ROBECO SUSTAINABLE MULTI-ASSET SOLUTIONS

Balancing sustainability and returns: What multi-asset investors need to know

ROBECO
The Investment Engineers

- Sustainability has historically improved multi-asset risk-adjusted returns
- Excluding less sustainable investments brings greater market deviation
- Sectors and regions often cause short-term differences in performance

Over the past six years, we have witnessed one of the most seismic changes to asset allocation policy over the past century: the sustainability of companies and countries has become a material consideration in evaluating the overall attractiveness of potential investments. This stems from the growing awareness that we are depleting the world's resources at an unsustainable and potentially disastrous rate, while many people see their well-being threatened due to lack of access to basic services. As a consequence of these challenges, governments, regulators and individual investors have been spearheading a shift toward a greener and more equitable tomorrow.

While the moral arguments and enthusiasm for this shift in asset allocation policy are often compelling, one could question the lack of consideration and transparency on how sustainability and ESG ratings can affect client outcomes from a broader investment journey and investment returns perspective. If our starting point is that there is no such thing as a free lunch, what are the costs associated with pursuing a more sustainable investment approach in a multi-asset (equity and corporate bonds) context? This is a complex question that requires a multi-dimensional approach to address. This should facilitate more tangible and credible conclusions.

How are the demand and supply for sustainability-focused investments changing?

Just like in any market, the supply and demand for sustainable investments can vary depending on the market and type of asset, but the appetite for that is clearly rising. This in itself can be a bit of a self-fulfilling prophecy in that if demand for companies with stronger sustainability characteristics is rising, this higher demand can in turn benefit their share prices. Within the debt market, this could lead to lower cost of financing, as seen in the slightly lower yields of corporate bond indices with stronger sustainability credentials.

Historically, the use of the term ‘sustainable’ in a fund name has been somewhat ‘open to interpretation’ as there was no clearly set industry standard. The chart below shows that the amount of money flowing into sustainably focused multi-asset funds and exchange-traded funds (ETFs) globally exceeded the EUR 60 billion mark, whereas those with no sustainability focus have generally seen significant outflows. Going forward, the rules set by the European Securities and Markets Authority (ESMA) are expected to offer greater degree of harmonization on what is required for a fund to use sustainability-related terms in its name. This will further distinguish the available opportunity set and set a higher standard for investor choices within the sustainability-focused fund space.

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Marketing material for professional investors, not for onward distribution

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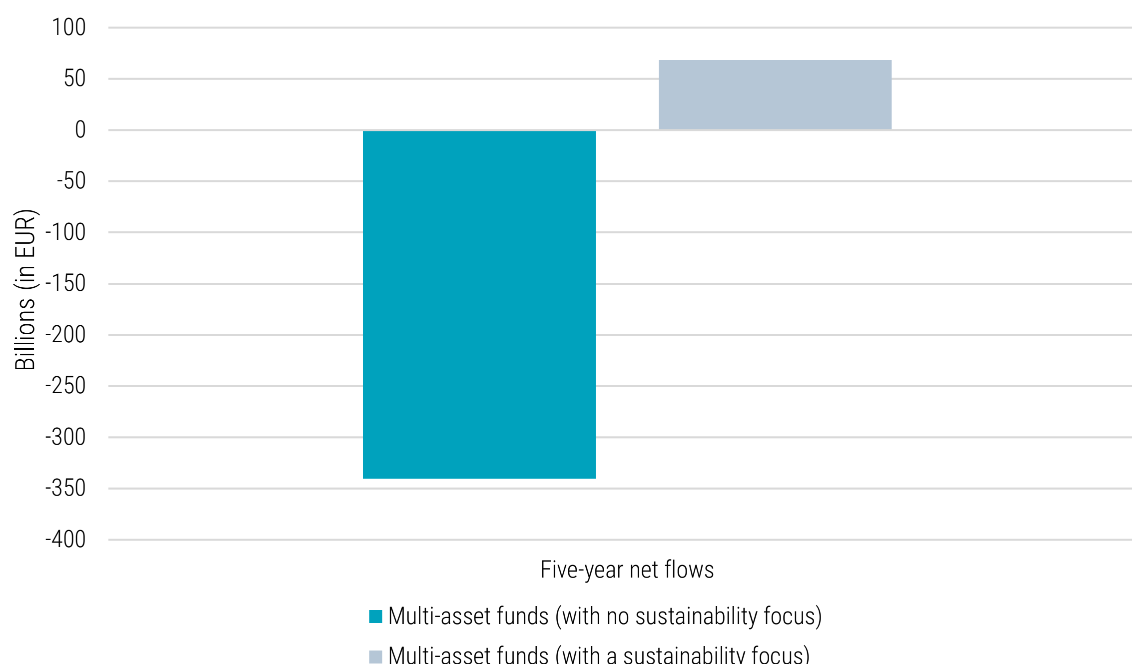
Figure 1 – Global net flows into multi-asset fund and ETFs



