BostonPartners

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Pursuing better outcomes for investors

A closer look at our time-tested, Three Circle approach to investing

At Boston Partners, we take a different approach to investing, one we've been using consistently since our founding in 1995. Every strategy we manage—across all market capitalizations and geographies—is built on the same three principles: that stocks with low valuations, strong fundamentals, and positive business momentum, over time, tend to outperform those with high valuations, weak fundamentals, and negative momentum. In this paper, we'll take a closer look at why each of these characteristics is such a vital part of our process, how we bring them all together in an actively managed portfolio, and how this strategy has delivered better investment experiences for our clients.

Undervalued stocks have long been considered a reliable source of alpha

Eugene Fama and Kenneth French became household names in the investment industry, not to mention Nobel laureates, through their research into the equity market factors that command reliable premiums—the value factor being one of them. What Fama and French found was that investing in value stocks offered a statistically significant edge over buying stocks trading at higher multiples. This makes intuitive sense: The expectations for stocks with lower multiples are generally not as high as they are for stocks priced for continued rapid growth. Value stocks feature an inherent potential for multiple expansion, while growth stocks offer more or less the opposite: the constant risk of compressing multiples should investors reprice a company's growth prospects.

Not all value stocks represent a good value, however. Our own research has demonstrated the problems inherent in relying too heavily on price multiples as an investment criteria, with so-called "value traps" being one of the most prevalent embodiments of such risks. That's one reason we seek out companies that have more to offer beyond just being attractively priced.

Strong fundamentals are essential to outperformance

It wouldn't be an overstatement to say that vetting corporate fundamentals is the backbone of the entire active management enterprise. This, too, makes intuitive sense: Companies tend to have solid quantifiable fundamentals because they're well run and generating revenue, and it's hard to imagine a scenario where these qualities aren't highly desirable. Determining which particular metrics to focus on is another matter, as there are dozens of ways to gauge the health of a company, each of which carries its own nuances and idiosyncrasies.

We prefer to keep it as simple as possible. Our analysts typically seek to answer three questions when evaluating a company's fundamentals:

- **How does the business generate revenues?**
- **What is the underlying cost structure?**
- **How much cash does the business generate?**

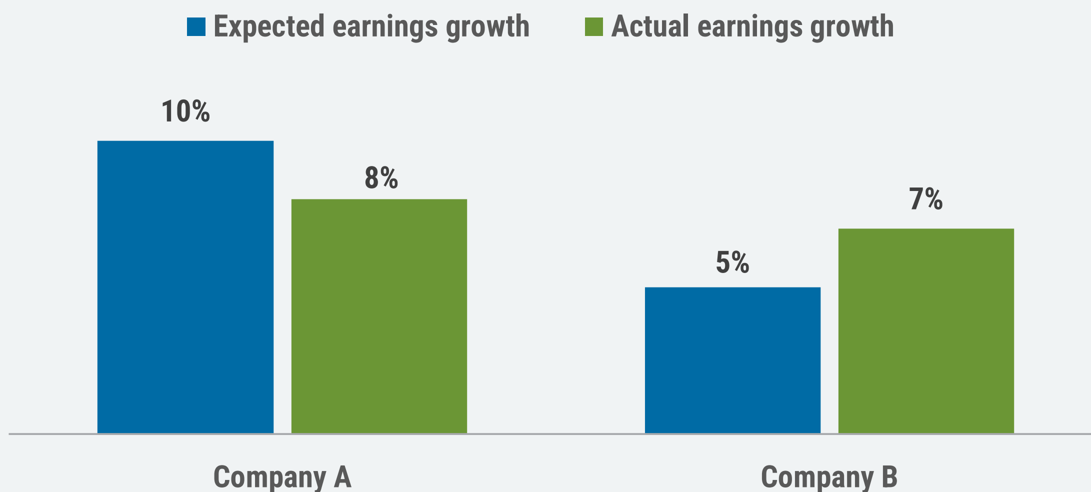
Once we have a better understanding of these key metrics, we can begin to evaluate how healthy a company is, both relative to its particular industry and to the market as a whole. Stocks that are attractively priced and fundamentally sound will typically make our short list for investment—but we also seek out companies with positive characteristics in a third, often underappreciated dimension: business momentum.

