Summary
• The government recently announced its intention to place the UK at the forefront of green finance and revealed its plans to launch the first Sovereign Green Bond in 2021.
• Like many asset classes, opportunities for responsible investment through fixed income are increasing.
• Fixed income can offer pension investors with the opportunity to direct capital that benefits society and the environment in a focused way.
• However, there are risks of greenwashing and investors may need to be diligent in where they choose to invest.

Investing in a greener future

With the UK looking to 'build back better' in the aftermath of the coronavirus pandemic, pension investments have been touted as one of the ways in which the economy can recover in a more sustainable manner. Jack Gray investigates the role fixed-income investments have in the responsible post-Covid recovery

In November 2020, the government conducted a financial services update that outlined its intentions to make the UK a world leader in green finance. Included in the update was the announcement of plans to introduce the UK's first Sovereign Green Bond in 2021. The gilts aim to support the country in meeting its 2050 net-zero target and help it 'build back better' in the aftermath of the Covid-19 pandemic.

The announcement demonstrated the increasing role that fixed-income investment is playing in responsible investment. Opportunities for fixed-income investors to make investments in line with environmental, social and governance (ESG) targets are becoming more commonplace. The types of sustainable bonds available have developed over the past decade, alongside the growing take up of ESG-related metrics across the whole investment landscape, making ESG-friendly investments safer and more reliable.

Although equity markets may have traditionally led the way in sustainable investing and ESG-focused products, fixed income seems to be catching up.

Playing its part

"Fixed income benefits from being able to provide a powerful and focused way for investors to direct capital to uses that benefit society and the environment, that is not available to the same extent for equity investors," begins Newton Investment Management fixed income team analyst and portfolio manager, Scott Freedman.

These include investments in private companies, development agencies, and green, social, and sustainability-linked bonds.

Freedman explains that green and social bonds are 'use of proceeds' bonds, where the capital is directed to specific environmental and social projects, while sustainability-linked bonds are where there exists a whole business key performance indicator, such as an emissions reduction target.

"If this target is not met, the interest cost on the bond steps up," he continues. "This provides a valuable covenant with bondholders, ensures there is 'skin in the game' for the issuer and ensures senior management buy in to transition the issuer towards better outcomes, rather than just specific projects."

Hymans Robertson investment research consultant, Penny Cochrane, notes that, "to a degree", debt markets are already pricing in ESG risks, with many managers seeing this as integral to their investment processes.

"Sustainability is also taking a front seat with more issuance of sustainable or sustainability-linked bonds, although this market is still relatively illiquid," she adds. "Exposure to unsustainable issuers, such as fossil-fuel producers, is widely recognised as a risk as we transition to a low carbon economy.

"With DB pension funds holding a growing portion of their assets in fixed income, there is a need to think about sustainability, especially over the longer term as ESG factors such as climate risk play out and give rise to the potential for increased defaults. Investors can choose to avoid lending to corporations unable to demonstrate sufficient ESG management or choose actively to fund sustainable projects."

Evolving environment

Although the first-ever green bonds were issued by the World Bank in 2007 and the UK has announced its intention to issue its first Sovereign Green Bond, Pensions and Lifetime Savings Association (PLSA) deputy director, Joe Dabrowski, believes that fixed income is "often overlooked" in the public debate about sustainable investing.

"The market for green bonds has grown significantly since then with over 50 countries issuing them," he notes. "However, the UK is, so far, not among them. This is something the PLSA would like to see change and have called for the issuance of green gilts."

Dabrowski adds that the new rules for climate disclose coming into force for large pension schemes from October 2022 will mean that pension trustees will need a broader array of investments to meet their climate ambitions.

"Green gilts issued by the UK government would be particularly appealing for funded DB pension schemes as they are lower risk when compared to investing directly in green energy projects, and, being sterling-denominated, would be suitable for funding the benefits of their retired UK members," he explains. "DB schemes would also likely have appetite for index-linked green gilts. If these assets were priced attractively, it could fuel lots of capital going into 'greening' the economy."

Despite concerns that fixed income is being overlooked by some as a means for responsible investment, Cochrane says that sustainable investing through the fixed-income market has become more mainstream.

"We have seen the launch of sustainable bond funds, including funds for retail investors," she continues. "There has been substantial growth of the green bond market. Green bonds represent only about 1-2 per cent of the fixed-income market but is quickly growing, with 2020 seeing a higher level of issuance than 2019.

"There has been notable expansion in the sectors issuing green bonds, moving beyond predominantly utilities and banks. The types of sustainable bonds available to investors have developed over the past 10 years, with diversity-linked bonds available in the US, as well as blue bonds, which support initiatives aiming to preserve and protect oceans."

Opportunities for sustainable fixed-income investing have improved, with innovation in the types of instruments available to investors, according to Freedman.

He states that, as these instruments mature, they are becoming more mainstream and liquid, and that several bodies are involved in promoting the standardisation of principles and frameworks behind these instruments.

"Allocating fixed income capital to issuers undergoing a favourable ESG transition will be the next leg of growth and opportunities for a broader allocation of capital. I believe that the mobilisation of mainstream capital will be more important for the environment and society than some of the already best in class green and social projects," Freedman says.

Beware of greenwashing

As with any asset class, there are risks associated with sustainable fixed-income investing. The most commonly cited risk is that of 'greenwashing'. Cochrane explains: "There is the perception that sustainable investing may mean an impact to overall returns but this not the case in most instances.

"However, there are other risks that investors need to be aware of. In particular, greenwashing, whereby a company touts its environmental policies but doesn't follow through with action, can be an issue in sustainable investing. Robust pre-issuance due diligence should ensure proceeds raised are being used to fund sustainability projects where that is the intention."

Freedman agrees, and encourages fixed-income investors to conduct fundamental issuer analysis to determine the robustness of the ESG plan, or the credibility of the projects or targets for green, social and sustainability-linked bonds.

Looking to the future

Looking to the future, Freedman believes that further growth will likely to lead to greater diversification of investment opportunities and touch more areas of society.

"Today, if you solely invest in green bonds, you will be exposed predominantly to banks, utilities and relatively high-quality, investment-grade debt, with a higher degree of interest rate sensitivity," he says. "Therefore, further growth into other sectors, geographies and credit ratings, will help sustain the demand side of the green bond market."

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