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Conversations with…

Hendrik-Jan Boer, Senior Portfolio Manager and Head of Global Equities Group

Durable, Sustainable, Adaptable: The Mutually Reinforcing Characteristics of "Transition Winners"

How should investors identify the most promising global companies now that information technology and intangible capital drives the development and disruption of so much of the modern economy? What characteristics enable businesses to identify opportunity and sustain profitability? **Hendrik-Jan Boer, Senior Portfolio Manager and Head of the Global Equities Group,** talks about why his team focuses on companies that have a durable competitive position, do no harm, and can adapt to change—and how they find them.

You describe your approach to investing as "Global Sustainable Equity." What does "sustainable" mean to you and your team?

One can think of our approach as having three pillars: we seek out companies that have a durable competitive position, do no harm, and can adapt to change. The most obvious sense in which we seek out sustainability is in companies that do no harm. When environmental, social and governance (ESG)-related factors are materially relevant to a specific business, and we ask forward-looking questions rather than looking only at historical data, we believe that good performance and planning around those factors can have a direct relationship with a company's broader financial performance.

But the sustainability of a business clearly overlaps with its durability—the two words are near-synonyms. We look for companies that are profitable today and able to reinvest those profits to sustain their core business and take advantage of attractive opportunities. And the ability to adapt to change makes a company much more likely to sustain today's profitability into tomorrow. So, strictly speaking, sustainability means environmental, social and governance sustainability; but the concept really informs every aspect of the type of business that we look to invest in.

You also refer to your "value-chain lens" and talk about seeking out "Transition Winners." How does this make your portfolios look different from traditional global equity portfolios?

Our research starts with this deliberately broad "value-chain lens." We currently identify five value chains as particularly important in the modern economy. We believe companies that are set to benefit from the digitalization of the economy or the demand for renewable energy will be the winners in what we call the Digital Enterprise and Energy Transition value chains, for example. In addition, we look at Access to Healthcare (lower-cost solutions for unmet or high-cost medical needs), Conscious Consumer (products and services that recognize the consumer's increasing focus on ethics, health and convenience), and Fintech and Financial Inclusion (solutions in the rapid shift to digital payments and online access to finance).

Why look at things in this way? Much investment management still tends to think in terms of industrial sectors, but we think the shift toward services and the growth of information technology has substantially blurred the lines between the traditional sectors. Amazon's tools are the internet and logistics, but its impact has been felt in the retail sector. Today, the performance of a manufacturer in the industrials sector is less likely to be determined by what it has in common with other industrials stocks than by whether it makes things for, let's say, the renewable energy industry rather than the extractive commodity industry. That's why we believe the value chains we have identified offer a more realistic view of what's going on in today's economy.

We then look for the companies that are, in our view, best positioned to adapt to and take advantage of the major transitions identified by those value chains—companies that are on the right side of change. These are our "Transition Winners."

How do you identify companies with "durable competitive positions"?

We look for businesses that can sustain high profits for an extended period by building "economic moats," especially with intangible capital such as a lead in a particular technology, a unique consumer offering, protected intellectual property, an unassailable cost advantage or a hard-to-replicate platform, network or ability to scale. As a starting point, we look for two important quantitative markers of a business that is compounding profits due to economic moats: Cash Flow Return on Investment (CFROI) and Asset Growth. CFROI tells us how efficiently cash flow is generated from capital invested, and therefore the level of cash resources that are available for reinvestment. Asset Growth tells us whether or not a company is finding opportunities to invest that cash.

When both are relatively high, that indicates to us that a company is investing for growth while simultaneously guarding its profitability from potential competitors. When CFROI is high but Asset Growth is low, that suggests a company whose past investments remain profitable, but which is struggling to find new opportunities. When CFROI is low and Asset Growth high, that may indicate an early-stage business that has not yet established the moat that will protect its profitability. When both CFROI and Asset Growth are low, it is likely that we have a business that is struggling with "stranded assets" that used to be profitable but now act as a costly deadweight.

Are companies with high CFROI and high Asset Growth always likely to be among the "Transition Winners"?

Not always, but we believe it's a strong indicator. Let's take an example of one of our value chains—Energy Transition. It is perhaps obvious that a lot of the companies working in this value chain with low CFROI and low Asset Growth are fossil-fuel producers threatened by cheaper and more sustainable alternatives and weighed down by stranded assets. It is fairly clear why these companies struggle to adapt to change—they are massively geared to yesterday's economy.

But how do you think a manufacturer of batteries, electric vehicles or solar panels looks, according to these metrics? Asset Growth tends to be high but CFROI does not follow, because these products are easily commoditized, and competition is fierce. We tend to find high CFROI and high Asset Growth in the manufacturers of solar invertors, equipment for electricity grids and specialized home energy services. We think it is much harder to identify the obstacles that will prevent the best of them from emerging as Transition Winners generating sustainable, durable profits.

There is a simpler way in which high CFROI makes a business more likely to be a Transition Winner. Profitable businesses usually have established brands and reputations which they can bring to new markets, and their cash flows remove the necessity to borrow or sell more equity if they identify an opportunity to pivot and invest in new opportunities. That opens up the possibility for a mature, old-economy business with high CFROI and low Asset Growth today to adapt to change and find new growth opportunities tomorrow—but in our experience, successful examples are rare.

What distinguishes your approach to ESG investing?

