UNLOCKING SUSTAINABLE & TRANSITION INDICES

iShares by BlackRock

Drivers of sustainable & transition index sentiment in 2024

Know your beta

It's important for investors who are seeking to allocate sustainably to dig deeper into sustainable and transition index methodologies, to select those that are best aligned to their investment goals. Differences in methodologies can lead to significant variations in the drivers of performance.

Stock-specific and factor effects drove sustainable equity returns

Stock-specific and factor tilts – particularly underweights to size and momentum – drove active equity underperformance in 2024, amid ongoing strong sentiment to a narrow portion of the market.

Traditional macro factors remain key

Quality, duration and sectors had a larger impact in High Yield (HY) than Investment Grade (IG). Quality was a detractor in EUR and USD IG, while duration and sectors were additive overall. In HY, the opposite was true, with country differences and issuer-specific news also playing key roles in EUR and USD HY, respectively.

Setting the scene: resilient risk sentiment amid global elections and rate adjustments

2024 was a positive year for risk, despite almost half the world voting in elections, and a tighter interest rate environment in the first half of the year. In equities, tech continued to lead earnings and drove markets in the US, with earnings just starting to broaden out into the end of the year. In Europe, earnings were slower to recover and thus played less of a role in driving equity market returns across the board.

Broadly resilient macro data and sticky inflation caused developed market rate cut expectations to be pushed further out. Sovereign bonds continued to reprice based on rate expectations adjusting to better-than-expected data, while market attention also turned to politics, with elections in India, Mexico, the UK and France. The European Central Bank (ECB) led the way in cutting rates, in a widely expected move, while stronger-than-expected US CPI and continued resilience in the jobs market pushed meant the Federal Reserve (Fed) follows a less dovish path.

Q4 was a strong quarter for risk assets, with markets kicking on post-US election, as perceived 'Trump trades' led the way – the S&P 500 posted its best monthly gain of the year in November, while small caps also rose 11%. The stumbling block for risk sentiment was a slightly hawkish tilt from the Fed at its December meeting, which affected sentiment across asset classes.

Sustainable flows ease off in 2024, driven by outflows in equity products

Sustainable UCITS ETPs recorded $40B of net inflows in 2024, down from $49B in 2023 and $54.9B in 2022. Screened strategies gathered the majority of the flows ($20B), signalling a willingness of the market to direct investments to strategies that are able to stay closer to the benchmark in terms of tracking error and which performed best in the year.

The overall drop in 2024 flows was driven by outflows from equity ETPs and slower flows into fixed income sustainable ETPs. This was led by ongoing outflows from best-in-class products, which generated -$11.4B, led in particular by outflows from SRI exposures (specifically USA SRI, which saw $9B of outflows). Factor + ESG indices also contributed negatively to equity flows (-$1.7B). Meanwhile, ESG optimised exposures captured $16B, led by investor flows into S&P 500 ESG strategies and Climate Transition Benchmark ETPs. In contrast to 2023, when global exposures saw the strongest inflows and emerging market (EM) exposures saw the largest outflows, in 2024 it was all about USA exposures, which saw both the largest inflows ($22B) and the largest outflows ($11B), for a total net inflow of $11B..

Fixed income flows ($12.4B) remained relatively stable compared to 2023 ($12.7B). Similar to previous periods, best-in-class exposures gathered the largest inflows ($9.4B), followed by climate-focused indices ($1.9B) and green bond indices ($0.9B). Eurozone exposures captured the majority of flows in sustainable fixed income ($8.0B), followed by global exposures ($1.3B).

Source: BlackRock GBI, as of 31 December 2024. All figures are in US dollars, unless stated otherwise. **Past flows into global ETPs are not a guide to current or future flows and should not be the sole factor of consideration when selecting a product.**

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Figure 2: Performance of equity indices used in this analysis

	Index	2019	2020	2021	2022	2023	2024
Global equities	**MSCI World**	27.67%	15.90%	21.82%	-18.14%	23.79%	18.67%
	MSCI World ESG Screened	28.15%	17.56%	22.16%	-19.61%	26.23%	20..01%
	MSCI World ESG Enhanced Focus CTB	28.36%	17.59%	22.34%	-20.19%	22.78%	17.85%
	MSCI World SRI Select RFF	30.14%	21.20%	25.05%	-21.37%	24.96%	10.81%
	MSCI World Climate Paris-Aligned Select	29.36%	18.35%	22.01%	-21.88%	25.48%	18.25%
	Dow Jones Global Index	26.06%	16.21%	17.70%	-18.63%	21.32%	16.24%
	Dow Jones Sustainability World Enlarged Index ex Alcohol, Tobacco, Gambling, Armaments & Firearms and Adult Entertainment	26.75%	13.94%	21.67%	-16.89%	26.84%	11.16%
	MSCI World Small Cap	26.19%	15.96%	15.75%	-18.76%	15.76%	8.15%
	MSCI World Small Cap ESG Enhanced Focus CTB	27.12%	16.08%	15.45%	-18.95%	14.07%	7.81%
US equities	**MSCI USA**	30.88%	20.73%	26.45%	-19.85%	26.49%	24.58%
	MSCI USA ESG Screened	31.29%	22.20%	27.14%	-21.14%	29.64%	26.06%
	MSCI USA ESG Enhanced Focus CTB	31.82%	22.27%	26.70%	-21.58%	25.38%	23.39%
	MSCI USA SRI Select RFF	31.80%	26.28%	30.49%	-18.80%	23.88%	13.45%
	S&P 500	30.70%	17.75%	28.16%	-18.51%	25.67%	24.50%
	S&P 500 ESG Net USD	32.54%	19.13%	31.22%	-18.08%	27.36%	23.50%
	S&P 500 Paris-Aligned Climate Sustainability Screened	33.48%	23.56%	31.42%	-22.86%	30.14%	25.51%
	MSCI USA Small Cap	26.74%	18.32%	19.11%	-17.55%	17.86%	11.57%
	MSCI USA Small Cap ESG Enhanced Focus CTB	27.21%	19.12%	19.01%	-17.53%	15.53%	11.02%
European equities	**MSCI Europe**	26.05%	-3.32%	25.13%	-9.49%	15.83%	8.59%
	MSCI Europe ESG Screened	25.99%	-1.70%	24.77%	-11.60%	17.67%	9.00%
	MSCI Europe ESG Enhanced Focus CTB	26.41%	-1.57%	25.26%	-12.62%	15.87%	8.51%
	MSCI Europe SRI Select RFF	31.37%	3.80%	26.67%	-15.38%	16.99%	5.64%
	MSCI Europe Climate Paris-Aligned Select	28.97%	2.20%	25.14%	-13.88%	16.44%	8.36%
Eurozone equities	**MSCI EMU**	25.47%	-1.02%	22.16%	-12.47%	18.78%	9.49%
	MSCI EMU ESG Screened	24.89%	-0.08%	22.46%	-13.42%	19.71%	9.36%
	MSCI EMU ESG Enhanced Focus CTB	25.59%	0.90%	22.39%	-13.32%	18.28%	9.98%
	MSCI EMU SRI Select RFF	32.10%	1.49%	20.93%	-15.31%	15.07%	9.31%
	MSCI EMU Climate Paris-Aligned Select	27.72%	2.92%	21.95%	-15.38%	17.15%	9.37%
Japanese equities	**MSCI Japan**	19.61%	14.48%	1.71%	-16.65%	20.32%	8.31%
	MSCI Japan ESG Screened	21.02%	15.18%	1.58%	-17.04%	19.90%	7.71%
	MSCI Japan ESG Enhanced Focus CTB	21.95%	15.26%	1.35%	-17.47%	19.82%	5.72%
	MSCI Japan SRI Select RFF	25.63%	15.69%	1.68%	-17.93%	13.28%	4.04%
Emerging market equities	**MSCI EM**	18.42%	18.31%	-2.54%	-20.09%	9.83%	7.50%
	MSCI EM ESG Enhanced Focus CTB	17.86%	19.62%	-2.09%	-21.82%	8.93%	7.28%
	MSCI EM SRI Select RFF	12.12%	19.00%	-0.44%	-18.33%	2.53%	6.01%
	MSCI EM IMI	17.64%	18.39%	-0.28%	-19.83%	11.67%	7.09%
	MSCI EM IMI ESG Screened	18.23%	19.25%	-0.82%	-20.72%	11.38%	7.67%
Pacific ex. Japan	**MSCI Pacific ex Japan**	18.36%	6.55%	4.68%	-5.94%	6.44%	4.59%
	MSCI Pacific ex Japan ESG Enhanced Focus CTB	20.81%	5.31%	4.86%	-6.49%	4.28%	3.96%

