ROBECOSAM
We are Sustainability Investing.

ESG data and analysis offer deeper diagnostics on company health.

Sustainable investing—strengthening portfolio immunity

The COVID-19 pandemic has been an existential stress test playing out in real-time where only the resilient will survive. ESG analysis goes deeper to identify sources of company resilience that go undetected in traditional financial analysis.

The COVID-19 pandemic has been an existential stress test for companies globally—one that will display their strengths, reveal their weaknesses, and push them to never before seen limits for survival.

RobecoSAM and Robeco consider sustainability the determinant factor in signaling a company's resilience and shock resistance which is why we focus on ESG criteria when selecting companies for our portfolios. Resilient portfolios are less vulnerable to systemic risks resulting from weaknesses such as poor human capital, inflexible processes, over-extended supply chains, and excessive environmental footprints. True to their design, sustainable investment strategies have been resilient relative to the broader market over the course of the pandemic thus far.

Here we discuss why crisis planning should be part of portfolio construction and why a focus on ESG offers more comprehensive diagnostics that can help bolster company and portfolio immunity.

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ESG—deeper diagnostics, healthier performance outcomes

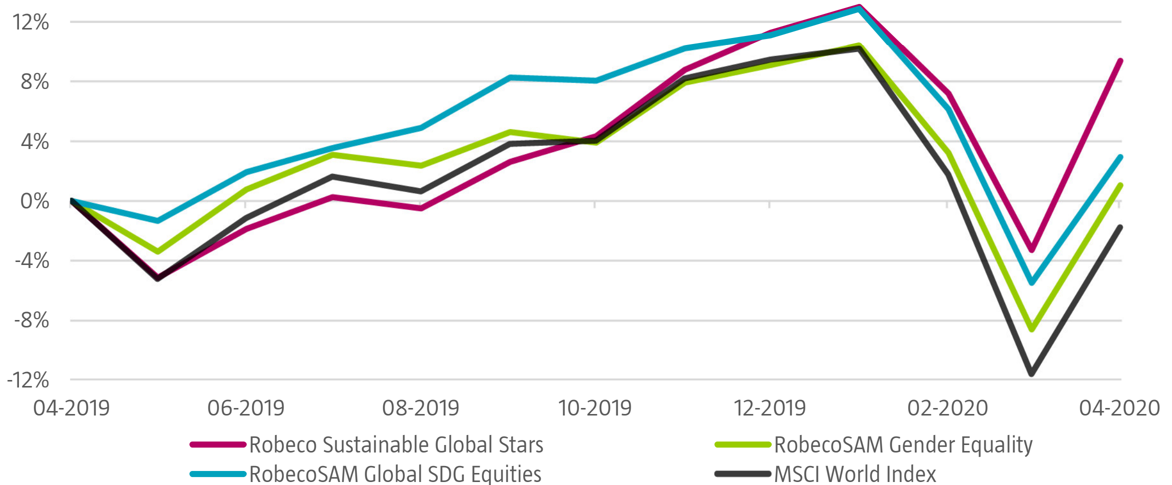
Performance presented in Figures 1-3 below show a selection of funds that rigorously incorporate sustainable investing research into their bottom-up fundamental research and portfolio construction process. All strategies are classified as unconstrained, high-conviction strategies investing in a diversified portfolio of global equities or fixed income securities.

As demonstrated below, these strategies have performed better than their non-ESG benchmarks. What's more, most have outperformed prior to the outbreak and have maintained a performance advantage even as the crisis spread and infected global financial markets.

Fundamental investment strategies that rigorously incorporate ESG into their investment decisions have performed better than their non-ESG benchmarks.

