# Making fixed income work harder

## Putting sustainable euro bonds to work in institutional investment portfolios

BMO Global Asset Management

# Introduction

Despite the myriad challenges 2020 has presented, interest in sustainable bonds is undimmed. If anything, the desire to 'build back better' after the pandemic has refocused investors' attention on the crucial role these instruments will play in securing a sustainable future.

Demand for the average green bond issue is generally three times higher than supply, evidencing a strong appetite for green bonds in the investment community[1]. Meanwhile, the Climate Bonds Initiative estimates that issuance of green bonds will exceed $350bn in 2020, up from $265bn in 2019. There's a clear trend of investors seeking to balance returns with making a positive impact.

In this paper, we discuss the opportunities for investors in sustainable bonds and show how an allocation to these instruments sits within a wider fixed-income allocation. We also explore how investors can avoid greenwashing, using case studies to highlight how our team of professional investors upholds rigorous standards for our clients.

### A note on terminology

We use "sustainable bonds" as a collective term for green, social and sustainability bonds. All of these are bonds that finance projects with environmental and/or social benefits. Examples of such projects include, but are not limited to, renewable energy, water conservation, energy efficiency, affordable basic infrastructure, affordable housing and food security.

## Key risks

The value of investments and any income derived from them can go down as well as up and investors may not get back the original amount invested.

Changes in interest rates can reduce the value of your investment. Screening out sectors or companies may result in less diversification and hence more volatility in investment values.

[1] https://www.ft.com/content/61631c2c-1a65-11ea-9186-7348c2f183af

# Sustainable bonds – a growing opportunity

In October 2020, China announced plans to transition to a zero net carbon economy by 2060[2]. In the US, President-elect Joe Biden has committed to rejoining the Paris Agreement and campaigned on the promise of a 'clean energy revolution', including a federal investment of $1.7 trillion over 10 years[3]. A green US Treasury bond has also been mooted. In Europe, the €750bn EU recovery fund has a caveat attached – 25% of the funding must be used for 'green' projects and applicants must meet minimum 'do no harm' criteria. And the European Commission's **Green Deal Investment Plan** is a €1 trillion commitment to making Europe carbon neutral by 2050. Lest we forgot, that's one of the goals of sustainable bonds: to raise capital for projects that will enable carbon emissions to stay below 1.5 degrees, the goal of the 2015 Paris Agreement.

Renewed political will and action from the US and China, combined with the ongoing efforts of EU policy makers and investor interest, create a highly encouraging environment for potential issuers. Indeed, the Climate Bonds Initiative estimates that issuance of green bonds will exceed $350bn in 2020, up from $265bn in 2019[4].


[2] https://www.ft.com/content/c5239cb9-6a18-4b76-b219-d8568fbc67fa
[3] https://joebiden.com/climate-plan/#
[4] https://www.climatebonds.net/

# How does an allocation to sustainable bonds sit within a wider fixed-income portfolio?

As the market for sustainable bonds matures, it offers a natural home for investors seeking to incorporate climate change and sustainability considerations into their investment strategies. On a more granular level, sustainable bonds can be integrated into an existing portfolio in various ways.

The sustainable bond market should be considered as more than a "responsible" allocation. In the euro market, the risk/return dynamics of the sustainable bond market reflect those of the euro government bond market, with an average credit rating of 'AA' and an average duration of around nine years.

By allocating a portion of their government bond exposure to sustainable bonds, investors can exert a positive impact on society and the environment, without altering the risk/return characteristics of their existing government debt holding. From a credit perspective, the growing market for green, social and sustainability bonds is opening up opportunities to launch new responsible corporate bond funds or increase the ESG 'tilt' of existing corporate bond portfolios. The growth of the renewable energy sector provides an alternative to fossil fuels, while capital raising from industrial companies for green and social projects is helping to change the ESG dynamics of that corporate bond sector. An allocation to sustainable bonds can also play a role in contributing to the decarbonisation of fixed income portfolios – a goal set to become increasingly important. The sustainable bond market should, therefore, be seen as a flexible part of the fixed income market, which can dovetail into the portfolio construction of a wide range of fixed income strategies.

This can include sustainable bond strategies that comprise exposure to government, government-related and corporate debt or else strategies that focus on a specific part of the sustainable bond market, such as credit.

Active managers can add value through a research process that includes the analysis of fundamental, valuation and technical factors.

