
Short Euro Corporate ESG Indices: An Overview

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Investors appear keen on integrating ESG into their credit exposures. The many different approaches to ESG mean that understanding the type of screening and issuer selection process is important. As ESG indices evolve, investors will need to appreciate the impact that selection criteria can make to the characteristics of an index.

Overview

It is clear that ESG has come of age. In 2021, 13 out of the 14 UCITS credit ETFs launched had some type of ESG screening.¹ There were several different approaches, ranging from broad ESG screens to funds that focused on climate transition or specifically on green bonds. This variety of approaches to ESG integration means it is essential to understand the differences in underlying exposures across a variety of indices.

This note provides a summary of the key statistics of the Bloomberg SASB Euro Corporate 0–3 Year ESG Ex-Controversies Select Index and how it compares with the most widely followed short-maturity ESG indices in the market: the Bloomberg MSCI Euro Corporate 0–3 Sustainable SRI TR Index and the Bloomberg MSCI Euro Corp ESG BBB+ Sustainability SRI 0–3 Year Index.

The ESG Screening Process

The common factor across most ESG approaches is the screening or exclusion process. The indices we analyse here are maturity-constrained versions of the Bloomberg Euro Aggregate Corporate Index. Aside from a maturity cut-off at three years, they then 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 (next page).

Figure 1

ESG Screens — Business-Related Exclusions

Bloomberg SASB Euro Corporate 0–3 year ESG Ex-Controversies Select Index	Bloomberg MSCI Euro Corporate 0–3 Sustainable SRI Index	Bloomberg MSCI Euro Corp ESG BBB+ Sustainability SRI 0–3 Year Index
<p>Issuers are excluded from the index for the following reasons:</p> <ul style="list-style-type: none"> • 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>Issuers without R-Factor scores are excluded from the index.</p> <p>Portfolio optimisation maximise the ESG score while at the same time trying to replicate the characteristics of the parent index.</p>	<p>Securities must have an MSCI ESG Rating of BB or higher. Unrated issuers from sectors with ratings are excluded. Ratings are applied at the ticker level.</p> <p>The index excludes issuers involved in the following business activities:</p> <ul style="list-style-type: none"> • 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>The index additionally excludes issuers with greater than 5% revenue related to</p> <ul style="list-style-type: none"> • Thermal coal • Generation of thermal coal • Oil sands <p>Excludes any issuer with a “Red” MSCI ESG Impact Monitor score (less than 1), which measures an issuer’s involvement in major ESG controversies and how well they adhere to international norms and principles.</p>	<p>Securities must have an MSCI ESG Rating of BBB or higher. Unrated issuers from sectors with ratings are excluded.</p> <p>Ratings are applied at the bond level which may result in bonds with the same Bloomberg ticker having different MSCI ESG Ratings. The index excludes issuers involved in:</p> <ul style="list-style-type: none"> • Alcohol • Tobacco • Gambling • Adult entertainment • GMO • Nuclear power • Civilian firearms • Conventional and nuclear weapons (including mines, cluster bombs and chemical weapons) • Thermal coal • Fossil fuels • Generation of thermal coal • Oil sands • Tobacco distribution • Tobacco retailing • Tobacco supply <p>Excludes any issuer with a “Red” MSCI ESG Controversy Score (equal to zero), which measures an issuer’s involvement in major ESG controversies and how well they adhere to international norms and principles.</p>

Source: Bloomberg Finance L.P., as of 31 March 2022.

These 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 Euro Corporate 0–3 year ESG Ex-Controversies Select Index runs a portfolio optimisation process that is a part of the monthly rebalancing, which actively overweights bonds that have above average ESG scores.² For the Bloomberg MSCI Euro Corporate 0–3Y Sustainable SRI Index, issuers need to be rated BBB or higher by MSCI to be included. For the Bloomberg MSCI Euro Corp ESG BBB+ Sustainability SRI 0–3 Year Index, the BBB rating criteria is at the bond rather than issuer level.

