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ROBECO
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Sustainability integration in Quantitative Equity strategies

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- **All Robeco Quantitative Equity strategies integrate ESG factors to ensure a better sustainability profile**
- **Extensive research shows unchanged risk/return characteristics, while unrewarded ESG risks are avoided**
- **Increased ESG coverage in emerging markets allows for a consistent integration across all strategies**

Taking ESG integration to the next level

Robeco is committed to sustainable investing. As a thought leader in sustainable investing and quantitative investing, we are continuously exploring in which manner sustainability can be incorporated into our capabilities. All Robeco Quantitative Equity strategies already integrated ESG factors (Environment, Social and Governance), and since December 2014, we have taken this one step further.

It goes both ways

This article focuses on how we further integrate ESG scores into the investment strategies. A key feature of our new approach is that companies with a favorable ESG score have a higher chance of ending up in the portfolios as we ensure that the portfolio's ESG score is at least as strong as that of the benchmark or reference index. This implies that we also positively screen stocks, contrary to an exclusion policy which only allows for negative screening.

Increasing sustainability while maintaining exposure to the model factors

Sustainability is a broad topic, with different trends per industry, ranging from effective environmental policies to solid employee satisfaction levels, and from decent corporate governance to a positive brand image. Whereas a holding in one or two mediocre companies would not be a reason for immediate alarm, a strong exposure to unsustainable companies at the portfolio level poses a serious risk, as certain sustainability risks could materialize in the future.

We expect our policy to be beneficial in such cases. Empirical analyses show that the improved sustainability profile can be achieved while maintaining the same attractive exposure to the quantitative model factors. Moreover, due to the increased coverage of ESG data in emerging markets we are able to implement this approach in a consistent matter across all regions and strategies. For an overview of all quantitative equity strategies, we refer to Appendix I. Besides this consistent integration of ESG factors, stocks with corporate governance issues or stocks that have major litigation or regulatory risk may be excluded from the investable universe. In addition, Robeco advocates active engagement and proxy voting, which is further discussed in Appendix II.

Sustainability measured by RobecoSAM scores

To measure sustainability, we build on the vast experience of RobecoSAM. Founded in 1995, RobecoSAM was one of the first asset managers to focus exclusively on sustainability investing. It was acquired by Robeco Group in 2006 in line with Robeco's strategic ambition to further develop into the thought leader in the field.

Corporate Sustainability Assessment of over 3,000 companies

Every year since 1999, RobecoSAM obtains financially material information from a range of public sources and directly from companies by inviting them to the annual Corporate Sustainability Assessment (CSA) survey. RobecoSAM has one of the largest proprietary corporate sustainability databases with over 3,000 companies. Dedicated sustainability researchers integrate the latest sustainability insights into the survey and analyze the information obtained. The recognition of RobecoSAM's research is demonstrated by the strong interaction between analysts and companies, which often use this feedback loop to strengthen their business processes.

Rapid increase in emerging markets coverage

RobecoSAM follows a best-in-class approach. Companies receive a RobecoSAM score between 0 (low) and 100 (high) on environmental, social and corporate governance factors and are ranked against other companies in their industry[1]. The growing attention for sustainability is reflected by year-on-year increases in the company participation rate. Especially in emerging markets, RobecoSAM's coverage has increased significantly, with around 75% of the companies in the MSCI Emerging Markets index being covered. In terms of market capitalization this is more than 90% of the index. This allows for a consistent integration of sustainability in all quantitative products. The sustainability scores are further enhanced in-house to be most effective for our quantitative strategies.

ESG integration in the investment strategies

We made an enhancement to the investment processes of all quantitative equity strategies in December 2014.[2] In our Global Enhanced Indexing strategies we have already been integrating ESG factors since 2010, as the stock selection model used for this strategy contains a sustainability factor.[3] For our other strategies we used an exclusion policy by not overweighting or including stocks of companies that score very poorly on the RobecoSAM sustainability score in each sector. With our new policy we integrate ESG factors in all the quantitative equity strategies.

Portfolio sustainability score at least as high as that of the index

In the portfolio construction phase we ensure that the portfolio has a weighted sustainability score that is at least as high as that of the relevant benchmark or reference

[1] More information on the methodology of RobecoSAM can be found on http://www.robecosam.com/images/CSA_methodology_en.pdf
[2] Note that the Quant Sustainable Global Equities fund is an exception as for this fund ESG factors are the main driver in the decision-making process. See the Robeco article "Equity returns with enhanced sustainability", October 2013.
[3] For more information we refer to the Robeco article "Enhanced Indexing equity strategy benefits from RobecoSAM scores", June 2014.

index. This implies that companies with a favorable sustainability score have a higher chance of ending up in the portfolios, especially during moments when needed, namely when the portfolio score is on the low side. We have researched this integration technique empirically in extensive portfolio simulations, with sustainability data going back to 2001.

Unchanged risk-return characteristics

In these simulations, we find that the exposure to the quantitative models hardly changes when the new policy is implemented. A measure to quantify this is the average weight of the portfolio in the 20% most attractive stocks, which e.g. for our Global Conservative Equities strategy is more than 70%. We observe that this number stays similar or decreases by 0.2% at most in our strategies. The reason this figure hardly changes is that for each attractive stock that does not score well on the sustainability factor, there are sufficient sustainable alternatives. This is an important finding, as the new policy would have come at a price if this would not have been the case. In our empirical analyses, we therefore observe that reducing this ESG risk is associated with unchanged risk/return characteristics.

