
European Passive ESG Bond-Fund Landscape

Small Market Ripe for Rapid Expansion

Morningstar Manager Research
December 2019

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Key Takeaways

- ▶ The European passive ESG bond-fund market is small. We identified 36 passive funds with an explicit ESG mandate, representing EUR 11 billion in assets, as of the end of November 2019.
- ▶ The outlook is positive, though. Year-to-date net flows are six times the amount gathered in 2018.
- ▶ Passive providers see ESG and fixed income as key areas of growth in coming years.
- ▶ A key selling point of ESG bond funds is that management of ESG risks can make bond issuers less vulnerable to credit-rating downgrades and default.
- ▶ Almost half of the funds and 69% of the assets are in investment-grade corporate bonds, but the product suite is expanding into emerging markets and high-yield bonds.
- ▶ ESG for government bonds remains a challenging subject.
- ▶ Green-bonds passive funds account for 13% of the assets.
- ▶ ESG is not at odds with performance. Broad ESG bond indexes have shown similar risk/return characteristics to parent indexes.
- ▶ The specific characteristics of impact-bond funds — for example, green bonds — make them difficult to assess against mainstream ESG bond propositions.

Still a Small Market, but Flows and Assets Are Growing Strongly

The European passive fixed-income ESG-fund universe remains small and underdeveloped. As of the end of November 2019, assets in European-domiciled passive-bond funds — both exchange-traded funds and traditional index funds — with an explicit ESG mandate totaled EUR 11 billion. This only represents 5% of the assets held in ESG bond funds, meaning that 95% of assets are in active ESG bond funds¹. By contrast, assets in equity ESG passive funds surpass EUR 110 billion and already account for 30% of total money invested in ESG equity funds in Europe.

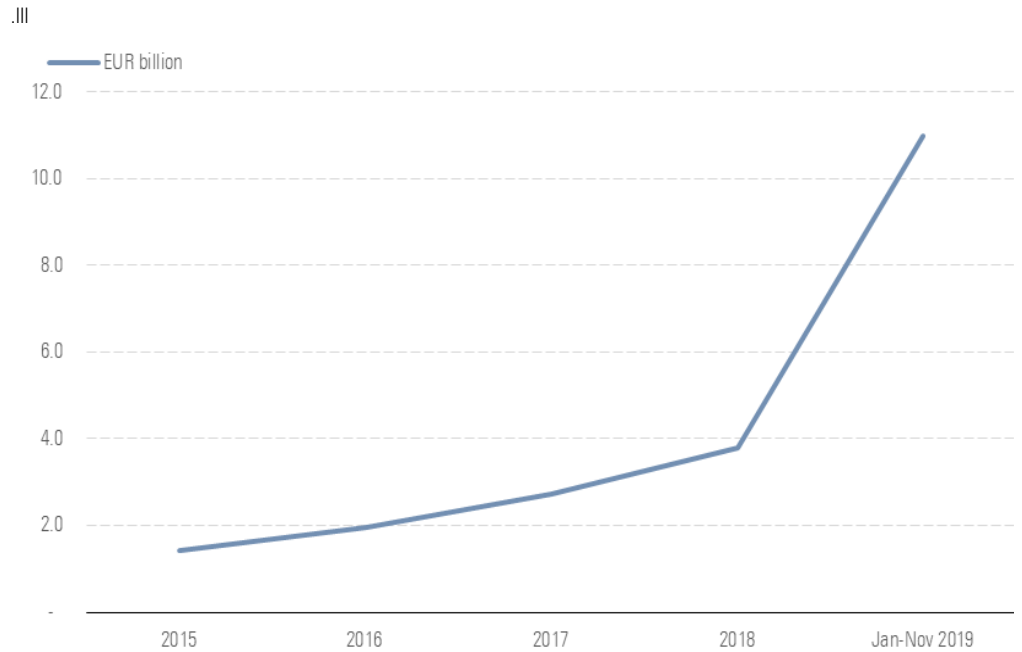
Looking at the passive-fund market alone, ESG represents only 2% of the assets in fixed income, while in equity it is 9%. As was the case with the development of the mainstream (that is, non-ESG) passive-fund market, equity has also had a clear head start compared with bonds when it comes to ESG. Many of the early equity ESG index funds came to market around the turn of the century and the first equity ESG ETF was launched in 2006. By contrast, the bulk of the current ESG bond passive-fund offering has been developed in the last three years.

