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Robeco Sustainable Global Stars

Sustainable Investing: Don't sign the divorce papers just yet

- Between 2017-2022 around 22% of the strategy's excess returns can be attributed to ESG
- Unsurprisingly 2022 bucked the trend and provided headwinds
- Sustainable investing is very much alive; a fall-out doesn't mean an imminent divorce

From time to time even best friends can experience a fallout. For years it seemed the stock market and ESG tailwinds were a great match, with little to worry about. Then 2022 happened: war, an energy crisis, rampant inflation – we've all seen the headlines. For sustainable investment strategies, in particular, all these events proved to be a perfect storm.

2022 turned out to be the year where former ESG darlings struggled, whilst ESG 'baddies' such as defense companies, fossil fuels, and even tobacco, thrived. In other words, sustainable strategies got a reality check. It also reinvigorated the discussion over what "ESG" actually brings to the table return-wise, something we again explore in this paper with our core global equity strategy, Sustainable Global Stars Equities. In doing so, we've analysed the impact of ESG on our investment performance over the years, concluding the following:

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Chris Berkouwer, Portfolio Manager

- Tracking the data since 2017, ESG integration and specific sector exclusions had a positive contribution to investment performance, despite 2022 being an 'annus horribilis'.
- 2022 marked the first year though where all 'sin sector' exclusions detracted from performance.
- Between 2017-2022, around 22% of the strategy's excess returns can be attributed to ESG[1].
- Put differently, of the annualized 334 basis points (bps) excess performance achieved over this time period, about 75 bps can be attributed to material ESG factors.

From numbers to context

Sustainable investing is essentially about broad value creation, investing in companies that do business with respect for all stakeholders[2]. In practice, we do not only look at financial sustainability, but we are integrating the concept more broadly and consider environmental and societal value creation too. Technically, this way of sustainable investing is called "ESG integration", whereby material ESG factors form an additional lens in the decision-making process. Note that ESG is not a political ideology but a key step in our investment process.

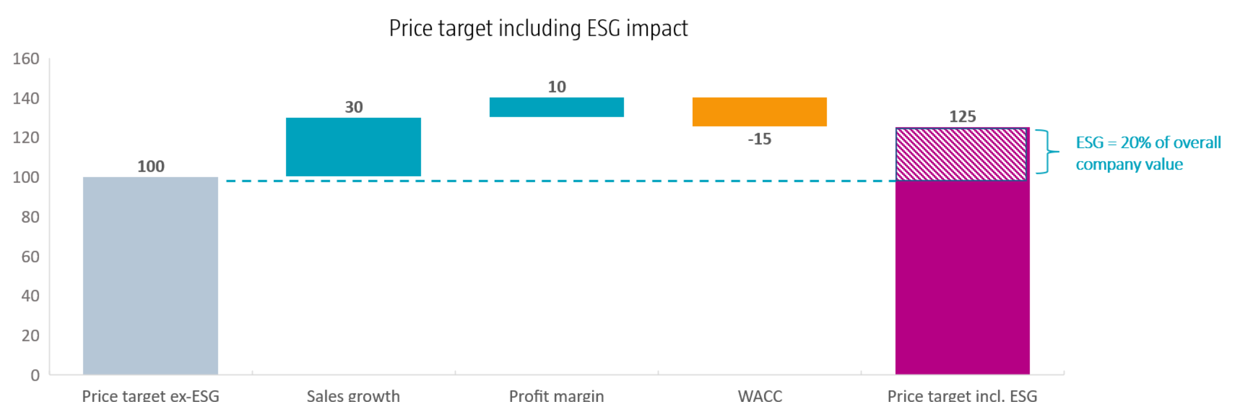
To that end, within the Sustainable Global Stars Equities strategy, we invest in quality businesses that have strong sustainability strategies that can really impact a company's business model, potentially creating value over the longer term. At the same time, we might also want exposure to so-called ESG improvers, or even ESG laggards, where upside potential can be quite meaningful if challenges are properly addressed. The benefit of such a barbell approach is that it enables us to invest in different segments of the market, making the portfolio more robust across different market cycles.

Methodology recap

Fundamental, bottom-up stock analysis draws on many different sources such as company filings, management interviews, expert networks, and increasingly, ESG information. It's this mosaic of inputs – and a healthy dose of *common sense* – that leads to a view on the company and, ultimately, to an investment decision. To single out the exact importance of ESG in this process, which is a qualitative metric in nature, is almost undoable. Still, our research-based approach as explained below, allows us to present a good proxy.

