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NORDSIP
NORDIC SUSTAINABLE INVESTMENTS

# insights

# SUSTAINABLE FIXED INCOME

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# the editor's word

*Th'is this time of the year again*

Believe it or not this is our third edition of the Sustainable Fixed Income Handbook.

We all remember how 2020 started, the year everything was finally supposed to start: the dawn of a new sustainable decade. Instead, the world has faced the strangest period this generation has known. A 'temporary new normal' which never seems to end.

Meanwhile, investors continue to invest, and sustainable investment practice continues to grow. In this issue, there is plenty of evidence that sustainable fixed income is finally coming of age and there are no more excuses for asset owners make the right choices.

On the one hand, ESG integration in fixed income has proved as effective for credits as for equities in fundamental strategies. The same three letters have also earned their space in passive strategies.

Bondholder engagement has finally climbed the agenda as well, even in sovereign bonds! Who would have ever thought that holding govies would ever become a tool to stir the political agenda?

Let's not forget that exclusions, one of the powerful tools used by asset owners to take a stand, can also be effective in the fixed income world.

Quietly but surely, the green bond market has continued to spread and establish its legitimacy. What was once only wishful thinking has become reality: green bondholder can influence corporate decisions and stir financing away from fossil-fuel projects.

Finally, all the way up north, the Icelandic market is just one example of how well green and social bonds are faring in the Nordics.

We hope you enjoy this update and find the tools to guide you towards making better investment choices in 2021.

Aline Reichenberg Gustafsson, CFA

Editor-in-Chief

NordSIP


Photo by andreyyalansky19 on Twenty20 / NordSIP

# The Growing Role of ESG in Fixed Income

*by* Mahesh Jayakumar

*With ESG issues becoming more important across the globe, Mahesh Jayakumar explains how MFS incorporates ESG factors into fixed income research, and looks at the opportunities and challenges facing investors.*

**ESG and Fixed Income**

While ESG has been a theme in equities for many years, it is now a growing trend in Fixed Income. Fixed income has traditionally been used for its ability to manage downside risk while generating income and, in general, it continues to play a diversification role in asset allocation. The fixed income investor base is growing as both institutional investors, such as pension plans, and an increasing number of retail investors, such as retirees and everyday savers, perceive greater volatility within equity markets and allocate more of their capital to fixed income.

*"When evaluating corporate bonds, integrating ESG issues into our fundamental analysis of the issuer's credit and leverage profile is critical."*

Mahesh Jayakumar
Fixed Income Research Analyst
MFS

At the same time, market participants such as asset managers, asset owners, regulatory agencies and policymakers are increasingly thinking about ESG issues beyond just the implications for equity shareholders. In addition, more investors are seeking to use their capital to have a positive social or environmental impact, which involves a greater degree of ESG integration.

In light of this, and given that fixed income markets are significantly larger than equity markets, it is clear why ESG is becoming an increasingly important part of fixed income investing.

**Incorporating ESG issues into Fixed Income analysis**

Our investment approach has always focused on identifying companies and issuers with sustainable, long-term competitive advantages. As investors, we need to take into account all factors that can affect the viability of our investments through multi-year business cycles and ever-evolving macro environments. We believe that the integration of ESG factors into our research is essential, as these issues often affect the long-term sustainability of cash flows for issuers.

When evaluating corporate bonds, integrating ESG issues into our fundamental analysis of the issuer's credit and leverage profile is critical. ESG analysis involves understanding issues that are typically nonfinancial in nature, such as environmental impacts, employee well-being, supply chain management, product safety and workforce diversity. In the short term, shocks to these factors can affect cash flows and the ability to pay interest to debt holders. In the long term, they can harm corporate culture and impact operating models, which can lead to the erosion of revenue generation and, ultimately, profitability.

While governance is widely considered the most prominent ESG factor affecting various fixed income sectors, environmental and social factors must also be considered. For instance, the deterioration of social or environmental factors can influence the political stability or business climate of a particular country. Therefore, we evaluate social factors, such as inequality, and environmental considerations, such as air quality and water stress, along with a country's governance practices.

**The most important elements in an integrated approach**

ESG factors are assessed within the context of overall credit risk. Traditional credit analysis involves understanding the ability and willingness of the borrower to service their debt. An integrated approach must consider how ESG factors could affect the ability of the borrower to pay back the lender.

