RBC Global Asset Management

Is it time for a new wave of ESG funds?

August 30, 2021

Climate-conscious investments could be due a refresh, as challenging markets reveal the limitations of long-only ESG funds. A new wave of liquid alternative funds could provide investors with a new string to their bow, allowing for greater diversification and a product potentially better suited to market volatility.

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My-Linh Ngo, Portfolio Manager and Head of ESG Investment, reflects on the possible risks and rewards of this alternative approach to ESG investing. Can short selling affect real world change? Or could ambiguous regulation result in problems down the line?

Q. It's been a volatile year – do you see more attention shifting towards liquid alternatives in the ESG space, such as long/short funds?

My-Linh: Yes, definitely. It could afford more flexibility in the tools available to manage downside risks - but not necessarily. Given the high correlation between strategies managed according to ESG considerations, and quality factors, it could be argued that during a market downturn, some long-only ESG funds could potentially be quite resilient given their quality bias.

Q. More traditional, long-only ESG funds have generally thrived in bull run markets. But are they best suited to volatility? Are investors missing an opportunity by focusing on long-only funds alone?

My-Linh: I would say that the reality is not as black and white. Historically speaking, active strategies certainly offer better protection against market volatility than passive ones, particularly in market downturns. Arguably, having the flexibility to go long or short can broaden the tools you have at your disposal to manage market moves. But let's not forget long only strategies can still make use of derivatives, which can offer protection such as through buying CDS protection for a single name company or an index, and are often more liquid than simply shorting an individual name.

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Q. What about today's shorting regulations? If we're dealing with responsible investments, have European regulators ensured ESG shorting can be conducted fairly?

My-Linh: There is certainly a need for regulators – not just European ones – to provide better guidance for shorting activities in portfolios. Often, they are forgotten, and many requirements are written with a long-only bias.

The ambiguity is not helpful when, under ESG regulations, investors are to conduct portfolio level reporting. Take the EU's SFDR regulation for instance; there is little explicit guidance on how to account for shorts – whether they should be in scope or not when it comes to whether this promotes an E or S characteristic in the case of an Article 9 product, or when it comes to principal adverse impacts (PAIs) calculations.

Q. Finally, what about current issues around greenwashing? Do liquid alternative funds need to increase their ESG reporting transparency?

My-Linh: When reporting on long/short investment exposures at the portfolio level, its critical to be clear whether shorting has been used to manage exposure to financially material risks and/or opportunities, or to evidence real-world ESG impacts associated with portfolio level positions. The two should not be conflated – reporting for ESG transparency is different from reporting for ESG risk exposure.

Best practice would be to provide full transparency to avoid misleading representation. This may mean reporting both long and short exposures to ESG factors separately, alongside side any aggregation approaches which may include netting of long/short positions.

See more about ESG and the BlueBay Fixed Income Team

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