“We are shorting your stock”: Combining sustainability-based shorting with engagement

Dr. Ralf Seiz*
CEO Finreon, Lecturer University of St.Gallen

Arnaud Gougler, M.A. HSG, CESGA
Finreon

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Abstract

Limiting global warming to below two degrees Celsius by the end of the century has become a political and social consensus. This paradigm shift is also influencing the investment strategies of investors, who are searching for new ways to contribute to the transition. In the following paper, we present an innovative strategy for investors in liquid markets that combines shorting and engagement. Short positions have the advantage of both reducing the climate risk exposure of investors while at the same time expressing their sustainability views through the market signal produced. In this working paper, we show how combining short positions and engagement with the shorted companies can help clarify the market signal, aligns incentives between investors and companies and can complement other sustainable investment approaches. The working paper is meant to be enriched with empirical data in a later stage.

* Contact: ralf.seiz@finreon.ch

1. Introduction

Climate change is increasingly becoming reality and has already profound effects on society and the economy. Accordingly, limiting global warming to below two degrees Celsius by the end of the century has become a political and social consensus. In order to achieve this goal, global greenhouse gas (GHG) emissions must reach net zero by 2050. This transition involves profound changes in how we produce energy, manage resources, and conduct business. Such a transition is associated with major risks for unsustainable companies with, among other things, high greenhouse gas emissions, whereas it represents an opportunity for forward-looking companies.

This paradigm shift is also influencing the investment strategies of investors. On the one hand, this means that greater transparency and disclosure about the extra-financial characteristics of portfolios is required. On the other hand, investors are also expected to contribute to the transition. However, investors – especially in liquid markets such as listed equities or bonds – do not have the same influence channels as companies when it comes to contributing to the transition.

While a company can directly affect the real world by e.g. cutting GHG emissions (= company impact), investors cannot directly impact the real world. As a matter of fact, reducing the financed carbon footprint of a portfolio – by e.g. selling stocks of a company with high GHG emissions – does not lead to an immediate reduction of GHG in the atmosphere. Rather, investors can indirectly influence companies through various impact channels, which will in turn lead to real-world effects (= investor impact)[1].

1.1 Academia has identified several impact channels for investors

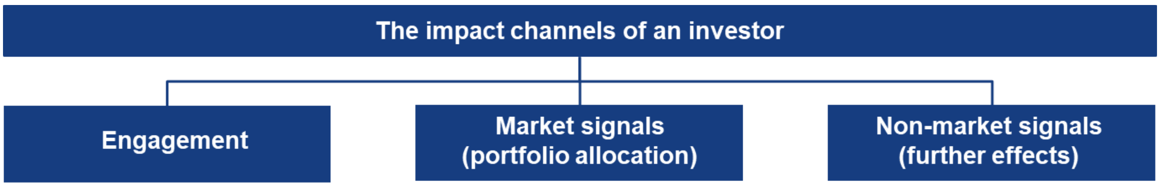

Illustration 1: The three channels of investor impact in liquid markets. Own illustration based on Wilkens et al., 2022.

In the realm of the investor impact, academia generally recognizes three different types of impact channels[2]. Next to market signals (investment and divestment activities) and non-market signals (such as generating information or raising awareness), engagement plays a key role in the impact toolkit of investors, especially in liquid markets (e.g. listed equities and bonds). Engagement refers to the process by which investors interact with companies to influence their behaviour and decisions, particularly in areas related to corporate governance, social responsibility, and environmental practices. Several papers have shown the effectiveness of engagement for instance on companies' environmental, social and governance (ESG) performance[3] or their corporate climate policy[4]. While traditionally, engagement has been in the spotlight for shareholders wishing to influence

[1] See e.g. Busch T., Pruessner E. & Brosche H. (2023). Principles for Impact Investments: Practical guidance for measuring and assessing the life cycle, magnitude, and tradeoffs of impact investments. *Working Paper*. Available at SSRN, also Heeb, F. & Kölbel, J.F. (2021). The Investor's Guide to Impact; evidence-based advice for investors who want to change the world. University of Zurich, Center for Sustainable Finance and Private Wealth (CSP). Available at csp.uzh.ch.
[2] Wilkens, M., Jacob, S., Rohleder, M., Zink, J. (2023). The Impact of Sustainable Investment Funds – Impact Channels, Status Quo of Literature, and Practical Applications. Available at *SSRN*.
[3] Barko, T., Cremers, M. & Renneboog, L. (2021): Shareholder Engagement on Environmental, Social, and Governance Performance. Journal of Business Ethics. Available at Springer.com
[4] Heeb, F. & Kölbel, J. F. (2024). The Impact of Climate Engagement: A Field Experiment. Swiss Finance Institute Research Paper, No. 24-04. Available at SSRN.