In general, 2019 has been a good year for bond funds, and ESG passive-bond funds have benefited from this. Net flows in the period to the end of October totaled EUR 6 billion, almost six times the amount gathered in all of 2018.

1. This includes assets in active ETFs, such as Franklin Liberty Euro Green Bond ETF.

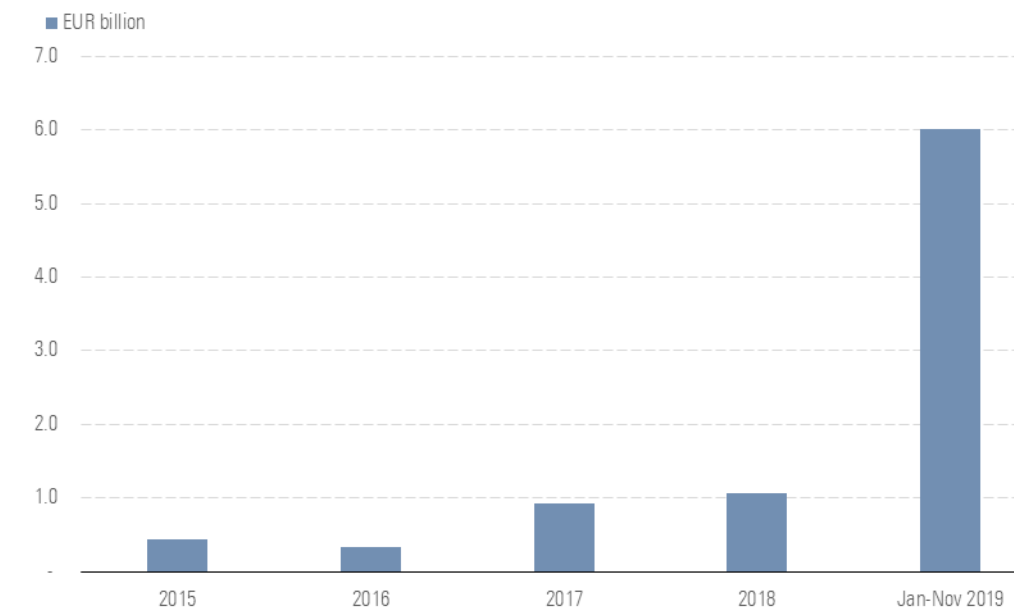
Meanwhile, assets have tripled from EUR 3.8 billion at the end of 2018, propelled by both money inflows and capital appreciation. In addition, at the end of August 2019, Lyxor switched the benchmark of the Lyxor Euro Corporate Bond ETF from the mainstream Markit iBoxx EUR Liquid Corporates 125 Mid Price TCA Index to the Bloomberg Barclays MSCI EUR Corporate Liquid SRI Sustainable Index. In one stroke, close to EUR 0.9 billion in assets went into the ESG bucket.

Exhibit 1 Assets in European-Domiciled Passive ESG Bond Funds (EUR billion)



Source: Morningstar Direct. Morningstar Research. Data as of 30/11/2019.

Exhibit 2 Net Flows to European-Domiciled Passive ESG Bond Funds (EUR billion)



Source: Morningstar Direct. Morningstar Research. Data as of 30/11/2019.

Growth prospects for ESG bond strategies are positive. ESG considerations are fast becoming key selection criteria for investors. The old-fashioned notion of ESG as a nice-to-have benefit is being replaced by a careful assessment of how good ESG credentials can mitigate investment risk and lead to improved performance over the long term. In the specific case of bonds, good management of ESG risks may make issuers more resilient and thus less vulnerable to credit-rating downgrades, or even worse, default. And this is what ultimately matters most to bond investors.

The expected growing demand for ESG bond solutions comes at time of rising popularity of low-cost passive funds. The conditions are thus ripe for expansion of the ESG passive-bond-fund offering in Europe—especially considering that fixed income has been identified as one of the key areas of growth in the coming decade by passive-fund providers.

