Insights
Sustainable Investing

September 2024

Achieving New Frontiers
The Role of Bonds in Sustainable Investing

Incorporating sustainability principles into investment strategies has typically been seen through the lens of equity investments, but we believe fixed income assets play an equally important role in fostering corporate responsibility and integrating environmental issues into investment strategies with sustainability investment objectives.

State Street Global Advisors' new survey, *The Climate Opportunity*, found 29% of institutional investors say climate bonds would be a focus for their investments over the next 12 months.

When considering fixed income investments in the context of incorporating sustainability objectives into investment portfolios, institutions face several issues. Access to meaningful data on sustainability factors is a challenge in all asset classes but is particularly acute for some types of fixed income assets. Stewardship and engagement are a further challenge since bondholders have no voting rights on corporate strategy.

Furthermore, these challenges vary in their intensity across different types of fixed income assets from sovereign debt to bonds issued by supranational bodies, such as the World Bank or other international development organizations, and of course corporate issuers.

However, these challenges are not insurmountable and solutions from State Street Global Advisors are available to help institutions bring their climate investing objectives to bear on fixed income.

Sovereign, Supranational, and Labeled Bonds

Vanilla sovereign bonds (for example those that have not been labeled as 'green', 'social', etc.) pose some of the hardest challenges in terms of sustainability data. This is reflected in our survey, which found that just 29% of institutions incorporated impact investing principles into their sovereign bond investments. This was a lower proportion than for any other asset class, except private equity and venture capital.

Despite the challenges, resources are available for assessing the climate and wider sustainability credentials of sovereign issuers. Freedom House, which monitors human rights and democracy across different nation states, is one such widely cited source used by sustainability investors. More specifically on climate issues, there are sources such as the Yale University Environmental Performance Index (EPI) or Notre Dame Global Adaptation Index, which analyzes and compares environmental and climate-related policies of over 180 countries.

Supranational issuers — the most obvious examples being international or regional development banks — can be attractive to investors with sustainable investment objectives since they regularly issue bonds explicitly designed to finance development of healthcare, educational, or environmental initiatives in deprived countries or regions.

For investors looking to back these kinds of initiatives, supranational bonds may be more attractive than those issued by sovereigns of those countries. Firstly, the use of proceeds may be more clearly defined by a supranational issuer and, secondly, the creditworthiness of the supranational is considered low risk as it issues investment grade (BBB and above) credit-rated bonds.

However, we believe the clearest solution for finding climate supportive fixed income are labeled bonds, whose specification typically comes with recognized standards for transparency and often specific terms for the use of proceeds.

While sustainable investing in sovereign and supranational bonds is possible, labeled bonds, especially from corporate issuers where the availability of labeled debt is relatively high compared with other fixed income sectors, offer some of the clearest solutions in our view.

The Climate Opportunity survey found a high proportion of institutional investors (42%) say their corporate bond investments integrated impact principles. Only infrastructure investments scores higher (52%) and significantly the figure for corporate bonds was higher than that for listed equity investments.

The International Capital Markets Association provides guiding principles behind green bonds, social bonds, and sustainability-linked bonds, and impact reporting recommendations for issuers providing quantitative indicators that can be used by institutional investors to measure their own sustainability contribution. For example, labeled bonds increasingly specify the number of gigawatts being generated by a renewable energy project or indicate the annual GHG emissions reduced/avoided in tons of CO_2 equivalent by the activities it funds.

Stewardship and Engagement

The ability of bond investors to engage with and influence corporate bond issuers is less obvious than for equity investments, but it is far from negligible. Such engagement may encourage those bond issuers most in need of help to establish a transition program and to do so in a way which can be broadly recognized by investors.

For investors with this objective, screening out fossil fuel-related groups is possible, but it can be challenging if an investor is aiming to track benchmarks. It is also scarcely possible for the world to transition to net zero without action from fossil fuel groups themselves and simply restricting their access to capital is viewed by some investors as not necessarily the most constructive approach. Hence, labeled bonds that demonstrate a clear plan to support the transition activities of a fossil fuel intensive issuer report regularly on the use of proceeds and can potentially serve as important facilitators.

A small but growing part of the labeled bond family are sustainable-linked bonds (SLBs). Such bonds may come with ratchets, in which the coupon is dependent on meeting such pre-set targets. If the issuer misses its carbon reduction targets, it will see its interest bill increase. Crucial to the effectiveness of such terms, however, is that the issuer establishes goals and incentives recognized as suitably ambitious and provides metrics to investors to enable them to effectively monitor progress.

Greening a Fixed Income Portfolio

The financial role of labeled fixed income investments is the same as for any bond portfolio, but some additional factors also come into play. One is in building a fixed income portfolio with sustainability principles in mind. The challenge of tracking benchmarks has been mentioned regarding exclusions, but it also has a global and currency dimension. For example, while the US represents over 40% of the Bloomberg Global Aggregate Bond Index and is therefore the largest market for bond issuance, the proportion of US dollar green-labeled bonds is substantially lower than the euro-denominated market. In other words, it is harder to allocate proportionally to the dollar fixed income market if an investor takes a traditional broad market-weighted approach to their green bond allocation.

The solution is typically to take an incremental approach and build a portfolio that matches as closely as feasible benchmark constituents, while also overweighting green-labeled bonds.

This is eminently achievable, in our view, even for indexed investors with limited tracking risk tolerance. For example, we find that investors with a global corporate bond strategy but seeking a fixed income indexing portfolio with a targeted overweight to green bonds, potentially as part of their climate-thematic objective, can have a portfolio that seeks to closely replicate the performance of the benchmark (i.e. an annualized ex-post and ex-ante tracking error of under 0.50% on an annualized basis) while still comfortably achieving a 2–3x overweight to green bonds.

There has been explosive growth in some types of sustainable bonds in recent years, but overall, the application of sustainability principles in fixed income allocation has lagged other asset classes. However, sustainable fixed income investment is set to accelerate as demand from institutional investors grows — as respondents to our survey indicates it will.

The Climate Opportunity

A State Street Global Advisors study of EMEA-based asset owners' integration of climate considerations into investment decisions. Read the full report here.

To explore how State Street Global Advisors can support your climate investment efforts, please visit us, contact your relationship manager, or email us at SSGA Insights to discover how we can help.

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* Pensions & Investments Research Center, as of December 31, 2023.
† This figure is presented as of June 30, 2024 and includes ETF AUM of $1,393.92 billion USD of which approximately $69.35 billion USD is in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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Important Information

In partnership with FT Longitude, part of the Financial Times Group. This study was conducted in May of 2024 via an online survey instrument (n=330) and qualitative telephone interviews (n=2). Respondents were limited to senior leaders and Chief Investment Officers who are directly involved in ESG investment decisions at Pension Funds, Sovereign Wealth Funds, Endowments, and Insurance companies.

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