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For professional investors
February 2019

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The Investment Engineers

Overcoming the challenges of ESG integration in Chinese A-shares

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- Tailored ESG integration methodology for Chinese A-shares
- Powerful tool to spot the winners and losers in domestic market
- ESG profile coverage for 100% of portfolio and 70% of universe

Growing interest in sustainability investing is driving changes in markets. It is having an impact either through stricter regulation on issues such as climate change, or due to changing consumer preferences with respect to food and electric cars. Sustainability concerns are subsequently directly affecting companies and investors. A structured approach to assessing the risks and opportunities that come with these changes can help investors make better-informed decisions and spot risks and opportunities at an early stage.

This trend is particularly relevant for investors in Chinese companies. Against the backdrop of China's slowing economic growth and the government's shift of focus from seeking GDP growth in absolute terms to a higher quality of it, there is increasing spotlight on the environmental impact and social implications of economic growth. Corporates are being steered towards pursuing sustainable growth, both for the national interest and their own good. At the same time, their corporate governance mechanisms are under increasing international scrutiny, as the A-share market opens up to more foreign capital.

'ESG use in China has become an irreversible trend'

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The pace of opening up China's stock market has accelerated in the past 12 months. MSCI and FTSE Russell, two of the world's leading index providers, have stepped up A-share inclusion into their mainstream indices. This will drive a long-term fundamental change in the participation dynamics of the A-share market. Unlike its counterparts in developed markets, the Chinese A-share market is dominated by local funds, and by domestic retail investors in particular. Overseas investors tend to have better ESG investment discipline, which will push local institutional investors to follow suit. It means that ESG use in China has become an irreversible trend, and companies or investors who fail to embrace it will get left behind.

As a pioneer in sustainability investing, Robeco has long believed in the usefulness of applying ESG principles to fundamental equity investments. We have integrated ESG into the investment process for choosing stocks for the Chinese A-shares strategy from the very beginning. We have ESG profile coverage for 100% for our portfolio holdings, and for more than 70% for our broader Chinese stock universe. We do much more than just scratch the surface by only looking at ESG scores from external data providers. Our ESG analysis is based on Robeco's global framework and tailored to the specific characteristics of the Chinese stock market.

ESG information leads to better-informed decisions

In a way, this is nothing new for. We have long believed that using financially material ESG information in our investment process leads to the ability to make better-informed investment decisions, contributing to superior risk-adjusted returns in the long run. This investment belief is supported by a growing body of evidence. A good example of such research is the 2015 study entitled 'From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance' by Oxford University and Arabesque Partners. This paper examined more than 200 sources – including academic research, industry reports, newspaper articles and books – and concluded that "80% of the reviewed studies demonstrate that prudent sustainability practices have a positive influence on investment performance".

A separate survey later that year by Deutsche Bank's asset and wealth management division in conjunction with the University of Hamburg went much further. This research examined the entire universe of 2,250 academic studies published on the subject since 1970, using data spanning four decades until 2014. It concluded that ESG made a positive contribution to corporate financial performance in 62.6% of meta-studies and produced negative results in only 10% of cases (the remainder were neutral).

We integrate sustainability factors into our decision-making process for our entire range of fundamental equities, fixed income and quantitative strategies. The key to success is to focus only on those ESG factors that are financially material – they have a direct impact on the bottom line. Most of the academic studies document a positive contribution from doing this. An example is 'Corporate Sustainability: First Evidence on Materiality' by Khan et al[1] (2015), which shows that focusing on financially material sustainability factors that directly impact revenues or costs can be value-enhancing for shareholders.

Hurdles to overcome in the Chinese A-shares market

We can therefore confidently assert that it works, but there remain hurdles to overcome in applying it fully to investing in China, where the concept is still nascent. First, listed Chinese companies have a relatively lower awareness of the ESG concept, and a limited appreciation of the importance of sustainability to their business operations. This leads to a misalignment of mindsets that can be frustrating for western investors who want to tap the Chinese market but also want to stick to their sustainability principles where possible.