Investment-Grade Corporate Bonds Dominate Product Offering

Investing according to ESG principles can be applied to both equities and bonds, as ultimately it is all about assessing the ESG credentials of the companies with whom we want to invest.

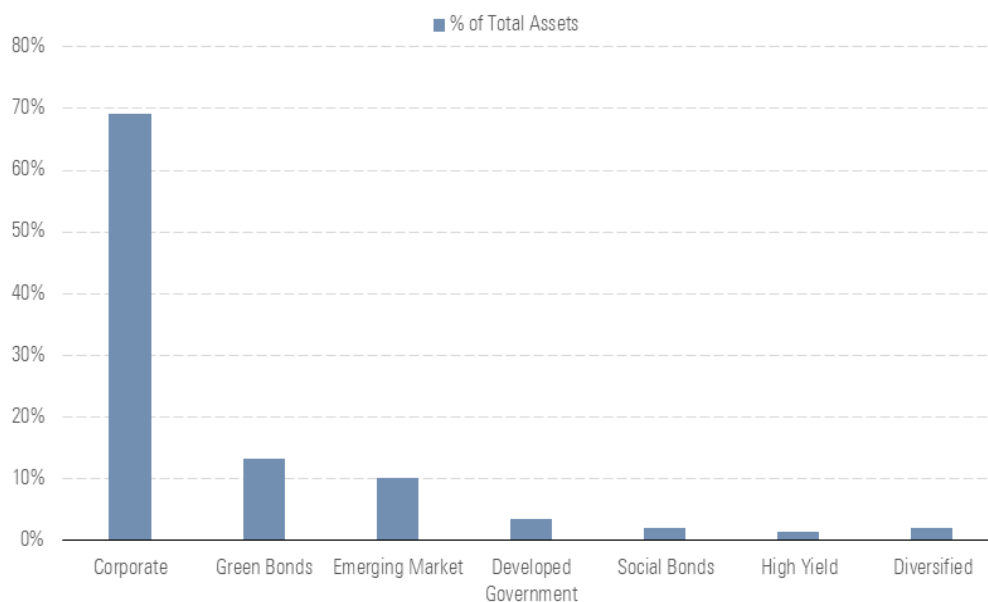
The challenge here is to carry out due diligence, which can be straightforward on large corporations but difficult on midsized and smaller companies due to the lack of resources needed to disclose a large amount of sustainability information. ESG-rating agencies themselves also may not have the resources to undertake relevant analysis. Historically, it has been easier to do due diligence on companies that carry an investment-grade rating than for those who do not, as the latter group typically falls short on disclosure.

While the availability and quality of ESG data remain an issue, progress has been made in recent years, allowing index providers to develop new indexes. In November 2019, iShares launched the first two high-yield bond ESG ETFs: iShares EUR High Yield Corporate Bond ESG ETF and iShares USD High Yield Bond Corporate Bond ESG ETF.

Still, at the time of writing, 17 of the 36 passive-bond ESG funds available for sale in Europe² were products focused on the investment-grade-rated corporate-bond market. Assets in these funds accounted for 68% of all the money invested in ESG passive-bond funds (see Exhibit 3).

Thirteen percent of total assets were in a group of five green-bond funds, while the four existing emerging-markets bond ESG passive funds gathered 10% of assets. We identified five funds with a focus on developed-government bonds (3.5% of assets). The only social-bond fund—UBS ETF Sustainable Development Bank Bonds—accounted for 2% of assets, and the remaining 2% was split between the two new iShares ESG high-yield bond ETFs and two Euro aggregate ESG bond offerings from Candriam.

2. See Annex 1 for a list of ESG bond passive funds available for sale in Europe.

Exhibit 3 Assets in ESG Passive Funds by Bond Market Exposure (% of total)

Source: Morningstar Direct. Morningstar Research. Data as of 30/11/2019.

Applying ESG criteria to governments is no easy matter, as there is a fine line between making an objective ESG assessment and straddling into political territory. Taking a stand against the policies of an elected government, even if rationalised from an ESG perspective, is something that individual investors may find easy to do; however, large asset managers or ESG-rating companies risk being accused of unduly interfering with a political process.

