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PERSPECTIVE

Green Bond Investments: avoid sub-optimal investment portfolios

Both asset owners and asset managers would like to contribute to the UN Sustainable Development goals (SDG's). Green bonds are an excellent opportunity to make this contribution and simultaneously add a return that's comparable with a normal bond.

The Green bond market is growing year by year in size as well as popularity, because of an increasing demand amongst stakeholders for more sustainable and impact-driven investments. For example authorities require the financial sector to contribute to the Paris Agreement on climate change and customers demand that their pension or insurance money is invested with a positive impact on society.

CHARACTERISTICS OF A GREEN BOND

Green bonds have the risk and return characteristics of normal bonds with the difference that the use of proceeds are allocated to eligible Green Projects. Green bonds have an (un)secured claim on the whole company and not only on the allocated assets (use of proceeds). Green bonds are for the most part issued in the Investment Grade (IG) rating category and the EURO is currently the dominating currency in the universe.

While the risk and return characteristics of individual Green bonds are comparable with individual normal bonds, this is not the case for a diversified fixed income index or portfolio.

The Euro Green bond market is still in its infancy if we compare the size (<1% of Euro iBoxx overall) and diversification of the Green bond universe. Especially the credit market (credit = corporates + financials) is relatively concentrated in the banking and utility sector and the number of different issuers is limited. When a credit strategy is to only invest in Green bonds it will make the portfolio vulnerable to concentration biases in both sector and single name exposures. In this article we give some background on how one could deal with these factors.

GREEN BONDS: AVOID SUB-OPTIMAL SOLUTIONS

In the management of investment grade credit portfolio's for institutional clients it is commonplace to maintain diversification above a certain minimum level. Because of lower correlation between different constituents a diversified portfolio can generate a predictable net return with equates to less risk at the same net spread.

In the construction of credit Green bond portfolio investors are currently more or less obligated to buy every new issue, because of the limited supply and huge demand. Consequence is a portfolio that is not ideal. With a substantiated fundamental view you can select the issuers that are less vulnerable for credit events. However, events like natural disasters or fraud are usually difficult to predict but can have serious consequences on a portfolio if not well enough diversified. Volkswagen is a good example were a lot of investors were caught by surprise (Volkswagen acknowledged in 2015 to have cheated on installing software in cars with diesel engines whereby emissions were manipulated in a testing environment).

Our view is that the number of Credit Green bonds is too limited for a diversified standalone credit mandate. Because of limited supply and number of outstanding bonds, there is limited room to add value based on selection of individual issuers and sectors. This is demonstrated in the graphs below.

This is a publication of our Fixed Income & Multi Asset team, consisting of 17 professionals with an average experience of 16 years in the industry.

ACTIAM is the responsible asset manager for more than one million people. With over 100 staff we manage €56.3 billion (ultimo June 2018) primarily for insurance companies, pension funds, banks and intermediaries. ACTIAM invests for its clients not only to achieve an optimal financial return, but also a social return. We do this by taking into account the consequences for the environment and society and continue to develop responsible investment solutions for the general public.

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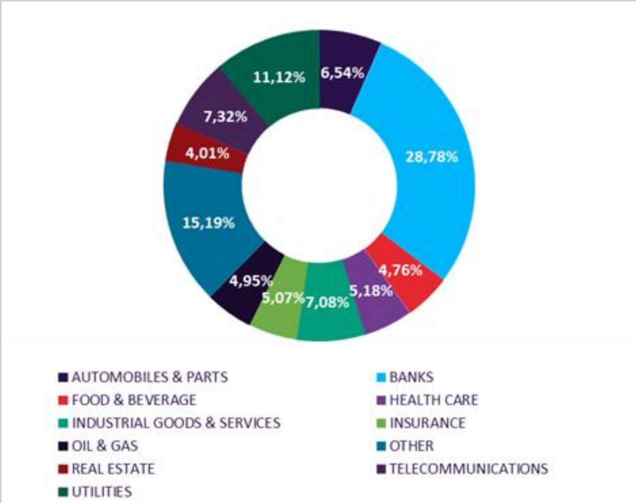
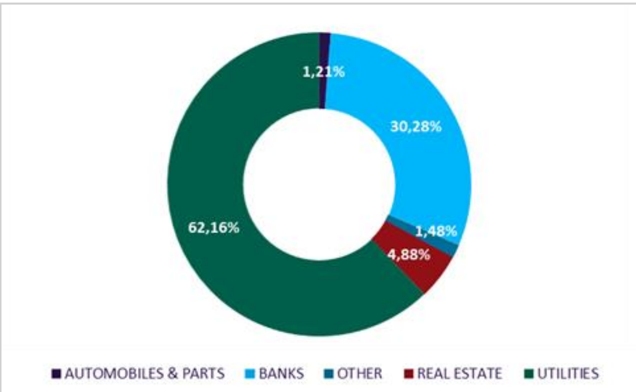
A split in sectors is shown for both the Euro iBoxx Corporate benchmark and the Green bonds from that benchmark.

