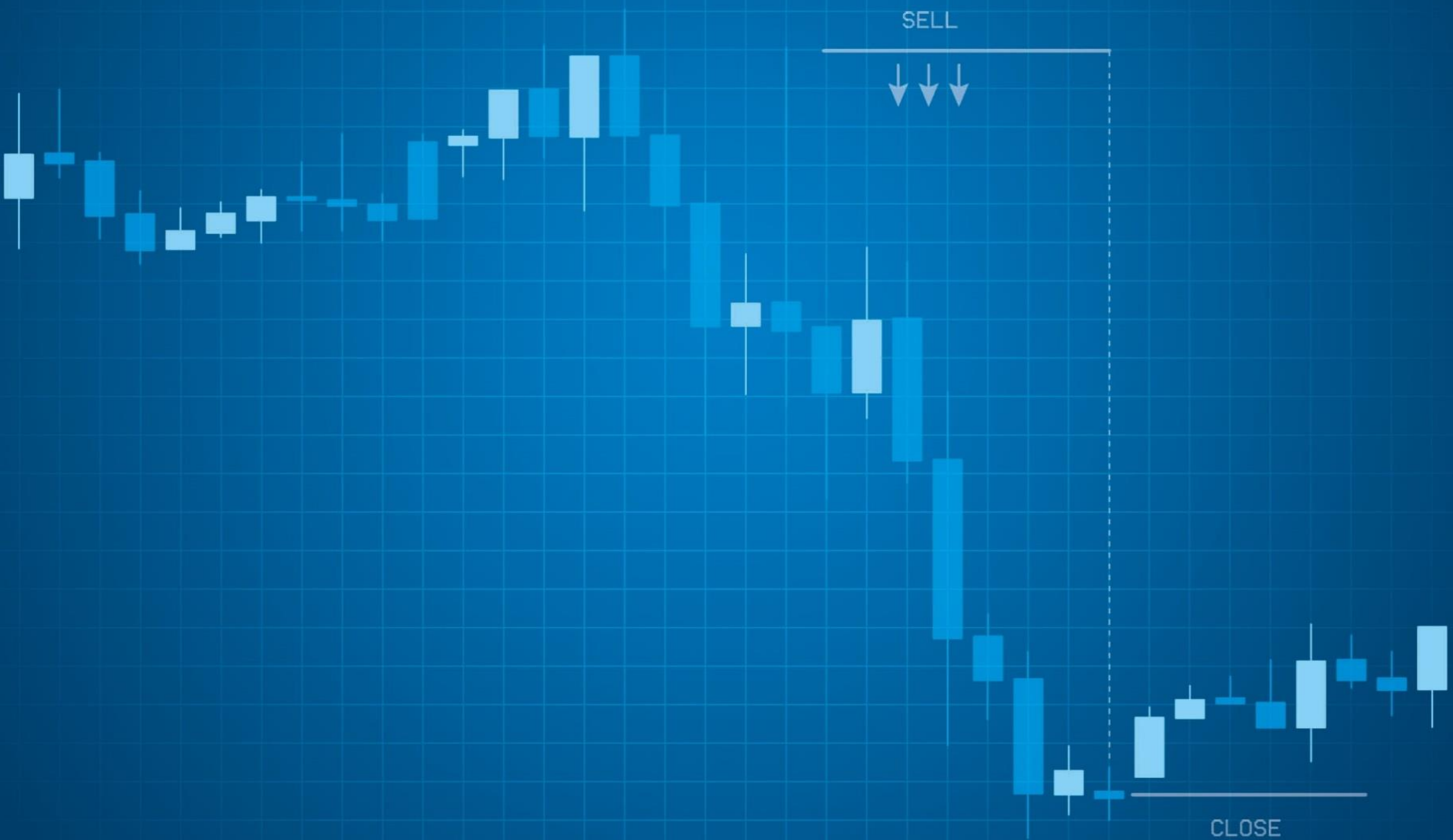
Principles for Responsible Investment

SHORTING AND RESPONSIBLE INVESTMENT:

