QUANTIFYING SUSTAINABILITY

Crafting solutions that meet your sustainability objectives

5 CLIENT CASES
SOLUTIONS

ROBECO
The Investment Engineers

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Unlocking solutions

Investors worldwide are facing the challenge of making their portfolios more sustainable. This can be done in several ways. Some investors aim to contribute to the SDGs, while others choose to invest in the climate transition. The challenge is to offer appropriate solutions.

In this publication, we look at five client cases which differ from each other in many ways – different types of clients, different challenges and different solutions – but have one thing in common: their sustainable investment objective.

Of course, every case is unique, but the message is clear: whatever your challenge is, we can come up with a unique solution together.

1 Creating bespoke solutions for five clients

Client demand for sustainable solutions is continuously changing. Robeco does not just offer 'off-the-shelf' investment strategies that meet generic sustainability goals. We also create bespoke strategies for specific objectives, including mandates that cover separate topics, those using multi-asset, or using the assets of more than one product. Here are five examples of how this worked for clients who wanted to go the extra mile.

CLIENT CHALLENGE 1

Build a buy-and-maintain, SDG and Paris-aligned strategy

Build a credits-based 'buy-and-maintain' portfolio which also included a Paris-aligned climate objective and contributed to the SDGs for a UK pension fund.

CLIENT CHALLENGE 2

Generate superior returns and an SDG impact

Create an insurance-linked product combining multiple, pure-play thematic equity strategies that contribute to the SDGs for an Asian insurer.

CLIENT CHALLENGE 3
Capitalize on growth spurred by the climate transition

Decarbonize investments using a highly diversified multi-asset solution aimed at generating climate-aligned returns for a UK savings scheme.

CLIENT CHALLENGE 4
Create a strategy combining SDGs with engagement

Blend Robeco's active ownership and SDG capabilities to create a product based entirely on engaging with its investee companies for a major European distributor.

CLIENT CHALLENGE 5
Reduce the tracking error of sustainable equities

Deploy our quant investing expertise to help reduce the tracking error of the sustainable equities portfolio of a medium-sized European private bank.

They're different stories, but they all have the same underlying strategy – placing long-term sustainability and the climate transition at the heart of bespoke mandates. Here's how we did it.

2 From frameworks to traffic lights: Our repertoire of cool tools

Robeco has developed research tools over many years to fully integrate ESG factors into the investment process. In more recent years, this has meant a greater focus on the environmental element embodied in our drive for a sustainable transition to net zero. But it also includes the social factors that the transition affects, such as the changes to jobs in the renewable energy transition, and the improvements in governance necessary at high emitters, backed by engagement.

We also have a strong commitment to the Sustainable Development Goals (SDGs), several of which directly address the low-carbon transition. Then there is the wider issue of how nations are reacting, and how more forward-looking data can be acquired. Many tools are used to generate this data, which is then used across all investment processes when deciding whether to buy a company's equities or corporate bonds (credits) or a country's sovereign bonds.

OUR RESEARCH TOOLS INCLUDE:

THE NET-ZERO FRAMEWORK – Launched in 2020, this gives a comprehensive overview of Robeco's commitment to making all its assets under management carbon neutral by 2050, in line with international agreements. At the core is a strategy to decarbonize all portfolios by 7% a year, a rate which would achieve the goal within the 30-year timeframe.

This is not a simple matter of 'decarbonizing' by excluding high emitters from portfolios. Divestment simply transfers the problem from one owner to another, and does not change the real world economy. Instead, we have a big focus on engagement – partly through collaborative projects like the Climate Action 100+ – to get companies to change from within.

ESG BOND FRAMEWORK – The market for ESG-labeled bonds such as green bonds is growing, but it faces considerable concerns about greenwashing, where the bond exaggerates its environmental contributions. Robeco developed a five-step framework to properly assess the ESG credentials of bonds for investments in green bond or credit portfolios.

In the first three steps, we assess whether the bond meets the labeled ESG objective along with the stipulated allocation of proceeds, and whether the sustainability targets are material. Then we scrutinize the impact reporting, the issuer's sustainability strategy and its issuer's conduct. The bond must pass each step to be eligible for Robeco's strategies.

