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INVESTMENT MANAGERS

Climate bonds Q&A

Growing impact in fixed income

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Bertrand Gacon, Head of Impact Office, **Guillaume Bonnel,** Head of Impact Investing at Lombard Odier Investment Managers (LOIM) and **Stuart Kinnersley,** Managing Partner at Affirmative Investment Management (AIM) celebrate the first anniversary of LO Funds–Global Climate Bond, a joint initiative between LOIM and AIM. They discuss a flourishing green bond market and what investors can expect in the near future.

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HOW HAS THE GREEN BOND MARKET DEVELOPED OVER 2017?

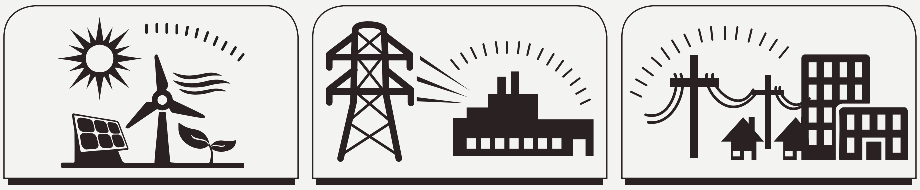
The market continues to grow at a fast pace with a noteworthy increase of diversification among issuers.

The labelled green bond market saw USD 155 billion of new issuance in 2017, a 78% increase on the previous year. Of the 239 different issuers from 37 countries, 61% were new issuers.[1]

Sovereigns made quite an entrance during the year. France issued the largest ever green bond of USD 10.7 billion, alongside a spate of issues from Poland, Fiji, Belgium and others. Nigeria became the first African nation to issue a green bond in December 2017. In February 2018, Indonesia, a top coal exporter, became Asia's first with the USD 1.25 billion sale of an Islamic-compliant green Sukuk bond.[2]

LO Funds–Global Climate Bond: Top 3 sectors of portfolio holdings

1. Energy **2.** Resource Efficiency **3.** Physical Infrastructure



Source: AIM issuer frameworks. An issuer may invest in multiple eligible sectors. Holdings and/or allocations are subject to change.

[1] Source: Climate Bonds Initiative, January 2018.
[2] Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.

There was also significant growth across government-backed, local government, emerging markets, corporate and ABS.[3] The Canton of Geneva, for example, launched financing for green buildings in the medical research sector. HSBC pioneered a new type of sustainability bond called Sustainable Development Goal (SDG) bonds that link projects to the UN SDG agenda. Another financial institution, ANZ, has since issued its own SDG bond. We expect growth of this section of the market to accelerate in the near future.

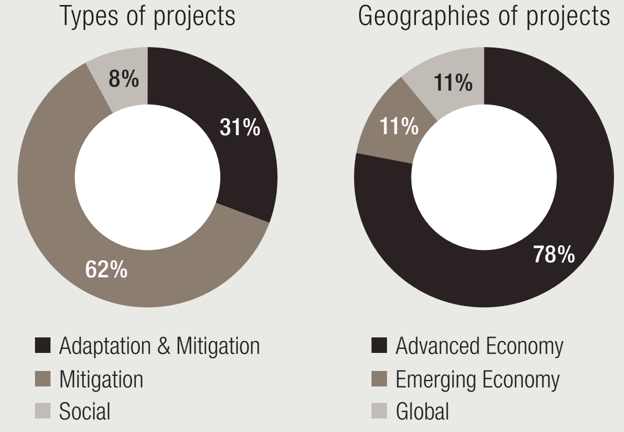
WHAT ARE THE CHALLENGES INVESTORS IN THE GREEN BOND MARKET FACE AS IT GROWS?

We welcome the addition of opportunities to lower down the credit curve and believe the market has the capacity to absorb continued global growth. At the same time, in the scramble to access oversubscribed primary issuance, investors should remain selective over credit quality and be mindful of greenwashing risk.[4]

For example, China, a top carbon emitter,[5] is a global green bond leader – an encouraging sign in the development of clean energy. However, there has been concern over the use of some green bond proceeds in "clean coal" projects and lack of transparency in tracking earmarked capital. This highlights the persistent need for harmonised global standards, and a strict impact verification process from investors.

