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Integrating ESG in your credit portfolio

UBS ETFs On Track Research

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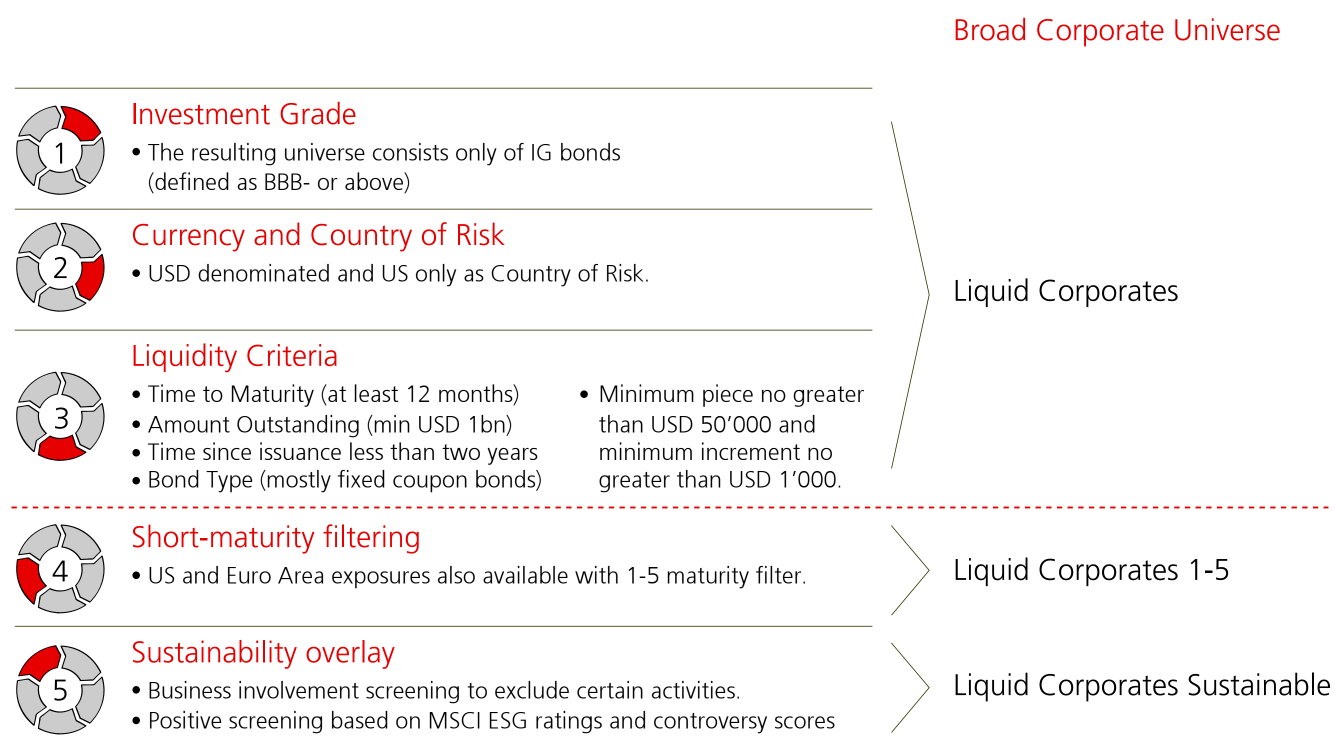
Corporate bonds represent a key component in many investors' portfolios. With an investment universe that is vast and heterogenous, a well-constructed approach plays a key role in building a sustainable corporate exposure. We will showcase how our sustainable approach allows investors to achieve various ESG improvements while keeping a limited tracking error.

A multi-layer approach

Before discussing ESG integration, let us start by focusing on the different steps that are required to create the Liquid Corporates universe. As shown on Figure 1, we first apply a credit filter that excludes all issuers which are not Investment Grade. In a second step, we filter issuers for which the currency and country of risk are different. By taking the US exposure as an example, we select only bonds denominated in USD and from issuers that have the United States as country of risk. This step is important, as it allows our solutions to avoid unwanted issuer or country risks. In a third and final step, we apply a broad set of criteria to further enhance the selection and to focus on the most liquid issuers of the remaining universe.