THE SDG FRAMEWORK – In 2016, Robeco became the first asset manager to develop a system for calculating the contributions that companies can make to one or more of the 17 SDGs. The system scores them on a range that extends from -3 (highly negative) through zero (neutral) to +3 (highly positive). It uses net contributions, since companies can often make both a positive and negative contribution, depending on the product or service.

Originally developed for bespoke SDG strategies that only bought the credits of companies with positive scores, the framework is now used across Robeco as a means of evaluating the sustainability of potential investments, including the multi-asset range.

TRAFFIC LIGHT ASSESSMENTS – These calculate whether a company's projected emissions are in line with its required sector decarbonization pathway under a well below 2 °C scenario. As a second step it checks whether verified targets and a credible plan are in place for achieving its emission-reduction goals.

The result is visualized by a green light indicating that the company is 'aligned' with its decarbonization pathway; an amber light for those which are still 'aligning' or are 'partially aligned' (i.e. those in transition); and a red light for those that are 'misaligned'.

QUANT CUSTOMIZER – This is a versatile tool for creating customizing investment solutions in collaboration with clients. It combines elements of risk, return, and sustainability to generate customized portfolios. Particularly useful in its ability to address diverse sustainability preferences, including ESG factors and environmental footprints, it's adaptable enough to focus on specific UN SDGs. This enhanced its relevance in current investment scenarios, and its user-friendly design allows clients to actively participate in portfolio design.

The tool's benefits include rapid customization, precision, and flexibility. With real-time portfolio characteristic insights, it enriches client interactions and decision-making. The Quant Customizer's continuous development and focus on client relevance, data engineering, and research keep the tool at the forefront of investment technology.

PARIS-ALIGNED BENCHMARKS – These are defined by the EU as a benchmark "where the underlying assets are selected in such a manner that the resulting benchmark portfolio's emissions are aligned with the long-term global warming target of the Paris Agreement". To qualify for inclusion in an index, a security must be capable of decarbonizing by at least 7% a year.

Until 2020, no such benchmark existed for measuring the performance of investment strategies against the goals of the Paris Agreement. Robeco innovated in this area by working with German index firm Solactive to create Paris-aligned benchmarks for corporate credits and aggregate bond strategies.

3 Five sustainability solutions

Building from the bottom up is the essence of all investing. When we create portfolios, we use our tools to find the best stocks or bonds for the strategy. The same concept applies when we create mandates that have specific sustainability targets. We take the client's wish list and then construct a portfolio that meets all their expectations, whether that be a drive for net zero and alignment with the Paris Agreement, something more thematic, or a strategy that directly contributes to the SDGs.

And there's no limit to the size or complexity that we can accomplish to meet the mandate. In this chapter we present a number of solutions which deal with four different sustainability goals:

- Aligning to the net-zero pathway;
- Balancing risk, return and impact;
- Mitigating sustainable risk;
- Investing in the sustainable transition.

Combining Buy-and-Maintain with Paris Alignment and the SDGs

CLIENT CHALLENGE 1

Build a credits-based 'buy and maintain' portfolio which also included a Paris-aligned climate objective and contributed to the SDGs for a UK pension fund.

Aligning to the net-zero pathway

The challenge

Pension funds face the dilemma of needing to generate sufficient returns to be able to meet the far-reaching liabilities of an aging population, while also managing the risks of these investments. In addition, sustainability objectives keep rising on pension funds' agendas, particularly regarding climate change, which is changing the landscape for long-term risk and returns.

Reconciling the risk versus return conundrum while also keeping in line with regulation and sustainability objectives is a major challenge. For pension funds, this includes liability matching – the practice of ensuring that liabilities (pension payments) that run from today to far into the future are met with cash flows that are secured in the present. Such cash flows are usually procured from bonds which pay a regular income.

The sustainability challenge can be met in many ways. Two of the most impactful are to devise strategies that are rooted in meeting the Paris Agreement and the path to carbon neutrality by 2050 that it necessitates, along with those promoting the UN's Sustainable Development Goals (SDGs). Both are recognized frameworks for long-term sustainable investing in their own right.

The approach

A major UK pension fund came to us with this very challenge: to build a fixed income-based liability matching portfolio which also included both a Paris-aligned climate objective and contributed to the SDGs. The pension fund wanted to construct a portfolio which matched a specific set of cash flow tenures, for which we advised a customized 'buy-and-maintain' approach allocating to investment grade corporate bonds (credit). This approach offers regular cash flows with a minimized risk.

