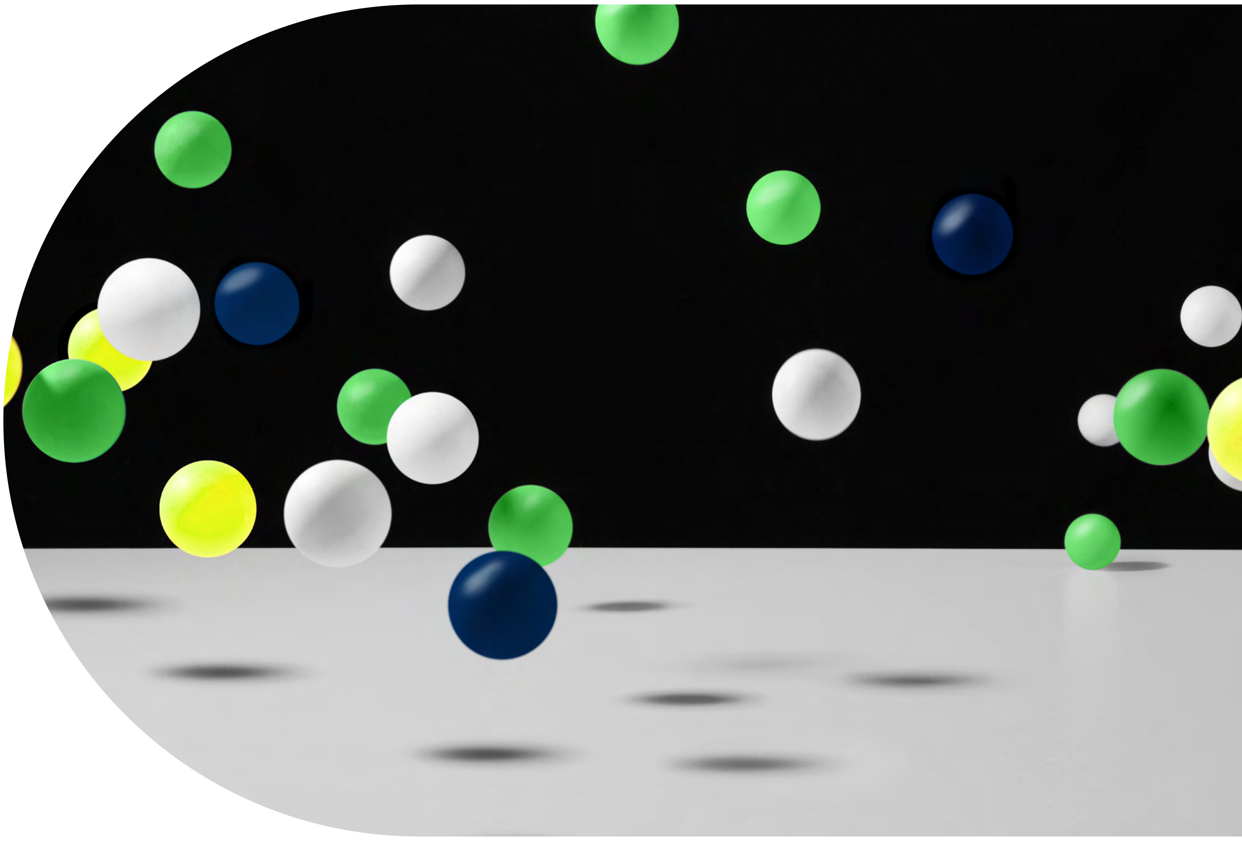
Fixed income: ESG-compliant and passive investing

Considerations regarding ESG strategies and ESG indices



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Executive summary

Sustainable investment strategies are increasingly becoming standard in fixed-income investing. This white paper examines which of the ESG strategies used in equity investments can also be applied to this asset class.

It details various sustainable investment approaches as well as the particular challenges in the fixed-income sector.

A further focus is the development of ESG fixed-income indices and their potential use in passive investing.