Core to this approach is the full integration of material ESG factors into our valuation models[3]. As we've argued before, company valuation and ESG go hand in hand as the latter can (in)directly impact a company's traditional value drivers such as sales growth, margins, investment needs and discount rate (Figure 1).

Figure 1 | Valuation bridge including ESG impact

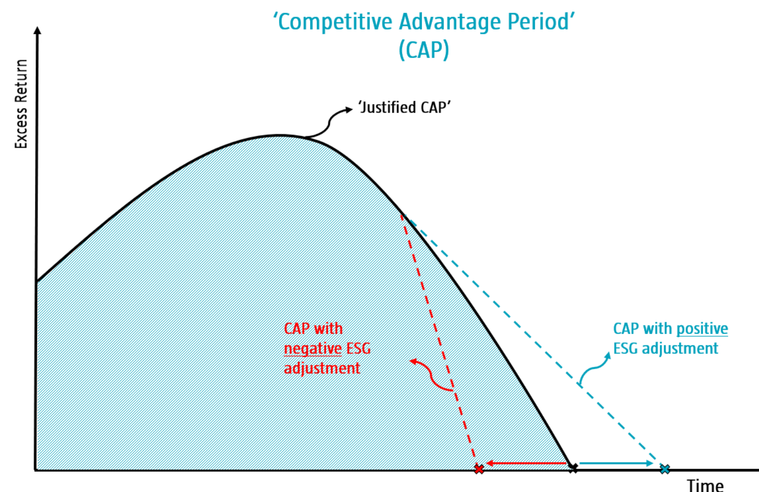


Source: Robeco

[1] Sustainable Global Stars uses the MSCI World EUR Index as a reference index.
[2] "Solving the ESG Rubik's Cube", Robeco, January 2021.
[3] Please refer to "Valuing ESG at Robeco Global Equity", Robeco, 2015.

In 2017, we also introduced an alternative approach of adjusting a company's valuation through the so-called "competitive advantage period" or CAP, the period over which a company can generate excess economic profits (i.e. earn returns above its cost of capital)[4]. This methodology is based on pioneering work by Credit Suisse HOLT, with the CAP concept illustrated in Figure 2. In the Technology or Healthcare sectors, for example, we often choose adjustments of CAP over traditional value drivers as we feel it better captures the long-term value creation capability of such business models.

Figure 2 | Competitive Advantage Period



Source: When CAP meets ESG. Robeco, 2018

In addition, the Sustainable Global Stars strategy applies the Robeco exclusion policy. Most relevant to the exercise laid out in this paper, is the exclusion of all companies in the tobacco sector and most in the aerospace & defence (A&D) sector. Moreover, over time, exclusions of fossil fuel companies have only grown, hence for the purposes of our research we've now included the net effect of the exclusions of most of the energy sector, and recalculated our previous findings retrospectively. It's important to note that our strategy can still invest in some areas of energy (e.g. advanced biofuels), but only when they meet very strict sustainability thresholds, effectively ruling out large positions in most energy stocks. In our calculations we netted the effect of our energy holdings against those that we effectively cannot or do not want to own[5].

Finally, our strategy also actively engages with companies to improve their sustainability profile as this is often more impactful than simple exclusion[6]. However, in our ESG performance attribution methodology we only focus on the first two approaches: ESG integration and exclusion, as the alpha effects of these can be measured best. For a full description of our methodology, please refer to the articles in the footnotes[7].

Example: Eli Lilly

To refresh your memory of our ESG performance calculation methodology, let's walk through a practical example. In the strategy we hold Eli Lilly, a large US pharma company, and one of the best innovators in the pharma industry. On the back of our ESG analysis, we conclude that ESG effectively makes up about 11% of overall company value, owing to strong corporate governance and innovation management. Subsequently, we looked at the performance contribution of Eli Lilly in the portfolio, which was +156 bps during 2022. Multiply both figures and you get a proxy for the ESG attribution to performance. Thus, in this case we get: 11% x 156 bps = +17 bps excess performance being attributable to ESG. Again, this

