ROBECO INSTITUTIONAL ASSET MANAGEMENT

A smarter alternative: Enhanced Indexing

20 years
Celebrating 20 years of
Enhanced Indexing
2004-2024

ROBECO
The Investment Engineers

Overview

Is passive investing truly the right choice for a core allocation in equities?

- Over the years, passive investing has gained popularity for its low costs, predictable return versus the benchmark, liquidity, diversification and transparency. These qualities have made passive strategies a staple in core allocations among investors, allowing them to efficiently capture benchmark returns.

- However, we believe Enhanced Indexing represents a smarter way to achieve these benefits while also aiming for better returns, smarter risk management and the ability to tailor portfolios for client requirements.

- Enhanced Indexing involves using quantitative, rules-based investment strategies that aim to outperform a reference benchmark with minimal tracking error and low costs. They are highly customizable strategies which can be tailored for client-specific requirements such as custom benchmarks, tracking error and sustainability.

This publication explores the key reasons why investors should consider Enhanced Indexing: a smarter alternative to passive investing. We delve into how the concept can address the challenges of passive investing effectively, and share insights into how Robeco has successfully implemented this approach over the past 20 years.

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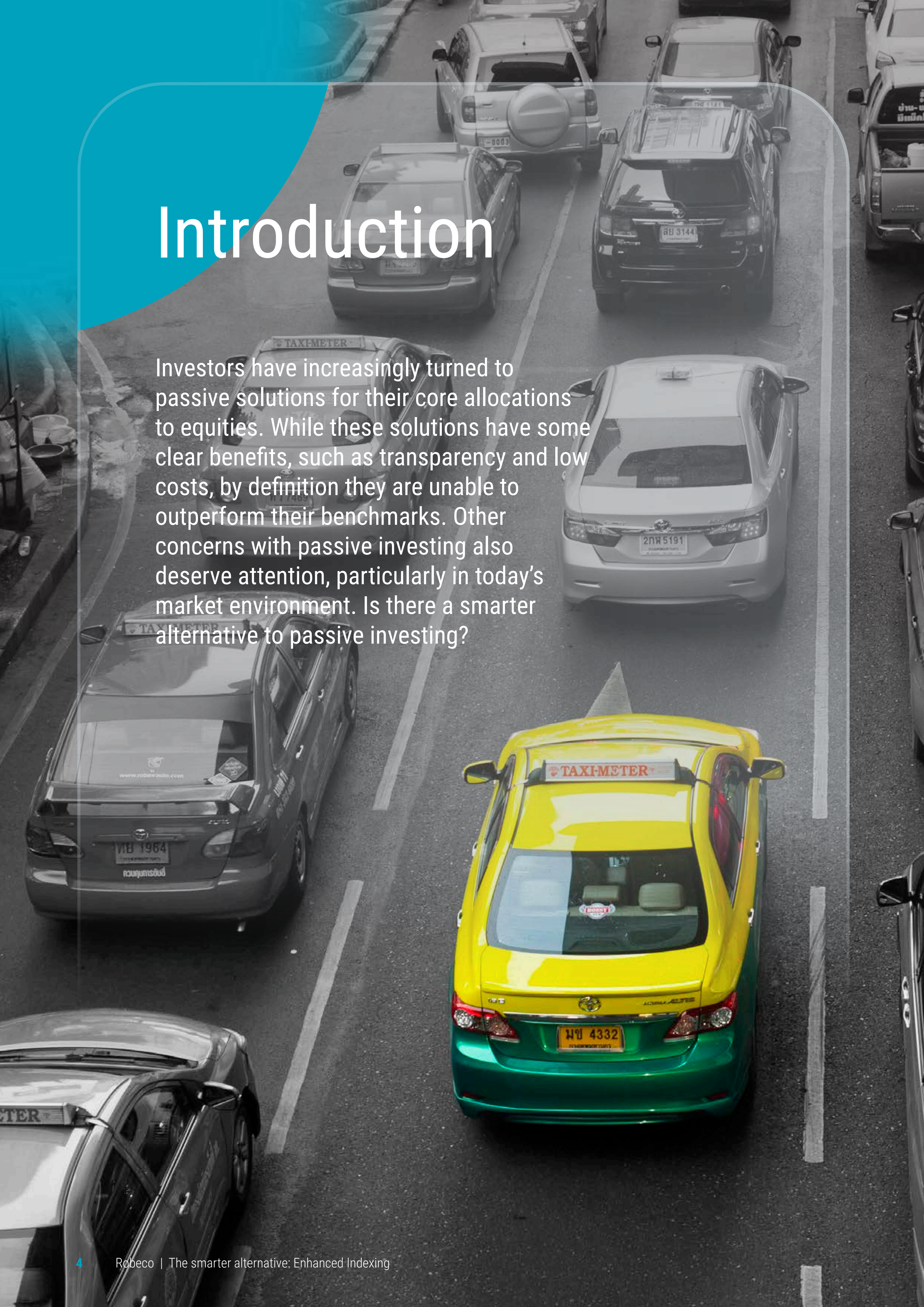
August 2024