Second, although more than half of Chinese listed companies now publish annual sustainability or corporate social responsibility reports, most of them treat this as a box-ticking exercise, and do not provide adequate disclosures about ESG management.

Third, there is lack of a comprehensive regulatory framework to promote sustainability investing, in contrast with Europe, where many national laws or stewardship codes exist to regulate it. The Netherlands, for examples, bans investment in controversial weapons, while the UK introduced a sugar tax to combat unhealthy food, which had a major impact on the business models of food producers. Meanwhile the EU is working on a pan-European framework for sustainable finance to make the financial sector a more powerful voice in fighting climate change. [2] In the absence of top-down push, ESG disclosures by Chinese companies are often sporadic and non-standardized.

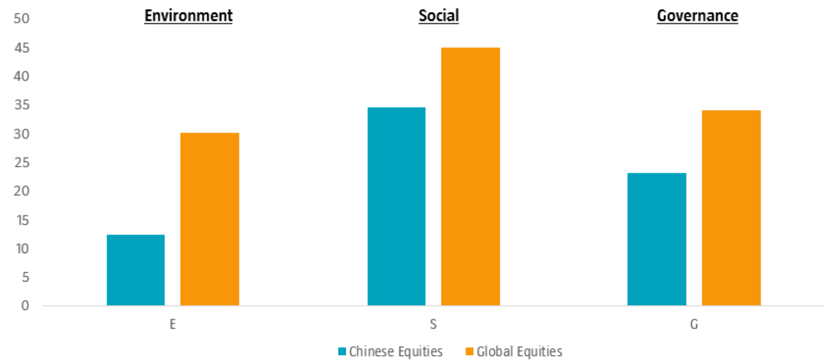
Fourth, a lack of information, especially in structured data, makes forming a view of one's ESG performance and cross-company comparison challenging. Fifth, the community of investors in Chinese companies does not have a collective voice – the UK has the Sustainable Investment and Finance Association, for example – to demand more ESG-oriented management and disclosures. International associations such as the UN Principles for Responsible Investment or the International Corporate Governance Network tend to have little influence on Chinese businesses or domestic investors. This in part contributes to the slow-moving process at the regulator and company level.

Despite these hurdles, a number of institutions have taken a first step in assessing Chinese companies' ESG performance. The leading ESG rating providers who partly base their assessment on company disclosures tend to score Chinese A-share companies lower than

[1] Corporate Sustainability: First Evidence on Materiality, The Accounting Review 91-6 (http://aaajournals.org/doi/10.2308/accr-51383)
[2] http://europa.eu/rapid/press-release_IP-18-3729_en.htm?locale=en

their counterparts in western markets because of the lack of transparency. Based on the limited assessments of the ESG performance of Chinese companies by RobecoSAM, it is no surprise to find that on average, Chinese companies score lower on all aspects of sustainability than their global peers (see figure 1). It is worth pointing out though that ESG coverage for A-shares is currently limited, mainly due to the inaccessibility of information. This situation is bound to improve as China's capital market opens up, and more international investors make allocations to China. We believe that the investment firms that are fundamentally best equipped for managing ESG issues will enjoy the greatest benefits of this increased ESG coverage.

Figure 1 | Chinese companies' average score on E, S and G compared to the global universe



Source: RobecoSAM

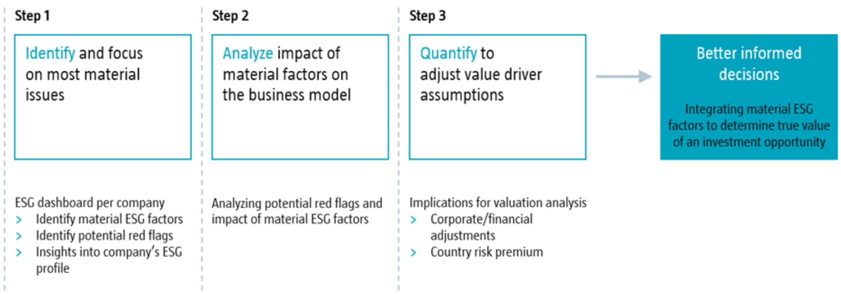
How Robeco integrates ESG into the investment process

Recognizing the inherent challenges, the Robeco Chinese A-shares strategy is still committed to ESG-integrated investment decisions. We believe that there is value to be gained using our access to RobecoSAM's research and analysts, combined with our own in-depth understanding of the companies and industries being analyzed.