Emphasis is placed on materiality and time horizon, i.e., the maturity of a bond. Materiality measures the likelihood that a particular ESG issue will affect a borrower's revenues, costs, long-term financial condition and, ultimately, ability to repay debt. Time horizon determines materiality. ESG factors can become increasingly impactful over time, so

*"Fixed income investors can help tackle larger issues such as climate change by unlocking badly needed capital."*

the maturity of a bond is a critical lens for any ESG analysis.

Finally, high-quality ESG data sources are crucial to truly understanding an investment's material ESG risks and opportunities. Market data, such as ESG ratings, are important to consider as one of many inputs into the fixed income research process. However, more holistic and relevant insights require assessing these topics deeply and independently.

**Challenges in applying ESG factors to Fixed Income**

The quality of ESG data has come a long way, but it continues to vary in terms of coverage and availability. For example, there is still not enough disclosure of ESG information from private and emerging market companies. As awareness of ESG issues increases, the demand for relevant data also increases, which means a greater number of market data providers are stepping in to fill this void.

Another challenge relates to engagement between investors and issuers. Unlike equity shareholders, bondholders do not have formal engagement mechanisms such as the ability to vote proxies or raise shareholder resolutions.

The relationship between credit ratings and ESG ratings is also a challenge specific to fixed income investors. High credit ratings do not necessarily imply high ESG scores and vice versa. The impact of a given ESG factor on credit spreads can be uncertain and change over time. Therefore, it is important to assess whether ESG factors are fully reflected in the credit rating.

**Opportunities for Fixed Income investors**

The rise of thematic investing, such as green bonds, is providing fixed income investors the means to directly finance projects that address specific issues, such as climate change mitigation and adaptation, renewable energy production and increased energy efficiency. Growth in green bonds has led issuers to structure bonds with similar use-of-proceeds and project selection frameworks, such as social and blue bonds. Social bonds fund projects in such areas as education and health while blue bonds focus on oceans and marine life.

The United Nations' Sustainable Development Goals (SDGs) are increasing awareness among both investors and companies about the role we can all play in developing a more sustainable society and economy. Fixed income investors can help tackle larger issues such as climate change by unlocking much needed capital. Bond markets are deep enough to provide required financing, and the structure of fixed income investments lends itself very well to project financing. Investors provide capital up front to a borrower who uses the proceeds to complete or accelerate a project. The borrower can then use the cash flows generated by the project to pay the lenders back over time.

Like equity investors, fixed income investors can employ screening and tilting strategies to reflect ethical values and include bond issuers with better sustainability profiles. They also have the opportunity to increase engagement with borrowers on sustainability and related ESG issues since increased disclosure benefits all participants in the capital structure, including bondholders.

**Thematic bonds & the impact of Covid-19**

The sustainable debt market showed resilience amid the health and economic shocks of the first half of 2020, which saw a fall in green bond issuance and a surge in social bond supply. The increase in social bond issuance has been significant this year; these securities are dedicated to funding social projects and/or activities that have a positive impact on health. COVID-19 has pressured societies and economies to support care systems and the populations that are the most affected by the crisis, and this aligns with the mission of governments and supranationals that have always been the biggest issuers of social bonds. The total issuance in the first half of the year was more than twice as large as last year's total volume.

We believe that thematic bonds could provide an attractive investment opportunity which can be held within traditional fixed income portfolios, not just in a standalone thematic fund.

If you are interested in learning more about how Sustainable Investing works at MFS, please visit us at mfs.com/sustainability.



# No excuse for inaction

## *How sovereign debt investors can engage on ESG issues*

*by* Carmen Nuzzo

Carmen Nuzzo
Head of Fixed Income
Principles for Responsible Investment (PRI)

Engagement is integral to responsible investment in all asset classes – including sovereign debt – and it is a key component of systematically integrating ESG factors into the investment process.

The engagement practices and channels used differ by asset class, given that not all purchasers of financial instruments are shareholders, and within debt capital markets they depend on the issuer type. Corporate bondholders find themselves in a better position than their sovereign counterparts, when it comes to legal standing, the obligations of issuers towards them and access to issuers.

Nonetheless, engagement is not an alien concept for sovereign bondholders, who have always engaged with issuers to better understand relevant credit risks and opportunities based on balance sheet and economic fundamentals, including countries' long-term growth outlook and fiscal debt trajectory.

