Sustainable Global Stars Equities

Solving the Rubik's cube called ESG

- We propose a way to measure ESG's contribution to performance
- We find close to 20% of excess returns can be attributed to ESG[1]
- ESG seems to act as a performance cushion during rougher patches

Like a Rubik's cube, sustainability investing has many colors and dimensions. This is why the underlying concept of ESG investing can be so difficult to grasp. As asset managers, we strive to solve the ESG attribution conundrum by putting actual numbers on all the dimensions of ESG investing. We do not do this because of our desire to put numbers on everything, no matter how arduous to measure, is hardwired in our brains. We simply do this because, as management guru Peter Drucker once said, "what gets measured, gets managed".

For several years now, we have been measuring the impact of ESG on our investment performance. Our main findings are the following ones:

- Between 2017 and 2020, close to 20% of our Sustainable Global Stars Equities fund's excess returns can be attributed to ESG.[2]
- Put differently, of the annualized 720 basis points (bps) of excess performance generated over this period, about 130 bps can be ascribed to ESG.
- Bottom-up ESG integration, as well as specific sector exclusions, have made a positive contribution.

Article
For professional investors
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Chris Berkouwer, portfolio manager

[1] Source: Robeco, based on past performance for the Dutch incorporated Sustainable Global Stars N.V. fund in euros, over the four years from 2017 to 2020. Sustainable Global Stars uses the MSCI World Index in euros as a reference index. Past performance is not a reliable indicator of future results.
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Einstein was right

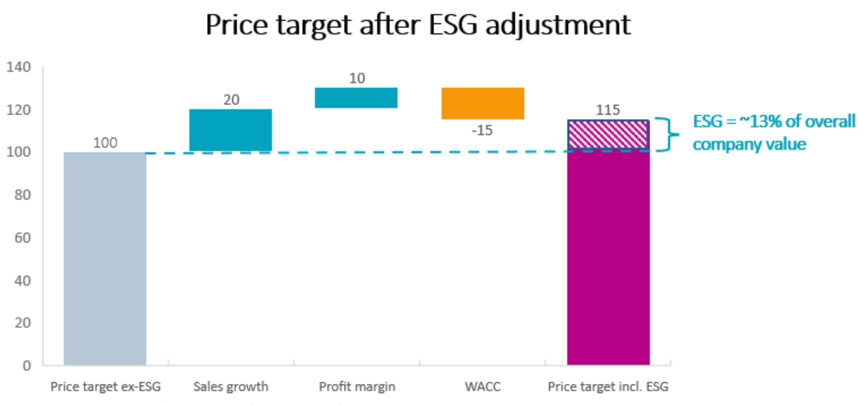
As Albert Einstein famously said, "not everything that counts can be counted, and not everything that can be counted counts". Sustainability investing is essentially about broad value creation; going beyond the traditional realm of financial number crunching. This means not only looking at sustainability with our financial glasses on, but also considering environmental and societal value creation.

Fundamental, bottom-up stock analysis requires information from many different sources, such as company filings, expert research, management interviews, industry blogs, and, increasingly, ESG data. This mosaic of inputs – and a healthy dose of common sense – help forge a view on a company, and ultimately lead to an investment decision. Singling out the exact importance of ESG considerations in this process, and their impact on investment performance, is a formidable task. Yet, our research-based approach allows us to provide a good proxy.

Methodology recap

Within Robeco's sustainable product range, the flagship Sustainable Global Stars Equities strategy follows an 'ESG integration' approach, whereby we fully integrate material ESG factors into our valuation models.[3] Company valuation and ESG criteria go hand in hand, as the latter (in)directly impact a company's sales, margins, cost of capital or its so-called 'competitive advantage period' (CAP).[4] Figure 1 illustrates this process.

Figure 1 | Valuation adjustments due to ESG factors



Source: Robeco.