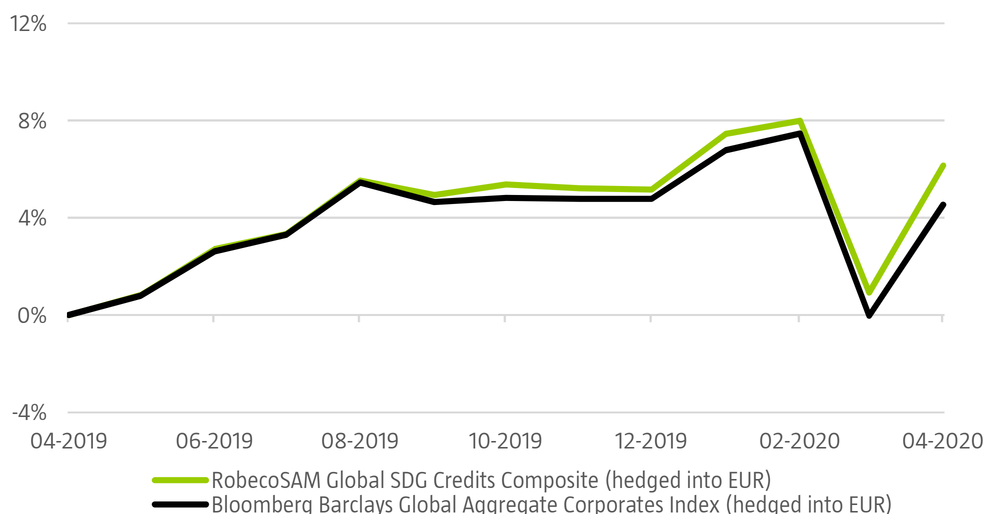
Better performance in pre-COVID-19 and present-COVID-19 markets

Figure 1 | 12-month gross composite performance (in EUR) for RobecoSAM and Robeco's sustainable equity strategies vs the MSCI World TRN Index



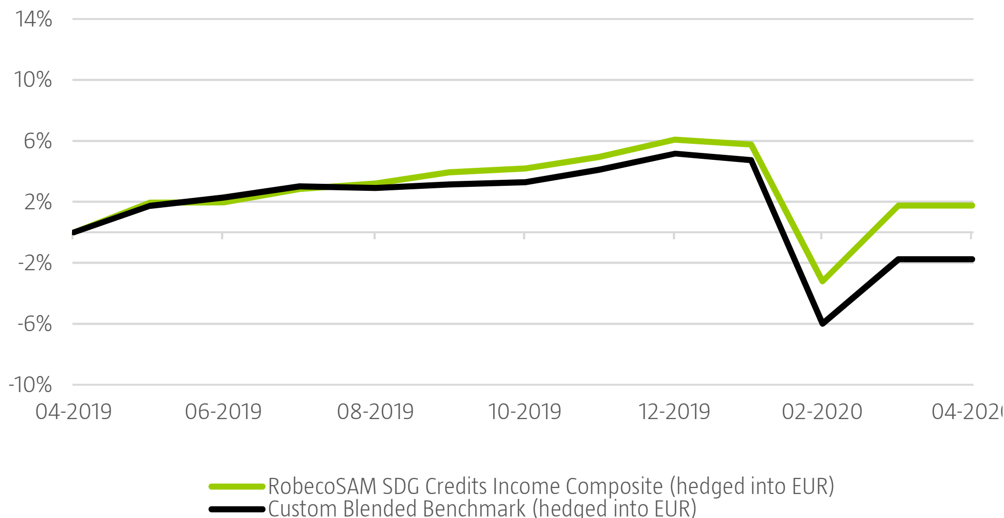
Source: RobecoSAM, Robeco. Gross performance for all strategies is calculated based on composite data cumulated monthly over 12-months through 30 April 2020. Past performance is no indication of future results. The values and returns indicated here are before cost; neither consider the management fee as well as other administration costs related to the fund nor the fees and costs which may be charged when subscribing, redeeming and/or switching units. These have a negative effect on the returns shown.

Figure 2 | 12-month gross composite performance (hedged in EUR) for the RobecoSAM Global SDG Credits Strategy vs the Bloomberg Barclays Global Aggregate Corporates Index



Source: Robeco. Gross performance is calculated based on Gross Asset Value and is based on composite data cumulated monthly over a 12-month period ending 30 April 2020. Past performance is no indication of future results. The values and returns indicated here are before cost; neither consider the management fee as well as other administration costs related to the fund nor the fees and costs which may be charged when subscribing, redeeming and/or switching units. These have a negative effect on the returns shown.

Figure 3 | 12-month gross composite performance (hedged in EUR) for the RobecoSAM SDG Credit Income Strategy vs its benchmark (hedged into EUR)



Source: Robeco. Gross performance is calculated based on Gross Asset Value and is based on composite data cumulated monthly over a 12-month period ending 30 April 2020. The Strategy's benchmark is a customized blended index incorporating global aggregate corporate bond and composite credits income indices. Past performance is no indication of future results. The values and returns indicated here are before cost; neither consider the management fee as well as other administration costs related to the fund nor the fees and costs which may be charged when subscribing, redeeming and/or switching units. These have a negative effect on the returns shown.