the policies and practices of their portfolio companies on environmental, social and governance questions, organizations and investors are increasingly recognizing the potential of engagement in a broad sense[5] for catalysing real-world change, especially because global warming is already unfolding its consequences and it is key that all actors use the levers at their disposal to try and influence the economy.

1.2 Combining shorting with engagement as an emerging strategy

Shorting refers to an investment practice that involves taking a position in a financial instrument by borrowing an asset (such as e.g. a listed equity) and selling it. The instrument must later be returned to the party from which it was borrowed[6]. By taking a short position in a financial instrument (i.e. selling it), the investor gains a negative economic exposure towards the company underlying the instrument[7] and sends a market signal[8]. The United Nations Principles for Responsible Investing (2021) observes that a growing number of their signatories use shorting in their investment portfolios. As a matter of fact, the organization recognizes[9] that taking a short position (whether physical or synthetic) reflects an economic exposure that has real-world implications for employees, the environment and affected stakeholders. Used in the framework of a sustainable investment approach, Shorting can be:

- a strategy to signal that an entity, security, or asset may be inaccurately priced due to its insufficient consideration of environmental, social, and governance factors in its operations. Such an approach supports the fiduciary duties of investment managers and asset owners.
- 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”.
- a strategy to mitigate the aggregate exposure of a portfolio to significant risks associated with ESG factors.[10]

Short positions thus have the advantage of helping investors reduce their climate risk exposure while at the same time helping them to express their sustainability views. In that sense, short positions accompanied by the impact channel of engagement can help convey a view regarding ESG-related risks, practices or policies[11]. In the following, the working paper shows how engagement coupled with short positions can lead to positive outcomes both for investors, the broader market and society because it helps clarify the market signal, because it aligns incentives and because it can complement other sustainable investment approaches. The working paper is meant

[5]Engagement can be conducted by various stakeholders and be addressed to various organizations, see e.g. UN-convened Net-Zero Asset Owner Alliance. (2022) The Future of Investor Engagement: A call of systematic stewardship to address systemic climate risk. Available at unepfi.org. See also Swiss Sustainable Finance and AMAS (2023). *Swiss Stewardship Code*. Available at www.sustainablefinance.ch.
[6] A short position can also be entered synthetically (with e.g. a contract for difference).
[7] Seiz, R., Vial, C. & Gougler, A. (2023). Avoiding greenwashing in investment portfolios through consistent emissions classification and transparent reporting of derivatives. Available at SSRN.com
[8] Furdak, R., Xiang, V. & Zheng, D. (2020).The Big Green Short. Man Institute Analysis. Available at man.com
[9] United Nations Principles for Responsible Investment. (2021). Shorting and Responsible Investment: A Review. Available at UNPRI.org.
[10] For the motivations underlying the use of such financial instruments, see also Varsani, H. et al. (2024). ESG and Climate Reporting with Derivatives. MSCI Research Insights. Available at MSCI.com.
[11] United Nations Principles for Responsible Investment. (2021). Shorting and Responsible Investment: A Review. Available at UNPRI.org.

to be enriched with additional information, especially empirical results once Finreon's initiative combining shorting with engagement will have delivered representative data that can be analysed and included in this working paper.

2. Engagement on the short side clarifies the market signal

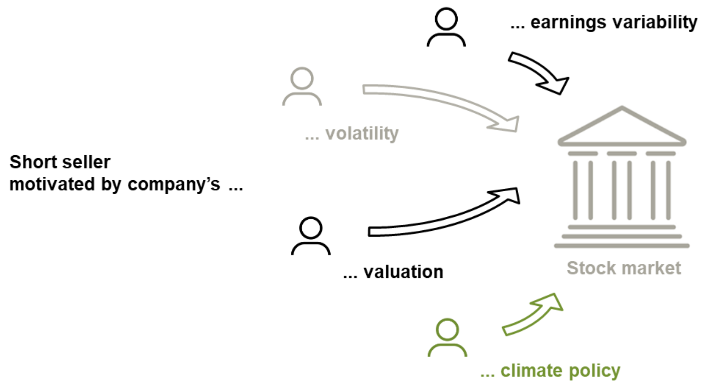

Illustration 2: Examples of motivations behind taking a short position through the stock market.

