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Weighing up the cost of ESG bonds

Tara Torrens

Fixed income portfolio manager

Omer Brav

Quantitative analyst

Green, social or sustainable bonds (ESG bonds for the purpose of this article) are an increasingly popular way for fixed income investors to signal that they are taking ESG seriously. But how do they compare to traditional bonds? Is there a “greenium” to investing this way and if so, how can investors avoid paying it?

Our research indicates there is a spread concession for investors in ESG bonds. Given this valuation differential and a lack of standardisation within the ESG bond markets, we think that investors are better served with a broader approach to ESG that explicitly incorporates E, S and G analysis into the investment process.

What are ESG bonds?

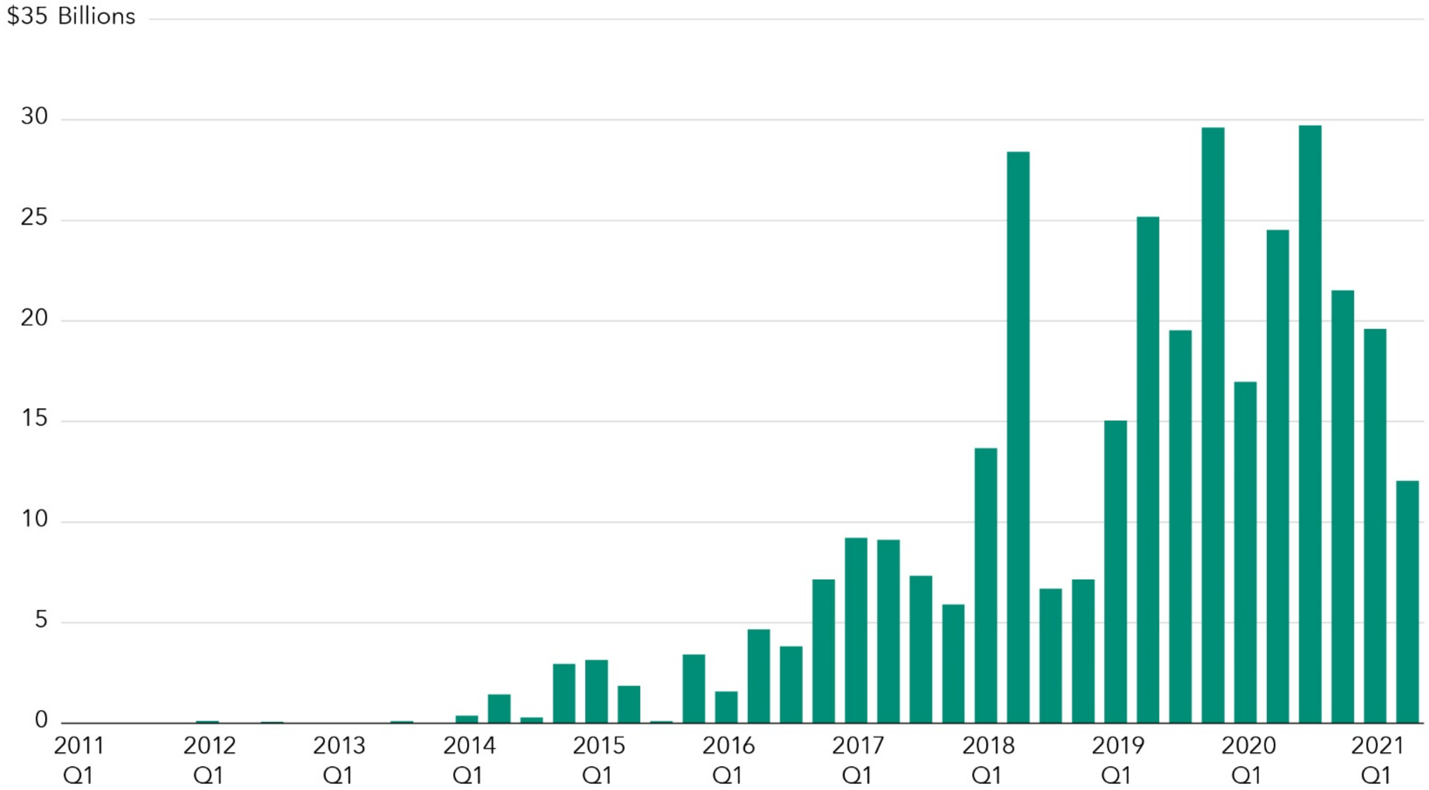
Although there is a lack of standardisation around what constitutes an ESG bond, it’s widely accepted that ESG bond issuers use these instruments to raise proceeds to fund sustainable projects, whether these are environmental or social in nature.