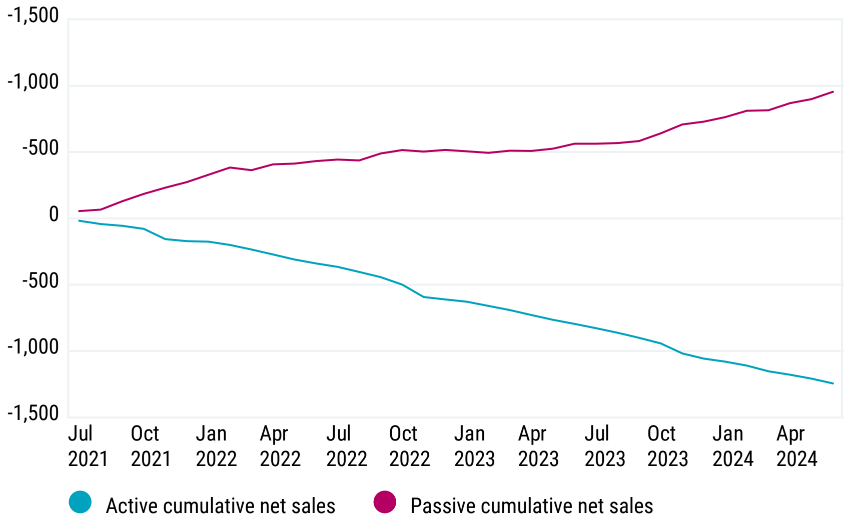
Introduction

Investors have increasingly turned to passive solutions for their core allocations to equities. While these solutions have some clear benefits, such as transparency and low costs, by definition they are unable to outperform their benchmarks. Other concerns with passive investing also deserve attention, particularly in today's market environment. Is there a smarter alternative to passive investing?

The passive trend

Over the past decade, passive investing has become increasingly popular, changing the asset management industry. The surge in popularity is easy to explain: passive strategies generally are a transparent, low cost approach to capturing benchmark returns.

Figure 1 | Trends in passive and active investing for equities and ETFs



Source: Broadridge. Sales region North America. Equities and ETFs. August 2021 to July 2024.
In USD (bn)

Potential pitfalls of passive

Despite the appeal, there are compelling reasons to question this approach, especially concerning a core allocation.

No alpha potential: Passive strategies by nature cannot exceed their benchmark returns. Passive investing also ignores decades of academic insights on asset pricing, thus passing up on opportunities to enhance returns through actively exploiting market inefficiencies.

Sustainability issues: For clients with sustainability requirements, passive approaches may be problematic since ESG or sustainable indices require active management by definition. As such, they can deviate from their parent benchmarks, leading to different risk-return outcomes in terms of heightened country, sector or relative risk levels.

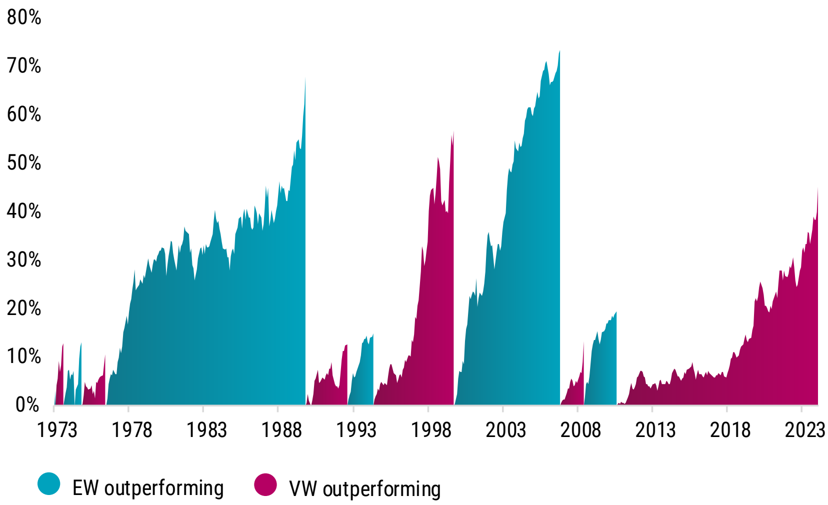
Not customizable: Passive strategies cannot be tailored to the specific preferences of clients. For instance, clients may have unique risk/return objectives, regional or sector preferences, or sustainability preferences such as specific exclusions.