Traditionally, investors have shorted companies because they anticipate a decline in the share price due to financial reasons. This includes beliefs that the company is overvalued or that it might be in financial distress. To a lesser extent, investors have also been using short selling as a means to hedge against the risk of a downturn in a specific sector or due to a specific factor to which a company might be exposed. As seen in section 1.2, climate-related or ethical reasons are also increasingly playing a role in taking short positions on specific companies (see illustration 2). The activity of short sellers is generally considered beneficial to the price discovery process, as noted e.g. by Boehmer & Wu[12] (2013), because it helps accelerate the incorporation of public information into prices, among others. Using temporary bans on short selling during different periods in various countries to study the impact of short selling, Bohl & al.[13] (2012) find that banning short-selling was detrimental to stocks return volatility. Beber & Pagano[14] (2012) further show that banning shorting resulted in lower liquidity and slowed price discovery. Moreover, short positions typically attract the attention of a company's management because of the message it sends and the impact it can have[15].

Because it has historically been conducted due to reasons linked to the financial situation of a company, an investor shorting a company for extra-financial or climate-related reasons should therefore proactively engage with a shorted company to clarify the reasons. Because short interest matters to corporate managers, a short position is also a novel way to attract their attention to engage on sustainability-related topics. Conducting engagement then provides shorted companies with a more in-depth understanding of why it is being shorted. It allows the investors to express

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[12] Boehmer, E. & Wu, J. (2013). Short Selling and the Price Discovery Process. The Review of Financial Studies, 26, 2, 287–322, Available at https://doi.org/10.1093/rfs/hhs097

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[14] Beber, A. & Pagano, M. (2012). Short-Selling Bans Around the World: Evidence from the 2007–09 Crisis. The Journal of Finance. 68, 1, 343-381. Available at https://doi.org/10.1111/j.1540-6261.2012.01802.x

[15] Furdak, R., Xiang, V. & Zheng, D. (2020). The Big Green Short. Man Institute Analysis. Available at man.com

both through the market signal and the engagement activity its view on e.g. the company’s insufficient consideration of ESG factors in its operation, the company’s lagging climate policies, or too high level of greenhouse gas emissions. On the one hand, it clarifies that the stock is being shorted and the reasons behind the short position. On the other hand, it sends a clear signal to companies that climate concerns matter to investors and that these investors use all available impact channels to try and influence companies in taking steps to accelerate the transition.

3. Engagement on the short side helps align incentives

A typical strategy used in traditional shareholder engagement is to escalate their stewardship activities to encourage investee entities towards generating long-term financial and societal value and towards reaching positive and long-term sustainable outcomes. When the engagement is considered to be failing, one of the “last resort” measures would be to divest or inform the company about the intention to divest[16]. Some companies value engagement dialogues and view engagement as a constructive way to increasingly consider extra-financial factors in their strategy and operations. Others tend to rely on cheap talk. For instance, Bingler, Kraus, Leippold and Webersinke (2024)[17] have used a natural language processing methodology to identify climate-related cheap talk in annual reports in order to discern between genuine and unspecific climate commitments and to understand the quality of the firms’ climate-related pledges. The authors find that the level of cheap talk in annual reports (approximated by a cheap talk index) has steadily increased between 2010 and 2020, with an overall rise of close to 80% for companies in the MSCI World index. Among other things, the study reveals a correlation between cheap talk and higher emissions growth. Firms with higher levels of unspecific climate commitments tend to show less progress in reducing their greenhouse gas emissions. This underscores the importance of specificity and actionability in corporate climate commitments for achieving real emission reductions. In a similar fashion, Coen, Herman and Pegram (2022)[18] also find that corporate climate talk does not consistently translate into climate action, with some commitments being genuine and others constituting 'greenwashing'.