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Figure 2: Performance of equity indices used in this analysis

	Index	2019	2020	2021	2022	2023	2024
Sectors	**MSCI World Communications ESG Reduced Carbon Select 20 35 Capped**	22.47%	21.00%	17.50%	-32.75%	34.54%	30.65%
	MSCI World Consumer Discretionary ESG Reduced Carbon Select 20 35 Capped	28.18%	38.00%	15.94%	-36.54%	24.61%	15.20%
	MSCI World Consumer Staples ESG Reduced Carbon Select 20 35 Capped	19.31%	7.69%	13.28%	-9.06%	1.81%	2.25%
	MSCI World Energy ESG Reduced Carbon Select 20 35 Capped	14.32%	-25.60%	27.56%	34.63%	8.73%	0.32%
	MSCI World Financials ESG Reduced Carbon Select 20 35 Capped	25.68%	-0.61%	26.25%	-11.25%	17.13%	25.07%
	MSCI World Health Care ESG Reduced Carbon Select 20 35 Capped	24.85%	14.16%	21.25%	-3.37%	4.02%	-5.10%
	MSCI World Industrials ESG Reduced Carbon Select 20 35 Capped	28.54%	18.27%	19.94%	-16.43%	23.86%	13.10%
	MSCI World Information Technology ESG Reduced Carbon Select 20 35 Capped	48.98%	43.82%	33.25%	-33.64%	59.99%	26.23%
	MSCI World Materials ESG Reduced Carbon Select 20 35 Capped	23.84%	19.13%	13.51%	-18.73%	11.09%	-4.76%
	MSCI World Utilities ESG Reduced Carbon Select 20 35 Capped	24.42%	13.90%	7.76%	-13.12%	3.57%	4.40%
Factors	**MSCI World Quality ESG Reduced Carbon Target Select**	28.30%	19.16%	23.28%	-21.76%	25.77%	13.62%
Thematics	**S&P Global Clean Energy**	44.35%	141.31%	-23.41%	-5.00%	-20.36%	-20.36%
	STOXX Global Electric Vehicles & Driving Technology NET	15.11%	33.25%	16.95%	-27.54%	26.45%	26.45%

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Figure 3: Performance of fixed income indices used in this analysis

