FINDING ALPHA IN SUSTAINABILITY

Have your cake and eat it, too

- Alpha possible from sustainability factors, when financially material
- Both must lie at the core of investment philosophy and signal construction
- Robeco has successfully developed a library of SI-related alpha signals

Asset owners and their stakeholders increasingly expect investors to achieve their financial goals while ensuring positive non-financial results for future generations as well. The key question is whether it is actually possible to achieve both, with many investors believing that buying more sustainable companies leads to an erosion of alpha.[1] In other words, more alpha equals less sustainability, and vice versa. A growing number of empirical studies show that it is possible to increase both simultaneously. The key is to develop and follow a process that explicitly focuses on both dimensions instead of treating them as separate goals that must be traded off against each other. In this note, we explore Robeco's sustainable investing journey and identify stock selection signals that, when incorporated into our quantitative equities strategies, can enhance both the sustainability profile and expected alpha of a portfolio.

The intangible economy and financial materiality

Milton Friedman's famous doctrine[1], 'the social responsibility of business is to increase its profits,' is often interpreted as an argument against combining alpha and sustainability[2]. After all, a company that diverted its profits to support social causes is unfairly straying from its core purpose: to make money for the shareholders. However, we argue that in our increasingly intangible economy, sustainability is a key component of financial success.

In the 1970s, companies' values were predominantly tied to physical assets. The three largest firms in the S&P 500 Index in 1970, General Motors, Exxon Mobil, and Ford Motors, primarily dealt in physical goods.[3] In that environment, intangible assets represented a relatively small portion of companies' balance sheets. Fast forward to 2020 and the three largest companies in the S&P 500 Index – Apple, Microsoft, and Google (i.e. Alphabet) - derived much of their value from intangible assets such as intellectual property, brand value, and network effects.

Sustainability can be a powerful lens for analyzing these intangible assets. For example, satisfied employees who align with their company's mission contribute to intellectual property and customer services. Thus, making employee satisfaction an example of a relevant intangible asset. The condition under which intangible assets and

[1] See: "A Friedman Doctrine: The Social Responsibility of Business is to Increase its Profits." The New York Times, Sept 1970. https://nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html
[2] According to a 2021 survey by Morgan Stanley, 70% of investors believe sustainable investing implies a financial trade-off. https://www.morganstanley.com/assets/pdfs/2021-Sustainable_Signals_Individual_Investor.pdf
[3] https://money.cnn.com/magazines/fortune/fortune500_archive/full/1970/

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Sustainable Investing Expertise by ROBECOSAM sustainability-related elements affect corporate valuation is termed 'financial materiality'. (For more on this, see Khan, Serafeim, and Yoon, 2017; Chen and Mussalli, 2020, and Lo and Zhang, 2022.) As such and contrary to initial appearances, our approach to sustainability and alpha aligns with Friedman's thinking. By enhancing intangible assets and hence profitability, sustainability actually may help in fulfilling a company's obligation to increase its profits.

While we reference Friedman's doctrine, it's important to note that we don't endorse all aspects of his views. Rather, we cite his emphasis on profitability to highlight how sustainability, seen through the lens of financial materiality, can indeed contribute to a company's bottom line in our modern, intangible-heavy economy.

Our sustainability journey to date

Robeco's commitment to sustainable investing (SI) has been a pillar of our approach for many years. This began in earnest in the early 2000s, when we acquired SAM (Sustainable Asset Management), a Swiss company known for its expertise in sustainability. This gave us access to SAM's groundbreaking and detailed corporate sustainability assessment, an evaluation tool for companies' ESG performance.

