ROBECO
The Investment Engineers

For professional investors

Sustainable Enhanced Indexing

AN ALTERNATIVE TO SUSTAINABLE PASSIVE

Sustainable Investing Expertise by ROBECOSAM

1. Shortfalls of passive investing

One of the major shifts seen in the financial industry over the past couple of decades has been the big rise of passive investment strategies at the expense of traditional active management. But, despite its undisputable merits of being low-cost and transparent, passive investing comes with its own set of challenges as it:

- inevitably lags the market index due to management fees and transaction costs;
- is prone to arbitrage due to its transparent approach that can be exploited by active investors;
- ignores decades of academic insights on asset pricing and can have negative exposure to proven factors;
- faces sustainability integration limits and does not have the tool of divestment as recourse.

An alternative to sustainable passive

More recently, investors have increasingly looked to passive strategies to address their sustainability preferences, for example by tracking passive sustainable solutions such as controversy-screened or low carbon indices. However, these sustainable passive investment vehicles are often prone to inherent issues which are effectively addressed by Robeco's Sustainable Enhanced Indexing strategies. Through the application of our cutting-edge factor and sustainability expertise in our investment process, we are able to provide an attractive alternative to sustainable passive. This concept is a means to systematically capture the broad market return and benefit from well-rewarded factor premiums, while integrating multiple sustainability dimensions: including values-based screening, SDG alignment, ESG integration, environmental footprint steering and active engagement.

Ultimately, our strategies provide the same benefits to those offered by sustainable passive investing, with diversified and transparent portfolios as well as liquidity and low fees. In addition, they also ensure the following:

- potential to harvest a higher return after cost through tilts to proven factors;
- ability to avoid arbitrage risk and actively take advantage of rebalancing opportunities;
- incorporation of 50 years of research in factor investing, risk management and portfolio construction;
- steering on key sustainability drivers by a leader in sustainable investing;
- reflection of voting and engagement outcomes in portfolio positioning.

2. Building an alternative to sustainable passive in three steps

Our Sustainable Enhanced Indexing strategies aim to deliver stable outperformance after costs and a superior sustainability profile compared to the market index with a low tracking error. We apply a rules-based investment process designed to benefit from decades of factor investing, sustainable investing and portfolio construction insights.

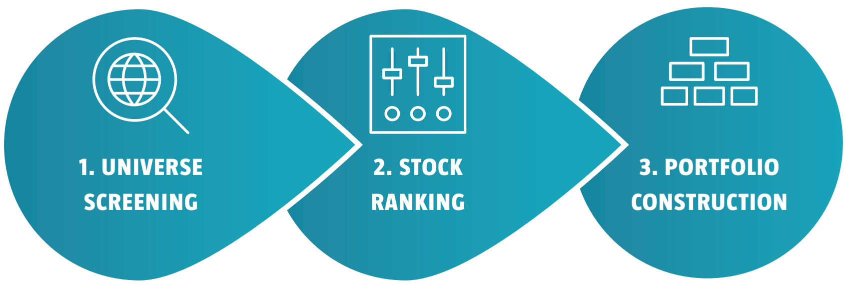
We believe that our integration of established quantitative factors and rigorous focus on risk management improve the long-term risk-adjusted returns compared to generic (passive) sustainable strategies. Our strategy is based on a successful track record in Enhanced Indexing since 2004. It is supported by a stable and dedicated team.

The incorporation of return drivers and the valuation awareness makes this a unique offering as many sustainable passive solutions may be heavily tilted towards growth stocks and may come with large active risks, such as large sector bets (for example underweight exposure to energy and materials) as value stocks generically tend to score less well on sustainability aspects. Our proven process allows us to achieve a significantly better, multi-dimensional sustainability profile, while also providing attractive upside potential with limited deviations from the reference index.

1. Sustainable investable universe

The starting point is the definition of an investable universe. Given that the strategy is benchmarked against the MSCI World Index, its departure point is a global developed investment universe which consists of approximately 2,000 stocks.