	Index	2019	2020	2021	2022	2023	2024
Ultrashort bonds	iBoxx GBP Liquid Investment Grade Ultrashort	1.20%	0.92%	0.19%	1.23%	4.80%	5.47%
	iBoxx MSCI ESG GBP Liquid Investment Grade Ultrashort	1.17%	0.89%	0.19%	1.21%	4.79%	5.46%
	iBoxx EUR Liquid Investment Grade Ultrashort	0.24%	0.14%	-0.28%	-0.28%	3.39%	4.05%
	iBoxx MSCI ESG EUR Liquid Investment Grade Ultrashort	0.15%	0.20%	-0.31%	-0.30%	3.39%	4.04%
	iBoxx USD Liquid Investment Grade Ultrashort	3.16%	1.41%	0.23%	1.43%	5.67%	5.68%
	iBoxx MSCI ESG USD Liquid Investment Grade Ultrashort	3.11%	1.64%	0.22%	1.40%	5.68%	5.67%
Investment grade (IG) credit	Bloomberg EUR Corporate 0-3 Year	1.00%	0.62%	-0.03%	-3.53%	4.66%	4.49%
	Bloomberg MSCI Euro Corporate 0-3 Sustainable SRI	0.95%	0.62%	-0.04%	-3.61%	4.61%	4.45%
	Bloomberg Euro Corporate	6.24%	2.77%	-0.97%	-13.65%	8.19%	4.74%
	Bloomberg MSCI Euro Corporate Sustainable SRI	5.92%	2.70%	-0.99%	-13.48%	8.00%	4.66%
	Bloomberg MSCI EUR Corporate Climate Paris Aligned ESG Select	-	2.59%	-0.95%	-13.88%	8.16%	4.84%
	Bloomberg US Corporate 0-3 Year	4.65%	3.18%	-0.01%	-2.07%	5.47%	5.34%
	Bloomberg MSCI US Corporate 0-3 Sustainable SRI	4.56%	3.32%	-0.06%	-2.14%	5.48%	5.30%
	Bloomberg US Corporate	14.54%	9.89%	-1.04%	-15.76%	8.52%	2.13%
	Bloomberg MSCI US Corporate Sustainable SRI	13.81%	9.98%	-1.28%	-15.03%	8.40%	2.08%
	Bloomberg MSCI US Corporate Climate Paris Aligned ESG Select	-	10.94%	-1.09%	-16.10%	8.51%	2.05%
High yield (HY) credit	Bloomberg Pan-European High Yield (Euro)	11.33%	2.29%	3.43%	-10.64%	12.12%	8.22%
	Bloomberg MSCI Euro Corporate HY Sustainable BB+ SRI Bond	-	1.74%	2.76%	-10.76%	11.02%	7.02%
	Bloomberg Euro High Yield 3% Issuer Capped	11.27%	2.25%	3.44%	-10.64%	12.12%	8.23%
	Bloomberg MSCI EUR Corporate High Yield Climate Paris Aligned ESG Select	-	-	3.19%	-11.08%	11.05%	7.96%
	Bloomberg US Corporate High Yield	14.32%	7.11%	5.28%	-11.19%	13.45%	8.19%
	Bloomberg MSCI US Corporate HY Sustainable BB+ SRI Bond	-	7.13%	4.81%	-11.98%	12.77%	7.76%
	Bloomberg US High Yield 3% Issuer Capped Bond	14.32%	7.10%	5.28%	-11.19%	13.44%	8.19%
	Bloomberg MSCI US Corporate High Yield Climate Paris Aligned ESG Select	-	-	4.46%	-13.09%	12.31%	8.31%
Emerging market debt	JP Morgan EMBI Global Diversified	15.04%	5.26%	-1.80%	-17.78%	11.09%	6.54%
	JP Morgan ESG EMBI Global Diversified	15.94%	5.78%	-2.35%	-18.92%	10.26%	5.75%
	JP Morgan EMBI Global Diversified IG	16.57%	8.92%	-1.93%	-19.76%	7.08%	0.32%
	JP Morgan ESG EMBI Global Diversified IG	16.36%	10.12%	-2.29%	-20.43%	7.18%	-0.11%
Aggregate indices	Bloomberg Global Aggregate	6.84%	9.20%	-4.71%	-16.25%	5.72%	-1.69%
	Bloomberg MSCI Global Aggregate Sustainable and Green Bond SRI	6.74%	9.24%	-4.83%	-16.41%	5.76%	-1.77%
	Bloomberg EUR Aggregate	5.98%	4.05%	-2.85%	-17.18%	7.19%	2.63%
	Bloomberg MSCI EUR Aggregate Sustainable and Green Bond SRI	5.84%	4.11%	-2.87%	-17.21%	7.26%	2.65%
Government bonds	FTSE EMU Government Bond	6.72%	5.03%	-3.54%	-18.52%	7.16%	1.86%
	FTSE Advanced Climate Risk-Adjusted EMU Government Bond	6.77%	5.57%	-3.47%	-18.26%	7.29%	2.02%
	FTSE World Government Bond	5.90%	10.11%	-6.97%	-18.26%	5.19%	-2.87%
	FTSE Advanced Climate Risk-Adjusted World Government Bond	6.11%	11.91%	-8.05%	-22.08%	6.60%	-5.20%

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Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. Source: BlackRock, as of 31 December 2024.

Sustainable & transition equity indices: sentiment turns more negative in 2024 compared to 2023

Sustainable and transition equity indices saw a slight drop in sentiment in 2024 versus their non-sustainable parent benchmarks, compared to 2023. Our analysis of 27 global and regional sustainable equity indices covering a range of methodologies shows that 22% outperformed their parent benchmarks in 2024, down from 33% in 2023. Average relative performance remained negative at -1.37%, compared to -1.13% in 2023.

Assessing sustainable equity indices by exposure, ESG Screened was the only methodology that had positive average performance across the range in 2024, returning a positive 0.19% on average. I also had the most outperforming indices (four out of six), confirming the trend of positive performance that we highlighted for this suite throughout 2023 and 2024.The MSCI USA ESG Screened Index generated the best result across indices, with an outperformance of +1.48% versus its parent index. At the bottom of the scale, SRI indices underperformed by an average of -1.99%, followed by the Paris-Aligned Benchmark range, averaging -0.81%. At a regional level, performance was generally negative, with Global and Japan indices being the largest underperformers (-1.45% and -1.04%, respectively).

Figure 4: Proportion of sustainable equity indices outperforming parent benchmarks and average active returns

	5Y	3Y	1Y
Proportion of indices outperforming	41%	19%	22%
Average active performance	-0.15%	-1.14%	-1.37%

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Digging deeper: analysing index exposures

Breaking down the return attribution of sustainable and transition indices can help to shed some light on the drivers of active returns. Figure 5 demonstrates how differences in methodologies across a range of sustainable index exposures can lead to significant variations in performance and in the factors driving such variations. As figure 5 highlights, the choice of sustainable index type can have a significant influence on investment outcomes, with variations in drivers of return across different methodologies. Over the following pages, we dig deeper into some key drivers of active returns for sustainable indices versus their non-sustainable parent benchmarks across the different approaches.

Figure 5: Drivers of active returns vs. parent benchmarks for MSCI World sustainable indices, 2024

