STANDARDS BOARD FOR ALTERNATIVE INVESTMENTS

Practical Implementation of Responsible Investment in Equity Long/Short Strategies

SBAI Toolbox

1. Introduction

Equity-based strategies are diverse, investments can be in both public and private equities, make use of long and short positions, and may include derivative positions. Discussion on Responsible Investment ("RI") within equity strategies has historically been centred on traditional long only portfolios. However, with RI rising in both importance and prominence across all asset classes and strategies, long/short equity portfolios are now also in focus.

The nature of equity instruments – ownership in public or private companies – means there are increased opportunities for implementation of RI using exclusion, inclusion, or impact strategies. These instruments also typically offer a range of possibilities for engagement. Each of the instruments and investment techniques used within equity long/short strategies have different considerations for both integration of financially material RI risks and dedicated RI products with specific objectives.

As discussed in our Toolbox Memo on a Responsible Investment Policy Framework (SBAI Policy Framework) we have defined the spectrum of approaches to RI as follows[1]:

- **Responsible Integration:** Including financially material RI related risks in the investment process but not pre-defining an investment universe using RI criteria
- **Responsible Asset Selection:** Dedicated RI approaches including exclusions, inclusions, and impact strategies.
- **Responsible Asset Ownership:** Voting, engagement, and activism.
- **Responsible Corporate and Market Citizenship:** Organisational initiatives, market behaviour, and carbon offsetting. These practices are strategy agnostic and therefore not covered within this memo[2].

This memo will assess each of these as they apply to equity long/short strategies and the instruments traded.

> This memo forms part of a series of SBAI Toolbox memos helping institutional investors and asset managers increase their understanding of how RI can be applied to different alternative investment strategies including equity long/short, macro, credit, systematic, and insurance linked strategies.
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> The memos are designed to be used in conjunction with the SBAI Policy Framework.
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> Please see our SBAI Responsible Investment Toolbox for further information.

[1] Fuller explanations of these categories can be found in Appendix A

[2] See the SBAI Toolbox Memo on an RI Policy Framework within the SBAI Responsible Investment Toolbox for further information.

2. Executive Summary: Responsible Investment in Equity Long/Short Strategies

Equity long/short strategies predominantly invest in three broad types of instruments:

- Public Equities,
- Private Equities (such as private placements or pre-IPO positions within liquid portfolios), and
- Equity Derivatives (single name, baskets, and indices).

There are nuances to both the availability of data and the practicality of implementing different RI approaches to each of these instruments which are summarised at a high level below:

Public Equities	Private Equities	Derivatives
Data: Listed equities are typically covered by most data vendors and several jurisdictions have mandated (or are in the process of mandating) issuer disclosures on climate risks. There remain challenges in certain jurisdictions and coverage decreases with market cap. **RI:** Typically, implementation of RI is relatively more straightforward in public equities due to the increased availability of data and a clearer view on the impact of any investment on RI objectives. For long positions in particular, engagement is enhanced due to voting rights attached to these securities.	**Data:** There is increasing data coverage of private assets by third party consultants, but availability remains much lower relative to public equities and will likely require fundamental research. **RI:** Typically, implementation of RI is relatively straightforward in private equities (subject to resources for fundamental research or data availability). Asset managers will typically have increased access to or control over management teams and company policies.	**Data:** Where a derivative is based on a public equity then there is likely to be available data. For those based on indices or baskets of securities there may be additional challenges in sourcing data. **RI:** Careful consideration would have to be given as to whether dedicated approaches using derivatives achieve the stated RI objectives. Engagement will be limited as these securities do not typically have access to the companies and do not have voting rights attached

Strategy Considerations

In all alternative investment products, there may be additional complexities to implementing RI depending on the characteristics of the strategy. Asset managers running dedicated RI products should consider some of the following things to ensure the product meets any specified RI objectives:

Long vs Short Positions	Time Horizon
Whether a position is held long or short could have an impact on whether the investment satisfies any RI objectives. For example, managers may want to consider whether exclusion lists would apply to both the long and short book of the portfolio.	Positions held for a longer period of time may increase opportunities for meaningful engagement with issuers on RI related issues. However, strategies with a shorter time horizon could consider engagement at a sector or industry level rather than an individual security level.
Portfolio Concentration	**Hedging**
Concentrated portfolios typically have larger positions, meaning engagement and any exclusions or inclusions could have increased impact. Asset managers with concentrated portfolios may also have more resources per position than more diversified portfolios. For more diverse portfolios thematic exclusions and industry or sector level engagement may be able to achieve any specific RI objectives.	Asset managers have a fiduciary duty to manage the risk in the portfolio appropriately and may be required to hedge certain risks. This may mean that instruments not necessarily aligned with RI objectives may be present in the portfolio. Engagement remains possible regardless of the reason the security is being held in the portfolio.

3. Practical Implementation of RI in Equity Long-Short Strategies

Data

Data is an important component for both integration of financially material risks and dedicated RI approaches. Typically, data is either purchased from a vendor or sourced by an internal research team. The SBAI Policy Framework discussed the following considerations about ESG data in general:

- Inconsistency of data and ratings across vendors,
- Data may be delayed and not reflective of recent events,
- Differences in methodologies for aggregation of E, S and G scores and weightings,
- Lack of consistency in issuer disclosures globally,
- Risk of cherry picking by selecting the vendor that produces the best portfolio scores, and
- Thorough due diligence being required to ensure that the vendors methodologies align with the portfolio's objectives.

Data for equities or single name equity derivatives is the most established within the alternative investment asset classes. Many jurisdictions mandate that listed issuers produce RI related data (although there is a heavy focus on climate related disclosures versus other ESG data points). This data can be biased towards large market cap issuers in more developed jurisdictions for a combination of reasons, including regulatory frameworks and the availability of resources to provide reliable and consistent data. Equity strategies focused on small or mid cap issuers or emerging markets may find sourcing data to be less straight forward and may have to rely more on fundamental research.

For fundamental research investment approaches, it may be more straight forward (relative to other alternative asset classes) to source data via in-house research where it is not available from a vendor or public disclosures. Investments in private placements or smaller IPOs may offer opportunities to make the investment contingent on the production of RI-related data if the size of the investment is large enough relative to the overall offering (this may not be effective for investments with scarce capacity).

Responsible Integration

The inclusion of RI-related factors into investment and risk management processes, where they have financial materiality. This involves the use of all relevant financial and non-financial information to aid asset valuation and risk assessment, but RI factors are not used to pre-define an asset universe.

As the focus on RI related risks has increased, these risks have begun to feature more prominently in the investment process. In the SBAI Policy Framework we highlighted the importance of a flexible and well understood process to ensure that time and resources are spent on the financially material risks to the strategy.

Public and Private Equities

As data, for the most part, is commonly available on public equities (especially for large cap issuers in developed markets), integration of financially material RI related risks should be relatively straightforward. As with any other risk factor, the complexity lies in understanding which RI related risks are financially material to the specific investment.

For private equity such as pre-IPO positions and private placements, data is not as widely available through third party vendors (although there is an increase in consultants moving into the space). These types of investments typically rely more on fundamental analysis and therefore questions on RI related practices can be factored into the investment due diligence process.

Derivatives

For derivates based on single name equity positions, typically if data is available for the equity, then it is also available for the derivative. Holdings of baskets of equities or exposure to indices; however, comes with additional data challenges due to exposure to several underlying issuers.

Where data on the individual security is available (either through vendors, issuer disclosure, or fundamental research) then integration of financially material RI related risks could be completed via a look through to the underlying positions. Where this level of transparency is not available, or not practical given the strategy, asset managers may choose to use sector or industry level RI risk information as part of their investment process.

The CFA provides guidance and case studies for ESG integration in equities and fixed income which may provide some useful information on which investment tools can be used as part of integrating ESG[3].