[4] Berkouwer, C. (2018), "When CAP meets ESG: Uncovering Unchartered Territory", Robeco White Paper.
[5] Thresholds include but are not limited to environmental footprint metrics (e.g., carbon, water and waste intensity), ESG risk ratings and SDG scores. Though not always being 'hard' exclusions, we tend to avoid companies that could violate the *spirit* with which we run our sustainability strategy, and therefore, can be deemed 'soft' exclusions.
[6] For a full description of the Sustainable Global Stars ESG approach, please read "Two Worlds Colliding: Insights from Three Years of ESG Integration", Zandbergen, M., Robeco White Paper, 2017.
[7] "Separating the Sugar from the Tea: Measuring the ESG impact on Investment Performance", Robeco, 2019.
"Solving for the ESG Rubik's Cube", Robeco January 2021.

might not be the ultimate scientific method to quantify "ESG", but with this we have established a research-based attempt to proxy ESG's contribution to investment performance.

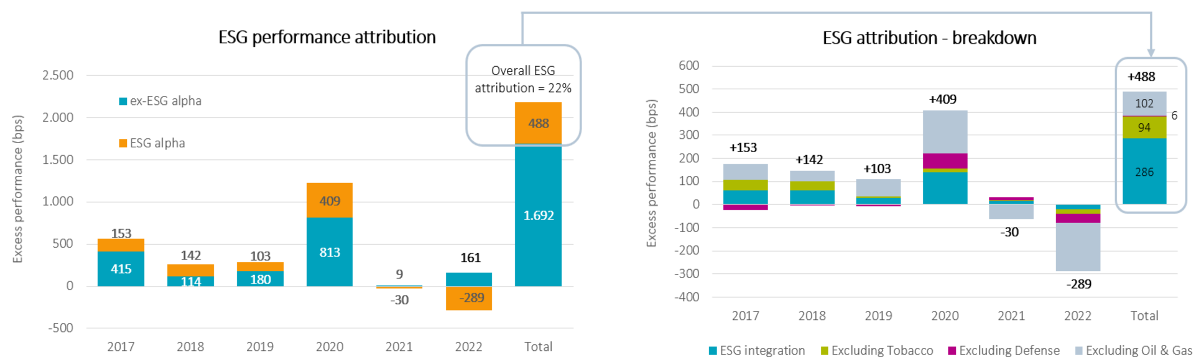
As it comes to outright exclusions, for example the tobacco sector, by not owning any tobacco stocks, we 'win' alpha in case that category of stocks underperforms relative to our benchmark, and vice versa. In 2022, tobacco actually did quite well, so we 'lost' close to 20 bps of alpha. Over the full 2017-2022 time period, however, not being invested in tobacco paid off given weak performance of this industry, providing us with 94 bps of excess performance.

Our data analysis shows that over the longer term, ESG integration has contributed to alpha

Results

Even though we've incorporated ESG into our decision-making since the inception of the strategy, we started explicitly measuring the ESG attribution to investment performance in 2017. Hence, we now have a six-year track record for our analysis (2017-2022), which is illustrated in Figure 3. The left chart of Figure 3 illustrates the strategy's overall excess performance split by ex-ESG and ESG alpha contribution. For example, in 2020, excess performance totalled 1,222 bps of which 409 bps could be attributed to the aforementioned way of ESG integration plus ESG exclusions. The figures also indicate that the ESG attribution to excess performance from 2017-2022 has been significant: ESG explains about 22%, or 75 bps, of the annualized 334 bps of excess performance[8].

Figure 3 | ESG attribution to investment performance



Source: Factset data, 2022

Subsequently, the right-hand chart of Figure 3 breaks down the different sources of ESG performance attribution. It shows that our method of bottom-up ESG integration has helped improve investment performance most, mainly as it helped us in our decisions to include a stock in the portfolio or not, built our conviction level, and helped determine position sizing. It is only in 2022 that it detracted from performance.

Next, we can see that the exclusions of tobacco and most of the energy sector helped alpha generation as well over time. Not being invested in the aerospace & defence (A&D) sector has had a more neutral effect. At the same time, however, we do see the positive exclusion effect of these ESG based exclusions really as a 2017-2020 phenomena, reversing the trend in recent years. In 2022, in particular, the portfolio incurred opportunity costs from common exclusions, some of which within the energy sector but also related to A&D stocks that 'benefited' from the Russia/Ukraine war.