A REVIEW



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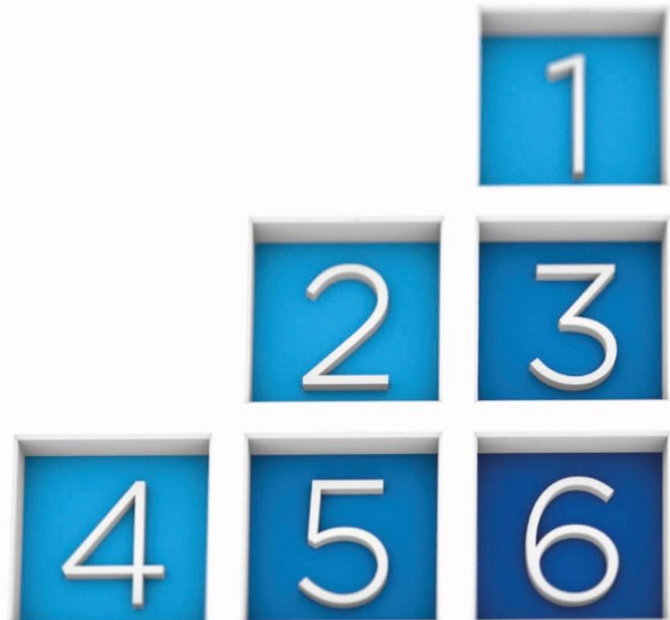
THE SIX PRINCIPLES

PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.



PRI'S MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

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EXECUTIVE SUMMARY

The PRI has a growing number of signatories that allocate to investment strategies that use shorting. These signatories also seek to adhere to the PRI's six Principles.

Shorting is a well-established trading practice, and while some investors have embedded it into their responsible investment policies and approaches, this is still developing across the industry.

Short selling can be beneficial for financial markets by facilitating price discovery and informational efficiency, although some policy makers consider that a more cautious approach is needed, particularly in times of acute market stress. In certain circumstances, policy makers and corporates also have concerns regarding transparency surrounding short positions.

This review explores some of these issues and identifies a series of next steps that PRI signatories might want to consider when allocating to or undertaking an investment strategy that uses short positions.

ESG INCORPORATION

Shorting can be one way to express the view that an entity, security or asset is mispriced and not adequately incorporating ESG factors or systemic risks into its business activities, governance structures or future scenarios. Doing so aligns with investment managers' and asset owners' fiduciary responsibilities and is in the interests of beneficiaries.

It can be used as an alternative to screening, providing opportunities to profit from an underlying economic exposure and engage with companies – opportunities that would not be available were the position to be excluded.

Shorting can also be used to hedge a portfolio's overall exposure to material ESG-related risks.

STEWARDSHIP

Investment managers and asset owners are under increasing pressure from a range of stakeholders to consider their role and responsibility as stewards of capital[1], and investors that use shorting are not exempt from this.

Indeed, taking a short position (whether physical or synthetic) reflects an economic exposure that has real-world implications for employees, the environment and affected stakeholders. This is of increasing concern to savers and regulators.

[1] Dr Emma Sjöström Misum, Stockholm School of Economics & Stockholm Sustainable Finance Centre, (2020) Active ownership on environmental and social issues: What works? A summary of the recent academic literature

Despite these changing pressures, only a small number of leading hedge funds have taken a public stance on ESG issues such as climate change.[2]

When accompanied by engagement, taking a short position in a company or issuer can convey a view regarding an ESG-related risk or practice. This can have implications for a company's cost of capital and valuation, thereby creating an incentive for management to engage on the issues identified.

When used for hedging purposes, shorting could also help investors to build larger long positions than they could otherwise hold, providing greater leverage to engage with corporate management.

However, corporate engagement can be difficult to implement within investment strategies that predominantly trade derivatives or hold their positions for a limited duration. In such cases, investors will need to develop stewardship approaches focused on public advocacy, collaborative action and influencing systemic issues, consistent with the PRI's Active Ownership 2.0.

CLIENT PORTFOLIO REPORTING

Reporting on the ESG impact of short positions within portfolios can be challenging for hedge fund managers. They invest in a range of asset classes and financial instruments that are not always extensively covered by ESG data providers, and there is no industry standard for reporting the ESG impact of portfolios that combine long and short positions.

The hedge fund industry and data vendors need to be innovative in their approach to measuring and reporting portfolio ESG exposures and impact, such as carbon footprints or net-zero targets.

Investment managers also need to develop a consistent, transparent approach that allows clients and other stakeholders to better understand their rationale for shorting in a responsible investment context.

[2] For example, see https://www.sayonclimate.org and Bloomberg (2020) The world's most profitable hedge fund is now a climate radical.

