

US High Yield ESG Indices: Different ESG Approaches

SPDR EMEA Strategy & Research

Investors appear keen on integrating ESG into their high yield exposures. The many different approaches to ESG means that understanding the type of screening and issuer selection process that is undertaken is essential. As this asset class grows, it becomes important for investors to understand the differences that ESG selection criteria can make to the index.

Overview

Earlier this year, the State Street Global Advisors fixed income client survey highlighted high yield as a key area in which investors are looking to integrate ESG exposure.¹ Approaches to ESG integration vary widely, meaning it is essential to understand the differences in exposures across a variety of indices.

This note provides a summary of the key statistics of the Bloomberg SASB US Corporate High Yield ESG Ex-Controversies Select Index and how it compares with two of the most widely followed indices in the market: the Bloomberg MSCI US Corporate High Yield Sustainable BB+ SRI Bond Index and the Bloomberg MSCI US Corporate High Yield SRI Sustainable Index.

ESG Screening Process

The common factor to most ESG approaches is the screening or exclusion process. These three indices we analyse here start with the Bloomberg US Corporate High Yield Total Return Index and exclude certain companies based on either their business area or on their overall ESG score. For the three ESG strategies, these exclusion rules are outlined in Figure 1.

Some ESG indices also endeavour to skew the weight of bonds within the index toward those issuers with a higher ESG score, or a best-in-class solution. The Bloomberg SASB US Corporate High Yield ESG Ex-Controversies Select Index runs on a portfolio optimisation process that is a part of the monthly rebalancing, which actively overweights bonds that have above average ESG scores. For the Bloomberg MSCI US Corporate High Yield Sustainable BB+ SRI Bond Index and MSCI US Corporate High Yield SRI Sustainable Index, certain exclusions are made if an issuer has a rating that is too low for it to be included in the index. There is also a mechanism for ranking the bonds by ESG score and then excluding those that have the lowest rating. However, this rule only kicks in if the initial exclusions do not remove more than 20% of the total number of issuers.

Figure 1
**ESG Screens —
 What's In, What's Out**

Bloomberg SASB US Corporate High Yield ESG Ex-Controversies Select Index	Bloomberg Barclays MSCI US Corporate High Yield Sustainable BB+ SRI Bond Index	Bloomberg Barclays MSCI US Corporate High Yield SRI Sustainable Index
<p>Issuers are excluded from the index for the following reasons: Extreme Event Controversies Controversial Weapons UNGC Violations Civilian Firearms Thermal Coal Extraction and power generation Oil Sands Extraction Arctic Oil and Gas exploration Tobacco Companies</p> <p>Issuers without R-Factor scores are excluded from the index.²</p>	<p>The index excludes issuers involved in the following business activities: • Alcohol • Tobacco • Gambling Adult Entertainment • Genetically Modified organisms (GMO) • Nuclear Power • Civilian Firearms • Military Weapons (Landmine or Cluster Bomb Manufacturing, Depleted Uranium, Chemical and Biological Weapons)</p> <p>The index additionally excludes issuers with greater than 5% revenue related to • Thermal Coal • Generation of Thermal Coal • Oil Sands</p> <p>Securities must have an MSCI ESG Rating of BB or higher — Unrated issuers from sectors with ratings are excluded.</p>	<p>The index excludes issuers involved in: • Alcohol • Tobacco • Gambling • Adult Entertainment • GMO • Nuclear Power • Civilian Firearms • Military Weapons (Landmine/Cluster Bomb Manufacture, Depleted Uranium and Chemical & Biological Weapons)</p> <p>From Oct 2020, index excludes issuers with greater than 5% revenue from: Thermal Coal, Generation of Thermal Coal, Unconventional Oil & Gas, Arctic Gas or Oil</p> <p>Starting Jun 2019, excludes any issuer with a "Red" MSCI ESG Impact Monitor score (less than 1), which measures involvement in major ESG controversies and adherence to international norms and principles.</p> <p>Starting Jun 2019: • Securities must have an MSCI ESG Rating of BBB or higher. • Unrated issuers from sectors with ratings are excluded.</p>

Source Bloomberg Finance L.P., as of 30 September 2021.