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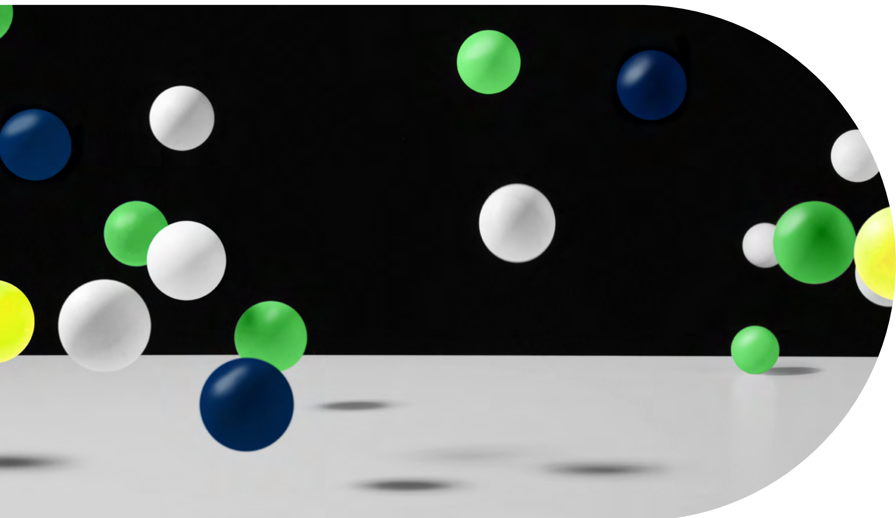


1 Introduction

ESG: three letters with an enormous impact

The EU Commission's Action Plan on Sustainable Finance in 2018 made it clear to investors and financial market participants that the steering and procurement of capital required for the transformation of our entire economy will be one of the crucial defining factors to shape the investment environment. Investors can have a positive impact on companies' investment behaviour by steering not just equity but also debt. Changes in the social and regulatory framework have prompted an increasing number of public institutions such as the Federal Financial Supervisory Authority (BaFin) and asset managers to build the necessary specialist and technical expertise to offer ESG-compliant investments. As the regulation and standardisation progress gains momentum, ESG-compliant investing may cause considerable disruption in the financial industry. The first issue of a green 10-year German government bond in September 2020 finally brought sustainability to the fore on the credit, i.e. fixed-income, side. Germany is namely a benchmark issuer in the euro zone and aims to create a green yield curve by issuing more sustainable government bonds. It will thus be possible to compare sustainable and conventional securities.

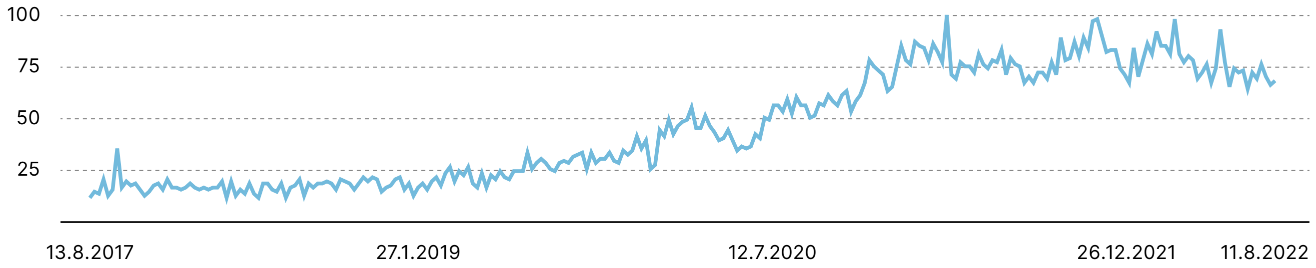
Considerable challenges remain:

These include the prevention of deliberate or inadvertent "green washing", and, in particular, the transition from conventional to ESG-compliant investments. The transition to ESG investments is still in the early stages but it is highly likely it will pick up speed. The investment committees of institutional investors are keeping a close eye on developments and are increasingly integrating ESG criteria into their investment guidelines.

Ever-increasing public awareness of environmental and social issues (**see figure 1**) has also prompted the integration of ESG criteria into investment processes. ESG is not a regional phenomenon. **Figure 2** illustrates the global appeal of ESG.

