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Sustainable Investing Insights

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Diversify your fixed income with sustainable bonds

SUMMARY

- Green, social, sustainability, blue and sustainability-linked bonds can be an integral component of an investor's fixed income allocation – and many of the larger financial services firms are at the forefront of new and exciting opportunities to help finance innovation that challenges the status quo and seeks to transform our world for the better.
- Although corporate and financial bond issuance in the broader fixed income market declined 13% in the first quarter year-over-year, sustainable bond issuance had a strong first quarter at $285 billion, up 4% year-over-year (Figure 1 and 2). It was one of its busiest quarters on record as borrowers, including debt issuers, capitalized on favorable market conditions before the recent banking turmoil briefly shut debt markets.
- During the global pandemic, some public sector companies financed their response to COVID-19 through social bond issuance. They were used to fund medical research, healthcare services and equipment or support initiatives that helped alleviate unemployment resulting from the pandemic. An example is the $100 million World Bank UNICEF (United Nations Children's Fund) Bond.
- Last year, the World Bank issued another innovative structure, the $150 million Wildlife Conservation Bond. Instead of going to the investor, proceeds from the bond are allocated to conservation efforts aimed at protecting and increasing the population of black rhinos in South Africa.
- When markets reversed course in October, macroeconomic conditions and limited availability may have contributed to a sustainable bond rebound late last year. Driven by more demand for sustainable instruments particularly in Europe, sustainable bonds outperformed traditional bonds year-to-date through March 2023 (Figure 4).
- Although still in its early development stage, one potential opportunity for issuers is harnessing the voluntary carbon market to crowd in more investors. Today, issuers of bonds that finance projects and initiatives that generate carbon offsets can sell voluntary carbon units (VCUs) in the voluntary carbon market. Each VCU represents the reduction or removal of one tonne of carbon dioxide equivalent achieved by the initiative or project funded by the bond issuance.

Strong sustainability bond issuance in Q1

Green, social, sustainability, blue and sustainability-linked bonds can be an integral component of an investor's fixed income allocation – and many of the larger financial services firms are at the forefront of new and exciting opportunities to help finance innovation that challenges the status quo and seeks to transform our world for the better.

Although corporate and financial bond issuance in the broader fixed income market declined 13% in the first quarter year-over-year[1], sustainable bond issuance had a strong first quarter at $285 billion, up 4% year-over-year. It was one of its busiest quarters on record as borrowers, including debt issuers, capitalized on favorable market conditions before the recent banking turmoil briefly shut debt markets. Sustainable bond issuance was slightly lower than the peak in Q1 2021 – a positive development for the sustainable debt market after a more difficult 2022.

Green bond issuance in the first quarter reached a record $180 billion, exceeding the previous record established in Q4 2021 by 8%.

Figure 1: Sustainable Bond Issuance (January 2020 – March 2023)

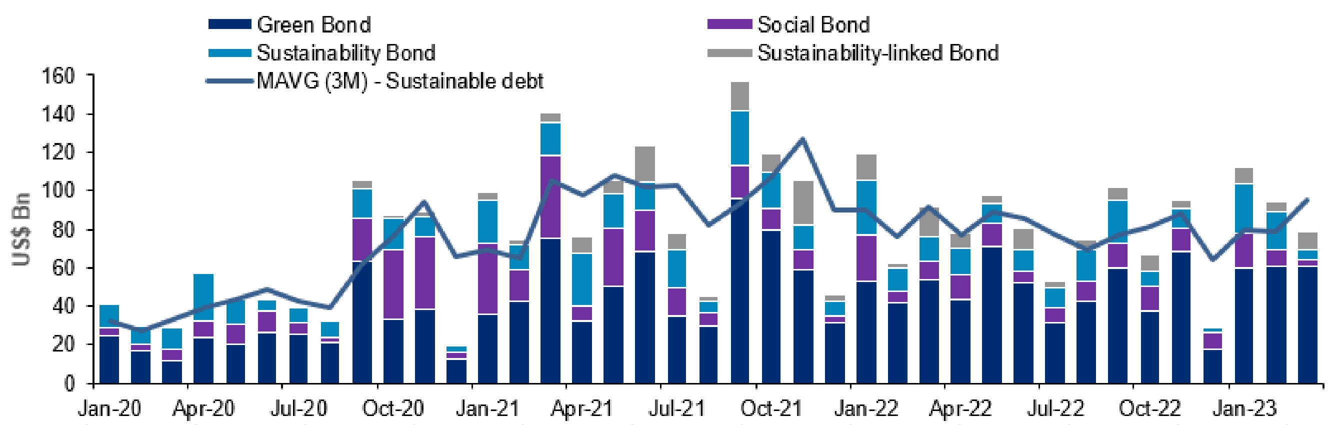
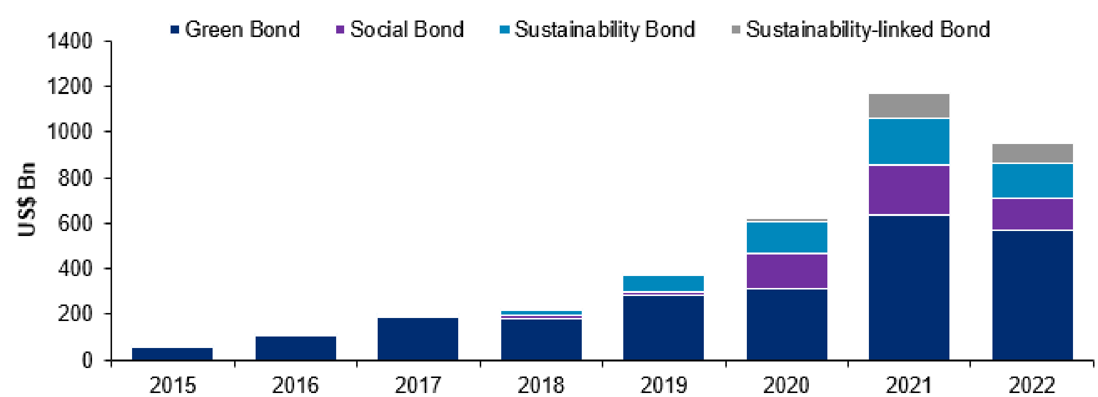