A lot of ESG investing remains top-down and quantitative. These screens are useful for weeding out the very riskiest businesses, but, in our view, they are much less useful for differentiating between businesses that pose similar levels of risk or identifying attractive opportunities. There are two reasons for that: top-down screens do not differentiate the true materiality of certain factors to specific companies; and they are backward-looking.

Companies can often score low on ESG factors that do not pose a significant risk to their businesses, and working on those factors could be a poor use of time and resources. As a result, very few companies have uniformly strong performance across all ESG factors, and this tends to make the aggregate ESG scores of many businesses bunch around the average regardless of how well or badly they perform on the factors that matter most to them.

Furthermore, the historical data that feeds into quantitative ESG scores does not fit well with our focus, as active investors, on businesses that are making marginal ESG improvements that are yet to be priced into securities. They offer no insight into a company's sustainability action plans. They tell us nothing about the likelihood of changes in regulation or consumer attitudes, which could alter a company's material ESG exposures. Most of all, they say nothing about opportunities to help companies improve their ESG performance through active shareholder engagement. For us, low current ESG risk is a plus, but we see the most attractive alpha opportunities in active efforts both to manage and to change ESG exposures.

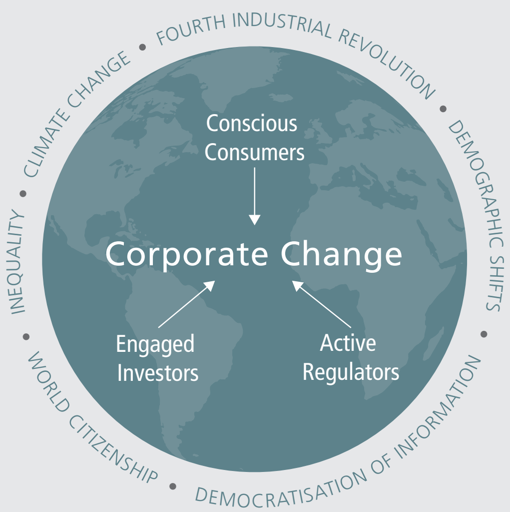
Do you consider these three pillars of your approach—durable competitive positions, adaptability, doing no harm—to be mutually reinforcing? So, perhaps less like pillars and more like the blocks that sit together to form a strong arch?

We certainly regard them as mutually reinforcing. Our two markers of a durable competitive position are high CFROI and high Asset Growth. High Asset Growth suggests that a company is finding opportunities to invest for growth, which also suggests that it has found a way to adapt to change happening in the economy: a growth opportunity is an opportunity that was not there before. High profitability gives companies the reputational and financial means to adapt to change. Moreover, a greater reliance on intangible over tangible capital, which we often find associated with durable competitive positions, can also give companies the operational means to adapt quickly to change. It is often easier to change the productive focus of technology or knowledge than to change the productive focus of specialized machines and factories.

In addition, a forward-looking view on ESG helps both investors and company management teams to appreciate how societal change can make what were once non-material ESG risks into potentially material threats or opportunities. If a company has a forward-looking plan of action on ESG it often indicates a general adaptability to new practices and changing circumstances, and therefore an enhanced ability to adapt to change to sustain profitability. We find that companies like these are more likely to be thinking ahead and taking a holistic view of their position in society, the economy and the wider environment—and it's no coincidence that this way of looking at the world overlaps considerably with the value-chain lens that we apply in our own research.

At a Glance – Neuberger Berman Global Sustainable Equity Fund

- Seeks to invest in quality companies where sustainability reinforces competitive advantage
- Global, best ideas portfolio of typically 40 – 60 quality holdings
  - Diversified across non-correlated high-quality business models and value chains
  - Long-term bottom-up research outlook (typical two to four years holding period)
  - Active share >75%
- Sustainability, value chain lens and engagement key to approach
- The fund fully complies with the E.U. Sustainable Finance Disclosure Regulation ("SFDR") and is classified as an Article 9 SFDR fund



Investment Opportunity
Rapid societal and technological change is driving corporate evolution and creating value chain disruption

Conscious Consumers
Holding corporations and governments accountable through consumption behaviour, elections, activism

Active Regulators
New directives and collaboration across borders to address ESG issues

Engaged Investors
Increasingly view ESG as a fiduciary responsibility, require transparency and change

Hendrik-Jan Boer, Lead Portfolio Manager
Alex Zuiderwijk, Co-Portfolio Manager
Jeroen Brand, Co-Portfolio Manager

CITYWIRE AAA

All three lead portfolio managers are Citywire AAA-rated, as of September 17, 2021

Risk Considerations:

Counterparty Risk: The risk that a counterparty will not fulfil its payment obligation for a trade, contract or other transaction on the due date.
Currency Risk: Investors who subscribe in a currency other than the base currency of the portfolio are exposed to currency risk. Fluctuations in exchange rates may affect the return on investment.
Liquidity Risk: The risk that the portfolio may be unable to sell an investment readily at its fair market value.
Market Risk: The risk of a change in the value of a position as a result of underlying market factors, including among other things, the overall performance of companies and the market perception of the global economy.
Operational Risk: The risk of direct or indirect loss resulting from inadequate or failed processes, people and systems, including those relating to the safekeeping of assets or from external events.
Sustainable Risk: The strategy may focus on investments in companies that relate to certain sustainable development themes and demonstrate adherence to environmental, social and corporate governance practices. This may mean the universe of securities from which the strategy can invest in may be smaller than that of other strategies and may underperform the market as a result.

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