ESG assessment of governments is an area that is still a work in progress and remains largely based on social and macroeconomic indicators, like data on labour markets, educational standards, and social mobility.

It is fair to say that this approach has proved more successful for emerging markets rather than for developed sovereigns. This is partly because of the greater disparity in risk/return profiles and macroeconomic conditions between the large cohort of emerging-markets sovereign-bond issuers.

Also, in the case of developed sovereigns, applying ESG filters can lead to outcomes that are difficult to implement. For example, some ESG-conscious investors may consider some of the policies of the current U.S. administration—like the withdrawal from the Paris Climate Accord—to go against the most basic of ESG principles. Though, one must seriously consider the implications of excluding the largest-developed government-bond market in the world from a bond fund.

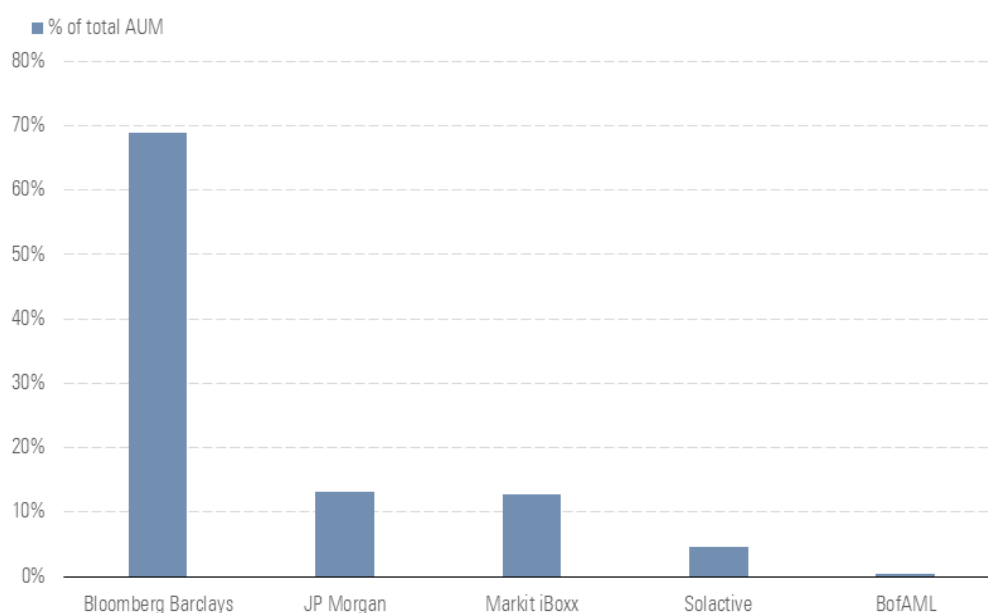
Aside from mainstream ESG bond offerings, investors are also interested in impact investing, such as green bonds or social bonds. Green bonds are issued to finance-specific environmental and climate projects. Green bonds are issued by corporations, governments, and supranational bodies such as the

World Bank or the European Investment Bank. Investor demand for green-bond funds is only expected to grow, and so we expect more green-bond passive funds to come to the market in the coming years.

Bulk of Assets Referenced to Bloomberg Barclays Indexes

Over two thirds (69%) of assets in European-domiciled passive-bond funds with an explicit ESG mandate are referenced to Bloomberg Barclays benchmarks. Other index houses are interested in a slice of this growing pie. Amongst these we find JPMorgan, Markit iBoxx, and Solactive.

Exhibit 4 Assets in ESG Passive Funds by Index Provider (% of total)



Source: Morningstar Direct, Morningstar Research. Data as of 30/11/2019.

Bloomberg Barclays is the dominant force in ESG bond indexes for developed markets. Bloomberg Barclays and MSCI have joined forces in the development of ESG bond indexes, the former providing the expertise on bond-index construction, while the latter provides the framework to screen-issuers on ESG criteria.