Figure 2
**Levelling Up with a
 Best-in-Class Approach**

Bloomberg SASB US Corporate High Yield ESG Ex-Controversies Select Index	Bloomberg MSCI US Corporate High Yield Sustainable BB+ SRI Bond Index	Bloomberg MSCI US Corporate High Yield SRI Sustainable Index
<p>The Bloomberg PORT Optimiser is used to select and weight each security in the index. The optimiser runs once per month, selecting securities and calculating notional positions. This process will not impact bond prices and other security-level analytics.</p> <p>The optimiser has three main objectives:</p> <ul style="list-style-type: none"> • Maximise the overall R-Factor Score. • Minimise Active Total Risk versus the Parent Index. This is the ex-ante (or predicted) annualised tracking error based on the Bloomberg Fixed Income multi-factor risk model. • Minimise Turnover. 	<p>On the last bd before month end, using the Forward Universe of the previous day, after applying the Non-ESG criteria rules for inclusion and removing any non-ESG rated bonds, the number of issuers for the eligible universe are defined. If, after having additionally applied the ESG selection criteria, less than 20% of the total number of issuers in the eligible universe are excluded, then the issuers are ranked in the order below, according to the following criteria:</p> <ul style="list-style-type: none"> • MSCI ESG Rating score (higher Ticker ESG Rating score preferred to remain in the index) • MSCI ESG Controversies score (higher Ticker Controversies score preferred to remain in the index) <p>Based on this ranking, issuers will be excluded from the index, until the number excluded is >20% of the eligible universe.</p>	<p>On the last bd before month end, using the Forward Universe of the previous day, after applying the Non-ESG criteria rules for inclusion and removing any non-ESG rated bonds, the number of issuers for the eligible universe are defined. If, after having additionally applied the ESG selection criteria, less than 20% of the total number of issuers in the eligible universe are excluded, then the issuers are ranked in the order below, according to the following criteria:</p> <ul style="list-style-type: none"> • MSCI ESG Rating score (higher Ticker ESG Rating score preferred to remain in the index) • MSCI ESG Controversies score (higher Ticker Controversies score preferred to remain in the index) <p>Based on this ranking, issuers will be excluded from the index, until the number excluded is >20% of the eligible universe.</p>

Source: Bloomberg Finance L.P., as of 30 September 2021.

The removal of issuers according to the screens and the selection of bonds with higher ESG scores leads to a considerable reduction in the number of constituents. Figure 3 shows the three ESG indices versus the parent Bloomberg US Corporate High Yield Total Return Index.

Looking at the market risk characteristics, it is clear that there are some significant deviations from the parent index. For instance, the duration on the Bloomberg MSCI US Corporate High Yield SRI Sustainable Index is 20bp greater than that of the broad corporate high yield index, yet its yield to worst and current yield are both over 50bp lower and its option-adjusted spread is tighter. This could prove to be an issue if switching over legacy assets that track a purely market-weighted strategy.

Figure 3
Index Characteristics

	Bloomberg SASB US Corporate High Yield ESG Ex-Controversies Select Index	Bloomberg US Corporate High Yield Total Return Index	Bloomberg MSCI US Corporate High Yield Sustainable BB+ SRI Bond Index	Bloomberg MSCI US Corporate High Yield SRI Sustainable
Market Value (USD 000)	674,049,189	1,627,527,076	922,282,273	554,471,475
Number of Constituents	896	2,213	1,196	746
Coupon	5.777	5.782	5.492	5.261
Yield-to-worst	3.97	4.02	3.59	3.38
OAD	3.88	3.85	4.11	4.05
OAS	277.05	283.73	238.71	214.58
OAC	-0.16	-0.15	-0.04	-0.07
Maturity	6.54	6.54	6.89	6.87
Current Yield	5.49	5.49	5.16	4.95
LQA	61.61	60.66	62.27	61.34
Index Rating	BA3/B1	BA3/B1	BA3/B1	BA3/B1

Source: Bloomberg Finance L.P., as of 30 September 2021. Characteristics are as of the date indicated and should not be relied upon as current thereafter.

The index that is closest to the parent index in its characteristics is the Bloomberg SASB US Corporate High Yield ESG Ex-Controversies Select Index. This is by design, with the optimisation process not only working to maximise the ESG score but also to push the key characteristics of the index toward those of the Bloomberg US Corporate High Yield Total Return Index. Key measures of risk and return, such as duration and yield, are within 5bp of the parent index.