In addition, the Sustainable Global Stars Equities strategy adopts the Robeco exclusion policy.[5] Most relevant to the exercise laid out in this paper is the exclusion of all companies in the Tobacco sector and most of the Aerospace & Defense (A&D) industry. Finally, we actively engage with companies to improve their sustainability strategy as this is often more impactful than simple exclusions.[6] In our ESG performance attribution methodology, we focus on the first two approaches: ESG integration and exclusion, as these can be measured best.[7]

Example, please

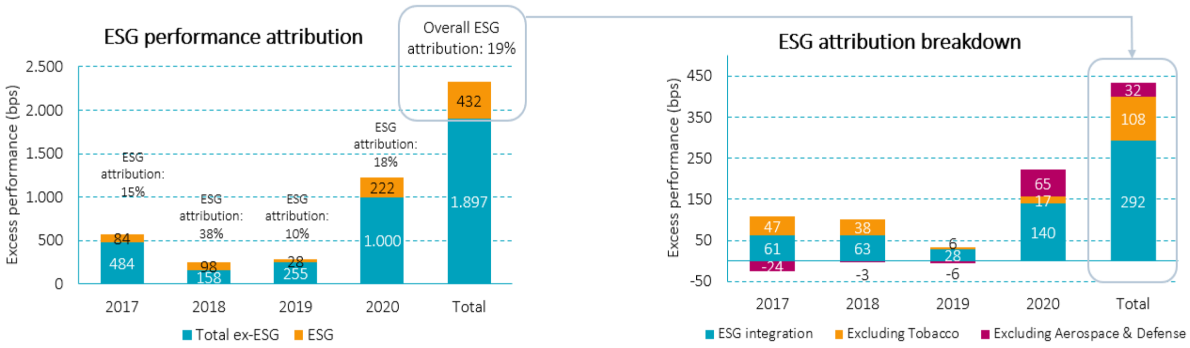
[3] Please refer to: Schramade, W., 2014, "Valuing ESG at Robeco Global Equity", Robeco article.
[4] See: Berkouwer, C., 2020, "From Alchemy to Gold – Quantifying the ESG Impact for Sustainable Global Stars Equities", Robeco article.
[5] https://www.robeco.com/docm/docu-exclusion-policy-and-list.pdf
[6] For a full description of the Sustainable Global Stars ESG approach, please read: Zandbergen, M., 2017, "Two Worlds Colliding: Insights from Three Years of ESG Integration", Robeco white paper.
[7] For a full description of our methodology, please refer to: Berkouwer, C., 2019, "Separating the Sugar from the Tea: Measuring the ESG impact on Investment Performance", Robeco article.

To help you understand our methodology, we take Finland's Neste Oyj as a practical example. This company is the world's largest producer of sustainable fuels and is often considered as one of the most sustainable companies globally. Based on our ESG analysis, we lifted the price target for the company in such a way that ESG effectively comprises about 22% of its overall value. Subsequently, we looked at the relative performance contribution of Neste Oyj in the portfolio, which was +237 bps in 2020. To get a proxy for the ESG contribution to relative returns, we multiplied both figures and found: 22% x 237 bps = +52 bps of excess performance being attributable to ESG.

Results

Even though we've incorporated ESG into our decision-making since the inception of the fund, explicitly measuring the ESG attribution to investment performance has only been done since 2017. We therefore have a four-year track record (2017-2020) for our analysis. The left-hand chart of Figure 2 shows that the ESG contribution to excess performance has been significant. ESG explains about 19%, or 432 bps, of the cumulative 2,329 bps of active returns over this time period.[8]

Figure 2 | ESG attribution to investment performance



Source: FactSet data. Past performance is not a reliable indicator of future results.

The right-hand chart of Figure 2 breaks down the different sources of ESG performance attribution. It shows that both bottom-up ESG integration and the exclusion of Tobacco companies, as well as most of the A&D sector contributed to the outperformance. We chose these two sectors for our analysis as they are almost completely excluded from our investable universe according to Robeco's basic exclusion policy.[9]

Figure 2 also shows that up until 2020, not owning A&D stocks in the portfolio meant incurring opportunity costs. The main reason is that A&D companies generally generated high shareholder returns and exhibited healthy balance sheets. Unsurprisingly, Covid-19 hit this sector badly, resulting in a positive excess return by simply not being exposed to it at all. Finally, it is clear that not owning any Tobacco stocks has paid off, resulting in outperformance of more than 100 bps.

Another interesting observation is that ESG seems to act as a performance cushion during rougher patches, which is consistent with other empirical studies.[10] For example, while 2018 was a difficult year for equity markets, ESG stocks did well and had a significantly positive impact on our performance. No less than 38% of our excess returns could be explained by ESG. During the early part of the Covid-19 crisis, companies with a strong ESG profile also performed significantly better than the overall market.