Understanding a stock's momentum offers vital investment context

The third leg of our investment process focuses on momentum, which we consider in terms of two interconnected types. Fundamental momentum looks at a variety of quantitative metrics—revenue, sales, earnings, margins, and so on—and asks, are these measures getting better or worse? Catalyst-driven momentum has to do with events that directly impact the business—management or regulatory changes, new product developments, or industry consolidation, for example.

Momentum is a characteristic that we generally think about in relative terms—specifically, how a stock is positioned relative to Wall Street expectations, its peer group, and to performance trends. Take a hypothetical example of Companies A and B. On an absolute basis, at 8%, Company A's earnings growth results are higher than B's at 7%. But only Company B exhibits positive momentum versus expectations, and we've found that exceeding expectations is one factor that's been a meaningful driver of long-term outperformance over time.

Companies that beat earnings expectations often outperform those that miss forecasts

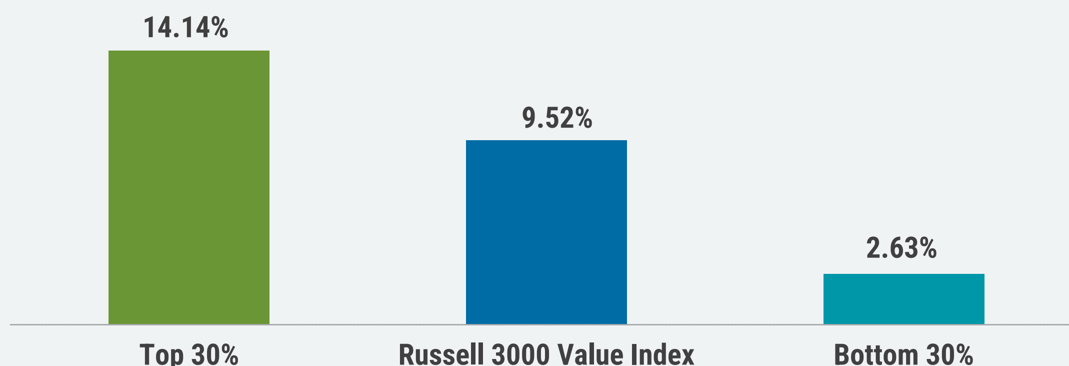


Source: Boston Partners. For illustrative purposes only.

This phenomenon has an abundance of evidence to support it. If we look at the performance of the broad stock market segmented out by momentum characteristics, the companies in the top 30% outperformed both the market and, not surprisingly, those companies in the bottom 30%—the latter by more than 1,000 basis points per year.

Companies exhibiting positive momentum have significantly outperformed over time

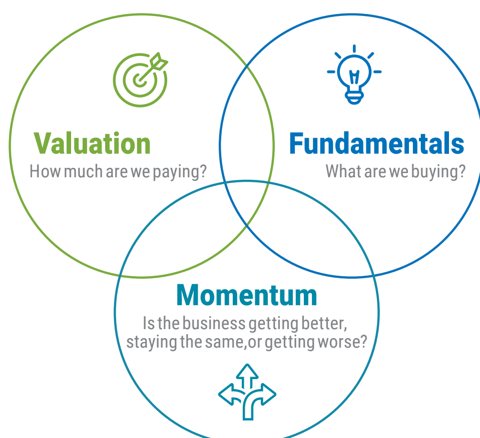
High-ranking companies vs. low-ranking companies within the Russell 3000 Value Index:
Average annual total return (6/30/95–9/30/24)



Boston Partners' proprietary momentum model assigns scores to securities based on quantitative factors related to business momentum and sentiment. Those securities receiving 1–3 rankings are considered to score in the top 30%; those receiving 8–10 rankings are in the bottom 30%. Rankings are observed on a monthly basis, and the number of securities in each tier will vary. Past performance does not guarantee future results. It is not possible to invest directly in an index; see last page for definitions.