Each of the Bloomberg MSCI indices has 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 2
**Optimising Index
 ESG Scores**

Bloomberg SASB Euro Corporate 0–3 year ESG Ex-Controversies Select Index	Bloomberg MSCI Euro Corporate 0–3 Sustainable SRI Index	Bloomberg MSCI Euro Corporate ESG BBB+ Sustainability SRI 0–3 Year 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 business day 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 business day before month end, using the Forward Universe of the previous day, after applying the non-ESG criteria rules for inclusion, defined above, and additionally 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 eligible 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 of excluded issuers is > 20% of the eligible universe total number of issuers.</p>

Source: Bloomberg Finance L.P., as of 31 March 2022.

The Impact on the Index Characteristics

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 that the parent Bloomberg EUR Corporate 0–3 Year Total Return Index has more than 1,200 bonds. The most drastic reduction is from the Bloomberg SASB Euro Corporate 0–3 year ESG Ex-Controversies Select Index methodology, which removes around 45% of the parent bond holdings.

Figure 3
Index Characteristics

	Bloomberg SASB Euro Corporate 0–3 year ESG Ex-Controversies Select Index	Bloomberg EUR Corporate 0–3 Year Total Return Index	Bloomberg MSCI Euro Corporate 0–3 Sustainable SRI Index	Bloomberg MSCI Euro Corporate ESG BBB+ Sustainability SRI 0–3 Year Index
Market Value (USD 000)	686,804,250	934,463,183	706,963,157	695,949,910
Number of Constituents	656	1238	933	919
Coupon	1.633	1.514	1.491	1.492
Yield to Worst	0.62	0.65	0.61	0.62
Option-Adjusted Duration	1.44	1.57	1.58	1.6
Option-Adjusted Spread	88.37	87.4	83.54	83.23
Option-Adjusted Coupon	0.02	0.02	0.02	0.02
Duration Times Spread	0.65	0.65	0.61	0.62
Maturity	1.5	1.63	1.63	1.66
Index Rating	A3/BAA1	A3/BAA1	A3/BAA1	A3/BAA1
LQA	76.37	77.84	78.67	78.55

Source: Bloomberg Finance L.P., as of 1 April 2022. Characteristics are as of the date indicated, are subject to change, and should not be relied upon as current thereafter.

In terms of index risk characteristics, the Bloomberg SASB Euro Corporate 0–3 year ESG Ex-Controversies Select Index has a slightly shorter duration and maturity than the other indices but has a very similar yield to worst, option-adjusted spread and duration times spread to the parent Bloomberg EUR Corporate 0–3 Year Index.

Overall the differences in characteristics are fairly small, with the same rating across all indices, although the Bloomberg MSCI Euro Corporate 0–3 Sustainable SRI TR Index and the Bloomberg MSCI Euro Corp ESG BBB+ Sustainability SRI 0–3 Year Index do enjoy a slightly higher Bloomberg Liquidity rating.

Sectors: Some Divergence

While many of the key index characteristics look similar, Figure 4 shows that there are some meaningful differences in sector allocations. Both the Bloomberg MSCI Euro Corporate 0–3 Sustainable SRI TR Index and the Bloomberg MSCI Euro Corp ESG BBB+ Sustainability SRI 0–3 Year Index are heavily overweight the banking sector, with it comprising close to half of these indices. The Bloomberg SASB Euro Corporate 0–3 year ESG Ex-Controversies Select Index has a far lower allocation to banks but higher to insurance, which means the overall allocation to financials is more in line with the parent index than it is for the other two ESG indices.

It is also the case that the industrials and utilities sectors are better aligned between the Bloomberg SASB ESG index and the parent index. Both of the Bloomberg MSCI ESG indices look significantly underweight industrials and utilities sectors versus the Bloomberg EUR Corporate 0–3 Year Index.

