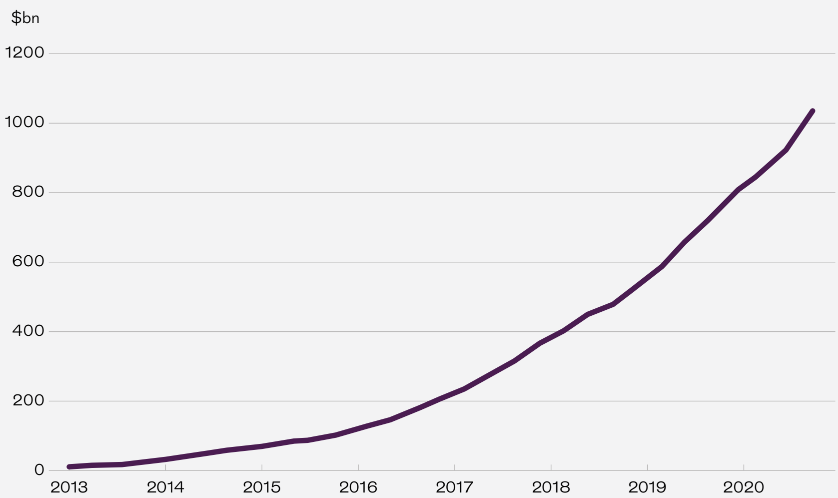
For professional clients only, not suitable for retail clients.

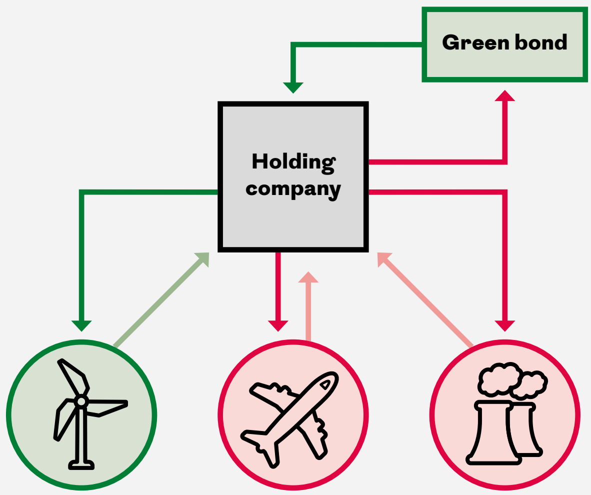
Getting to grips with green bonds

Figure 1: Cumulative green bond issuance



Source: Bloomberg NEF, Bloomberg L.P., based on quarterly issuance from 2007 to Q3 2020

Figure 2: Typical structure of a green bond – arrows indicate cash flows



Source: RLAM

Green bonds are one of the more visible sides of the increasing interest in environmental, social and governance (ESG) impacts on investing. The events of 2020 appear to have only accelerated this trend.

It is something of a truism that where there is investor demand, supply will follow. As investors have focused more on ESG issues, so bond markets have responded. Ratings agencies now include ESG analysis in their ratings, while there are a host of ESG-related bond labels including social bonds, sustainability-linked bonds and green bonds.

Issuance of these bonds has been increasing, with green bonds dominating this area. As can be seen in figure 1, in 2016, green bond issuance was around $100 billion. Last year it was just under $300 billion[1], and HSBC is expecting this to increase to between $310 and $360 billion in 2021, partly due to ongoing demand, but also given news that a Biden-led US will rejoin the Paris Climate Accord and create a backdrop more open to ESG considerations.

Green is good?

At face value, there can be little argument about the positive impact of the green bond concept. As a bridgehead to get investors and issuers considering and elevating critical societal issues, this has undoubtedly been a success and the market has delivered exponential growth in issuance.

1 https://www.ft.com/content/021329aa-b0bd-4183-8559-0f3260b73d6

However, green bonds also have limitations – the main ones being that a bond does not have to clear certain hurdles or external validation to be labelled as green – meaning that a green bond issued by company A may have very different 'green' credentials than company B. And given the fungible nature of cash, there are often no guarantees that funds raised will be used solely for green purposes, nor that cashflows back to bond holders will come exclusively from green operations. An illustrative example is shown in figure 3.

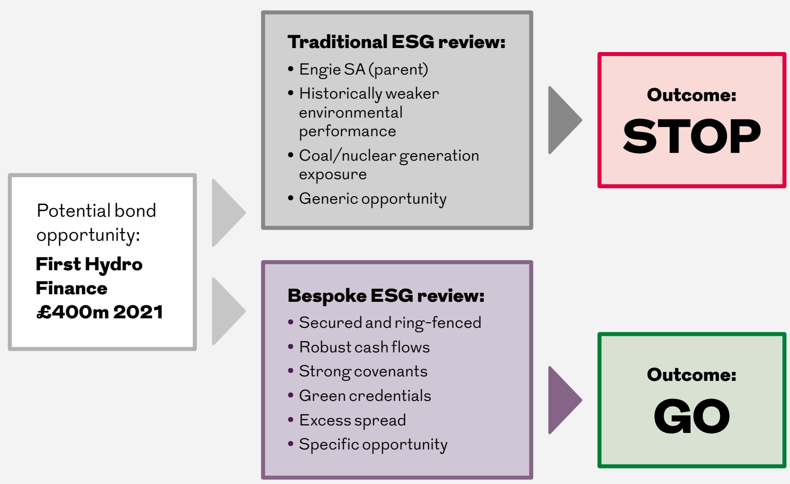
Figure 3: The market isn't always efficient

