The SFDR Article 8 Label's Impact on Fixed-Income Funds With Morningstar Analyst Ratings

Morningstar Manager Research
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All ratings mentioned in the text refer to the fund's representative clean share class.

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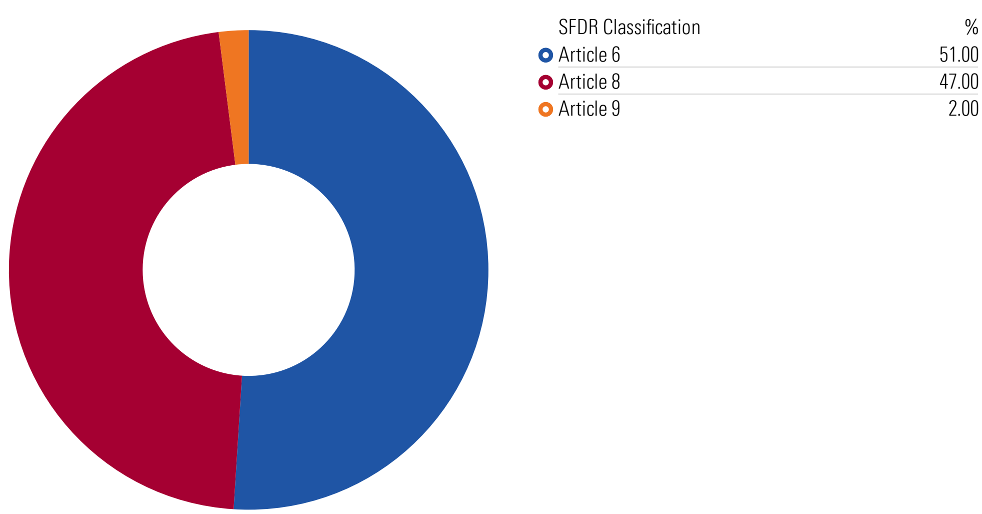
Article 8 Transition and Drivers for Fixed-Income Funds Rated by Morningstar Analysts

Since the SFDR regulation came into effect in March 2021, only a small fraction of the universe of fixed-income funds with Morningstar Analyst Ratings have been classified as Article 9. These typically include strategies focused on green, social, or climate bonds, or thematic funds focused on the United Nations Sustainable Development Goals or meeting low-carbon targets. Most funds that embed environmental, social, and governance factors into their investment processes and have diversified sector and allocation profiles have been classified as Article 8. According to the SFDR regulation, Article 8 refers to financial products that promote "among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices."

Exhibit 1 SFDR Classification by AUM for Fixed-Income Strategies With Morningstar Analyst Ratings



Source: Morningstar Direct. Data as of 5 May 2022.

There are two main drivers that have led to the Article 8 transition for an increasing number of funds. The first is client demand, especially from European institutional investors for which ESG factors are of increasing importance. Second, several asset managers have been putting emphasis on developing tools and systems that integrate ESG factors into their investment processes, while also hiring ESG-dedicated teams that provide support and guidance to fund managers and analysts on how to embed ESG into investment processes. It should be noted that as fund groups assign the designation, there are differences on the level of ESG implementation when taking a qualitative view on the Article 8 cohort. We have examined the impact that the Article 8 designation has had on some of our rated European-domiciled fixed-income strategies' portfolio positioning and how ESG is embedded into their investment processes, while also assessing the expected impact on risk/return characteristics of these funds going forward.

Impact on Fund Positioning at the Time of Article 8 Transition

The transition to Article 8 did not have a significant impact on portfolio composition. Most funds had exit 2% to 5% of their portfolios. These were typically so-called "value-based" exclusions of holdings that generate revenues from controversial sectors such as thermal coal, controversial weapons, tobacco, alcohol, and gambling. Another set of exclusions that some managers implemented were norms-based and impacted companies that were included on the list of UN Global Compact violators, were classified as Freedom House fails, or operate in jurisdictions that are considered to be high-risk from an ESG perspective. Overall, examples of corporate holdings that have been exited include **Anglo American**, **Gazprom**, **Glencore**, **Vale**, **Altria**, **British American Tobacco**, **Raytheon Technologies**, **Greene King**, **Volkswagen**, and **Bayer**. Examples of sovereigns that are considered high ESG risk for some managers include Russia, Saudi Arabia, China, Turkey, and Venezuela.