Figure 4
Sector Allocations

	Bloomberg SASB Euro Corporate 0–3 year ESG Ex-Controversies Select Index	Bloomberg EUR Corporate 0–3 Year Total Return Index	Bloomberg MSCI Euro Corporate 0–3 Sustainable SRI Index	Bloomberg MSCI Euro Corporate ESG BBB+ Sustainability SRI 0–3 Year Index
Financial Institutions	46.54	47.65	57.69	57.92
Banking	33.52	37.97	47.43	47.50
Brokerage, Asset Managers, Exchanges	0.14	0.37	0.16	0.16
Finance Companies	0.00	0.21	0.28	0.29
Insurance	7.14	4.31	4.79	4.87
REITS	3.29	1.41	1.47	1.49
Other Financial	2.45	3.38	3.56	3.61
Industrial	47.42	46.46	39.68	39.51
Basic Industry	3.65	2.49	2.26	2.25
Capital Goods	5.58	4.75	5.17	5.20
Consumer Cyclical	11.20	12.92	10.63	10.35
Consumer Non-Cyclical	11.92	11.15	9.13	9.27
Energy	3.75	3.81	0.25	0.25
Technology	5.79	2.94	3.89	3.95
Transportation	0.71	2.36	2.62	2.66
Communications	4.82	5.49	5.54	5.39
Industrial Other	0.00	0.54	0.18	0.19
Utility	6.04	5.89	2.63	2.57
Electric	3.27	3.55	1.14	1.16
Natural Gas	1.86	1.69	0.80	0.70

Source: Bloomberg Finance L.P., as of 1 April 2022. Weights are as of the date indicated, are subject to change, and should not be relied upon as current thereafter.

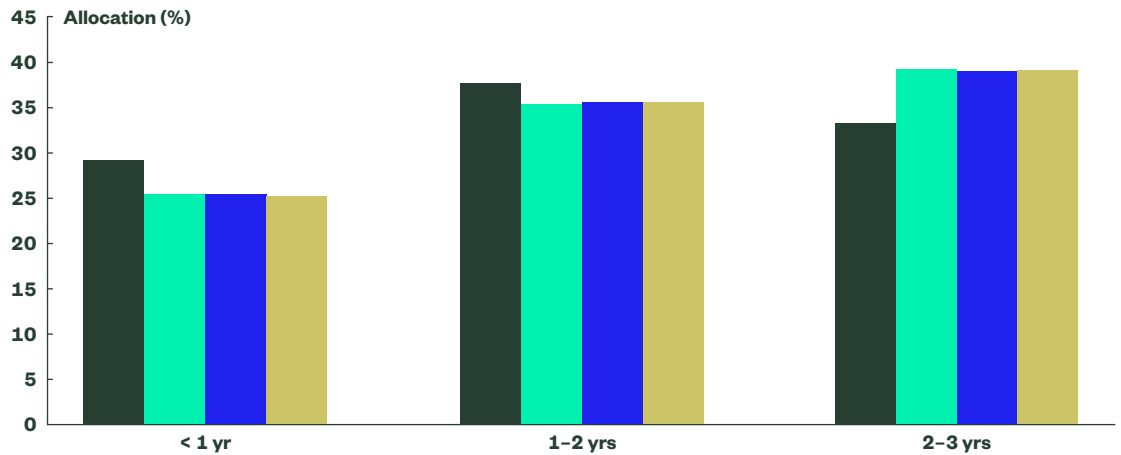
This more precise mirroring of the Bloomberg EUR Corporate 0–3 Year Index at a sector level by the Bloomberg SASB Euro Corporate 0–3 year ESG Ex-Controversies Select Index is a consequence of the optimisation process that the Bloomberg SASB ESG Ex-Controversies Select Indices undergo. This sets a soft constraint that class 2 sector weights should be within 100bp of the parent index.

Maturity and Ratings

These indices are maturity-constrained at three years, meaning there is unlikely to be a radical difference in allocations to maturity buckets. There is a slightly greater amount of sub-one-year paper in the Bloomberg SASB Euro Corporate 0–3 year ESG Ex-Controversies Select Index, which is reflected in the shorter duration and maturity shown in the characteristics table (Figure 3).

