

Short, But Sweet: Returns from Irresponsible Companies

By *Robert Furdak, Man Group* – Let's conduct a thought experiment. There exists a factor which many people contend causes some stocks to outperform.

Most hedge funds would argue that there is a simple way to exploit this. Buy the stocks positively exposed to the factor, short stocks negatively exposed, and construct the portfolio so that it remains neutral to the movement of the index itself. Indeed, betting on both the long and short side is an intrinsic part of being a hedge fund: this is how we 'hedge'.

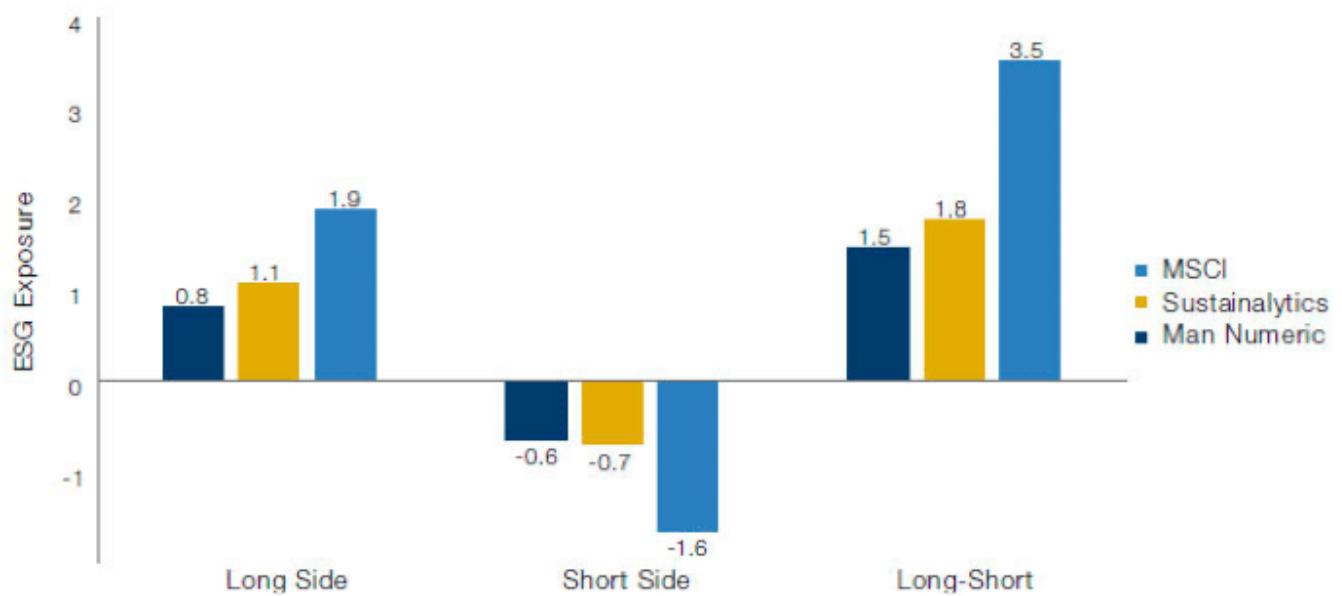
If this decision was taken with reference to traditional factors it would be so passé as to be unworthy of comment. But what if the factor in our experiment above is a company's environmental, social and governance ('ESG') ranking?

For some reason, when it comes to responsible investing, very few investors wish to discuss shorting, happy simply to restrict names which don't match their values and move on. By failing to short companies which rank poorly on ESG criteria, we implicitly take one of two views: 1) that we are prepared to sacrifice performance for moral rectitude; or 2) we believe firms who have good ESG performance will (vastly) outperform peers, so there is no need to focus on the poorly ranked companies.

SHOULD YOU SHORT IT?

To explore the implications of shorting 'bad' ESG companies, we constructed sector-neutral, decile long-short portfolios from a universe of about 4,500 of the most liquid developed market stocks between 1 January, 2013 and 31 December, 2019. Portfolios are formed by longing (shorting) the best (worst) 10% of firms within each sector, selected based on various ESG characteristics. We examined three broad-based strategies, including two commonly used data vendors (MSCI and Sustainalytics ESG rankings) as well as Man Numeric's proprietary ESG model. Man Numeric's proprietary ESG model is based on 15 fundamental ESG pillars, which are sector neutral and neutral to common factors. We also evaluate performance from the long (short), high (low) carbon efficiency level data from Trucost and an event-driven strategy built by shorting firms associated with negative ESG news using natural language processing ('NLP') techniques – something we have previously covered in our paper "Natural Language Processing: Shakespeare Without the Monkeys".