Engaging on specific ESG topics, particularly those relating to environmental or social issues, is less common. This is largely due to concerns that such efforts could be misinterpreted as political criticism, or if it could only succeed if an investment was of a certain size or are not necessary in the context of developed markets, especially those which serve as regional benchmarks and are most liquid.

*"Stepping up action is particularly critical at a time when, exacerbated by the COVID-19 crisis, fiscal deficits are swelling in several countries and in many instances endangering the sustainability of future fiscal plans. As a result, investors have a unique opportunity to convey to governments their expectations that future corrective actions and debt issuance are aligned with sustainability criteria."*

While these barriers do make ESG engagement in sovereign debt more difficult than in other asset classes, they do not provide an excuse for inaction.

When engaging directly with government institutions, bondholders do not approach sovereigns for lobbying or advocacy but to assess bond valuations and risks. In an ESG context, this involves

investors getting more information about the delivery of existing policy commitments, encouraging more forceful action to progress the ESG agenda or discussing funding needs for ESG-related reforms.

Indeed, the international commitments and frameworks that sovereigns have already subscribed to – such as the Sustainable Development Goals and the Paris Agreement – can be used to facilitate engagement discussions and minimise potential pushback.

**How can sovereign bondholders engage on ESG issues?**

Whether issuer initiated or investor led, sovereign bondholders have several avenues through which they can discuss ESG issues, including:

*Unveiling of fiscal plans*

Most democratic governments convene investors to provide clarifications and details when they unveil annual budgets and medium-term fiscal plans. This is an opportunity to ask for better public disclosure (including ESG-related information), discuss underlying budget assumptions and enhance fiscal sustainability assessments. Similarly, engagement opportunities exist with some central banks around inflation and financial stability report releases.

*Roadshows*

Governments and debt management offices may organise roadshows to promote new bond issues, including thematic bonds – the latter can be particularly useful for dialogue, as issuers are better prepared to answer ESG-related questions than in other settings.

*Ad-hoc events*

Some countries don't hold roadshows often, but their government officials might instead feature regularly in public conferences and events where investors can ask ESG-specific questions – at large development finance institution conferences, such as the Annual and Spring World Bank/IMF meetings and their side events, for example.

*Country research trips*

Country research trips have long been a regular feature of the institutional investment process. They are typically organised by investment banks for groups of clients and offer an opportunity to meet with a variety of country stakeholders, including those that aren't directly tied to the issuer, such as NGOs, members of non-ruling parties, business associations and national or multinational companies. Having access to non-issuer stakeholders can help investors to get a holistic view of developments in a country and substantiate official information.

*Investor collaboration*

Collaborative platforms, although limited, offer an important channel to improve transparency and uphold ESG best practices by governments. Furthermore, collaborative engagement can encourage local pension and insurance funds, banks and asset managers – who might otherwise be reticent to engage, either because they invest only in domestic sovereign bonds, as is the case for many Nordic investors, or for political reasons – to be more proactive.

**To road ahead**

Material ESG factors are starting to become integrated into investment analysis, decision making and engagement activities across the finance industry. While these practices are not yet widespread in sovereign debt markets, investors are starting to recognise that fiduciary duty extends beyond equity holdings, and that ESG engagement in sovereign debt and other fixed income assets is not only possible, but vital to improving future financial sustainability.

Sovereign ESG engagement can take many forms and can be a very effective input to sovereign debt analysis if it is done in the right spirit. Issues such as climate change, income inequality and human rights are becoming more prominent in risk assessment, and market participants are starting to recognise that these impact sovereign bond valuations, although attribution remains difficult.

Sovereign debt investors are, however, uniquely placed to contribute towards shaping sustainable real-world outcomes – in terms of supporting policy engagements, and by using every opportunity for direct individual and collaborative engagement with sovereign issuers to broaden the conversation.

Stepping up action is particularly critical at a time when, exacerbated by the COVID-19 crisis, fiscal deficits are swelling in several countries and in many instances endangering the sustainability of future fiscal plans. As a result, investors have a unique opportunity to convey to governments their expectations that future corrective actions and debt issuance are aligned with sustainability criteria.


Photo by wanaktek on Twenty20

Photo by SteveAllenPhoto via Twenty20

# Green Bonds Growing in Europe

*by* David Zahn, CFA, FRM

**David Zahn, CFA, FRM**
Head of European Fixed Income,
Franklin Templeton Fixed Income

Growing concerns about climate change have caused an explosion in "green" bonds amongst environmentally conscious investors. David Zahn, Head of European Fixed Income at Franklin Templeton, highlights some exciting developments in the green bond market, including new issuance from Germany.