As is the case with mainstream emerging-markets bond exposure, JPMorgan is also the go-to house for indexes with an ESG focus. Currently, all four European-domiciled ESG passive emerging-markets bond funds are referenced to indexes produced by JPMorgan.

Most bond-index providers also offer thematic benchmarks to fit the specific mandates of impact-bond funds, such as green bonds or microfinance. Examples include the Bloomberg Barclays Global Green Bond Index tracked by iShares Green Bond Index Fund, the largest green-bond passive fund in Europe.

ESG Doesn't Have to Mean Sacrificing Performance

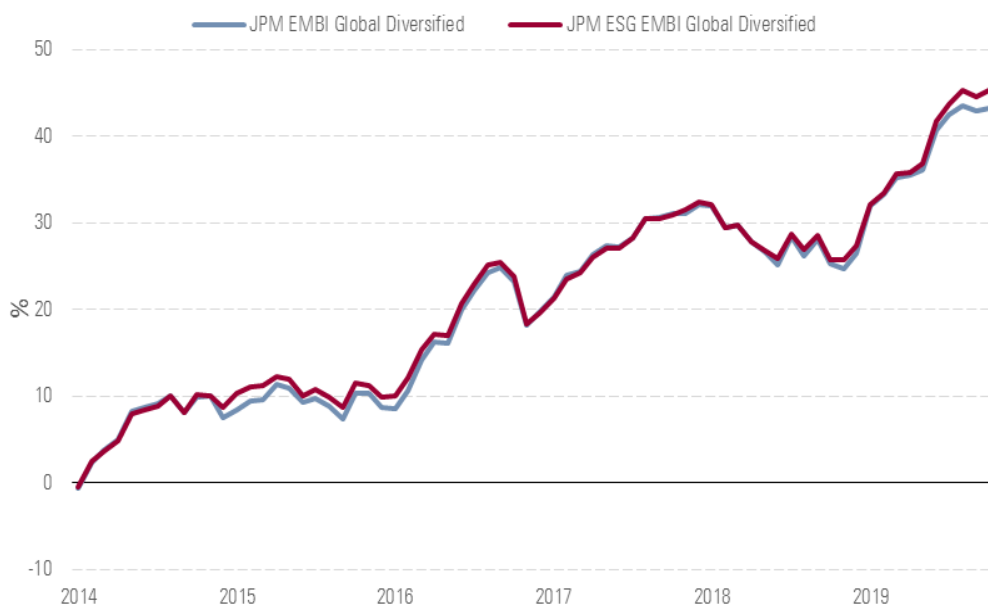
When it comes to broad ESG bond indexes, the analysis of performance shows that they have closely mirrored the overall risk/return characteristics of their non-ESG-screened parents.

In May 2019, we issued a Morningstar Analyst Rating™ of Bronze to three ESG corporate-bond passive funds domiciled in Europe: State Street EUR Sustainable Corporate Bond Index Fund, UBS ETF Bloomberg MSCI European Liquid Corporate Sustainable, and UBS ETF Bloomberg Barclays MSCI US Liquid Corporate Sustainable. This is the same rating typically awarded to mainstream corporate-bond passive funds.

The analysis we carried out for these funds showed a similar level of diversification across sectors and maturity than their non-ESG counterparts. The main difference was one of a slight quality tilt in the ESG portfolios, as measured by the distribution of credit ratings of the index constituents. Intuitively, this should not come as a surprise if one accepts that addressing ESG risks can help buffet issuers over the long term. The quality tilt may make ESG bond funds lag relative to the broad universe during risk-on market phases. By the same token, it may help it to cushion the downside when the tables turn.

Similar return profiles are also found beyond the area of developed-markets bonds. For example, Exhibit 5 shows the historical returns of the ESG and mainstream versions of the JPMorgan EMBI Global Diversified from inception of the ESG index to the end of October 2019.