Typically, a corporation's ESG bond issuance is backed by its balance sheet, and therefore carries the same ratings and credit risk as that entity's traditional debt.

As noted, use of the ESG bond designation is not standardised, producing a wide variety of interpretations by issuers. A recent green bond issue by a high yield industrial company offers an example of the need for careful analysis on the robustness of the designation beyond the label. This particular bond:

- Did not require escrow of proceeds for green uses, making it explicit that any proceeds would be held in a commingled corporate account.
- Did not identify specific green projects that the proceeds would fund, instead it listed generic ongoing projects that proceeds could be used to support.
- Did not identify any explicit ESG/green goals or thresholds for the issuer to meet.
- Did not offer a coupon step to investors if the proceeds weren't used for green projects or ESG targets weren't met.
- Did not create an event of default if the proceeds were not used for green projects, therefore creating no recourse for bond holders once bonds were issued.
- At issue, we estimated the approximate spread concession for investing in this "green" bond, relative to a traditional bond from that issuer, was about 25 basis points (bps).

Green bond supply history[1]



1. Source: Bloomberg. As at June 2021.

Isolating the influence of ESG factors

To evaluate how "ESG" an investment is, it must be possible to isolate the influence of ESG factors while effectively holding constant all other influencing factors.

This is difficult to achieve in the stock market because no two companies are identical. Isolating stock price differences that are attributable exclusively to ESG factors and comparing relative valuations on this limited basis is very difficult.

It's different in the bond market. Here we can more readily assess the valuation differential between traditional and ESG bonds if we compare bonds within a single issuer's capital structure. It's easier to isolate the influence of ESG factors – namely the ESG designation (albeit no standard set of criteria apply to any ESG designation) – while effectively holding constant all other factors that influence bond pricing. This allows us to determine if there is an average spread discount (lower compensation) on ESG bonds versus traditional bonds, for companies that issue in both markets, and if so, to quantify that spread concession.

Process: How we assessed spread differences between ESG and traditional bonds

Our Quantitative Research Analysis (QRA) group built a model to assess the spread differentials between ESG and traditional bonds for issuers active in both markets, across corporate and government entities.

To assess the impact of the ESG designation, the QRA group began by estimating the fair value for all green, social, and sustainable bonds outstanding as of November 2020 and May 2021. They did this by determining the valuation of adjacent traditional bonds on the issuer's yield curve. Only bonds with the same currency, seniority, collateral, and rating, with durations within one year of the ESG bond, were used to assess fair value. In many cases sufficiently comparable bonds did not exist, and therefore the number of designated bonds under study was reduced to 843 and 1,175 for the November 2020 and May 2021 samples, respectively.

For the remaining sample, the average yield spread and duration of the adjacent bonds was calculated and a fair value spread – agnostic of the ESG designation – was linearly interpolated for the ESG bond, given its duration. We did not adjust for possible differences in the liquidity of ESG bonds versus the non-ESG bonds control group.

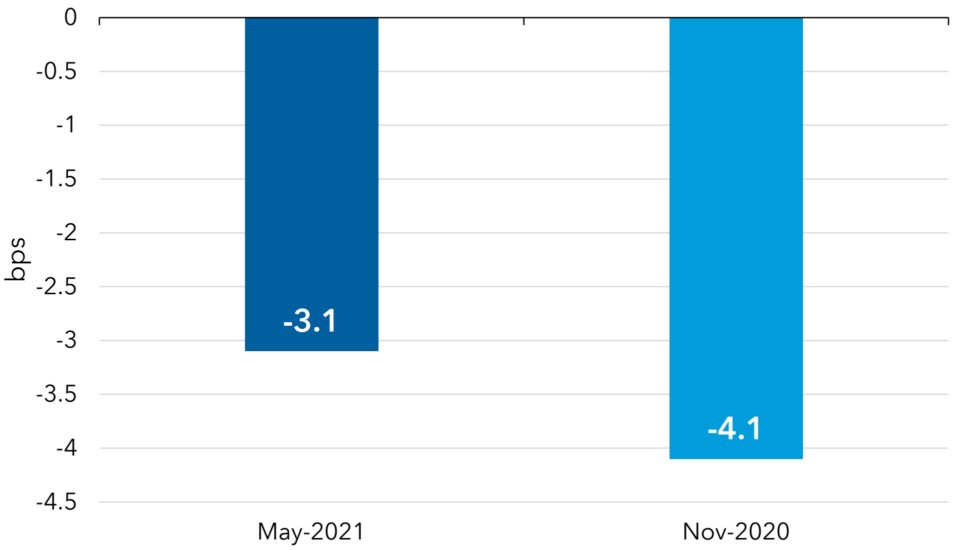
Isolating valuation differentials exclusively to the ESG designation in this way allowed us to conclude that the difference between the observed market spread on the ESG bond and the linearly interpolated fair value spread, is the estimated cheapness (if positive) or richness (if negative) of the ESG bonds relative to their non-ESG bond counterparts.