Green bonds have been growing in popularity as a way to combat the negative effects of climate change across the globe. Similar to traditional bonds in structure, green bonds offer investors the ability to put their money to work in lessening greenhouse gas emissions. Major governments are now getting involved in this space—with European countries taking the lead.

### What Are Green Bonds?

Green bonds are capital market instruments used to fund projects that will have a positive environmental and/or climate benefit. According to the Green Bond Principles (GBPs)[1], the issuer needs to certify where and how the proceeds are spent, the process for project evaluation and selection, and the effectiveness of these investments in meeting their decarbonization goals. The GBPs do not require cash to be held in segregated bank accounts or that the assets financed be subject to separate security.

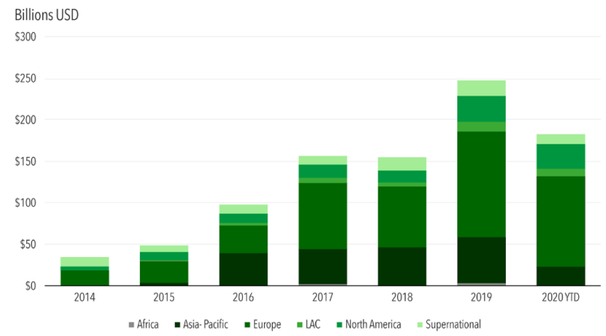
Green bonds made their first appearance in 2008 with an issue from the World Bank. Since then, growing concerns about greenhouse gas emissions and climate change have prompted both a surge in the popularity of environmental, social and governance (ESG) mandates and green impacted-related issuance to finance climate-related expenditures. Green bonds have quickly become common across jurisdictions, industries and currencies.

Issuers seeking the green label for a bond take the additional step of certification, which is typically done by a third party that verifies compliance with the GBPs.

### Governments Getting Involved

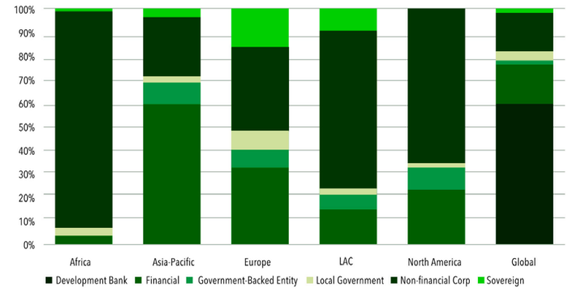
While companies already aligned with "green" initiatives—such as producers of solar panels or wind turbines—have been a natural fit for green bond issuance, a variety of companies in a range of industries have realised the need to reduce their carbon footprints. Green bonds in general have been growing worldwide in terms of issuance and market size. Global green bond and green loan issuance reached an adjusted US$257.7 billion in 2019, marking a new global record[2].

**Europe Leads Growth in Green Bonds**
2014–23 September 2020




Sources: Franklin Templeton Capital Markets Insights Group, Bloomberg. Year-to-date through 23 September 2020. Includes corporate and government green bonds.

**Types of Green Bonds by Region**
Regional issuer type split, as at 2019




Sources: Franklin Templeton Capital Markets Insights Group, Bloomberg, data as at 2019.

Environmentally conscious investors have seen the attraction of green bonds for several years, but what has changed recently is that the bigger governments are getting involved. European countries are taking a leadership role in this space. Germany, Europe's largest economy, recently issued a 10-year green sovereign bond which was met with record demand, raising €6.5 billion[3].

What's even more significant is that Germany intends to create a green bond curve with the addition of two-year, five-year and 30-year credit instruments. We think this is a very positive development, as it will create a benchmark curve in the green bond space for new issuers to trade off of. Germany is "twinning" these bonds—there will be a green bond with the same coupon and maturity as a conventional government bond. The characteristics are the same, but the proceeds are to be used differently. The importance of this is that the premium investors will pay for green bonds will be readily apparent as the difference in yield will be for the greenness.

Europe has made the greening of its economy a priority, and the financial costs of these efforts require the government to work with the private sector to meet their goals. The European Union (EU) recognises the crucial role of financial markets in capital raising. A third of the EU's coronavirus rescue fund and €1 trillion of its seven-year budget are earmarked for initiatives directed at fighting climate change and achieving carbon neutrality by 2050. The greening of Europe is naturally very supportive for the green bond market, and we would expect more issuance and a broadening of issuance to support this focus.