In particular, we see this as an opportunity for our investment strategy to:

1. Gather more information and a better understanding of how companies are addressing the changing environment, thereby gaining a better insight into a company's strengths and weaknesses, using this alongside the traditional fundamental analysis.
2. Help drive change and improvement in companies' ESG behavior, thereby unlocking investment value in the long run.

Figure 2 | Integrating ESG into our investment strategy



Source: Robeco

For Robeco Chinese A-share equities, we base our ESG-integrated investment analysis on Robeco's global framework (see figure 2), and strengthen it by incorporating characteristics exhibited by the Chinese capital market. To achieve this, we use a framework of three steps. First, we use an ESG database of quantitative scoring which combines data from RobecoSAM's Emerging Markets ESG dashboard and Corporate Sustainability Assessment (CSA). The dashboard collects data specifically pertaining to the ESG issues that emerging markets face, from pollution (E) to poor labor practices (S) and corruption (G), and is quite useful in identify high risk ESG areas which warrant further investigation. The CSA is an annual evaluation of the sustainability practices of more than 3,000 participating companies, and grows in its scope every year. We also use information from third-party data providers. And some data is relatively straightforward to acquire directly – for example, by reading through company disclosures, attending conferences, having meetings with investee companies, or just reading the news.

What is important when choosing stocks for the Chinese A-shares fund is to factor in the data points that are particularly relevant and informative in the context of China. For example, shareholders of private companies in China often pledge their shares as collateral in order to obtain financing, as alternative funding channels are not well developed. This leads to a stock pledge ratio, the level of which can be an indicator of future risk. A high ratio sends a warning signal, especially under bearish market conditions, as the share price gets near the threshold at which a transfer of ownership to cover the debt becomes imminent.

Once we have enough data, we build an ESG profile for the company based on sector-specific factors that are material to a company's performance over the long term. For example, having a robust environmental strategy is critical for players in the oil and gas industry, but is less important for educational services. We are then able to integrate all this ESG analysis into our investment cases in the form of valuation adjustments, forming a view on what is the true value of the company (which may not be reflected in its share price). In order to reach this point, the Chinese A-shares strategy takes a deep-dive into company's value drivers, including such things as the sustainability of growth in its industry, the company's competitive advantage and market share. We can then benchmark its financial and ESG performance against those of peers and industry best practice, and finally take an investment decision on whether or not to buy the stock.

Further to ESG-integrated investment analysis, Robeco also applies active ownership by engaging with companies to try to address any ESG issues and help steer them towards a more sustainable business model. We have a dedicated team of engagement specialists based in our offices around the world who enter into dialogs with the companies in our portfolios. Such dialogs are usually successful when companies realize that it is in their own interests to change. The second main way for Robeco to make the most of its voice as an investor is by voting at around 5,000 shareholder meetings per year globally. Voting against a company – or threatening to if it doesn't address serious problems – can also be a highly effective means of acquiring change, thereby enhancing value.

Sustainability is therefore an indispensable part of our investment decision making. We believe that using this comprehensive ESG integration framework makes our investment cases more robust, and helps us identify unpriced in upside opportunities and circumvent potential downside risks.