The Liquid Corporates universe that is created with the steps described above serves as the basis for our UBS Bloomberg family of indices. From this universe, we can derive shorter duration solutions by applying a 1 to 5 years maturity filter, as well as also being able to create sustainable versions as we will demonstrate in the next section.

Figure 1: Bloomberg US Liquid Corporates index framework



Source: Bloomberg MSCI, UBS Asset Management. For illustration purposes only.

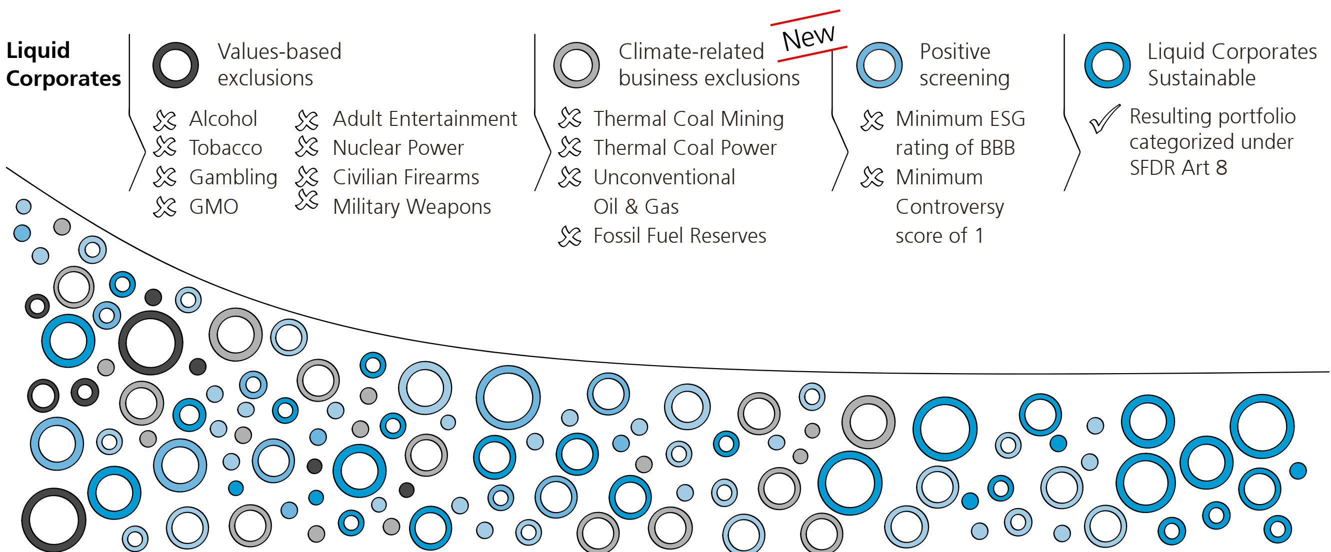
Sustainability integration

Using the Liquid Corporates universe that we have described previously as a starting universe, we can create a sustainable version that integrates ESG characteristics to further refine the bond selection process. The process to create the sustainable version of the Liquid Corporates follows a multi-step approach, that combines business-involvement exclusions and ESG-based exclusions. The first values-based exclusions are designed to exclude issuers tied to activities seen as controversial, such as Weapons, Tobacco and Alcohol to name a few. In a second step, as climate change is becoming an ever increasing concern for investors, the methodology excludes issuers involved in a broad set of activities that are more impactful for the environment (e.g. Thermal Coal mining and Unconventional Oil & Gas).

As we will see later on, this reduces the carbon intensity of the final portfolio compared to its starting universe. Finally, only issuers with a minimum MSCI ESG rating of BBB (and above) and an MSCI ESG Controversy score of 1 (and above) are selected for inclusion in the final index.