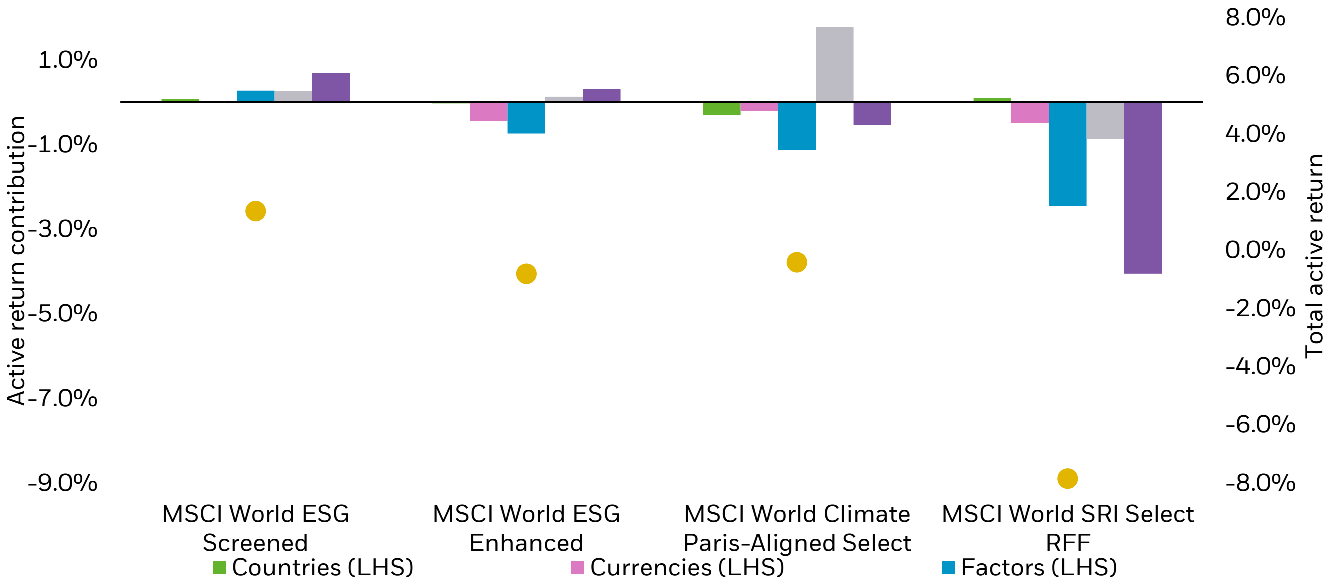

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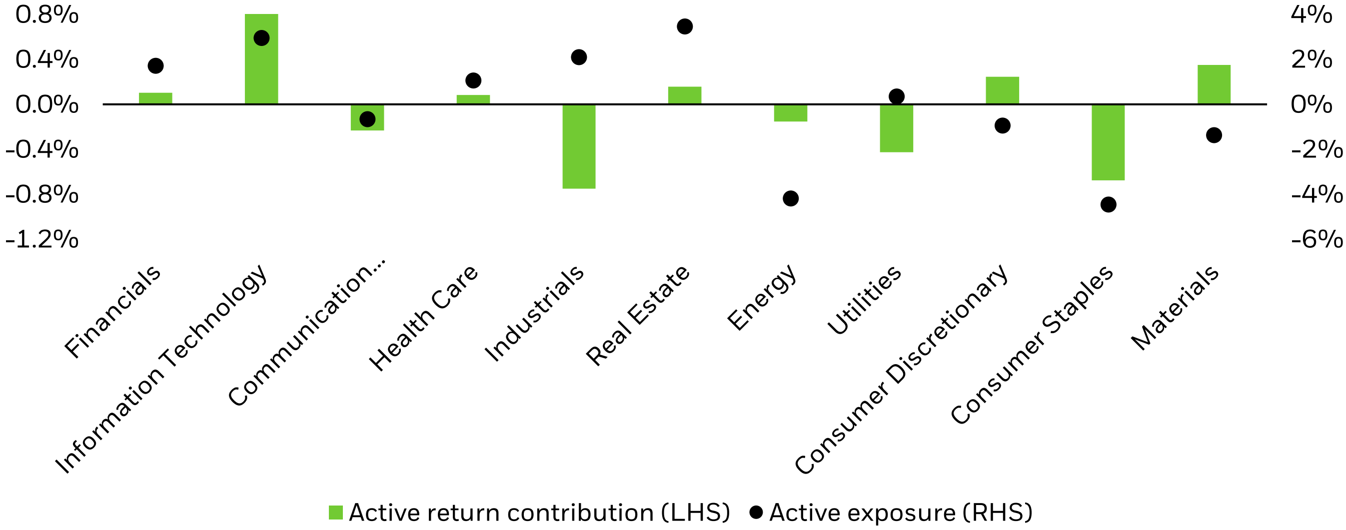
Figure 6: Sector contribution to active returns for MSCI World Climate Paris-Aligned Select Index vs. MSCI World Index, 2024



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Sectors

Sector composition contributed positively to active returns in 2024 for two out of the four sustainable variants of the MSCI World Index in our analysis. The sector contribution was particularly strong in the MSCI World Climate Paris Aligned exposure, while it had a muted effect on active returns for the ESG Screened and ESG Enhanced indices and was one of the detractors from relative returns for the SRI RFF index.

At the headline level, overweights to information technology and underweights to energy contributed positively to returns. An overweight in communication services generated positive results in the Screened range (+25 bps). Underweights in the same sector contributed negatively to performance in Enhanced and SRI ranges. An underweight to consumer staples was a detractor from performance, overall, particularly in Screened and Enhanced exposures.

Focusing on the MSCI Climate Paris Aligned Select Index – which saw the largest net positive impact on active returns from sector allocations in 2024 – overweighs to information technology, coupled with underweights to materials and consumer discretionary, proved to be the most significant drivers, with +87, +35 and +25bps of positive performance contribution, respectively. Conversely, overweight to industrials (-75bps) and utilities (-42bps) caused the highest negative contribution, alongside the underweight in consumer staples, which generated -67bps of performance differential versus the parent.

An underweight to the energy sector positively contributed to active returns for the majority of the World indices, with Enhanced being the biggest beneficiary after having had the opposite effect across 2023.

Sustainable sector indices

Performance across the MSCI World ESG Reduced Carbon Select 20 35 Capped sector index range diverged by more than 35% over 2024, positioning these exposures as a powerful tool to seek out performance or de-risk portfolios.

The ESG communications sector led active returns, outperforming the MSCI World Index by 12.7%, while the healthcare sector underperformed the broad index by the most (-23.77%). The tech sector's performance was fuelled by solid earnings and continued focus on AI-related themes. Broad cyclical versus defensive groupings explained only 2.5% of the divergence, indicating that investors may need to look deeper than these high-level attributes to unlock the potential of sector investing.

