Green bonds will continue to be a key part of environmental solutions

BY JOLANDA DE GROOT

Financial Investigator asked Ilia Chelomianski, Associate Investment Director at Fidelity, some questions about green bonds and ESG approaches. ESG investing continues to gain importance and the markets are responding with new products like green bonds.

How do green, social, sustainability and SDGs differ?

'New products to cover this demand for ESG investing are for example green bonds, including green hybrids and green ABS, social bonds, and other securities aligned directly to one or more of the UN Sustainable Development Goals (SDGs). All these instruments can be issued by any company or government as long as the proceeds finance a predefined sustainable project/a range of projects. Green bonds are meant to finance climate change related projects whereas social bonds, a newer asset class, as the name suggest, are supporting social programs.

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The SDGs are a set of 17 goals with 169 underlying targets covering social and economic development issues, such as poverty, education, global warming, gender equality, water, sanitation, energy, urbanization, and social justice. Recently, a number of funds aligned with one or more goals have been introduced in the market.

If we focus specifically on climate change green bonds are a highly 'en-vogue' approach to tackling this challenge. The positive reinforcement is its key advantage. Although the total green bond market size is smaller than other bond asset classes, issuance has been breaking one record after another.'

How can you integrate green bonds and an ESG approach into investing?

'Investors can implement ESG considerations into their portfolios in a host of ways, stretching from active ownership to impact investing. One way to think about the different approaches is as a dial, switching from 'less ESG' to 'more ESG'. On the lower side we have an 'Exclusion/norms based'-approach that excludes investments in companies that do not meet widely accepted norms, such as the UN Global Impact principles. A more sophisticated way is 'ESG integration' whereby consistent fundamental analysis of 'E', 'S' and 'G' issues are included into research and investment processes to identify additional sources of risk and opportunity, and to deliver better overall investment decision-making. Statistical methods can also be used to establish a predictive correlation between the sustainability aspects of a company's performance and financial factors. Finally, for investors who are looking to achieve measurable and beneficial impacts alongside a financial return there are 'impact/thematic funds'. Those often follow themes such as renewable energy, water treatment, education providers et cetera. Particularly, green bond investing falls into this category.

One element that binds all these forms together is the careful consideration, by investors, of environmental, social and governance effects on stakeholders. ESG investing requires investors to conduct, intentionally and systematically, an assessment of relevant risks and opportunities as part of their financial analysis, in order to allocate capital in a society-conscious way.'

What is the size of the green bond market?

'Green bond issuance has been breaking one record after another. In 2017, the green bond market once again posted a new all-time high with issuance of close to US$ 160bn, an increase of approximately 60% YoY (year over year). The market estimates for this growth to continue in 2018 (US$ 250mln) and years to come but at a lower rate. Some sources even suggest the market could reach US$ 1tn of annual issuance by 2020. The investment gap to reach the 2°C trajectory is around US$ 16tn through 2040, and green bonds play a critical role in raising the required capital.

More importantly the diversification across regions, sectors and instrument types continues to improve with large expectation lying on Emerging Markets. However, it is also important to mention the laggards which in this case are US and UK. While those two countries represent 43% of the global bond universe (Bloomberg Barclays Global Aggregate Index) they only contribute 8% to the global green bond universe.'

Do you believe that you can achieve sufficient diversification and returns comparable to a corporate mandate by investing solely in green bonds?

'Concerns around green bond returns have arisen as a result of the historical high-quality nature of Green bond issuance to date. Indeed, the ICE BofAML Green Bond Index comprises 30% in AAAs and another ~25% in AAs. This compares to the global corporate benchmark at 1.2% and ~9% respectively. As a consequence, the OAS on the green benchmark of 60bps is some 40bps lower than (say) the global corporate index.

But this does not necessarily mean that green bonds underperform on a quality matched basis. Green bonds in a senior unsecured package frequently price on top of the existing non-green curve and in some cases, go on to trade through the non-green curve as dedicated buyers of GBs drive up prices. Indeed, recent issuance has moved away from the traditionally dominant high quality quasi-sovereigns and more towards BBB corporates, High Yield, Emerging Markets and even Corporate Hybrids. With the ongoing diversification of the green bond universe and issuance for 2018 slated at $140-180bn, constructing a portfolio with risk and return characteristics commensurate with a global credit portfolio, is increasingly feasible. Moreover, the dedicated green bond buyer base can provide the securities with consistent demand, resulting in lower volatility in market sell-offs and consequently better risk adjusted returns than the wider bond market.'

Where is the next big growth area in fixed income environmental investing?

'To date, environmental investing in fixed income has been dominated by green bonds, but we expect low carbon investing approaches to become increasingly prominent. Green bonds will continue to be a key part of environmental solutions but investors could benefit by expanding the universe of issuers to include those who are leaders in their sectors.

If investors seek to minimise the carbon intensity of their portfolios they can overcome some of the challenges faced in the green bond market such as the lack of standardisation and promote a more holistic assessment of a company's environmental activities. A carbon reduction mandate creates a clear, objective target and we can use established carbon-intensity indices to construct a portfolio which quantifiably reduces carbon production.

We also found that by removing carbon laggards from a global corporate bond index, an investor is left with a sufficiently large universe (66% of the global corporate bond market), which provides a fruitful hunting ground to build portfolios with risk and return characteristics that are similar to a conventional credit portfolio. This portfolio can then be supplemented with selective investments in green bonds or companies which are transitioning to a more environmentally friendly policy.' «

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