[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.

Now what?

Interestingly, 2022 has debunked the common wisdom that ESG acts as a performance cushion during difficult market conditions[9], at least for now. Of course, there are still plenty of examples where ESG stocks did well during difficult stock market years such as 2018, or the early part of the Covid-19 crisis. However, 2022 was quite extraordinary with ESG favourites coming under attack combined with sin sectors enjoying their moment in the sun. In that sense, after a stellar rise for years, sustainable investing now seems at a crossroads.

Like many structural trends, sustainable investing is going through growing pains. 2022 clearly was a good reminder that there's no such thing as a free lunch. Geopolitics matter, just like higher interest rates and valuation. Does this mean there's a great ESG reset needed? Not necessarily. Our data analysis shows that over the longer term, ESG integration has contributed to alpha. And as argued before, the structural underpinnings for sustainable investing have certainly not disappeared[10].

Conclusion

As we've argued in an earlier publication (see footnote 11), we believe sustainable investing is very much alive, despite the 2022 reset. A fall-out doesn't mean an immediate divorce. There is a clear need though to move to the next level, finding the right balance between idealism and realism in the practical implementation of ESG considerations in investment portfolios. In renewing the ESG wedding vows, a forward-looking approach, ESG financial materiality, enhanced engagements in combination with thoughtful exclusions are critical; this should not only be a thought process at the asset manager level, but also among asset owners and regulators.

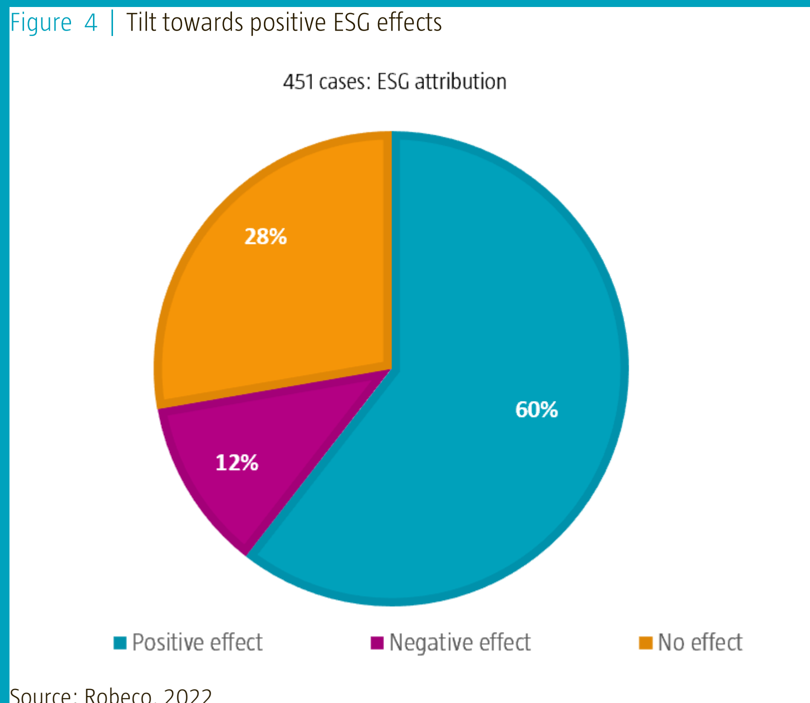
At Robeco Fundamental Equities, we go beyond nice-sounding ESG narratives and try to measure the actual impact ESG has on investment performance. As demonstrated, our way of consistently integrating and tracking ESG in our decision-making, allows for a good proxy of the importance of ESG in our investment portfolios. Our analysis suggests that based on the 451 investment cases written by the Sustainable Global Stars equity team from 2017 to 2022, around 22% of the excess performance can be attributed to ESG. In other words, about 75 bps of the annualized 334 bps outperformance during this time period can be explained by our ESG integration approach.

[9] "Sustainable Reality, Analyzing Risk & Return of Sustainable Funds", Morgan Stanley, 2019.
[10] "Sustainability investing under threat? Not so fast", Robeco, 2022.