After removing the most extreme top and bottom two percentiles of the universe, the final November 2020 and May 2021 samples amounted to 809 and 1,128 bonds, respectively.

Results: There is a spread concession for ESG bonds

Our analysis found that investors are in fact paid less, in terms of spread, to invest in ESG-designated bonds. Overall, as can be seen in the figure below, we found that, on average, spreads of bonds with an ESG designation are 4.1bps and 3.1bps tighter relative to their adjacent non-ESG bonds, in the November 2020 and May 2021 samples, respectively. These differences are statistically highly significant.

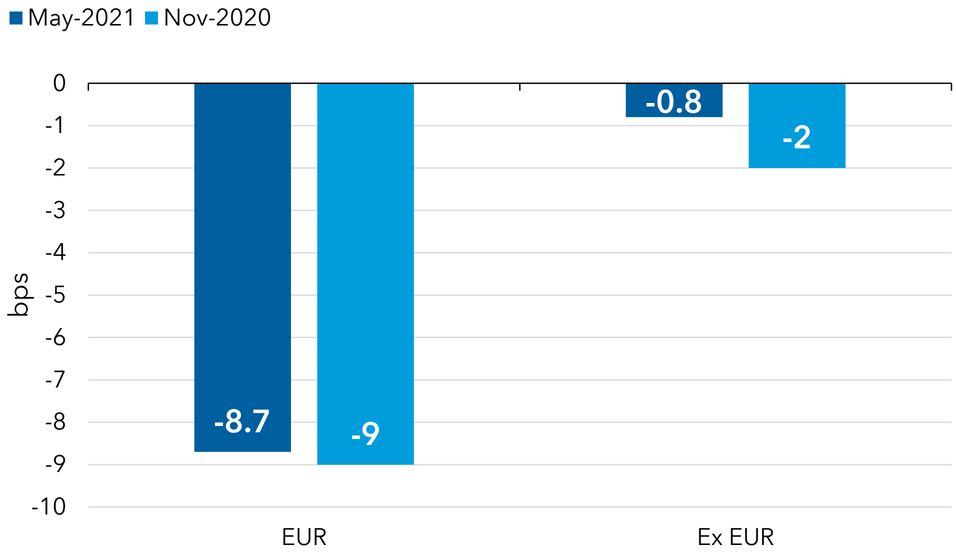
ESG option adjusted spread relative to non-ESG control group[2]



We also found regional differences in this spread differential. As can be seen in the next chart, in the November 2020 sample EUR-denominated securities exhibit a 9 bps richer valuation for ESG-designated bonds, while non-EUR denominated securities exhibit only a 2 bps richer valuation. Similarly, in the May 2021 sample, the corresponding figures are 8.7 bps versus 0.8 bps.

2. Source: Bloomberg and Capital Group calculations. As at June 2021

ESG option adjusted spread relative to non-ESG control group[3]



The presence of the spread differential indicates that in pure return terms, fixed income investors are disadvantaged by investing in ESG bonds.

Our analysis as to the estimated spread discount investors accrue in buying ESG bonds was point-in-time and will be continually monitored, as this market likely continues to grow.

For the ESG bond investor, key investor questions should include:

- Has the company identified a specific use of proceeds, or will proceeds go towards "general corporate purposes?"
- Will proceeds be escrowed for green projects?
- Is there third-party auditing around the use of proceeds and "greenness" of the project, and are there explicit measurement goals the company must meet? What are the report requirements?
- What recourse do bondholders have if proceeds aren't used for green projects or green goals aren't met – i.e. coupon steps, event of default, etc.?
- Investors in green bonds also must understand whether there is a spread discount from investing in a green issue, relative to a traditional bond from the same company, and if so, what is the magnitude of that concession.