Clearly, targeting companies that are beating expectations or benefiting from improving operating conditions offers a significant source of alpha for investors.

Leveraging quantitative analysis allows our portfolio construction process to be more efficient



Although at Boston Partners we consider ourselves first and foremost to be value managers, we begin our search for investments not by looking at any particular value-oriented benchmark index, but instead at the entire investable universe within our target geography and market cap—often up to 10,000 individual securities. Within those universes, we use a proprietary quantitative screening process to assign statistical rankings to each security for each of our three primary criteria: valuation, fundamentals, and momentum. Those securities that rank within the top 30% across all three dimensions become candidates for investment.

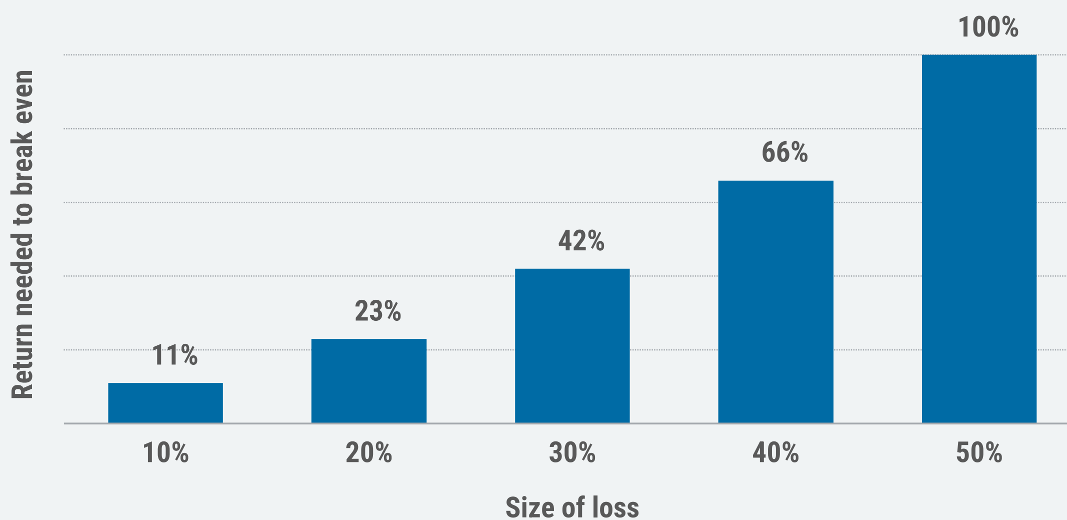
A question we often hear is, why would a fundamentals-driven manager make quantitative research an integral part of the investment process? Simply put, we view the insight our quantitative research team delivers as a tool—and quite a valuable one—that allows our fundamental analysts to use their time far more efficiently. With thousands of potential holdings available for inclusion in most of our portfolios, being able to distill an investment universe down to those securities that appear most attractive across our three main investment criteria allows our analysts to focus less on finding potential opportunities and more on vetting them.

Risk management is crucial to delivering a superior client experience

There's no shortage of asset managers that describe the ultimate purpose of their investment process in starkly analytic terms: seeking to eke out so many basis points of excess return over a benchmark, or delivering a certain Sharpe ratio over a full market cycle—the list goes on. At Boston Partners, we understand the point of what we do, the true underlying value, rests in delivering a better investment experience for clients. At the end of the day, genuine investment risk is not a statistical measure of volatility, variance, or estimated tracking error; it's a permanent impairment or loss of capital. That's the definition of risk that our clients ultimately care most about.

We believe that in order to provide better outcomes for clients, our portfolios must exhibit as high a degree of consistency in their performance as possible—as we like to say, to win by not losing. Consider the asymmetry involved in breaking even after a loss. Because any losses diminish the asset base, the return needed to offset a decline must be larger than the loss—and the bigger the loss, the bigger the gain required.