Some analysts argue this was due to the broad 'flight to quality' move seen during the selloff, and we tend to agree with this explanation (see Figure 5). Meanwhile, during the strong market rallies of 2019 and the better half of 2020, ESG lost

[8] Results shown are for the Dutch incorporated Sustainable Global Stars N.V. fund. The Luxembourg incorporated CGF fund has a slightly different absolute performance track record, yet the ESG performance attribution results are roughly similar.
[9] Robeco exclusion policy dictates that firearms, military contracting and controversial weapons are categories excluded from investing.
[10] See for example: Morgan Stanley, 2019, "Sustainable Reality, Analyzing Risk & Return of Sustainable Funds".

some of its 'shine', explaining much less of the fund's excess returns. Importantly, ESG had a positive impact on performance in both up- and down markets.

Conclusion

At Robeco Fundamental Equities, we've solved one of the dimensions of the ESG Rubik's cube. Our way of consistently integrating and tracking ESG in our decision-making enables us to calculate a good proxy of the importance of ESG in our investment portfolios. Our analysis suggests that based on the 257 investment cases (see appendix) written by the Sustainable Global Stars Equities team over the 2017-2020 period, close to 20% of the excess performance can be attributed to ESG. In other words, about 130 bps of the annualized 720 bps outperformance during this period can be explained by the ESG tilt of the portfolio.

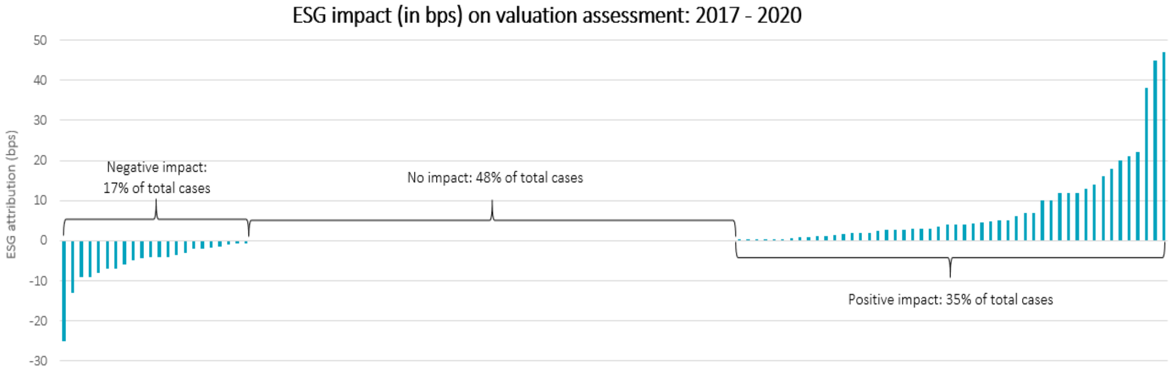
ROBECO
The Investment Engineers

Appendix: Deep dive into 257 investment cases

For our analysis, we relied on 257 investment cases written by the Sustainable Global Stars Equities team from 2017 to 2020. These included a mix of existing case updates as well as new research ideas. In total, 90 investment cases (35%; see Figure 3) saw a positive adjustment to the price target, 123 cases (48%) saw no adjustment, and 44 cases were assigned a negative adjustment (17%). Because the Sustainable Global Stars' investment philosophy focuses on companies with a high return on invested capital (ROIC), high free cash flow (FCF) generation and a strong sustainability strategy, there is a natural tilt towards positive target adjustments. These reflect the opportunities offered by attractive ESG characteristics.

Yet our adjustments are not static. Given that an essential part of the Sustainable Global Stars Equities strategy is to engage with companies to improve their sustainability efforts, we apply a negative ESG valuation adjustment to some of the companies in our portfolio. However, once our engagement pays off and the company improves, it might see positive ESG adjustments over time. An example of this is Deutsche Boerse, a German exchange operator, for which successful engagement on improving its corporate governance structure ultimately led to a change in its ESG adjustment, from negative to positive.

Figure 3 | ESG has a bias towards making positive adjustments



Source: Robeco.