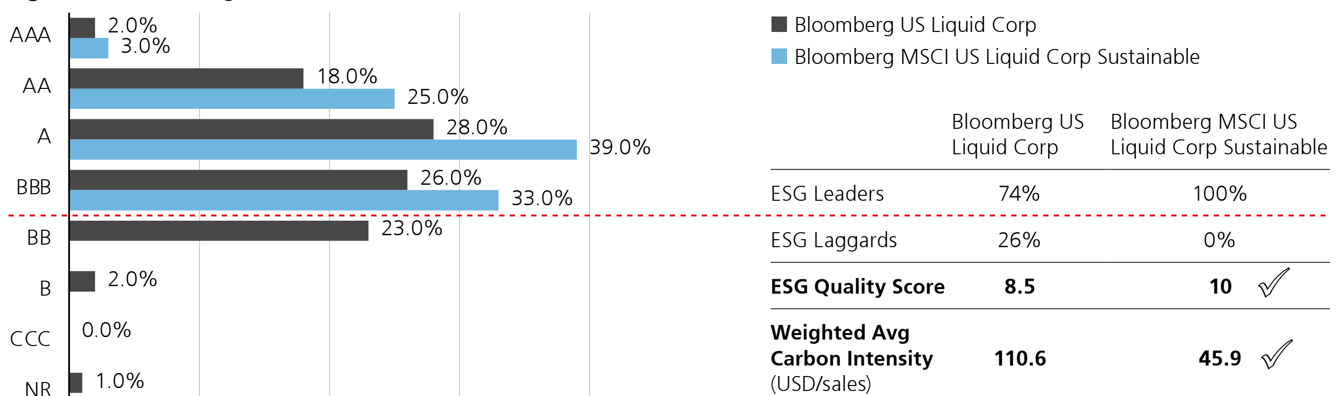
While the impact of ESG integration on an equity index has been well documented, what is the impact of these ESG screens on the characteristics of a credit portfolio? Keeping the example of the US exposure (Bloomberg MSCI US Liquid Corporates Sustainable index), if we start with ESG metrics in Figure 3, we can observe that removing the worst ESG-rated issuers results in an improved ESG Quality Score for the sustainable index compared to the non-sustainable version.

Figure 2: Bloomberg MSCI Liquid Corporates Sustainable methodology



Source: Bloomberg, MSCI, UBS Asset Management. For illustrative purposes only.

Figure 3: ESG Rating distribution



	Bloomberg US Liquid Corp	Bloomberg MSCI US Liquid Corp Sustainable
ESG Leaders	74%	100%
ESG Laggards	26%	0%
ESG Quality Score	**8.5**	**10** ✓
Weighted Avg Carbon Intensity (USD/sales)	**110.6**	**45.9** ✓

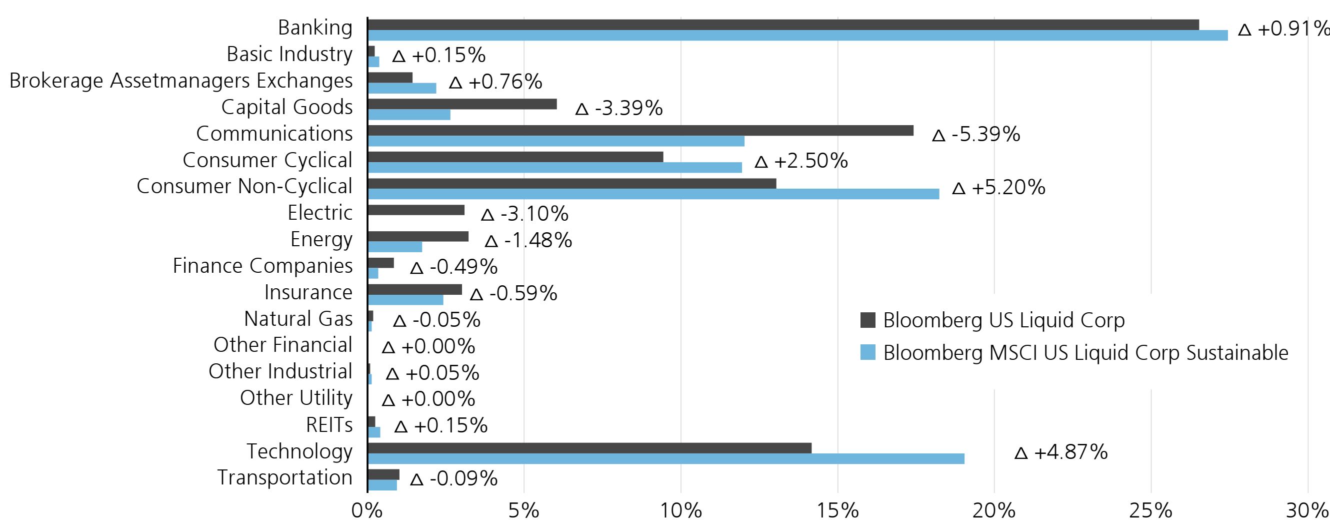
Source: Bloomberg, MSCI, UBS Asset Management. Data as of 29 April 2022. ESG Ratings as of 9 May 2022.