Source: Morningstar, as at 30 August 2024. Morningstar classifies a fund or ETF as sustainable overall if in the prospectus or other regulatory filings it is described as focusing on sustainability, impact investing, or environmental, social or governance factors. Funds must claim to have a sustainability objective, and/or use binding ESG criteria for their investment selection. Funds that employ only limited exclusions or only consider ESG factors in a non-binding way are not considered to be a sustainable investment product.

Determining a sustainability score: Should we be looking backward or forward?

A sensible starting point is to define a framework that outlines to what extent a company can be classified as making a positive or negative impact on society from a sustainability perspective. There are two methods from which we can choose: a rating which analyzes how ESG (environmental, social and governance) factors affect the risk/return profile of a company, or a score that measures a company's impact on society and the environment.

In our case, we have decided to assess the company's impact on the UN's Sustainable Development Goals using the proprietary Robeco SDG Framework. This includes both current and forward-looking elements, rather than analyzing a company based on its historical behavior using only an ESG rating. This may seem trivial, but it could have a profound impact on the results – particularly on the size of the investment universe that has positive SDG scores and therefore underpins the investible opportunities for investors targeting a positive impact.

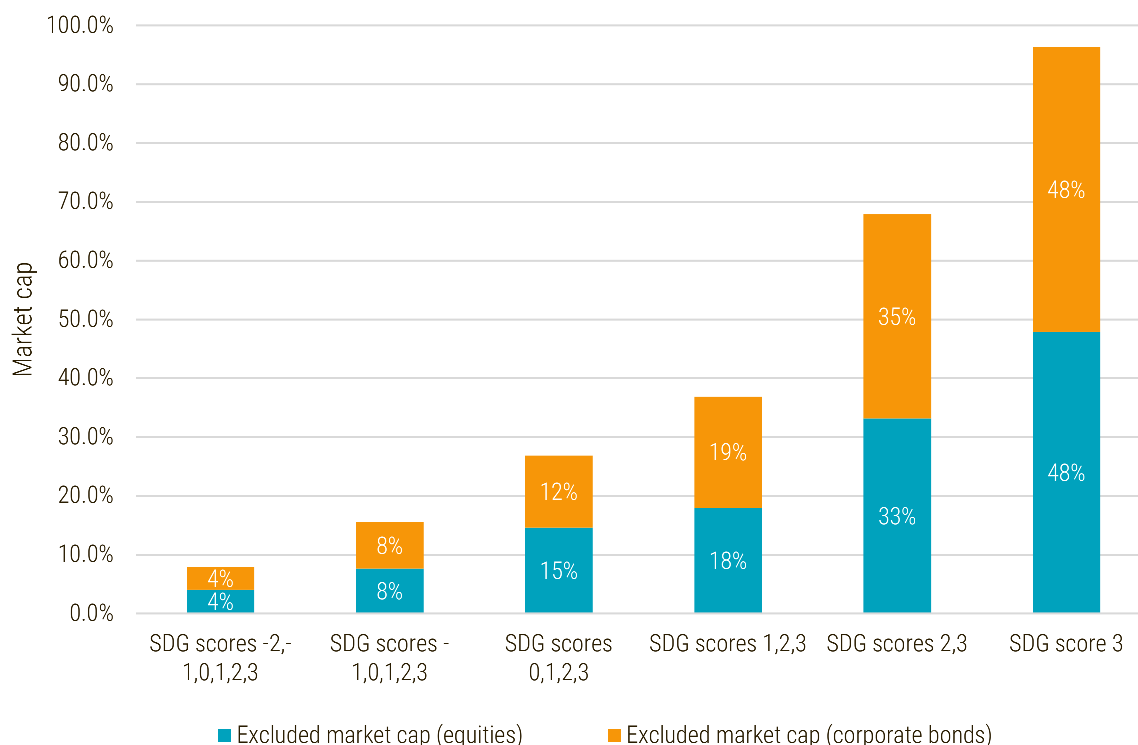
How does the degree of sustainability affect the investment universe?