Box 1: The numbers: deep dive into 451 investment cases

For our analysis, we relied on 451 investment cases written by the Sustainable Global Stars Equities team from 2017 to 2022; a mix of existing case updates as well as new research ideas. In total, 60% of the investment cases saw a positive ESG effect to the price target, 12% of the time there was a negative effect, while in 28% of the cases no effect (Figure 4). Because the Sustainable Global Stars investment philosophy focuses on companies with a high ROIC, high FCF generation and a strong sustainability strategy, there is a natural tilt towards a positive impact as this reflects the opportunity side of ESG.

Figure 4 | Tilt towards positive ESG effects

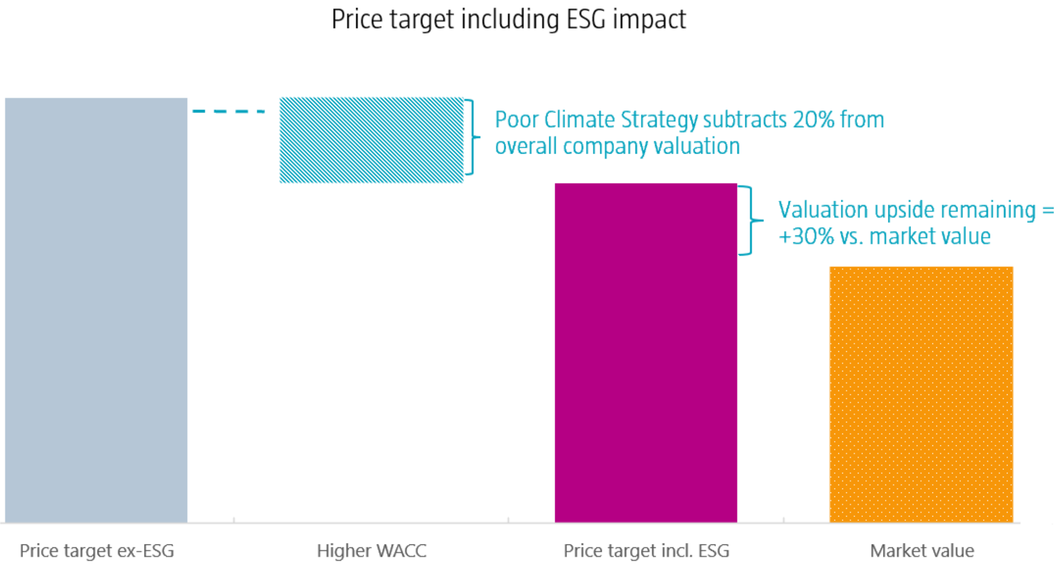


Source: Robeco, 2022

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

In a few cases, however, there are simply more ESG risks than opportunities given the company's business model. This doesn't always mean we cannot invest in such a stock, but it does make it more difficult. As long as the valuation upside, even after discounting the ESG risks, remains sufficient and the company does not violate any strict ESG requirements (e.g. hard exclusion), it could still be in scope of investment. An example of such a stock in portfolio would be a large pure-play US liquified natural gas (LNG) producer. In the context of renewables, LNG is negative, but if used to replace coal, it is good news. Ultimately though, our price target for the company was lowered by 20%. Yet, the valuation upside that remained was still significant (Figure 5). In combination with a growing ROIC and strong FCF generation, we entered the position.

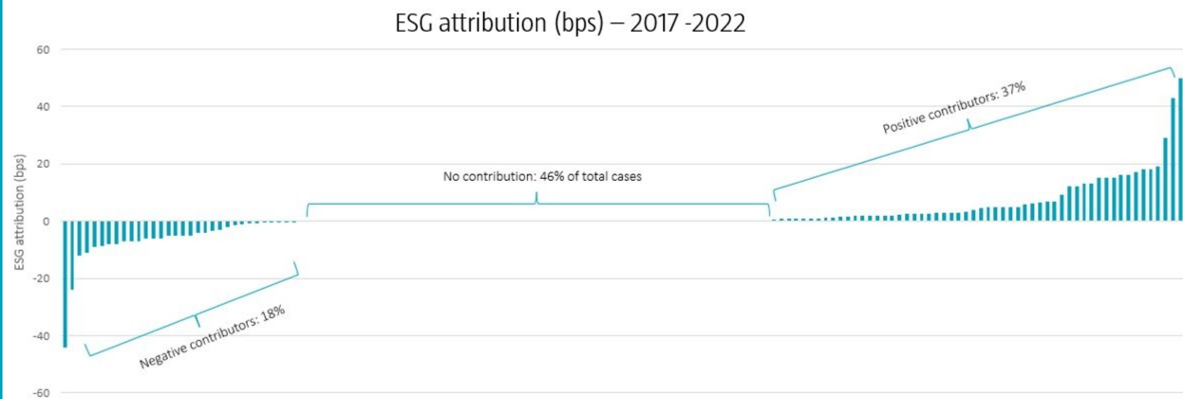
Figure 5 | Example of a negative ESG impact on company valuation