Figure 7: Active returns for MSCI World ESG Reduced Carbon Select 20 35 Capped sector indices vs. MSCI World Index, 2024

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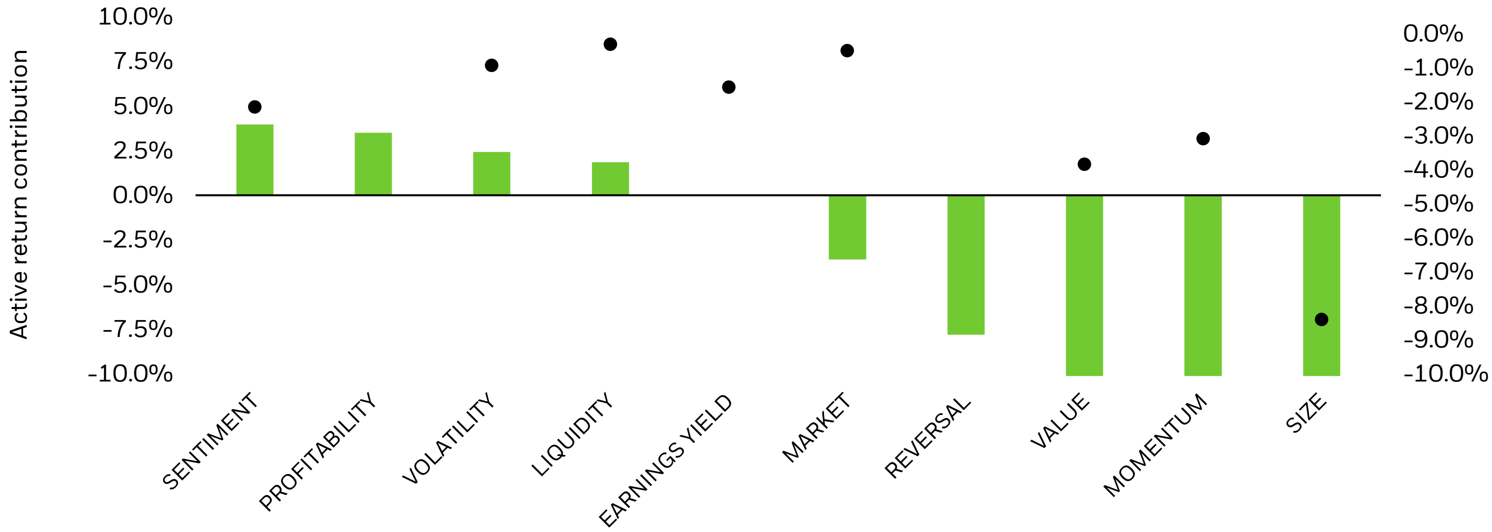
Figure 8: Select factor contribution to active returns for MSCI World ESG Enhanced Focus CTB Index vs. MSCI World Index (top five and bottom five contributors), 2024



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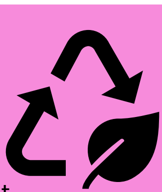
Factors

Style factor exposure contributed negatively to active returns for the MSCI World ESG Enhanced, MSCI World Climate Paris-Aligned Select and MSCI World SRI Select RFF indices in 2024, with only the MSCI World ESG Screened Index seeing a positive active return contribution from factor weights. Digging deeper, the MSCI World ESG Enhanced Index underperformed the MSCI World by 0.82% in H1 2024, with style factors contributing -0.75% of this. A significant negative contributor within these factors was the negative tilt to large-cap stocks, otherwise known as 'size', which accounted for -0.46% of active returns.

2024 was continuously dominated by mega-cap companies and AI, although we have seen an increase in market breadth beyond the 'Magnificent Seven' and strong momentum across the board. Negative exposure to the trend factor momentum, which is well represented in the IT, communication services, financials and industrials sectors, detracted from performance (-0.31%). Additionally, a stronger tilt to smaller companies (negative large size exposure) detracted from performance across the board, as larger companies continued to outperform the broad market. The inherent negative value tilt of the MSCI World ESG Enhanced Index also detracted from relative performance (-0.11%), given that the value factor has continued to experience tailwinds from its short duration in a high inflation and rates environment. On the positive side, a tilt to short-term momentum (reversal), liquidity and volatility factors proved positive in 2024.

Climate Transition Aware Indices



Many companies in high-emission sectors are undergoing significant transformations, playing a crucial role in the broader decarbonization process.

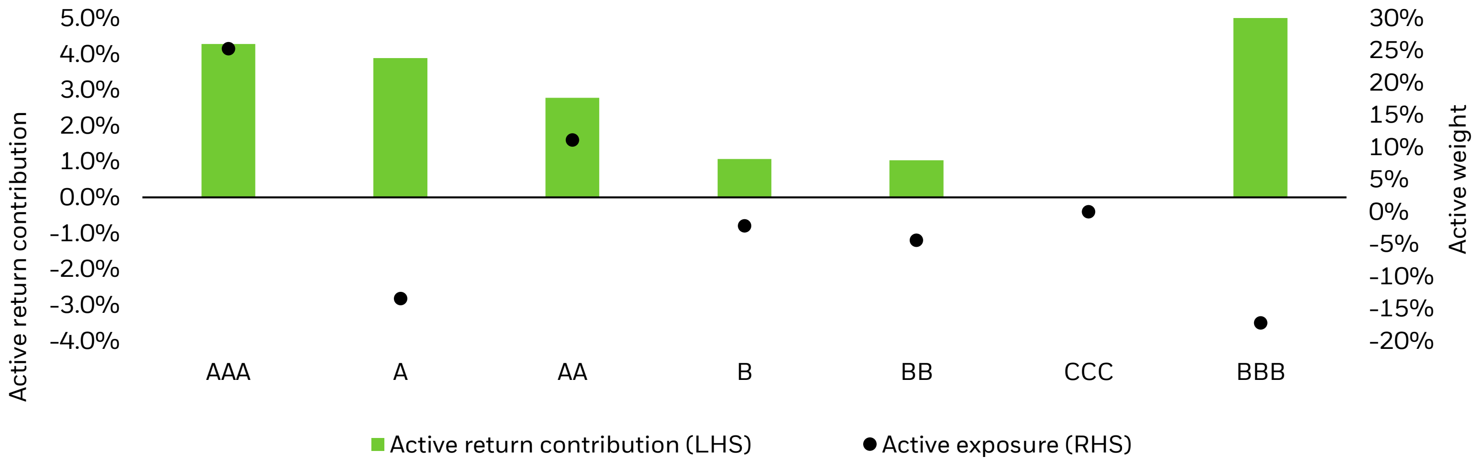
The shift to a low-carbon economy presents both investment opportunities and risks. A BlackRock survey found that most institutional investors have set transition investment objectives for their portfolios. Some investors are particularly interested in ETFs that align with real-economy decarbonization, and the evolving transition landscape is driving the development of such products.

Investors now have the opportunity to gain exposure to companies that are actively investing in the low-carbon transition—focusing on those with credible targets—while maintaining proximity to traditional benchmarks.