Discussion Points for Asset Managers and Investors

Discussions should be held on how different RI related risks are factored in over the time horizon of the portfolio. Investors may also wish to discuss with managers both the process for assessing materiality of these risks and the experience of the investment team in the relevant jurisdictions.

For basket or index positions, asset managers and investors should discuss the level (if any) of look through completed on the positions to integrate financially material RI related risks. Where a look through is not completed, managers and investors may wish to discuss the alternative ways that RI related risks are being considered in the investment process.

Responsible Asset Selection

A dedicated approach where RI factors are used to pre-define the investment universe using tools such as exclusions, inclusions, or impact strategies.

Exclusions and Inclusions:

Public and Private Equity Positions

In general, for long public and private equity positions, inclusion and exclusion strategies have a relatively long history. These strategies can be practically applied and designed to meet the RI objectives of the fund or investor mandate.

For short positions there are additional considerations for asset managers and investors. At a high level there can be a debate over whether the use of short positions in portfolios is "ethical" overall. At the SBAI, we believe that short selling is an important tool aiding price discovery and efficient markets[4]. Whilst this can be an important discussion between asset managers and investors, it is outside the scope of this discussion on the practical implementation of RI in equity long/short strategies.

There are different ways that exclusions and inclusions may be applied in an equity long/short strategy including amongst others:

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[3] Page 5 : https://www.cfainstitute.org/-/media/documents/survey/guidance-case-studies-esg-integration.ashx

[4] For a detailed overview of the SBAI's position see our memo on Gamestop and the short selling discussions it raised: https://www.sbai.org/wp-content/uploads/2016/04/The-SBAI-Gamestop-and-Short-Selling-1.pdf

- A baseline exclusion or inclusion list for securities that is applied to both long and short positions,
- An exclusion list that applies to long positions only, allowing short positions in the securities on this list,
- Taking long positions in relatively higher ESG rated securities and short positions in relatively lower ESG rated securities, or
- Taking long positions in issuers who are improving their RI related practices and short positions in those that are either not improving or deteriorating.

Derivative Positions:

For derivatives there is potential debate as to whether the use of exclusion or inclusion lists would contribute to any stated RI objectives. This will depend on the reason for any exclusions being applied i.e., are they intended to make an impact on the issuer or underlying issuer (which may be limited in effectiveness) or to reflect an "ethical" view that profit should not be made from issuers that do not meet required standards (likely to be effective). In the case of the former, it may be more practical to assess the RI related practices of the counterparty for the asset.

Indices and baskets of securities may also be used in this type of RI approach. There may be exclusions applied on specific sectoral indices or a bias towards inclusion of "green" or "ESG" indices (noting that these may have lower liquidity than more traditional indices). The challenges here are similar to those discussed with RI integration – i.e., the potential need for a look through to bottom-up data on the underlying constituents of the derivative.

Discussion Points for Asset Managers and Investors:

For a dedicated RI product that uses short positions there may be conflicting views between asset managers and investors on how these positions should (or should not) be used as an RI tool. Views on this topic vary and may include:

- An "ethical" viewpoint that no profit should be sought from issuers that score poorly on RI-related factors.
- A view that shorting increases the liquidity of poor RI scoring securities as there is always a guaranteed buyer.
- Shorting based on RI related issues allows a manager to explicitly express a negative view on issuers. This may send a message to the issuer that improvements are required. In jurisdictions where position information is publicly disclosed this can also provide a public statement on the practices of the issuer.
- Shorting is effective at increasing the cost of capital for "bad" companies.
- Shorting may cause downward pressure on share prices which may affect executive compensation packages and therefore encourage changes in RI related practices.

An asset manager's RI Policy should specify whether exclusion or inclusion criteria are applied to both long and short books and how this will work in practice. For example, excluding securities from the entire portfolio or allowing short positions to be taken in securities on the exclusion list. Conversations should be held between asset managers and investors to ensure that the proposed methodologies align with any RI objectives on both sides.

