Diving Deep

We believe that using sustainable research to guide investment decisions can be a powerful driver of returns. In our quest for long-term outperformance, or what we call "sustainable alpha," our research team finds compelling investment opportunities by looking well beyond standard financial and nonfinancial data.

ARM Holdings rose to dominance among makers of smartphone microprocessors by focusing on energy efficiency rather than pure computational power and speed. **WhiteWave Foods** has grown faster than its more conventional rivals because of its commitment to producing organic, healthful and minimally processed foods.

Both ARM and WhiteWave have staked out a competitive advantage by seeking to reduce their environmental impact. In July, they each gained validation for their success—their share prices surged by double digits—after Softbank announced a plan to buy ARM Holdings and Danone said it will acquire WhiteWave.

The acquisitions are validating the approach of Brown Advisory's Large-Cap Sustainable Growth strategy, whose composite returned 15.4% over the five-year annualized period ending July 31, gross of fees.* That compares with a median return of 11.7% annually for U.S. managers focused on environmental, social and governance (ESG) factors and the 13.6% annualized return of the S&P 500 Index.

We bought shares in WhiteWave in December 2015, in recognition of the healthy-living category of foods moving mainstream. Danone bought WhiteWave for 19% more than the previous day's share price. We bought ARM Holdings in July 2011 and held on even as oversupply slowed growth in smartphones sales. We were confident that the company's energy-efficient chip design would give it an edge in supplying the silicon neurons for products ranging from computer servers to wearable devices. On July 18, 2016, Softbank announced plans to buy the company at a 43% premium to the prior day's closing price.

To find these under-appreciated opportunities for our equity and bond strategies, we dive deep beneath the surface of corporate disclosures, regulatory filings and investor releases. We look for fundamental strengths, attractive valuations and what we call Sustainable Business Advantage (SBA). Companies with SBA pursue sustainable strategies that have the potential to strengthen financial performance and increase shareholder value. Through original sustainability research into stocks and fixed income securities—including diligence into government databases, company transcripts and interviews with executives—we find strengths that are not apparent in standard company reports.

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Rearward View

"A lot of the information companies provide is backward looking and risk-focused rather than forward looking and opportunity oriented," according to Daniel Esty, a Yale Law School professor and director of the Yale Center for Environmental Law and Policy. "The reporting is not consistent across industries or across companies, so it's very hard to make accurate comparisons," said Esty, a member of Brown Advisory's Sustainable Investing Advisory Board.

When sizing up a company's opportunities and risks, portfolio managers vary widely in how they weigh ESG factors. As a result, strategies focused on sustainability range broadly in performance. Some portfolio managers use ESG data to find companies that they believe are less harmful than others. They focus largely on industries that have low environmental footprints, including technology and financial services companies. The limited diversification from such an approach may pose risks.

Passive investment strategies focused on ESG goals take a best-in-class approach, mimicking the sector allocation of their benchmark index by finding top ESG scorers within each industry. For example, they may overweight companies that have low carbon emissions and vice versa. Such strategies aim to match the risks and returns of the broad market and as such are unlikely to outpace the benchmark.

Still other managers gather together a pool of companies with favorable ESG characteristics. They then construct their portfolios by using traditional measures for valuation and performance.

Our strategy is different from all of the above. After identifying a company with strong fundamentals, one of the first steps in our search for SBA is to comb the database of MSCI, a New York-based research firm. This helps us to spot companies that face ESG risks, such as labor-management tensions, excessive vulnerability to commodity prices or inappropriate incentives for executive compensation. We also review company reports detailing efforts to promote sustainability in operations, including reductions in the use of water, energy or materials used in production. Such disclosure is surging, with the proportion of companies in the S&P 500 Index that publish sustainability reports increasing to 81% in 2015 from less than 20% in 2011.

Still, a company may expand its reporting on sustainability without actually reducing its environmental impact or risk, or improving its competitiveness and profitability. With that in mind, the Financial Stability Board—created in 2009 by the G20, a group of leading developed and developing nations—mobilized a task force of executives in 2015 to build a framework for climate-related disclosures applicable across myriad industries.

Led by former New York City Mayor Michael Bloomberg and made up of executives from companies ranging from JPMorgan Chase to Unilever to Tata Steel, the task force is constructing a model for financial risk reports that will be geared to the needs of investors, lenders, insurers and other stakeholders. Former SEC Chairwoman Mary Schapiro serves as an adviser.