Typically, a wide range of sustainability factors are considered in most frameworks, which allows companies to be ranked based on these criteria. Robeco's SDG Framework assesses whether companies are supporting or harming a transition to more sustainable societies. This assessment serves to screen companies on their suitability for inclusion in equity and credits investment universes based on their contributions to the goals.

Using Robeco's SDG Framework, where scores range from -3 to +3 (laggards to leaders), we can see the outcome of applying SDG exclusions in a 50:50 Global Equity: Global Corporate bond universe. The chart below indicates that the available investable universe, measured by market cap, ranges from around 92% (when only companies with an SDG score of -3 are excluded) to 4% (when only companies with an SDG score of +3 are included). For a mixed asset universe that only excludes negative scoring companies, thus abiding to the 'do no significant harm' principle, the

available investable market cap stands at 73%. As we move toward a universe that targets positive impact and as such only invests in companies with positive SDG scores, the accessible market cap decreases to 63% of the conventional investable 50:50 MSCI ACWI: Bloomberg Global Agg Corporate opportunity set.

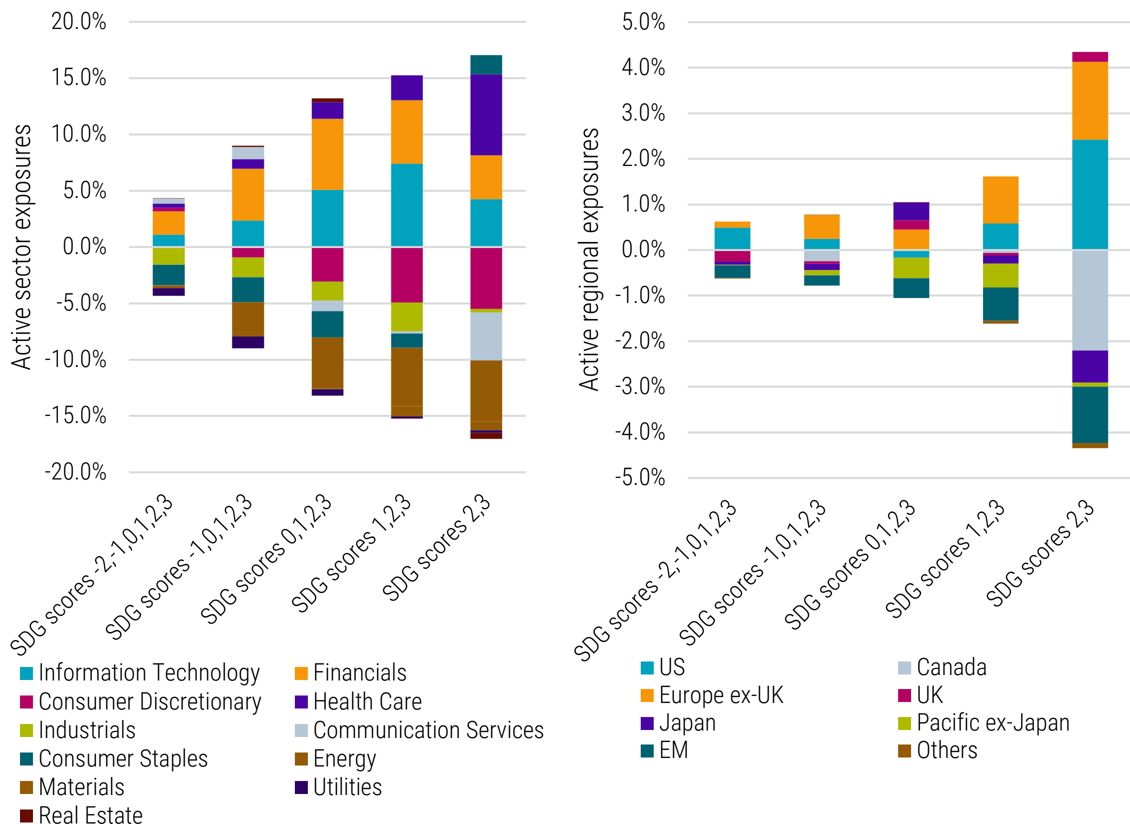
Figure 2 – Trade-off between investable market cap and SDG scores exclusionsfor the 50:50 MSCI ACWI: Bloomberg Global Agg Corporate universe



Source: Robeco, Bloomberg. As at 31 Dec 2023.