Buy-and-maintain is based on limiting turnover within the portfolio to keep trading costs down. They are similar to 'buy and hold' strategies, but with in-depth active monitoring. The buy phase is essential, since you must select a suitable and diversified portfolio of bonds to begin. It needs to be able to make it through the market cycle, largely avoiding significant

rating drops and what are known as 'fallen angels'. Once seen as gems, these companies have since lost their investment grade status to become high yield instead.

Our approach to meet the climate objective was achieved by combining our current carbon footprint data with our forward-looking climate metrics. The latter is important to be able to select those companies that are on a clear trajectory to meet the net-zero carbon 2050 goal, decarbonizing by an average of 7% per year.

The obstacles

One of the biggest obstacles to climate investing – and to sustainable investing in general – is getting hold of the right data. Carbon footprints essentially look backward, stating what a company has done in the past. So, we also use forward-looking climate analytics based on our 'Traffic Light' system, which scores a company's degree of Paris alignment with a below 2 °C scenario from one to five.

The main obstacle for SDG investing is in finding companies that can make a net positive contribution to one or more of the 17 goals. For this we use our proprietary SDG Framework which uses a scoring system ranging from -3 (highly negative) through 0 (neutral) to +3 (highly positive).

Meanwhile, all credits run the risk of default (however small), so it is essential to use in-depth credit analysis and rating migration research to minimize this risk. This is magnified in a buy-and-maintain portfolio, since turnover is restricted – it's not acceptable to simply remove and replace securities on an ongoing basis if they fall into or out of favor. The right ones must be chosen in the first place.

The solution

The solution was to create a bespoke SDG Climate Buy-and-Maintain credit strategy which met all the client's objectives, applying in-depth bottom-up issuer research, top-down macro views and dedicated proprietary portfolio optimization tooling. Its highlights are shown in the table below.

After lengthy client consultations, we constructed a portfolio that balanced the pension fund's various risk, return, regulatory and sustainability criteria. It has a yield return and spread-to-treasury – the differential in yields with a government bond of the same maturity – that is higher than its passive reference index. It has a strong average credit rating of A-/A, and a higher fundamental credit score as assigned by our research analysts on a scale of -3 to +3.

More importantly, the strategy's carbon footprint is only half that of the reference universe and 50% of the portfolio's constituents are already Paris-aligned. Moreover, none of the issuers have a negative SDG score compared to 21% of the reference index. And the portfolio was achieved with limited impact on the return potential and quality of the assets.

Table 1: Highlights of the SDG Climate Buy-and-Maintain credit strategy

	Metric	SDG Climate portfolio	Passive reference
Return	Spread to Treasury	139	133
Risk	Rating	A- / A	A- / A
	Fundamental credit score	0.9	0.2
	Duration	4.7	4.7
	Cash flow matching	Yes	No
	Fallen angel % (annualized)	1.6%	2.1%
	Maximum sector exposure	20%	30%
	Number of issuers	80	1439
Sustainability	% negative SDGs	0%	21%
	Carbon footprint	50%	100%
	Paris aligning %	50%	44%
	Climate laggards %	0%	6%

Source: Robeco, Trucost, Bloomberg and using September 2023 valuations. For illustrative purposes only and based on model assumptions. Fundamental score ranges between -3, +3 and reflect Robeco's credit analysts' assessment of the credit quality. SDG score ranges between -3, +3 and reflects Robeco's SI analysts' assessment of the SDG alignment. Carbon footprint is Scope 1, 2 & 3 and indexed to passive reference. The Fallen angel % uses average historical rating migration numbers annualized by dividing on the average portfolio maturity. In this example the portfolio cashflow profile is relatively evenly distributed across the 2024-2033 tenors. Paris-aligning companies defined as companies that score aligning or aligned on Robeco's climate traffic light assessment. Climate laggards defined as companies with a high carbon footprint and not scoring aligned or aligning on Robeco's climate traffic light assessment. Past performance and current spreads/yields are not a reliable indicator of future results.

SOLUTIONS

Helping savers retire comfortably and sustainably

CLIENT CHALLENGE 2

Create an insurance-linked product combining multiple, pure-play thematic equity strategies that contribute to the SDGs for an Asian insurer.

