ESG Epiphany

ENVIRONMENTAL, SOCIAL AND CORPORATE GOVERNANCE INVESTING

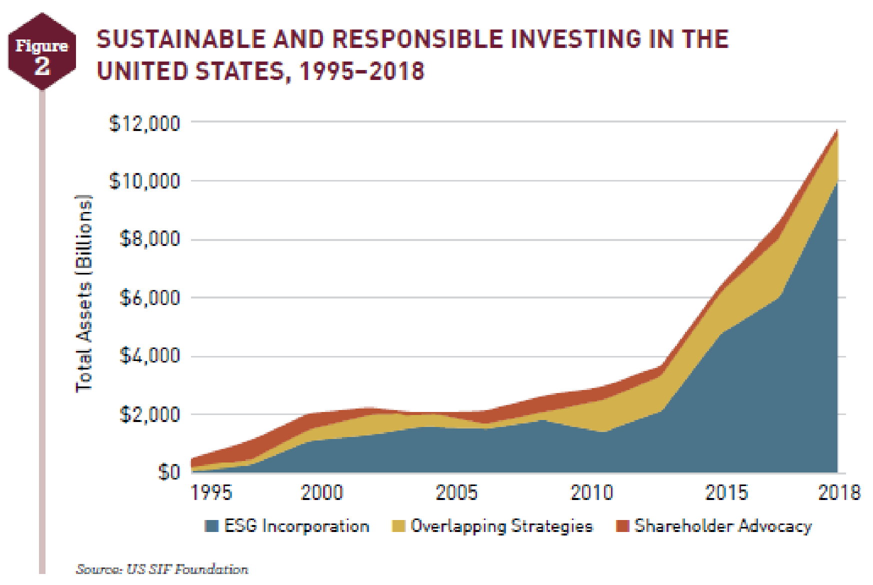
Bradley, Foster & Sargent, Inc.

Rosa Y.C. Chen
Head of Research & Portfolio Manager

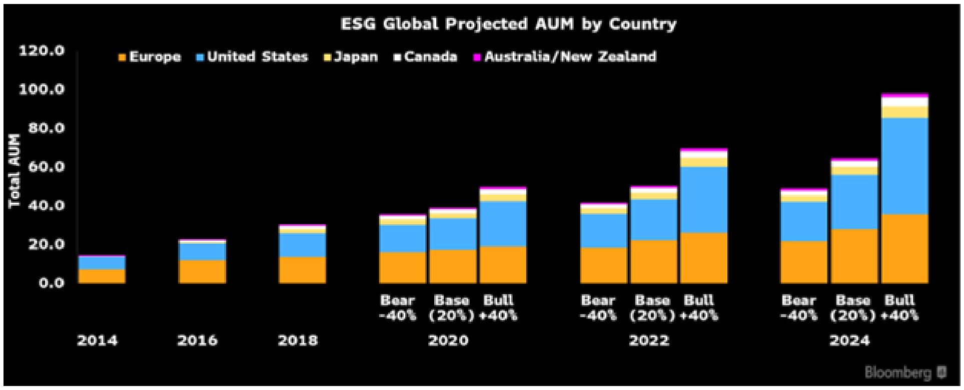
Investor interest in climate change, social justice, and corporate power has been making its presence known in the capital markets for some time and has recently seen a significant uptake. These ESG (Environmental, Social, and Governance) factors are increasingly being identified, evaluated, and scored as a premise for investment in particular companies, as well as being used to avoid certain companies and industries.

"Environmental" can encompass everything from energy use, water conservation, pollution, waste management, and carbon footprint. "Social" pertains to diversity among employees and executives, inclusionary policies, pay equity, labor standards, health and safety, privacy, and human rights. Lastly, "governance" includes evaluating the self-interest of managers versus the stakeholders in the company, such as board compensation and structure, compliance, executive compensation, and bribery or corruption.

Because of this growing interest in all things ESG, ESG-focused funds have experienced strong investment fund flows (Exhibit A). According to The Forum for Sustainable and Responsible Investment Foundation (US SIF), a non-profit that focuses on sustainable and responsible investing for non-profits, ESG-type assets in the U.S. had grown to almost $12 trillion by 2018. Global assets estimated by Global Sustainable Investment Alliance (GSIA) and Bloomberg were over $20 trillion in 2018 and are expected to grow to over $50 trillion by 2024. They also believe that ESG assets could encompass as much as 30% of assets under management by 2025.



The primary objective of ESG is to align personal philosophical beliefs with corporate actions. Secondary, but perhaps just as important, is finding companies that could benefit from incorporating ESG into decision-making processes by lowering the cost of doing business as well as being beneficial to society and the climate. These two goals have been supported by meta-studies which show a high correlation between ESG criteria and corporate performance, including lower cost of capital, better operating performance, and, eventually, above-market stock performance.



Given the strong client interest in ESG-related investing and the potential to generate positive equity performance, Bradley, Foster & Sargent evaluated how we might integrate ESG criteria into our investment process. There are a number of different ways to infuse ESG into portfolio management, the easiest and earliest form being exclusionary investing, which is specifically isolating and avoiding certain companies and/or industries, such as tobacco, guns, and petroleum producers. The most challenging, but probably most effective from a total return perspective, is full integration of ESG criteria within the fundamental research process.

Some challenges to full integration include data gathering and disclosure. There is no legal requirement for companies to publish ESG-related data, though significant pressure from investors means most companies offer some form of sustainability reporting. Unfortunately, the industry has not yet come up with a working standard and thus not all of the data are comparable to one another. Standardization and guidelines to improve disclosure are in the works.

Three companies — S&P, MSCI, and Sustainalytics — provide ESG scoring services for a partial solution to the data challenge. All three have very different methodologies as well as criteria and data sources. By using a combination of the three, we avoid being biased toward any one methodology.

We then ran our universe of high-quality stocks — essentially stocks Bradley, Foster & Sargent has researched deeply and deemed to be of high quality — to see how companies we typically buy would score on an ESG scale as determined by third-party experts. It turns out the vast majority of these high-quality stocks scored in the top half of the rated universe.

This result was not a surprise to us. Our fundamental deep dive on each company incorporates identifying risks as well as beneficial actions of a company, including ESG factors like environmental risk, governance issues, and social risk. It is also no surprise to us that, in aggregate, these types of stocks have done well over long periods of time, thus lending credence to the idea that ESG is a net positive for stock selection.

The end result of our ESG evaluation is to not change how we research, analyze, or buy companies, as our instilled practices already incorporate ESG factors to a great extent. We can, however, through the intersection of third-party ESG scoring and our fundamental research, come up with a universe of high-quality, highly rated ESG stocks to include in ESG-focused portfolios for those clients who desire it.

If this approach sounds like the right fit for you and your family, we encourage you to connect with our team.