Our new iShares Climate Transition Aware UCITS ETF range incorporates forward-looking metrics such as credible decarbonization targets to access companies that are actively invested in the transition, while providing broad, diversified market representation.
This new range of ETFs can help investors access companies with science-based targets as well as transition solution providers, while aiming for sector neutrality.

- Three selection criteria: science-based targets, green revenue and emissions intensity.
- Key feature of this new range is that it aims to be sector neutral. This means that high-emitting sectors, such as energy, remain a critical part of the products.
  Source: BlackRock and MSCI, as of 31 December 2024.

Figure 9: ESG rating contribution to active returns for MSCI World SRI Select RFF Index vs. MSCI World Index, 2024



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Stock-specific effects & ESG ratings

Stock-specific effects contributed negatively to active returns for the MSCI World SRI RFF Index and the Climate Paris-Aligned Select Index, but contributed positively to the returns of the MSCI World ESG Screened and MSCI World ESG Enhanced Indices.

SRI indices saw the largest negative impacts from stock-specific effects. Of the total -7.86% underperformance of the MSCI World SRI RFF index versus the parent, -4.06% was caused solely by stock-specific factors. Specifically, four out of the top five biggest stock contributors to the underperformance of SRI indices were part of the Magnificent Seven. Nvidia was the name that contributed the most to the underperformance of the index; this is due in large part to the fact that during the first five months of the year, the stock was excluded from the index based on best-in-class ESG Ratings-related selection criteria. Even after the name re-entered the index at the end of May rebalance with a slight overweight compared to the parent, the average return for 2024 was -204bps.

The three other names that actively contributed to negative SRI index performance in 2024 were Apple, Amazon and Meta Platforms. These three names do not meet the ESG Rating selection criteria to be included in Best-In-Class indices because of their average ESG Ratings (Apple and Amazon: BBB, Meta Platforms: B) and their exclusion generated -134bps, -106bps and -91bps of underperformance, respectively. On the positive side, an overweight to Tesla contributed +140bps of performance.

The above results put an interesting spotlight on the ESG Rating allocation effect in SRI indices. As evident from Figure 9, there are benefits in underweighting practically all ESG Rated companies below the AA level; with underweights of A and BBB-rated companies proving to be the most additive, alongside an overweight to AAA stocks.

Conversely, ESG Screened exposures benefited most from a slight overweight to the aforementioned companies. A 1% overall overweight to Nvidia, Apple and Amazon generated +60bps of outperformance on average in exposures that include these three stocks. European ESG Screened exposures also saw positive returns in 2024, benefiting from the exclusions of Nestle (+67bps), Bayer (+16bps) and Glencore (+13bps) and suffering only from an underweight to Unilever, which generated -34bps of performance, on average.

Reference to individual companies mentioned in this communication is for illustrative purposes only and should not be construed as investment advice or investment recommendation. Source: BlackRock , MSCI as of 31/12/2024.

Sustainable fixed income indices: macro factors still key

Analysis of 19 sustainable fixed income indices covering a range of strategies and regions shows that 21% outperformed their parent benchmarks in 2024, a decrease versus historical periods (see figure 10). Average relative performance of sustainable fixed income indices versus their parent benchmarks was -0.29% over the year, driven largely by the underperformance of global climate government, HY and hard currency EM strategies. Excluding these strategies, average relative performance of sustainable indices versus parent benchmarks was -0.02%.

Figure 10: Proportion of sustainable fixed income indices outperforming parent benchmarks and average active returns

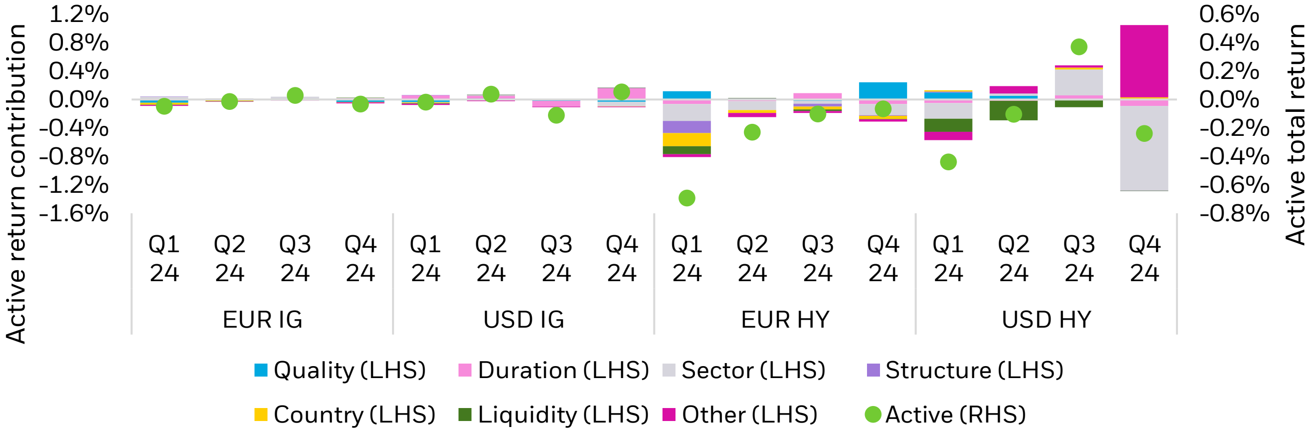
	5Y*	3Y*	1Y
Proportion of indices outperforming	35%	27%	26%
Average active performance	-0.17% (annualised)	-0.31% (annualised)	-0.17%

The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. Source: BlackRock, as of 31 December 2024. Analysis based on 19 sustainable fixed income indices, including USD and EUR Credit IG, Credit IG 0-3, USD, EUR and GBP Ultrashort, EUR and USD HY, EUR and USD Credit IG PAB, EUR and USD HY PAB, Global and EUR Aggregate, USD EMD Broad and IG-only, as well as Global and EUR Climate Govt. See page 4 for full performance per index. *Given limited history for HY, IG PAB and HY PAB, the analysis includes 13 index pairs for the period 31 Dec 2017 to 31 Dec 2018, 15 pairs from 31 Dec 2018 to 31 Dec 2019, and 17 pairs for the period 31 Dec 2019 to 31 Dec 2020 and 31 Dec 2020 to 31 Dec 2021.

