Using Environmental, Social and Governance (ESG) Non-Financial Factors in Creating Portfolios

The rise of the use of Environmental, Social and Governance (ESG) factors in investment research has caused a great deal of confusion to many investors. In the end, it really isn't all that complicated.

Investors have used fundamental analysis as a research tool for as long as stocks have been around. Fundamental analysis uses different financial factors, such as earnings, revenue, and profit margins to determine a company's value. This data helps an investor decide if the stock of a company looks attractive (selling below its intrinsic value) or expensive (selling above its intrinsic value). There are tens of thousands of people scouring these data sets, along with the help of powerful computers, deciding if a stock is attractively priced or not. We believe fundamental analysis is an important component to investment research.

However, focusing only on financial factors may only give investors part of the story. We believe incorporating non-financial factors, such as Environmental, Social and Governance criteria into the analysis may provide an edge to investment researchers. How?

If similar companies in the same industry have similar outlooks based on fundamental analysis, an investor may decide that it doesn't matter which stock is purchased because they both seem alike. However, when utilizing non-financial factors in the analysis one of the stocks may look dramatically more attractive than the other. For instance, what if one of the companies had hired a director of sustainability to reduce the amount of energy and water used in the manufacturing process while its competitor hadn't? Does one company have a better compensation, benefits, and bonus structure for its non-management employees than the other? Is one of the corporate boards filled with diverse board members representing a variety of backgrounds and experiences while the other does not?

Not that long ago, it was difficult to evaluate and compare corporate non-financial factors because the information was not available to investors. There has been an explosion of data over the past five years related to all sorts of non-financial factors, which we believe helps investors who focus on these factors provide value compared to only relying on the fundamental analysis process. In our experience, using ESG themed investing has the potential to help reduce risk in portfolios because it may help reduce the number of stocks that are in danger of down risk due to poor management of the ESG factors.

Click here to make an appointment and learn more about how using ESG non-financial factors in the investment process could help improve your investment outcomes.