As we alluded to earlier, the exclusion of certain carbon intense activities reduces the carbon intensity of the sustainable index compared to its parent counterpart in a substantial manner (-58%). As one would expect, most companies that are captured by climate-change related exclusions are part of the "Energy" and "Electric" sectors. If we look at the sector breakdown in more detail in Figure 4, we see that the sector composition of the ESG index is kept broadly in line with the parent. Having said that, there are a few exceptions in certain sectors where the underweight is driven by the exclusion of large issuers that have a 'BB' ESG rating.

Considering the sustainability improvements and the sector composition mentioned above, it is also interesting to analyze how the ESG overlay influences more traditional metrics. As shown in Figure 5, the Yield-to-Worst and modified duration are comparable between the sustainable and the standard version, while credit rating appears to be higher for the ESG portfolio. This can be explained by the slightly positive relationship that is present between ESG ratings and credit ratings, such that a company with a superior credit rating tends to also exhibit a higher ESG rating (and vice versa).

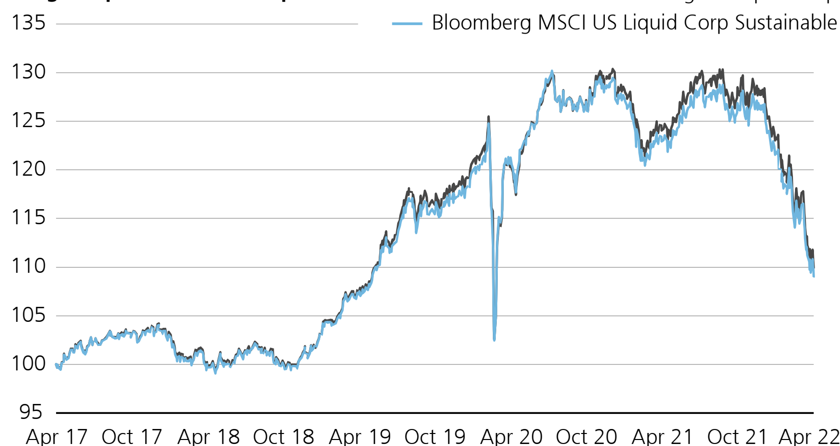
Thanks to these metrics being in line between the sustainable and the standard portfolio, the tracking error is relatively limited at 56bps. This confirms how a well-constructed sustainable approach allows clients to add an ESG overlay without changing the nature of the exposure. Similar results can also be found when focusing on the Euro Area exposure (Bloomberg MSCI Euro Area Liquid Corporates Sustainable index).

Figure 4: Sector Comparison



Source: Bloomberg, UBS Asset Management. Data as of 29 April 2022.

Figure 5: Index performance and characteristics



Source: Bloomberg, UBS Asset Management. Data from 28 April 2017 to 29 April 2022.
Please note that past performance is not a guide to the future.

Key parameters of the US Liquid Corporates Sustainable Bond

56bps
Tracking Error (daily) Apr 2017 – Apr 2022

-90bps
Tracking difference Apr 2017 – Apr 2022

0.997
Correlation in daily returns Apr 2017 – Apr 2022

4.22 (vs 4.36)
Yield to worst April 2022

8.40 (vs 8.56)
Modified Duration April 2022

A2/A3 (vs A3/BAA1)
Rating: (Middle rating of Moodys/S&P/Fitch) April 2022

Does focusing on the shorter end of the curve matter?

