Investing for impact in fixed income

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Responsible investment has become a central focus for investors around the world. Signatories to the UN-supported Principles for Responsible Investment now account for tens of trillions of dollars of assets under management.[1]

There are many reasons for this growing interest. Regulatory pressure is growing: over half of all related corporate and investor sustainability-focused policy initiatives have been implemented since 2013. There is also growing recognition that environmental, social and governance (ESG) factors can have a material impact on investment performance.

While responsible investment has traditionally been the preserve of equity investors, the relevance of ESG risks in fixed income markets – and the influence of fixed income investors over debt issuers – is now widely recognised.

A unique opportunity for fixed income investors

Uniquely, fixed income investors have access to impact bonds, which explicitly use their proceeds for positive environmental or social themes. The impact bond market has been steadily growing since the early 2010s, and they can offer opportunities for investors to incorporate explicit positive ESG impact objectives in their wider investment portfolios.

Responsible investment in fixed income does not require investment in impact bonds. Responsible investment is about incorporating ESG risks in wider investment processes to support better long-term risk management and prospective performance.

Also, investing in these types of securities is not without its challenges, as the market is relatively small and not all impact bonds have robust frameworks for measuring their targeted outcomes.

However, we believe impact bonds can help some investors achieve their long-term objectives. As with any fixed income investment, using impact bonds effectively requires sophisticated and thorough analysis. And of course, impact bonds may be issued by good companies with sound financials, making them potentially appropriate for inclusion in a traditional fixed income portfolio.

What is an impact bond?

Impact bonds use proceeds for positive environment or social themes. Investors can use them to contribute towards their sustainability objectives – for example, achieving the UN Sustainable Development Goals is expected to require $5 trillion to $7 trillion of total investment by 2030[2].

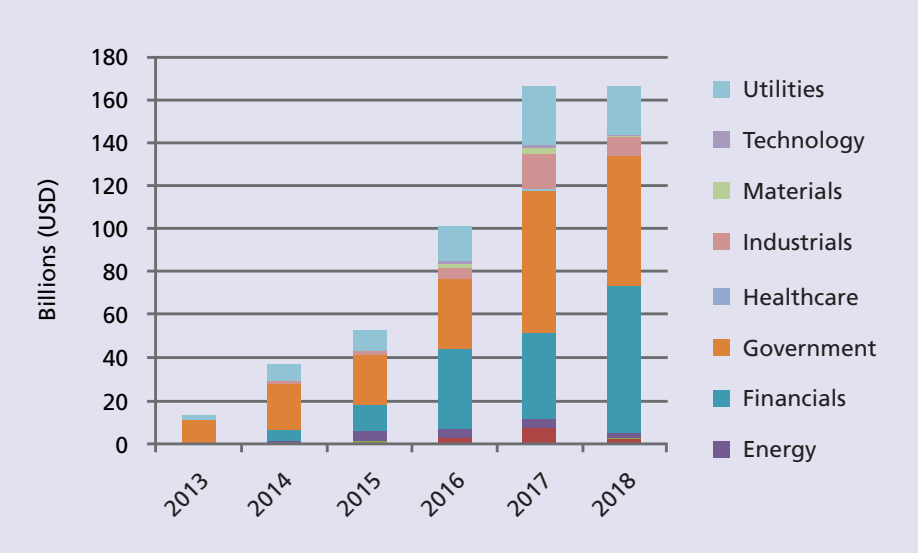
Impact bonds are typically categorised in the following ways:

- Green bonds: earmarked to finance climate and environmental projects
- Social bonds: earmarked to finance social projects
- Sustainable bonds: allocate proceeds to either green or social projects

Growth slowed in impact bond market in 2018

Growth in the impact bond market has risen rapidly in recent years, but growth slowed in 2018, with US dollar issuance of all impact bonds over the year totalling $166.3 billion – only slightly up from 2017's $166.1 billionn (see Figure 1). However, this upward trend seems to have stagnated.

Figure 1: Growth of the impact bond market slowed in 2018[3]



Source: Insight Investment

Adopting a sector-specific view, the trend of growth also seemed to be moderating. For example, governments accounted for around 36% of impact bond issuance in 2018, a slight drop from the 39% issued the previous year. Utility issuance remained considerable, at 13.7%, although volumes also fell compared to 2017, marking the first year-on-year drop.

Notably, financials became the biggest issuer of impact bonds, accounting for 41% of impact bond issuance, up from 24% in 2017.

In our view, there are several possible reasons for the slowdown in growth:

- General market weakness and cautious investor sentiment may have limited the issuance of impact bonds, as they did for conventional bonds.
- Uncertainty over the implications of the European Commission's green taxonomy (part of proposed regulation for creating a more sustainable financial market), which may have limited supply.
- Many companies with leading sustainability programmes have already issued impact bonds and are now putting the bond proceeds to work, so the pool of potential issuers has shrunk.

Are impact bond portfolios viable?