Mitigating sustainable risk

The challenge

Longevity is increased globally thanks to better health, living, and working conditions. That's good news, but it also makes retirement savings more challenging. This is particularly true for younger generations who will have the greatest longevity (and consumption rates) of any group in history.

While younger populations have the luxury of time to accumulate retirement wealth, insurance entities do not. Guaranteeing the good life for policyholders means increased liabilities both for current retirees as well as generations ahead. Insurance-linked products (ILPs) help insurers spread the risks related to capital requirements in financial markets. Given their high returns compared to fixed income, equity markets provide an ideal way to transfer longer-term risks but also capture higher payoffs in the short term. Equities are, however, also naturally more volatile compared to bonds, so the risk-return trade-off needs to be skillfully managed.

Moreover, to secure long-term cash flows, insurers must also expand their capital base and appeal to a new breed of policyholders acutely aware of climate change and social challenges. They form a group of next-generation investors who want to sustainably save money and drive positive real-world change. Meanwhile, insurance regulators are pushing for more sustainability in financial markets and in investment portfolios, driven by concerns about the impact of climate change and transition risks on long-term system solvency.

The approach

The above is an apt description for the predicament faced by many insurers globally. It was even more keenly felt by one large Asian insurer in particular, who was seeking to replace an underperforming ILP that it mass-marketed to a wide swath of savers.

Simplicity and effectiveness drove us toward thematic equities. It is an asset class that offers attractive expected returns thanks to their tilt toward trends and industries with high-growth potential. In addition, thematic equities are geared toward long-term growth, ensuring a longevity of returns that match the age longevity of the customer base. An added

benefit was that as an asset class, equities are easy to understand by a wide array of investors. Finally, a blend of themes in a fund-of-funds provides exposure to multiple trends and growth while diversifying return risks.

Given the strong demand for sustainability and impact, we constructed a multi-themed fund-of-funds composed entirely of strategies classified as Article 9 with the explicit aim of contributing to the SDGs. Article 9 strategies are a part of the EU's package of sustainable financial regulation and must fulfil specific sustainability objectives.

In this way, the product's sustainability risks are lowered – a win for regulators. But more importantly, it enhances the appeal to younger generations eager to use their capital to advance progress on the real-world challenges. Finally, from an organizational perspective, equities nicely complement other asset classes used across the insurer's ILP platform. This has the added advantage of diversifying return sources and boosting overall solvency.

The obstacles

Contributing to real-world progress is a noble aim but how do you execute that in a portfolio and over such a broad set of sustainability challenges? And how do you objectively measure the impact of your investments on sustainability challenges?

Fortunately, Robeco has built a reputation for creating thematic investments that capture the value associated with solving real-world challenges. After more than two decades, we have an extensive thematic platform from which clients can choose single themes or a thematic blend. To measure positive change and progress of our thematic investments, we have developed a proprietary SDG Framework that assesses, quantifies, and reports portfolio companies' SDG contributions.

Figure 2: Sustainable multi-thematic equity solution

CIRCULAR ECONOMY
Saving virgin resources via virtuous loops of recycled waste and shared assets

SMART MOBILITY
Enabling a future of clean, safe and efficient transport

SMART ENERGY
Powering the energy transition to a low carbon future

Sustainable multi-thematic

SUSTAINABLE WATER
Protecting the quality and quantity of world's water supplies

SUSTAINABLE HEALTHY LIVING
Promoting prevention, early intervention and population health

SMART MATERIALS
Making manufacturing cleaner, greener and leaner

Source: Robeco, 2023.

Another problem is achieving high performance without a lot of volatility. Thematic equities are growth-oriented, meaning they can generate higher returns but also higher volatility, with betas well above 1.0. The multi-theme approach helps dampen the deviations by allowing us to include low-beta themes as a complement to higher volatility strategies.

The solution

We designed a customized solution that blended six of Robeco's pure-play sustainable strategies into one vehicle. The strategies focus on renewable energy and more efficient energy use, clean mobility through electric vehicles, and the efficient use of natural resources in manufacturing. Other strategies focus on the intersection of biology and business. For example, the sustainable water strategy focuses on clean water supplies for populations, industry and the environment. The healthy living strategy focuses on disease prevention and rising healthcare costs.

A long investment horizon allowed us to pursue a pure-play approach which involves investing early in new and emerging solution providers with a long runway for growth and earnings. Though performance is important, it also needs to be balanced against risks. As a result, the strategy aims to maximize the Sharpe ratio, a metric which demonstrates returns from smart investments versus returns from excessive risk-taking.