Moreover, we find similar outperformance if we expand the scope to include other fundamental strategies that incorporate ESG criteria into the investment process.

Though highly concentrated and so less representative of movements in broader global markets, thematic and sector equities nevertheless provide further evidence of the capacity of ESG to offer portfolio performance and protection in both rising and falling markets. Over a full year through April 30 2020, 91% of our sustainable thematic and sector focused

equity strategies have outperformed their benchmarks; if we isolate performance to cover only the pandemic period (year to date through April 30), we see that 75% have remained resilient with relative outperformance despite dramatic drawdowns and volatility.

Increasing frequency of fat tail events

An important insight of sustainable investing is the recognition that systemic factors interact in unpredictable ways producing unexpected events with extreme impacts. Given the low probability that the right factors will combine in the right ways to create a catastrophic cocktail, these factors are usually ignored and their "fat tail" outcomes dismissed. We argue that these systemic risks will only become more relevant for business and investments.[1] As recent events have shown, vigilant monitoring of these factors (after all, epidemics have always existed) is important and complacency dangerous, even fatal.

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The COVID-19 pandemic illustrates the risks of fragile systems, fat tail events, and their extension to the real economy. Most of us (especially in the developed world) have never experienced a pandemic with such dramatic health and economic consequences. The scale of business disruptions, job losses, and GDP contractions make the economic crises of recent decades look relatively mild in comparison. Unfortunately, cognitive biases prevented us from effectively managing these fat tail risks.

Without immediate and sustained action, climate change (like this pandemic), is an entirely certain event—the only uncertainties are those of timing and degree of devastation. The certainties and uncertainties surrounding the pending climate emergency is exactly the reason why it should be addressed with renewed focus and rigor in order to more precisely manage its risks. While the COVID-19 pandemic will eventually subside, climate change is a permanent impact on civilization and the environment.

ESG principles remain relevant both in and out of crises

The erratic waves of market volatility sparked by the pandemic reinforces our core investment principles:

1) recognize people are a company's most valuable (but also most vulnerable) asset;
2) protect access to the resources and respect the complexities of the environmental and economic ecosystems in which businesses thrive long-term;
3) balance current performance with future returns; and
4) ensure the underlying resources from one investment portfolio are available to others, both current and future.

These principles are executed in a variety of ways within our investment strategies. We apply them broadly in our top-down views to specify our investment universes as well as in our sector analysis where we concentrate on industries producing products with long-term value for present and future generations.

We also apply them more specifically in our bottom-up analysis of companies where we focus on indicators of resilience over the long run. Companies oriented toward the future target long-term outcomes and employ sustainability-driven thinking to get there safely.

[1] For more on this topic please see: 1) "No Firm is an island: using the SDGs to bridge modern portfolio management to the future", RobecoSAM Sustainability Yearbook, 2019 edition and 2) "Capitalism without Capital", (Haskel & Westlake, 2017) a book explaining how intangibles factors in business can contribute to company performance.

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ESG data in sector allocations and company analysis

We pay careful attention to sector exposure, favoring some sectors over others. Generally, we recommend underweighting energy, financials, and consumer discretionary sectors and overweighting healthcare, technology, and communications services. The latter group have outsized potential in improving health, reducing inequalities, and expanding economic opportunity globally—all prominent objectives of the UN Sustainable Development Goals (SDGs).

When it comes to core strategies, we prefer companies that exhibit quality in terms of strong financials (e.g. balance sheet, cash flows, and returns on invested capital) as well as strong sustainability performance. Described in more detail below, our sustainability assessment of companies includes several criteria including risk and supply chain management, human capital development, R&D, and governance—important structural blocks for building diverse and robust companies (at the microlevel) and economies (on a larger scale).

Vital signs—resiliency indicators

Risk & Crisis Management

Risk & Crisis Management assessments include governance, sensitivity analysis, stress testing, and the identification of emerging risks. While the timing of a global pandemic is impossible to predict, the magnitude of the risk, if realized, is well known. Already in 2014, the Ebola outbreak pushed infectious diseases into the top ten of the WEF Global Risks Report, where it has remained since. Moreover, globalization and the interconnectedness of financial markets has enabled growth but also increased our vulnerability. As a result, shocks in one geographic region or economic sector will almost certainly be felt across the entire system. To understand and prepare for such risks, well managed companies would have (at the very least) invested in basic stress testing that included scenarios where access to capital was limited or absent for an extended period of time.