Current market conditions and their implications

Concentration risks in global equity markets are rightfully garnering more attention from market commentators and investors. Indeed, catchphrases like FAANG, Magnificent Seven, and GRANOLA highlight the narrow market leadership that has driven market-cap-weighted passive indices in recent years. While they have recently outperformed equal-weighted ones, history suggests this isn't always the case, as seen in Figure 2. And when the tides reverse, passive investors will not have the flexibility to marginally tilt the portfolio to exploit the prevailing market environment for their benefit.

As such, a smarter alternative that can provide efficient exposure to the market premium, while offering some flexibility to respond to changing market conditions, can serve as a more appropriate core equity allocation for investors going forward. Enhanced indexing strategies can use enhanced factors and alpha signals to identify equities more likely to outperform, can access a larger universe of stocks, and can rebalance the portfolio to target outperformance while minimizing tracking error.

Figure 2 | Relative performance of MSCI World Equal Weighted vs. MSCI World



Source: Robeco, LSEG, MSCI. The figure shows the relative performance of the MSCI World Equal Weighted Index vs. the MSCI World Index. Performance is measured via the total return index and the sample period is May 1973 to June 2024.

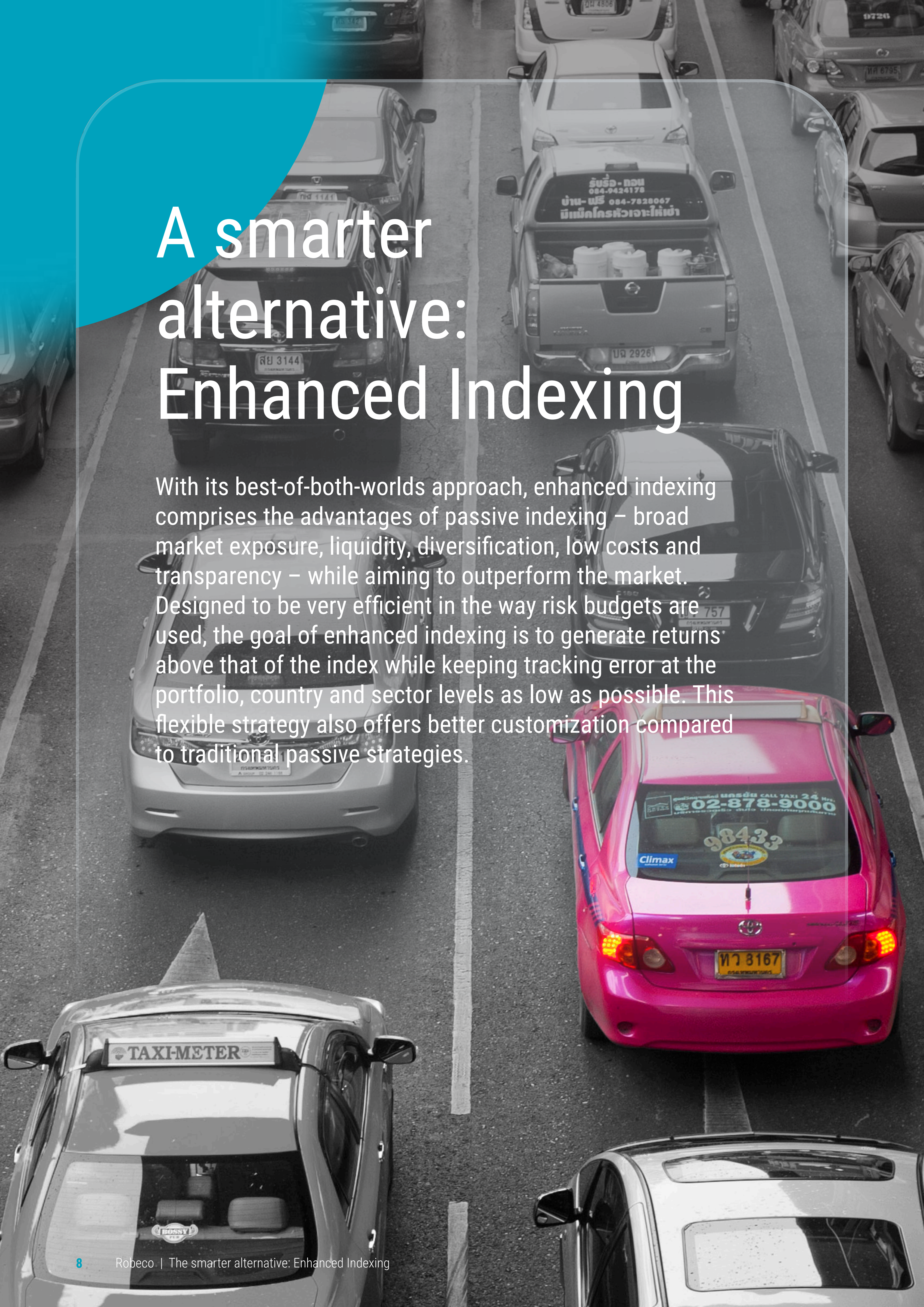
Another conundrum facing investors today is determining where we are in the global equity market cycle and if US exceptionalism will continue. It's worth noting that the macro environment characterized by high interest rates, increasing geopolitical instability and sustainability concerns poses challenges for all types of investing. These conditions, coupled with high equity market valuations and elevated earnings expectations, might lead to lower future returns over the next decade. This is also the view held by the Robeco Sustainable Multi-Asset Solutions team, as outlined in its medium-term asset class returns outlook in Table 1.