Sectors: Some Divergence

While some of the key index characteristics may be different, at the highest level, sector allocations look similar for financial institutions, industrial and utility exposure (Figure 4). However, there are meaningful differences at a more granular level. Bloomberg SASB US Corporate High Yield ESG Ex-Controversies Select Index has a far greater exposure versus the parent index in banking, basic industry and technology. Both the Bloomberg MSCI US Corporate High Yield Sustainable BB+ SRI Bond Index and MSCI US Corporate High Yield SRI Sustainable Index are also heavily weighted to technology (which makes sense for an ESG fund) but also have high allocations to consumer non-cyclicals and, in addition, the Bloomberg MSCI US Corporate High Yield Sustainable BB+ SRI Bond Index has a high allocation to communications.

Figure 4
Sector Allocations

	Bloomberg SASB US Corporate High Yield ESG Ex-Controversies Select Index	Bloomberg US Corporate High Yield Total Return Index	Bloomberg MSCI US Corporate High Yield Sustainable BB+ SRI Bond Index	Bloomberg MSCI US Corporate High Yield SRI Sustainable
Financial Institutions	10.00	9.67	10.92	10.01
Banking	5.21	1.42	2.70	2.58
Brokerage Asset Managers Exchanges	0.14	0.67	0.52	0.38
Finance Companies	1.52	2.45	1.86	0.41
Insurance	1.23	2.32	2.94	4.08
REITS	1.13	1.74	1.36	1.36
Other Financial	0.77	1.06	1.53	1.20
Industrial	88.87	87.59	88.11	88.50
Basic Industry	9.00	5.19	5.48	6.54
Capital Goods	9.24	8.35	8.72	9.23
Consumer Cyclical	22.96	21.29	16.93	16.55
Consumer Non-Cyclical	7.68	13.49	17.88	17.69
Energy	12.38	13.32	7.59	7.22
Technology	12.16	6.38	9.39	12.79
Transportation	2.42	2.34	1.35	1.80
Communications	12.94	16.08	19.70	15.24
Industrial Other	0.10	1.14	1.07	1.44
Utility	1.13	2.74	0.97	1.49
Electric	1.13	2.73	0.97	1.49
Natural Gas	—	0.01	—	—

Source: Bloomberg Finance L.P., as of 30 September 2021. Weights are as of the date indicated and should not be relied upon as current thereafter.

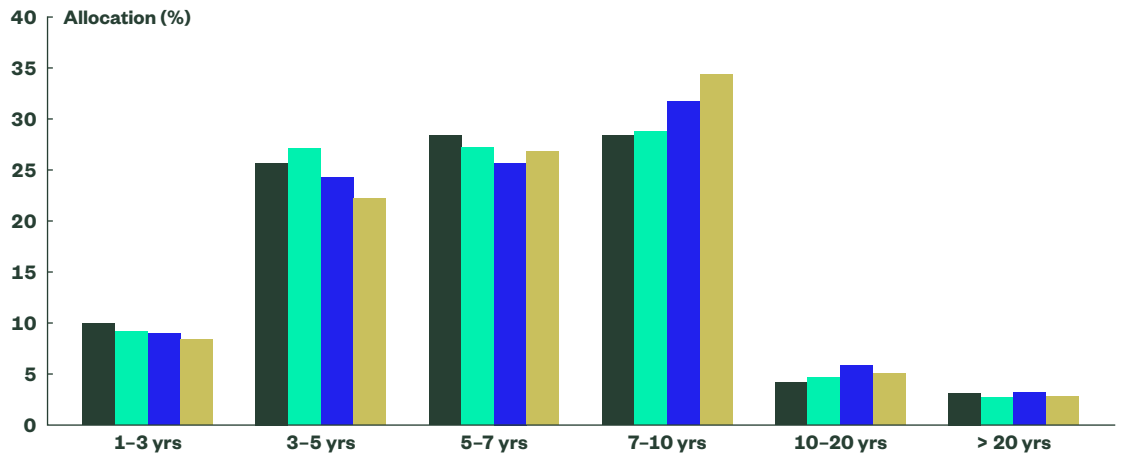
The largest underweights relative to the parent index are in consumer non-cyclicals and communications for the Bloomberg SASB US Corporate High Yield ESG Ex-Controversies Select Index and in energy and consumer cyclicals for the Bloomberg MSCI US Corporate High Yield Sustainable BB+ SRI Bond Index and MSCI US Corporate High Yield SRI Sustainable Index.

