ESG Investing

Shorting Counts

February 23, 2022

It's no longer news that investors care about addressing climate change in their financial portfolios. Investors who want to maximize their impact can, and should, do so across many types of securities, investment vehicles, and techniques. Investment policy itself isn't going to solve this global problem, but it can help, and the methods we embrace should be a "big tent." In particular, short-selling companies who are the biggest climate offenders should be one of our tent posts.

In contrast, Man Group on 2/18/2022 writes "Short-selling does not count as a carbon offset." Well, firstly let's just agree, of course it doesn't. But take this headline's superficial rationale further and you end up with full-on ESG nihilism much broader than just about short-selling. Another practice besides shorting that doesn't count as a direct "carbon offset" is the common ESG practice of just owning less or none (not short) of some companies (the bad guys) compared to traditional indices. Reducing your holding of a big carbon emitter does not immediately change the underlying firm's emissions,[1] nor does it magically remove CO_2 from the atmosphere. Thus, it would be wrong to think of it as a direct "offset" in the sense most seem to mean it. But it still does what it's supposed to do – raise the cost of capital to the emitters.

What does that mean? It's instructive to back up and examine how the more traditional non-shorting ESG approach of own less or none of the bad guys can matter to global emissions in the first place. If a significant fraction of the market doesn't own certain securities (or insists on owning less than their index weights), then other investors have to own more. You can't underweight something someone else won't overweight, or, in econo-geek speak, "the market must clear." Now, owning more than you previously wanted to is not riskless as it reduces your diversification. Thus these other (clearly not so virtuous!) investors will demand to be compensated for this extra risk. That comes through the offending firms being priced to a higher cost of capital.[2] The upside is that this higher cost of capital is what the emitters will have to use to evaluate every possible investment project they contemplate. This higher cost of capital will mean they do, well, less of the stuff we want them to do less of.[3] Many seem to think not owning the bad guys itself will magically change the world. Well, it does, but it's not magic, it's the math that many of us were taught the second week of business school. That is, only pursue projects whose current and future cash flows are "positive net present value" after discounting for time and risk. By raising the cost of capital, or discount rate, on the bad guys we get them to do less of the bad stuff as fewer of their (bad for the world) projects clear the higher hurdle. This is the mechanism where we actually affect the real world.[4]

Shorting does the exact same thing, only more so. If the virtuous investor is willing to actually sell the bad guys short, the non-virtuous will have to own even more, and the cost of capital goes still higher (even less bad stuff!). So, while Man Group's op-ed is accurately titled, as it's not an "offset," it's also quite misleading if taken to mean shorting has no role in the fight to reduce carbon emissions (as, you know, they clearly mean it[5]). Were that true, it would also be true that divesting from (i.e., owning none or less of) the big emitters, as ESG proponents have done for years, has no role. And that just ain't so. In fact, it's quite surprising that there are those who believe you make the world better and better owning less and less of something bad, but that impact mysteriously stops at a zero holding. It doesn't![6]

Furthermore, there's something more prosaic than the math of discounting that we can offer as evidence. If shorts have no impact, why does corporate management famously hate and fear them so much? From CEOs like Elon Musk to a large and consistent pile of academic evidence it's pretty clear that management hates short-sellers. If giant emitters are the enemy, and the enemy of my enemy is my friend, and if you care about reducing global emissions, then the short-sellers of these bad-acting companies are your buddy.

Finally, as a more practical matter, allowing shorting means investors' final portfolios can have a far larger impact on emissions compared to a long-only solution that simply eschews owning the bad guys. If a long-only portfolio could even come close to zero emissions (not so easy) it would have to be quite concentrated and risky. Not so for a portfolio that allows shorting. You can get to zero net emissions without risking the (wind) farm.[7] Not bad for just allowing a relatively modest amount of shorting.