Source: Robeco, 2022

Furthermore, of all 451 investment cases analysed, only 153 either made it to the portfolio or otherwise had an impact on overall investment performance (e.g. a large benchmark weight not owned in the portfolio). Of those 153 cases, around 37% had a positive contribution to performance, 18% detracted from performance, while in 46% of the cases there was no impact at all (Figure 6).

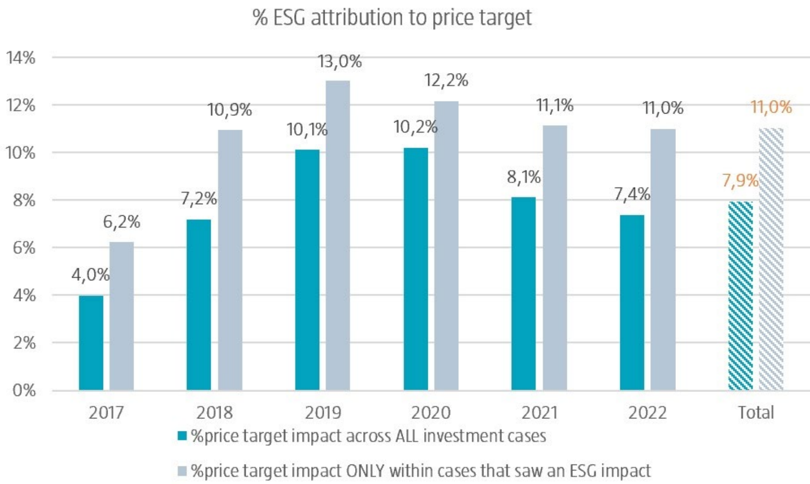
Figure 6 | ESG contribution to investment performance has been positive, on average



Source: Robeco, 2022

Across all 451 investment cases (i.e., including the 28% where no impact was measured) there is an average ESG attribution to our price targets of +7.9% (Figure 7). Even more so, looking *only* within the set of investment cases that *did* see an ESG impact (72% of the total), the average price target attributable directly to material ESG factors proved to be +11.0%.

Figure 7 | ESG impact, on average, led to higher price targets



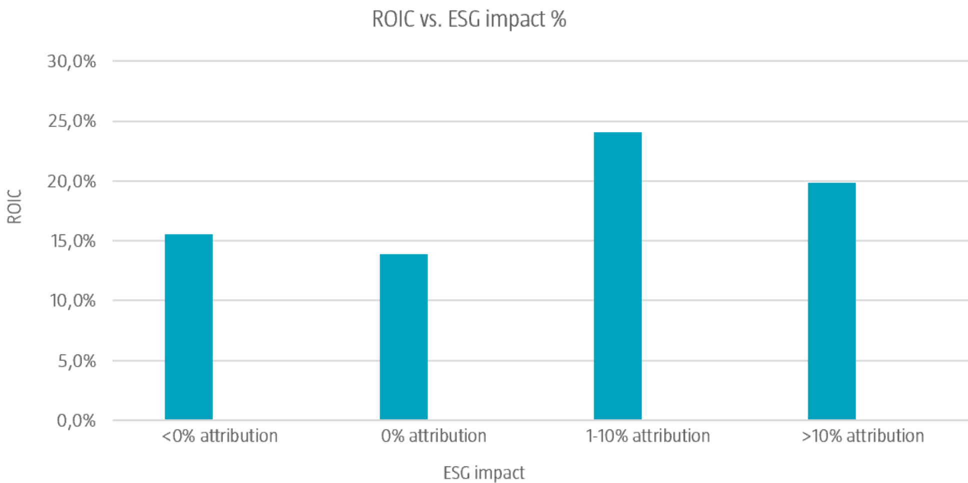
Source: Robeco, 2022

In terms of financially material ESG factors used in the investment cases, we tend to see familiar ESG topics such as "Corporate Governance" and "Product Impact" dominate. However, more recently, ESG issues such as "Climate Strategy" and "Product Quality & Safety" are also often mentioned as the main factors impacting valuation. These factors are quite generic, therefore it's important to note that for each factor we look at slightly different aspects, depending on the sector to which it is applied.

