

“Short selling has a role in the road to net zero”

This is an excerpt from the opinion article featured in [Environmental Finance](#), 21 October 2021, by Ulf Erlandsson (). [Link to article](#) – please support quality journalism.*

A recent Environmental Finance article [Short selling not a shortcut to net zero](#), says ISS ESG, references a recent ISS report on the impact of short-selling with the conclusion that shorting is not making a difference: "[...] by going short on Volkswagen you are not removing cars from the road!"

Allow us to disagree.

First, some underlying economics. A short seller of Volkswagen bonds effectively shifts the supply of capital to the company to the left. Less supply of capital, ceteris paribus, leads to a higher yield required for supply and demand to equilibrate.

Effectively this means a higher cost-of-capital for the issuer, in turn leading to a higher cost base and lower margins for Volkswagen. And Volkswagen will produce less cars to put on the road if their margins on doing so are lower. That should not be controversial. The Anthropocene Fixed Income Institute (AFII) makes a formal mathematical argument on this in the recent article [Carbon negative leveraged investment strategies](#).

Second, in terms of engagement, there are likely few investors who are engaging as much with their investment targets as short sellers. Engagement does not need to be internal in order to work – external pressures can work just as well. Let us exemplify:

Back in 2015, a Scandinavian asset owner took out a short position on utility company Vattenfall due to the company's massive lignite exposures as well as the start of operations of newly built Moorburg, a large hardcoal plant near Hamburg. The position was successful financially, but more importantly drove a long-standing engagement from involved short sellers vis-a-vis the company's coal strategy. Following the story all this time, the Anthropocene Fixed Income Institute (AFII) wrote a note last year, [Hard coal auction](#), where AFII argued for Vattenfall to bid low in the German coal decommissioning auctions, effectively offering to shut Moorburg.

And Moorburg actually shut early this year,¹ which was a fortunate decision for Vattenfall, considering the last week's news that Germany might now look for a 2030 coal exit. As a substitute for the analogy of the Volkswagen cars on the road, seeing shorts' engagement contribute to removing Moorburg-type of coal plants is not too bad.

Lastly, let us also protest the notion that short selling in any shape or form is a shortcut as the article claims. Short selling is one of the hardest exercises in finance. It is a lonely and barren road to travel, especially in the rallying markets of the past decade.

¹ [So long. Farewell. xAuf Wiedersehenx. Adieu](#), AFII, 2 Dec 2021.

Volkswagen may be the perfect case to illustrate this; the interested should read the excellent FT Alphaville article [The day Volkswagen briefly conquered the world](#) outlining the 2008 Volkswagen/Porsche monumental short squeeze. To call short-selling a shortcut underestimates the difficulty of the trade and the risks associated with it.

To summarise, we believe there are very strong quantitative/financial as well as engagement arguments as to why short selling can and should be credited in terms of carbon accounting and real climate impact. **Afil is adamant that an investor buying 200% Orsted and shorting 100% Glencore deserves a lower carbon footprint for her portfolio and more positive climate impact attribution than an investor only buying 100% Orsted.**

Shorting in equities as opposed to fixed income

Assume that VW stock trades such that the dividend yield is 3%. We then assume that VW will only invest in projects/produce cars that actually generate a return on equity in excess of 3%.

A short-seller enters, arguing that the stock is overvalued. She borrows VW stock from pension fund A, promising to deliver the returns of the VW stock to A over the life of the borrow and then return the stock. She then immediately sells the borrowed VW stock to fund B.

In this way, the short-seller creates a synthetic VW stock (a return stream identical to the VW stock) through the contractual promise to A while also re-selling the original stock to fund B. Looking across the marketplace, there are now more VW return streams than before the short seller entered. We have the original VW stock plus some synthetic VW stock created by the short seller.

Higher supply of identical return streams/stocks mean a lower price by the simple demand/supply relationship. A lower price also means that the dividend yield increases.

We now assume that, due to the oversupply of VW return streams, the price of the stock falls such that new dividend yield is 5%. For example, if the original stock price was €100 and annual dividend €3 per share (\Rightarrow 3% dividend yield), a new stock price of €60 gives us a dividend yield of $\frac{€3}{€60} = 5\%$.

We now switch to VW management. They are looking to make a decision to launch a new series of cars that will earn the company a return on equity of 4% (€4 per €100 invested). This would have been profitable/generated shareholder returns prior to the entrance of the short-seller, but the company could now instead buy back its own stock to get a yield of 5% (€5 per 100 invested) from its current operation. Indeed, doing anything else would destroy shareholder value. And in this case, when the new car line is not launched, it is the short-seller and the short-seller only who has driven VW cars to not be put on the road.

Out of this perspective, why is the short-seller in the trade? The short-seller will have a bearish view on the company. It might be that the short-seller believes there is a significant risk the company will default in three years' time. Thus the short-seller believes that the dividend yield needs to be so high that it compensates for that probability-weighted loss if the company goes bust.

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