**A Commitment to Decarbonise**

The European Commission has made a clear commitment to remain at the forefront of decarbonising the economy, with a vision of zero net greenhouse gas emissions by 2050. In her State of the Union speech in September, European Commission President Ursula von der Leyen upped the ante significantly on the EU's already-ambitious goals in regard to cutting emissions. She proposed a new target of 2030 to achieve a 55% reduction in emissions versus 1990 and suggested that €225 billion euros in green bonds should be issued to raise money for the 30% of the EU's coronavirus recovery fund directed toward green initiatives. The issuance of the EU green bonds will expand the Euro green bond market significantly and allow Europe to increase its lead as the place to issue green bonds.

The European Central Bank (ECB) has also been supportive of the green bond market. As of the end of 2019, the ECB possessed nearly a quarter (24%) of eligible euro-area public sector green bonds and 20% of eligible euro-area corporate green bonds[4]. More recently, ECB Head Christine Largarde has reiterated it is an area of focus for the central bank. So not only do we have new major sovereign issuers in the form of Germany and the European Union, but a central bank that looks to be a willing buyer. It seems as if Europe has plenty of support amongst its leadership to become the green bond capital of the world.

Over the next few years, we believe the green bond market will continue to grow as more investors recognise they don't have to sacrifice yield when following their conscience and can make a positive impact on the future. As investors ourselves in this space, we believe an active approach helps us uncover the most compelling risk-reward opportunities that also provide environmental benefits.

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In April 2019 Franklin Templeton launched Europe's first actively-managed Euro Green bond ETF, managed by London-based David Zahn, Head of European Fixed Income, and Rod MacPhee, Portfolio Manager, Franklin Templeton Fixed Income Group. The ETF invests at least 70% of its net assets in green-labelled bonds, with the balance made up of climate-aligned bonds, i.e. bonds that are not labelled as green but are nonetheless financing solutions that contribute to a low-carbon future. By investing in this manner, the ETF provides liquidity to projects with positive environmental or climate benefits whilst aiming to maximise total investment returns.



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Sources:
1 International Capital Market Association.
2.Climate Change Initiative, February 2020; data as at 2019.
3.Bloomberg, "Germany Seizes on Demand for Green Debt with $7.7 Billion Debut," 1 September 2020.
4. FTSE Russell, "ECB developing an appetite for green bonds," 10 July 2020



*Case Study*

## The Power of Green Bond Investors:

# Adani & the Carmichael Mine

*by* Aline Reichenberg Gustafsson, CFA

While the legitimacy of the green bond market is slowly but surely establishing itself as a viable investment tool, the net additionality of this growing sub-asset class is still up for debate. However, amidst the controversy surrounding the funding of the Carmichael mining development in Queensland, Australia, green bondholders might have a concrete opportunity to play a role in influencing the fate of a project with a high negative environmental impact.

Following the entire financing chain from the pockets of Nordic pensioners to the excavation of coal in the middle of Australia, passing on the way through France and India, this case study brings to the forefront the potential reputational leverage the green bond market may finally be able to yield.

**The Green Bond Challenge**

Detractors of the green bond market often claim that this so-called environmentally-friendly financing has very little or no impact on the behaviour of companies, let alone the planet. The critics often point out that, while green bonds need to be earmarked for certain projects, they sit alongside any other regular bond on the issuer's balance sheet, resulting in the same risk. Pricing is also the name of the game in bond markets and evidence of a significant "greenium" is still hard to come by.

For proponents of the green bonds, the answer lies beyond the simple bond math. By issuing green bonds, companies will initiate an internal journey which, in some cases, has proved beneficial in bringing environmental concerns into the day-to-day decision-making process.

From an institutional investor's perspective, green bonds are a simple and investable vehicle to place part of the fixed income allocation in a sustainable manner. Some institutions even place green bonds in their 'impact investment' efforts. Since they are priced so close to regular bonds, but do offer that little extra commitment to the environment, Nordic investors have piled up in the major green issuances. Several of the largest pension funds have also supported the launch of the first emerging market green bond fund: the 'EGO fund' managed by French-headquartered global asset manager Amundi.

**The Backing of the EGO**

Launched in April 2017 as the largest green bond fund yet, the Amundi Planet Emergin Green One (EGO) fund was born thanks to the support of the International Finance Corporation (IFC), on of the investment arms of the World Band. The financing of the EGO successfully closed in the first quarter of 2018 with investments from several Nordic asset owners including Alecta, AP3 and AP4 in Sweden, MP Pension in Denmark and LocalTapiola in Finland.