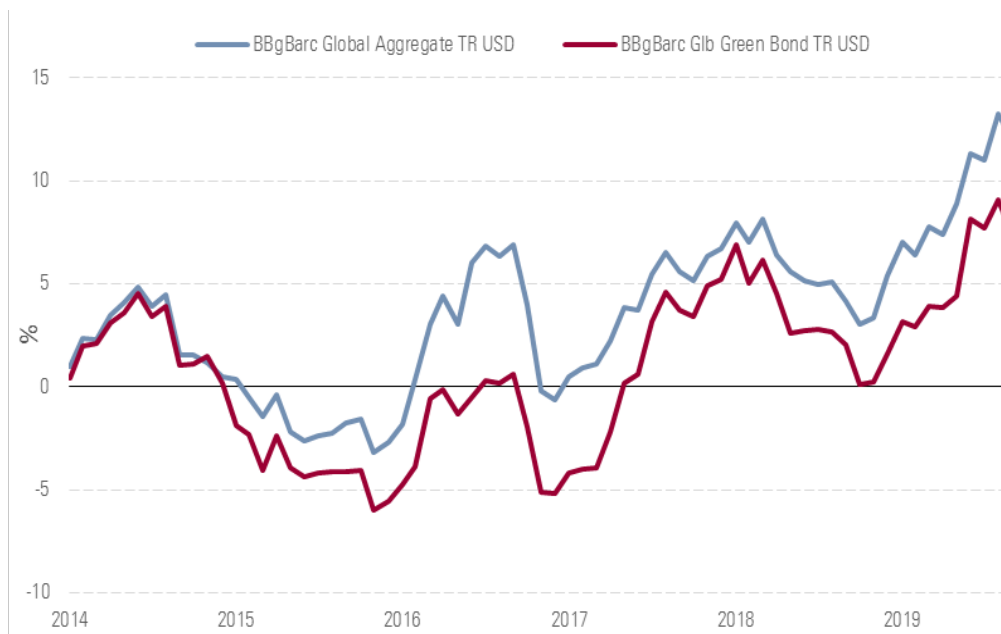
Exhibit 5 Historical Returns of ESG and non-ESG Emerging Markets Bond Indexes



Source: Morningstar Direct. Data as of 30/11/2019.

It is only once we move from broad ESG bond propositions to impact funds, such as green bonds, that we observe significant differences in performance relative to the non-ESG-screened wider bond universe (see Exhibit 6). But this is to be expected given the very different nature of the two investment propositions.

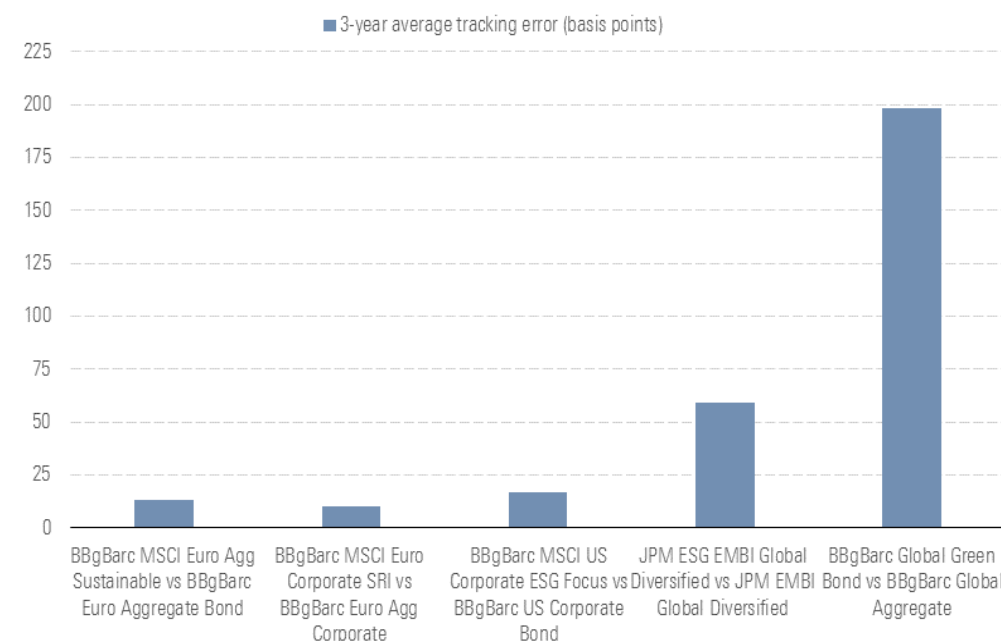
Exhibit 6 Historical Returns of Green Bond and Global Aggregate Bond Indexes



Source: Morningstar Direct. Data as of 30/11/2019.