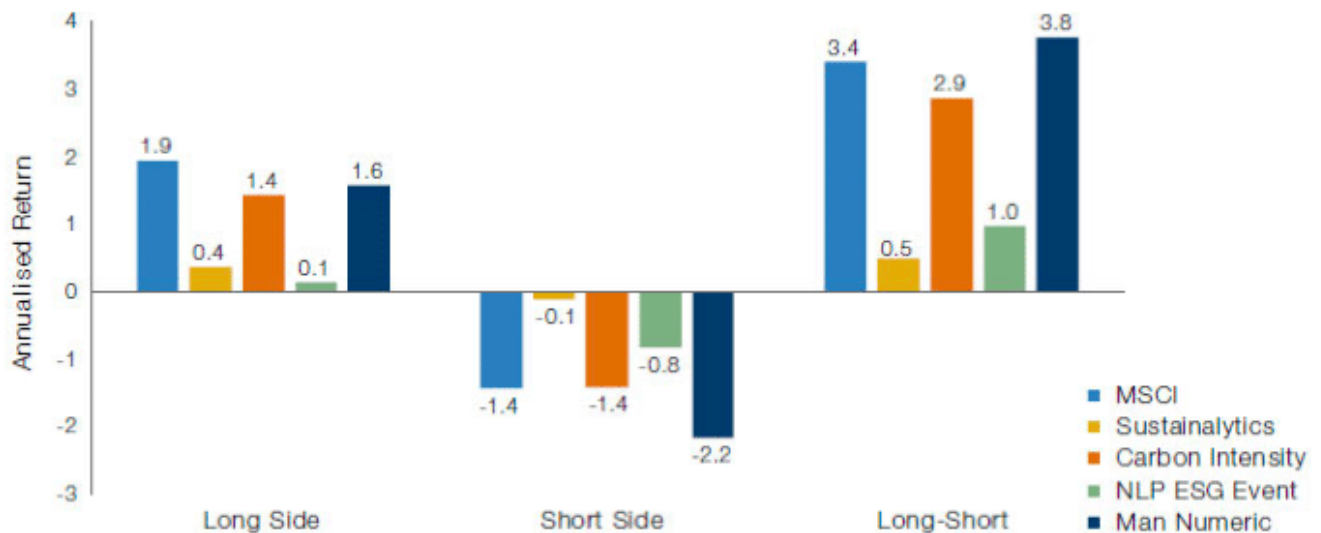
Figure 1: Shorting Doubles Portfolios' ESG Exposure



Source: Source: MSCI ESG score, Sustainalytics ESG score: as at 31 December 2019

By shorting, one can almost double a portfolio's overall exposures to ESG factors (Figure 1). The sector-neutral decile return (Figure 2) shows that firms with poor ESG performance underperform in the market. Moreover, our analysis indicates that returns were about equal from both the long side and short side of all broad-based ESG strategies, including MSCI, Sustainalytics and Numeric models, as well as the carbon-efficient strategy. NLP news-driven strategies have a stronger return from the short side than the long side.

Figure 2: Bad ESG Companies Have Underperformed



Simulated past performance is not indicative of future returns.

Source: MSCI ESG score, Sustainalytics ESG score: as at 31 December 2019

All model spread performance shown is gross-of-fees and does not represent the performance of any portfolio or product. To calculate long-only model spreads, we invest in the top 10% ranked names within each sector and display the gross of fees return. To calculate long-short model spreads, we invest long in the top 10% ranked names within each sector and are short the bottom 10% ranked names within each sector and display the gross of fee return. These spread returns are instantaneously rebalanced and do not reflect transactions costs. Rankings are based on Man Numeric's internal Alpha model scores.

The simulated data should not be used as a guide to the future. This approach has inherent limitations, including that results may not reflect the impact material economic and market factors might have had on an investment manager's decision-making and/or the application of any trading models had a strategy been managed throughout the period over which the simulated performance is illustrated.

Shorting poor ESG firms can offer other added benefits. Analysing the Barra factor exposures of the long and short sides of the portfolios (ranked on Man Numeric proprietary ESG scores) illustrated that betting against bad companies greatly reduces portfolios' risk and lowers the drawdown. As shown in Figure 3, we found that while both groups had lower residual volatility than the overall universe, the stocks with good ESG scores had much less residual volatility exposure. Moreover, poorly ranked ESG firms had much lower investment quality, lower earnings quality, and lower profitability.