As expected, this leads to sector and regional biases which become more pronounced as the universe becomes more limited. The charts below highlight the respective over/under weights of a 50:50 Global Equity: Global Corporate bond universe of combined SDG investable cohorts relative to a conventional one. Notably, the magnitude of deviations is larger at the sector level where over/under exposures can be as high as 15% if only invested in positive-scoring SDGs. Energy, Consumer Discretionary and Industrials appear to be the largest underweight sectors, and Information Technology, Financials and Health Care the most overweight ones. Regionally, deviations versus the conventional bond universe can be as high as 4%, with the main underweights in emerging markets and the Asia-Pacific region excluding Japan, and the main overweights in the US and Europe.

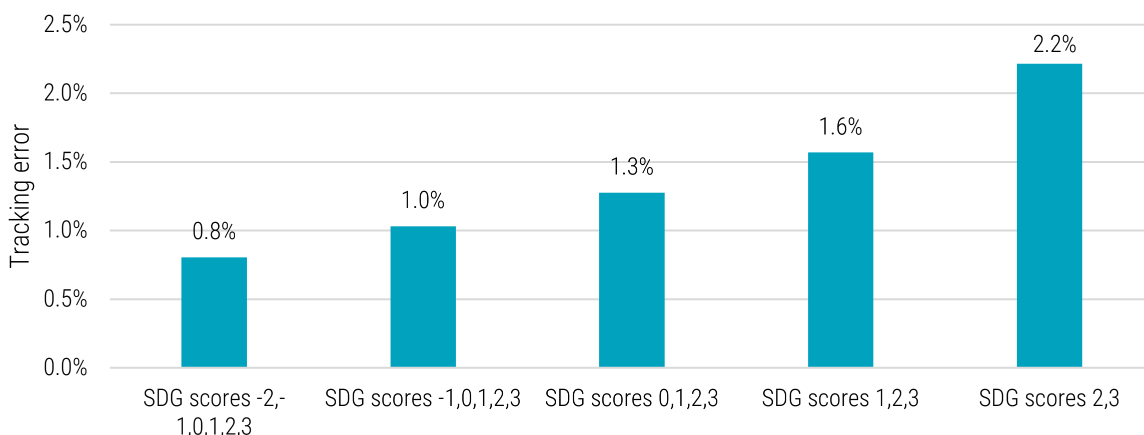
Figure 3 – Impact of SDG exclusions on sector and regional expousres versus the 50:50 MSCI ACWI: Bloomberg Global Agg Corporate universe



Source: Robeco, Bloomberg. As at 31 Dec 2023. The Corporate bond index Bloomberg sector classifications have been mapped to the Equity GICS sector classifications in order to accommodate the construction of the active regional exposures of the 50:50 Global Equity: Global Corporate Bond universes vs. the 50:50 MSCI ACWI: Bloomberg Global Aggregate Corporate benchmark.

It should come as no surprise, that over the last six years to the end of 2023, the observed tracking error for a 50:50 Global Equity: Global Corporates bond portfolio for various combinations of SDG-rated cohorts has been as high as 2.2%, with higher positive impact universes exhibiting a higher tracking error relative to the conventional 50:50 market.

Figure 4 – Tracking error versus the 50:50 MSCI ACWI: Bloomberg Global Agg Corporate universe tends to be higher for higher impact universes