Because climate commitments require time to take shape and because the risk of cheap talk is present, the escalation process found in traditional shareholder engagement might in some cases fail to set the right incentives. This could be due to several reasons:

- Some investors might have to stay invested in some specific stocks, e.g. for diversification purposes, because they invest passively in an index or because of historical ties to the company. Therefore, even though they conduct engagement with the companies, such investors would not divest from companies not taking action. These investors might therefore rely on cheap talk to avoid the ultimate steps of the escalation process, i.e. divesting.
- Due to the structure of the escalation process of traditional engagement concepts, some investors might take years before informing their intention to divest from a company with whom they are engaging on climate-related topics and which is lagging behind or which

[16] Swiss Sustainable Finance and AMAS (2023). *Swiss Stewardship Code*. Available at www.sustainable-finance.ch.
[17] Bingler, A., Kraus, M., Leippold, M. &Webersinke, N. (2024). How Cheap Talk in Climate Disclosures Relates to Climate Initiatives, Corporate Emissions, and Reputation Risk. Swiss Finance Institute Research Paper Series, Nr. 22-01. Available at SSRN.
[18] Coen, D., Herman, K. & Pegram, T. (2022) Are corporate climate escorts genuine? an empirical analysis of the climate 'talk-walk' hypothesis, Business Strategy and the Environment 31(7). Available at discovery.ucl.ac.uk

might have used cheap talk. This slow discovery is not aligned with the need for the economy to rapidly take concrete measures to fight climate change.

- Because of the "last resort" nature of divestment and its potentially far-reaching consequences for a portfolio, shareholder engagement with companies might be focussing on aspects that are less material or require less efforts from companies (so-called low-hanging fruits). This focus might take place at the expense of climate-related topics that would have positive consequences on the climate but that require more time, resources and effort (due e.g. to other concurring factors, to the necessity of change management, to finding in-house support at the company and getting the approval of the board, etc). This would seriously undermine the incentivizing nature of divestment as a last resort.

Using a combination of sustainability-based short positions on companies that fail to meet certain climate-related criteria and then engaging with them on those topics can reverse the traditional escalation process. Instead of remaining invested and thus having a positive exposure to a lagging company, the short position allows for a negative exposure towards such a company. The short position can then remain open until the company proves that they have met concrete measures to remedy their weaknesses or that they are on a plausible transition path. The short position sends a negative market signal that is consistent with the investors' view and incentivizes the shorted company to take the necessary steps to have the position removed. With engagement, investors can clearly communicate to the company which aspects need to be improved before the short position can be reversed. In the engagement process, the company can also share concrete steps taken and have a constructive discussion with the sustainability-minded investor. Both sides then have an incentive in the companies improving the climate-related aspects in question. Should the company improve and the short position be removed, the investor can then consider taking a long position in the company to provide a positive signal and invest in a company that is now aligned with its sustainable investment criteria and has proved it takes climate-related concerns seriously and acts accordingly.

4. Engagement on the short side can complement other approaches

	Short position	No position	Long position
Sustainable investment strategies	ESG short strategies Carbon swaps	Exclusion	Sustainability-themed investment Best-in-Class investment selection ESG integration Norm-based screening
Market signal	negative	-	positive
Economic exposure	yes	no	yes
Likelihood of engagement	high	low	high

Illustration 3: The characteristics of different sustainable investment approaches.

Sustainable investing encompasses a variety of approaches aimed at integrating sustainability-related criteria into investment decisions. One family of strategies consists in investing based on criteria linked to sustainability: sustainability-themed investment involves allocating capital to companies that demonstrate robust climate change mitigation strategies, are leaders in reducing carbon emissions or are active in specific sectors. Another option would be to integrate ESG criteria to all investment decisions in a portfolio or to use these ESG criteria to choose the best companies in each sector (Best-in-Class). Other investors choose to use international norms and principles to decide whether to allocate capital to certain companies that align with these very norms. Such investment strategies send a positive market signal about these companies to the market and contribute to its financing. Consequently, investors also build up an economic exposure to these companies. Because they have stakes in the company, these investors might also successfully engage with management.

Many investors also choose to exclude certain sectors, companies, or practices from an investment portfolio based on specific ESG criteria (also known as negative screening). This approach is one of the earliest forms of sustainable investing and remains popular for its straightforward application and clear ethical stance. By using this approach, investors make sure they are not investing in activities they deem unethical or detrimental to e.g. the climate. With no investment, they do not send any market signal nor do they have an economic exposure to those companies. For this reason and depending on the specific conditions, the likelihood of engaging with these companies might be low.

