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Sustainable bonds: unlocking new dimensions in ESG investing

The market is expanding and diversifying, and can be used to finance a Just Transition with an innovative approach.

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Against a backdrop of rising inflation and interest rates, investors are turning to bonds, with a particular focus on the safest options such as sovereign and investment grade, which are offering the highest yields in a generation.

This shift in investor sentiment is benefiting the sustainable bonds market, which has a high proportion of sovereign and investment grade issuers. Despite a challenging year for bonds in 2022, sustainable bond issuances are approaching $1 trillion annually and account for over a quarter of new issues in the eurobond market.

Such bonds may also become more attractive to investors, as this somewhat concentrated market continues to grow in terms of geographies, sectors, issuers and instruments.

Nathalie Beauvir-Rodes, head of sustainable bond analysis at Ostrum Asset Management (Ostrum AM), says: "We are well positioned to take advantage of this expanding market, with a proprietary analysis and rating process which assesses both the environmental and social policies of issuers as well as the nature of the projects supported by the proceeds of the bonds. This allows us to select high-quality bonds."

Ostrum AM has invested in €35bn of green, social, sustainability and sustainability-linked bonds to date.

Sustainable bond markets expand and diversify

The sustainable bond market has seen significant growth since its inception in 2007. Since 2021, for instance, the yearly volume of issuances is close to $1 trillion. Meanwhile, the penetration rate has hit new records every year, and sustainable bonds represented nearly 15% of global bond issuance in 2023 and 25% of the eurobond market.

Once the preserve of global development banks and supranational organisations, sustainable bonds are now issued by governments, corporates, municipalities and financial institutions alike. Over the past years, in fact, private sector sustainable bond markets have deepened and expanded to high yield issuers. Diversification has also taken place across sectors, geographies and instruments (such as sustainable-linked bonds).

Since 2014, the International Capital Market Association (ICMA) has developed the "Principles" to enhance transparency and credibility and highlight best market practices in this self-labelled market. These guidelines help standardize the market and ensure that the proceeds from bond issuances are used for genuine environmental and social projects.

In particular, sustainable bonds are important in helping to bridge the

Key takeaways:

- The sustainable bond market has seen significant growth since its inception in 2007. Issues are now approaching $1 trillion a year and account for more than a quarter of new issues in the eurobond market.
- Sustainable bonds can amplify investors' approach to sustainable investing, and finance a climate transition respectful of societies and economies.
- Long-term stability is critical for fixed income investors, and sustainability-focused companies are more likely to minimise transition and financial risks, while having a closer engagement with stakeholders.

massive investment gap required to meet the targets set out in the 2015 Paris Agreement on Climate Change (effective in 2016) and the 2015 UN Sustainable Development Goals.

Why investors are drawn to sustainable bonds

Private investors are playing a crucial role in this growth. Many institutional investors, including pension funds and asset managers, have incorporated ESG criteria into their investment strategies.

Their take-up of sustainable bonds has been driven by a number of factors – primarily investors' more ambitious ESG policies and the search for climate and social positive impacts.

First, sustainable bonds are a robust long-term risk mitigation instrument, allowing investors to finance projects and companies which create a more sustainable world. Companies issuing sustainable bonds are expected to be more resilient, minimising transitional and financial risks. This kind of corporate stability is paramount for fixed income investors.

Second, companies that prioritize sustainable business practices tend to have better relationships with customers, employees, and regulators, as they are seen as more responsible and trustworthy. This can result in benefits such as higher retention rates, and stronger pricing power.

Third, there are growing political pressures on investors to ensure financial flows are compatible with the climate targets of the Paris Agreement. This pressure is materialising through a stringent and expanding regulatory environment, such as the EU's Sustainable Finance Disclosure Regulation and the green taxonomy.

Finally, from mid-2022 to end-2023, interest rates rose substantially, making the fixed income market more attractive. "In this context, investors have switched their allocations towards bonds, especially the highest-rated ones which dominate the sustainable bond market", says Timothée Pubellier, portfolio manager for the Climate and Social Impact Bond strategy.

Alignment with "Just Transition" concepts

In addition to the environment, socio-economic factors need to be taken into account if the energy transition is to be equitable for all society. "The transition to a resilient, low-carbon economy calls for a more holistic and inclusive approach," says Beauvir-Rodes. "In other words, a just transition."