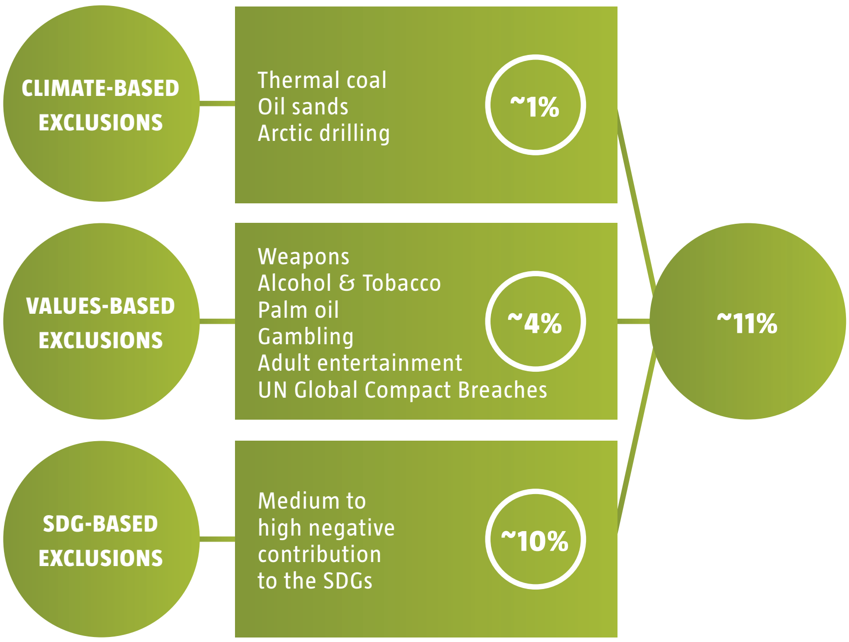
Figure 1 | Investment process



Source: Robeco

The first step of sustainability integration relates to the exclusion of companies with harmful business practices. In our view, these firms are incompatible with a sustainable investment strategy. We exclude stocks linked with alcohol, adult entertainment, Arctic drilling, cannabis, coal power expansion plans, controversial weapons, firearms, gambling, military contracting, nuclear power, oil sands, palm oil, thermal coal, tobacco and United Nations (UN) Global Compact breaches. These are based on strict revenue thresholds. We also preclude stocks if our engagement efforts are not successful or when we identify persistent governance issues.

Figure 2 | Climate and values-based exclusions combined with SDG screening



Source: Robeco. The percentages in the boxes state the weight of exclusions per category in the MSCI World Index. The total percentage of excluded companies is lower than the sum of the parts due to certain companies overlapping across the three exclusion themes (for example, an energy company excluded due to the climate theme generally also contributes negatively to SDG 13 - Climate Action). The total number of exclusions is approximately 600 stocks. As per end of December 2021.

Following on from values-based exclusions, we take into account the UN Sustainable Development Goals (SDGs) which are a collection of 17 interlinked global goals set by the UN as a blueprint to shift the world onto a sustainable and resilient path. We believe stocks with strong negative (-3) and medium negative (-2) contributions to the SDGs may entail unrewarded sustainability risks. Consequently, we refrain from investing in these companies.

Robeco's proprietary SDG framework

Our SDG framework assesses how a company contributes (positively or negatively) to the realization of the SDGs. It consists of a three-step sequence. It starts with a baseline product and service-based assessment, followed by company-specific analyses on how products and services are produced and delivered. The process ends with a final screening and review of controversies that could negatively influence the SDG impact and hence the SDG scores. The final results of this three-step analysis are quantified in an SDG score. Company scores vary from +3 (high positive) to -3 high negative.

Figure 3 | Proprietary SDG framework

Step 1 Products	Step 2 Procedure	Step 3 Controversies
What do companies produce?	How do companies produce?	Are controversies known?
Positive contribution examples: Medicine, water, healthcare Negative contribution examples: Shale gas, fast food, gambling	Governance factors Pattern of questionable conduct? Differentiate between firms with highest SDG impact	Examples of controversies: Spills, bribery and fraud, mis-selling

Figure 4 | KPI assessments are summed to determine a final SDG score

Products	Quantifying contributions
Operations	Quantifying contributions
Controversies	Quantifying contributions

Assesment	Impact	SDG Score
Positive	High	+3
	Medium	+2
	Low	+1
Neutral		0
Negative	Low	-1
	Medium	-2
	High	-3

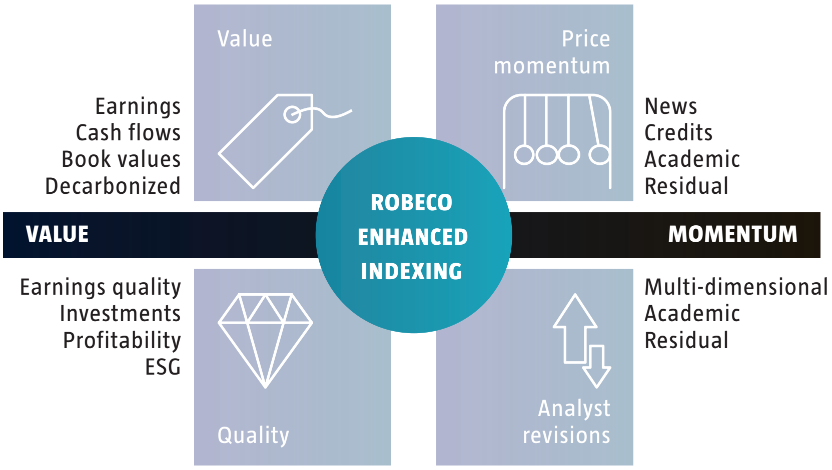
Source: Robeco

2. Scoring and ranking constituents

Once a sustainable investable universe has been defined, we then move on to the stock-ranking phase. Our live track record shows that we can achieve balanced exposure to proven and enhanced alpha factors that we have thoroughly tested over time. We have used these variables in our stock selection models since the 1990s, including our Enhanced Indexing range since its inception in 2004.

