Summary
• Social bonds are issued by governments and companies aiming to raise finance for projects that will have a positive social impact.
• The pandemic helped to push the agenda on social bonds – the number issued in 2020 was four times those issued in the previous year.
• Social bond funds have twin aims – positive social impact and adequate returns.
• These double aims are a good fit with pension funds' long-term objectives.
• A new area, there is some ironing out to be done – particularly when it comes to avoiding 'social washing' and ensuring the closure of any loopholes that allow bonds to be labelled as 'social' when they do not really fit the criteria.
• The future looks promising – 65 per cent of investors were actively interested in social bonds, according to a GSAM survey.

Looking at social bonds

Sandra Haurant considers the growing appeal of social bonds and the role they can play within pension fund portfolios

According to Goldman Sachs Asset Management (GSAM), social bonds have begun to come into their own in recent years, moving out of the niche and into the mainstream. The shift is partly due to the pandemic, when governments began issuing more bonds aimed at protecting public health and squaring up to other social challenges, and in 2020, 227 social bonds were issued – compared with 50 in 2019.

By the end of 2022, social bonds had grown into a €464 billion market, and investors are increasingly seeing the attraction. The findings of a GSAM survey, published in May 2023, showed that 65 per cent of investors expressed an 'active interest' in investing in social bonds, while 29 per cent said they were already investing. But what's in it for pensions?

Back to bond basics

Bonds, in general, have traditionally formed part of the bedrock of pension funds' investment portfolios; effectively loans made to governments or companies, they usually allow the bond issuer to raise funds and the investor to receive an income on that loan, and recover their capital on maturity.

But with social bonds, also known as social impact bonds, the benefits are twofold; here, the social aims of the bond's issuer are as important as its potential to deliver financial gains.

Tammie Tang is the portfolio manager of Columbia Threadneedle's CT UK Social Bond Fund, set up in 2014. She says: "The CT UK Social Bond Fund was created nearly a decade ago to deliver socially beneficial outcomes to people in the UK, through investment in the public bond market." Its mission, then, is clear: "The fund was incepted on the belief that the public bond market has great potential to deliver better outcomes for society, in light of the large scale of capital provided by the bond market and noting the growing social issues and inequality affecting our society," says Tang.

What lies beneath

Typical underlying assets held within a social bond fund, says Tang, include a diverse range taking in the likes of social housing, infrastructure and the delivery of healthcare or education.

And, AXA IM senior portfolio manager, fixed income, Johann Plé, explains: "We invest at least 75 per cent of our social strategies in social and sustainability bonds. Within our portfolios we will find several banks with social issuances that tend to support employment through loan to SMEs, for example, or affordable housing."

He adds: "We also tend to like agencies that can cover a broader range of projects, including access to basic needs or health services. On the corporate side, the lack of social issuances makes us favour companies with activities that positively contribute to the society, favouring access to education, healthcare or addressing mobility issues for disabled people for example."

What's in it for pensions?

Pension funds have been paying increased attention to social bonds, with good reason. "Pension funds are long-term investors. Social bonds not only offer them the highest level of transparency with regards to what they are financing but they also provide them an opportunity to mitigate risk related to social issues while benefiting from an exposure to issuers that are a better fit to thrive in a transition towards a more sustainable economy," says Plé. "Indeed, we believe credible social bonds are issued by issuers that are less likely to be impacted by social movements, but that also anticipate the potential shift in demand driven by consumers' broader awareness of social issues and appetite for more sustainable products and practices."

While Tang adds: "Our social bond strategy delivers impact investment via the bond market. Impact investments should appeal to pension funds, because they target twin objectives of positive social impact alongside financial return."

Like Plé, Tang asserts that delivering social impact allows pension funds to contribute long-term capital to social solutions, and in so doing help to tackle issues such as deprivation, high cost of living and the widening inequality gap. "We are strong believers that in targeting populations more deprived, and in delivering better social outcomes, such as in health, housing, education and access to services, we seek to benefit all of society," Tang says.

Reaping rewards

There is, then, a balance to be attained here: Doing social good and achieving the returns that pension schemes very much need. So how do social bonds compare to their conventional counterparts?

Tang says social aims don't have a negative impact on returns; indeed, the opposite can be true: "Our social impact funds have the track record to evidence that financial return can be achieved alongside social alpha. Our financial performance compares well with non-impact fixed income funds. For example, the CT UK Social Bond Fund references the one 10-year non-gilt index and has delivered both financial alpha and social alpha."

"We do not see any significant pricing difference between social bonds and equivalent conventional bonds," says Plé. "Performance differences at universe level have been more driven by the key characteristics differences such as geographical or sector breakdowns."

Sitting, as they do, in an adjacent category to so-called 'green bonds', it's also interesting to see how social and green bond indices compare, says Plé.

"When comparing social bonds index with a green bond index or a global aggregate index, one can observe that social bond and green bonds performed relatively the same since the end of 2021, underperforming a conventional aggregate universe," Plé explains.

Much of this is down to the increase in interest rates, and a greater exposure to euro and US rates, and, he adds: "In the meantime, the higher exposure to credit and quasi-sovereign has made social and green bond universe more exposed to the widening of spreads observed over the period." But Plé argues that these can be reasons for optimism – they will, he says, stand to benefit if or when inflation slows and central banks eventually relax rates.

What next for social bonds?

This is, says Plé, a "nascent market", and some of its momentum has slowed since the highs of 2020 and 2022. But, he says, it "has still a lot to offer," particularly since "social issues are becoming more and more crucial".

Corporate issuance, he argues, holds particularly high potential. "Some real estate companies, as well as utilities, have already issued social bonds, and we expect to see more of these issuers finance their investment in affordable housing or access to electricity or water for example," he says.

"The telecom or healthcare sectors could be the next to join this market. In the meantime, supply chain management comes under more scrutiny and could bring additional issuers. Eventually, one cannot turn a blind eye to the social impact of transitioning to a low carbon economy. This transition needs to be a just transition, and we believe social bonds will be the perfect instrument to accompany this effort and grow hand in hand with green bonds."

Inevitably, many analysts insist that there is scope for refinement and improved clarity in social bond arena. Investors are increasingly alert to unscrupulous greenwashing tactics in the environmental investment sphere, and similar concerns have been raised about social investment. Issuers will need to be clear on their aims, and investors should expect reporting to be robust.

But many argue this growing area of social investment is, nonetheless, promising, for issuers and investors alike. Commenting on its survey, GSAM global head of green, social and impact bonds, Bram Bos, said: "At present, only a small number of managers offer a dedicated social bond fund, but we believe the market is now large and diverse enough to make social bonds a viable complement to investors' existing fixed income exposure."

But, he added, the future is looking bright: "The market's growth potential will make social bonds increasingly attractive to a wider range of investors over time. The opportunities offered by social bonds should earn them a place in any well-diversified portfolio."

Written by Sandra Haurant, a freelance journalist