Digging deeper: analysing index exposures

Analysing performance attribution for sustainable fixed income indices can help to provide more transparency and understanding around the drivers of active returns. Below, we compare a range of USD and EUR IG and HY credit exposures to show the varying impacts of sustainable integration across the different segments, and over time. Overall, in 2024, the sustainable SRI indices underperformed their parent indices in IG and HY. Figure 11 highlights that traditional macro factors, such as duration, credit quality and sector differences remain key. We see that the liquidity and sector factors had a larger impact on active returns in HY, while IG (especially USD IG) was more impacted by the duration factor over 2024. Sector differences detracted from active returns across the board, but primarily in HY. The duration factor had a positive impact on active returns for IG exposures as compared to HY assets, while other factors such as quality contributed positively in HY, while having a negative effect on IG active performance. In the following sections, we dig deeper into the drivers of return for sustainable fixed income indices over 2024.

Figure 11: Drivers of active returns vs. parent benchmarks for sustainable credit indices



The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. Source: BlackRock, as of 31 December 2024. Active return is defined as the total return difference between ESG and non-ESG index. For each Total return component theoretical DxS tilt return is calculated, except for the duration return: [Active DxS / Parent DxS * Excess Return of Parent] Components are additive and their ordering matters as previous tilt returns are subtracted from any additional tilt return. E.g. sector tilt will be calculated by combining quality and sector partitions and subtracting quality return (duration already being accounted for, as outlined above). See page 4 for full performance data. USD IG: Bloomberg MSCI US Corporate Sustainable SRI Index. EUR IG: Bloomberg MSCI Euro Corporate Sustainable SRI Index. USD HY: Bloomberg MSCI US Corporate High Yield Sustainable BB+ SRI Bond Index. EUR HY: Bloomberg MSCI Euro Corporate High Yield Sustainable BB+ SRI Bond Index.

Investment grade: varied factor impact in USD and EUR IG

Overall, in 2024, both the USD IG sustainable SRI index (Bloomberg MSCI US Corporate Sustainable SRI Index) and the EUR IG index (Bloomberg MSCI Euro Corporate Sustainable SRI Index) underperformed their non-sustainable parent indices. Factors had differing importance in USD and EUR active performance – for instance, duration was a more significant factor in USD IG, while sector differences had greater impact on active returns in EUR IG.

Quality: our research shows that sustainable SRI methodologies tend to create a quality tilt in the underlying index exposure. As most of 2024 saw significant spread compression in IG markets, quality detracted from active returns in both USD and EUR IG. June was an exception, as spreads widening contributed positively to returns for the sustainable SRI indices versus their parent benchmarks – i.e. the quality factor provides resilience in risk-off periods.

Duration: the duration profile of sustainable indices may be slightly altered as a by-product of index construction rules, resulting in performance variations across different rates environments. In USD IG, the sustainable SRI index has a shorter duration versus its parent index, which was additive in months following stronger-than-expected inflation and unemployment prints that caused hawkish repricing of US rates – especially in April, October and December. Conversely, this factor detracted when data showed signs of the economy cooling, as markets priced in lower interest rates in the US, notably in May and July. In EUR IG, the duration profile of the sustainable SRI index is closer to its parent, hence the factor had a smaller impact on active returns, proving marginally additive in December.

Sectors: sector nuances remained a key factor in IG, but with a larger impact in EUR IG. The USD and EUR IG sustainable SRI indices both have an overweight to financials and underweight to utilities versus their parent indices. In EUR IG, the sector factor was most additive in March, May and September (due to an overweight to financials), but detracted from returns notably in June, stemming from underweight to utilities and industrials. In particular, underweights to consumer non-cyclicals and energy were key detractors in June. In USD IG, sector differences overall had a negative effect on active returns over 2024, and mainly in H2, as a result of an overweight to the banking sector.

Other drivers: other drivers of active returns remained largely flat in 2024 for both USD and EUR IG indices, having a marginally higher impact on the latter. In particular, in EUR IG, January, February and May saw a small negative impact from the country factor, with the underweight to Germany in the sustainable SRI index being a key detractor.

Figure 12: Drivers of active returns for Bloomberg MSCI US Corporate Sustainable SRI Index

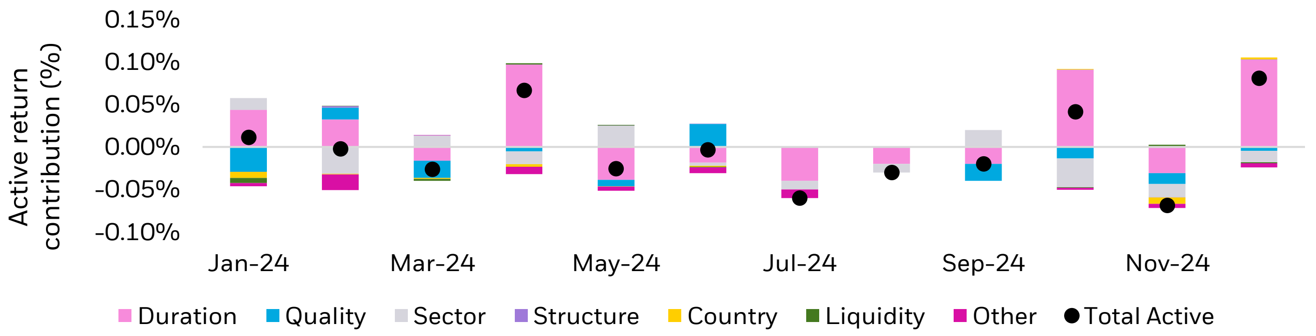


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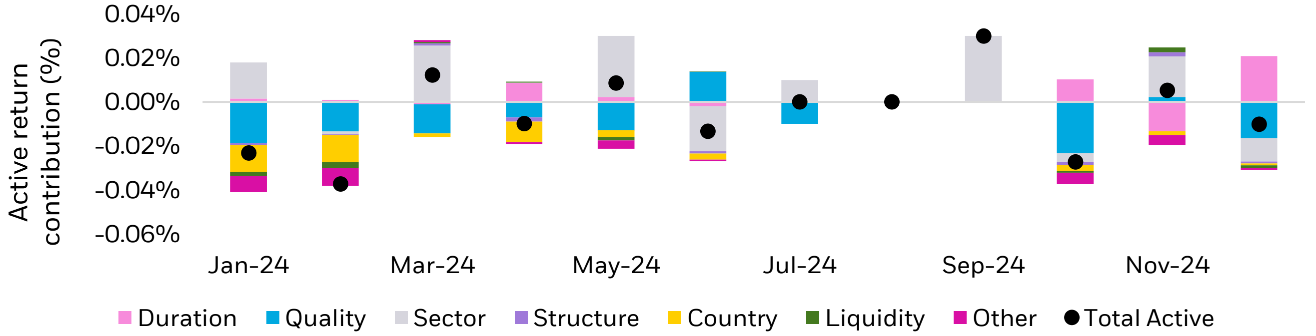
Figure 13: Drivers of active returns for Bloomberg MSCI Euro Corporate Sustainable SRI Index



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High yield: traditional factors remain key, while EUR HY was also impacted by issuer-specific news

Extending our analysis to USD and EUR HY, the sustainable SRI indices (the Bloomberg MSCI US Corporate High Yield Sustainable BB+ SRI Bond Index and Bloomberg MSCI Euro Corporate High Yield Sustainable BB+ SRI Bond Index) both underperformed their respective parent benchmarks over 2024. Factors such as duration, quality, sector, country and liquidity remained key in HY, with larger impacts than in IG. Issuer-specific events were also relevant in USD HY.