The return needed to break even increases exponentially relative to the loss



Source: Boston Partners. For illustrative purposes only.

The picture doesn't get any rosier when viewed through the lens of time. Assuming a hypothetical 10% annual gain during up markets, it would take nearly four years to recoup the losses suffered after a 30% sell off. That's a massive missed opportunity: Those four years of lost time can spell the difference between achieving or missing a long-term investment goal. This law of investing physics—the need to minimize capital impairment and losses—serves as a constant guide for our company and informs a large part of why we adhere to the investment principles we do.

A rigorous sell discipline is a vital to mitigating downside risk

Knowing when to buy a stock is, naturally, only half the battle. Exiting a position at the right time is essential to locking in profits (when an investment thesis comes together) and to avoiding value traps (when a company's situation takes a turn for the worse). Our process for selling stocks is based on the same three pillars we use to screen for potential investments: If a stock has appreciated to its price target, if its business fundamentals weaken, or if its business momentum reverses, we exit the position.

One noteworthy factor here is that we will not sell a held security simply because it has become too expensive to buy. Price changes can occur quickly, and it's often the case that we'll continue to hold a company in our portfolios that represented an attractive valuation when we initially bought it, but due to price appreciation no longer appears as compelling in terms of valuation criteria. As long as the security continues to exhibit solid fundamentals and has positive momentum working in its favor, we'll be inclined to hold it. Occasionally, these types of securities—the "holds" in our portfolios—no longer meet third-party criteria of value stocks. But that's not to suggest we're any less keenly attentive to valuation as both a buy and sell metric.

We employ multiple checks and balances to buffer against capital losses

Our first defense against incurring capital losses is ultimately our three-pillared investment approach. By understanding valuation risk, we seek to avoid overpaying for an investment; looking at balance sheet risk helps us gauge the solvency risk of the business; and studying earnings risk informs our view of the sustainability of a company's cash flows over time. But beyond these three pillars, we also employ a broad system of checks and balances to help guard against capital losses:

- **Analysts set price targets for all owned stocks**
  We seek to own securities that not only meet our three base investment criteria, but also offer more upside return potential than downside risk. It's another important way we seek to tilt the odds of a better investment outcome in our favor.
- **Portfolio managers engage with our analysts in an ongoing feedback loop**
  Our portfolio managers are in constant dialogue with analysts, monitoring for any material changes in a holding's outlook and its underlying investment thesis, as well as staying informed of any changes in the relative opportunity set.
- **Ongoing quantitative analysis helps ensure we stay true to our discipline**
  We build our portfolios through bottom-up security selection based on three critical factors: valuation, fundamentals, and momentum. But it's just as important to continue to monitor individual securities for these characteristics after we've invested in them—not to mention scrutinizing portfolios as a whole. Our ongoing quantitative analysis provides a comprehensive picture of each portfolio, helps identify any unintended risks that may have crept in, and enables our portfolio managers to adjust accordingly as market conditions change.
- **Ensure our portfolios are well diversified—always**
  The future is unknowable and there are a host of factors that can affect stock prices in unexpected ways. We've found the most effective way to manage this reality is by maintaining a broad-based allocation across sectors, industries, and companies that meet our valuation, fundamentals, and momentum criteria. Experience shows that successfully doing so has greatly contributed to consistency in our results.

The result: consistent outperformance and better client outcomes

There's little value to an investment approach that works only in theory. At Boston Partners, we're proud to report that our approach has delivered exceptional results in practice: Our investment strategies have a track record of outperformance over the long term.

