BALDWIN BROTHERS
The evolution of investment

Enhancing Downside Protection
Addressing Investment Risk through Augmented Fundamental Analysis
May 2019

Investors should utilize environmental, social and corporate governance (ESG) analysis to better understand a company's fundamentals. Corporations instituting sustainable business practices experience muted share price volatility, reduced earnings variability and higher profitability.[i] We argue an executive management's attention to the ESG criteria composing its business model allows for better profitability (and reflective stock behavior) in the latter stages of an economic cycle.

Aware of industry-relevant sustainability measures, proactive management teams typically cultivate customer loyalty, preserve margins and target long-term strategic goals. Such attributes are particularly important when input costs rise and labor markets tighten at the end of economic expansions. Companies that regard sustainability as a core business practice are likely to increase their competitive advantage during these periods, as less perceptive peers cut variable costs, including critical investment like research and development.

For both security selection and asset allocation, capital preservation underpins Baldwin's investment philosophy. Our proprietary, ESG-aware research should help us invest in companies better able to withstand economic variability and broaden their competitive advantages during economic downturns. To that end, research mindful of a company's exposure to ESG criteria should help preserve and build upon client wealth to meet financial goals.

Stable Revenue
Throughout the economic cycle, firms with heightened awareness about sustainability should more readily identify consumer trends and adapt their product portfolios accordingly. Research shows that corporate culture similarly influences new product development. Engaged employees innovate more efficiently, utilizing cost-effective research and development to increase patent issuances that ultimately promote new product sales.[ii] [iii] Brands with sustainable operations often elicit loyal customers who help command premium pricing that reinforces outsized sales growth.

As the business cycle matures, raw material costs traditionally rise and labor markets tighten. To maintain profitability, firms typically pass along these costs to consumers. Companies operating sustainability-oriented models are more likely to experience stable sales during downturns via brand loyalty, pricing power and customer satisfaction. Academic research suggests a strong corporate culture corresponds to higher customer satisfaction that translates to increased profitability.[iv]

Coffee giant Starbucks has long sat at the cutting edge of corporate social responsibility, offering healthcare to all employees since 1988. Over a similar period, it has likewise afforded college education for those eligible. The company leads peers in ethical coffee sourcing and improving the sustainability of its own operations. Due in part to these initiatives, the company's brand awareness and customer loyalty contribute to recurring sales. Seamless integration into customers' daily routines via a rewards program and mobile app should likewise stabilize sales during a potential downturn.

Margin Preservation

Understanding ESG criteria within fundamental analysis can help uncover underappreciated profitability drivers. Although specifics vary by industry, employee engagement and resource efficiency often aid margin expansion. Not only are engaged employees more productive, they are also less likely to seek new employment, reducing turnover costs. Employee training and workplace safety likewise reduce costs via insurance savings, employee satisfaction and higher productivity.

Finding qualified employees is more difficult when labor is tight. Less likely to seek new employment, engaged employees inevitably generate cost savings at a time when hiring and retaining employees is more expensive. Research shows employees willing to take pay cuts to work at sustainability-minded firms would likely widen the cost-savings gap between sustainability-forward companies and laggards.[v] Firms with better supply chain management and resource efficiency similarly experience richer profit margins. Rising raw material, labor and transportation costs create weaker headwinds for firms that have minimized environmental impacts, including streamlining logistics and reducing waste.[vi]

Costco benefits from such ESG-related initiatives. The wholesale club rewards employees via industry-leading wages and advancement opportunities to reduce employee turnover and ensure more satisfied customers, membership retention and sales growth. Costco's leadership prioritizes paying a living wage. As an example, Costco not only avoided lay-offs, it raised wages in the wake of the 2008 financial crisis.[vii] [viii] At the same time, Costco maintained consistent margins, reinvesting profits to lower costs while returning membership fee income to shareholders.

Shareholder Alignment

Firms with comprehensive ESG oversight tend to utilize management teams that set longer-term strategic goals focused on high quality results. Such leadership circumvents conventional biases toward instant gratification. A recent survey found 60% of executives would delay projects, 80% would cut discretionary spending and 40% would give discounts to customers simply to meet quarterly guidance.[ix] Management teams that prioritize sustainable business practices typically commit to longer-term goals. In so doing, they reduce earnings variability, increase transparency to stakeholders and reduce the cost of capital.[x] [xi] Firms with ESG-aware management teams consequently better align themselves with investor values, and their investors have typically rewarded their stocks with higher valuations.[xii]

These competitive advantages become even more apparent in economic downturns. Not only do sustainably aware firms benefit from enhanced sales opportunities and margin stability, they also achieve additional upside from long-term share ownership. Shareholders often reward proactive investments in long-term drivers and preparedness for potential recessions by continuing to hold their positions, ultimately granting the company financial flexibility during economic downturns. ESG-minded investment is arguably critical to a firm's competitive advantage, and as a result, corporate ESG awareness has proliferated since the financial crisis. In 2018, 85% of S&P 500 constituents published sustainability reports compared to just 20% in 2011.[xiii]

We attempt to uncover businesses that view sustainability as inherent to good business sense. We regard this analysis as critical in an economic downturn when companies should most capitalize on those investments in sustainability. Firms that view ESG holistically typically implement comprehensive solutions. To reduce carbon emissions, for instance, such firms are more likely to invest in new manufacturing processes and fuel-efficient fleets than firms buying carbon offsets in isolation. Continued investment in cost savings should prove far more valuable than discretionary, one-off spending in an economic contraction.

Pharmaceutical giant Merck illustrates how long-term orientation benefits shareholders. The company continues to increase research and development to support its cancer immunotherapy drug, Keytruda. While myopic investors have called for revenue diversification, management holds true to its mission, reiterating its aversion to blockbuster deals (due to heightened integration risks). Similarly, Wall Street analysts have clamored for the sale of Merck's animal health unit. Management has pushed back by emphasizing the segment's cash generation as a means to support continued investment in Keytruda.

Baldwin's Framework

We believe comprehensively integrating sustainability into our corporate structure is also critical to our own business model. A collaborative culture that emphasizes employee engagement and client satisfaction underpins Baldwin's continued success. Despite our small size, we are proud to seek the same industry-leading standards we prioritize in the companies we invest. The average tenure at Baldwin, for example, is nearly fifteen years, a testament to our team mentality, all-inclusive profit-sharing plan and best-in-class healthcare. No better example of Baldwin's employee prioritization exists than the 2008 financial crisis, when many of our peers reduced their staffs. Baldwin in contrast held steady, retaining quality employees to help clients achieve their goals.

ESG awareness is the fabric of our business model, the cornerstone to our investment philosophy and key to client wealth preservation. We argue ESG mindfulness makes us better stewards of your capital and helps bring us closer to you through our enhanced transparency and emphasis on long horizons.

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This report is not an offer or a solicitation to buy or sell securities. The information contained in this report has been compiled from third party sources and is believed to be reliable; however, its accuracy is not guaranteed and should not be relied upon in any way, whatsoever. This report may not be construed as investment advice and does not give investment recommendations. Any opinion included in this report constitutes the judgment of Baldwin Brothers, Inc. as of the date of this report, and are subject to change without notice.

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