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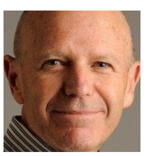
Sustainable Research's Shilling on ESG Bond Funds

This month, ***Bond Fund Intelligence*** interviews **Henry Shilling**, Director of Research at **Sustainable Research & Analysis LLC** (www.sustainableinvest.com). **We discuss the growing trend of ESG, or environmental, social and governance factors in bond funds and fixed-income investing.** Our Q&A follows.

BFI: *Give us some history.*

Shilling: SRA is an independent provider of research that's focused on sustainable investing for the benefit of institutional investors. **The focus is to monitor, analyze and report on this sector through the lens of mutual funds and ETFs that characterize themselves as sustainable, or as sustainable investment vehicles.** [We saw] an information gap developing between the implementation of these strategies and reporting and disclosure…. I started this forum two and a half years ago after I left **Moody's**, where I'd spent 25 years.



Henry Shilling

BFI: Talk about ESG bond funds.

Shilling: At the end of 2019, mutual funds and ETFs that have adopted some form of sustainable investing … reached an all-time high of $1.6 trillion. That represents about 6.3% of the [overall] fund industry…. **Taxable and municipal bond funds stood at $339.3 billion at the end of 2019 and now account for 21% of sustainable fund assets**…. The growth of sustainable investment funds, both taxable and municipal, accelerated in 2019 when a number of large conventional money management firms re-branded sizable fixed income portfolios. Fund firms such as **Hartford, JPMorgan, MFS, Eaton Vance and Franklin Templeton** contributed meaningfully.

As an aside, at year-end 2019, money market funds reached almost $300 billion and now account for 19% of the segment's assets. Fixed income funds and money market funds now make up 40% of sustainable fund assets.

Most practitioners agree that ESG refers to one of several strategies that make up sustainable investing. It happens that ESG integration is the fastest growing strategy. When we talk about sustainable investing and sustainable funds, there is a lot of confusion and misunderstanding that has become common in the space. So it's important to start the discussion by defining what is meant by these terms. When used here, **sustainable investing refers to an overarching approach that encapsulates a variety of different strategies ranging from values-based investing, negative screening or exclusions, impact and thematic investing to ESG integration**. [T]hese may be combined with active investee engagement and proxy voting initiatives.

Values-based investing, which also goes by the label of ethical investing, social investing or religious investing, typically relies on screening out selected industries and companies that produce products or services such as tobacco, alcohol, or more recently coal mines and fossil fuel companies. **Negative screening and exclusions can also be applied in concert with other forms of sustainable strategies, such as impact investing, thematic investing and ESG integration.**

According to the **CFA Institute**, **ESG integration refers to the accounting of environmental, social and governance risks and opportunities in a consistent and systematic manner**, where these are considered to be relevant and material to investment decision making. That said, it seems that **the term has been hijacked to more broadly describe sustainable investing strategies** and because of this, **there is growing confusion around these various strategies**.

Then lastly, it should be noted that **sustainable investing also encapsulates strategies that involve engagement with the investee companies as well as proxy voting**. These are not mutually exclusive strategies, and they can be applied singularly or in combination. So, when you think about these strategies, and you identify funds and ETFs that have taken on board one or more of these strategies by **explicitly adopting language in their prospectus** … that's how you get to the $1.6 trillion figure. **The strategy may not be reflected in the fund's name, but it is explicitly called out in the fund's prospectus or statement of additional information.** Funds have been rebranding themselves to reflect the adoption of these strategies, so that there are now about 1,000 funds in this segment.

BFI: *What about green bonds?*

Shilling: Well, green bonds and green bond funds fall into the category of impact and thematic investing. **By the end of 2019, seven fund firms offered green bond funds, including Allianz, Calvert, which was the first to introduce a green bond fund back in 2013, BlackRock's iShares, Mirova, TIAA-CREF and VanEck.** In late 2019, **Franklin Templeton** launched the first green municipal bond fund, and PIMCO has announced plans to launch a green bond fund.

BFI: *Talk about the strategies.*

Shilling: In fixed income, **the dominant strategy as of year-end involves intermediate-term investment grade funds (both intermediate core and core plus) that have adopted ESG integration approaches**. These funds managed $88.4 billion or 26.1% of the sustainable fixed income segment. (See the table on p.2 for the 10 largest funds and their corresponding ESG strategies.)

The next three largest categories,

(Continued on page 2)

(*Sustainable Research* from p.1)

again dominated by funds that have integrated ESG or may integrate ESG, include **non-traditional bond funds** with $44.3 billion in assets, or 13.1%; **ultra-short bond funds** with $24.3 billion, or 7.2%; and **high yield taxable bond funds** with $23.6 billion or 7%.

BFI: *Who is analyzing funds?*
Shilling: Morningstar is probably the biggest player, using a system of globes that range from 1-5 and relying on scores produced by **Sustainalytics**.... **MSCI**, which also scores companies, likewise applies tits scores to mutual funds based on their holdings. More recently, **Refinitiv** announced plans to rate mutual funds based on ESG company scores.

BFI: *Do you think the space will grow?*
Shilling: I think the space in general will continue to gain momentum.... We've already seen assets grow substantially between year-end 2019 and the end of February, rising to $1.8 trillion, and that will continue, notwithstanding perhaps temporary dislocations because of the coronavirus.

In large part, the growth that we observed in 2019 was attributable to rebrandings, taking existing funds and adopting sustainable investment language.... But in the process of this exponential growth, **issues have arisen**.... To address these, **there will likely be various initiatives either on the regulatory front or voluntary side to try to standardize terms, definitions and disclosures**.

This is already taking place in Europe, and in the U.S., **the SEC just last week issued a Request for Comment seeking input on the framework for addressing names of registered investment companies, including funds that reference ESG and or the term sustainable in their names**. The SEC is seeking to determine whether the existing rule is effective in prohibiting funds from using names that are materially deceptive or misleading, and whether there are alternatives that the Commission should consider. ◈

Ten largest intermediate investment-grade sustainable fixed income funds and their sustainable investing strategies (Funds listed in alphabetical order)

Fund	Symbol	Size* ($ M)	Sustainable Investing Approach
BMO TCH Core Plus Bond I	MCBIX	1,090.7	ESG integration
Calvert Bond I	CBDIX	1,759.2	ESG integration, negative screening (exclusions), impact, engagement
Hartford Total Return Bond A	ITBAX	2,184.7	ESG integration
JPMorgan Core Bond R6	JCBUX	31,850.3	ESG integration, engagement
Morgan Stanley Inst Core PlsFxdInc Instl	MPFIX	737	ESG integration, engagement
Pax Core Bond Fund Institutional	PXBIX	708	ESG integration, negative screening (exclusions), impact, engagement
PIMCO Total Return ESG Institutional	PTSAX	1,447.3	ESG integration, engagement
Praxis Impact Bond I	MIIIX	586.6	ESG integration, negative screening (exclusions)
TIAA-CREF Social Choice Bond Instl	TSBIX	4,681.9	ESG integration, negative screening (exclusions), impact, engagement
Transamerica Intermediate Bond I2	None	2,508.8	ESG integration
Total		47,554.5	

Notes of Explanation: *Funds/share classes listed in size order as of December 31, 2019 applicable to the entire fund. Fund A source: STEELE Mutual Fund Expert, Morningstar data. Sustainable investing approach research and analysis by Sustainable and Analysis, based on prospectus and SAI filings.

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