The trend towards sustainable investment is reaching the bond market

Within *Focus* we comment on extraordinary market events and analyse capital market related special topics.

So far, the trend towards sustainable investment has been focused primarily on equity markets. Many market participants have attributed greater importance to the analysis of environmental, social and governance (ESG) criteria in equities due to the higher perceived influence and potential share price impact. Sustainable investment in the fixed income market on the other hand, is still in its infancy, partly because it is comparatively difficult to assess. Bonds are issued not only by companies, but also by governments or institutions, for which it is more difficult to analyse its sustainability credentials. Moreover, so-called sustainability-linked or project-related bonds such as green bonds can be considered sustainable investments, even if the issuer or company itself does not meet all sustainability criteria. The demand, however, for sustainable fixed income products is growing, not least as a result of the COVID-19 crisis. We discuss why sustainability criteria also play an important role in bond markets and what to look out for in such investments.

COVID-19 crisis increases demand for sustainable investment

In 2019, 270 billion euros were already invested in equities and bonds in Germany

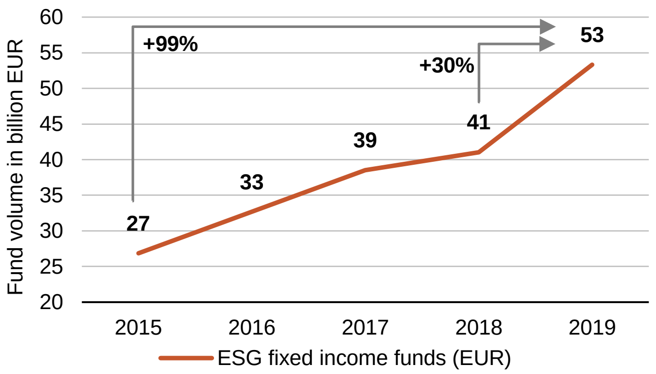
More and more investors are no longer just interested in absolute returns, but want to change something for the better or achieve a positive impact with their investment. According to figures from the Forum Nachhaltiger Geldanlage, around 270 billion euros in Germany were invested in sustainable equities and bonds in 2019 - an increase of more than 20 percent compared to the previous year. According to data from MSCI ESG, the volume of EUR bond funds that take ESG aspects into account in their investment process even rose by 30 percent in 2019 (Fig. 1).

In addition to environmental aspects, factors such as social standards or economic inequalities are becoming more important

The COVID-19 crisis has accelerated this development. On the one hand, the price losses of many ESG-compliant investments were lower during the recent crisis. On the other hand, the COVID-19 crisis has brought factors such as social standards, access to healthcare or economic inequalities increasingly into the focus of investors. In the past, environmental factors were considered to be of particular importance. However, the pandemic has made investors aware of the impact that social and governance aspects can have on a company's creditworthiness. After all,

Fig. 1: Demand for ESG fixed income funds is increasing

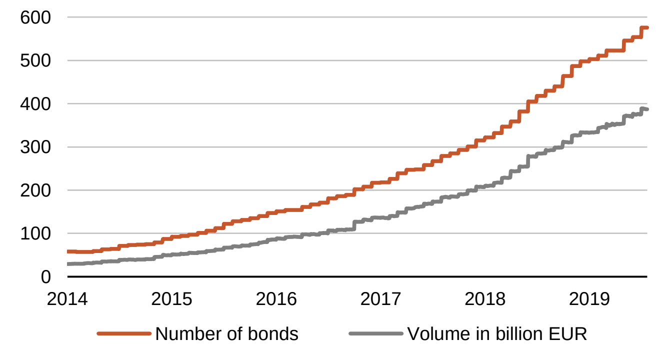
Development of the fund volume of EUR fixed income funds with an ESG Policy (according to MSCI ESG Manager) as of 31.12.2019



Date: 31.12.2015-31.12.2019, Annual data
Source: MSCI ESG Manager, EUR bond funds with ESG Policy

Fig. 2: Primary market activity of green bonds (project-related bonds) is increasing continuously

Number and volume of bonds in the ICE Green Bond Index



Date: 31.12.2014-20.07.2020, Daily data
Source: ICE Data, ICE Green Bond Index, Own calculations

in addition to the direct impact of the acute economic slump, the management of ESG risks also has a direct influence on how quickly, and in what condition, a company emerges from the crisis.

The challenges of ESG integration in the bond market

Many investors believe that careful ESG analysis is much more important in the equity market than in the bond market. It is true that in the event of acute distress or potential default of a company due to the materialising ESG risks, the potential loss of capital for shareholders is generally higher. However, the impact on bond prices will also be significant and lead to severe price distortions. These too must be kept as low as possible.

Fixed income investors tend to be long-term investors - therefore, the sustainability of the investment should be of particular importance

Nevertheless, beyond traditional factors such as interest rate levels or credit quality, sustainability in bond analysis continues to be of relatively little importance to many investors. Paradoxically, it is precisely because fixed-income investors tend to be long-term investors (pension funds are a good example), that ESG-related considerations, which in many cases are also structural and long-term in nature, should be given greater priority.