# Transparency: meeting the challenge

Our approach to investing in sustainable bonds is driven by a desire to meet investors' wish for transparency. Consequently, we screen potential investments in two ways – at an issuer and an issuance level. At the issuer level, we undertake ESG analysis. This considers exposure to ESG risk, management practices, controversies and norms breaches – such as the UN Global Compact (UNGC) – at the issuer level. We also assess the issuer's ability to issue green, social and sustainability bonds in a robust manner. Our analysis looks at issuers' ESG profiles, and considers the following questions:

1. Has the issuer has been involved in any controversies?
2. Does the issuer have a social or environmental strategy?
3. Does the issuer manage ESG risks poorly?

Having concluded this work, we then conduct analysis at an issuance level. This involves an in-depth assessment of the issuance's ability to meet both the Green Bond Principles, social bond principles and sustainability bond guidelines, as well as BMO GAM's internal green, social and sustainability bond assessment criteria (which are stricter than the Green Bond Principles).

**There are three possible outcomes for the proposed investment:**

Unapproved | Approved | Approved with engagement

For issuers that meet minimum screening requirements, but show potential for improvement, we use our influence to engage the issuer to address areas of weakness and drive improvement. The following case studies outline how this process ensures high standards of transparency, quality and accountability in our sustainable bond funds.

## MEXCAT – an unapproved bond

MEXCAT, an issuer operating in the transportation & logistics sector, planned a $6bn issue of labelled green bonds in 2018. The proceeds were to be allocated to projects that fall into the categories of: renewable energy; energy efficiency (including efficient buildings); and sustainable waste management (among others). An independent second opinion had been provided by Sustainalytics, in favour of the bonds. Our own research echoed some of those findings: MEXCAT had put in place a clear process for identifying projects to be financed by green bonds, and its reporting commitments were robust. However, our analyst was concerned about several additional factors. Firstly, MEXCAT was planning a new airport to be located in a semi-dry lake bed that provides water for Mexico City. This location is home to a variety of local species of animals and plants; twelve of these were considered threatened species and one was endangered. Moreover, indirect carbon emissions from the aviation industry could not be discounted; these account for 4–9% of the total climate change impact of human activity. Finally, corruption allegations had dogged both the funding and contracting process.

### Analyst conclusion:

**Unapproved**. Having balanced the positive and negative effects, we concluded that the negative implications of airport activities on biodiversity, paired with the potential for further allegations, far outweighed the environmental benefits of the bond.

## POSCO: Initially approved subject to engagement

POSCO is a steel-making company headquartered in Pohang, South Korea. Although it had strong sustainability standards and practices, there were points of concern. POSCO was on index provider MSCI's UNGC watchlist for the involvement of one of its subsidiaries, POSCO International, in palm oil production in West Papua, Indonesia. The company also failed to update its emissions reduction target, having successfully met its previous one ahead of schedule. Seeing a prospect to improve the company's impact, we volunteered as a lead investor for the Climate Action 100+ (CA100+) initiative. The CA100+ is a five-year, investor-led initiative to partner with the world's largest corporate greenhouse gas emitters to curb emissions across the value chain, strengthen climate-related financial disclosures and improve governance of climate-related risks that may affect companies. We engaged with POSCO under the CA100+ umbrella and initially approved POSCO's bond subject to the following conditions:

- The company was required to publish an updated emissions reduction target within one year
- The company was required to show sufficient progress on its climate-change management strategy, as assessed by the CA100+ initiative.

### Analyst conclusion:

**Unapproved**. We initially approved this labelled green bond subject to POSCO's engagement. However, when we revisited the issue in June 2020, we found that POSCO had failed to disclose a new CO2 reduction target on time. Consequently, its green bond framework was reclassified as unapproved.

## African Development Bank: approved

The African Development Bank sought finance to fund a Moroccan solar complex. The proceeds of the fund were earmarked for the construction of two solar power plants with parabolic troughs, as well as a solar power plant with tower storage capacity. The programme would help Morocco to avoid 3.7 million tons of CO2 emissions. The project was also expected to create 250 permanent jobs and 2,400 temporary jobs. Moreover, Morocco currently depends on external sources for 95% of its primary energy needs and expects demand for electricity to quadruple by 2030.

### Analyst conclusion:

**Approved**, due to the transparent and tangible environmental benefits.

These examples highlight our commitment to ensuring transparency for our clients in the sustainable bonds market, which, after all, is relatively young and has still to mature.

# Impact reporting – an area of increased focus

In the broader market, the quality of reporting on sustainable bonds varies greatly, partly due to the lack of a common impact methodology. Such inconsistencies, especially when it comes to impact reporting, hamper investors' efforts to compare issuers' performance and to see the environmental and social benefits that sustainable bonds bring. Inconsistent reporting, in the absence of a globally agreed reporting standard, makes impact reporting difficult for clients at a portfolio level.