Table 1 | 5-year expected equity returns 2025-2029

	EUR			USD		
Equity	Bull	Base	Bear	Bull	Base	Bear
Developed	9.75	6.50	4.00	11.75	7.50	1.00
Emerging	16.75	7.25	5.00	18.75	8.25	2.00

Source: Robeco. September 2024. The medium-term influences correspond with our assessment of the valuation, climate and macro influences described in Chapters 2, 3 and 4 of our upcoming Expected Returns publication. The expected returns are geometric and annualized. The value of your investments may fluctuate, and estimated performance is no guarantee of future results.

Again, we believe Enhanced Indexing represents a smarter alternative. It offers the potential for improved returns with market-like risk and enhanced customization versus a passive approach. The strategy can play a pivotal role as a core equity allocation, especially if investors might need to preserve their risk budgets for alternative strategies as satellite investments to meet their overall objectives.



A smarter alternative: Enhanced Indexing

With its best-of-both-worlds approach, enhanced indexing comprises the advantages of passive indexing – broad market exposure, liquidity, diversification, low costs and transparency – while aiming to outperform the market. Designed to be very efficient in the way risk budgets are used, the goal of enhanced indexing is to generate returns above that of the index while keeping tracking error at the portfolio, country and sector levels as low as possible. This flexible strategy also offers better customization compared to traditional passive strategies.

Better alpha potential

Enhanced indexing strategies aim to deliver better returns while minimizing tracking error by using sophisticated portfolio construction techniques. Unlike passive strategies that blindly follow an index and do not favor one company over another, enhanced indexing strategically increases allocations to stocks that quantitative models indicate are more likely to outperform. The smarter stock selection is based on forward-looking return factors that possess robust predictive power (per empirical studies), allowing the strategy to take advantage of market inefficiencies to target better returns than the index after costs.

More efficient risk control

In their quest to deliver enhanced returns while keeping the risk profile in line with the index, enhanced indexing strategies maintain their risk-aware stance. While the strategy emphasizes stocks with the potential to outperform, this is implemented within measured limits from a portfolio, sector and company perspective to contain tracking error. Moreover, the advanced portfolio construction ensures that the relative risk budget is used efficiently in an attempt to generate returns sufficient to offset trading and implementation costs and to provide returns in excess of the index.