The direct exchange with the issuer and exertion of influence on the company is less common in the fixed income market

This is proving to be quite challenging - for example, the engagement or exercise of voting rights (proxy voting) is already a cornerstone of ESG integration in the case of equities. With bonds however, this is less developed. For bonds, a detailed but also standardised approach is needed to create such transparency in the direct communication with companies and to be more effective in its influence.

Sustainability analysis of government and quasi-government issuers is complex

Another obstacle, compared to equity markets, is the structure of fixed income markets. For example, the sustainability analysis of sovereign and quasi-sovereign issuers is more complex, and so active exchange and influence are usually more difficult to implement.

Different seniority levels of bonds and the diverse use of proceeds make ESG analysis more difficult

In addition, the complex capital structure of the bond segment, with different sub-asset classes (e.g. corporate and financial bonds, covered bonds, etc.), collateralisation and the diverse use of bond proceeds, requires a differentiated ESG analysis. There are also major differences with regards to available liquidity in the investment segment (compared to equities and within fixed income sub-asset classes).

To overcome these challenges and generate attractive returns, the classic, purely economic valuation of a company must be supplemented with sustainability criteria. This can be achieved, for example, by past-oriented ESG integration mechanisms such as exclusion lists or best-in-class approaches. It is also important to think outside the box. Sustainable investment is not purely synonymous with lower-risk investing, but can and should be used in a targeted manner to actively identify opportunities e.g. through structural trends. In the following section, the main focus is on integrating sustainability through impact investing.

Sustainable bonds - more than just bonds from sustainable issuers

Highest level of sustainable investing: Impact Investing - investments with a positive impact on the environment and society

In addition to the consideration of sustainability factors, from a performance and risk management perspective, another aspect that is becoming increasingly important is the impact of investments on the environment and society. Developments such as climate change, the increasing scarcity of resources or demographic change pose major challenges for our society and ecosystem. By making capital available in a targeted manner for projects, and bond issuers that promote sustainable change and make an active contribution to overcoming these challenges, a positive impact can be achieved.

With bonds, this can be achieved in several ways. Similar to the approach taken in equity markets, investments can be made in bonds from issuers whose products or services provide a solution to challenges such as climate change. Issuers that are strategically reorganising their business model and thus driving the transition towards a more sustainable economic model, such as an energy producer switching from fossil fuels to renewable energy sources, are also an option. Another option is offered by project-related bonds: green, social or sustainability bonds - a special feature that clearly distinguishes sustainable investment in fixed-income markets from equity markets.

Project-related green, social or sustainability bonds are a special feature of sustainable bond investing

Project-related bonds are usually unsecured bonds, which do not finance the general business activities of an issuer, but rather finance specific projects and assets that enhance or add environmental or social value and usually also have a direct impact on the 17 Sustainable Development Goals, as communicated by the UN. This can be, for example, access to affordable housing for disadvantaged and low-income families, or the financing of a wind turbine. Green bonds are used exclusively to finance projects with ecological added value, while social bonds are used equally for social projects. Sustainability bonds, on the other hand, are a kind of hybrid form used for financing ecological and social projects. The structure of these bonds, such as green bonds, is generally based on guidelines published by the International Capital Markets Association (ICMA) ("Green Bond Principles"). These principles are intended to set a market standard in terms of transparency and positive impact of the financed projects, but are not binding from a regulatory point of view.

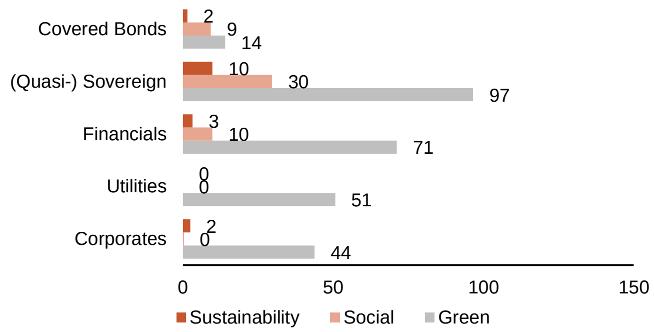
Project-related bonds specifically finance projects or assets with environmental/ societal added value

The ICE Green Bond Index (Fig. 2) illustrates the enormous growth of this market segment; in the past two years alone, the number of green bonds has more than doubled. In the wake of the COVID-19 crisis and the associated social challenges facing societies, companies and countries, the social bond segment in particular has seen a sharp increase of new issues in 2020. Social bonds were issued in this context, for example, by states or development banks to finance better and more extensive medical care. In the first half of 2020, the volume of new issues of EUR-denominated social bonds was almost 450% higher than in the same period of the previous year. Due to this strong growth, the segment of green, social and sustainability bonds now accounts for more than two percent of the total outstanding EUR-denominated bond universe. This allows for diversified investments across various sub-asset classes, regions and maturities, so that they are no longer just niche products for addition to a portfolio (Fig. 3 and 4).