Finally, a UCITS compliant structure enhances the appeal and simplifies the distribution of many mass-market financial products. It ensures that the product meets stringent EU investment regulations – a global standard for investment quality.

A multi-asset solution to capture climate-aligned growth

CLIENT CHALLENGE 3

Decarbonize investments using a highly diversified multi-asset solution aimed at generating climate-aligned returns for a UK savings scheme.

- Aligning to the net-zero pathway
- Investing in the sustainable transition

The challenge

Pension plans and long-term savings schemes have never had it easy. Securing the financial future of beneficiaries over the short, mid, and long term is a complex task. Their job is complicated still further by increasing lifespans and emerging sustainability risks, the latter of which are growing in frequency, intensity and costs.

To protect retirees and safeguard insurers' solvency, regulators are pressuring pension schemes and insurers to integrate environmental, social and governance risks into investments. Regulators are not alone. Investors from across the generational divide also worry. Not just about fiscal solvency and financial returns but also about whether those returns were responsibly generated and are positively contributing to the welfare of people and the planet. Many even prefer to forgo profits from polluting industries in favor of returns from companies promoting sustainable economic development and the SDGs.

But while it may be easy to divest from the most obvious offenders, cleaning up the climate will mean decarbonizing the entire global economy. That's what makes the Paris Agreement of 2015 so critical. Paris-aligned benchmarks show which companies are keeping up with the climate transition and which are risking extinction by not moving fast enough.

The approach

Generating alpha to meet the income demands of retirees in the short and mid term while also decarbonizing portfolios for a net-zero future leaves pension funds with a difficult, but not impossible, path to tread. A balanced approach using fixed income and equities helps to smooth returns to meet liabilities across generations. Bonds provide income streams for current retirees, while equities cover the long-term liabilities of younger investors with the luxury of longer investment horizons.

In addition, investors must also guard against systemic risks associated with climate change and the transition to a low-carbon economy. Here, green bonds and climate-transition equities create an ideal offensive-defensive strategy. Green bonds are used to finance projects that have a positive environmental impact. These include, for instance, the build

out of renewable energy, energy-efficiency improvements, or better water management facilities. Next to that, climate-transition strategies invest in companies that are decarbonizing their operations to align with the Paris Agreement and science-backed emission trajectories.

Moreover, real-world change is also critical. We don't view this as a constraint but rather as an investment opportunity. Exposure to companies making the solutions that are enabling the climate transition will provide significant upside in the decades ahead. These companies can be distinguished by their impact on climate-related SDGs.

The obstacles

A significant obstacle is how to construct a portfolio that can generate alpha while also helping to mitigate climate change. Alpha is normally achieved through exposure to higher-risk investments including high yield bonds and high-growth stocks. However, many high yielding asset classes have larger emissions and transition risks or fail to mitigate climate change in an appreciable way.

To overcome this challenge, we drew from our significant expertise in SI, climate, and SDG research to design a portfolio with superior risk-adjusted returns and exposure to the movers and shakers of a low-carbon economy. We can do this because we've spent the greater part of the past decade pioneering ground-breaking tools to identify and measure the risks and opportunities generated by sustainability challenges.

We were among the first asset managers to create an SDG Framework to measure whether a company is positively or negatively contributing to the SDGs. We also constructed Paris-aligned indices so we could benchmark the pace of decarbonization within our own investment strategies. Finally, we used our pioneering knowledge and methodologies in thematic equities to create exposure to high-growth companies clustered around developing sustainable solutions to the climate crisis and other development challenges.