Recognising the importance of impact reporting to clients, we partnered with sustainable finance firm South Pole to agree a methodology for quantifying and reporting on impacts. South Pole uses environmental impact metrics and indicators to analyse the alignment and contribution of our sustainable bond investments to the sustainable development goals (SDGs). This allows us to quantify, in a consistent way, the environmental benefits of our sustainable bond investments.

These indicators incorporate annual avoided emissions, energy savings, water that's sustainably managed and clean energy that's generated. In addition, we have created a framework that aligns our sustainable bonds with specific SDG goals and sub-targets, enabling a clear understanding of the impact delivered by the bonds and the underlying projects. By quantifying the SDG impacts, and increasing disclosure and transparency in the marketplace, we are playing our part in driving new standards for analysis and reporting.

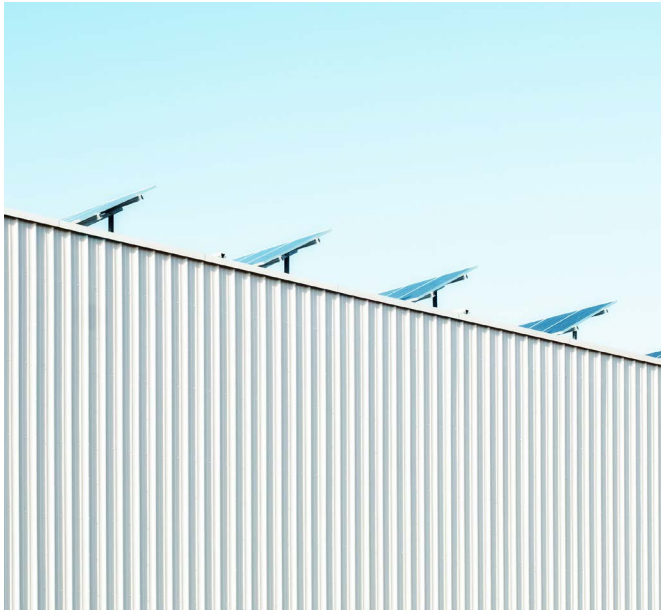
Moreover, in our role as stewards of investors' capital, we have been working to resolve the high-level and voluntary nature of the Green Bond Principles. As such, we are driving dialogue with other market participants, including issuers, investment banks, regulators, auditing firms and other stakeholders. Specifically, we are advocating for minimum reporting, independent assurance and verification of projects' 'greenness'.


kgNOx & kgSO2 emissions / year reduced or avoided


Water Savings (m3/year) or clean water provided (m3/year)


Renewable energy provided (Mwh/year) or energy saved (Mwh/year)


tCO2 emissions / year reduced or avoided



# BMO's approach – what makes us different?

## 35 years of experience

Our well-resourced team of 57 experts has a deep understanding of ESG issues and fixed-income markets. Our expertise covers: rates analysis and portfolio management; responsible analysis and engagement; and credit analysis and portfolio management. This experience ensures that we engage on ESG issues that are material to investors. A culture of sharing information means synergies are shared to the benefit of all.

## 20 years of engagement

| 5,588 | 87 | 3,763 |
|---|---|---|
| companies engaged | countries | instances of positive change recorded in ESG practices |

Read more about our history of engagement **here**.

Source: BMO GAM, as at 31 December 2019.

## Bringing ESG expertise to credit

Our credit approach is informed by a fundamental belief that ESG issues are a key part of a company's risk profile. For credit investments, we assess the impact ESG issues have on the ability and willingness of an issuer to service and repay its debt. We factor ESG issues into the credit investment process through a dual approach:

- **ESG Integration:** incorporate ESG risk assessment into the credit research process
- **Engagement:** active dialogue with companies on behalf of bondholders

To find out more about how we integrate ESG into corporate fixed income, see our **paper**.

## Diversification

By adding sector concentrations beyond banks and utilities (the biggest issuers in the green bond universe), we can improve portfolio diversification.

## Rated 'best in class'

The Wall Street Journal named BMO Financial Group in its top-15 ranking of sustainably managed companies. BMO was judged among the best in class for its management of financially material issues across key sustainability dimensions with a high degree of transparency and disclosure, driving long-term value. It's a critical part of fulfilling BMO's purpose-driven bold commitment to support progress toward a sustainable future, a thriving economy and a more inclusive society with zero barriers.

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