Over the past year, we have seen greater unity around guidelines concerning green bonds, which has improved standardisation in the market. The Loan Market Association has, together with the Asia Pacific Loan Market Association, recently launched the **Green Loan Principles** with the support of the International Capital Market Association and explicitly building on the Green Bond Principles. The International Finance Corporation, a World Bank agency, continues to provide technical assistance to private sectors in developing countries and contribute project data. This should all help to establish global standards around the attributes required for green bonds to be labelled as such.

LO Funds–Global Climate Bond portfolio breakdown



Source: AIM issuer frameworks. Holdings and/or allocations are subject to change. Number of impact bonds, as at 4Q17.

[3] Asset-backed securities; in the labelled green bond market mainly driven by US mortgage-backed securities backed by certified low-carbon buildings or secured financing for energy and water efficiency improvements in housing and other buildings.

[4] Percentages are based on greenwashing refers to making unsubstantiated or misleading claims about the environmental benefits of a green bond.

The multiplicity of documentation and nomenclature alone make comparing one green bond to another difficult. AIM uses an in-house proprietary framework to analyse each bond issue, on a one-by-one basis. This consistent approach avoids the plethora of different standards and indices which can cause confusion in the green bond market.

LO FUNDS–GLOBAL CLIMATE BOND RECENTLY WON ENVIRONMENTAL FINANCE'S 2018 GREEN BOND FUND OF THE YEAR.[6] WHAT DO YOU SEE AS THE KEY DRIVERS IN MANAGING A SUCCESSFUL CLIMATE BOND STRATEGY?

Independent impact verification is core to our strategy. It enables us to expand from the labelled green bond market to include the broader climate bond universe, worth almost USD 900 billion.[7] The strength of LOIM's set up with AIM is that we do not simply select bonds from a pre-defined labelled green bond index. We add that crucial additional layer of independent verification and monitoring. In our view, this process adds credit research rigour through enhanced issuer engagement, ensuring that we do not compromise on either investment quality or our impact criteria.

Secondly, the experience and research capability of the portfolio management team are extremely important. AIM is the world's first dedicated impact fixed income manager. We are collaborating with a team that has been instrumental in establishing and developing the green bond market.

Finally, in the green bond space, having good access to issuers is critical. Issuers sometimes approach us directly, even before issuance. Aside from mitigating greenwashing[8] risk, having early and private dialogue with issuers around proceeds' use provides investors an information advantage that enhances credit analysis and selection, in our view. The issuer in turn receives feedback that could improve its internal governance, increase transparency and drive project outcomes – therefore improving its overall credit profile.

Interestingly, regular bondholders are acknowledging the benefits of systematic engagement with issuers through active dialogue, whether to inform an investment decision or influence the use of proceeds. This feature, until now unique to green bond investing, is paving the way for rising bondholder engagement.

> **"We see green bonds as part of the broader sustainable investing evolution, one that is re-drawing the traditional risk-return equation to reconcile, measure and include societal impact."**

[5] Source: International Energy Agency, 2015 estimates, as at November 2017.

[6] Past performance is not a guarantee of future results.

[7] Source: Climate Bonds Initiative as at June 2017.

[8] Greenwashing refers to making unsubstantiated or misleading claims about the environmental benefits of a green bond.

We are convinced that the efficient management of a global climate bond portfolio has the potential to provide an attractive return with the benefit of meaningful fixed income impact.

WHAT IS DRIVING THE GROWTH OF THIS MARKET?

Regulation remains a key driver. France has led many firsts in this respect, the most important one being the passage of French Energy Transition Law (Article 173) that has seen institutional investors reporting on the climate impact of their investments.