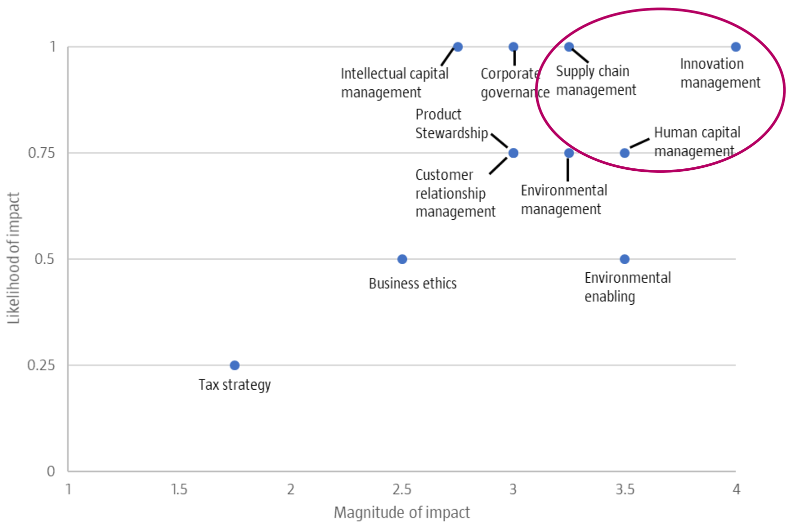
ESG integration examples

To better illustrate how we apply this ESG framework, let's use some examples. Company A is a leading Chinese equipment manufacturer and at the forefront of China's industrial upgrading. The company is well known for its product quality and responsive after-sales service. Its products are widely used in auto parts, information technology, packaging and hardware industries.

We first look at Company A's available ESG scores. The most important one comes from RobecoSAM Emerging Markets ESG dashboard, which gives the company a score of 55 and means it ranks first within its sector. Additionally, we evaluate ESG data points that are particularly relevant in China, such as the stock pledge ratio. Against the backdrop of the underperforming stock market in China during 2018, some companies with share pledges faced margin calls from brokers. This not only resulted in their financing being cut off, but also caused a transfer of the companies' ownership as their equities changed hands. We recognized that a high share pledge ratio by the company's largest shareholder, who was also the CEO, was a potential source of risk. After further investigation, we understood that the financing need did not conflict with the CEO's commitment to the main business. We also noticed that the company had a relatively strong reliance on key customers and suppliers, and it received government subsidies at a level of 4% of its profit before tax in 2017. Although we will continue to closely monitor these last two issues, they are not by themselves reasons not to invest.

Second, we build a qualitative ESG profile for the company based on material factors specific to this sector. For company A, we identified the management of innovation, human capital and supply chains as the most material ESG factors (see figure 3). On the innovation front, the company is considered to be a leading contributor to the automation of China's manufacturing industry. Regarding human capital, it offers a comprehensive range of employee benefits and training programs to support their career advancement. As the company expands its workforce, the percentage of university students employed is also increasing, which is proxy indicator of the company's technological knowhow. On supply chain management front, the company says it applies a consistent set of assessment criteria, but does not disclose further details.

Figure 3 | Materiality plot for Company A



Source: RobecoSAM

Third, we deep-dive into the company's value drivers and evaluate its performance in the context of the industry. The company deploys an environmentally friendly manufacturing technique and has a competitive edge in innovation. Its management has been deeply committed to research and development, and the related investment has been growing year-on-year. We believe that this will bring upside potential which will lead to the company outpacing the industry. The company is expanding the scope of industrial markets in which its products can be used, and is reducing its reliance on imports for a critical component. In the next three to five years, the company is likely to become self-sufficient in this critical component, which will drive up gross margins by as much as 10%. Additionally, its more cost-effective labor force results in more production capacity and a higher efficiency than peers.

With this analysis, we created a holistic view of Company A's ESG performance in the context of the industry. Given that we think it can outperform overall industry growth and sustain its competitive advantage, we lowered the cost of capital assumption and increased our growth forecast to reflect our more optimistic view than the market. This resulted in a 1% lower weighted average cost of capital and 3 percentage points in growth numbers, and subsequently led to 20% more upside than the pre-ESG adjustment case.

ESG also helps with downside risk control

In addition to systemically integrating ESG analysis into our investment case, we also use ESG information as a tool to filter out high-risk companies.