Each alpha factor consists of multiple underlying variables. We apply sophisticated risk controls in the definition of our factors to avoid unrewarded risks. We determine the relative attractiveness of stocks based on analyst revisions, momentum, quality and value factors, as shown in Figure 5.

Figure 5 | Balanced exposure to proven alpha factors in stock ranking model



Source: Robeco

In our stock ranking model, we use ESG signals as part of our quality factor. We also steer on a proprietary decarbonized value signal.[1] While many generic value-tilted strategies tend to tilt to asset-heavy sectors and 'brown' companies, our approach to valuations addresses unrewarded carbon risks and punishes stocks that are cheap for a reason (i.e. being overly pollutive).

The stock selection model produces a total score for each stock by combining the outcomes on the different factors, and then ranks all stocks from high (attractive) to low (unattractive). The rankings are compiled relative to stocks within the same region and sector to mitigate active risks. We then overweight the most attractive stocks. Conversely, stocks with less attractive profiles are underweighted relative to the benchmark. Portfolios are rebalanced monthly to ensure optimal exposure to the best-scoring stocks over time as well as achieving our sustainability objectives.

1. Swinkels, L., Ūsaitė K., Zhou, W., and Zwanenburg, M., October 2019, "Decarbonizing the Value factor", Robeco article.

3. Constructing sustainable portfolios

While passive vehicles generally either ignore sustainability aspects or limit their approach to negative screening or one single dimension like carbon footprint reduction, our Sustainable Enhanced Indexing strategies use a multi-dimensional approach. In the portfolio construction phase we aim for a superior sustainability profile versus the market index. This is achieved through the use of our proprietary portfolio construction algorithm which builds an optimal portfolio according to risk, return and sustainability considerations. Ultimately, our portfolio construction algorithm aims to achieve the desired factor tilts while simultaneously improving the portfolio's sustainability profile. This is accomplished with an ex-ante tracking error target of 1.3%, while satisfying the sustainability criteria set out below:

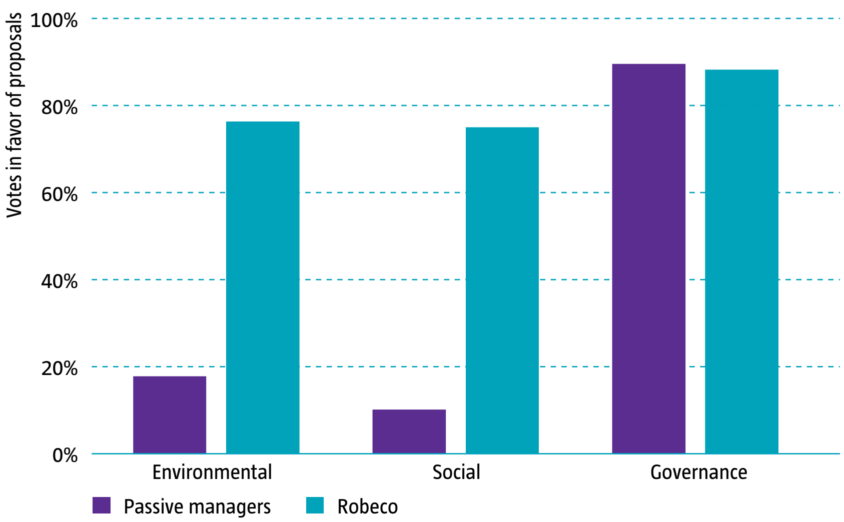
- 10% lower ESG risk rating than the market;
- 30% lower carbon footprint (based on greenhouse gas emissions) than the market;
- 20% lower waste generation than the market;
- 20% lower water usage than the market.

An active stewardship approach is reflected in portfolio positioning

Robeco believes that engagement and voting are key activities for a successful sustainable investing strategy. We target companies for a constructive dialogue on ESG factors. Several academics have documented that active ownership is associated with positive impact at company level.[2] Indeed, actively engaging with directors on sustainability issues can yield a positive effect on listed firms.

However, the ongoing rise of passive investing has introduced an agency problem: passive investors can engage with management, but cannot divest as they are required to replicate an index. Robeco research on the voting behavior of passive managers even revealed that they had blocked or voted against sustainability-related shareholder proposals over numerous years, as depicted in Figure 6.[3] Thus, the considerable influence held by passive investors is not sufficiently used and may delay progress.