Where an RI approach is chosen to influence external parties as opposed to reflect an investor's view, an important question is whether there is a difference in terms of an effective RI approach between holding a physical or a synthetic asset. Discussions should include whether holding a derivative of a security has the same desired societal or environmental impact as holding the cash equity, and whether applying an exclusion list to derivatives has the same potential impact on cost of capital for the issuer as excluding an equity.

The application of dedicated RI approaches to derivatives should be considered in the context of portfolio construction, i.e., are the securities being used for hedging purposes or as direct investments. For example, if a fund is using call options to hedge short exposure it may not make sense to include these positions in the RI objectives of the fund. Asset managers have a fiduciary duty to ensure effective risk management of the portfolio which may at times be at odds with RI objectives.

Impact

Public and Private Equities:

An impact strategy is practical with public and private equities, although it is likely to be more effective using long positions rather than short positions. There are many ways an impact strategy could be implemented using equity positions including amongst others:

- Purchase of equity in companies that align with one or more of the UN Sustainable Development Goals[5],
- Purchase of equity in companies seeking to make improvement in a chosen RI objective, or
- Investments focused on pre-IPO or private placements for smaller or newer firms that are aiming to contribute towards improvement in an area that is aligned with the RI goals of the product.

Derivatives:

Dedicated impact strategies are typically those with a stated objective of supporting companies that are making positive contributions towards the societal or environmental goals of the RI product. Whilst purchasing equity can provide capital to these issuers and offer opportunities for meaningful engagement, it is unlikely that derivatives will feature heavily in an impact product of this nature (note that these assets may be present for hedging purposes to ensure the risk profile of the fund remains in line with its mandate).

Discussion Points for Asset Managers and Investors:

As with any impact strategy both asset managers and investors should understand:

- The stated impact objective of the product,
- The assessment criteria of the investments chosen to be in the portfolio, and
- How these impact goals will be measured and reported.

Further detail on the governance and documentation of impact strategies in general can be found in the SBAI Policy Framework.

[5] https://sdgs.un.org/goals

Responsible Asset Ownership

The use of engagement to drive improvements or changes in RI related practices using tools such as voting, engagement, and activism

Public and Private Equities

Long public and private equity positions, in general, have good opportunities for engagement with underlying issuers on RI related matters. These positions are direct equity within the issuer and typically have voting rights (particularly for public equities) where asset managers can express views on RI related resolutions. In addition, depending on the size of the investment and the market cap of the issuer, there may be opportunities during company meetings or investor roadshows to directly engage with issuers on these topics. Private equity positions may offer asset managers a direct say in the operations of the company including on RI related matters.

Whilst short positions typically have more limited engagement opportunities, there may still be opportunities to press for improvements in RI related practices. Examples may include public statements on short positions, investor roadshows, or direct engagement with issuers on the subject.

Derivatives

Opportunities for direct engagement with the issuer, whilst not impossible, are reduced for derivatives and they do not carry voting rights. As discussed in the SBAI Policy Framework, there are alternative methods of engagement such as through regulators, exchanges, and industry organisations like the SBAI, that are available to owners of all types of asset classes and could be considered as part of an overall RI approach.

Discussion Points for Asset Managers and Investors

Engagement opportunities can have limitations, for example, investments that are small relative to the overall market cap of the issuer may limit the amount of influence a single investor has. Whilst there are ways to overcome this, for example through investor collectives representing larger combined ownership, discussions should be held on whether the construction of the portfolio allows for the type of engagement required to meet any stated RI objectives within dedicated products.

4. Reporting

Investor reporting will be discussed in more detail in an upcoming SBAI memo but the below highlights some equity long/short strategy specific elements that investors and asset managers should be aware of:

Short Positions:

There are two ways that short positions can be reflected on RI related reporting:

- Gross – where long and short positions along with any associated scores or metrics are presented separately, or
- Net – where short positions are netted against long positions, with aggregated scores or metrics presented (i.e., long metrics minus short metrics).

Discussion Points for Asset Managers and Investors:

Asset managers and investors should ensure to discuss which types of reporting make sense for the specific strategy and instruments held.