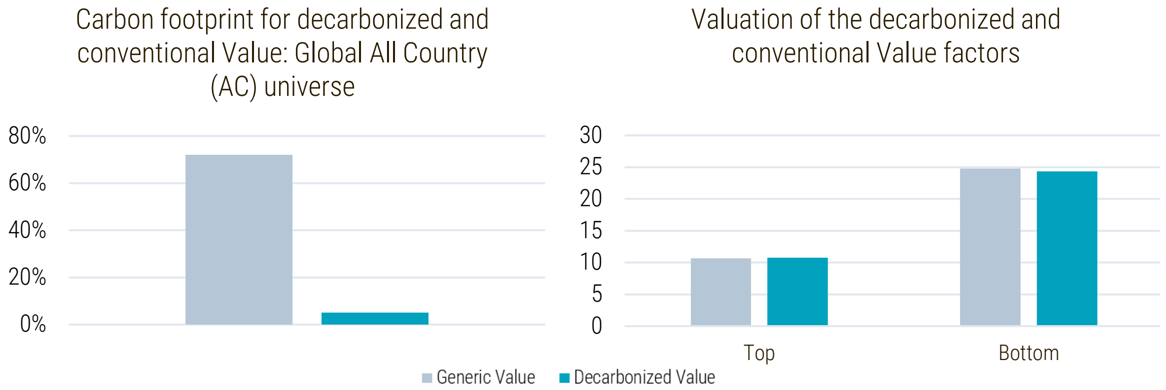
Historically, we have used values-based screens, or exclusion lists for our strategies. In addition, we introduced strategies years ago that favored sustainable companies during the portfolio construction phase. This helped to mitigate potential future ESG risks.

Negative screens could potentially diminish alpha by narrowing the investable universe and by making potentially financially attractive stocks non-investable. Our chief researcher David Blitz sheds a light on how to tackle such challenges in his papers on the effects of exclusions[4].Our focus in this note is on finding alpha opportunities within the vast amounts of sustainability data. For example, our quant research team found alpha 'hidden' within SAM's corporate sustainability assessment data. This research indicated that that companies with higher ESG scores tend to exhibit strong quality characteristics. As a result, we began incorporating proprietary ESG scores into our stock ranking models in the early 2010s.

Another innovation concerns the climate risk exposure of value-tilted strategies. Our research has shown that generic value strategies often have large environmental footprints due to their common, often structural, tilt towards asset-heavy companies and sectors such as energy, utilities, and materials. To address this, we developed an innovative way to improve the environmental footprint of value signals without lowering their value exposure (i.e. cheapness) so that we can retain their return potential, as described in two recent articles.[5] Figure 1 illustrates this.

[4] "Sin Stocks Revisited: Resolving the Sin Stock Anomaly" Blitz & Fabozzi, The Journal of Portfolio Management, 2017 and "Is exclusion effective" Blitz & Swinkels, The Journal of Portfolio Management, 2020
[5] "Decarbonizing the Value factor" Swinkels, Ūsaitė, Zhou and Zwanenburg, October 2019 and "Value investing: Avoiding climate traps" Hanauer, Ūsaitė and Baltussen, May 2023

Figure 1 - Mitigating undesirable environmental footprints while preserving desirable value exposure



Source: Robeco, Refinitiv, Trucost. The graph shows the average carbon intensity of the highest value quintile portfolio minus the lowest value quintile portfolio as a percentage of the footprint of the equally-weighted universe for the conventional and decarbonized value composite. A positive number means value stocks have a larger footprint than non-value stocks. Carbon intensity is the total GHG emissions in tons of CO2 equivalent (tCO2eq) per one million USD revenues across Scope 1+2. The investment universe consists of all non-financial constituents of the MSCI Developed and Emerging Markets indices. The sample period is January 1986 to March 2023.

Source: Robeco, Refinitiv, I/B/E/S. The graph shows the average forward price-to-earnings ratio (FWD P/E) for the top and bottom quintile portfolios of a conventional and a decarbonized value composite. For each month, we compute the median forward price-to-earnings ratio per portfolio and take the average over time. The investment universe consists of all non-financial constituents of the MSCI Developed and Emerging Markets indices. The sample period is January 1986 to March 2023.

Recent examples of sustainability-related alpha factors

Our innovation in sustainable investing and alpha generation has accelerated in recent years thanks to the improvement of sustainability data and the increasing availability of innovative data. We've developed a library of signals that contribute to both portfolio sustainability and expected alpha of our portfolios. To effectively elevate these dimensions, both must be incorporated throughout the research and development process, starting with the investment hypothesis. Approaches that merely consider sustainability as an add-on or afterthought, or that compromise it for the sole goal of alpha generation, are most likely to fall short of achieving optimal results.