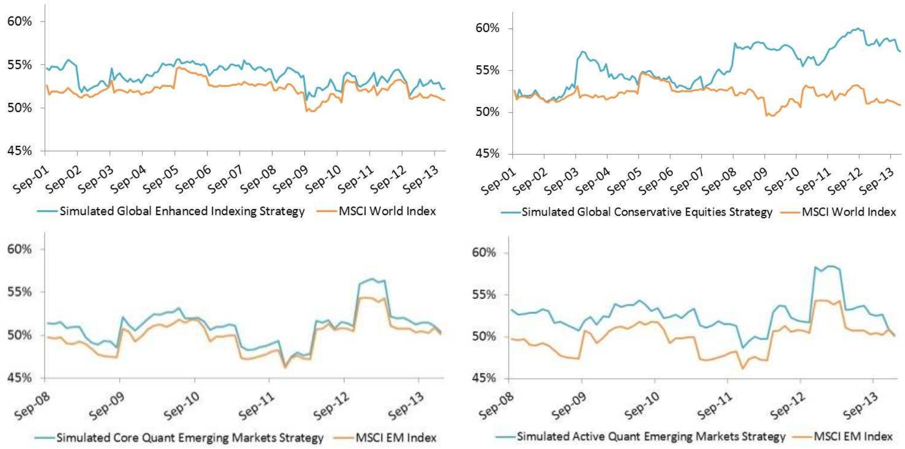
Note that stocks of less sustainable companies did not necessarily show higher volatilities over the limited sample period from 2001 onwards. However we want to be prepared for the possibility that this might happen in the future. The results indicate that all our quant strategies can benefit from this integrated sustainability policy both in developed and in emerging markets.

Empirical analyses

Figure 1 presents simulated historical empirical analyses for four of our core strategies that we use as an example: Global Enhanced Indexing, Global Conservative, Emerging Markets Core Quant and Emerging Markets Active Quant. Our sample starts in September 2001 for developed markets, when the RobecoSAM scores became available, and in September 2008 for emerging markets, when there was sufficient coverage. It ends in December 2013. We show the weighted enhanced sustainability scores of the simulated portfolio and benchmark through time, where a higher score means more exposure towards companies with a higher sustainability score. Our new policy ensures that the portfolio scores are at least as high as those of the benchmark or reference index at rebalancing dates.

Indeed we observe that the portfolio’s score is mostly higher and sometimes equal to that of the index for all strategies. A portfolio with a below-average score would be prone to negative sustainability risks that could materialize in the future. For strategies with a larger active share, such as Conservative Equities, we can expect larger differences in terms of sustainability score. This is also visible from the graph.

Figure 1: Simulated weighted portfolio and index sustainability scores for the Global Enhanced Indexing, Global Conservative, Emerging Markets Core Quant and Emerging Markets Active Quant strategies.



Source: Robeco. Figures present results of historical simulations based on the current strategies. Sustainability scores are ranked on a scale from 0% (lowest) to 100% (highest).

A symmetric rather than a negative approach

The consistent integration of sustainability in all portfolios advances upon the previous exclusion rule. Within the new framework, each individual stock's sustainability score impacts the likelihood of being included or excluded from the portfolio. This symmetric approach leads to a more efficient use of all available sustainability information by also focusing on companies that excel in the area of sustainability.

A form of avoiding unrewarded risks

We consider the integration of sustainability factors a form of prudent risk management. With our enhanced form of ESG integration we avoid the risk of being overexposed to less sustainable companies, and our empirical results show that this is associated with unchanged risk/return characteristics. This is in line with our general risk management philosophy to avoid all risks which are not rewarded with higher returns.

Summary

Robeco has a long tradition of integrating sustainability factors into the investment strategies. Our research has benefited from an increased coverage by RobecoSAM, especially in emerging markets. We find that ensuring that the portfolio sustainability score is at least as high as that of the relevant benchmark or reference index can be obtained with unchanged risk/return characteristics. Thus, it is not necessary to run the risk of being overexposed to less sustainable companies, which is in line with our general risk management approach. We are convinced that this step will help to maintain the attractive risk/return profiles that the quantitative equity strategies have demonstrated up until now.

Appendix I

The Quant Equity team manages two main types of strategies, i.e. the relative return (information ratio) strategies and the total return (Sharpe ratio) strategies. Both types make use of the finding that parts of the financial market realize better risk-adjusted returns than other segments over longer periods. Leading academic studies demonstrate that value, momentum and low-volatility stocks, for example, systematically generate higher risk-adjusted returns.

The information ratio strategies are managed against a benchmark and comprise active, core and semi-passive strategies for both developed and emerging markets. Key information ratio strategies are Global Enhanced Indexing and the Emerging Markets strategies. The Sharpe ratio strategies consider a total return perspective. Key strategies are Conservative Equities and the Value, Momentum and combined Factor Investing strategies.

Appendix II

Robeco's corporate policy on sustainability

Sustainability Investing ('SI') is a true commitment and an explicit strategic choice for Robeco. We aim to give responsibility and sustainability a prominent position in our strategy and operations. Our objective is to turn SI into a competitive advantage and to be regarded as market leader. It is Robeco's conviction that SI, especially the integration of ESG factors into the investment analysis and decision-making process, leads to more comprehensive company assessments and results in the earlier discovery of investment opportunities and risks. By exercising ownership rights through voting and engagement, we aim to create additional long-term value while also taking responsibility as an asset owner. Furthermore, by advocating sustainability investing we meet the demands of clients and society at large.

Governance and Active Ownership department

Engagement and voting activities are the responsibility of RobecoSAM's Governance and Active Ownership department. This department was established as a centralized competence center in April 2005, when Robeco decided to make Sustainability Investing a spearhead of its strategy. The Governance and Active Ownership department is primarily responsible for engagement activities (thematic and enhanced engagement), for exercising voting rights and for the firm's Corporate Responsibility in operational management.

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