Improved capabilities for sustainability integration

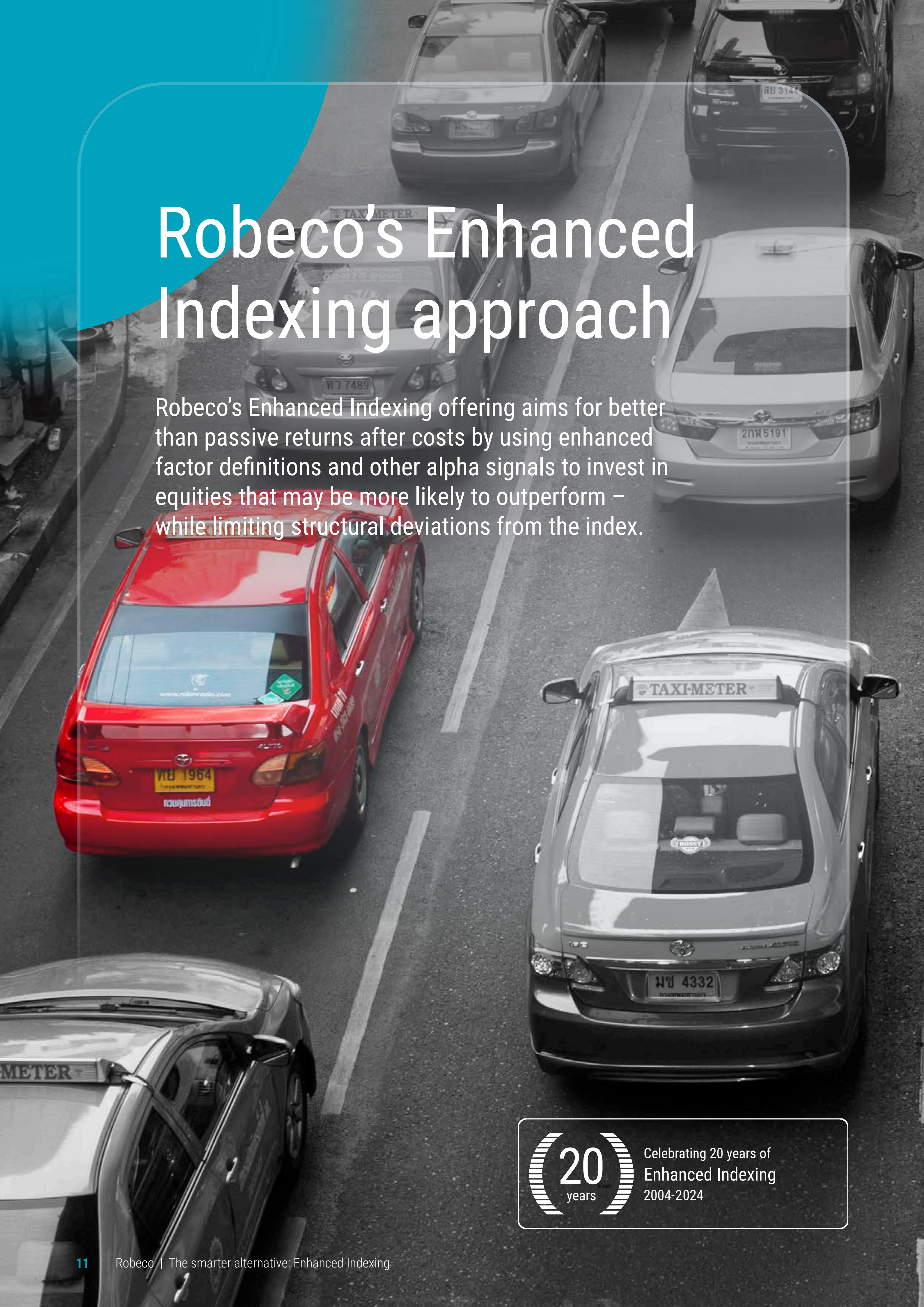
When passive strategies follow ESG-tilted indices, the risk profile of such indices can significantly deviate from their mainstream parent indices, for instance due to differences in sector or country exposures. This exposes investors to the kinds of active risk they aimed to avoid by choosing a passive strategy in the first place. Enhanced indexing strategies can be customized to tilt towards more sustainable companies while keeping country, sector and company deviations from the index limited.