"What we need is consistent and regular reporting across the broad swath of companies that investors might be looking at," Esty said in an interview with Brown Advisory. "The aim is to establish a reporting structure that is routine and institutionalized, much like the way that companies currently report to the SEC."

We have found that even with solid data, the impact of a company's sustainable strategies on its competitive position is not obvious at first glance. So we rely on our own digging to identify companies with SBA.

For example, in March 2015, we began seeking out a possible investment in a company that builds and maintains wireless towers, attracted by the business model's prospect of recurring revenue and rising demand from mobile phones and other digital devices.

Above and Beyond

While we identified three companies that met this fundamental business criteria, only one—American Tower—appeared to hold a Sustainable Business Advantage. Responses to a questionnaire drawn up by CDP, a London-based research firm formerly known as the Carbon Disclosure Project, and subsequent interviews with American Tower management, including senior executives in some emerging markets, revealed that the company exceeded environmental compliance measures and invested in environmental strategies to bolster its competitive advantages.

An example of American Tower's SBA is its providing of shared backup power generators for about 12% of its 27,200 towers in the U.S. This enables customers to avoid the disruption and risks from the construction and maintenance of their own generators, which tend to be energy inefficient. Through the service, American Tower seeks to help customers trim the losses from power outages and generator depreciation, which cost the industry about $15 billion each year. In addition, by seeking to improve its environmental performance, American Tower could speed regulatory approvals and minimize environmental risk to itself and its customers. Finally this helps the company's reputation outside the U.S., where environmental practices help win business.

Having identified American Tower's SBA, we purchased shares in September 2015. Since then, its stock has risen 25% as of Aug. 22, 2016.

Beyond equity-focused strategies, our approach to "sustainable alpha" helps our Core Sustainable Fixed Income strategy identify a company's weaknesses and more accurately forecast profitability. For example, during the second quarter we bought bonds in Digital Realty, the largest owner and operator of stand-alone data centers. The company's warehouses of servers store and transmit data for customers ranging from IBM to AT&T to Facebook. Highly dependent on electricity, Digital Realty has been a leader in adopting renewable energy, cutting one of its primary costs and boosting profitability.

We also bought bonds issued by Novelis, a global leader in recycling aluminum and producing rolled aluminum goods. The company has streamlined operations in recent years, reducing greenhouse gas emissions and cutting costs for water and energy use. During the course of five years, Novelis boosted the amount of recycled aluminum used in production to 52% from 30%, thereby trimming greenhouse gas emissions by 13% and increasing aluminum production by 5%. The company aims to expand its use of recycled aluminum to 80% by 2025.

Sustainability can create competitive advantages and help a company avoid risk, grow revenue, reduce costs or expand market share. By digging deep through original research, we seek to help investors find these underappreciated opportunities.

Full Immersion

While pursuing fundamental research into a company's business model and valuation, the Large-Cap Sustainable Growth strategy takes a three-level approach to identifying and monitoring Sustainable Business Advantage (SBA), or strategies that boost financial performance and increase shareholder value:

Level 1: ESG Risk Assessment

After identifying an attractive company, we look for signs that it is vulnerable to an environmental, social or governance (ESG) risk, such as excessive exposure to commodity prices, labor-management tensions or inappropriate incentives for executive compensation. We comb the database of MSCI, a research firm focused on sustainability, to gauge a company's ESG risk exposure and how it manages such risks, and to identify controversies it has faced in the past or may face in the future. We also review government databases for any information on environmental fines, and analyze a company's code of conduct and sustainability reports describing management systems related to the use of water, energy and other resources. We publish our findings in a ESG risk assessment.

Level 2: SBA Research

In a second report, we plunge into original research to measure a company's SBA, gathering information at industry conferences and poring over public filings, investor presentations, sustainability reports, CDP responses, academic research and case studies written by a company, supplier or customer. We interview industry thought leaders and a company's chief sustainability officer and other management. We also leverage the fundamental research of Brown Advisory equity research analysts.

Level 3: Updates

After buying shares in a company, we continuously freshen our SBA research reports with both quantitative and qualitative information to ensure the thesis underlying the investment remains solid and tracks our expectations. We look for warning signs among several sources, including academic reports, industry studies, press releases and company presentations.

1. http://www.fa-mag.com/news/millennial-interest-in-values-investing-rising-with-performance-27349.html

Private investments mentioned in this article may only be available for qualified purchasers and/or accredited investors.