A Sustainability-Focused Investor's Guide to Short Selling

Creating Long/Short Strategies with ESG Criteria

October 2018

Short selling strategies play an important role in a complete investment portfolio. Using environmental, social, and governance (ESG) characteristics, a sustainability-focused investor can incorporate a long/short strategy into his or her portfolio by going long the firms with excellent ESG characteristics and shorting those that have poor ESG performance. Investors who are not interested in profiting from short selling poor ESG performers are unlikely to be comfortable with any short strategy and thus should be in a long-only portfolio.

APPLESEED™
CAPITAL

A Sustainability-Focused Investor's Guide to Short Selling

Creating Long/Short Strategies with ESG Criteria

Short selling strategies can be an important part of a complete investment portfolio. Like any investment strategy, they carry unique risks; however, when deployed properly, short selling strategies may offer investment diversification and downside protection in difficult market environments. Sustainability-focused investors consider environmental, social, and governance (ESG) characteristics of firms in deciding where to invest, and generally go long strong ESG performers. When it comes to short strategies, however, a sustainability-focused investor likely will be faced with the choice of a long-only portfolio or a strategy of shorting the worst ESG performers. Incorporating a long/short ESG strategy into an investment portfolio can offer the potential for both financial and social returns.

The Benefits of Short Strategies

Shorting a stock is more technically complicated and offers differing risks than simply maintaining a long position. For a long position, an investor simply buys a stock and holds it, after identifying certain fundamental characteristics of the firm that the investor believes will drive the performance and the stock price up over time. Hoping to profit from a short position, an investor essentially borrows stock, sells those borrowed shares in the market, and buys back those shares at a later date. Short positions can offer significant returns if timed correctly, though higher returns are accompanied by higher risk. Short strategies are sometimes used to hedge other stock positions and reduce overall market exposure. While these strategies are not for all investors, shorting stock can have beneficial attributes.

To some investors, short selling is perceived to be associated with unethical behavior, as short sellers benefit when others lose money. However, in reality, short sellers make positive contributions by providing much-needed liquidity to the market and serving as a reality check during periods of extreme optimism. Short sellers have a history of exposing companies who have improperly inflated their performance or misled investors. Because the risks of short selling are significant, the investors who engage in this activity have typically done extensive research on the companies they are shorting, and may uncover unethical behavior that is not generally known to the public. Truthfully, short sellers typically have little interest in shorting companies that have reasonable valuations and viable long-term strategies.

Long and Short Strategies for Sustainability-Focused Investors

Broadly speaking, there are three types of companies from a sustainable investing perspective: those that excel on ESG characteristics, those that are ESG neutral, and the bad actors that either fail to address critical ESG issues or actively work against sustainability principles.

The values-oriented investor wants to hold long positions in companies with high ESG ratings, counting on that performance to cause the stock price to rise over time. A well-respected company in this category is Ecolab (NYSE: ECL), a Minnesota-based firm in the water, hygiene, and energy technologies and services space.[1] Ecolab serves a variety of industries, but the firm largely focuses on food safety and helping other firms handle waste more effectively and conserve water in their operations. In addition to their sustainability initiatives, Ecolab has also been named one of the world's most ethical companies for 12 years in a row.[2] Owing to its strong operational and ESG performance, Ecolab's stock price has also been climbing steadily over time to the benefit of investors who are long the stock, with its only major drop in value occurring during the 2008 financial crisis.

Outside the realm of individual stock picks, the sustainability-focused investor can also hold long-only mutual funds and ETFs that offer investors the ability to invest only in standout ESG performers or in a wide selection of firms with the worst ESG actors excluded. Mechanically, taking a long position in companies with strong ESG performance is relatively simple.

To incorporate a short strategy, the sustainability-focused investor typically is not inclined to short a strong ESG company. Hedged ESG strategies offer little appeal, as there are few ESG investors who want to simultaneously be long a strong ESG performer and be short a strong ESG performer, thus theoretically making money based on the spread between these two companies. As an example, being long one solar energy company and short another solar energy company simply is not that appealing. Shorting a company can also have a negative impact on that company, so a sustainability-focused investor shorting a strong ESG performer could actually hurt rather than support that firm.

Accordingly, when thinking about short selling, the values-oriented investor should look to the bad actor companies as potential investment opportunities. Short strategies rely on identifying firms with fundamental issues that will lead ultimately to drops in stock prices, and bad performance on ESG criteria certainly indicates issues with firms. Just from the perspective of

[1] https://www.ecolab.com/

[2] http://www.worldsmostethicalcompanies.com/honorees/

scandals, poor ESG performers make attractive targets for shorting: failure on ESG issues can easily lead to very public bad press and accompanying large drops in stock price, which is the ideal outcome for the investor with a short position.