“ Designed to be very efficient in the way risk is used, the goal of enhanced indexing is to generate excess returns while keeping the relative risk at the country, sector, and company levels as low as possible

Table 2 | Passive investing versus enhanced indexing at a glance

	Passive	Enhanced Indexing
Broad market exposure	✓	✓
Predictable risk profile	✓	✓
Low costs	✓	✓
Better return potential	X	✓
Smart company selection	X	✓
Improved sustainability	X	✓

Along with these key advantages, enhanced indexing offers a transparent, rules-based, quantitative investment process that ensures the risk profile of the portfolio is in line with the index, enabling clients to use the strategy as a core equities allocation. This approach is designed to implement a consistent investment process by following systematic, predefined rules and parameters, with the aim to deliver repeatable and predictable outcomes for investors. Additionally, enhanced indexing provides diversification by maintaining similar exposures to the market which reduces the impact of any single investment's performance on the overall portfolio.



Robeco's Enhanced Indexing approach

Robeco's Enhanced Indexing offering aims for better than passive returns after costs by using enhanced factor definitions and other alpha signals to invest in equities that may be more likely to outperform – while limiting structural deviations from the index.

20 years

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How does our enhanced indexing strategy work?

Smarter company selection

Robeco's Enhanced Indexing Equities strategies use time-tested, systematic approaches to identify stocks that are more likely to outperform. The strategies use Robeco's quantitative company performance and stock selection models, built on over 25 years of extensive proprietary and academic research.

Our models use enhanced factors to rank companies based on the attractiveness of their valuations (value), the nature of their market performance trends (momentum), and the degree of their quality characteristics, e.g., balance sheet strength and profitability (quality). The model also considers changes in sentiment on company prospects from financial analysts (analyst revisions), and the dynamics of short-term trends, e.g., share price reversals, and short-term sentiment (short-term signals).

Indeed, the essence of smarter company selection in enhanced indexing is to not take a few large active positions but to invest in a diversified manner with a preference for equities that are more likely to outperform. On average, in the longer run, this diversified approach has outperformed benchmarks after costs.

“ *Indeed, the essence of smarter company selection in enhanced indexing is to not take a few large active positions but to invest in a diversified manner with a preference for equities that are more likely to outperform*

Smarter sustainability approach

Thanks to our long heritage and deep expertise in sustainable investing, Robeco is able to credibly differentiate between more and less sustainable companies. We believe that understanding sustainability can lead to better investment decisions and we evaluate sustainability across multiple dimensions including ESG, SDG, environmental footprints and active ownership activities (engagement and voting).

For those clients with specific sustainability objectives, we can tailor Enhanced Indexing portfolios for those objectives, while also targeting outperformance and minimization of tracking error.

Smarter optimization

In our Enhanced Indexing strategies we use a proprietary portfolio construction algorithm that efficiently balances risk, return, and sustainability considerations to aim for returns beyond those of the index.

Client cash flows are also actively used to optimize portfolios by applying the latest company rankings while avoiding unnecessary portfolio turnover, reducing costs, and enhancing net returns. Moreover, these strategies also avoid arbitrage risk, which can impact passive solutions due to front-running ahead of index rebalances, and can, in fact, take advantage of these opportunities.

Smarter client-specific customization

In mandates, our Enhanced Indexing strategies can be customized to an investor's exact risk, return and sustainability preferences. To this end, we have built a proprietary customization tool that can facilitate the joint creation of tailored portfolios along with clients to better suit their unique needs.

Our portfolio customization capabilities and history of generating alpha have led to us managing tailored portfolios for several of the world's largest and most sophisticated institutional investors.

The now and next of Enhanced Indexing

Innovation is the best way to future-proof an investment process and Robeco's Enhanced Indexing strategies have evolved with technological advancements. Our cautious pioneering mindset serves us well: we have a robust infrastructure, a well-established quant team, and a history of innovation. The big data revolution and exponential growth in computational power are opening up more possibilities in the world of enhanced indexing. Given its research-driven culture, Robeco is well-positioned to navigate and exploit these opportunities.

For example, our Enhanced Indexing Equities company selection model evolved from focusing primarily on well-known, traditional factors such as value, quality and momentum to also incorporating alternative signals as far back as 2009. More specifically, this key innovation was our basket of short-term signals, which uses faster-moving, innovative signals. Our short-term signals offer diversification to our selection model as they tend to be uncorrelated to the well-known, traditional factors which have longer return forecasting horizons. Moreover, this basket has consistently contributed to performance since its incorporation[1].

Other recent advances include incorporating sustainable alpha signals, such as employee engagement and resource efficiency. Higher employee engagement, measured through platforms like Glassdoor, has shown a positive correlation with future stock returns, linking it to the social aspect of sustainability. Resource efficiency, particularly in resource-heavy sectors, also correlates with better stock performance and lower environmental footprints, providing both financial and environmental benefits. In this way we seek to discover sustainable alpha; where sustainability isn't just a nice-to-have but actually contributes to better return potential.