In periods of high uncertainty regarding potential increases in interest rates, many clients look for ways to reduce the interest rate risk of their portfolio to partially offset the negative effect that higher yields have on bond prices. To offer a solution that clients could use in such challenging environments, UBS recently launched two ETFs tracking the Liquid Corporates 1-5 Year Sustainable segment of the credit market (US and Euro-Area). Given that the Liquid Corporates 1-5 Year Sustainable index is built on the same concept outlined in the previous section, it allows us to analyze whether the results shown in the previous paragraphs are valid regardless of the portfolio duration profile.

In Figure 6 we compare the short-maturity indexes to the full maturity standard index and, as expected, we can see that the short-maturity version (1-5 Year) offers lower duration and lower yield compared to the standard Liquid Corporates exposure. In addition to these key characteristics, we can also see how the short-maturity approach appears to be a more risk-mitigating exposure, having offered less returns but paired with substantially lower volatility.

This dynamic suggests how the two solutions could potentially fit clients with different risk profiles or could be used during different market cycles.

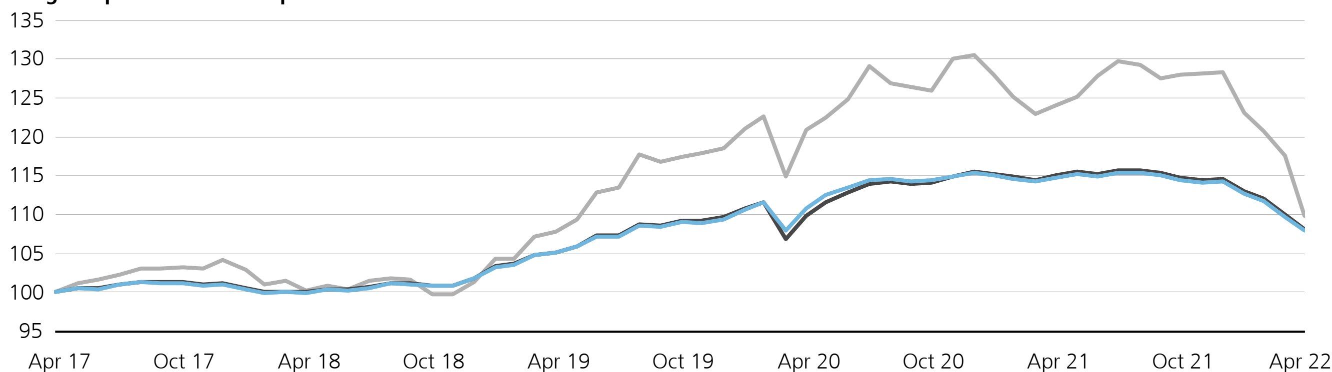
If we compare the Liquid Corporates 1-5 Sustainable index and its parent, we can see that, in line with our previous results, the ESG integration has only a small impact since all metrics (e.g. yield, duration and credit quality) are roughly in line between the Liquid Corporates 1-5 Index and its ESG variant.

Finally, looking at the sustainability metrics, we can see how the ESG overlay when applied to a portfolio that focuses on bonds with shorter maturity, offers substantial improvements in terms of ESG quality score and reduced carbon footprint.

In summary, these results confirm how a well-constructed sustainability overlay can offer ESG improvements while not changing the nature of the portfolio, and this being true regardless of portfolio duration (full-maturity or 1-5 Years) and geography (US or Euro Area).

Figure 6: Index performance and characteristics

Long run performance comparison



	Bloomberg US Liquid Corp	Bloomberg US Liquid Corp 1-5 Year	Bloomberg MSCI US Liquid Corp 1-5 Year Sustainable
Returns p.a.	1.91%	1.58%	1.53%
Volatility p.a.	7.30%	3.36%	2.99%
Option-Adj Duration	8.56	2.94	2.95
Yield To Worst	4.36	3.86	3.69
Credit Rating[1]	A3/BAA1	A2/A3	A2/A3
MSCI ESG Quality Score	8.5	9.6	10
Weighted Avg Carbon Intensity (USD/sales)	110.6	107.9	27.3

1 Middle rating of Moodys/S&P/Fitch

Source: Bloomberg, MSCI, UBS Asset Management. Data from 28 April 2017 to 29 April 2022.
Includes backtested data. Past performance is not a reliable indicator of future results.

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