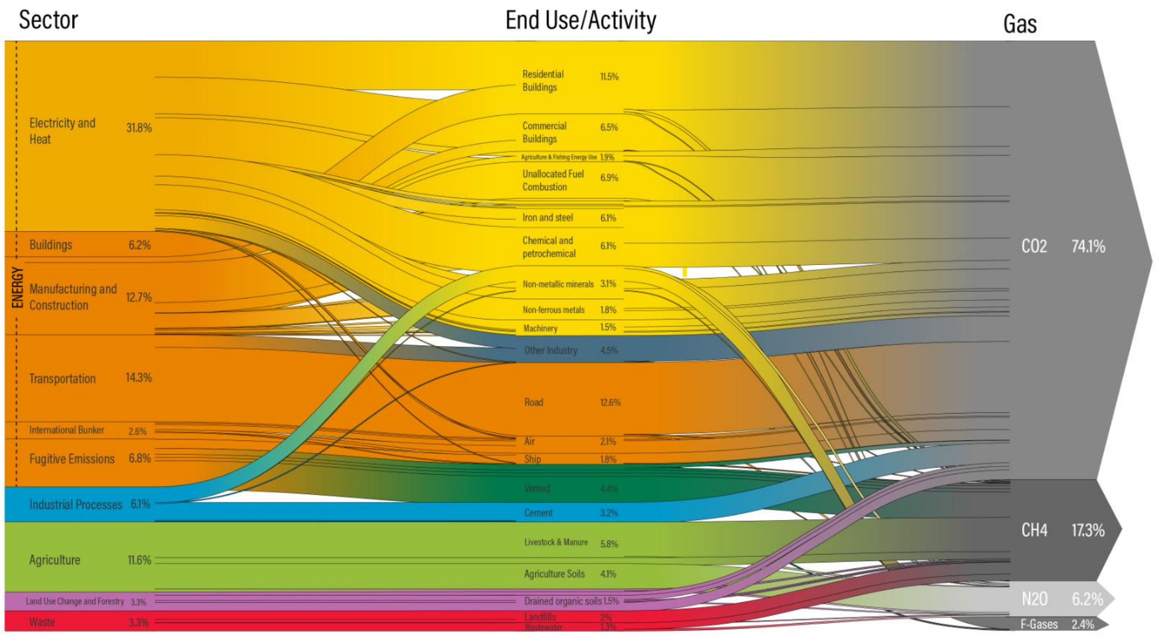
Developing sustainability-related alpha signals requires developing investment hypotheses that target both alpha and sustainability. This emphasizes the need for an economic rationale, particularly financial materiality, to underpin each investment hypothesis. We discuss two examples below.

Resource efficiency

Economic activity inevitably leads to CO_2 emissions as these are byproducts of the production process. The production process requires inputs, such as fossil fuels, which lead to emissions through combustion. Thus, emissions are closely tied to inputs used in a company's production process. This relationship's strength varies depending on the production process.

As shown in the figure below, industries with different production processes have different emission-output relationships. This highlights the importance of identifying economically meaningful peers when constructing investment signals based on resource efficiency. This signal is especially relevant for resource-intensive sectors where emissions serve as a good proxy for process efficiency. Our quantitative researchers, using valuable insights from our fundamental research teams, incorporate these considerations into our signal construction.

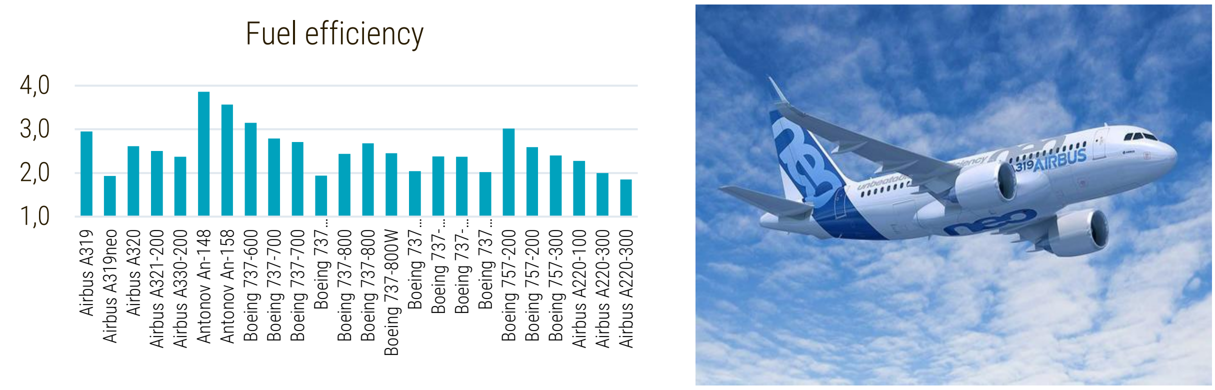
Figure 2 – World greenhouse gas emissions in 2019