The Just Transition concept has become increasingly important since 2015, when it was discussed as part of the Paris Agreement, and has been a key topic in subsequent COPs. It is found in the UN Sustainable Development Goals (SDGs), while the International Labour Organization (ILO) published guidelines for a Just Transition in 2015. Just Transition was also at the heart of the last G7 Action Plan in May 2023 and of the latest COP28 in Dubai.

However, support in financial markets for Just Transition remains limited. Beauvir-Rodes says: "As a major player in sustainable bonds, we decided to leverage our expertise to create an innovative fixed income impact strategy which supports Just Transition concepts. We think it aligns with institutional investors' ESG policies and their search for impact."

Turning Just Transition ideas into action

For Ostrum AM, sustainable bonds are an appropriate tool to support a Just Transition. It kickstarted its innovative approach by clearly defining its vision of a Just Transition: a transition to a low carbon world that is respectful of the environment and biodiversity, while being inclusive from a social and territories' point of view.

Ostrum AM uses this definition to finance sustainable projects in all geographies and across diverse sectors. To identify bonds and issuers with a Just Transition profile, meanwhile, it employs two proprietary tools: a Just Transition Indicator and a Sustainable Bonds Rating system.

The Just Transition assessment is integrated at three levels.

First, at project level, it identifies bonds earmarked to projects that:

- Reduce carbon footprints, by promoting renewable energy, environmental solutions and services, green buildings, clean mobility and the circular economy.
- Promote positive social impact, including health and wellness.
- Preserve ecosystems and local economies.

Second, at bond level, it uses a proprietary Sustainable Bonds Rating methodology which ensures issuers' ESG strategy is consistent with the sustainable bond issue and that the proceeds of bonds are transparently earmarked to assets that have a genuine and measurable impact.

Third, at issuer level, the Just Transition indicator focuses on issuers' sustainable management of resources and local development. "The indicator shines a light on issuers with good practices, in terms of human resources, inclusion and supporting local economies," says Beauvir-Rodes.

A well-diversified portfolio with impact

The resulting bond portfolio has true impact, based on the three principles of intentionality, additionality and measurability. It also complies with the Greenfin Label, the French public SRI Label and is classified as Article 9 according to the EU's Sustainable Finance Disclosure Regulation (SFDR).

"You can only make true impact if you have considerable expertise in sustainable bonds, combining financial and ESG capabilities," says Pubellier.

Pubellier adds: "Sustainability alone is not enough; financial soundness matters too. That's why we have a team of credit and ESG analysts who work side by side with portfolio managers to deliver investments that offer impact and returns."

The granularity of the rating tool and just transition indicator allows for tailor-made portfolio construction to support the energy transition in a number of ways.

Ostrum AM's climate and social impact bond approach is aligned to seven environmental themes and three social ones, as well to the 17 UN Sustainable Development Goals.

Currently, Ostrum AM's biggest sectoral allocations are to renewable energy and green buildings, though it also has material allocations to clean mobility, and to a lesser extent environmental solutions and biodiversity.

Ostrum AM also produces a comprehensive impact report for this strategy, which includes measures of social output – a rarity in the investment industry – in addition to environmental impact indicators such as CO_2 emissions avoided.

Social outputs include, among others, the number of loans granted to SME or microenterprises, the number of people with access to basic infrastructure, and number of people having benefited from health and nutrition services.

Creating social, as well as environmental measures, facilitates engagement with issuers of sustainable bonds. Ostrum AM engages with companies individually and as part of industry-wide efforts.

Pubellier says: "We view sustainable bonds as key instruments to engage with issuers, especially on their overall climate and social strategies, on the transparency of their ESG disclosure, and on key topics such as Just Transition."

Setting the pace

Long-term stability is critical for fixed-income investors, and sustainability-focused companies are more likely to provide this if they have better relationships with their stakeholders. Ostrum AM's aim is to ensure its investments are compatible with this position, adopted by many of its clients.

"We are not just keeping up, we're setting the pace in this," says Pubellier. "Our innovative approach is designed to deliver financial returns while making a real impact on the environment and society."

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