The last family of sustainable investment strategies uses short positions to express views on the climate-related efforts of companies. Next to hedging sustainability-related risks, these strategies allow the investors to send a negative market signal. This also leads to investors having a direct economic exposure towards these companies. As a consequence, and for the reasons aforementioned, the likelihood of engagement increases. This family of strategies widens the horizon and the tools accessible to investors in several ways:

- It broadens investor impact: While investing with other strategies supports those that are already making positive steps in sustainability or makes sure that investors do not benefit from activities they deem unsustainable, shorting and engaging with laggards address the other end of the spectrum. This dual approach ensures that the impact of sustainable investing is not limited to rewarding current leaders but also fosters improvement among those yet to make significant progress and in that sense complements existing approaches.
- It incentivizes change: Shorting the stocks of companies with poor sustainability records sends a market signal about the financial consequences of inadequate practices. When combined with direct engagement, where investors communicate their concerns and suggest improvements, it provides a clear incentive for companies to adapt their strategy. This approach allows an investor to use the full spectrum of possibilities the market offers (shorting, excluding or going long) to encourage better environmental and social governance practices.
- It enriches risk management: By shorting companies with poor sustainability performance, investors can hedge their portfolios from risks associated with unsustainable practices. This approach therefore complements other strategies that aim at gaining a positive exposure towards sustainable practices. Thanks to the combination of short positions with engagement, the approach is proactive and dynamic in the sense that engagement aims at fostering improvements in those shorted companies, which means that short positions (and therefore the hedging) might also be reversed if the companies improve.
- It fosters credibility: Engaging with companies on sustainability issues while holding short positions can enhance the credibility of sustainable investors. The short position shows the investors’ clear negative view on the current sustainability-related practices of companies and their potential impact on the companies’ valuations. Moreover, it demonstrates a

commitment not just to avoiding harm but, in the meantime, actively seeking to improve corporate practice, even with those companies that are among the most unsustainable ones. This can gain companies’ attention and therefore open the doors to a constructive dialogue with shorted companies.

5. Summary

Climate change is now and its consequences are already materializing. Accordingly, limiting global warming has become a political and social consensus. This paradigm shift is also influencing financial markets and the investment strategies of investors. Even though investors cannot directly change the world, they can indirectly influence companies, which have a real-world impact. To do so, investors have several impact channels at their disposal, namely engagement, market signals and non-market signals. By combining short selling - i.e. a negative market signal - with engagement, investors can have a more comprehensive impact on corporate behaviour.

This approach uses short selling to both send a negative market signal and simultaneously allows the investor to hedge the risks associated with unsustainable corporate practices. The approach combines short selling with engagement to clarify the investor's sustainability-related rationale behind the short position. It thus provides companies with a more in-depth understanding of why it is being shorted. Short interest matters to managers can gain their attention, but it has historically been conducted due to reasons linked to the financial situation of a company. Therefore, an investor shorting a company for extra-financial or climate-related reasons should proactively engage with a shorted company to signal that such concerns matter to investors and help them accelerate their transition.

Furthermore, taking a short position on companies that fail to meet certain climate-related criteria and then engaging with them on those topics can help align incentives in the escalation process: The short position will remain open until the company can prove that they have met concrete measures to remedy their weaknesses or that they are on a plausible path. As a next step, the investor can then consider taking a long position in the company to provide a positive signal. This contrasts with the escalation process in traditional shareholder engagement strategies, where divesting or informing the company about the intention to divest is seen as a “last resort” measure. We have shown some scenarios in which this type of escalation process might be prone to "cheap talk" or might fail to deliver the intended incentives in due time. The reversal of the escalation process that takes place when combining short positions with engagement underscores the urgency for immediate action against climate change and fosters a more proactive dialogue between investors and companies

Finally, we argue that sustainability-based short positions coupled with engagement complements the sustainable investment approaches available. It extends the impact of investing by targeting both sustainability leaders and laggards, enhances risk management through enabling negative exposure to sustainability risks and promotes a proactive and exposure-based engagement strategy. This approach to sustainable investing leverages the full spectrum of market signals to drive change, encouraging both rewards for sustainability leaders and support for improvements in those lagging behind by providing a clear incentive. Ultimately, we advocate for an integrated approach to sustainable investing, where the synergy of shorting and engagement emerges as a potent tool for advancing sustainability improvements and accelerating the transition of the economy towards a more sustainable future.

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