Source: Climate Watch, based on raw data from IEA (2021), GHG emissions from fuel combustion. Modified by World Resources Institute

Under the resource efficiency framework, if a company can generate more revenue than its competitors using the same input, it's indicative of a more efficient production process. In other words, lower emissions can be associated with higher operational efficiency by evaluating a company's resource efficiency. For example, airlines with more modern fleets, such as those using Airbus A319neo, are typically more fuel efficient than their counterparts operating Antonov AN-158. As Figure 3 shows, there can be significant variations in resource efficiency even among peer companies within the same industry.

Figure 3 – The bottom line: fuel efficiency for various short-haul aircraft types



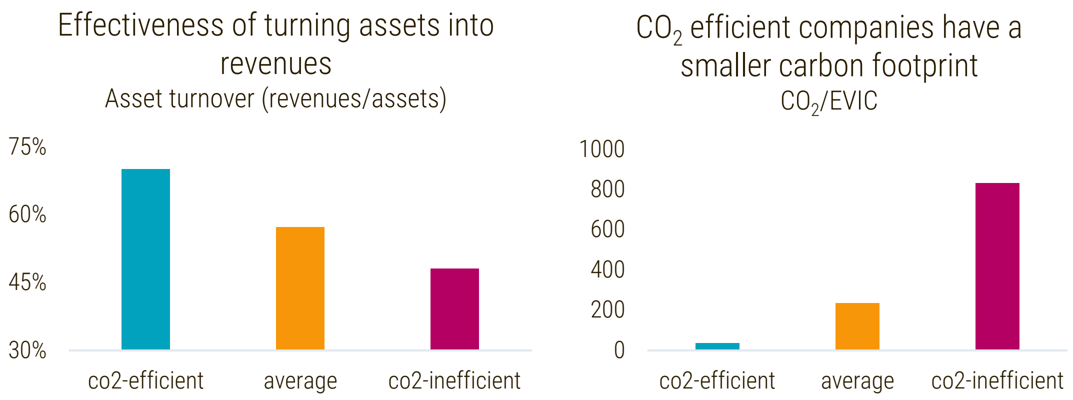
Source: Wikipedia, https://en.wikipedia.org/wiki/Fuel_economy_in_aircraft. Fuel efficiency per seat measured in liter per 100 km flown for short-haul flights (~1,000 nmi). For illustrative purposes only.

Companies with superior resource efficiency typically outperform their less efficient counterparts financially. Their outperformance is often linked to operational efficiency, which directly contributes to their financial outcomes. This ties into the notion that well-constructed SI alpha signals target both sustainability and return.

As depicted in Figure 4, companies that have effectively reduced CO_2 in their production process also tend to score better on more traditional measures of operational efficiency such as asset turnover. This is evident in the comparison between CO_2-efficient and CO_2-inefficient companies, with the former displaying a higher asset turnover. Asset turnover, calculated as revenues divided by assets, is an essential measure of a company's ability to efficiently use its assets to generate revenues.

A study by Robeco on alpha signals based on resource efficiency found compelling results. More resource-efficient companies not only yield higher expected alpha than their resource-inefficient peers, but are also associated with a reduction in a portfolio's overall environmental footprint. This is shown on the righthand side in Figure 4.

Figure 4 - Resource-efficient companies also more operationally efficient



Source: Robeco Quantitative Research. Asset turnover for CO_2 efficient and CO_2 inefficient companies; CO_2 efficient and CO_2 inefficient companies are defined by the top and bottom quintiles of sorting stocks based on CO_2 efficiency. Averages for 2010 – 2022 are shown. EVIC stands for enterprise value including cash.

