QUICK TAKES

Quick Clips: Shorting in ESG Strategies

February 17, 2022

In recent years, increased emphasis on sustainability practices in the investment community have caused investors and asset managers to prioritize their Environmental, Social and Governance ("ESG") efforts. Hear from AQR's Head of ESG Strategy, Brad Jones, about how investors can use shorting to more strongly express ESG views and hedge climate risks.

Why might investors incorporate ESG considerations into their alternatives allocation?
Many investors incorporate ESG considerations into their traditional long-only equity and fixed income portfolios in order to better align their portfolios with their broader values or because they believe ESG information is predictive of risk and returns. Given the urgency of the risks of climate change as well as the historically low expected returns from traditional assets, investors may want to consider positioning their alternatives allocation accordingly.

Until recently ESG implementations in liquid hedge fund strategies, also known as liquid alternatives, have been limited. ESG-focused liquid alternatives can offer investors a more effective way of expressing their ESG views and may help lower their portfolio's carbon exposure. Additionally, they may provide a valuable diversifier to other assets in the portfolio, which is particularly important now as traditional asset classes have historically high valuations and low expected returns.

ESG-focused liquid alternatives may offer a diversifying option for generating returns in a sustainable way (00:28)

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Liquid alternative strategies give investors more tools to incorporate ESG-driven investment views, hedge and manage ESG-related risks, and even generate incremental impact when compared to what they could do in a traditional long-only strategy. An especially important tool that liquid alternatives offer is the ability to short stocks with poor ESG characteristics.

How can shorting be used as a tool in ESG investing?

We believe shorting allows for greater impact than divestment (00:26)

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If an investor has ESG-related concerns about a company, shorting that company's stock is a stronger expression of that concern, as opposed to divesting from the company. Shorting may open a channel for investors to express their ESG concerns to company management teams and potentially impact their behavior. Such a channel is largely absent for long-only strategies that merely divest from companies with significant ESG concerns.

Shorting can provide an effective way to hedge ESG risks (00:26)

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Many investors believe that climate change may pose a material risk for companies – for instance, high-polluting companies may face an increasing likelihood of stringent carbon emissions regulations, which would negatively impact their operations. While long-only strategies seek a meaningfully lower carbon footprint than a benchmark, they cannot eliminate carbon exposure completely. In these strategies, climate risks are unlikely to be fully hedged, as nearly all stocks and bonds have at least some climate risk exposure. However, if investors allow shorting, then they may build allocations that fully remove such risks, effectively hedging climate exposure in their portfolio.

For more information, visit aqr.com/ESG or contact esg@aqr.com.