Figure 5
Maturity Distribution

- Bloomberg SASB Euro Corporate 0–3 year ESG Ex-Controversies Select Index
- Bloomberg EUR Corporate 0–3 Year Total Return Index
- Bloomberg MSCI Euro Corporate 0–3 Sustainable SRI TR Index
- Bloomberg MSCI Euro Corporate ESG BBB+ Sustainability SRI 0–3 Year Index

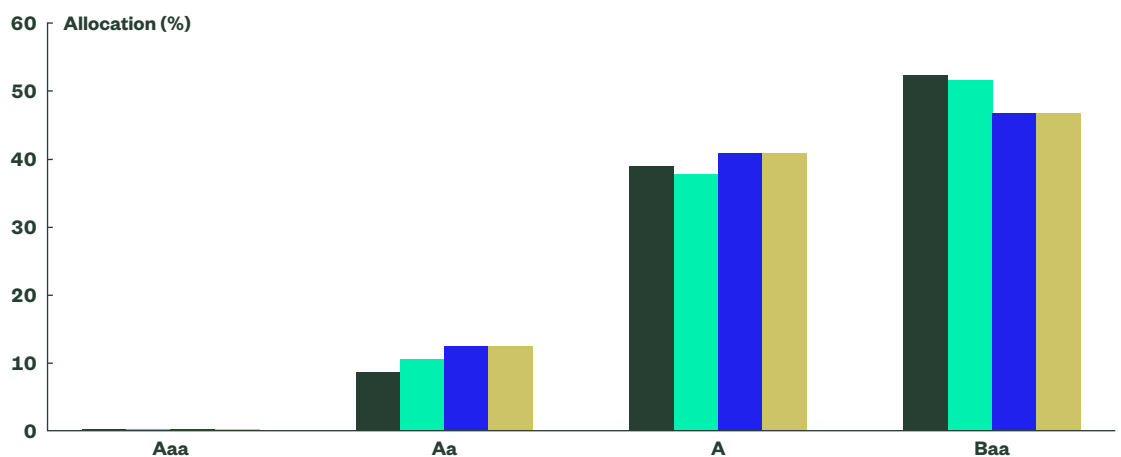


Source: Bloomberg Finance L.P., as of 1 April 2022. Allocations are as of the date indicated, are subject to change, and should not be relied upon as current thereafter.

All four indices have the same overall rating but the Bloomberg SASB Euro Corporate 0–3 year ESG Ex-Controversies Select Index more closely reflects the ratings profile of the Bloomberg EUR Corporate 0–3 Year Index than the two Bloomberg MSCI ESG indices, which have slightly more Aa paper and less in the Baa rating bucket.

Figure 6
Bond Index Ratings

- Bloomberg SASB Euro Corporate 0–3 year ESG Ex-Controversies Select Index
- Bloomberg EUR Corporate 0–3 Year Total Return Index
- Bloomberg MSCI Euro Corporate 0–3 Sustainable SRI TR Index
- Bloomberg MSCI Euro Corporate ESG BBB+ Sustainability SRI 0–3 Year Index



Source: Bloomberg Finance L.P., as of 1 April 2022. Allocations are as of the date indicated, are subject to change, and should not be relied upon as current thereafter.

Performance and Volatility

The impact that the shorter duration of the Bloomberg SASB Euro Corporate 0–3 year ESG Ex-Controversies Select Index has on performance and volatility is clear. During the last 12 months, a period when investment grade returns were negative, the Bloomberg SASB index outperformed the parent Bloomberg EUR Corporate 0–3 Year Index and the two other ESG indices. However, over a two-year period as the market has rallied, returns have been lower, with the non-ESG Bloomberg EUR Corporate 0–3 Year Index typically performing the best.