Employee satisfaction

Another example of a factor that can enhance both a portfolio's sustainability profile and alpha potential is the ranking of companies based on their employee satisfaction. As we discussed earlier, many companies' valuation hinge on their intangible assets, with human capital arguably standing out as one of the most important ones. Artificial intelligence is not – and may never be – mature enough to replace human employees entirely, with companies still remaining heavily reliant on humans. However, quantifying human capital is challenging, as its true value isn't explicitly stated in financial statements.

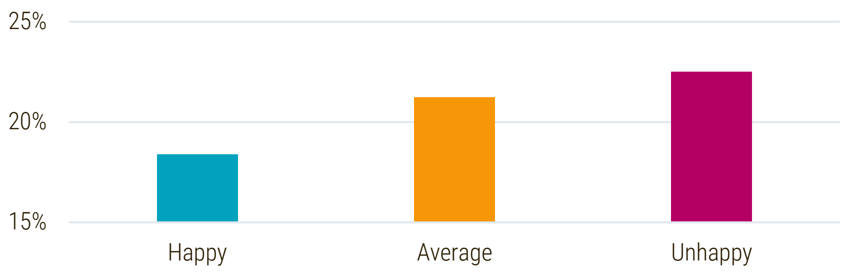
The economic rationale behind this alpha signals is that a happy workforce is expected to be more motivated and efficient. Employee satisfaction is a comprehensive measure that can be influenced by many factors, ranging from healthy food at the canteen to an open work culture that rewards innovation and allows for mistakes. Much like resource efficiency, employee satisfaction is expected to lead to improved operational efficiency and, in turn, financial performance. At the same time, a happy and satisfied workforce is a desirable goal from a corporate social responsibility point of view.

A natural way of gauging the impact of a satisfied workforce on operational efficiency is through payroll expenses. Hypothetically, contented employees might require less financial compensation compared to their disgruntled counterparts. Figure 5 shows that companies with a happier workforce do in fact spend less on payroll per unit of revenue generated compared to those with a dissatisfied workforce. Thus, overweighting companies with high employee satisfaction can generate positive alpha.

There are many different ways to gauge employee satisfaction and motivation, in other words, corporate culture. Approaches range from numerical ratings to written reviews and testimonials by current and former employees.

More advanced analytical techniques, such as natural language processing (NLP), are necessary to extract measures of employee satisfaction and corporate culture out of unstructured text data. However, we find that venturing beyond readily available datasets allows us to gain additional valuable insights into a company's human capital.

Figure 5 - Payroll expenses as percentage of sales compared to employee satisfaction



Source: Robeco Quantitative Research. Employee happiness is based on a proprietary signal from crowd-sourced employee reviews. Over the period 2013 –2021

Integration in Robeco's range of Quant Equities strategies

Robeco has been managing quantitative equity portfolios since 2004, with the range of systematic strategies under this umbrella growing rapidly. We first introduced developed markets and emerging markets enhanced indexing strategies, followed by the launch of our active low-volatility (Conservative Equities) range as well as other factor or style-focused strategies, like value or multi-factor portfolios. More recently, we also introduced our Quantum Equities strategy, which is more focused on playing into and taking advantage of shorter-term market dynamics. When we design our investment strategies, we make sure that their characteristics match our clients' goals. For example, our Enhanced Indexing and Sustainable Beta strategies are positioned as an alternative to passive equity indices and only allow small benchmark deviations to tilt to proven factor and/or sustainability criteria within a certain risk budget.

The sustainability alpha signals that we have described in this note have made their way through our rigorous quantitative research framework, and are now part of the different stock selection models that we employ. These signals are implemented differently depending on each strategy. For example, signals with a shorter investment horizon find their way into the proprietary trade timing indicator and the models with higher levels of turnover. More stable signals, like resource efficiency, are integrated into a basket of stable sustainability-linked signals within the Quality theme of our stock selection models. This way, we can ensure that the individual signals are additive, both in terms of a portfolios' sustainability profile and alpha generation, when added to time-tested stock selection models.