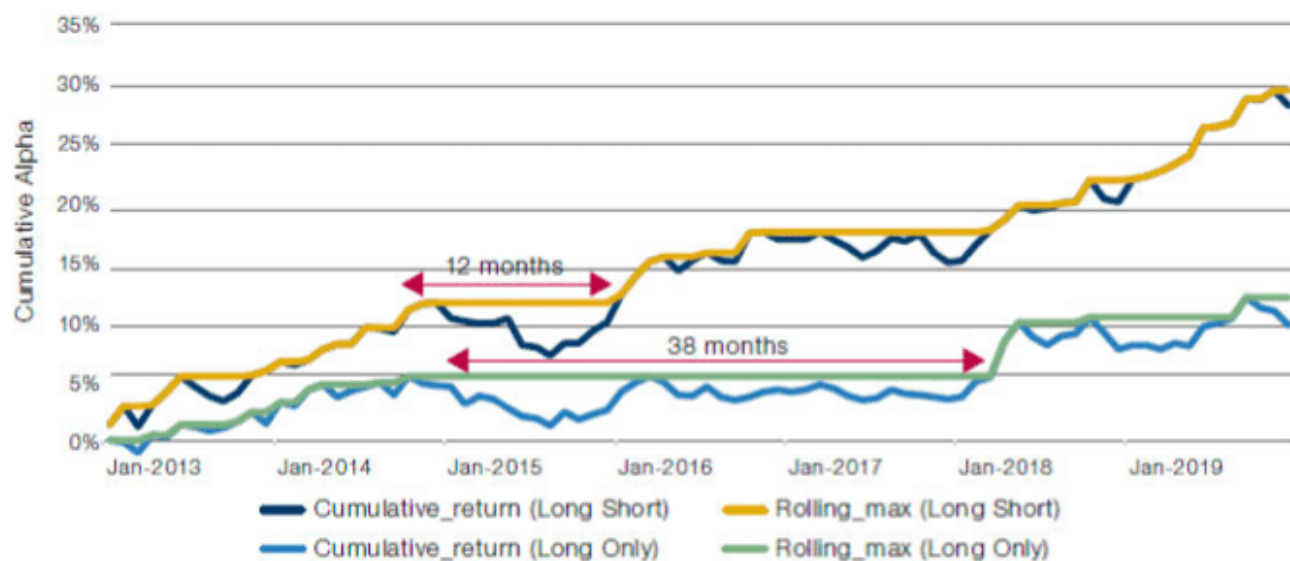
Figure 3: Portfolio Exposure to Barra Risk Factors, Bucketed by ESG Scores



Source: Barra risk model. Man Numeric: as at 31 December 2019

We further compared the drawdown patterns of the long-short portfolio and long-only portfolio. Figure 4 shows the cumulative returns from 2013 to 2019 for both portfolios. First, we found that the long-short portfolio realised more than double the cumulative return compared with the long-only portfolio at the end of 2019. From 2015 to 2016, both portfolios experienced drawdowns, with the maximum peak-to-trough decline of 4.3% for the long-short portfolio, while the long-only portfolio had a 4.1% drawdown. Though the long-only portfolio had a slightly lower absolute drawdown, it took more than three years to exceed the prior peak level, while it only took a long-short portfolio 12 months to recover the loss.

Figure 4: Long-Short Portfolios Are More Resilient Than Long-Only Portfolios



Simulated past performance is not indicative of future returns

Source: Bloomberg, Man Numeric: Between 1 January 2013 to 31 December 2019

Performance is gross of any fees or expenses and should be considered hypothetical. The simulated data should not be used as a guide to the future. This approach has inherent limitations, including that results may not reflect the impact material economic and market factors might have had on an investment manager's decision-making and/or the application of any trading models had a strategy been managed throughout the period over which the simulated performance is illustrated.

In our simulations, shorting poor ESG companies allowed portfolios to achieve a higher exposure to ESG signals and realise higher returns, lowering overall risk exposure and drawdown. Thus, it is natural to ask: why not profit from both good and bad companies, especially if those companies are unfriendly to the environment, employees or shareholders?

Furthermore, it allows portfolios to properly capture the value of a growing risk: the risk that companies fail to deal with the transition to more responsible models of operating, overstating the value of potentially stranded assets and failing to account correctly for the ESG risks to which their businesses are exposed.

More importantly, however, going short marks the evolution of responsible investment from a more passive approach (that just excludes stocks based on a categorical restriction list) to a more active approach that uses all available information to fully reflect their views in their positioning.

CONCLUSION

We recognise that some investors operate under constraints which could make shorting or even holding poorly ranked ESG stocks inappropriate. However, for those who are not constrained, it seems illogical not to harvest the full spectrum of available ESG information. Indeed, maximising performance is a fiduciary duty for investors. If that can be done while taking responsible investment one (short) step further, why not do it?

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