Integrating E, S and G

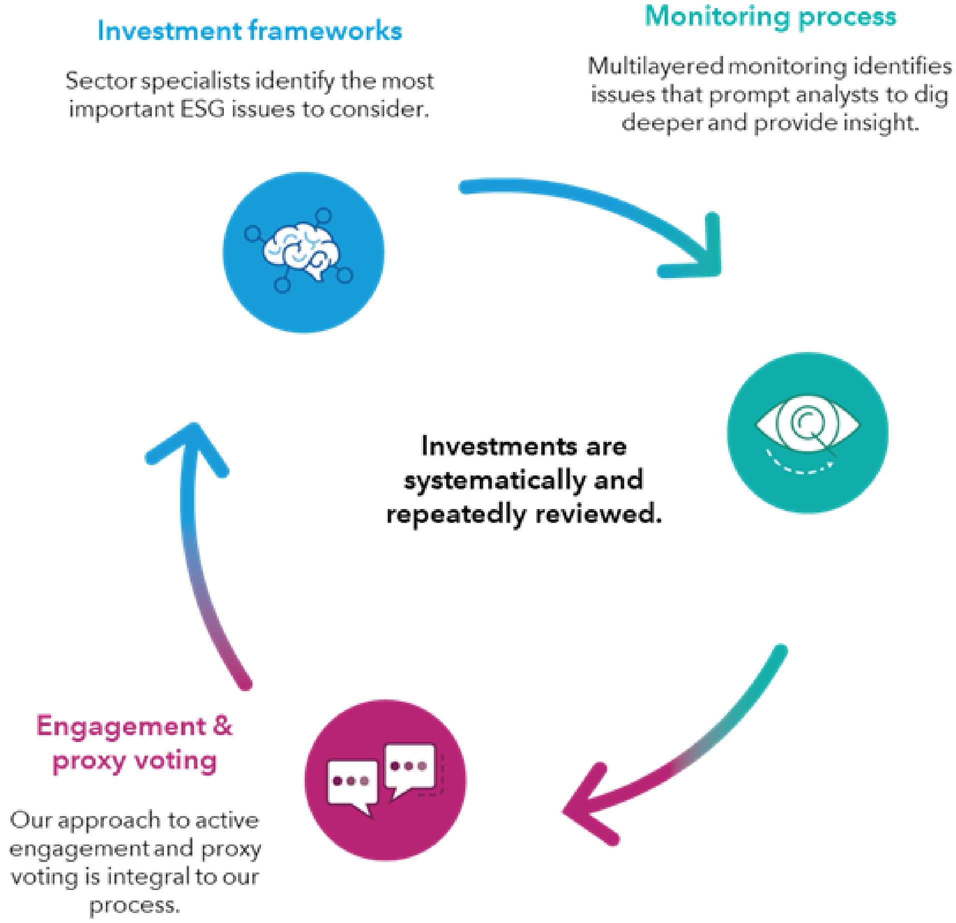
Of course, not all ESG bonds are the same and many provide attractive investing opportunities. In our portfolios, at the time of writing we own nearly US$650 million worth of green bonds, as classified by Bloomberg, across 65 issuers.

The ESG bond market is rapidly growing but it remains small relative to the greater fixed income investable universe. It is this broad universe that ensures an ample supply of opportunities across market environments.

3. Source: Bloomberg and Capital Group calculations. As at June 2021

That's why we don't focus solely on investing in ESG-designated bonds. Rather, by integrating ESG considerations into our investment process (illustrated by the graphic below), we can identify issuers that face risks – and opportunities – broadly and comprehensively across "E," "S," and "G" factors.

Our ESG strategy features three interrelated components



While managers will invest in ESG-designated bonds where they assess unique opportunity, because this requirement isn't embedded in our approach to ESG we don't suffer the valuation concession inherent in generic ESG bond investing.

Instead, we have the opportunity to use both our fundamental credit research, coupled with our in-depth ESG research, to identify long-term opportunities where we believe ESG risk is currently mispriced (i.e. investors are excessively compensated for the risks) and issuers are likely to see improvement over time.

We believe this approach is likely to produce consistently superior long-term investment returns, relative to a designated ESG bond-only strategy.

Tara L. Torrens *is a fixed income portfolio manager at Capital Group. She has 17 years of investment experience, all with Capital Group. She holds both a master's degree and bachelor's degree in finance from the University of Wisconsin-Madison. She also holds the Chartered Financial Analyst® designation. Tara is based in New York.*

Omer Brav *is a quantitative analyst at Capital Group, with fixed income research responsibility. Omer holds both a PhD and a master's degree in finance from the Wharton School at the University of Pennsylvania. He also holds an MBA from the Tel Aviv University and a bachelor's degree in mechanical engineering from the Israel Institute of Technology. Omer is based in New York.*

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