We are also seeing greater "self-regulation" ranging from the Financial Stability Board's **Task Force on Climate–related Financial Disclosures** to civil initiatives such as **Social Stock Exchange** and **Carbon Disclosure Project** in the UK, Dutch **SDG Investments** and **Climate Action 100+**. Insurance companies could potentially be incentivised to choose green bonds under Solvency II capital rules. Over time, we think policy makers will steer investors towards responsible investing through a mix of "hard" and "soft" regulations.

The European Commission unveiled recently its proposals on sustainable finance, which includes EU-wide taxonomy for green bonds – something that we deeply welcome. AIM places a strong emphasis on using our proprietary framework as well as comprehensive regular impact reporting capabilities, which investors appreciate in helping to make sense of this heterogeneous market.

Finally, we have witnessed an overall increase in social consciousness across investors. We see green bonds as part of the broader sustainable investing evolution, one that is re-drawing the traditional risk-return equation to reconcile, measure and include societal impact.

WHAT NEXT FOR GREEN BONDS?

The green bond market has seen rapid and consistent year-on-year growth in recent years. Moody's Investors Service projects global green bond issuance to eclipse USD 250 billion in 2018 and we expect issuance volume to continue increasing over the next few years.

A key feature will be the ongoing expansion in the range of issuers by type and credit rating, as well as more issuance across maturities. We have seen increasing types of green bonds coming to market: covered bonds, securitised issues, hybrid securities and Sukuk paper mentioned earlier, reflecting the response of issuers to increasingly diverse investor demand. Increasing awareness of climate finance and the impact of climate change on economies and businesses is likely to support growth.

We also expect companies to adapt accordingly and adopt sustainable practices to enable them to compete effectively in the medium term. For example, Danone[10] launched a EUR 300 million social bond in March 2018, following the integration of ESG criteria in its EUR 2 billion syndicated loan, to finance responsible agriculture and medical nutrition projects. We view social bonds[9] as a natural extension of green bonds principles. Development in this part of the market should encourage more private companies, especially those with strong balance sheets, to tackle social issues.

Our top SDGs contribution

By % of LO Funds–Global Climate Bond portfolio holdings aligned to specific SDG

Climate Action (SDG 13)

72%

Affordable and Clean Energy (SDG 7)

69%

Industry, Innovation and Infrastructure (SDG 9)

62%

Sustainable Cities & Communities (SDG 11)

62%

Source: AIM issuer frameworks. By % of impact bonds; each bond can support multiple SDGs. Holdings and/or allocations are subject to change.

[9] Social bonds are those that fund projects with clear social outcomes, e.g. education, training and employment.

With the many government initiatives worldwide to support green bond market development, we believe the diversity of participants, ratings and currencies will continue to grow rapidly as the green policy agenda continues to gain momentum globally. The breadth and depth of the market today make it possible for investors to implement a well-diversified credit strategy – of a quality comparable to, if not potentially better than, conventional fixed income, in our view.

We believe that green bonds have moved away from a niche space in investors' portfolios, to a firmly established mainstream fixed income investment option – with real impact.

Example of a green project

Iberdrola Green Bond: Dólar I Onshore Wind[10]

Coupon	Maturity	Rating
2.5%	October 2024 (10 years)	Baa1/BB+/A-

IBERDROLA

Iberdrola has funded an onshore wind power project in Huenéja, Dólar, near Granada in Southern Spain. The wind power farm consists of 25 turbines and is completely operated and owned by Iberdrola Renewables.

Wind power is one of the least controversial renewable energies in the market. Wind energy has become increasingly important in Spain. It is the second largest source of electricity generation in Spain, according to the Spanish Wind Energy Association (AEE). Generating wind power is critical in achieving a greater share of renewable energy in the Spanish electric grid, contributing to reducing GHG emissions in a high emitting country.

The project is located in Andalucía, an area with the highest unemployment rate in Spain (25.4% in 3Q17[11]) following a series of macroeconomic shocks, making investment and job creation in the area particularly attractive from a socio-economic perspective.

[10] Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document.

[11] Source: **European Commission,** Labour Force Survey, March 2018.

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