The analysis of tracking error between broad ESG and non-ESG indexes further helps to understand how closely they resemble each other. Exhibit 7 shows the 12-month rolling average tracking error between ESG and conventional bond indexes for a variety of market exposures for the past three years.

Exhibit 7 3-Year Average Tracking Error Calculations (basis points)



Source: Morningstar Direct. Data as of 30/11/2019.

In the case of developed bond markets, the calculated tracking error came in a tight narrowband of 10-20 basis points. For emerging-markets bond exposure, it was higher at around 60 basis points. But as shown in Exhibit 5, the differences in constituents as a result of the ESG screening have not resulted in divergent return profiles between the two indexes over the past few years.

By contrast, the calculated tracking error between the global green-bond index and the wider, conventional bond universe was around 200 basis points. This demonstrates the peculiar characteristics of impact-bond indexes—and thus the passive funds that track them—as investment propositions.

This makes impact-bond funds—passive or active—hard to assess against broad-based bond mandates. This is not to say that investors in impact-bond funds do not aspire to positive returns; but this is an area where investor success may be more closely related to whether the environmental and social programs that these bonds finance have been properly executed.

Conclusion

The market of ESG passive-bond funds in Europe remains small and underdeveloped compared with equity. Most fund launches have taken place in the last three years, and the bulk of the product offering and assets is in investment-grade corporate bonds. However, developments in indexing are already translating into a wider choice of bond-market exposures.

Prospects are positive. ESG considerations are becoming key for investors as they see that the management of ESG risks can make bond issuers more resilient and less vulnerable to rating downgrades and default. Besides, there is a growing awareness that ESG does not have to mean sacrificing performance. In fact, broad ESG bond indexes have closely mirrored the overall risk/return characteristics of their non-ESG-screened parents.

All the while, the popularity of low-cost passive solutions continues to rise, and fixed income is one of the target areas of growth for passive fund providers in the coming decade. All these factors bode well for expansion of the ESG-bond passive-product lineup and asset growth. ■■