EUR iBoxx Corporates



Source:ACTIAM, Bloomberg

EUR iBoxx Corporates - Green

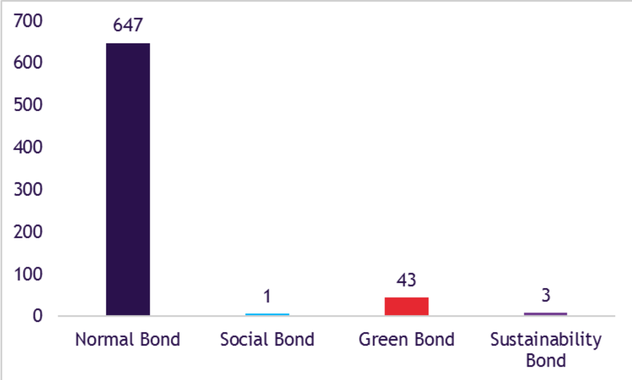


Source:ACTIAM, Bloomberg

The graphics show that the banking sector has a more or less equally market weight in both compositions but the utility sector is clearly dominating the Green bond credit landscape.

It is also worth taking a closer look at the number of Green bond issuers in the Euro iBoxx Corporate benchmark.

Number of issuers



Source:ACTIAM, Bloomberg

This underpins the view that number of Green bonds issuers is too limited for a diversified IG credit portfolio and too limited to add alpha by picking the right bonds or implement a sector view. Therefore it is good to add social (use of proceeds for social projects) and sustainable bonds (combination of green and social), but those bonds have a higher presence in the non-corporate universe (non-profit agencies and such). Furthermore, there are only a few issuers active in the credit universe. If you take the rating distribution in account, this is not a distinguishing factor because of the limited number of names and the bulk is located in the A/ BBB category.

Banks and utility companies are the logical sectors to issue Green bonds and they will dominate the universe going forward. We expect however more diversification in names and sectors. Automotive, Transport, Real Estate and Technical industries are promising sectors were we expect more issuance.

PROPRIETARY METHODOLOGY IS KEY

It is critical that besides having selection criteria based on a credit view and relative value, also to have your own Green bond methodology. Every Green bond should be assessed on the use of proceeds, framework and the level of 'Green' ambition of the issuer. If they are not fulfilling the criteria it means it is not marked as Green. A handful of Green bonds that are labelled Green by other market participants, would not pass this test.

There are different alternative strategies given the limited diversification and number issuance of Green bonds.

We believe that green bonds are an add-on strategy. This means that Green bonds are part of our Euro IG credit strategy.

The credit strategy is not only to optimize the return versus the risk of the portfolio, but also to take into account and improve the ESG score of the portfolio. Every issuer gets an ESG score, and based on that, the average ESG of the portfolio is calculated. The score is not only including a carbon footprint estimate but does take also in account the financial risk related to ESG.

Green bonds do also get an ESG score to integrate them in the portfolio strategy. The Green bond scores are generally higher than the normal issuer score. There are some exceptions whereby the issuer has already a high sustainable ambition level for all of their assets. Iberdrola is one of the rare cases where the Green bond score gets the same score as the issuer score. Because of the higher ESG score we have a natural preference to select Green bonds above normal bonds.

All in all Green bonds offer a big opportunity because of their positive impact and their risk, return characteristics. A fund offering with solely green bonds offer sub-optimal investment portfolios. We believe that it is necessary to integrate Green bonds in a broader credit strategy. Off benchmark and sub sovereign names are also a good source to increase the Green bond universe. This way green bonds can and should be a core holding of every fixed income portfolio!

Example - Iberdrola

We give the issuer Iberdrola a score of 91; they get a top score from MSCI, because they operate in the renewable energy sector, active coal facilities are phasing out, with 66% of their operations causing no emissions and being progressive when it comes to target setting and reducing emissions (carbon neutral in 2050). In addition, Iberdrola receives from us an analysis score - positively selected, because they are leading in the energy sector when it comes to their contribution to the energy transition. This gives them a higher score than their green bond score.

ESG SCORE CARD IBERDROLA

	WEIGHT	SCORE	QUARTILE
Environment	**72,0%**	**8.5**	
Carbon Emissions	19,0%	10.0	●●●
Opportunities in Renewable Energy	19,0%	6.8	●●●●
Toxic Emissions & Waste	19,0%	8.6	●●●●
Water Stress	15,0%	8.7	●●●●
Social	**12,0%**	**5.9**	
Human Capital Development	12,0%	5.9	●●●●
Governance	**16,0%**	**6.9**	
Corporate Governance	16,0%	6.9	●●●●
Overall Score			
Weighted-Average Key Issue Score		7.9	
Industry Relative Score		10.0	