Sovereign bond investing: A climate-focused approach

When it comes to responsible investment strategies, sovereign bonds have so far largely been overlooked. We believe that needs to change

Responsible investment has taken equity markets by storm. Although its penetration into fixed-income markets has been slower, it is picking up speed there too. Yet one area remains overlooked – government bonds. That's a major oversight. After all, governments set the rules and regulations that companies and individuals follow, and without their support and investment, the world will not be able to tackle its most pressing problems – climate change in particular.

Fixed-income investors have a key part to play in providing the capital required to keep climate change in check. While individually, investors have a negligible influence on government policy, collectively they can make a real difference – after all, the investment community holds $88 trillion in bonds issued by governments and their agencies.[1]

Focus on emissions

So how might fixed-income investors construct government bond portfolios in a way that has biggest possible impact in the fight against climate change? Investors in emerging-market bonds are central to the transition. That's because developing economies are more vulnerable to the physical impacts of global warming than their developed counterparts, in part due to geographical factors, but also because of weaker economic and institutional underpinnings. At the same time, emerging nations can be global leaders in many of the technologies needed for transition. But investors in developed sovereign bond markets also have a key role to play in the transition.

Based on today's level of emissions relative to GDP, bond investors should reward Western Europe (particularly Scandinavia). Some emerging markets, such as Mexico, are also relatively green. To tackle global warming, though, fixed income investors also have a duty to incentivise the laggards to reduce emissions. In other words, bond investors should consider allocating capital to countries whose carbon emissions are falling at the steepest rate relative to the size of their economy.

Focusing investments in the bonds of these nations may mean leaving out countries which are the mainstays of traditional bond indices. But that, in turn, increases diversification benefits for investors and should placate those who complain that funds that claim to embed environmental, social and governance (ESG) criteria are too often remarkably similar in their composition to non-ESG labelled ones.

By focusing on countries that are actively working on reducing emissions, sovereign bond investors can play a part in the fight against climate change and significantly reduce the carbon footprint of their own portfolios. As more investors take this view, we believe we can start to incentivise change in government policy.

Green returns

In terms of the type of investment, green bonds are a natural choice for climate-conscious government bond investors. It's a small but rapidly growing universe.

As well as its limited size (so far), the green bond market is hampered by a lack of universal rules and standards. Currently, the labelling and certification of sustainable bonds differs considerably from one country to another, while efforts to harmonise disclosure requirements haven't met with much success. We expect to see increased standardisation as the green bond market deepens and increases in value.

Given these limitations, we believe that a climate-focused sovereign debt portfolio shouldn't focus exclusively on green bonds. It should also invest extensively in traditional bonds, which are in greater supply, are easier to understand and exhibit more attractive valuations.

Change starts with planting a seed.

When Pictet launched its water equity investment strategy back in 2000, investments targeting positive change and sustainability were virtually unheard of. Two decades later, such strategies are mainstream and thriving. In just a year from launch, the Net Zero Asset Managers initiative has gained 220 signatories, who together manage $57 trillion.[2] We believe it is now time to transform sovereign bond investing by embracing climate change concerns and incentivising change – both through dedicated strategies and through including these considerations in the investment decision process for conventional bond funds.

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[1] International Monetary Fund, October 2021 **https://blogs.imf.org/2021/10/13/fiscal-policy-for-an-uncertain-world/**
[2] **https://www.netzeroassetmanagers.org/**