NEXT STEPS

Our discussions show there are several perspectives on the interaction between short selling, ESG incorporation, stewardship and ESG reporting.

There are a series of basic expectations and considerations that asset owners could set and refer to when selecting, appointing, and monitoring external managers that use shorting. To meet these, investment managers might implement several steps in their policies and practices, which include:

- Investment managers communicating:
  - whether an investment strategy takes short positions and under what circumstances;
  - how these are integrated into a responsible investment approach and policy; and
  - what implications this has for third-party service providers such as prime brokers.

- Investment managers developing:
  - a stewardship approach prioritising collaborative and/or policy engagement on systemic ESG issues, where direct corporate engagement is not possible;
  - a consistent approach to reporting on ESG portfolio metrics, such as a carbon footprint or greenhouse gas emissions.

We will continue to help signatories that use shorting in their investment strategies to implement the Principles – by assessing data from the Reporting Framework and engaging with them further to identify leading practices and areas where further guidance is needed.

We welcome industry discussion and feedback on this paper – please contact hedgefunds@unpri.org to share your views.

ABOUT THIS PAPER

The PRI has an increasing number of signatories, whether hedge fund managers or asset owners, that use shorting within their investment strategies.[3] These signatories also seek to adhere to the PRI's six Principles, including a commitment to report annually to the PRI on their responsible investment activities.

This paper intends to help them and other stakeholders develop their thinking on how shorting can be compatible with responsible investment.

It is a continuation of previous work, including a Technical guide on ESG incorporation in hedge funds, published in 2020, and a due diligence questionnaire for asset owners investing in hedge funds, published in 2017.

It provides a brief review of how shorting can fit within ESG incorporation and stewardship approaches[4] as well as highlighting the challenges it poses to client reporting on certain ESG risks and exposures, such as the carbon footprint of a portfolio.

Although responsible investment as a strategy and practice should aim to incorporate all relevant environmental, social and governance (ESG) factors in investment decisions and active ownership, the paper predominantly references material climate-related risks, reflecting the focus of discussions with the Hedge Fund Advisory Committee and the hedge fund industry more broadly.

[3] Examples of specific signatory approaches can be found in the Responsible investment policy database and the PRI Data Portal respectively, by filtering responses by asset class, under hedge funds.
[4] For definitions of these terms, see the Reporting Framework glossary.

PRI Principles for Responsible Investment

BACKGROUND

Alongside an explosion of interest in responsible investment, allocations to alternative asset classes – such as hedge funds – have been an important theme within the asset management industry over the last decade.

This convergence presents opportunities and challenges for asset owners and investment managers that use shorting as part of their investment strategies.

As highlighted in the PRI's Technical guide on ESG incorporation in hedge funds, shorting refers to taking a position in a financial instrument, either by physically borrowing an asset such as a listed equity or bond, or by obtaining synthetic exposure (e.g. a contract for difference), and selling it. The security must later be bought back (hopefully at a lower price) and returned to the party from which it was borrowed.

Although it is a well-established trading practice, largely supported by theoretical frameworks, it is important to recognise that there are different narratives in relation to short selling and responsible investment.

One perspective is that short selling benefits financial markets as it facilitates price discovery and informational efficiency. Another view, held by some policy makers and corporates, questions these benefits and highlights issues such as a lack of transparency and accountability among those that undertake shorting. As a result, short selling has attracted attention from the media, politicians, and regulators.

Depending on the jurisdiction or broader market conditions, shorting is subject to various restrictions and regulatory requirements[5] that seek to address or improve:

- settlement risk;
- potential market manipulation;
- transparency – either to regulators or the wider market.

[5] For example, see Financial Times (2021) S Korea politicians back short-selling ban to help retail investors.

ESG INCORPORATION

We will incorporate ESG issues into investment analysis and decision-making processes

Principle one of the six Principles

Market participants take short positions for a range of reasons – below we outline those that can most closely align with responsible investment practices.