Figure 1: Interest over time

Search term: ESG • Region: worldwide • Category: finance • Time range: 5 years

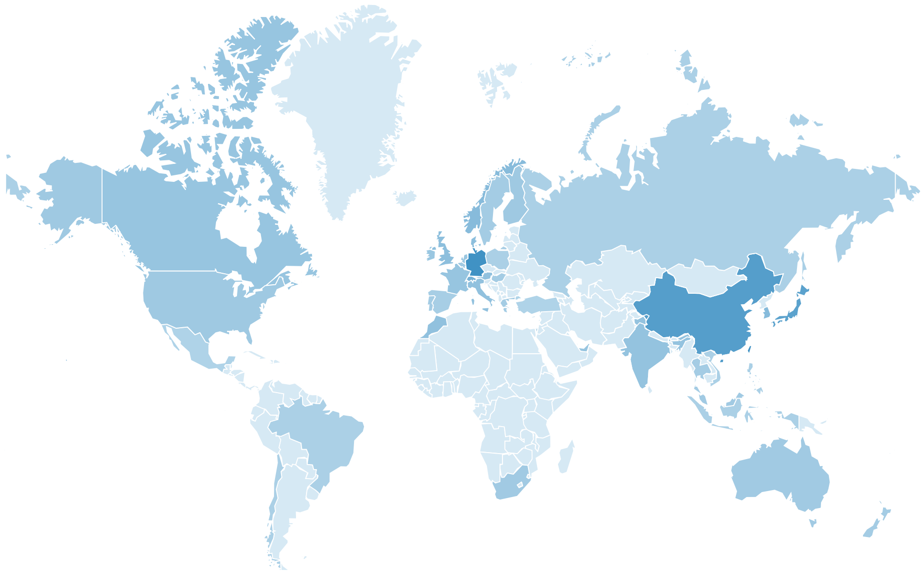


Interest over time: Numbers represent search interest relative to the highest point on the chart for the given region and time. A value of 100 is the peak popularity for the term. A value of 50 means that the term is half as popular. A score of 0 means that there was not enough data for this term.

Source: Google Trends (trends.google.com), 11.8.2022

Figure 2: Interest by region

Search term: ESG • Region: worldwide • Category: finance • Time range: 5 years



Source: Google Trends (trends.google.com), 11.8.2022

Fundamental changes are needed in the real economy and consumer behaviour if the global economic and social transformation is to succeed. The financial industry and investors worldwide bear a particular responsibility towards supplying the capital for this transformation.

2 Suitability and implementation of ESG strategies for fixed-income investments

There are various approaches to ESG-compliant investments as not every ESG strategy is suited to investing in bonds. And not every investment can be tapped into using passive investing, which follows a benchmark. The distinctions between the various ESG investment approaches are complex.

Table 1 provides an initial overview of the different investment approaches and their suitability for fixed-income investors:

Table 1:
ESG investment approaches

Investment approach	Classic fixed-income portfolios	Passive portfolios
Exclusions	Yes	Yes
Norms-based screening	Yes	Yes
ESG integration	Yes	Yes
Engagement and voting	Conditional	Indirect only
Best in class	Yes	Yes
Sustainability-based themes	Yes	Yes
Impact investing	Usually not	No

Source: Eurosif 2018

Background:

ESG-exclusion procedures eliminate companies, industries or countries engaged in inacceptable practices from the investment universe. The exclusion criteria usually relate to business activities such as weapons, tobacco or animal testing. The investors themselves therefore have the final say on whether they lend their money to a weapons manufacturer or a wind power producer.

Norms-based screening, on the other hand, follows international principles and norms, such as the UN Declaration of Human Rights, core labour standards and anti-corruption principles. Screening approaches can be based on specific exclusion criteria (negative screening) as well as targeted investments in companies with positive ESG criteria (positive screening).

ESG integration does not explicitly exclude specific issuers or sectors. ESG criteria are instead factored into asset allocation and securities analysis.

Engagement and voting rights are part of a strategy typical for equity investment. Shareholders have traditionally had more say and voting rights in companies than external creditors. However, depending on the financial structure of a company and the organisational skills of the creditors, bondholders can also influence company policy.

