Do well by doing good
Investing in green bonds

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INSIGHTS

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Executive Summary

- In a context of rising global temperature and increased regulatory burdens, investors are increasingly looking at ways of investing in a socially and environmentally friendly way
- Green bonds could be an attractive solution: the proceeds raised are earmarked specifically for eligible green projects whose purpose is to mitigate the risks of climate change
- A relatively nascent market, it is now booming: green bond issuance has grown by over 1,000% since the end of 2013, and currently stands at $170bn*
- Green bond investors can take comfort in knowing their money is used solely for the financing of green projects and assets, which is not always the case for ESG-themed bonds
- Lyxor has launched the first ever green bond ETF, facilitating access to the asset class for investors unable to tap directly into the primary market

Green bonds

There is mounting regulatory and investor pressure to incorporate green, ethical and governance factors into investment portfolios. France was the first country to introduce obligatory climate change-related reporting for institutional investors and other countries look set to follow suit.

As such, an increasingly pressing question for investors is how to support climate change projects. The green bonds market is rapidly maturing and offers a means to take highly targeted exposure to socially responsible themes. **François Millet**, **Head of ETF and Index Product Development** at Lyxor, discusses this growing area.

A developing market

Green bonds were created to fund projects that have a sustainable benefit for the environment. They were initially developed by supranational organisations, such as the World Bank and the European Investment Bank, but the market has now expanded into corporate and sovereign issues. Poland issued the world's first green sovereign bond in December 2016[1] and France issued €7bn worth of green bonds shortly afterwards.[2]

The bonds are specifically earmarked for green projects but backed by the issuer's balance sheet. This means investors are getting uniquely targeted exposure.

Having started as a niche area, the green bond market is flourishing. It now stands at over $170bn[3], which represents growth of over 1,000% over the past three years.

The role of the Climate Bonds Initiative

The Climate Bonds Initiative (CBI) is a non-profit organisation seeking to mobilise bond markets to raise money for climate change projects. It has built a set of eligibility criteria for assets and projects that can be used in green bonds. It also certifies green bonds, meaning organisations can use the Climate Bond Certification Mark in their marketing of bonds. The CBI defines the bonds eligible for inclusion in our ETF's index, and is limited to conventional bonds: floating rate notes, inflation-linked bonds, convertible bonds and municipal bonds are excluded from potential selection.

[1]Source: Reuters, 12/12/2016.
[2]Source: Reuters, 24/01/2017.
[3]Source: Climate Bonds Initiative, January 2017.

The bonds themselves

Eligible green projects are specific and each sector will have its own criteria. At the moment, green bonds cover solar, water, wind, low carbon buildings and transport, plus geothermal projects. There are plans to extend this to bioenergy, hydropower, land use, marine and waste management areas. The recent French green bond, for example, was designed to help the country implement the December 2015 Paris Climate Agreement, while companies such as Toyota have issued green bonds to finance energy efficiency projects and electric powered cars.

Why invest?

For investors with a socially responsible mandate, the appeal of green bonds is that there is a targeted mandate. With normal SRI investing, there is scope for slippage – one part of a company may be engaged in the development of green energy, while another may be involved in environmentally damaging projects.

Equally, normal SRI criteria may be subject to interpretation. With green bonds, there are established scoring criteria. As such, there is little controversy about the standards. This is more transparent for investors.

Green bonds are also an important tool in helping governments and corporates move to more sustainable practices. For example, Apple's $1.5bn green bond[4], issued in 2016, helped fund the company's conversion to 100% renewable energy, plus installation of energy efficient heating and cooling systems and promoting more widespread use of biodegradable materials.

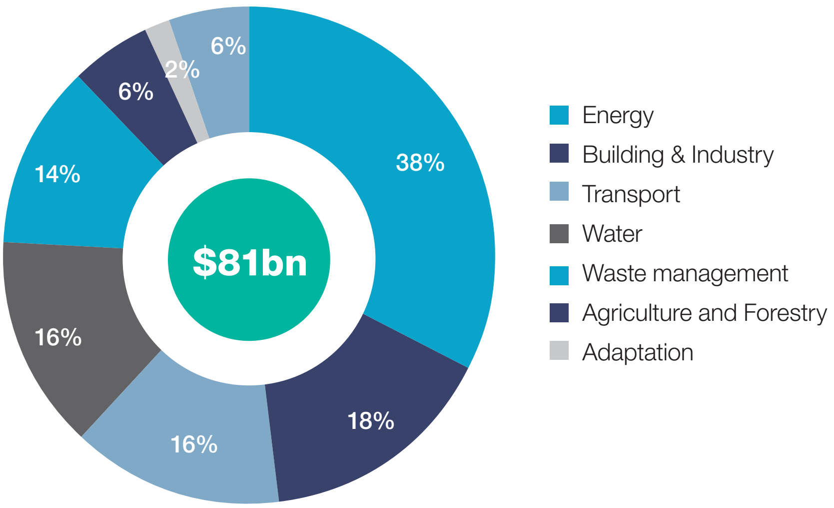
Why now?