Ok, clearly I feel strongly about shorts being an effective and important part of the solution here, as I believe many others do too. I even suspect much of my view overlaps with that of Man Group's despite their recent op-ed.[8] At least it did until recently. In this spirit, let me conclude by lauding a nice whitepaper the Man Group posted in 2020: "*What does responsible investing need to do to become fully mature? Go short*." Preach brothers.[9]

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[1] Though it can over time, even more so if you short, more on that below.

[2] While the higher expected return to the non-virtuous is sadly necessary, if it's any consolation, they may suffer real capital losses on the way there because an increasing expected return is, all else equal, the result of its price going down.

[3] Not my best sentence, but you get the point.

[4] At least through our investment holdings. There are lots of other ways too, e.g., direct engagement, that are not my topic here but also part of our big tent.

[5] There is a fallacious motte and bailey argument going on in their op-ed. The motte is that shorting isn't the same thing as a "carbon offset." That's true. The similar sounding but very different question of whether shorts should be netted against longs when calculating carbon exposure (longs that most everyone agrees matter and should count) is the bailey. That is, it's the much weaker argument, and by weaker I mean flat out wrong, you pretend to have won because it rhymes with the much stronger (in fact straw-man) argument you pretended you were going to discuss.

[6] In fact, this can get quite silly. If, when calculating carbon exposure going short doesn't count, but going long does, you get bizarre paradoxes. If most investors don't short at all, but some short the bad guys, then, again, other investors must own more of the bad guys. If you don't count the shorts surely you still count the longs, right? Well, if so, those shorting the bad guys just raised the carbon exposure of the whole market (as their shorts don't count towards reducing it but the extra longs the other guys need to take on do). If you were doing an ESG carbon emissions score on the whole market it just went up simply because who owns and who is short the stock changed. This paradox is resolved by the simple fact that the argument that drove it, that shorts don't count but longs do, is silly.

[7] Furthermore, you can then vote and engage also with those companies that are actually most responsible for what you care about as to balance your shorting you own a bit more on the long side.

[8] On a more personal note, I found this line from the recent Man Group editorial a little bit offensive: "In the push for net zero, where investor commitments have already been met with a degree of skepticism, hedge funds should avoid giving critics another excuse to attack them." First, I can't help feeling like they're talking about us! Though that may be my famous tendency to solipsistic fits of ego talking. But, if I disagreed with another firm so strongly I hope I'd actually name them, like I do here, and start an open debate. Second, the statement is just flat out wrong on several fronts. The label "hedge fund" has not been very accurate for us since about 1999. More important, the solution we proffer actually involves quite a small amount of shorting and would most often be done in a 100% net (not gross) long portfolio. Hardly a hedge fund (and certainly not in the ballpark of hedge fund fees). Third, it's vaguely, pusillanimously, threatening. Maybe I'm paranoid (it's a nice quality to offset the aforementioned solipsistic egotism) but I hear that as "Don't you dare push this solution you HEDGE FUND or we will sic the mob on you." Well, give it your best shot. But let's talk more about me (I said this footnote was personal!). Two of my most endearing personal qualities are how well I suffer foolishness and how I let mendacious threats roll off me like water off a duck's back. OK, maybe I'm not so good at those, maybe I'm like exactly the opposite of being good at those, and they've gone and triggered me on both accounts. We are, actually rather obviously, right on this. Our suggestions, whether implemented by us or others (when you speak the truth out loud you seldom own it all for yourself), can really help clients and help the world. They, on the other hand, are, actually rather obviously, wrong and either do not understand the investing math, or worse don't want to understand it a la Upton Sinclair. Simply put, we will not be cowed by misleading bait-and-switch analysis and vague threat ("it would be a shame if something happened to this nice hedge fund of yours"), by those who fear, quite correctly, that our solution is better than theirs.

[9] Of course we understand that there are investors who can't or won't short as a matter of policy. Long-only ESG portfolios are still quite reasonable. We don't argue shorting is absolutely necessary to do this, just that it makes impact greater and the end portfolio more efficient.

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