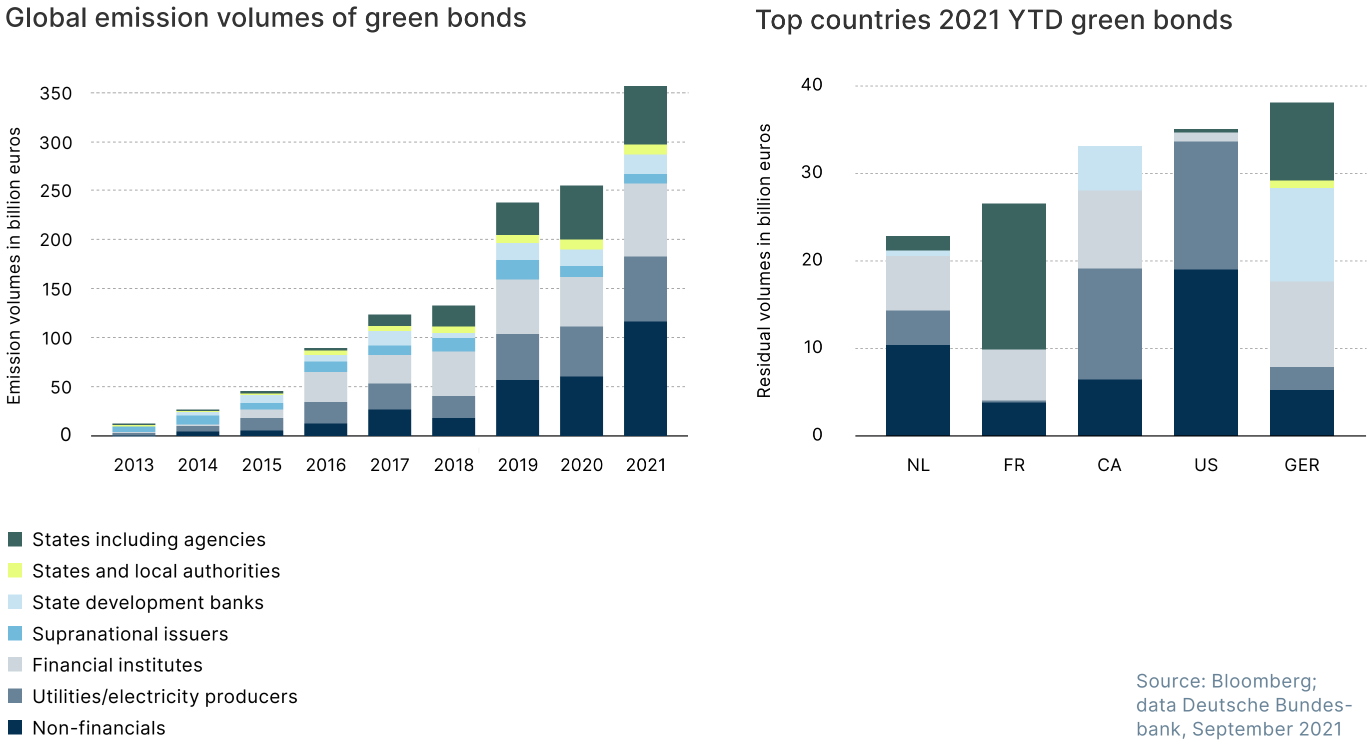
The **best-in-class strategy** selects ESG leaders from the investment universe, i.e. companies that are market leaders in specific areas of sustainability (for example, in the lowest CO_2 emissions).

Thematic ESG investments focus on individual aspects of sustainability, such as achieving the goals of the Paris Climate Accord or promoting global water supply. These investments aim to achieve specific environmental or social goals.

Impact investing is a specifically challenging aspect of sustainable investing. The main focal points, along with yields, are measurable positive social and environmental effects. There are four goals: intentionality, additionality, materiality and measurability. In the case of fixed income, however, the lack of a liquid secondary market is not the only test fixed-income investors face. In the extreme, extensive reporting and performance measurement requirements can also complicate the implementation of an ESG strategy. A balance needs to be struck between generating yields on the one hand and measuring and impact on the other.

Green bonds can also be classified as impact investments. In this fast-growing sector, the proceeds of bond issues are used to finance environmental or climate mitigation projects. Green bonds allow investors to make impact-oriented investments. **Figure 3** illustrates the sharp increase in green bond issues in recent years, with Germany emerging as the biggest issuer.

Figure 3:
Development of issue volumes of green bonds



Source: Bloomberg; data Deutsche Bundesbank, September 2021

2.1 ESG-compliant and passive investing in fixed income

ESG-compliant and passive investing in bond markets needs to be studied in further detail as the implementation of a passive ESG strategy is largely dependent on whether there are appropriate fixed-income indices and the liquidity of the bonds included in these indices.