To attract investments from large institutions, funds are required to offer sufficient room to invest sizeable amounts. From the start, the Amundi EGO fund targeted a US$ 2billion structure, despite the lack of a suitable green bond market in emerging economies. Therefore, the project paired the deployment of the fund's capital with an educational program directed at the financial community in India and other target markets. The representatives were invited to Sweden to follow a crash course on green bond issuance by specialists at the Stockholm School of Economics.

The additionality of the EGO fund could therefore rely on a double rationale: the fund would invest in green bonds that wouldn't have been issued if it weren't for the initiative behind the fund, and the projects ultimately funded by these bonds would not have been conceived had it not been for the availability of the green bond market.

**Adani and the Carmichael mine**

For Indian conglomerate Adani, coal represents an important resource, unlike what a casual visitor may think when visiting Adani's webpage, where the company proudly claims to be "fostering goodness through sustainability". Well-hidden at the end of the list of its 21 business lines, is thermal power generation.

One of the preeminent trade-offs for sustainable investors in emerging markets is, of course, to balance growth, which often offers the prospects of strong social benefits, with the accompanying damage to the environment. While wind and solar power generation are at the top of Adani's business list, they currently don't provide the continuity in the electricity grid that is needed to ensure a stable power supply.

Meanwhile, Adani's Carmichael mine may produce up to 60 megatonnes of coal per year, which, once exported and burned as fuel in India would lead to several gigatons of additional $CO_2$ emissions. Although both India and Australia have already suffered severe consequences from global warming and yet, the immediate financial benefit of developing the mining project are appealing enough to both Adani and the Queensland province; that is, if the project can be financed. For today's conscientious and sustainable investment firms and asset owners, being associated with dirty coal-stained paper could rapidly end in a major reputational fiasco.

**Gathering momentum**

In an attempt to harness attention against the Carmichael mining development, Ulf Erlandsson, Executive chair, Anthropocene Fixed Income Institute (AFII), has actively contributed in naming and shaming Adani and its enablers, particularly among Nordic sustainable investors. "I have been following this story quite intently since 2016. Following the big coal re-pricings in Europe in 2015-16 it was natural to enquire where other big coal exposures accessible through bond markets could be found," Erlandsson explains. "Australia is the top coal exporter, and it's hard to do any research on coal mines in Australia without coming across Carmichael. The project was always controversial already at that early stage and by Christmas 2017, it looked like the project was not going to go ahead due to lack of funding."

"However, the project came back to life when Queensland's government decided to approve the mine in June 2019. Just days after the decision, the Adani Group started issuing jumbo hard currency bonds, in what now appears to be strategy to raise funding for the mine," he adds. "These large size USD bond deals from Adani really caught my attention. I have even held a significant short position on Adani in a model (hypothetical) portfolio of the credit climate strategy I have been discussing with potential investors. I use the case it to illustrate how bad fixed income funding can be in terms of climate impact, but also to showcase how one could see potential big bond repricings when climate risks are accounted for," he explains.

"Since this summer, I have been receiving support from the Growald Family Fund (GFF) to actually talk about the case from a think-tank perspective, through the AFII," Erlandsson says. "GFF has a very strong network in the anti-fossil fuel space with a very keen interest in coal in Asia, so their involvement was crucial to building momentum on this project. It allowed me to share resources and insights with other organisations, such as the Sunrise project, which complements my bond market knowledge with a lot of detailed on-the-ground knowledge, such as the role of the of the State Bank of India as a facilitator of Adani, in this case."

**One step at a time**

Mid-November, the news spread that the State Bank of India was ready to sign a loan agreement of INR50 billion (US$670 million) to finance the Adani Enterprises Ltd's Australian mining company, now renamed Bravus Mining & Resources, raising concerns about the environmental credibility of SBI as a sustainable borrower.

Supported by the endorsement of the GFF, Erlandsson started to produce research about the affair to raise awareness about Adani's enablers and the environmental and financial risks created by this project. "We were alerted to the specific SBI Carmichael loan situation a while back and quickly did some analysis on the key parties involved in various SBI securities, as outlined in a research note[1]," he says.