Maturity and Ratings

Figures 5 and 6 illustrate that there are relatively minor differences in the maturity and ratings distributions of the four indices. Once again, the Bloomberg SASB US Corporate High Yield ESG Ex-Controversies Select Index is similar to the Bloomberg US Corporate High Yield Total Return Index. The Bloomberg MSCI US Corporate High Yield SRI Sustainable Index has a higher weighting to securities in the 7-10 year maturity bucket while the Bloomberg MSCI US Corporate High Yield Sustainable BB+ SRI Bond Index has the most bonds in the 10-year-plus maturity segment, which accounts for why it has the longest duration of all of the strategies.

Figure 5
Maturity Distribution

- Bloomberg SASB US Corporate High Yield ESG Ex-Controversies Select Index
- Bloomberg US Corporate High Yield Total Return Index
- Bloomberg MSCI US Corporate High Yield Sustainable BB+ SRI Bond Index
- Bloomberg MSCI US Corporate High Yield SRI Sustainable

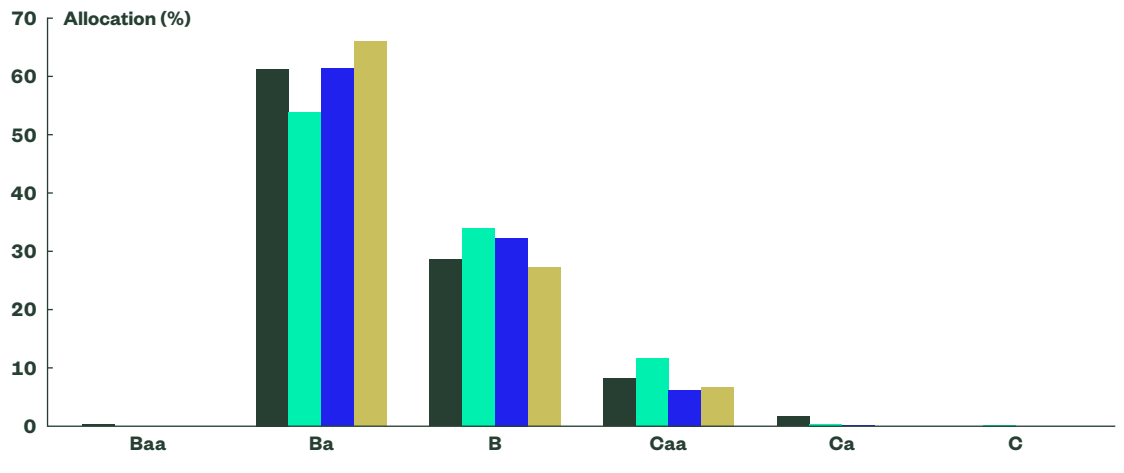


Source: Bloomberg Finance L.P., as of 30 September 2021.

All four of the indices have the same overall rating (BA3/B1 using the Bloomberg average rating) but the ESG indices have a greater proportion of their bonds in the Ba bucket than the parent Bloomberg US Corporate High Yield Total Return Index. This suggests that ESG filters do in fact push the indices towards selecting higher quality credits.

Figure 6
Bond Index Characteristics

- Bloomberg SASB US Corporate High Yield ESG Ex-Controversies Select Index
- Bloomberg US Corporate High Yield Total Return Index
- Bloomberg MSCI US Corporate High Yield Sustainable BB+ SRI Bond Index
- Bloomberg MSCI US Corporate High Yield SRI Sustainable



Source: Bloomberg Finance L.P., as of 30 September 2021. Characteristics are as of the date indicated and should not be relied upon as current thereafter.

Performance and Volatility

The track record of the ESG indices is limited so a long-run analysis of returns and volatility is not possible. From a return perspective, over both time periods shown (Figure 6), the highest returns came from the Bloomberg SASB US Corporate High Yield ESG Ex-Controversies Select Index. In fact, the Bloomberg MSCI US Corporate High Yield Sustainable BB+ SRI Bond Index and MSCI US Corporate High Yield SRI Sustainable Index both appear to have underperformed the Bloomberg US Corporate High Yield Total Return Index over both the periods.