Index providers are constantly expanding their portfolio of classic fixed-income indices to include ESG alternatives. Numerous experts are working to this end on the construction and structuring of ESG indices.

What needs to be taken into account? Above all, the structure of the index should be transparent and adhere to strict rules. It also needs to be based on reliable data. A number of prominent index providers have already launched ESG indices. Various examples of MSCI-based indices are explained in more detail below. As one of the most prominent developers of ESG ratings, MSCI has established a foothold in the market through its stringent and transparent methodology. This methodology provides the data for other index providers, including Bloomberg Barclays and Markit iBoxx, to form its ESG indices. MSCI also develops its own ESG fixed-income indices.

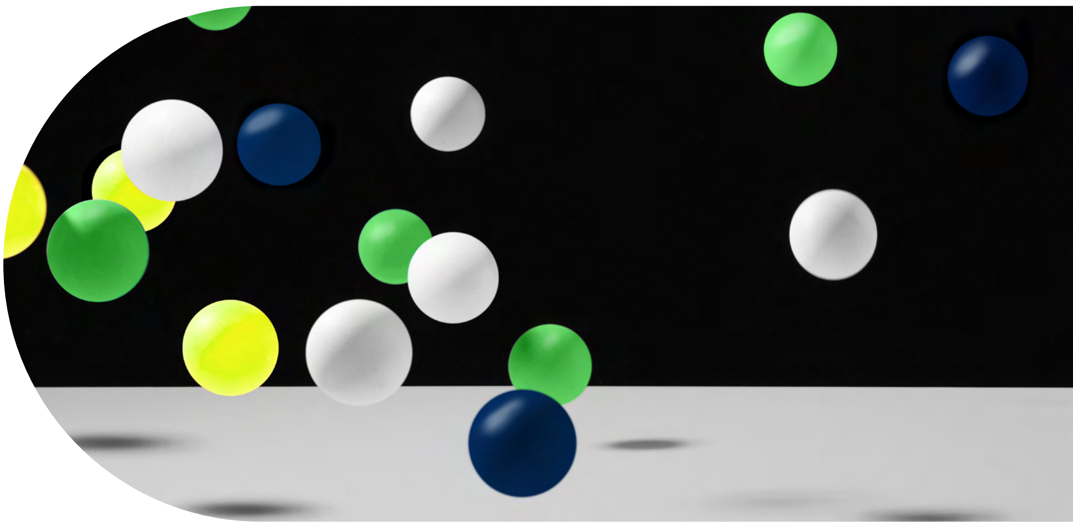
The investment process for passive ESG portfolios is the same as that for classic portfolios. Additional screenings and filters may, however, be necessary in order to apply exclusion criteria above and beyond the selected ESG index. It is therefore possible to choose customised and individual passive portfolio solutions. During the mostly monthly rebalancing of ESG fixed-income indices, changes in the issuers' ESG criteria are factored in on top of regular adjustments. The volume of trading is therefore higher than in passive equity portfolios.

This once again highlights the importance of the liquidity of the securities when selecting benchmark indices. It should also be noted that ESG-compliant bonds usually appeal to a larger number of buyers as they form part of the benchmarks for classic fixed-income investors. Consequently, the liquidity of newly-issued ESG bonds is at least as high as or even higher than that of conventional bonds or issuers.

In addition to a constant index and portfolio duration, the short rebalancing frequency has the advantage that ad-hoc exclusions – including those that would have been useful in the past in various cases of fraud by issuers – can be swiftly incorporated into the index and therefore also in the portfolio.

Apart from this, while fund movements in passive funds are beneficial at the end of the month as they save trading costs, they can also be implemented on any other trading day.

As with traditional fixed-income investments, ESG benchmarks can also include foreign currencies and, potentially, currency hedges. However, ESG-compliant fixed-income derivatives have yet to take hold in the market. Interest rate and spread hedging in ESG portfolios is carried out via classic futures and credit default swaps. It remains to be seen whether ESG derivatives will play a role in the future. Even more than is the case with the underlying securities, broad market acceptance and strong liquidity, combined with low transaction costs, are crucial for derivatives.



