BALDWIN BROTHERS
The evolution of investment

E, S & G: Three Pillars of Quality Investing
How understanding ESG risks and opportunities may self-select high quality companies
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Why Quality?

Purchasing shares of companies that generate strong returns on invested capital (ROIC), deliver stable earnings growth and boast investment-grade balance sheets while avoiding shares of firms with lackluster ROIC, sporadic profitability and excessive debt constitutes quality investing. Prominent investors from Benjamin Graham to Peter Lynch have championed such investing for almost a century. We likewise emphasize quality in our equity strategies at Baldwin Brothers.

Quality investing is logically compelling. American investor and Berkshire Hathaway's vice chairman, Charlie Munger, describes it as the ultimate reversion to the mean. A stock should never return better or worse than the average growth opportunities composing the company that issues it. "Over the long term," Munger has stated, "it's hard for a stock to earn a much better return than the business which underlies it earns." [1] His argument supports quality as a core investment pillar for long-term investors. Quality investing is of course not as simple as Munger may suggest. Blindly investing in a company based solely on its current ability to generate a high ROIC, for example, and forgetting about it for twenty years is a potential recipe for disaster.

Augmenting Analysis

The backward-looking nature of most quantitative measures of financial health is quality investing's biggest challenge. Accounting ratios like ROIC are based off of historical financial statements. History is great for telling you which companies have proved successful investments over the preceding twenty years, but it does little to answer the key question underlying future investment success: Will this company continue to generate similarly high returns over the go-forward twenty years?

These limitations force investors to supplement the science of financial statement analysis with the art of qualitative analysis. In practice, an investor must assess a company's competitive position to determine whether it can defend the comparative advantages that allowed for its strong historical ROIC. Metaphorically, an investor therefore needs to measure the breadth and depth of a corporate moat.

Moats come in various shapes and sizes: superior intellectual property, network effects, regulatory protections or revolutionary operational excellence, to name a few. We increasingly find diligence on environmental, social and corporate governance (ESG) criteria offers underappreciated insight into the quality of these moats. We argue a link between a company's attention to ESG risks and opportunities and its ability to protect its competitive position and reinvest its capital at a high rate of return. As Baldwin Brothers integrates ESG criteria into its own fundamental analysis, recognizing this link early may set us apart from peers.

ESG's Moat

Four sources of competitive moats: human capital, operational excellence, regulatory compliance and reputational management constitute (but do not encapsulate) ESG criteria. Analyzing such critiera arguably provides an enhanced assessment of companies that rely on these moats.

Human Capital As technology services dominate the American (and global) economy, a growing cohort of companies watch their most valuable asset, talent, walk out their doors at each workday's end. Ensuring that talent wants to return to work the next morning, i.e. managing human capital, is therefore critical to maintaining competitive advantages. Reviewing ESG-related critieria like workforce diversity, employee compensation and corporate culture can provide insight into a company's strategy behind talent management and help distinguish a company deepening its human capital moat from one that risks seeing it dry up.

Operational Excellence Poor information disclosure can limit an investor's ability to identify a high-quality operator. As reporting standards for injury rates, energy use, water utilization and waste generation, all ESG-related performance measures, become more prevalent, investors gain visibility into companies leading on issues of quality control, operational efficiency and workplace safety, as examples. Leadership in these areas help reduce operating costs and may improve profitability.

Regulatory Compliance Regulations can serve as a mixed blessing for corporate operators. Strict regulatory oversight may provide a barrier to entry, protecting incumbents from competition and thereby sustaining their ROIC. Regulation also allows for operational license and with it, consequences if abused. Following Wells Fargo's fake account scandal, the Federal Reserve capped the company's balance sheet, immediately curbing the bank's ability to reinvest capital at its prevailing 12% rate and tumbling the stock price. Heeding corporate controversies, whistleblower reports and legal fines, among other ESG-related information, can help investors differentiate companies with strong ethics and compliance oversight from those promoting fraud.

Reputational Management Consumers nowadays are more likely to evaluate the broader communal impact of their purchases. According to a 2015 Nielsen study, nearly three-quarters of millennials willingly pay up for the products and services of companies committed to positive social and environmental influences. [2] Such a shift in consumer behavior necessitates investors' attention to ESG-related drivers, including sustainability initiatives, product recalls and data privacy protocols, that may shape corporate reputations.