Supply Chain Management

Supply Chain Management has been another major differentiator during this period. The pandemic has left companies scrambling to better understand weak links and potential disruptive sources in their supply chains. As part of our assessment, we review whether critical suppliers have been identified and prioritized for high risk exposure. This applies not only to direct suppliers, but also suppliers further up the value chain. Companies that take these steps can better manage production and service interruptions and rapidly redesign supply chains.

Human Capital Development

Human Capital Development should be a top priority in any resilient company. Human talent is an expensive resource to lose. Good employees are productive, entrepreneurial, efficient and innovative. Moreover, recruiting and training capable replacements can be more costly than what is saved by reducing headcount in the short term. Companies with strong financials and long-term orientation will be able to retain more workforce talent and recover faster and stronger when the economy re-activates.

R&D Investments

R&D is another way companies remain robust and resilient. Innovation is a proactive defense against future threats. At innovation's core is a desire to create value by addressing real human needs that improve well-being. We look at companies' R&D budgets and key innovation metrics to gauge how they are planning for disruptive risks (both known and unknown). Innovation can be applied in many ways—improving products, services, operations, and/or delivery models that create value and opportunities for growth and survival. During the pandemic many companies rapidly re-tooled factories and facilities to shift production to life saving supplies and equipment. Responding with this type of speed and ingenuity to challenges is a strong signal of a resilient company culture.

Corporate Governance

Finally, Corporate Governance factors offer strong indicators of a company's capacity to effectively navigate choppy waters. Hallmarks of good governance include board diversity, aligned incentives, transparent decision making, and high employee engagement. We look for companies whose boards, policies, and structures ensure long term thinking and strategic decision making which are then effectively transmitted for execution throughout the organization.

Facing the next "fat tail"

Many cynics assume that ESG data's ability to signal a company's capacity to mitigate risk and generate value for its investors is more hype than reality. Some high-ranking opponents go so far as to claim that much of ESG data is too onerous, too nebulous and too superfluous to measure and therefore matter.[2] If this were true, then any perceived advantages of ESG investing would be eliminated in times of extreme economic stress and performance of ESG vs non-ESG portfolios would be the same (at best) and most likely worse. As we have shown, performance data reveals otherwise.

ESG data is a deeper diagnostic that can help reveal critical areas of weakness and strength in a company—areas that determine its resilience in times of extreme volatility and stress. So it makes sense that ESG strategies have outperformed their counterparts during the current crisis. Our globally focused fundamental equity and credit strategies which rigorously integrate ESG criteria into portfolio construction have maintained steady outperformance before and during the first months of the COVID-19 crisis; moreover, our own experience is shared by others.[3, 4]

Furthermore, academic research shows that ESG funds have outperformed their non-ESG peers in other volatile periods, including during the 2008-2009 financial crisis and the market turbulence of 2015 and 2018.[5, 6]

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Fat tail events will not end, nor will our inability to predict their exact timing and impact. However, with the right approach we can mitigate their impact and sometimes even contain them. If this crisis has shown us anything, it is that resilient companies can survive and thrive in times of unprecedented crises. We've already witnessed some companies actually supercharge adoption, expand market share, and increase stock values during the corona-era—all outcomes that are likely to remain permanent post-corona.

ESG analysis provides deeper and more comprehensive diagnostics on a company—diagnostic data that helps investors spot areas of concerns that weaken a company's resilience long before visible symptoms begin to appear in financials.

We anticipate that companies and investors will increasingly build preventative action into their operations and portfolios. Many so-called redundancies from a short-term efficiency perspective have proven to be optimal during volatility. Investors and managers should infuse portfolios with sustainable companies which appreciate growth but not at the cost of destroyed defenses and weakened resilience. Doing so will offer protection from the next fat tail that swipes.

Contact
For more information go to:
www.robecosam.com

[2] "SEC's Peirce: ESG is used like a 'scarlet letter' to shame, misjudge companies", S&P Global Market Intelligence, 18 June, 2019, https://www.spglobal.com/marketintelligence/en/news-insights/trending/GQvgMOqskXnxPvHnrnUZAg2
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[6] "Sustainable funds outperformed the broad market in the recent correction", Market Watch, 15 February, 2018, https://www.marketwatch.com/story/sustainable-funds-outperformed-the-broad-market-in-the-recent-correction-2018-02-15

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