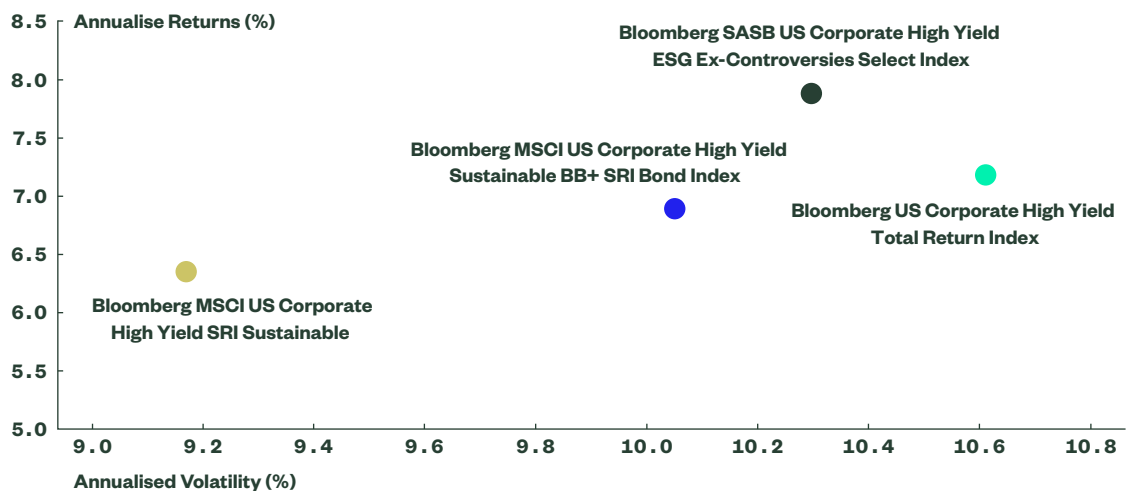
Figure 7
Returns, Volatility and
the Sharpe Ratio

		Last 12 Months	Last 2 Years
Annualised Return (%)	Bloomberg SASB US Corporate High Yield ESG Ex-Controversies Select Index	13.34	7.89
	Bloomberg US Corporate High Yield Total Return Index	11.28	7.19
	Bloomberg MSCI US Corporate High Yield Sustainable BB+ SRI Bond Index	10.44	6.90
	Bloomberg MSCI US Corporate High Yield SRI Sustainable	8.38	6.36
Annualised Volatility (%)	Bloomberg SASB US Corporate High Yield ESG Ex-Controversies Select Index	3.87	10.30
	Bloomberg US Corporate High Yield Total Return Index	3.83	10.61
	Bloomberg MSCI US Corporate High Yield Sustainable BB+ SRI Bond Index	3.81	10.05
	Bloomberg MSCI US Corporate High Yield SRI Sustainable	2.90	9.17
Sharpe Ratio	Bloomberg SASB US Corporate High Yield ESG Ex-Controversies Select Index	3.42	0.71
	Bloomberg US Corporate High Yield Total Return Index	2.91	0.62
	Bloomberg MSCI US Corporate High Yield Sustainable BB+ SRI Bond Index	2.71	0.63
	Bloomberg MSCI US Corporate High Yield SRI Sustainable	2.85	0.63

Source: Bloomberg Finance L.P., as of 30 September 2021. Past performance is not a reliable indicator of future returns.

While returns are higher for the Bloomberg SASB US Corporate High Yield ESG Ex-Controversies Select Index, volatility has also been higher over the past 12 months. There is some evidence that during the peak of the COVID crisis, volatility in investment grade credit was lower for ESG-screened indices than it was for the standard market-weighted index.³ This certainly appears to be the case when looking at the annualised volatility during the past two years, with it being highest for the Bloomberg US Corporate High Yield Total Return Index.

Figure 8
Returns vs. Volatility
Over Past 2 Years



Source: Bloomberg Finance L.P., as of 30 September 2021.

In terms of whether the trade-off between increased returns and higher volatility is worth it, the Sharpe ratio is highest on the Bloomberg SASB US Corporate High Yield ESG Ex-Controversies Select Index during both time periods. Despite the far lower volatility of the MSCI US Corporate High Yield SRI Sustainable Index, the Sharpe ratio over the past two years is in line with the Bloomberg MSCI US Corporate High Yield Sustainable BB+ SRI Bond Index.

Endnotes

- 1 **Preparing for the Big Shift.** The survey was conducted in partnership with Longitude Research, a Financial Times company. The research also included in-depth telephone interviews with two institutional portfolio managers (one in North America and one in Europe).
- 2 R-Factor® scores are the ESG scores of State Street.
- 3 See the paper **US Investment Grade Credit: Stability Through ESG.**

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A summary of investor rights can be found here: <https://ssga.com/library-content/products/fund-docs/summary-of-investor-rights/ssga-spdr-investors-rights-summary.pdf>.

Note that the Management Company may decide to terminate the arrangements made for marketing and proceed with de-notification in compliance with Article 93a of Directive 2009/65/EC.

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