Figure 7
Returns, Volatility
and the Sharpe Ratio

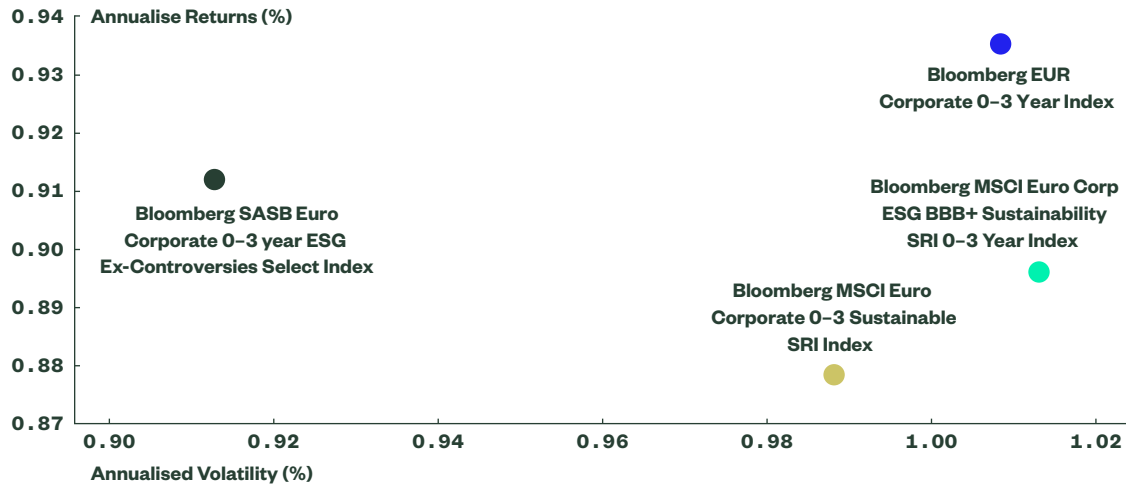
	31/03/2022	Last 12 Months (%)	Last 2 Years (%)	Last 3 Years (%)	Since Inception (1 February 2017) (%)
Annualised Return (%)	Bloomberg SASB Euro Corporate 0–3 year ESG Ex-Controversies Select Index	-0.95	0.91	-0.02	0.09
	Bloomberg EUR Corporate 0–3 Year Index	-1.10	0.94	-0.03	0.09
	Bloomberg MSCI Euro Corporate 0–3 Sustainable SRI Index	-1.09	0.88	-0.03	0.08
	Bloomberg MSCI Euro Corp ESG BBB+ Sustainability SRI 0–3 Year Index	-1.13	0.90	-0.05	0.07
Annualised Volatility (%)	Bloomberg SASB Euro Corporate 0–3 year ESG Ex-Controversies Select Index	0.58	0.91	1.52	1.19
	Bloomberg EUR Corporate 0–3 Year Index	0.65	1.01	1.61	1.26
	Bloomberg MSCI Euro Corporate 0–3 Sustainable SRI Index	0.65	0.99	1.55	1.21
	Bloomberg MSCI Euro Corp ESG BBB+ Sustainability SRI 0–3 Year Index	0.67	1.01	1.60	1.25
Sharpe Ratio	Bloomberg SASB Euro Corporate 0–3 year ESG Ex-Controversies Select Index	-0.64	1.60	0.33	0.47
	Bloomberg EUR Corporate 0–3 Year Index	-0.81	1.47	0.31	0.45
	Bloomberg MSCI Euro Corporate 0–3 Sustainable SRI Index	-0.79	1.45	0.32	0.46
	Bloomberg MSCI Euro Corp ESG BBB+ Sustainability SRI 0–3 Year Index	-0.82	1.43	0.30	0.44

Source: Bloomberg Finance L.P., as of 31 March 2022. Risk-free rate based on JP Morgan 1M EUR Cash index. Past performance is not an indicator of future returns. It is not possible to invest directly in an index. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. Diversification does not ensure a profit or guarantee against loss.

Lower duration also equates to lower volatility, with the Bloomberg SASB Euro Corporate 0–3 year ESG Ex-Controversies Select Index having the lowest level of volatility over the four periods shown. Conversely, the parent index has the highest level of volatility.

In terms of the Sharpe ratio, which looks at excess returns over the risk-free rate against volatility, the Bloomberg SASB Euro Corporate 0–3 year ESG Ex-Controversies Select Index has the highest ratio over all time periods shown.

Figure 8
Returns vs. Volatility
Over Past 2 Years



Source: Bloomberg Finance L.P., as of 31 March 2022.

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Summary

Longer-term returns from all strategies have been similar, but ESG does look like a route to reducing volatility. For the Bloomberg SASB Euro Corporate 0-3 year ESG Ex-Controversies Select Index, the reduction in volatility is meaningful as this index achieved lower volatility than the parent index over all of the time periods shown.

Endnotes

1 Source: Morningstar, as of 31 December 2021.

2 The Bloomberg SASB Corporate ESG Ex-Controversies Select Indices use the R-Factor ESG scoring system, developed by State Street, in the index optimisation process. R-Factor is based on inputs from five separate ESG data providers using the SASB Materiality Map as a framework.

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ID1018062-4675462.11.EMEA.INST 0522
Exp. Date 31/05/2023