Project-related bonds already represent more than 2% of the EUR bond universe

Fig. 3: Project-related bonds are no longer just a niche product, but are investable across sub-segments…

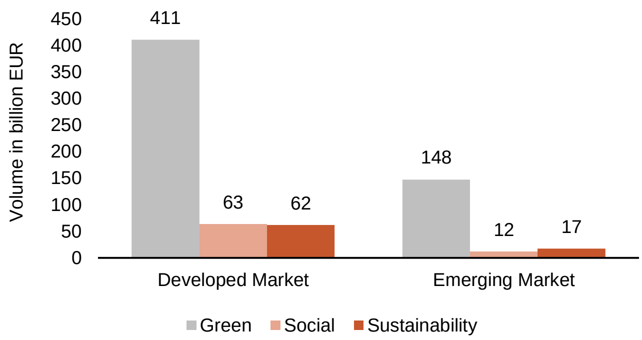
Oustanding volume of EUR-denominated green, social and sustainability bond in billion euros



Date: 31.07.2020
Source: Bloomberg, Own calculations

Fig. 4: … and regions

Outstanding volume of green, social and sustainability bond across regions in billion euros (Foreign exchange rates as of 31.07.2020)



Date: 31.07.2020
Source: Bloomberg, Own calculations

Sustainability-Linked Bonds: the latest innovation in sustainable bond investments

The increasing relevance of sustainability in the fixed income segment also brings further innovations in terms of bond structure; one of the latest innovations is sustainability-linked bonds, which - as the name implies - are linked to specific sustainable targets. The issuing company defines key performance indicators (KPIs) that must be achieved, such as the reduction of the company's average carbon dioxide emissions over the next ten years. Unlike project-related bonds, it is not defined how these sustainability targets are achieved and depends on the company's general strategy and development. If the previously defined targets are not achieved, the coupon payable on the bond may increase, for example. Thus, the further development of a company in terms of sustainability is directly related to the expected refinancing costs, and thus ultimately to the creditworthiness and profitability of the debtor. In this punitive bond structure, however, the question arises as to whether a positive financial incentive, in the form of lower interest payments when ambitious sustainability targets are achieved, might not be more effective in promoting the change to a more sustainable economic model. Similarly, an investor with a deeper understanding of sustainability may question if they would like to invest in such a bond structure if a company does not necessarily achieve its own sustainability goals and could even miss them by a wide margin.

How ESG integration can work in the bond market

In order to achieve a positive impact through bond investments, and simultaneously generate attractive returns, a detailed and future-oriented analysis of issuers and the bond framework is imperative. Such analysis is required due to the complex structure of project-related and sustainability-linked bonds, and the difficulty in identifying/measuring the positive impact of bonds and issuers on the environment and society.

ESG ratings from external data providers can only serve as a starting point

ESG ratings from external data providers can be helpful and serves as a starting point, but they are not suitable as the sole source of information and basis for decision-making. For project-related bonds especially, the simple application of ESG ratings is usually not appropriate, as they only relate to the issuer while the bonds invested and the resulting financial resources are allocated to specific green or social projects. In addition, ESG ratings are to some extent dependent on an issuer's level of disclosure, which may lead to a bias towards financially strong and resource-rich companies receiving better ESG ratings, regardless of the sustainability and positive environmental and social impact of their business model.[1]

Bottom-up analysis and engagement are essential components of sustainable and impact-oriented investing

In addition to bottom-up, detailed analysis, engagement is an essential component of sustainable and impact-oriented investing. This is possible, not only through proxy voting for equity investments, but also in the fixed income market through regular, active communication with issuers. For many companies, bond investors are important capital providers, who can and should exert influence by actively communicating expectations for the company and discussing sustainability. In order to gain better influence and access to issuers, it is therefore also beneficial if the interests and capital of various investors can be combined, e.g. in the form of target-oriented and broadly diversified mutual funds.

Conclusion

The topic of sustainable investment is high on the agenda of investors today. While the focus in the past was almost exclusively limited to equities, more investors are now turning their attention to integrating ESG criteria in bond markets. However, due to the comparatively higher complexity of issuers and the capital structure of

[1] Further discussion of this can be found in Berenberg's ESG Office Study: "ESG Ratings: The small and mid cap conundrum" https://www.berenberg.de/files/Presse/Presse-Informationen/2020/Small%20Cap%20Bias_White%20Paper.pdf

bonds, this represents a greater challenge that can only be met by a holistic sustainability approach to portfolio management.

Sustainable investment in bond markets is now more than just "green". The investment spectrum has broadened, which also means that focus, is increasingly shifting to the positive impact of investments. In order to effectively incorporate sustainability analysis for bonds, in light of its complexity, and capture the positive ecological and social impact of the investments, the mere application of ESG data from external providers is insufficient. Berenberg goes one step further. We supplement external ESG assessments with well-founded and forward-looking sustainability analyses, alongside active engagement with issuers to discuss sustainability considerations. Only then can we speak of a sustainable and impact-oriented investment in the bond segment.

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