Going forward, our research agenda continues to focus on refining and diversifying our investment approach, for example through the use of uncorrelated alternative signals from novel data sources and advanced modeling techniques.

The Enhanced Indexing team

Robeco's Enhanced Indexing strategies are run by an experienced quant investment team, with portfolio managers who collaborate with and benefit from the expertise of Robeco's researchers in managing the strategy.

With over 25 years of experience, our broader quant team – a group of more than 50 dedicated researchers and portfolio managers – leverages its deep expertise to develop innovative, cost-effective strategies. Our researchers have strong academic links and are responsible for the development and enhancement of quantitative models and applications, which form the heart of our quantitative product line. Together with the portfolio managers, this robust team enables us to deliver the precision and insights necessary to achieve enhanced performance, even in a cost-conscious environment.

1. Mosselaar, J, March 2024, "Robeco EM Quant Equities' recipe for success: 10 key ingredients", Robeco article.

Strategy range

Robeco's Enhanced Indexing strategies are offered across asset classes and in different geographic universes, including developed markets and emerging markets. .

- **The Robeco Global Developed Enhanced Index Equities strategy** is a compelling alternative to passive investing, designed to systematically capture the equity risk premium through its balanced multi-factor exposure. It aims to deliver superior risk-adjusted returns with limited relative risk.

Benchmark	MSCI World Index
Realized outperformance (since inception net of fees)	0.6%
Tracking error limit (ex ante)	1%
Realized information ratio (since inception)	0.5
AuM	> USD 11 billion
Inception date	Nov-04

- **The Robeco Emerging Markets Enhanced Index Equities strategy** is an equally compelling alternative to passive investing, designed to systematically capture the equity risk premium in emerging markets through its balanced multi-factor exposure. It aims to deliver superior risk-adjusted returns with limited relative risk.

Benchmark	MSCI EM Index
Realized outperformance (since inception net of fees)	1.5%
Tracking error limit (ex ante)	1.2%
Realized information ratio (since inception)	1.0
AuM	> USD 16 billion
Inception date	Jul-04

Sustainability

Robeco offers sustainable versions of these two strategies that also aim to deliver superior risk-adjusted returns along with improved sustainability profiles. For example, the strategies are managed to ensure that they have a carbon footprint that is at least 30% lower than the benchmark, waste and water footprints that are at least 20% lower than the benchmark, and ESG risk rating that is at least 10% lower than the benchmark, and also exclude the worst scoring stocks according to our SDG Framework.

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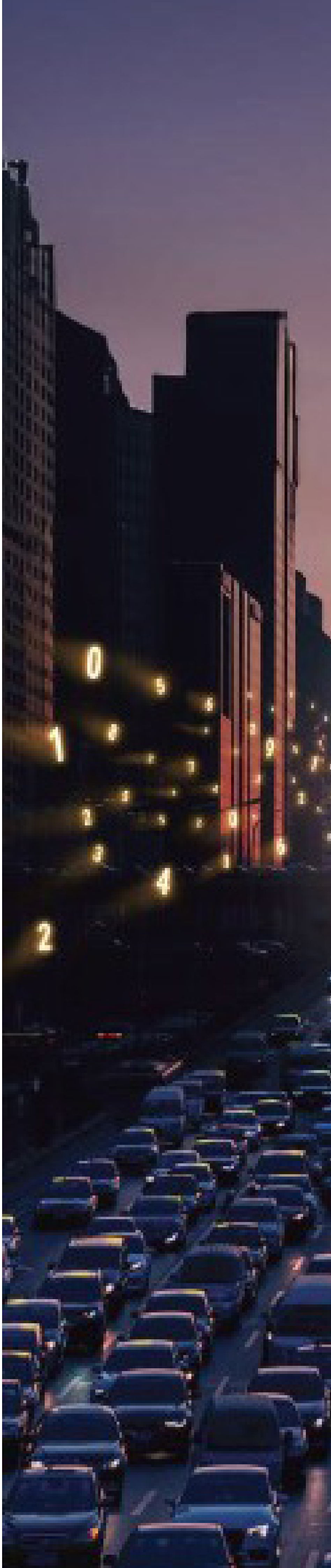

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