3 Examples of ESG fixed-income index providers and investment themes

The range of fixed-income indices is extremely dynamic, particularly in the case of ESG. The index supplier Bloomberg MSCI, which provides a comprehensive range of ESG indices, has already established a market position for:

- A range of currencies
- Different maturities (short, intermediate, long)
- Corporate bonds, aggregates (including government bonds, covered bonds)
- Different filters, including ESG-weighted, socially-responsible indices (SRIs), sustainability indices, Catholic values
- Green bond indices (mainly government bonds, agencies)

These ESG indices are always based on a standard Bloomberg fixed-income index. Using various ESG criteria and weightings, the base is adjusted so that the remaining securities comply with the principles of the new ESG benchmark. For Bloomberg MSCI **ESG-weighted** indices, for example, securities in the initial investment universe are over- or underweighted according to their ESG ratings. No issuers are excluded. The **SRI indices**, on the other hand, have far stricter exclusion criteria: companies associated with negative social or environmental activities are identified in the initial index. **Sustainability indices**, meanwhile, are based on the best-in-class principle. In this case, companies included in standard Bloomberg indices are first grouped by industry and then sorted according to their ESG ratings. Only the strongest issuers in a peer group are included in the ESG index. The bonus of these index families, in addition to their profile, are the high data availability and associated analysis options for portfolio managers.

MSCI offers a range of fixed-income ESG indices. Some of them comply to stricter ESG criteria or are based on investment themes.
Table 2 supplies an overview over the current range of ESG indices.

Table 2:
Summary of Bloomberg MSCI ESG indices

Investment approach	MSCI ESG fixed income	Bloomberg MSCI
Integration	ESG Universal ("some ESG") ESG Leaders ("more ESG") Climate Change	ESG-weighted Sustainability
Values and screens		Socially responsible (SRI) Faith-based
Impact		Green bonds

Source: MSCI 2021

The range of near-money market indices (0-3 years) presents an interesting alternative for new ESG portfolio approaches with short residual maturities. iBoxx MSCI in particular offers such indices, which we will discuss in chapter 3.2.

All the index providers mentioned also offer customised indices. With the appropriate ESG tools, however, the customisation of the portfolio management can itself also include additional ESG criteria in the investment process. Tailored portfolio management is initially more cost-effective although, depending on the amount of additional exclusion criteria, the tracking error compared with the official benchmark of the index provider may increase.

3.1 Specific example: MSCI Climate Paris-Aligned Index

The course has been set with the Paris Climate Accord which laid down the climate protection goals agreed in 2012 in an international treaty, and the 17 sustainable development goals (SDGs) in the United Nations' 2030 agenda.

Investors are fully aware that these binding development goals can only be achieved if capital flows are redirected and if they, too, contribute to the effort. There will be positive aspects for investors, namely in the area of risk management. If risky companies and states are identified at an early stage, investors face less risk later on.

Investors can play their part in mitigating climate change and physical climate risk through the MSCI Climate Paris-Aligned Index, as well as ensure their portfolios reach "net zero" and potentially avoid risk. The index is designed to exceed the minimum standards of the Paris Climate Accord and incorporates the recommendations of the "Task Force on Climate-related Financial Disclosures" (TCFD), an expert committee that aims to mitigate climate change.
The index follows a rule-based optimisation methodology that maps the 1.5°C Paris target using the MSCI Value at Risk and an automatic decarbonisation of ten percent year-on-year. Companies linked to fossil fuels are completely excluded. Similarly, Scope 1, Scope 2 and Scope 3 emission sources are greatly reduced. The index focuses on clean technologies and promotes companies with climate mitigation and sustainability solutions.

Table 3 summarises current bond-specific key data. It shows that the Paris-Aligned Index is very similar to its initial index in terms of key data. It is also evident, that sustainable investments do not necessarily have a performance disadvantage.

Table 3:
Comparison of standard index with Paris-Aligned Index

Key figures	MSCI EUR IG Corporate Bond	MSCI EUR IG Climate Paris-Aligned Corporate Bond
Active return		-0.01
Tracking error		0.18
Correlation		1 (!)
Coupon	1.30	1.21
Yield to maturity	2.97	2.95
OAS	205	200
Effective duration	4.96	5.15
Credit rating	A-	A-

Source: MSCI, June 2022

3.2 ESG in near-money market portfolios: iBoxx MSCI ESG indices

Money market funds are ideal for parking money for a short period of time. These types of short-term investments can now also be presented in an ESG-compliant way.