"The note reviewed holdings of SBI bonds and showed that Credit Agricole/Amundi and the EGO fund were top investors," Erlandsson adds. "I have been following the EGO fund for quite some time. I was present for one of the original pitches back in 2017 when I was still a senior portfolio manager at AP4 and have regularly been engaging with various people from IFC and Amundi, who originated the EGO fund."

**The French connection**

"As I know some of the Nordic asset owners involved in EGO, it was easy to reach out to them via email or Bloomberg chat," he explains. "I sought to warn them about the situation because I expected they would be concerned. That assumption was correct. One of them later told me they rang Amundi just minutes after our initial chat. It is quite encouraging to see some asset owners act so quickly. When they move decidedly, it is a very powerful signal to all other stakeholders."


"I also engaged with Amundi directly, although the asset owners really were ahead. It was a simple discussion," he says. "No one has anything to gain from SBI entering into bad economic and environmental loans. NordSIP had already written a story that started to get traction in the financial community," Erlandsson remembers. "By the time Environmental Finance reached out to Amundi about the story, I think they might have already decided to divest from the SBI green bonds in case the loan goes through."

As a sustainable investor, the Amundi EGO Fund's holding of such securities would bring Amundi to disrepute. Amundi's Jean Jacques Barberis, director of the institutional and corporate clients division & ESG, voiced his concern and publicly committed to divesting from the SBI.

"We have engaged with SBI. We have been quite clear that we would like them not to participate in the project. We have sent a letter and have had contact at high level at SBI. We have been told that the decision has not been made. I don't know what will be the results of the engagement, but we will divest if they go ahead with the project," Barberis told the media[2].

**Galvanising Support and Avoiding Tunnel Vision**

"This case illustrates the great power of green bond investors. As the parties with the most to lose from an issuer going rogue, green bond investors are ideally placed to galvanise other investors to engage with issues that they would otherwise not have been aware of," Erlandsson argues. "We are already hearing more, non-green bond investors piling in against SBI. The benefit of the green bond in this case may be less about the windmills it finances, but rather how it stops a company from potentially carrying out climate transgressions."

However, Erlandsson is keen to warn sustainable investors against the dangers of tunnel vision. "I think that a challenge particular to green bond investors is that they often focus on the 'good' of the green bonds at the detriment of the 'bad.'"

"For example, I think that understanding the dangers of coal, like in this case, can be much more impactful than being a master of the EU green taxonomy. We need both, of course. But I think there is a tendency in the business to lean too hard on the 'good' one creates rather than the 'bad' one avoids/dissuades," he concludes.

[1] AFII, "State Bank of India + Carmichael coal mine? Not so fast please", 18 November 2020 https://anthropocenefii.org/afii-sbi-carmichael
[2] Environmental Finance, "Amundi threatens to divest State Bank of India's green bonds over coal project", 27 November 2020.

Kristoffer Dreiman
Head of Responsible Investments
Länsförsäkringar

Image by Binniam Halid for NordSIP ©

# The Art & Science of Exclusions

*by* Filipe Albuquerque

For institutional investors, sustainability is a journey of continuous improvement. That is particularly true for sustainability-oriented investors who have specific climate change mitigation goals in mind. Fixed income products are particularly appealing from that point of view because liquidity needs, both of the issuer and of secondary market traders, imply recurrent primary market activity, which creates opportunities for high intensity and high value engagement. In these instances the threat of exclusions and divestment, as well as the promise of inclusion and support, gives a lot of bargaining power to asset owners.

Kristofer Dreiman, Head of Responsible Investments at Länsförsäkringar, a Swedish mutual insurance and pension provider, is keen to emphasise that exclusions work better in combination with other responsible investment strategies. Länsförsäkringar's experience shows that an incremental, dynamic and multifaceted approach to various responsible investment strategies and ESG criteria, involving both exclusion, transition and inclusion criteria, can provide a wide scope of action in fixed income markets.

**Corporate Exclusion Criteria**

As of the end of 2020, Länsförsäkringar applies a wide range of exclusion criteria. Companies deriving over 5% of their revenues from the production of tobacco products, commercial gambling (online and land-based), fracking and from the extraction of coalbed methane are automatically excluded. As a rule, Länsförsäkringar also excludes companies that derive more than 5% of their revenue from the extraction or production of energy using thermal coal, although exceptions for utility companies deemed to be in transition can be made. Most recently, exclusions were also extended to companies deriving more than 50% of their revenues from the exploration and extraction of conventional oil and gas. The remaining exclusion criteria are focused on serious violations of ESG norms and involvement with controversial weapons. As a result of these measures, Länsförsäkringar had blacklisted 160 companies within the MSCI ACWI by October 2020 .