For example, "Climate Strategy" in the context of Oil & Gas companies is very much their going concern, whether or not they face large risk from stranded assets. Whereas for a producer of industrial gases, having a good climate strategy is really about helping to lower the environmental footprint of your customers. The same holds for "Product Quality & Safety", where consumer companies need to have sophisticated processes in place in case of product recalls to avoid severe reputational damage. However, in the context of a US healthcare provider, 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 return on invested capital (ROIC) and the level of ESG adjustment, Figure 8 suggests that companies where ESG factors contribute positively to valuation also, on average, have ROICs 5-10% higher compared to companies where ESG factors contribute negatively to valuation. Our earlier research suggests that good performance on financially material ESG factors indeed marks a high quality company[11]. This reinforces our view that ESG information helps us build conviction in our stock calls.

Figure 8 | ROIC and ESG attribution shows a slight correlation



Source: Robeco, 2022

[11] Zandbergen, M. (2017), "Two Worlds Colliding: Insights from Three Years of ESG Integration", Robeco White Paper.

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The funds have not been and will not be registered with the National Registry of Securities, maintained by the Mexican National Banking and Securities Commission and, as a result, may not be offered or sold publicly in Mexico. Robeco and any underwriter or purchaser may offer and sell the funds in Mexico on a private placement basis to Institutional and Accredited Investors, pursuant to Article 8 of the Mexican Securities Market Law.

Additional Information for investors with residence or seat in Peru

The Fund has not been registered with the Superintendencia del Mercado de Valores (SMV) and is being placed by means of a private offer. SMV has not reviewed the information provided to the investor. This document is only for the exclusive use of institutional investors in Peru and is not for public distribution.

Additional Information for investors with residence or seat in Singapore

This document has not been registered with the Monetary Authority of Singapore ("MAS"). Accordingly, this document may not be circulated or distributed directly or indirectly to persons in Singapore other than (i) to an institutional investor under Section 304 of the SFA, (ii) to a relevant person pursuant to Section 305(1), or any person pursuant to Section 305(2), and in accordance with the conditions specified in Section 305, of the SFA, or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. The contents of this document have not been reviewed by the MAS. Any decision to participate in the Fund should be made only after reviewing the sections regarding investment considerations, conflicts of interest, risk factors and the relevant Singapore selling restrictions (as described in the section entitled "Important Information for Singapore Investors") contained in the prospectus. Investors should consult your professional adviser if you are in doubt about the stringent restrictions applicable to the use of this document, regulatory status of the Fund, applicable regulatory protection, associated risks and suitability of the Fund to your objectives. Investors should note that only the Sub-Funds listed in the appendix to the section entitled "Important Information for Singapore Investors" of the prospectus ("Sub-Funds") are available to Singapore investors. The Sub-Funds are notified as restricted foreign schemes under the Securities and Futures Act, Chapter 289 of Singapore ("SFA") and invoke the exemptions from compliance with prospectus registration requirements pursuant to the exemptions under Section 304 and Section 305 of the SFA. The Sub-Funds are not authorized or recognized by the MAS and shares in the Sub-Funds are not allowed to be offered to the retail public in Singapore. The prospectus of the Fund is not a prospectus as defined in the SFA. Accordingly, statutory liability under the SFA in relation to the content of prospectuses does not apply. The Sub-Funds may only be promoted exclusively to persons who are sufficiently experienced and sophisticated to understand the risks involved in investing in such schemes, and who satisfy certain other criteria provided under Section 304, Section 305 or any other applicable provision of the SFA and the subsidiary legislation enacted thereunder. You should consider carefully whether the investment is suitable for you. Robeco Singapore Private Limited holds a capital markets services license for fund management issued by the MAS and is subject to certain clientele restrictions under such license.

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: Affolternstrasse 56, 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 Investor Information Documents (KIIDs), 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. RobecoSAM-branded financial instruments and investment strategies referring to such financial instruments are generally managed by Robeco Switzerland Ltd. 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 temporarily 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 September 27, 1996, as amended.

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