Figure 6 | Voting of asset managers in favor of ESG proposals (2018)



Source: Robeco. The chart shows the percentage of votes in favor of environmental, social, and governance proposals by the 'big three' passive managers (BlackRock, Vanguard, and State Street) and Robeco in 2018. Data is based on over 500.000 fund-votes cast on ESG proposals in the first half of 2018.

2. Barko, T., Cremers, M., and Renneboog, L., September 2017, "Shareholder engagement on environmental, social, and governance performance", Journal of Business Ethics; Dyck, A., Lins, K. V., Roth, L., and Wagner, H. F., March 2019, "Do institutional investors drive corporate social responsibility? International evidence", Journal of Financial Economics; and Dimson, E., Karakaş, O., Li, X., January 2018, "Coordinated engagements", ECGI working paper

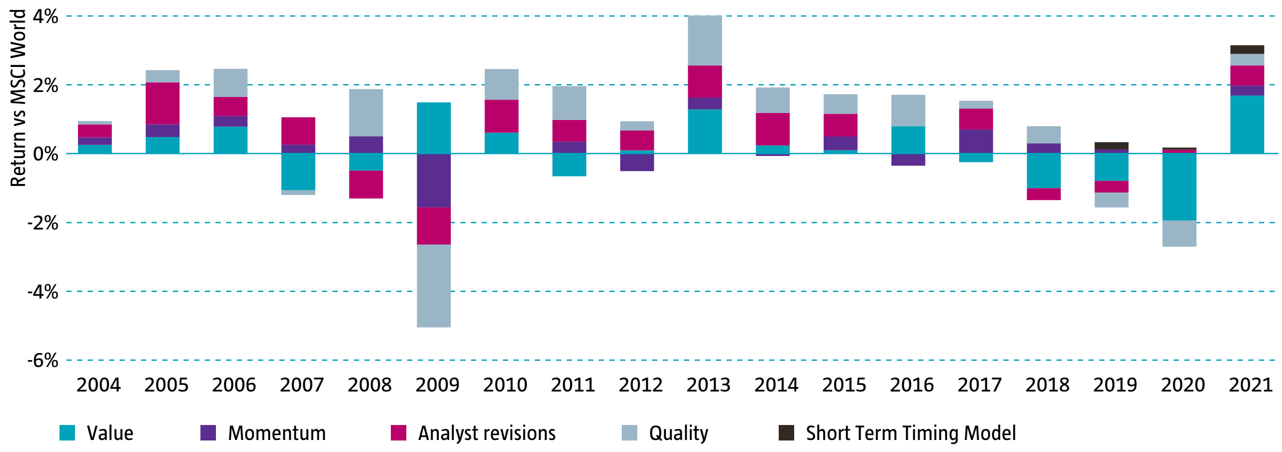
3. Groot, de, W., Koning, de, J., and Winkel, van, S., June 2021, "Sustainable voting behavior of asset managers: do they walk the walk?", Journal of Impact and ESG Investing.

By contrast, our Sustainable Enhanced Index strategies integrate active stewardship. There is a direct link between our active ownership activities and portfolio positioning. Companies that are placed under our enhanced engagement program or exhibit governance issues are underweighted relative to the MSCI World Index. Should the engagement be closed unsuccessfully, the company may be excluded from the investable universe and any remaining positions in the portfolio will be sold. Lastly, we also collaborate with like-minded investors and take part in initiatives such as Climate Action 100+.

3. A proven track record

We have managed Enhanced Indexing portfolios since 2004 and built a strong track record which is reflected by our flagship strategy outperforming in 14 out of the 18 years since its inception. This has been achieved through our proven stock selection model which attains balanced and diversified exposure to multiple factors. These factors have all contributed positively to performance since inception as shown in Figure 7.

Figure 7 | Robeco Composite Quant Developed Markets Equities



Source: Robeco. The chart shows excess portfolio returns versus the market index. The excess returns are fully attributed to four underlying Robeco factors: value, momentum, analyst revisions and quality. The returns are based on the gross asset value of the Robeco QI Institutional Global Developed Enhanced Indexing Equities Fund. Monthly data is used since its inception in September 2004, gross of fees. All figures are in EUR. Results obtained in the past are no guarantee for the future.

Using the strategy

We believe our Sustainable Enhanced Indexing strategies provide a solution for clients who are looking for low-cost, low-tracking error strategies, with a proven track record of alpha generation and sustainability integration. Our strategies achieve efficient factor tilts and significant sustainability improvements over the MSCI World Index, with a tracking error budget of only 1.3%. This gives clients exposure to a sustainable international core equity portfolio, that is tilted towards attractively valued, high-quality companies with favorable sentiment and sustainability characteristics such as SDG alignment.

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