When choosing how to present (or receive) this information, asset managers and investors should consider which method might be more appropriate based on some key considerations:

- If the fund is not a dedicated RI product with stated objectives, then the purpose of the reporting may dictate its format i.e., are investors looking for an aggregated portfolio score or position level transparency to be able to fully understand their exposure.
- For a dedicated RI product, the stated RI objectives will factor into how this is reported. For example, an objective to keep the entire portfolio above an average ESG score may better suit net reporting, but an objective to hold long positions in "good" scorers and short positions in "bad" scorers may be more accurately reported showing long and short positions separately.

5. Investor Due Diligence Questions and Policy Disclosures

The SBAI Policy Framework contains a detailed list of disclosures that should be included in an RI Policy. The below list adds further equity long/short specific disclosures that should also be considered.

Investors may also wish to use these points for discussions with asset managers on RI related practices.

Non-Dedicated RI Products
• What sources of data are being used for each instrument type traded?
• How is the data being used within the investment and risk management processes?
• How is data being sourced for any derivative positions e.g., a look through to the underlying constituent(s) or sector/industry level information?
Dedicated RI Products and Engagement
• Do exclusion and inclusion lists apply to long, short, and derivative positions? If not, which instruments do they apply to?
• How are short positions used (or not) to achieve any stated RI objectives?
• How are derivative positions used (or not) to achieve any stated RI objectives?
• Are there positions in the portfolio that are not used to further stated RI objectives e.g., assets used for hedging purposes only?
• How are voting rights used to further any stated RI objectives?
• What level of engagement does the manager have with issuers to further any RI related objectives?
• Does the manager express views on RI related issues through engagement either via voting or directly with the issuer?
• How will long, short, and derivative positions be presented in any RI related investor reporting?

6. Appendices

Appendix A: The Different Approaches to Responsible Investment

Different Approaches to Responsible Investment

Responsible Integration	The Inclusion of RI-related factors into investment and risk management processes, where they have financial materiality. This involves the use of all relevant financial and non-financial information to aid asset valuation and risk assessment, but RI factors are not used to pre-define an asset universe.	
Responsible Asset Selection	Exclusions	An "Exclusion List" or "Negative Screening" is used to pre-define an investment universe. Exclusions may be based on "damaging industries" such as gambling, fossil fuels, or tobacco, relatively low ESG ratings or other considerations such as faith-based investing.
	Inclusions	"Positive Screening" is used to pre-define an investment universe. Inclusions may be on a "best in class" basis, i.e., those with relatively high ESG ratings or on a "thematic" basis with investments in particular sectors or industries targeted.
	Impact	Investing with the specific goal of delivering meaningful societal and environmental outcomes, for example, reduction of carbon emissions, or more generally contributing to societal goals such as the UN's Social Development Goals (SDGs).
Responsible Ownership	Voting	A form of engagement based on participating in Annual Company Meetings and using voting rights to support RI-related initiatives or express a negative view on current practices.
	Engagement	Having a dialogue with underlying issuers or companies with a view to achieving improvements on RI-related practices. This can also be used for improvements in wider industries through collective engagement for example with regulators or investor groups.
	Activism	A more involved form of engagement where investors look to promote change through building up a significant holding within a company and potentially gaining a seat on the board. This may also be a more public form of engagement.
Responsible Corporate & Market Citizenship	Organisational Initiatives	Initiatives and policies put in within the Investment Manager's own firm to address environmental, social and governance issues for example, energy efficiency, diversity, and employee wellbeing.
	Good Market Citizen	Being a responsible market citizen by governing the firm's behaviour in the market and ensuring the maintenance of free and effective markets, for example, by having strong controls in place to prevent market abuse.
	Carbon Hedging	Offsetting carbon emissions either directly produced by the firm (for example via travel) or funded within the portfolio (for example by investing in high carbon emitters) using carbon credits or other forms of carbon hedging.

Appendix B: SBAI Responsible Investment Systematic Working Group

(Alphabetically by firm)

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