EXPRESSING AN INVESTMENT VIEW

There is a growing body of academic and industry evidence supporting the premise that identifying and incorporating ESG factors in an investment process may contribute to relative outperformance across a range of asset classes. [6]

Shorting can be one way to express the view that an entity, or security, is mispriced as it has not adequately incorporated ESG factors or risks into business activities, governance structures or future scenarios. Investors can make the case that doing so is consistent with their fiduciary duty and the interests of their beneficiaries.[7]

Some hedge funds already take short positions in companies having identified significant governance issues, such as accounting irregularities. As ESG incorporation becomes more widespread within the hedge fund industry, technological, regulatory, and physical climate-related risks may also drive short activity. Some observers also point to the role that shorting might play in highlighting companies or issuers that misrepresent their ESG credentials.[8]

AN ALTERNATIVE TO SCREENING

Investors can use screens to exclude certain securities or sectors from an investable universe or benchmark in a long-only portfolio, based on an explicit performance rationale – e.g. to avoid exposure to stranded assets – or for ethical concerns – e.g. to avoid exposure to tobacco, arms or alcohol. [9]

In a long/short or short-only context, shorting could offer an alternative way to incorporate such ideas, while also presenting an opportunity to profit from the underlying economic exposure that would have otherwise been excluded.[10] Additionally, holding a short position allows an investor to engage with a

[6] The PRI (2021) ESG factors and equity returns – a review of recent industry research
[7] See for example, The Economist (2020) Wirecard's scandal shows the benefits of short-sellers and Jonathan M. Karpoff, Xiaoxia Lou (2010) Short Sellers and Financial Misconduct.
[8] See for example, Investors' Chronicle (2020) ESG: The next big fraud? and The Financial Times (2020) Short-sellers step up scrutiny of ESG stocks.
[9] PRI (2020) Introductory guide to responsible investing: Screening
[10] AQR (2019) Responsible Asset Selection: ESG in Portfolio Decisions

company in a way that they could not do by excluding them from the portfolio – this will be discussed further in the section on stewardship.

Whether an investor uses shorting, screening, or a combination of these and other ESG incorporation practices, they should consider communicating clearly with clients and counterparties on any specific policies and processes in place related to these.[11]

HEDGING ESG RISKS

Shorting can be used to limit or offset exposure to systemic or idiosyncratic ESG issues – such as those related to material climate-related risks, as outlined in the PRI's Inevitable Policy Response work – where the gains from that short position can act as a counter to potential losses incurred from equivalent long positions.

A recent paper by the Alternative Investment Management Association, Short Selling and Responsible Investment, presents a simplified, theoretical discussion of how such risks could be hedged, using an equity short position as an example. However, short selling as a hedging strategy need not be restricted to equities or individual issuers.

Responsible investors that use shorting as a hedging tool should clearly disclose how they do so in their policies and relevant client communication.

[11] Man Group (2020) The Big Green Short

STEWARDSHIP

We will be active owners and incorporate ESG issues into our ownership policies and practices.

Principle two of the six Principles

Investment managers and asset owners are under increasing pressure from stakeholders to consider their role and responsibility as stewards of capital.[12]

The PRI defines stewardship as "the use of influence by institutional investors to maximise overall long-term value, including the value of common economic, social and environmental assets, on which returns, and client and beneficiary interests, depend."

Investors that use shorting – whether signatories or not – are therefore not exempt from this responsibility. Indeed, taking a short position (whether physical or synthetic) reflects an economic exposure that has real-world implications for employees, the environment and affected stakeholders.

Nonetheless, only a small number of leading hedge funds have taken a public stance on ESG issues such as climate change.[13]

Below we outline a series of individual and collaborative tools that investment managers and asset owners can use to implement a stewardship policy in conjunction with shorting.

ENGAGEMENT

When accompanied by engagement tools, such as public messaging and corporate dialogue, taking a short position in a company or issuer can convey and promote a view regarding an ESG-related risk or practice.

A short interest in a company can impact its cost of capital, creating an incentive for management to engage with investors on a specific issue or practice to improve the chances of obtaining more favourable financing or a higher valuation. This influence may be direct (as investors borrow or return stock to build or reduce short positions) or indirect (as public short positions can impact investor perceptions of an issuer or asset).

[12] Dr Emma Sjöström Misum (2020) Active ownership on environmental and social issues: What works? A summary of the recent academic literature

[13] For example, Chris Hohn's TCI Fund Management – see https://www.sayonclimate.org and Bloomberg (2020) The world's most profitable hedge fund is now a climate radical.

PRI Principles for Responsible Investment

When used for hedging purposes, shorting could facilitate investors building larger long positions in a company or issuer than they could otherwise hold, due to internal risk or exposure limits related to issuers, sectors or countries, providing greater leverage to engage with corporate management.