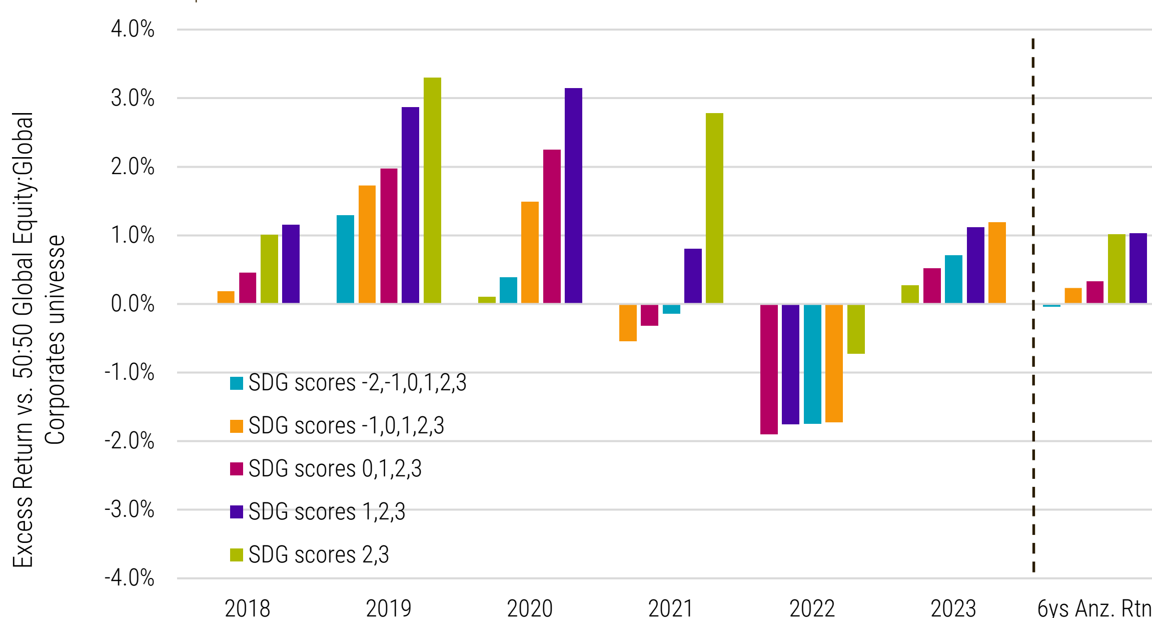


Source: Robeco, Bloomberg. As at 31 Dec 2023.

As such, moving to a more sustainable universe is expected to entail a degree of short-term deviation in the performance of universes with higher degrees of sustainability credentials relative to conventional indices. These deviations can be partly explained by sector and regional biases.

To put that into perspective, when the Energy sector considerably outperformed when the war in Ukraine began in 2022, the estimated degree of underperformance for the combined 50:50 Global Equity: Global Corporate bond universe which excluded negative and neutral SDG scoring companies was between 1 and 2%. This was partly driven by the underexposure of those universes to the Energy sector. However, the opposite was true during the pre- and post-Covid period where the IT sector considerably outperformed. This has partly supported the higher annual excess returns of up to 3% of SDG-limited multi asset universes.

Figure 5 – Sector differences can impact the variability of excess return versus the 50:50 MSCI ACWI: Bloomberg Global Agg Corporate universe over short-term periods



Source: Robeco, Bloomberg. As at 31 Dec 2023.

The historical analysis shows that there is an explicit impact on the expected investment performance when applying sustainable credentials in the investable universe, with clear sector and regional trade-offs when seeking higher degrees of sustainability. Considering the impact of sustainability on performance from a total return or risk-adjusted perspective is thus an important consideration for investors.