Figure 2: Annual Sustainable Bond Issuance (2015 – 2022)



Source: Bloomberg NEF

[1] Bloomberg League Table Reports

There are different labels emerging within the financial services industry for sustainable bonds – including green, social, sustainability, sustainability-linked and, more recently, blue. Green and social bonds are issued to address environmental and societal challenges, respectively. While sustainability bonds may address a combination of environmental and societal challenges. Blue bonds aim to protect oceans and marine ecosystems.

Other financing structures, such as sustainability-linked bonds, may set targets on key performance indicators, or "KPIs". The bond's coupon payments are linked to the issuer's ability to meet the target. Typically, if the issuer meets it, the issuer is afforded a lower interest rate – however in cases where the issuer falls short, the coupon of the bond increases.

One of the key challenges with sustainability-linked bonds is defining the target. How ambitious should it be? For example, you may look to establish a target that is ambitious enough to meet the Paris trajectory of a well below two-degree Celsius increase in global warming – but not so ambitious that companies shy away because the cost of meeting it or the reputational impact of not meeting it outweighs the benefit of achieving the target. Targets should focus on KPIs which are material to the issuer's strategy and connect to resource consumption, conservation efforts, or social impact, for instance.

During the global pandemic, some corporations as well as intergovernmental and non-governmental organizations (NGOs) financed their response to COVID-19 through social bond issuance. They were used to fund medical research, healthcare services and equipment or support initiatives that helped alleviate unemployment resulting from the pandemic. An example is the $100 million World Bank UNICEF (United Nations Children's Fund) Bond.

Half of the proceeds went to the World Bank to tackle broad sustainability challenges while the other half went to the UNICEF pandemic response, helping underprivileged children in emerging markets.

The World Bank UNICEF Bond leveraged liquid markets to implement an impact strategy generally reserved for private equity and direct investments.

Prior to this transaction, UNICEF was primarily donor funded and unable to directly raise debt. Essentially, this financial instrument paved the way for an investor to help UNICEF achieve its goals. The bond itself was unrated since half the proceeds were guaranteed by UNICEF, which is an unrated issuer.

And this is just the beginning. This novel transaction may open the door for some of the largest NGOs in the world to consider debt financing.