However, corporate engagement can be difficult to implement where investment strategies (whether long or short) predominantly trade derivatives or hold their positions for a limited duration. These factors can limit the opportunities for direct contact an investor would have with a company or issuer, or the time in which they could advocate for change.

PRI signatories allocating to or using these types of investment strategies should explore and develop policies and practices on policy engagement or advocacy on systemic issues that influence market rather than asset valuations. These could include climate-related risks, governance practices or human rights. This approach is aligned with the PRI's Active Ownership 2.0 (see box below).

ACTIVE OWNERSHIP 2.0

The PRI's Active Ownership 2.0 programme has been developed with investment managers and asset owners as a framework for more effective stewardship. It prioritises collaborative effort to seek real-world outcomes on the systemic sustainability issues that threaten common assets and therefore overall returns through three pillars:

- Outcomes, not inputs or processes
- Common goals
- Collaborative action

Engagement tools aligned with Active Ownership 2.0 include public disclosure, corporate dialogue, collaborative approaches and policy engagement.

When these tools are utilised alongside short selling and an investment mandate that aligns with beneficiaries' responsible investment priorities, Active Ownership 2.0 can be a powerful tool through which signatories can implement the PRI's Principle Two.

CLIENT PORTOLIO REPORTING

We will report on our activities and progress towards implementing the Principles

Principle six of the six Principles

Asset owners increasingly expect their investment managers to report on their responsible investment activities, including how ESG issues are integrated within investment strategies, disclosure of active ownership activities and/or the impact of these on broader portfolios.

Reporting on ESG activities and impact can be difficult in the context of long / short portfolios. Although the hedge fund industry has developed innovative approaches to the collection and analysis of alternative data, including data on ESG factors, the process for assessing and reporting ESG impact or outcomes is still developing.

For example, while the process for calculating the carbon footprint of a long-only portfolio is relatively established, there is no equivalent approach for reporting a similar metric for a portfolio that holds short positions.

Assessing the ESG impact of hedge fund portfolios more broadly is also complicated by the multiple asset classes and instruments traded, as well as the use of leverage.

Nonetheless, approaches for calculating a portfolio's net exposure for broader risk management purposes do exist. Conversations with the Hedge Fund Advisory Committee suggest that some investment managers and service providers have started adapting these to report, for example, on a portfolio's net carbon footprint, although there is currently no industry consensus on how to effectively do this.

Investment managers that utilise short selling in their strategies are likely to receive increasing requests from their clients for higher levels of disclosure on ESG metrics, particularly as asset owners increasingly commit to achieving net-zero portfolios.

Investment managers that develop a consistent approach for reporting the ESG impact of short positions can help clients and other stakeholders better understand their rationale for shorting in a responsible investment context.

NEXT STEPS

This section outlines a series of basic expectations and considerations that asset owners could set and refer to when selecting, appointing and monitoring external managers that use shorting, and that these investment managers can implement in their policies and practices.

ESG INCORPORATION

An investment manager might be expected to provide:

- provide clear, pre-contractual information on whether an investment strategy takes short positions and under what circumstances (e.g. hedging or to express an investment view); and
- a publicly available statement on how shorting is integrated into a responsible investment approach and policy and explaining the implications for third-party service providers such as prime brokers.

STEWARDSHIP

- When it is not appropriate or possible to undertake corporate engagement due to the type of investment strategy used, investment managers should develop a stewardship approach that prioritises collaborative and/or policy engagement on systemic ESG issues, either through initiatives such as the CA 100+, or other appropriate channels.
- Investment managers should communicate their approach – including their use of shorting, if applicable – in their responsible investment or stewardship policy.

CLIENT PORTFOLIO REPORTING

- Investment managers should a develop a consistent approach to reporting on ESG metrics, such as carbon footprint or greenhouse gas emissions – enabling clients and other stakeholders to better understand and compare the impact of a specific portfolio or position.

We will continue to help signatories that use shorting in their investment strategies to implement the Principles – by assessing their reporting data and engaging with them further to identify leading practices and areas where further guidance is needed.

We welcome industry discussion and feedback on this paper – please contact hedgefunds@unpri.org to share your views.

CREDITS

AUTHORS

Toby Belsom, PRI
Diba Ahour, PRI
Felix Soellner, *ex*-PRI

EDITOR

Jasmin Leitner, PRI

DESIGN

Will Stewart, PRI

PRI | Principles for Responsible Investment

The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org