Outperformance across strategies since inception (%)

Boston Partners Strategy	Inception date	Outperformance (%)
Large Cap Value vs. Russell 1000 Value Index	6/1/95	1.20
Large Cap Value Select vs. Russell 1000 Value Index	7/1/17	2.37
Premium Equity vs. Russell 3000 Value Index	6/1/95	2.61
Mid Cap Value vs. Russell Midcap Value Index	5/1/95	1.56
Small Cap Value vs. Russell 2000 Value Index	7/1/95	1.92
Small Cap Value II vs. Russell 2000 Value Index	7/1/98	2.47
Small/Mid Cap Value vs. Russell 2500 Value Index	4/1/99	0.61
Global Equity vs. MSCI World Value Index-Net	7/1/08	1.86
International Equity vs. MSCI EAFE Value Index-Net	7/1/08	1.44
Long/Short Equity vs. S&P 500 Index	8/1/1997	1.50

Data as of September 30, 2024. Source: Boston Partners. The green bars reflect the average annual excess return (net of fees) versus the indexes shown since each strategy's inception. Past performance does not guarantee future results. It is not possible to invest directly in an index; see last page for definitions.

In our industry, we often say that past performance does not guarantee future results, but we believe the consistency of our strategies' performance is very much a testament to the durability of our investment philosophy. To lean on a metaphor, we swing for singles and doubles, and work hard to avoid striking out. As the results show, generating those kinds of small wins consistently over time can lead to significant outperformance. More importantly, we feel it leads to the kind of investment results our clients have come to expect: one with less volatility, a greater degree of consistency, and ultimately a higher likelihood of achieving investors' goals.

About Boston Partners

Boston Partners is a value equity manager with a distinctive approach to investing—one that combines attractive valuation characteristics with strong business fundamentals and positive business momentum in every portfolio. The consistent application of this approach over nearly 30 years by an experienced and long-tenured team has created a proven record of performance across economic cycles, market capitalizations, and geographies.

Important information

The opinions expressed are those of the contributors as of the publication date and are subject to change. No forecasts are guaranteed. This commentary is provided for informational purposes only and is not an endorsement of any security, mutual fund, sector, or index. Boston Partners and affiliates, employees, and clients may hold or trade the securities mentioned in this commentary. Past performance does not guarantee future results.

Key terms

Alpha measures the excess risk-adjusted return of a portfolio relative to a benchmark index. A **market cycle** is the period from a market's peak, through the subsequent low, to the next market peak. **Sharpe ratio** measures a portfolio's total return per unit of risk. The higher the ratio, the better the portfolio's historical risk-adjusted performance. **Tracking error** measures the variation between the performance over time of a portfolio versus an index. **Variance** is a statistical measure of how much a data set tends to deviate from its mean value.

Index definitions

The **MSCI EAFE** Index tracks the performance of large- and mid-cap equities traded across global developed markets, excluding the United States and Canada. The **MSCI World Index** tracks the performance of large- and mid-cap equities traded in developed markets. The **Russell 1000 Value Index** tracks the performance of those large-cap U.S. equities in the Russell 1000 Index with value style characteristics. The **Russell 2000 Value Index** tracks the performance of those small-cap U.S. equities in the Russell 2000 Index with value style characteristics. The **Russell 2500 Value Index** tracks the performance of those small- and mid-cap U.S. equities in the Russell 2500 Index with value style characteristics. The **Russell 3000 Value Index** tracks the performance of those U.S. equities in the Russell 3000 Index with value style characteristics. The **Russell Midcap Value Index** tracks the performance of those mid-cap U.S. companies in the Russell 1000 Index with value style characteristics. The **Russell Microcap Value Index** tracks the performance of those micro-cap U.S. companies in the Russell Microcap Index with value style characteristics. It is not possible to invest directly in an index.

Stocks and bonds can decline due to adverse issuer, market, regulatory, or economic developments; foreign investing, especially in emerging markets, has additional risks, such as currency and market volatility and political and social instability; value stocks may decline in price; growth stocks may be more susceptible to earnings disappointments; the securities of small companies are subject to higher volatility than those of larger, more established companies. This material is not intended to be, nor shall it be interpreted or construed as, a recommendation or providing advice, impartial or otherwise.

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