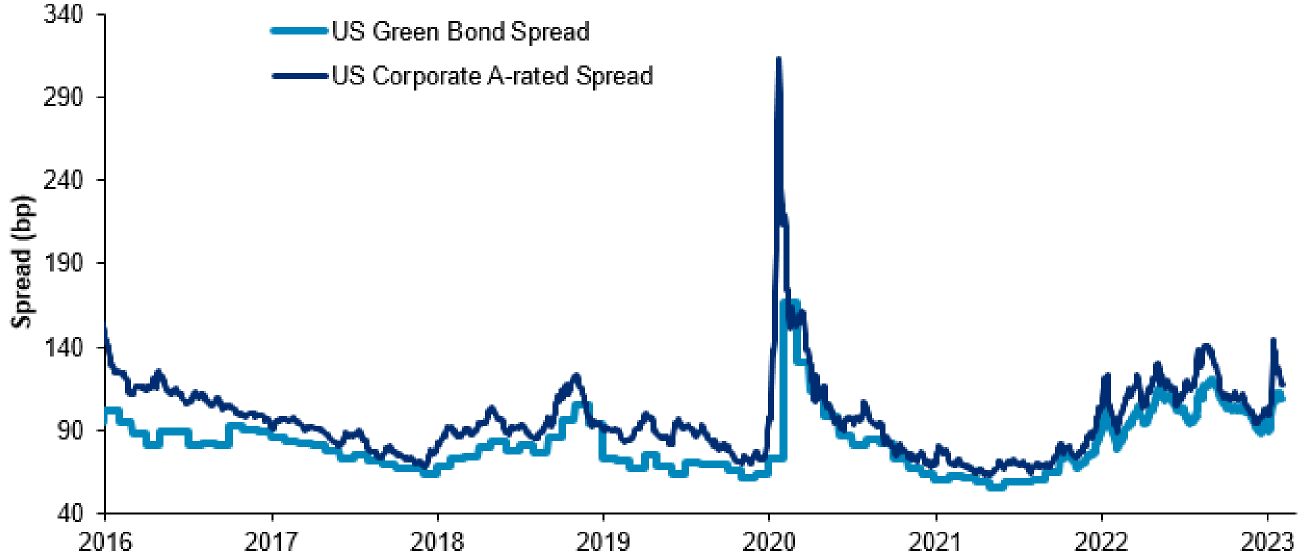
Last year, the World Bank issued another innovative structure, a $150 million Wildlife Conservation Bond. Instead of going to the investor, proceeds from the bond are allocated to conservation efforts aimed at protecting and increasing the population of black rhinos in South Africa. At maturity, in addition to principal redemption of the bond, the issuer pays a potential payment which is based on the rhino population growth.

Greenium – is it real?

There has been much debate around the presence of a "greenium" (green premium) – having to pay more for a bond with a sustainability label. It is fair to say that, over time, the greenium has narrowed in the primary issuance market – particularly during the second half of 2022 (Figure 3).[2]

[2] Bloomberg, January 13, 2023: Goldman Says Goodbye 'Greenium' as ESG Now Priced Like All Debt

Figure 3: US Green Bond vs. US Corporate A-Rated Bond Spread (January 4, 2016 – April 3, 2023)