The solution

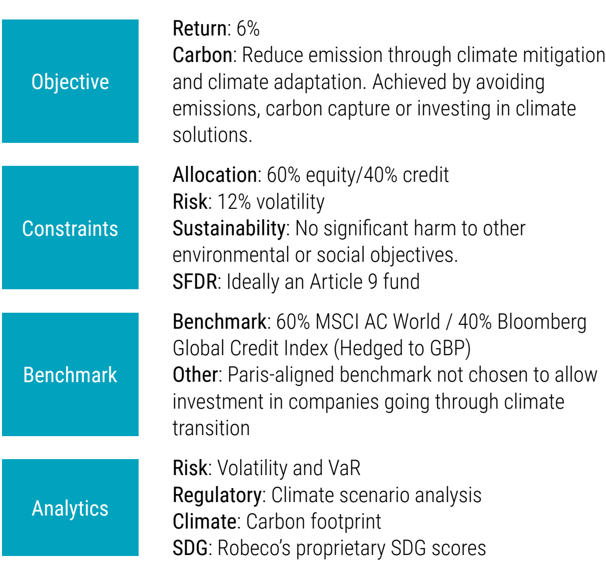
For a UK-based long-term savings provider, Robeco created a bespoke multi-asset solution featuring a conventional 60-40 split. But beneath the surface, convention stops and innovation begins.

To emphasize sustainable change, the solution places a particular focus on Article 9 investments, which achieve a measurable sustainability objective under the EU SFDR. Fixed income allocations are further divided between climate bonds, green bonds and SDG high yield bonds designed to generate steady, climate-aligned returns.

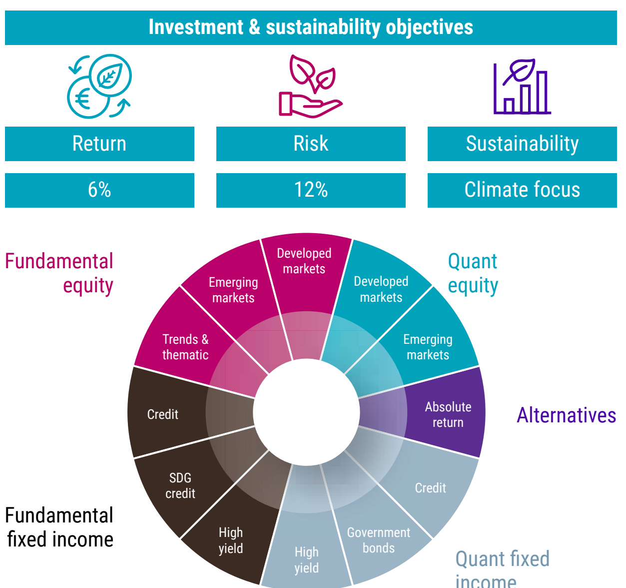
Equity shares are also split between pure-play thematic equities and a broadly focused climate equity strategy. Thematic equities provide direct exposure to companies creating the solutions that enable high-emissions sectors such as energy, real estate, materials, and transportation to grow cleaner, leaner, and greener. Climate transition equities invest more generally in companies across the economy that are rapidly decarbonizing and leading the net-zero transition.

Robeco's proprietary SDG scoring system ensures investments contribute to climate-related SDGs including SDG 7 (Affordable and clean energy), SDG 11 (Sustainable cities and communities) and SDG 13 (Climate action). The portfolio uses exclusions and ESG integration to further enhance the risk-return profile. Moreover, active stewardship and engagement helps drive portfolio companies to address material ESG challenges related to their operations and business models.

Figure 3: Multi-asset Climate Transition solution



Objective	**Return**: 6% **Carbon**: Reduce emission through climate mitigation and climate adaptation. Achieved by avoiding emissions, carbon capture or investing in climate solutions.
Constraints	**Allocation**: 60% equity/40% credit **Risk**: 12% volatility **Sustainability**: No significant harm to other environmental or social objectives. **SFDR**: Ideally an Article 9 fund
Benchmark	**Benchmark**: 60% MSCI AC World / 40% Bloomberg Global Credit Index (Hedged to GBP) **Other**: Paris-aligned benchmark not chosen to allow investment in companies going through climate transition
Analytics	**Risk**: Volatility and VaR **Regulatory**: Climate scenario analysis **Climate**: Carbon footprint **SDG**: Robeco's proprietary SDG scores



Source: Robeco, 2023.

SOLUTIONS

Active management meets active ownership for SDG investing

CLIENT CHALLENGE 4

Blend Robeco's active ownership and SDG capabilities to create a product based entirely on engaging with its investee companies for a major European distributor.

- Balancing risk, return and impact

The challenge

Sustainable investing fundamentally relies on the integration of environmental, social and governance (ESG) factors into the decision-making process when choosing stocks for portfolios. But this isn't enough on its own; the use of active ownership is also essential. Companies are ultimately owned by their shareholders, so voting and engagement can be powerful tools in seeking progress.

