BALDWIN BROTHERS
The evolution of investment

Modernizing Fundamental Analysis
How Baldwin Brothers Integrates ESG into Traditional Equity Research
May 2018

A modern investment debate contemplates best ways to utilize environmental, social and corporate governance (ESG) parameters in public company analysis. To that end, investors currently argue whether ESG analysis is more effective when integrated into research or utilized through metric-driven screens. We argue the former.

We analyze ESG-related risks and opportunities to uncover companies with undiscovered growth, efficient operations and best-in-class management teams and believe various obstacles to ESG investing, including a lack of standards, comparable data or consensus opinion, offer us a comparative advantage.

Baldwin's integration of ESG into fundamental research should result in less volatile investments that can individually and collectively support greater corporate transparency and longer investment horizons. ESG is simply part of our fundamental analysis, which currently gives us a competitive edge over traditional asset managers harboring outdated notions of socially responsible investing.

Foundation
Factors, traditionally classified as macroeconomic (i.e. economic growth, real rates and inflation) or style (i.e. value, momentum and quality), attempt to describe characteristics that persistently drive stock returns. [1] Investor sophistication in and greater reliance on technology have contributed to factor growth since its introduction in the late 1960s. In recent years, the creation of exchange-traded funds (ETFs) has enabled investors to overlay traditional indices with these factors. “Smart beta” products now offer stock baskets tilted towards specific investment objectives (high dividend payers, for example) in an ETF wrapper.

Coinciding with technological innovation, big data and passive investing, interest in ESG has recently proliferated. These trends have increased dependence on third-party ESG research and the creation of ESG ETFs as firms seek to harness client interest in sustainable investing. The debate over ESG as a distinct factor emerged from these efforts and stimulated a conversation around the usefulness of ESG data versus ESG research.

Thanks in part to our own client demand, Baldwin has integrated ESG parameters into its investment decisions for several decades. We are excited about the growing interest in sustainable investing and believe it will improve corporate transparency, heighten management awareness and lead to market-wide recognition of ESG’s importance.

We believe incorporating ESG analysis into research informs our investment decisions and enhances their outcomes. In our opinion, ESG strengthens our fundamental research process, enabling insights into a company's strategic philosophy, operating structure and growth opportunities while supporting investments that should strengthen our global community.

Obstacles

Duplicitous corporate reporting that preceded (and fostered) the Great Depression inevitably lead to the creation of securities regulation known today. In 1934, Congress established the U.S. Securities and Exchange Commission (SEC) to set accounting and reporting standards for publicly traded companies. While this oversight is often underappreciated, it is the foundation to our capital market structure. From this structure, investment firms manage more than $80 trillion that ultimately facilitates the flow and transfer of capital across the globe.[2] [3]

ESG-related disclosures have no such standards. While several industry groups have recently created reporting templates, analyzing a company's ESG performance is arguably more difficult than ascertaining its financial health.

Standards. Despite robust traditional financial disclosure, the United States has yet to set ESG requisites. By contrast, the European Union is far ahead with standardization, requiring annual reporting on business models, human rights, gender diversity and environmental impact.[4] Third parties have attempted to fill our domestic void: Global Reporting Initiative (GRI) publishes best practices and guidelines for sustainability reporting; the Sustainability Accounting Standards Board (SASB) promotes industry-specific sustainability metrics akin to current financial reporting standards; and Carbon Disclosure Project (CDP) manages reporting for environmental impacts. Research providers like MSCI and Sustainalytics likewise aggregate various ESG disclosures for investor consumption.

Despite these measures, ESG-related reporting remains largely at executives' discretion. Which ESG topics are material? How should companies integrate ESG into business practices? How should managements define ESG metrics, set targets and measure progress? Each company needs to answer these questions individually, making it difficult for investors to grasp a company's ESG capabilities, determine improvement or compare peers.

As frustrating as it may be for investors, the absence of reporting standards is also burdensome for companies themselves. Investor Relations (IR) and Corporate Social Responsibility (CSR) teams may suffer reporting fatigue as they respond to repeated requests from research providers, survey developers and investors. In addition to regular ESG publications, such requests can increase the costs of ESG reporting.

Subjectivity. ESG issues are often amorphous. A lack of widely accepted measurement metrics compounds this problem. Investors are left with ESG reporting difficult to contextualize and latitude when interpreting bigger picture ESG-related questions. Because ESG is currently more subjective and harder to define, answers will vary.

How investors pose and answer these questions have implications for corporations too. Managements may have difficulty justifying the additional expenses, including labor and systems, associated with ESG reporting. Short-termism, a focus on quarterly over longer-horizon performance, may exacerbate the challenge as the benefits of ESG often require adherence to long-term goals.