Annex 1 List of European-Domiciled Funds with Explicit ESG Mandate

Name	Inception Date	ESG Conversion Date	Investment Type	Morningstar Category	Bond Market	Provider
Amundi Index US Corp SRI	24/04/2018		Open-End & ETF	EAA Fund USD Corporate Bond	IG Corporate	Amundi
Amundi IS Euro AGG Corporate SRI	14/04/2014	29/10/2018	Open-End & ETF	EAA Fund EUR Corporate Bond	IG Corporate	Amundi
BNPP E € Cp Bd SRI Fsl Fr 1-3Y	04/10/2019		Open-End & ETF	EAA Fund EUR Corporate Bond - Short Term	IG Corporate	BNP Paribas
BNPP E € Cp Bd SRI Fsl Fr 3-5Y	04/10/2019		Open-End & ETF	EAA Fund EUR Corporate Bond	IG Corporate	BNP Paribas
BNPP Easy €Corp Bd SRI Fssl Fr Trk	15/01/2019		Open-End & ETF	EAA Fund EUR Corporate Bond	IG Corporate	BNP Paribas
Cleome Index Euro Corp Bds	31/03/2017		Open-End	EAA Fund EUR Corporate Bond	IG Corporate	Candriam
Cordius Index Euro Corporate Bonds	16/09/2010		Open-End	EAA Fund EUR Corporate Bond	IG Corporate	Candriam
IndexIQ Factors Sust Corp EUR Bd ETF	28/06/2017		ETF	EAA Fund EUR Corporate Bond	IG Corporate	Candriam
iShares \$ CorpBd 0-3y ESG UCITS ETF	12/12/2018		ETF	EAA Fund USD Corporate Bond	IG Corporate	iShares
iShares € Corp Bond ESG ETF	27/06/2018		ETF	EAA Fund EUR Corporate Bond	IG Corporate	iShares
iShares € Corp Bond SRI 0-3yr ETF	07/01/2016		ETF	EAA Fund EUR Corporate Bond - Short Term	IG Corporate	iShares
Lyxor Euro Corporate Bond ETF	04/02/2009	26/08/2019	ETF	EAA Fund EUR Corporate Bond	IG Corporate	Lyxor
Stt Strt EUR Sust Corp Bd Idx	16/05/2011		Open-End	EAA Fund EUR Corporate Bond	IG Corporate	State Street
UBS ETF BBMSCI €ArLiQ CorpSust	17/01/2017		ETF	EAA Fund EUR Corporate Bond	IG Corporate	UBS
UBS ETF BlombgBarcIMSCI USLqCpSu	23/07/2015		ETF	EAA Fund USD Corporate Bond	IG Corporate	UBS
Vanguard SRI Euro IG Bd Idx	18/07/2017		Open-End	EAA Fund EUR Corporate Bond	IG Corporate	Vanguard
Xtrackers II ESG EUR CorpoRt Bd ETF	18/10/2010	27/09/2016	ETF	EAA Fund EUR Corporate Bond	IG Corporate	Xtrackers
BNPP E JPM ESG EMBI GI Dvr Cmps Trk	26/02/2016		Open-End	EAA Fund Global Emerging Markets Bond	Emerging Markets	BNP Paribas
iShares JP Morgan ESG \$ EM Bd ETF	24/09/2018		ETF	EAA Fund Global Emerging Markets Bond	Emerging Markets	iShares
Stt Strt EM ESG LclCcyGvtBdIdx	19/08/2019		Open-End	EAA Fund Global Emerging Markets Bond - Local Currency	Emerging Markets	State Street
UBS ETF JPM USD EM IG ESGDvrsBd	02/08/2019		ETF	EAA Fund Global Emerging Markets Bond	Emerging Markets	UBS
Cleome Index Euro Govt Bds	31/03/2017		Open-End	EAA Fund EUR Government Bond	Government	Candriam
Cleome Index Euro Shrt Tm Bds	31/03/2017		Open-End	EAA Fund EUR Government Bond - Short Term	Government	Candriam
Cordius Index Euro Bonds	08/01/2008		Open-End	EAA Fund EUR Government Bond	Government	Candriam
IndexIQ Factors Sust Sov EUR Bd ETF	28/06/2017		ETF	EAA Fund EUR Government Bond	Government	Candriam
UBS ETF JPM Gbl Govt ESG LiqdBd	01/10/2019		ETF	EAA Fund Global Bond	Government	UBS
Candriam SRI Bond Eur Aggt Idx	24/03/2017		Open-End	EAA Fund EUR Diversified Bond	Diversified	Candriam
Cleome Index Euro Long Tm Bds	31/03/2017		Open-End	EAA Fund EUR Bond - Long Term	Diversified	Candriam
CSIF (Lux) Bond Green Bd Gbl Blue	15/04/2019		Open-End	EAA Fund Global Bond	Green Bonds	Credit Suisse
iShares Green Bd Idx (IE)	16/03/2017		Open-End	EAA Fund Global Bond	Green Bonds	iShares
Lyxor Green Bond (DR) ETF	21/02/2017		ETF	EAA Fund Global Corporate Bond	Green Bonds	Lyxor
Lyxor Green Bond Esg Screened ETF	13/09/2019		ETF	EAA Fund Global Corporate Bond	Green Bonds	Lyxor
UC MSCI European Green Bond EUR ETF	20/11/2018		ETF	EAA Fund EUR Diversified Bond	Green Bonds	Structured Invest
iShares € HY Corp Bd ESG ETF	12/11/2019		ETF	EAA Fund EUR High Yield Bond	High Yield	iShares
iShares \$ HY Corp Bd ESG ETF	12/11/2019		ETF	EAA Fund USD High Yield Bond	High Yield	iShares
UBS ETF Sust Devpmt Bk Bds (USD)	08/11/2018		ETF	EAA Fund USD Government Bond	Social Bonds	UBS

Source: Morningstar Direct, Morningstar Research. Data as of 30/11/2019.

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