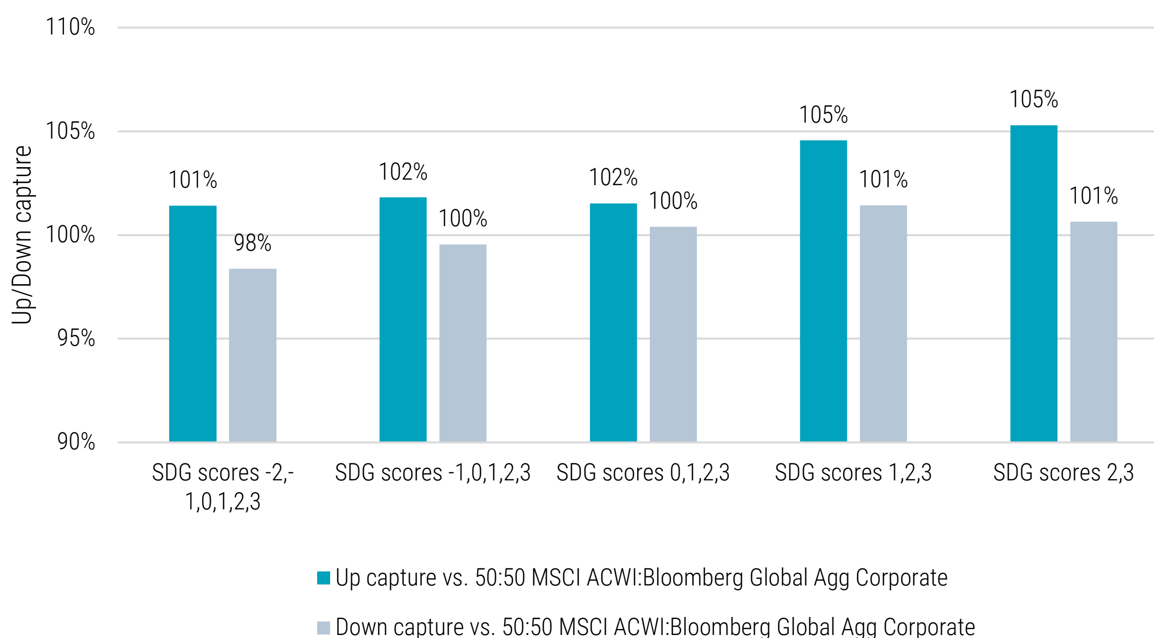
Should we assess the impact of sustainability on total return or risk-adjusted performance?

In order to understand the impact of sustainability across various dimensions, we focus our analysis not only on total returns but also on risk-adjusted performance (such as the Sharpe ratio). Here the question for investigation is to ask whether investments with higher sustainability credentials exhibit a similar volatility profile to broader based asset class indices, and whether this sufficiently compensates for any potential sacrifice in total returns.

Historically, we can examine return asymmetry by measuring how much of the market return sustainable universes captured during positive or negative market quarters. Here, we find that higher impact SDG combined cohorts exhibited a more favorable upside-market capture relative to the 50:50 conventional Global Equity: Global Corporates bond benchmark and similar down-market capture qualities. Overall, despite the considerable sector biases of sustainable universes, up and down market capture ratios close to 100% indicate that for the various 50:50 Global

Equity: Global Corporate bond SDG-defined universes' risk exposures did not deviate that much from the market during the 2018-2023 period.

Figure 6 – Up and down capture ratios versus the 50:50 MSCI ACWI: Bloomberg Global Agg Corporate universe



Source: Robeco, Bloomberg. As at 31 December 2023. The up-market and down-market capture ratios measure the proportion of the market return captured by a portfolio during only positive (up) or only negative (down) quarterly market returns over a predefined timeframe. The up/down-market capture is calculated as the combined portfolio return during quarters of positive/negative market performance over the market return during those periods. A higher than 100% up-capture ratio indicates that the portfolio outperforms the benchmark during positive benchmark quarters, while a lower down-capture indicates that the portfolio captures on average less of the downside relative to the benchmark during negative quarters. The up/down capture ratios measure the asymmetry of returns relative to the benchmark and provide an indication of the rerun profile of an investment versus the market.

This is also evident in the historical six-year annualized volatilities of the SDG-constrained universes, which have been very close to that of the 50:50 MSCI ACWI: Bloomberg Global Agg Corporate index. Thus, from a medium-term perspective, there was no material trade-off between risk and sustainability, and total return has been the main driver of absolute and relative risk-adjusted performance when investing in universes with higher sustainability credentials. This relationship is evident in Table 1 and Figure 7, where the more sustainable multi-asset universes show a higher historical Sharpe Ratio compared to less sustainable ones.

Table 1 - Risk and return metrics for SDG Mixed Equity and Corporate Bonds universes

Statistics	50:50 MSCI ACWI: Bloomberg Global Agg Corporate	SDG scores -2,-1,0,1,2,3	SDG scores -1,0,1,2,3	SDG scores 0,1,2,3	SDG scores 1,2,3	SDG scores 2,3
Excess return vs. Cash	2.8%	2.7%	3.0%	3.1%	3.8%	3.8%
Volatility	13.8%	14.0%	13.9%	13.8%	13.8%	13.8%
Sharpe ratio	0.20	0.19	0.22	0.23	0.28	0.27

Source: Robeco, Bloomberg. As at 31 Dec 2023. The statistics are calculated for the 6 year period between 31.12.2017 to 31.12.2023. The ICE BofA US Dollar 3-Month Deposit Offered Rate Constant Maturity Index has been used as a proxy for cash. The excess return vs. cash statistic is annualized. For the annualized volatility estimation quarterly returns have been used. All returns are in USD.