Historical context. Financial reporting has existed in some form for decades, helping investors analyze and extrapolate past performance to create better forecasts. ESG has no similar history. While academics have studied links between various ESG indicators (i.e. diversity, executive compensation or emissions intensity), the industry is nascent. General understanding of ESG's tie to a company's overall performance remains underdeveloped.

This uncertainty becomes foggier when investors presuppose ESG topics critical to future performance. Because ESG lacks an historical record, forecasting is incrementally harder. Ever evolving environmental and social risks likewise muddy projections.

Resource Intensity. ESG research is time consuming. It requires an understanding of environmental, social and governance issues traditionally overlooked in securities analysis. It likewise requires deeper dives into sustainability reporting, corporate controversies and shareholder perceptions. Sell-side research often aggregates company financial disclosures to summarize strategic outlooks. No such equivalent ESG aggregation exists, while research attempting to marry the two seems limited in scope.

Opportunities

Utilizing public information, active equity investors seek to understand companies in a manner their peers do not. Such outside-the-box thinking can lead to performance that exceeds the overall stock market's. Valuing intangibles, particularly intellectual capital, is arguably key to this differentiated analysis.[5] Understanding a company's ESG exposures extends this analysis, helping an analyst better decipher whether a company is proactively investing in growth, streamlining its operations or running the business for long-term success.

Though it grew from these roots, ESG analysis is not "socially responsible" or “values based" investing. Those objectives utilized exclusionary methods to align investments with a predetermined belief system. This legacy has unfortunately fostered Wall Street's perception of ESG as an impact tool rather than a means to better understand financial drivers. It has also resulted in a proliferation of new ESG products that fail in both their scope and intent. Traditional asset managers seem all too ready to adopt the term "ESG" in their marketing materials without recognizing its connection to solid fundamental analysis.

We believe the field of ESG analysis poses a unique opportunity. Rarely can investors capitalize on a repeatable but differentiated analytical method not yet broadly adopted. Furthermore, headwinds to ESG may position Baldwin advantageously. ESG is generally outside traditional investors' foundational training, requiring time for analysts to perfect a new skill. Our long-standing work to strengthen the links between ESG and financial materiality should keep us ahead of the curve. As the market eventually recognizes the validity of integrated ESG analysis, the link between sound ESG strategy and financial materiality should further result in increased shareholder value.

Integration

We believe ESG analysis can enhance fundamental research by providing additional insight into how corporations address growth opportunities, expense management and shareholder interests. Academic studies have shown firms attentive to sustainability financially outperform firms that are not.[6] Firms with strong sustainability-oriented performance have also generated higher financial returns via return on equity (ROE) and return on assets (ROA).[7]

We utilize MSCI data as a stepping stone to develop deeper understandings of pertinent ESG issues. As part of our fundamental analysis, we review a company's sustainability reporting, oversight of material ESG issues and potential exposure to ESG-related risks. We relate these findings to the fundamental drivers underpinning a company's strategy.

Growth. Companies contemplating ESG issues may more adeptly capitalize on potential growth opportunities. Companies quick to recognize consumer demand for energy efficient products or healthier foods, for example, captured first-mover advantages. Going forward, ESG-aware firms should better evolve as consumers increasingly contemplate the social and environmental ramifications of their purchases. Sustainability-oriented firms typically generate higher rates of return when they key off consumer preferences than when they rely solely on brand recognition.[11]

Operations. Firms that appropriately implement ESG programs should realize leaner operating structures, as higher employee satisfaction and improved resource efficiency reduce costs. Firms stringently overseeing their supply chains typically face less reputational risk. Academic studies have found prospective employees prefer working for ESG-aware companies.[8] Engaged employees boost productivity, reduce attrition, improve safety and increase customer retention, all of which translate to better profitability.[9] [10] Attention to efficient water, energy and raw material usage likewise lead to cost savings and better position companies for changing environmental regulations.

Shareholders. Management teams versed in ESG tend to operate companies better aligned with shareholder values. Such teams typically emphasize transparency, a long-term focus and awareness of non-financial risks. Studies suggest firms with greater emphasis on ESG witness more frequent revenue opportunities and experience lower stock price volatility.[12] [13] ESG-minded oversight also encourages comprehensive ESG integration across business segments that should ensure the highest standards of corporate behavior. Such managements also tend to fund ESG- over non-ESG related projects that typically lengthen the horizon of executives' strategic vision.

Evolution

Consideration of environmental, social and governance risk exposures and growth opportunities reflects transparent corporate communication and sound fundamental analysis. We anticipate a world where ESG-related reporting, research and investing become so commonplace the moniker is no longer necessary. In the meantime, we will continue to capitalize on currently underappreciated opportunities to enhance fundamental equity research through ESG integration and believe the inevitable market-wide recognition of ESG will not only validate our long-standing efforts but also transform the societal influence of our global capital markets.

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