As part of the Article 8 designation, the proportion of the funds' respective benchmarks that was excluded from the investment universe ranged between 1% and 6%. The proportion excluded was higher for corporate-bond-biased strategies as opposed to strategies that use developed-markets sovereign-bond benchmarks.

How Are Managers Embedding ESG Integration Into Their Investment Processes

Besides the exclusions mentioned above, over the years, and in some cases well in advance of the Article 8 classification, several of our rated funds have been integrating ESG factors into their investment process in order to achieve a more ESG-friendly profile, higher ESG scores, and lower carbon emissions than their benchmarks and competitors. For the large majority of our rated fixed-income managers, ESG factors are fully embedded in fundamental bottom-up analysis undertaken by credit analysts and fund managers. Funds typically use a combination of ESG data from third-party providers and their own proprietary internal ESG scores. Additionally, ESG specialists within most of our rated funds are driving engagement processes with companies to ensure they are moving in a positive direction and that potential ESG weaknesses are addressed. Detailed ESG analysis on holdings is used as a source to capture alpha in companies that are ESG leaders in their respective sectors or are on a positive ESG trajectory, but also as a source of managing and mitigating risk by avoiding companies that are ESG laggards.

Impact on Flexibility and Alpha Sources

Most of our rated managers believe the Article 8-related positioning and process changes will not have an impact on the flexibility of their investment process and availability of alpha sources.

Neutral-rated **JPMorgan Global Corporate Bond** adjusted allocation parameters to counterbalance the impact of exclusions on the flexibility of its mandate. It increased its allocation limit to high-yield bonds and contingent convertibles (bringing it also in line with peers). The managers of Bronze-rated **BlueBay Investment Grade Bond** have been trying to substitute tobacco with other noncyclical sectors that behave in a similar way, such as healthcare and beverages. Overall, managers do not feel constrained by the exclusions and ESG integration implemented into their processes.

Emergence of ESG Versions of Flagship Funds

Some managers have classified their long-standing flagship funds as Article 6, while launching ESG-versions with an Article 8 designation. One example is Silver-rated **Jupiter Dynamic Bond**, which launched an Article 8 version in January 2022 (**Jupiter Dynamic Bond ESG**) in order to meet client demand and utilise the ESG work and tools Jupiter has been developing over the years. The team now offers clients the choice of investing in the Article 6 flagship or its Article 8 version. In comparison to the flagship fund, the ESG version uses stricter ESG criteria, excluding sectors such as alcohol and gambling and sovereigns such as China and several emerging markets, while also being more selective in carbon-intensive sectors such as oil and gas.

Impact on Risk/Return Expectations

Fund managers don't think that the transition to Article 8 will materially impact the overall risk/return characteristics of their funds. One risk on the performance side would be idiosyncratic stories that positively impact fossil fuels, tobacco, and other sectors that now represent a lower weighting in portfolios. However, we expect the impact on relative performance to be muted over the cycle. First, the weight of more controversial sectors such as tobacco, coal, and weapons in benchmarks is relatively small. Second, many large-cap energy and utilities names have been actively developing actionable road maps to increase exposure to renewable energy and have therefore not been impacted by portfolio exclusions to the same extent as some of the ESG-sensitive sectors mentioned above.

One broad expectation is that the Article 8 designation could slightly enhance risk-adjusted returns over the cycle going forward. On one hand, avoiding controversial sectors and companies with an adverse ESG records should be a useful risk-management tool for fund managers. On the other hand, ESG integration and a best-in-class ESG approach are expected to be return-enhancing as responsible companies typically manage business risks more efficiently and increase their market share and cash flows, all positive factors for their creditworthiness.

Client demand and utilising available ESG tools and teams by integrating ESG analysis into investment processes have been the main drivers behind the SFDR Article 8 classification for many European-domiciled fixed-income funds. Our rated managers typically exited up to 5% of their portfolios and excluded up to 6% of their benchmarks as a result of the Article 8 designation. However, most managers don't see these exclusions of having a negative impact on the flexibility of their processes.

Overall, when there has been a move to Article 8, portfolio changes have been relatively subdued. Managers have been looking to replicate the risk/return profile of bond issues that have been excluded—whether that includes cyclical names or ones with a defensive profile—by replacing them with securities that have exhibited a similar upside/downside behaviour. What we can expect in terms of any material differences in absolute and risk-adjusted profiles and the management of drawdowns, compared with if these changes hadn't been made, appears therefore minimal. But only time will tell if that's the case.

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