	Anglian Water 2.75% 2029	Anglian Water 6.625% 2029
Size	£300m	£200m
Issuance platform	Common terms	
Credit rating	A-	A-
Index constituent	✓	✓
Green label	✓	✗
Spread	0.8%	0.9%

Portfolio characteristics and holdings are subject to change without notice. This does not constitute an investment recommendation. For information purposes only.

Source: RLAM as at 31 December 2020.

Figure 4: Digging beneath the surface: the bespoke route to adding value



Source: RLAM

This isn't necessarily a criticism of all green bonds – more that in our view, applying a single rating or label to any bond is problematic. In our view, it is extremely difficult to outsource the analysis of credit ESG risks to third parties. As well as the limited scope of equity-based platforms – only c. 40% of the bonds in the sterling credit index have a public equity profile – the apparent convenience of a single 'ESG score' often fails to capture the idiosyncrasies of credit. We know this inefficiency from credit ratings: while broadly helpful, the over-distillation of information into one rating creates distortions that active investors can exploit.

The grass isn't always greener

While the convenience of attaching a label or a rating is broadly helpful, the desire to distil a lot of information into a single badge creates distortions. As active managers, we welcome this. We know that at times, the market will flock to buy green bonds, attracted by the label. This additional demand can compress the spread available on those bonds. In theory, markets should not allow such an obvious distortion, but a glance at figure 3 shows two bonds from UK utility Anglian Water, of similar maturity, both backed by the exact same assets, trading at different spreads simply because one is 'green'.

Giving the green light to invest

Our investment approach has always been to focus on the specifics of any bond we buy, rather than someone else's assessment or labelling of it. In this way, a bond labelled as green is not intrinsically good or bad, any more than a BBB rating means that we should or shouldn't invest.

We prefer to focus on the overall ESG performance of our bonds beyond any spoon-fed prescription. Indeed, the credit market provides real opportunities for end investors to access critical and socially strategic sectors and issuers that are not accessible to equity investors. We think it is much more compelling, for instance, to focus on our ability to directly fund affordable housing and environmental infrastructure, and earn appropriate economic returns for our clients.

Positively, the market's preference for convenience generates opportunities for active managers who are prepared to put in the hard work to understand a company's overarching sustainability, or search for bonds secured on specific green assets, to embed these bonds into portfolios without compromising achievable yields.

An example of one such bond is First Hydro Finance 9% 2021, which is an unrated, off-benchmark bond issued by a subsidiary of French company, Engie (see figure 4). As an electricity generator with some non-renewable capacity, the parent company may have a poor ESG rating. However, its subsidiary, First Hydro, generates hydro-electric power in Snowdonia and has a far better sustainability assessment. In addition, the bonds are secured, with strong covenants and ring-fenced assets and cash flows. The attractions of a bond that may fail a traditional ESG credit screen only become apparent under our more bespoke and integrated credit and ESG approach.

In our view, the need to focus on what is behind the label applies to all bonds, not just green. Figure 5 shows two very different companies whose bonds offer very different spreads. Both have an attractive label – but in Burberry's case, the bonds are paid from general company revenues, not from specific 'sustainable' assets. MORhomes is a social housing provider – so all monies raised go to funding this activity, and revenues paying coupons come from this source. In addition, the MORhomes bonds have a claim over the properties, providing additional protection for bondholders compared to the unsecured nature of the lending to Burberry. Yet Burberry bonds, with their greater name recognition and more conventional unsecured issuance, pay investors less.

It pays to dig deeper

Our approach to ESG in credit is built on the longstanding investment philosophy that credit markets do not accurately price idiosyncratic risk. We use ESG analysis in the same way as any other form of credit research – to uncover information that rating agencies and other market participants might be missing, helping us to make better investment decisions and deliver excess returns.

The green bond label offers the attraction of convenience – a fund buying the bond can point to an allocation to ESG-friendly assets. But is that really the case, and is it worth paying for? We may buy labelled bonds, but if we are paying for ESG 'additionality' it has to be tangible and demonstrable.

Figure 5: Market favours familiarity and convenience

	Burberry 1.125% 2025 (£300m BBB)	**MORhomes 3.4% 2038 (£334m A-)**
Bond label	**Sustainable**	**Social**
Security	Unsecured	Legal charge on properties
Visibility of proceeds	No	Yes
Debt service	General group treasury	Social housing assets
Spread	1.1%	1.6%

Source: RLAM as at 31 December 2020

Investment risks

The value of investments and the income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Credit risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

Sustainable investing: The investment strategy will result in certain industries being excluded as a result of our ethical and sustainable investment policy. As a consequence, there may be increased risk due to reduced diversification opportunities

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