Engagement with a company typically lasts up to three years to improve specific ESG metrics, such as on its performance on emissions (E), labor relations (S), or returning capital to shareholders (G). In a standard portfolio of about 50-80 companies, engagement is usually undertaken with a handful of ESG metrics seen as having room for improvement.

The challenge was to create an entire strategy where every company is engaged with, using a central metric of improving the contributions they could make to the Sustainable Development Goals (SDGs). The underlying belief is that engagement will improve their contributions to one or more of the 17 goals, turning them into more sustainable companies, and therefore eventually boosting overall returns.

The approach

A major European distributor came to us with this very challenge. Although Robeco has conducted active ownership since 2005, with a whole team dedicated to engagement, it was the first time that such an engagement-based product has been created. This necessitated a slightly different approach.

Firstly, Robeco's Head of Engagement was included on the portfolio management investment team so that he could steer the dialogues with the chosen companies. The proprietary Robeco SDG Framework was used to find companies in transition, with room to improve their contributions to the goals. The scoring ranges from -3 (highly negative) through 0 (neutral) to +3 (highly positive).

Our engagement team looks for those with scores of -1, 0 or +1, offering plenty of scope for improvement, with a mantra of 'turning caterpillars into butterflies'. Those with a score of -3 or -2 were deemed unsuitable for engagement, as they are not yet ready to transition from a negative to a positive contribution to the goals, while those scoring +2 or +3 are already advanced in their sustainability objectives. The companies in the -1 to +1 range are in the middle of their transition journey.

The obstacles

The biggest obstacle to engagement generally is that the chosen companies need to be willing to engage with us so that together we can set an agenda, agree common target setting and select communication about the relevant topics. We define several key performance indicators (KPIs) that targeted the areas in which we believed they could better contribute to the SDGs, with clearly defined metrics agreed upon in advance.

Another obstacle as that targeting the SDGs is a form of impact investing, which must have three things to work properly: intentionality, measurability, and making a financial return. The hardest one of these is demonstrating a real-world improvement on the ground, while making such an impact must not detract from the primary role in generating financial returns, or alpha.

A final hurdle was that some of the goals are more investable than others. For example, it is fairly easy to find companies contributing to SDG 9 (Industry, innovation and infrastructure) or SDG 8 (Decent work and economic growth). Finding contributors to the 'basic needs' goal of SDG 2 (Zero hunger) or the biodiversity-based SDGs 14 (Life under water) and SDG 15 (Life on land) is much harder.

Figure 4: Some goals such as SDG 9 are more investable than others

Basic needs		Healthy planet		Sustainable society		Equality & opportunity		Robust institutions	
SDG 2 Zero hunger	2%	**SDG 7** Affordable and clean energy	6%	**SDG 9** Industry, innovation and infrastructure	31%	**SDG 1** No poverty	0%	**SDG 16** Peace, justice and strong institutions	9%
SDG 3 Good health & well-being	19%	**SDG 12** Responsible consumption & production	9%	**SDG 8** Decent work and economic growth	25%	**SDG 5** Gender equality	5%	**SDG 17** Partnerships for the goals	2%
SDG 4 Quality education	0%	**SDG 14** Life below water	3%	**SDG 11** Sustainable cities and communities	6%	**SDG 10** Reduced inequalities	0%		
SDG 6 Clean water and sanitation	4%	**SDG 15** Life on land	2%	**SDG 13** Climate Action	4%				

Source: RobecoSAM impact data. Data as of 31 December 2021.

The solution

The solution was to create the high-conviction Robeco Global SDG Engagement Equities strategy of just 30-35 stocks, with a low-expected turnover of constituents. And while the emphasis is on engagement, our standard investment criteria on finding the most financially attractive companies still need to be met, so that alpha can be generated.

Three of our key criteria were to target companies with a high return on invested capital (ROIC) and a high free cash flow (FCF) generation. This led to choosing highly cash-generative companies – many of which are household names – and all willing to engage with us. It also meant low exposure to very capital-intensive and low-ROIC businesses, and the largest exposures to IT, Health Care and Financials. There is limited exposure to Materials and Energy, and no exposure to Utilities. If the engagement is successful, the company is upgraded in Robeco's SDG Framework, gaining a higher SDG score. If the company's scores are anything above +1 and the engagement is closed successfully, it ceases to be eligible for the strategy. The caterpillar has become the butterfly evolving in its sustainability trajectory.