A recent example of a bad actor creating an appealing short opportunity is Equifax (NYSE: EFX), the consumer credit reporting agency. In September 2017, the firm announced a data breach that affected over 140 million consumers. Worse, Equifax had known about the breach for months before the firm publicly announced it, and during that time executives had sold $1.8 million worth of their stock.[3,4] In the face of this clear failure of corporate governance, the stock price dropped from a high of $141.59 to $92.98 in the first two weeks of September. Investors who were short Equifax at the time would have benefited considerably from the public realization of the firm's ESG failures. Prior to this data breach, Equifax was well known to have multiple social and governance shortcomings that would have likely dissuaded a sustainability-focused investor from going long the stock. In fact, before the data breach became public, MSCI gave Equifax its lowest possible ESG rating, specifically citing issues related to privacy and data security. ESG criteria provide relevant, material information upon which investors can act.

Hedge funds and other alternative investment vehicles can create a combined long/short ESG equity strategy, allowing investors to hold long positions in firms with positive ESG characteristics and simultaneously hold short positions in the bad actors. This type of strategy should provide some downside protection to investors in the event of a large downturn in the market as well as allow the investor to support strong ESG performers and negatively impact the poor ones.

The Benefits of Shorting the "Bad Actors"

The investor who was short Equifax at the beginning of 2017 would have realized a clear financial benefit from taking this position. But values-oriented investors are concerned with both returns and with the social impact of their investment decisions and consider more than just the outright financial outcomes from taking a long or short position in a stock.

A common objection to shorting within a sustainable investment strategy is that shorting still produces profits resulting from bad actors: while a short strategy does not require an investor to hold the stock directly, the investor still benefits when the company's stock price moves. Some

[3] https://www.usatoday.com/story/tech/2017/09/26/timeline-events-surrounding-equifax-data-breach/703691001/

[4] https://www.npr.org/sections/thetwo-way/2017/09/08/549434187/3-equifax-executives-sold-stock-days-after-hack-that-wasnt-disclosed-for-a-month

investors may want nothing to do with bad actor companies, whether they are benefiting from the company's good or bad fortune. The investor who is disgusted with Equifax's corporate governance failures may be glad to see the firm's stock price drop, but they personally may not want to realize any gain from the scandal.

Investors who are not interested in profiting from short selling poor ESG performers are unlikely to be comfortable with any short strategy and thus should be in a long-only portfolio. If you are an investor who cares about the advancement of sustainability issues, you simply do not have another way to add a short strategy to your portfolio apart from shorting the bad actors. Shorting positive or neutral ESG performers will have negative effects on those companies, which would be counterproductive for the socially conscious investor. In addition, as an ESG investor, you have accepted that good ESG characteristics translate into positive impacts on the stock's price and risk, so you would be essentially shorting against your own investment thesis.

Beyond the financial benefit to the investor, there are other effects to shorting poor ESG performers that sustainability-focused investors will appreciate. One major benefit of shorting the bad actors is that it sends a signal to the market that the stock may be overvalued, which may cause other investors to assess their own positions in the stock. Without a short strategy, an investor can only express a negative opinion about a stock by not holding that stock to begin with. Taking a short position, however, allows an investor to more publicly provide a vote of no confidence. Any investor can easily research the size of all the aggregated short positions on a given stock and take that information into account when deciding whether or not to buy into or maintain a position.

Sustainability-focused investors who choose to short companies with poor ESG performance are contributing to skepticism about those firms' performance in the market at large. In theory, this can affect the short-term stock price of the firm but also its long-term outlook for investors, who may become more hesitant to invest. Shorting a stock will theoretically increase the firm's cost of capital, which can have an impact on the firm's ability to undertake new projects. This can be costly to the firm, which, in turn, may encourage the firm to improve its performance on ESG issues so it is better able to attract investors. Shorting the bad actors can also help increase the spread between positive ESG firms and the bad actors, benefiting both the ESG investor and the broader market.

Conclusion

For the sustainability-focused investor, it is becoming increasingly simple to take long positions in companies that match your values, but adding short positions to your portfolio remains challenging. Short selling opportunities do exist for values-oriented investors in the form of the "bad actor" firms. While it does create the potential to profit off of the bad actors, participating in a short strategy can have positive social and financial impacts along with portfolio diversification benefits, and should be considered as part of a comprehensive investment strategy.

This commentary is prepared by Pekin Singer Strauss Asset Management ("Pekin Singer") for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of any security. Short sales theoretically involve unlimited loss potential since the market price of securities sold short may continuously increase. The information contained herein is neither investment advice nor a legal opinion. The views expressed are those of the authors as of the date of publication of this report, and are subject to change at any time due to changes in market or economic conditions. The comments should not be construed as a recommendation of individual holdings or market sectors, but as an illustration of broader themes. Pekin Singer cannot assure that the type of investments discussed herein will outperform any other investment strategy in the future. The companies and securities referenced in this paper do not necessarily represent current or past recommendations made by Appleseed Capital or Pekin Singer to clients, nor do they necessarily represent positions we hold currently or have held in the past.