Company B is a Chinese homeware manufacturer that operates in a fragmented industry. We quite liked the company because of its leading position and visible growth trajectory. However, our ESG analysis showed that not only did the largest shareholder (who was also the chairman and CEO) hold more than 40% of shares, his stock pledge ratio was also high. Additionally, he showed early signs of reluctance to run the business for the longer term. We therefore chose not to invest. The stock initially went up, but started to fall on concerns related to the high stock pledge ratio, and then dropped over 50% to well below the price point it was at when we first made our analysis. The company was ultimately taken out by a major competitor. This is an example of where our ESG analysis really protected us from a poor investment which had initially looked quite attractive.

Company C is a leading Chinese metals and mining company. Our fundamental analysis showed upside because of expected long-term commodity price increases which would benefit the company's ownership of key mines and scale of operations along the entire supply chain. However, based on our ESG integrated investment analysis, we saw that the company has been consistently negligent in protecting employee safety, and reluctant to upgrade facilities to make its mining processes more environmentally friendly. We believed that such practices will expose the company to more risks of environment-related fines, and lead to margin contraction and increasing capital expenditure in the future. After taking this into account, this opportunity was no longer attractive for us.

Company D is a leading Chinese food and beverage company. Our fundamental analysis showed upside because of the company's competitive advantage, positive relative growth to the industry, and its valuation. However, based on our ESG integrated investment analysis, it came to our attention that the company had an abnormally high level of related party transactions with its holding company, and with other subsidiaries of the parent. These transactions were ordered and approved by the CEO in order to transfer company interests for his personal benefit, and he was ultimately arrested for unethical conduct. ESG integrated analysis once again helped us avoid a high-risk investment candidate.

Conclusion: our firm belief in ESG

In conclusion, we observe that Chinese companies are gradually improving their ESG standards. One of the reasons is that the Chinese government is pushing these companies; another has to do with the opening up of China's stock markets. The process of opening up has accelerated in the past 12 months: MSCI and FTSE Russell – two of the world's leading index providers – have stepped up A-share inclusion into their mainstream indices. This will drive a long-term fundamental change in the participation dynamics of the A-share market, meaning that more foreign institutional investors with higher ESG standards will participate, and push ESG standards higher.

As a pioneer in sustainability investing, Robeco has long believed in the usefulness of applying ESG principles to fundamental equity investments. We are privileged to be able to leverage all the work our sister company RobecoSAM has done over the past two decades: this has been very helpful in our efforts to tailor our proprietary ESG framework to the A-share market. We are happy to talk the talk, but walking the walk is what counts as an asset manager; our portfolio holdings on an equal-weighted basis have a 21% higher ESG scores than Robeco's monitored A-share universe.

As an early mover in investing using ESG factors in China, we believe that our systematic approach can uncover threats and opportunities that are not priced in. This can be very beneficial in our efforts to improve the risk/return characteristics of our strategies in this vibrant, challenging and changing investment space.

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The sale of the Fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627. The Fund must not be offered or sold to the public in Uruguay, except in circumstances which do not constitute a public offering or distribution under Uruguayan laws and regulations. The Fund is not and will not be registered with the Financial Services Superintendency of the Central Bank of Uruguay. The Fund corresponds to investment funds that are not investment funds regulated by Uruguayan law 16,774 dated September 27, 1996, as amended.

Additional Information concerning RobecoSAM Collective Investment Schemes

The RobecoSAM collective investment schemes ("RobecoSAM Funds") in scope are sub funds under the Undertakings for Collective Investment in Transferable Securities (UCITS) of MULTIPARTNER SICAV, managed by GAM (Luxembourg) S.A., ("Multipartner"). Multipartner SICAV is incorporated as a Société d'Investissement à Capital Variable which is governed by Luxembourg law. The custodian is State Street Bank Luxembourg S.C.A., 49, Avenue J. F. Kennedy, L-1855 Luxembourg. The prospectus, the Key Investor Information Documents (KIIDs), the articles of association, the annual and semi-annual reports of the RobecoSAM Funds, as well as the list of the purchases and sales which the RobecoSAM Fund(s) has undertaken during the financial year, may be obtained, on simple request and free of charge, via the website www.robecosam.com or www.funds.gam.com.

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