Conclusion

As discussed in this note, it is possible to deliver both better portfolio sustainability characteristics and expected alpha, under the financial materiality condition. Crucially, sustainability and alpha considerations must both lie at the core of any SI alpha signal. The additional benefit of using the quantitative approach to sustainable investing is the comprehensive toolbox comprising statistical and analytical techniques that allows for quantifying alpha and sustainability-related enhancements.

Robeco, being both a quant pioneer and a sustainability leader, has developed a library of SI alpha factors that do both. We have carefully constructed these signals based on our rigorous quantitative research approach complemented with unique insights from in-house sustainability and fundamental research experts. Enhancing returns, stripping out unrewarded risks, and pushing the sustainable frontier are integral to our philosophy and research process. We are happy to share our findings with our clients and other stakeholders, and look forward to finding new ways to achieve their financial and sustainability goals.

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Additional information for investors with residence or seat in Spain
Robeco Institutional Asset Management B.V., Sucursal en España with identification number W0032687F and having its registered office in Madrid at Calle Serrano 47-14º, is registered with the Spanish Commercial Registry in Madrid, in volume 19.957, page 190, section 8, sheet M-351927 and with the National Securities Market Commission (CNMV) in the Official Register of branches of European investment services companies, under number 24. The investment funds or SICAV mentioned in this document are regulated by the corresponding authorities of their country of origin and are registered in the Special Registry of the CNMV of Foreign Collective Investment Institutions marketed in Spain.
Additional information for investors with residence or seat in South Africa
Robeco Institutional Asset Management B.V. is registered and regulated by the Financial Sector Conduct Authority in South Africa.
Additional information for investors with residence or seat in Switzerland
The Fund(s) are domiciled in Luxembourg. This document is exclusively distributed in Switzerland to qualified investors as defined in the Swiss Collective Investment Schemes Act (CISA). This material is distributed by Robeco Switzerland Ltd, postal address: Josefstrasse 218, 8005 Zurich. ACOLIN Fund Services AG, postal address: Leutschenbachstrasse 50, 8050 Zürich, acts as the Swiss representative of the Fund(s). UBS Switzerland AG, Bahnhofstrasse 45, 8001 Zurich, postal address: Europastrasse 2, P.O. Box, CH-8152 Opfikon, acts as the Swiss paying agent. The prospectus, the Key Information Documents (PRIIP), the articles of association, the annual and semi-annual reports of the Fund(s), as well as the list of the purchases and sales which the Fund(s) has undertaken during the financial year, may be obtained, on simple request and free of charge, at the office of the Swiss representative ACOLIN Fund Services AG. The prospectuses are also available via the website.
Additional information relating to RobecoSAM-branded funds/services
Robeco Switzerland Ltd, postal address Josefstrasse 218, 8005 Zurich, Switzerland has a license as asset manager of collective assets from the Swiss Financial Market Supervisory Authority FINMA. The RobecoSAM brand is a registered trademark of Robeco Holding B.V. The brand RobecoSAM is used to market services and products which entail Robeco's expertise on Sustainable Investing (SI). The brand RobecoSAM is not to be considered as a separate legal entity.
Additional information for investors with residence or seat in Taiwan
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Additional information for investors with residence or seat in Thailand
The Prospectus has not been approved by the Securities and Exchange Commission which takes no responsibility for its contents. No offer to the public to purchase the Shares will be made in Thailand and the Prospectus is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.
Additional information for investors with residence or seat in the United Arab Emirates
Some Funds referred to in this marketing material have been registered with the UAE Securities and Commodities Authority ("the Authority"). Details of all Registered Funds can be found on the Authority's website. The Authority assumes no liability for the accuracy of the information set out in this material/document, nor for the failure of any persons engaged in the investment Fund in performing their duties and responsibilities.
Additional information for investors with residence or seat in the United Kingdom
Robeco is deemed authorized and regulated by the Financial Conduct Authority. Details of the Temporary Permissions Regime, which allows EEA-based firms to operate in the UK for a limited period while seeking full authorization, are available on the Financial Conduct Authority's website.
Additional information for investors with residence or seat in Uruguay
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 under 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 27 September 1996, as amended.