Thoughtful attention to human capital, operational excellence, regulatory compliance and reputational management may facilitate ESG-driven corporate leadership and illustrates the ability of quality-oriented investors to capture ESG criteria in their financial analyses.

Data Enhancement

That ESG-related reporting remains amorphous and limits comparability between companies could confound the argument that corporate leadership around ESG-related issues arguably predicts long-term business quality. Despite the growing prevalence of corporate and third-party ESG reports, long-term ESG data remains sparse. Three-quarters of the businesses in accounting powerhouse KPMG's proprietary index published corporate responsibility reports in 2017, but only one quarter of those companies published comparable data two decades prior. [3] While the paucity of historical data may limit investors' ability to link long-term business success with ESG-driven leadership, academic and industry studies promote ESG's influence on business quality. Aggregated, such data suggests ESG analysis may naturally lend itself to quality investing:

- A 2018 Goldman Sachs study showed that among high quality companies, those more focused on ESG-related risks and opportunities are likely to deliver sustainably higher returns than those less focused. [4] This divergence suggests ESG leaders may do a better job defending their moats than ESG laggards.

- A 2014 Harvard Business School research paper found firms acutely focused on sutainability, especiallly those selling products to consumers, competing on brand reputation and utilizing natural resources, perform well across quality accounting metrics, including return on equity (ROE) and return on assets (ROA). [5] This study may support the argument that defensible reputational and operational moats are closely linked to ESG leadership.

- A 2018 MSCI study found that companies with shares that outperformed peers' over the 2007-2017 decade demonstrated strong management of industry-specific ESG-related risks and opportunities. The shares of peers with weaker management of those same risks and opportunities typically underperformed. [6] This study suggests attention to industry-specific ESG criteria may also indicate long-term corporate winners.

Forward Application

Traditional investment analysis should ultimately utilize ESG criteria as it currently does standardized financial metrics. As executives more readily view management of environmental, social and governance risks and opportunities as critical to maintaining and widening corporate moats, investors' incorporation of those same ESG risks and opportunities will likewise permeate long-term, quality-oriented fundamental analysis. Due diligence on pertinent and financially material ESG-related matters should elevate the research behind quality characteristics and help parse out long-term winners. We approach research in this manner and believe thoughtful attention to ESG criteria should enhance investment returns over a market cycle.

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[1] *Munger, Charlie. "Art of Stock Picking." Graham and Doddsville, Nov 2016, http://www.grahamanddoddsville.net/wordpress/Files/Gurus/Charlie%20Munger/Charlie%20Munger%20_%20Art%20of%20Stock%20Picking.pdf Accessed 22 August 2018.*

[2] *Farraj, Grace et. al., "The Road Ahead; The KPMG Survey of Corporate Responsibility Reporting 2017.", October 2015, https://www.nielsen.com/content/dam/nielsenglobal/dk/docs/global-sustainability-report-oct-2015.pdf Accessed 23 August 2018.*

[3] *Blasco, José Luis, et. al., "The Sustainability Imperative; New insights on consumer expectations.", 2017, https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2017/10/kpmg-survey-of-corporate-responsibility-reporting-2017.pdf Accessed 23 August 2018.*

[4] *Bingham, Derek, et. al., "GS SUSTAIN: Chart of the Week: Evidence of Excellence from ESG.", 23 February 2018, https://www.forbes.com/sites/bobeccles/2016/05/03/what-the-world-needs-now-sustainability-accounting-standards/#3f1a38de74d8. Accessed 23 February 2018.*

[5] *Eccles, Robert G. et al. "The Impact of Corporate Sustainability on Organizational Processes and Performance." Harvard Business School, Nov 2014, https://www.hbs.edu/faculty/Publication%20Files/SSRN-id1964011_6791edac-7daa-4603-a220-4a0c6c7a3f7a.pdf, Accessed 27 August 2018.*

[6] *Seretis. Panos et al. "Enhancing Economic Value with ESG." Feb 2018, https://www.msci.com/documents/10199/48e85d65-66d4-40e7-b316-c64a95b83a04, Accessed 27 August 2018.*