Quality: overall, the impact of the quality factor on active returns was positive in both USD and EUR HY. In USD HY, this factor had a positive contribution in every month except for April, June and September, as credit spreads widened in the C and D-rated buckets over the year. In EUR HY quality was even more impactful, with most of the relative outperformance coming in March, April and December, as spreads in CC-rated issuers jumped higher.

Duration: the duration factor detracted from active returns in both USD and EUR HY SRI, as both indices have a slightly longer duration profile than their parents. In USD HY, this mainly detracted in April and October, as markets dialled back expectations on the possibility of rate cuts, partially offset by positive active returns over Q2 and Q3. In EUR HY, duration mainly detracted from returns in February, April, October and December, given the hawkish repricing of interest rates in Europe, while the opposite scenario played out in June, July and November.

Sectors: sector nuances continued to be an important return driver in HY, especially in USD, where this factor was detractive mostly in January, March and December. Underweights to energy, capital goods and consumer cyclicals were key reasons. In the EUR space, underperformance was driven primarily by the underweight in industrials. In particular, the underweight to consumer cyclical and basic industry were top detractors in every month except for March and April.

Other drivers: in USD HY, issuer-specific events added to performance in December, notably due to an exchange event that positively affected IHRT, an issuer that is relatively overweight in the SRI index. Country allocation and liquidity factors were also key in HY, with varying levels of impact month-on-month. The country factor had a larger impact in EUR HY, especially in January, February and April, while liquidity had a more significant negative impact in USD HY, particularly in March, April and May.

Figure 14: Drivers of active returns for Bloomberg MSCI US Corporate High Yield Sustainable BB+ SRI Bond Index

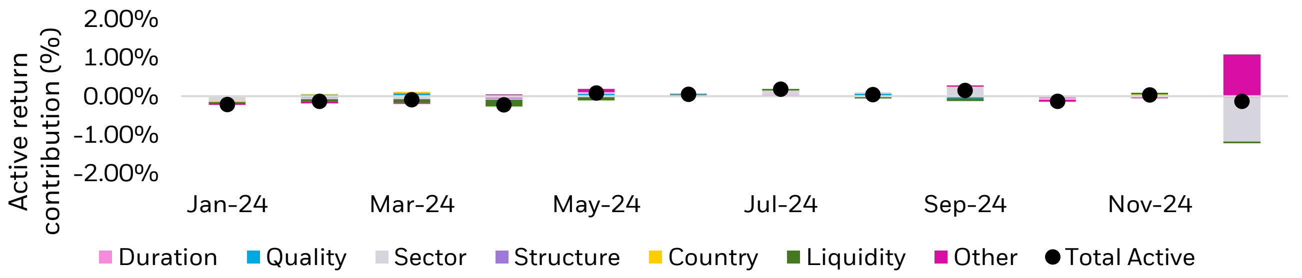

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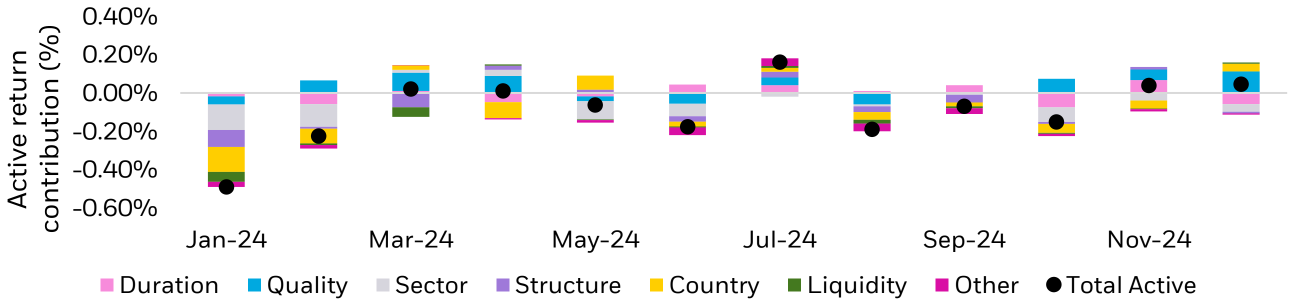
Figure 15: Drivers of active returns for Bloomberg MSCI Euro Corporate High Yield Sustainable BB+ SRI Bond Index



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Looking long term

We believe the transparency, clarity and choice of an indexing approach can help investors who choose to invest sustainably. It is important, however, to understand how risk factors such as sectors, style factors, duration, and country exposure can affect the performance of sustainable indices.

Clarity

The transparency of sustainable indexing methodologies empowers asset allocators looking to build sustainable portfolios with consistent methodologies across various exposures and asset classes. Using indexing to invest sustainably harnesses the simplicity, optionality, and transparency of a rules-based methodology that delivers measurable, deliberate and distinct investment outcomes – which can be critically important in the face of market uncertainty. Investors have direct insight into portfolio construction, can understand what drives the index methodology, and have instant access to key data to support their investment decisions. This also allows them to articulate and report on their sustainable objectives to clients, boards and other key stakeholders, especially during times of uncertainty and market volatility.

Choice

As shown in this paper, different index construction methodologies can lead to different investment outcomes in the face of market volatility. This differentiation is due to the variety of ways to incorporate sustainability considerations in index construction. The breadth of choice available, coupled with the transparency of the different methodologies, means that indexing tools can help investors to take control of their sustainability goals and investment outcomes. Index investors are active in their selection and portfolio construction processes – especially when looking to align to their sustainability goals across a spectrum of choices.

MKTGM0225E/M-4277581-12/18

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