Combine minimizing tracking error with enhancing the sustainability of an equity portfolio

CLIENT CHALLENGE 5

Deploy our quant investing expertise to help reduce the tracking error of the sustainable US equities portfolio of a medium-sized European private bank.

Balancing risk, return and impact

The challenge

In an era where sustainability takes center stage in investment strategies, a medium-sized European private bank found themselves at a crossroads in terms of their US exposure. Facing growing demand for sustainable investment options, the bank was grappling with the limitations of standard indices that often fall short in terms of flexibility and sustainability. This challenge was further compounded by the high tracking error associated with sustainable indices, particularly when there is an overweight in US assets, leading to underperformance.

Furthermore, the bank's goal to elevate the sustainability profile of its US portfolio was met with the dual obstacles of high correlation among investment instruments and the quest for diversification. Our client not only sought a solution that diversified their portfolio beyond their conventional methodologies, such as the MSCI SRI Index, but also an instrument with a lower tracking error relative to their parent benchmark, without compromising on performance against traditional benchmarks.

The conversation around enhancing the sustainability of investment portfolios is gaining momentum, and this private bank's journey encapsulates the intricate balancing act required. The specific challenges they face – achieving diversification with a lower tracking error compared to conventional benchmarks and managing the high correlation among its chosen instruments – underscore the wider complexities of integrating sustainability into the core of investment portfolios.

The approach

In the pursuit of enhancing their portfolio's sustainability without compromising on performance, our client embarked on a collaborative journey with us, leveraging our longstanding relationship built on mutual trust and Robeco's quantitative

strength and sustainability track record. This partnership was instrumental to deploying our Quant Customizer tool to devise a customized solution.

This innovative tool is at the forefront of crafting portfolios that balance risk, return, and sustainability considerations, tailored to the unique demands of each client. The Quant Customizer's ability to facilitate real-time, comprehensive analysis during client interactions allows for rapid modifications based on client feedback, ensuring that the solutions devised are in perfect harmony with the client's objectives, in terms of specific tracking error limitations, enhanced returns, and superior sustainability credentials.

The obstacles

Navigating the intricate balance between wanting to maintain the sustainability level of SRI indices and achieve a substantially lower tracking error presented quite a challenge. This endeavor required a meticulous process of back-testing and adjustments, aiming to refine the portfolio's tracking error to align with the bank's strategic objectives within their US allocation. The journey included debates over the inclusion criteria, which were influenced by the SDG scores, highlighting the complexity of integrating sustainability considerations into traditional investment frameworks.

The task was further complicated by the variability in regional acceptance of sustainability-linked underperformance, necessitating a clear and convincing rationale to stakeholders about the potential trade-offs between sustainability focus and return profiles. These challenges not only drew on the adaptability and resilience of the collaboration but also underscored the evolving nature of sustainable investing, where achieving a balance between sustainability goals and financial performance remains a dynamic and ongoing pursuit.

The solution

Using its Quant Customizer, Robeco crafted a bespoke, quant-driven strategy that fulfilled and even surpassed the bank's aspirations. Moreover, we accommodated the bank's diverse geographic presence by creating specialized share classes, coupled with dedicated marketing support. The bank's clients are fully aware that this innovative solution comes from Robeco, underlining the transparency and trust in our relationship.

Ultimately, transforming an existing, back-tested enhanced index solution into a US Climate Beta portfolio, specifically positioned as a sustainable product, testifies to our commitment to addressing client needs with innovative solutions. This approach has been applied for both advisory and discretionary portfolios, mostly for the latter.

The cooperation from both sides made this a success, exceeding initial expectations. While the client had initially estimated assets of around USD 150 million to 200 million, the solution has now exceeded USD 450 million AuM. Robeco promised and delivered US exposure with a lower tracking error and a high level of sustainability and even outperformed the benchmark.

This outcome was met with widespread acclaim within the bank, notably in regions that had previously viewed the performance of sustainable indices with skepticism. It's seen as a good addition in their sizable US block, which contains a number of lower tracking error, semi-passive US solutions, including ETFs, along with a few active strategies. The Robeco solution is the bank's biggest allocation in that block and as such plays a key role. The success of this initiative highlights our proficiency in crafting a solution that adeptly balances sustainability with risk and returns. ●

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