The impact bond market is sizeable – but for investors seeking to build a dedicated portfolio, it is smaller than it might at first appear. To be incorporated within broad fixed income benchmarks, a bond issue must be at least $300 million (or the equivalent in other currencies) in size.

In 2018, 97 impact bonds of this size were issued, of which 89 were from issuers in the government or sovereign, financials or utilities sectors, accounting for $90 billion of issuance. Most of these were green bonds (see Figure 2).

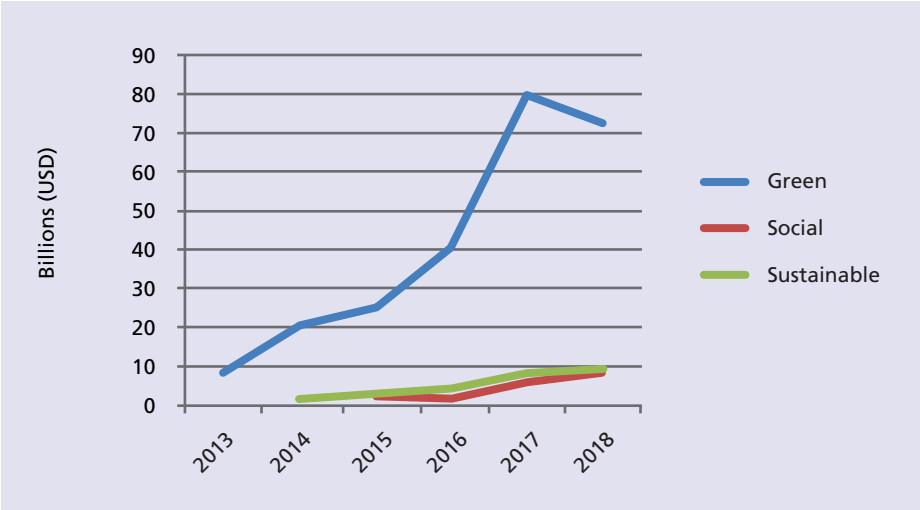
The relatively small amount of benchmark-size issues means that for fixed income investors, the opportunities to invest in dedicated impact strategies remain limited and are concentrated within only a few sectors.

Given the relatively small amount of impact bonds, investors seeking to construct a portfolio of impact bonds should benefit from clear parameters and skilled analysis to ensure they invest in suitable assets.

The importance of analysing impact bonds

We believe it is important to analyse sustainable bonds to see whether they are as sustainable as they might claim to be. The absence of regulatory or even industry standards for sustainable issuance means there are varying expectations among issuers and bondholders. This has been demonstrated by our own analysis: in 2018, we analysed 39 issuers of impact bonds, and less than

Figure 2: Issuance of impact bonds above $300 million in size[4]



Source: Insight Investment

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half fully met our minimum sustainability requirements.

For example, one of the 39 issuers we analysed was a global financial, which issued a bond linked to the UN Sustainable Development Goals. The proceeds were used for health and wellbeing, quality education, clean water and sanitation, affordable and clean energy, industry innovation and infrastructure, sustainable cities and communities and climate action. The issuer follows best practice, with a green bond committee and sustainability representatives having oversight of projects with the power to veto. These factors indicated that the issuance met our minimum sustainability standards.

On the other hand, we analysed a US telecommunications company that issued an impact bond, with proceeds used for energy efficiency projects, renewable energy, green buildings and water management. However, there was very little detail surrounding the project selection process and the company only committed to allocation, not impact reporting. For these reasons, our analysis indicated that the bond did not meet our minimum sustainability standards.

When analysing sustainable issuance, we believe investors should consider:

1. ESG profile: the ESG performance of the issuer, including corporate governance quality, its history of environmental and social activity and breaches of global norms.
2. Structure of bond: the strengths of the framework outlining the impact of the bond, which provides guidance for how the company will use bond proceeds.
3. Bond impact: the tangible impact of the bond proceeds. This will likely be a qualitative and quantitative assessment as to the actual impact of the bond.

A growing opportunity

Impact bonds present fixed income investors with exciting opportunities to have a positive impact on society or the environment.

We believe investors should treat them in the same way as any other fixed income instrument – analysing them according to their financial and non-financial risks, but also applying in-depth research to ensure the bonds have a robust approach to their sustainability objectives.

Despite strong growth, the investable market remains small relative to the traditional equity and bond markets. But as demand grows and frameworks are more firmly established, impact bond strategies may come to play an increasingly significant role in the wider markets.

It will become all the more important for institutional investors, and their investment managers, to fully assess how well these instruments can help them achieve both their financial and non-financial objectives.

1. https://www.unpri.org/
2. http://www.undp.org/content/undp/en/home/blog/2017/7/13/What-kind-of-blender-do-we-need-to-finance-the-SDGs-.html
3. Bloomberg and Insight. As at 31 December 2018.
4. Bloomberg and Insight. As at 31 December 2018.