



Cliff's Perspective

Shorting Your Way to a Greener Tomorrow

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My colleagues (and even I) have written extensively on responsible investment, as in the use of ESG factors in investment decisions.¹ In this piece I aim to examine one issue that generates tremendous confusion: the use of shorting in an ESG context. When it comes to calculating a portfolio's ESG score, we have heard arguments ranging from "ignore the shorts" to "net them against longs," and, my favorite as it's creatively insane, "pretend the shorts are actually longs." To say there is confusion would be an understatement.

You may wonder why AQR thinks this question is important. Well, the proper treatment of shorting matters for the ultimate goal of responsible investing: to effect change. Also we care because it matters to our clients, who often have ESG needs and preferences and may opt to invest in a Sustainable version of our strategies (approximately 80% of our AUM use some form of ESG signals, and 20% of our AUM is directly in [Sustainable-labeled strategies](#)²). Our industry is currently in the process of grappling with foundational questions of what ESG means in a portfolio context and short selling is an important tool in this endeavor.

There are three broad reasons why shorting would make sense in ESG-focused portfolios:

First, shorting is a great way for portfolio managers to express their investment views. The obvious point is that if a manager expects a security to do poorly, simply not holding it is a less significant expression of that view than shorting. This is, of course, not particular to ESG.

Second, shorting is a great way to hedge risks, including those of an ESG nature.

Third, many ESG-oriented investors seek impact through their financial portfolios. Impact is never easy, but the most realistic case by far for affecting the real economy is holding a large position in an issuer, voting shares, engaging, and maybe even getting a seat on the board. None of this will happen if the investor takes no position in the company. But you can have some impact when you short a company – not as much as a long investor, but

¹ For example, my colleagues wrote "[Clearing the Air](#)," in partnership with the UN PRI, to enable communication and thinking about ESG in investment and ownership. "[Responsible Investing: The ESG Efficient Frontier](#)" is an academic piece which examines the various tradeoffs inherent in ESG investing, while "[A Framework for Environmental, Social, and Governance Considerations in Portfolio Design](#)" and "[Responsible Asset Selection: ESG in Portfolio Decisions](#)" are more practitioner-focused working papers on the same topic. We certainly do not claim to be among the founding parents of ESG investing, but I will say we were early and prolific (2009 was early!). ESG was even discussed in 2017 on my blog in "[Virtue Is its Own Reward: Or, One Man's Ceiling Is Another Man's Floor](#)." Although that piece may not have been the most popular among ESG practitioners at the time :), I might claim victory on that one since ESG proponents increasingly rarely focus only on pure industry exclusions – for good reason. I also think it was rather unique as it actually explained why an ESG tilt might have real world impact and lead to less of what an ESG investor wants less of (amazingly that's usually elided). In addition to the aforementioned, there are many AQR articles on the topic of Governance and, generally speaking, financial shenanigans that investors should look out for – all of which are available at [aqr.com/ESG](#).

² Approximate as of June 30, 2021, includes assets managed by AQR and its advisory affiliates.

more than a non-investor (and, of course, adding shorting doesn't detract from your ability to impact through your long positions).

The points above are general enough to apply to all of ESG; but to build up a richer example, let's focus on one specific aspect relevant to the "E" in ESG: climate change. Specifically, the change induced by greenhouse gas emissions.³

How does climate change rank on the three dimensions listed above?

Returns are easy to interpret. If it is your belief that we will experience a (possibly rapid) transition to a low-carbon economy, or if you expect a global carbon tax or something similar, then you probably want to position your portfolio accordingly.⁴ You can articulate this belief by not holding stocks with, say, high emissions or fossil fuel reserves. But if you truly have this investment view, why wouldn't you short the stocks with the most egregious climate exposure? Some might think this is a long-term view and that shorts are only useful for short-term positioning. That's just not true, at least not for AQR and (probably) similar managers. We typically hold our shorts close to a year, and we have a nontrivial book of short positions that we've held for multiple years. Plus, even when there is turnover, it is generally into stocks with the same characteristics, long or short, that we desire.

Second, many investors (and maybe also regulators) believe that climate change may be a material risk. We hedge risks, and to put it succinctly, hedging is far easier with shorting, and may sometimes be impossible without it. One of my colleagues has an academic paper that is literally titled "[Hedging Climate Change News](#)." They construct hedge portfolios that, you guessed it, heavily rely on shorting.

Finally, there is impact, and the argument here is straightforward.⁵ Shorting has impact by dissuading companies from pursuing whatever is objectionable to the short community in aggregate; in this case, carbon emissions. And, if you need any evidence that companies hate to be shorted, I have [multiple anecdotal references](#), but it's also far from [just anecdotal](#).

If you buy into what I am saying, then this opens up new options for ESG investing. For example, many investors want to reduce the carbon footprint of their portfolios, even going so far as pledging to go net zero to support the Paris accord. The problem of course is that getting to net zero is quite difficult, if not impossible, today – and for the foreseeable future – with just long positions. One would need to buy an enormous amount of carbon offsets to even come close to going net zero. But that is not the only option. An investor could use a combination of both offsets and shorts to meaningfully lower emissions to get close to, if not achieve, net zero.

Thus, if one is measuring the carbon footprint in a portfolio, the shorts should be accounted for: one should count the net footprint, which is the value of the long side minus the value of the short side. You cannot ignore the shorts or the system is imbalanced. In fact, if you do anything but count them as reducing emissions exposure, it's impossibly inconsistent. If you ignore shorts, then adding up the ESG exposure of all the separate market participants will not equal the ESG exposure of the market portfolio. You certainly cannot ignore them or, for some real crazy talk, add their absolute value to the longs.⁶ Anything other than attributing negative carbon to the shorts just won't work, it doesn't add up, and it certainly doesn't help anyone. Counting them, putting pressure on companies with short positions to reduce their emissions and enabling investors to achieve their net zero goals, most certainly does.

Using short selling to reduce carbon exposure, to get to net zero or to achieve other ESG goals, is a vital tool for ESG investing. It's also a tool that can readily be incorporated into portfolio construction.⁷ For those who want their investing to lead to a lower carbon (and better S and G) world, this is one important tool to help us get there.

³ This one is undoubtedly a major focus among many ESG investors today.

⁴ A more technically accurate statement would be if you believe in this transition and that it is not yet priced in fully. My guess is that many investors believe both of these things.

⁵ "[Hit 'Em Where It Hurts, ESG Investing 2.0](#)" was the first AQR article to propose using shorting to reduce a portfolio's carbon footprint and potentially have positive impact (that is, a carbon footprint with, for once, the right sign!). This argument was further expanded in the wonderfully titled "[\(Car\)Bon Voyage: The Road to Low Carbon Investment Portfolios](#)."

⁶ We have actually seen this proposed by a serious investment firm, though their logic is deeply flawed.

⁷ Full disclosure (or bragging as the case may be), we currently run ~\$1.5B in net zero assets. Approximate as of June 30, 2021, includes assets managed by AQR and its advisory affiliates.

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