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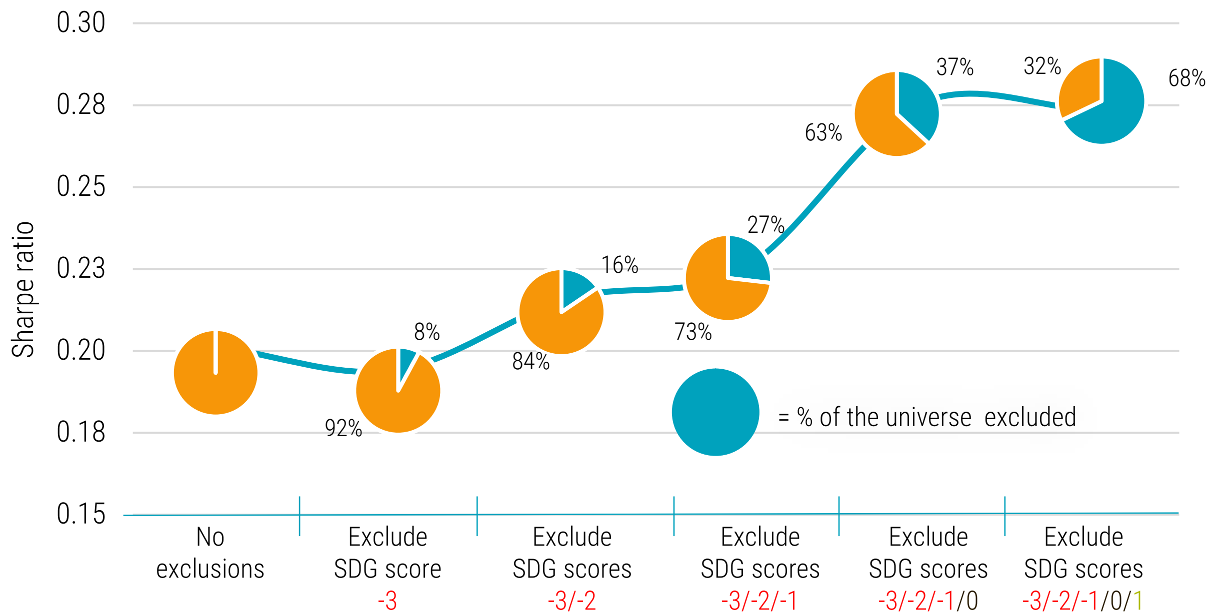
Figure 7 – Historical Sharpe ratio (6yrs) of the impact of the Robeco SDG Framework in 50:50 Global Equity: Global Corporate bond universes



Source: Robeco, Bloomberg. As at 31 Dec 2023. Historical period covers December 2017 to December 2023. The MSCI ACWI index is used for Global Equities and the Corporate part of the Bloomberg Global Aggregate Bond index for Global Corporate Bonds. Return contribution data are based on the aggregated bottom-up analysis, SDG data source is Robeco. All returns are in USD.

Conclusions

The rise in demand for sustainable investments has been a tailwind over the last six years, and the evolving ESMA guidelines on sustainability-related funds should provide investors more transparency and standardization on defining the available investable opportunity set.

However, there are a number of things investors need to know when thinking about balancing sustainability and returns from a multi-asset perspective. Our analysis shows that excluding the less sustainable parts of the investment universe typically increases tracking error versus the broader market and can lead to periods of material performance divergence – both positive and negative. This is partly evident during periods of significant performance divergence across sectors or regions, in which more sustainable universes are over or underexposed relative to the market. Over the past six year period to the end of 2023, a focus on companies with positive SDG scores - within a multi-asset context - has had a marginally positive impact relative to a 50:50 MSCI ACWI: Bloomberg Global Agg Corporate index, but more importantly it has not detracted from performance. Overall, we conclude that the trade-off between sustainability and risk-adjusted returns has been somewhat positive for the 2018 to 2023 period, as seen in the higher historical Sharpe ratios of more sustainable multi-asset universes.

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