that short sellers can play in basically sense-checking company share prices is important, and the rise of ESG is giving short sellers a whole bunch of new data that can inform their strategy. We may see interesting applications of ESG data in this way in future but, by and large, direct ownership opens more doors to conversations with company management, more scope to constructively push for improvements and changes. The other question that will continue to underpin these discussions is one about economic exposure versus ownership.

Miranda Carr:

So in terms of whether you short or whether you go long and how you should think about your ESG position on that, one school of thought, which basically says that ESG is a price risk, or climate is a price risk. So, in common with any other risk, such as currency, interest rates, or even bad governance, you could basically just say, "I want to hedge that out of my portfolio. I don't want exposure to that. And so, therefore, I'm going to take a short position to hedge either that ESG or climate risk," in the same way you would do with any other metric. The trouble is obviously when you get into the exposure side and how you're making money from that short position, it starts getting into the topics that ESG tackles, things like whether the company has exposure to child labor, whether it has exposure to controversial weapons. So if you then net out some of those risks and therefore it looks like the portfolio is not exposed to that risk, then there's a risk that you're not reporting your full exposure to some of these bigger issues that are flagged under ESG reporting.

It was interesting. The asset owners very much said, "Okay. If someone's long or someone's short and they have exposure to a company that's involved in child labor, we need to know that, regardless of what the economic position is. We need to know it, we need to understand it, and it just needs to be reported." That's why the transparency element is so important, because how the money is being made, how the positions are potentially leading to exposures in some of these more controversial areas, is a really important part of the total ESG picture for both a company and a portfolio.

Bentley Kaplan:

So the impact of specific company activities on myriad ESG metrics is becoming increasingly important. For asset owners at our consultation, netting out ESG risk was not equivalent to reducing impact, and reducing impact matters to more and more investors, including asset owners, because the frameworks surrounding investment and responsible investment are crystallizing rapidly, and where regulators ultimately set down their markers on ESG and short selling is really going to matter.

Miranda Carr:

The EU regulators, they haven't yet taken any stance and they're going to wait a few years. Further consultations will be had in terms of how to treat shorting in portfolio reporting. But what the regulators are very keen, particularly in the EU, to avoid is obviously any sense of greenwashing, so that if you have exposure to a high climate emitting company, you're netting that off in your reporting, there's a potential that the regulator would still like to know that that position exists and what your total economic exposure is, regardless of the total risk position. So I think this is going to be a key factor in terms of how important this issue is going to become because how you report at the portfolio level, how you report at the fund level, will then influence how the companies will be reporting to the regulators and whether the funds are going to be classed as green or not green, or Article 8 or Article 9.

So this becomes the regulatory treatment of the short positions, is going to be the next big hurdle that we'll see over the next few years, and that's where a lot of the discussion is going to happen.

Bentley Kaplan:

So Miranda and Rumi have given us plenty to think about. For now, even though it's early days, we at MSCI do have some early recommendations based on the majority opinions we heard from the investors that we talked to. If you have a long-short portfolio, we don't think that there is a single report or aggregation method that's going to cover all ESG and climate requirements. Because there are so many different integration priorities, like strategy and intention and ownership and risk management, you invariably end up with multiple potential reports and a fair dollop of complexity. So, as always, our trustee starting point here is transparency, and here it's important to note that there is a clear difference between ESG risk and ESG transparency. Carbon emissions is a clear example of this.

Mitigating physical units of emissions is not the same as mitigating your economic exposure to those emissions.

So we think that, as a standard approach, long and short positions and the ESG metrics should be reported separately. If an investment manager wants to show aggregated ESG metrics of their total portfolio and wants to show net ESG risk, then we think that, in the interests of transparency, they should also show separate ESG metrics for both the long and short positions. I know, even though more reporting is the last thing that a money manager wants to hear, we think this is the simplest way for now to avoid potential conflation of intent, impact, ownership and risk management into any one aggregation scheme. It's not easy to add apples and oranges together and approaches to incorporate long and short positions in reports will clearly differ, but, at the very least, we should be clear about what is an apple and what is an orange.

That is it for the week. A massive thanks to Rumi and Miranda for their take on the news with an ESG twist. A reminder that the full paper is available for free on msci.com, and it's called Long-Short ESG Investing: Best Disclosure Practices. It's pretty readable, even for non-specialists, and we do think it's going to help clarify some of the outlines around this growing ESG topic. Most of all though, thank you very much for tuning into the show. Don't forget to rate and review us wherever you're listening, and do tune in again next week for the spicy, saucy Mike Disabato.

TRANSCRIPT

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