The green bonds market is coming of age. Its rapid growth means there is now significant choice and diversity in the sector. In 2016, 90 new issuers and 50 repeat issuers issued $81bn worth of green bonds, a total of 241 transactions.[5] There is also an increasing choice of maturity: in the early stages of development for the green bond market, many issuers focused on the five-to-seven year maturities, but longer maturity bonds are increasingly common.

HSBC predicts green bond issuances to reach up to $120 billion by the end of 2017, with other estimates placing even higher figures to the market. Yet they remain a fraction of global debt markets, less than 0.2%, so there is considerable scope for their growth from here.

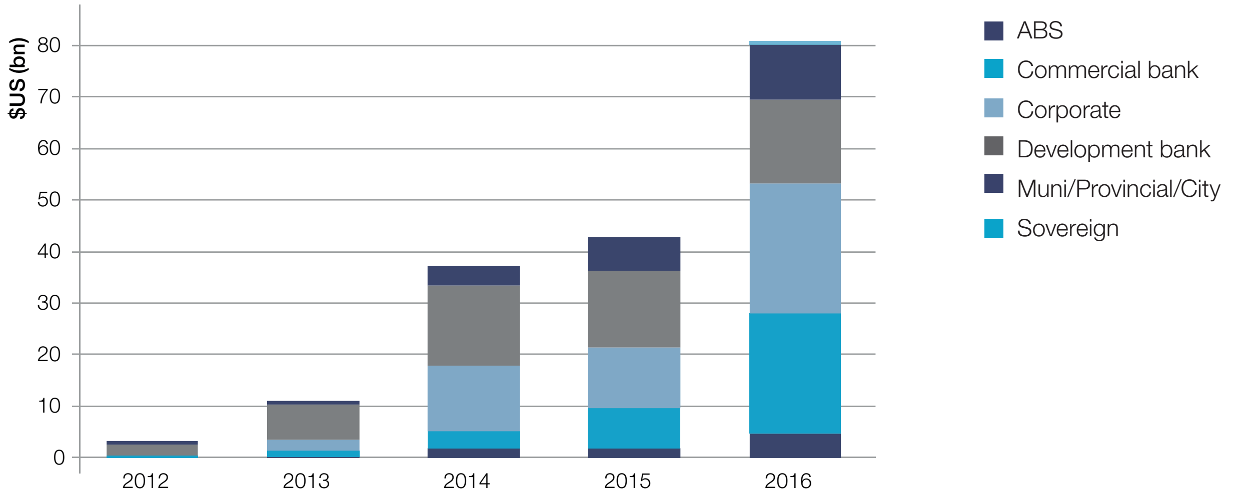
2016 green bond proceeds by sector[5]

Where the money went in 2016



[4]Source: Reuters, 17/02/2016.
[5]Source: Climate Bonds Initiative, January 2017.

Annual green bond issuance by issuer type ($bn)



Source: Climate Bonds Initiative, January 2016

There are both push and pull factors promoting growth: there is increasing demand from end investors, but there are also increasing regulatory pressures encouraging issuance. Green bonds are becoming a compelling way to divert capital to climate change projects, while also managing portfolio risk.

Return profile

Green bond issues are designed to share the same quality rating as comparable sovereign or corporate issues. In practice, the coupons will vary with that of the issuer, but the difference tends to be marginal. In the recent French Republic bond, there was a 13bps premium in yield on selected maturities. However, from an investor perspective, there should be no cost to investing in the green bond over the traditional sovereign or corporate bond.

Inherently, the risk and return profile of a diversified portfolio of green bonds is comparable to that of a global aggregate bond fund. However, it may help with management of climate related micro and macro risk.

Selection of indices

There are a number of green bond indices. However, some were launched before proper certification of green bonds (by the CBI) was put in place. As such, they may include bonds that are not subject to the same strict governance criteria.

The criteria for the Solactive Green Bond EUR USD IG index developed in partnership with Lyxor are stringent: for starters, the eligible bond universe is restricted to labelled green bonds selected by the Climate Bonds Initiative. To then be included in the index, bonds must have at least €300m/$300m outstanding for bonds denominated in euros and US dollars, respectively, with a time to maturity of at least 12 months. The index weights individual components by their outstanding market value, with individual issuers capped at 5% for corporates and 10% for sovereign issues. As such, we believe this index provides appropriate diversification, while ensuring climate change standards are maintained.

Why Lyxor

Lyxor is committed to addressing the challenges of energy transition, and servicing the growing demand for responsible investments. As one of Europe's great ETF pioneers, we are well placed to help investors achieve their environmental goals. Our existing range of socially conscious funds, such as our World Water ETF, New Energy ETF and Commodities ex-Agriculture ETF, will now be enhanced with the first ever Green Bond ETF in the world. Our ambition is to offer a full suite of innovative environmental, social and governance themed products over the coming years.

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