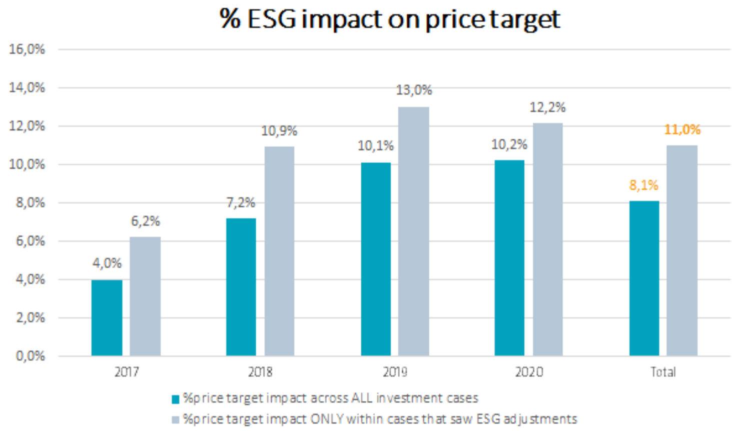
At Robeco Fundamental Equities, we've been integrating ESG into our valuation models for a long time, adjusting sales growth, margins, investment needs, and/or the cost of capital. Across our dataset, we see that these 'traditional' value drivers were frequently adjusted based on ESG considerations. However, in 2017 we introduced an alternative approach of adjusting a company's valuation, through the so-called 'competitive advantage period' or CAP, which is gaining ground in our ESG analysis.[11] In the technology sector, for example, we often choose adjustments of CAP over traditional value drivers, as we feel this better captures the long-term value creation capability of tech business models.

Across all investment cases (including the 48% where no adjustments were made) the average price target uplift was +8.1% (Figure 4). If we consider only the investment cases that did see some adjustment, the average target increase was +11.0%. As ESG data quality and our responsible analysts' experience improve over time, so does our conviction in the adjustments made in either direction.

In terms of the most financially material ESG factors used in the investment cases, we tend to see familiar ESG topics, such as 'corporate governance' and 'innovation management', dominate. However, more recently, ESG issues such as 'climate strategy' and 'product quality & safety' are also often mentioned as major factors impacting valuation. Obviously, these factors are quite generic. Therefore, we look at slightly different aspects for each factor, depending on the sector considered.

[11] Berkouwer, C., 2018, "When CAP meets ESG: Uncovering Unchartered Territory", Robeco white paper.

Figure 4 | ESG adjustments, on average, lead to higher price targets

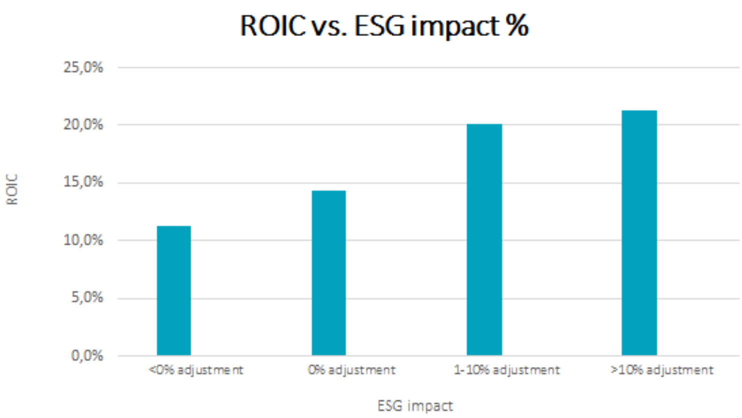


Source: Robeco.

For example, 'climate strategy' for oil & gas companies is very much about the potential risk of stranded assets. Whereas for a producer of industrial gases, having a good climate strategy is really about helping to lower their customers' environmental footprint. The same holds for 'product quality & safety'. Consumer goods companies need to have sophisticated product recall processes to avoid severe reputational damage. Meanwhile, for US healthcare providers, service is becoming ever more important, with new reimbursement models being introduced based on the quality of healthcare delivered.

Lastly, in assessing the relationship between the 'quality' metric of ROIC and the level of ESG adjustment, Figure 5 illustrates that companies experiencing the highest positive adjustment to their price target also have ROICs almost twice that of companies getting a negative ESG adjustment, on average. Our earlier research suggests that good performance on financially material ESG factors marks a high-quality company.[12] This reinforces our view that ESG information helps us build conviction on the sustainability of financial returns.

Figure 5 | ROIC and ESG adjustment are slightly correlated



Source: Robeco.

[12] Zandbergen, M., 2017, "Two Worlds Colliding: Insights from Three Years of ESG Integration", Robeco white paper.

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