The iBoxx MSCI ESG index family offers investors access to near-money market portfolios in which the included issuers are required to fulfil certain ESG standards. From the initial universe of a conventional iBoxx MSCI index, companies are excluded that are linked to negative criteria such as controversial weapons, tobacco, gambling and fossil fuels or that violate the principles of the UN Global Compact. Similarly, companies must have an ESG rating of BBB or above to be included in the near-money market ESG index.

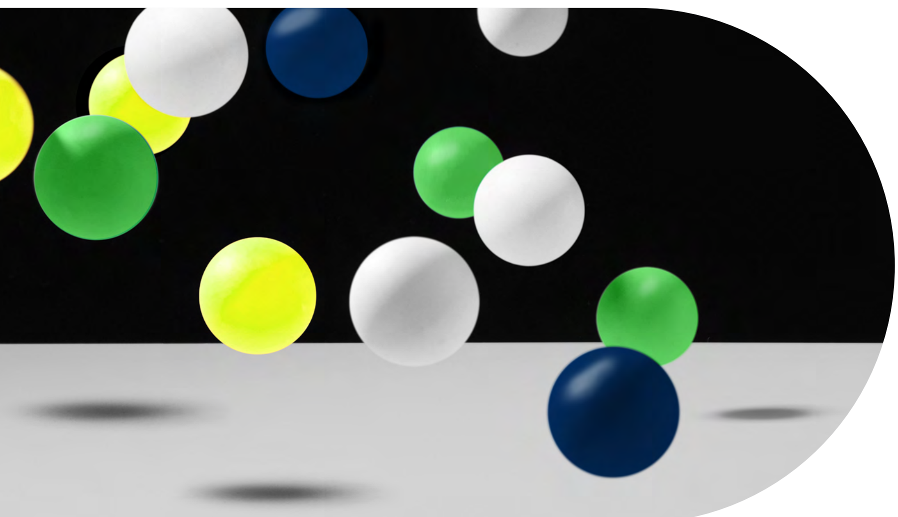
The iBoxx MSCI ESG indices include high-quality, investment-grade corporate bonds that offer better returns than traditional money market papers. Investing in these indices involves a certain amount of credit risk, however. Both fixed- and variable rate bonds are included in the indices, with a residual maturity of one and three years respectively, using the iBoxx MSCI ESG Ultrashort Index as an example.

The market value-weighted indices are rebalanced monthly, with the weight of any one issuer in the index not exceeding three percent. The key features of the near-money market iBoxx MSCI ESG indices are shown below.

Table 4:
Key figures of the iBoxx MSCI ESG indices

Key figures	iBoxx MSCI ESG EUR Liquid Investment grade Ultrashort	iBoxx MSCI ESG EUR Corporates 0–1
Current yield	1.40	1.01
Duration	0.43	0.55
Bonds in index	340	202
Minimum size	EUR 300 m	EUR 500 m
Return YTD	-0.45 %	-0.58 %
Average rating	A-	A-
Maximum residual maturity	3 years	1 year

Source: IHS Markit (ihs-markit.com), 15.8.2022



4 Conclusion

Although the first sustainable stock index was launched back in 1990, demand for ESG-compliant investments in the fixed-income sector has only taken off in recent years. The rapid formation and evolution of regulatory frameworks as well as a growing investor appetite also pose new challenges for the asset management industry. Expertise in ESG products is required to constantly keep pace with the latest requirements.

Various approaches can be applied for sustainable investment portfolios. Classical screening procedures are probably the most frequently-used methodology. Costly active portfolio management is, however, not needed when integrating ESG standards into the investment process. Investors' growing appetite for sustainability continues to drive the development of ESG fixed-income indices. Passive portfolio solutions therefore provide investors with easy and cost-effective access to ESG-compliant investments.
In addition to standard exclusion criteria, theme-based or near-money market indices, ESG solutions that are tailored to individual customer needs can also be passively implemented within the framework of customised indices.

Equity and bond mandates

The range of rule-based portfolio concepts in the field of equities and bonds is extensive, ranging from a strategy that precisely mirrors a market index (passive) to one that adapts an investment universe to a client's specifications (passive customised).

It is also important to keep an overview of this dynamic market with its constantly expanding universe of indexes.

Learn more

As of August 2022