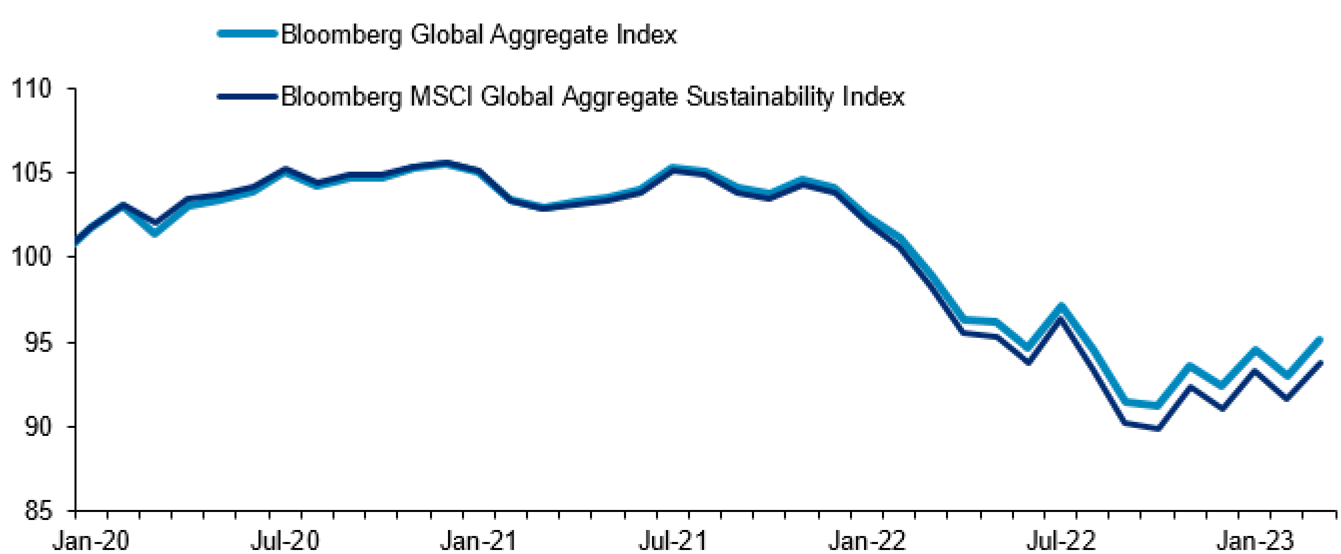


Source: Bloomberg as of April 3, 2023

Shifting our focus to the secondary market, sustainable bonds generally have a longer duration compared to traditional bonds, which can result in larger price impacts during a period of rising rates like we saw last year (Figure 4). As we noted earlier, last year's market volatility, inflation, and rising interest rate environment led to fewer issuances across the board.

When markets reversed course in October, macroeconomic conditions and limited availability may have contributed to a sustainable bond rebound late last year. Driven by more demand for sustainable instruments particularly in Europe, sustainable bonds outperformed traditional bonds year-to-date through March 2023.

Figure 4: Sustainable Bond Index vs. Traditional Bond Index January 2020 – March 2023



Source: Bloomberg as of March 31, 2023. Indexes are unmanaged and are not investable. They are gross of all advisory fees. Past performance is not indicative of future returns.

In certain instances, sustainable bonds are attractive to investors and investment managers because they seek to serve a dual purpose in a portfolio. They have similar characteristics as traditional fixed income instruments – offer potentially attractive returns – and seek to finance projects with a positive environmental and/or societal impact. For example, the issuance of a green bond may have been allocated to a project that prevented a certain amount of greenhouse gas emissions from reaching the atmosphere. Or the issuance of a social bond may have resulted in vaccinations to a certain number of children who otherwise would not have had access.

It should be noted that when purchasing sustainable bonds they should come with allocation and impact reports that provide insight into the bond's use of proceeds initiatives and project results. External assessments are often used to validate processes and reporting.

Achieving more innovation in finance

Looking ahead, we believe there will continue to be new ideas and innovative financing structures available to investors that seek to drive capital to areas where it is most needed.

Although still in its early development stage, one potential opportunity is harnessing the voluntary carbon market. As this space continues to develop, the market enables investors, governments, organizations, and businesses to purchase carbon offsets against their greenhouse gas emissions (GHGs). They can purchase credits for nature-based projects or technological initiatives that remove existing GHGs from the atmosphere.

Nature based projects focus on preserving, restoring, and managing carbon sinks (forests, oceans, soils, and plants) with the aim to reduce or sequester greenhouse gas emissions. Technological initiatives seek to capture, store, or provide clean energy, such as building a windfarm, to generate carbon offsets.

Today, issuers of bonds that finance projects and initiatives that generate carbon offsets can sell voluntary carbon units (VCUs) in the voluntary carbon market.

Each VCU represents the reduction or removal of one tonne of carbon dioxide equivalent achieved by the initiative or project funded by the bond issuance.

In closing, fixed income serves as a core allocation for many investors in today's environment, the income on sustainable bonds may offer competitive yields and can help align portfolios with the United Nations Sustainable Development Goals.

DISCLOSURES

Sustainability and Sustainability Risk

Sustainable / Sustainability: In environmental science, the quality of not being harmful to the environment or depleting natural resources, and thereby supporting long-term ecological balance. Sustainability presumes that resources are finite and should be used conservatively and wisely with a view to long-term priorities and consequences of the ways in which resources are used. Within context of sustainable development, operating practices that meet the needs of present users without compromising the ability of future generations to meet their own needs, particularly with regard to use and waste of natural resources. UNESCO assigns four dimensions to sustainable development - society, environment, culture and economy.

Sustainability Risk: Risk of an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of an investment. The financial position of the investments in the portfolios managed by a portfolio manager may deteriorate due to the environmental, or social, or governance risks these investments are exposed to, which in turn may impact the market value of investments.

ESG ("Environmental, Social and Governance") within an investment context, is an umbrella term for investment approaches that seek to incorporate environmental, social and governance considerations in security selection and investment management, with the aim of achieving a more sustainable, responsible and/or ethical investment outcome.

The Bloomberg Barclays MSCI Global Aggregate Sustainability Index is a multi-currency benchmark that includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers with strong positive environmental, social and governance (ESG) ratings.

The Bloomberg Global Aggregate Index is a flagship measure of global investment grade debt from a multitude local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

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Credit risk	**Moody's[1]**	**Standard and Poor's[2]**	**Fitch Ratings[2]**
Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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