"We introduced climate exclusions criteria in a piecemeal manner," Dreiman says. "We started with thermal coal with a maximum threshold of 50% revenues and then, over, time we lowered it to 20% and then to 5%, between 2016 and 2019. Gradually, and on a quarterly basis, we review and refine all of our existing exclusion criteria."

The exclusion criteria apply across asset categories. There's no dichotomy between equity and fixed income corporate holdings. "We apply the same exclusion criteria and the same thresholds, regardless of whether it's listed equities or fixed income corporate bonds," he adds.

**Sovereign Exclusion Criteria**

Beyond corporate bonds, Länsförsäkringar has also introduced and applies two types of overarching exclusion criteria to sovereign bonds since 2020. "On the one hand, we follow the EU's blacklist of non-cooperative tax jurisdictions, which covers twelve countries," Dreiman says referring to the exclusion of bonds from American Samoa, the Cayman Islands, Fiji, Guam, Oman, Palau, Panama, Samoa, Seychelles, Trinidad and Tobago, US Virgin Islands and Vanuatu.

"The other set of sovereign exclusion criteria covers corruption, human right violations, and impediments to the freedom of speech," he adds referring to the exclusion of Afghanistan, Burundi, the Democratic Republic of Congo, Equatorial Guinea, Libya, North Korea, the Republic of Congo, Sudan, Syria, Turkmenistan, Venezuela and Yemen. "These assessments are informed by combining open resources such as Transparency International, and information compiled by The Economist Intelligence Unit, Freedom House, Transparency International and Sweden's Ministry for Foreign Affairs' country reports on human rights, democracy and the rule of law," Dreiman explains, adding that the initial set of ESG criteria for sovereign bonds will evolve and be further refined over time.

**The Effectiveness of Exclusions**

"Exclusions are not as effective as they can be if used as standalone strategies. It's only when they are combined with other approaches, such as active ownership, dialogue and voting at AGMs that exclusions reach their true potential," he argues.

According to Dreiman, exclusions and engagement work well together. "Blacklisting a company should be understood as the end point of an escalation pathway. Investors can engage with the company

about its sustainability profile and its performance, and if it is not willing to respond or if it ignores investors' concerns, then exclusion can be the last point of action."

"The exclusion criteria are not static," Dreiman adds, referring to Länsförsäkringar's ability to tighten restrictions over time. However, they also do not need to be uniform. Not only have the criteria evolved over time, the fact that Länsförsäkringar has exclusions and climate transition lists publicly available, means that potential investees can move from being black listed to being accepted. There are other strategies that asset owners can follow to apply investment criteria.

**Transition Criteria**

According to Länsförsäkringar, the asset owner makes an exception to its thermal coal exclusions for certain utility companies in cases where it can be argued the companies are moving in the right direction. "We introduced so-called transition criteria in the third quarter of 2019," Dreiman explains. As with the exclusions, Länsförsäkringar's introduction of transition criteria has also been a step-by-step affair. "At this early stage, the criteria apply for now to utility companies only and are focused only on revenues from thermal coal that range from 20% to 5% . We will probably expand the transition criteria to other sectors, particularly those with significant $CO_2$ emissions," he adds.

The twelve companies presently included in the transition list are part of Länsförsäkringar's investment universe. However, this does not automatically mean that investments will happen. Moreover, companies have to continue to prove themselves.

"Companies can be part of our transition list if they can demonstrate they have begun their energy transition journey," Dreiman explains. "They can do this by shifting away from fossil fuel dependence to renewables, by setting science-based targets to reduce emissions in line with the Paris Agreement goals, or if a Transition Pathway Initiative (TPI) assessment shows that they are aligned with a below 2°C temperature increase scenario with respect to their $CO_2$ emissions.".

Both the climate specific exclusion and transition criteria can be linked to Länsförsäkringar's so-called climate smart vision that aims to harmonise its portfolios' emissions by 2030 with a trajectory equivalent to limiting climate change to 1.5°C.

**Inclusion and COVID-19**

"As many of our peers, Länsförsäkringar takes several approaches to responsible investments," Dreiman says. The insurance and pension company punishes laggards that are not aligned with its values and supports those that are transitioning to more sustainable practices. "But we also give preference to specific entities that are leading the transition, both in terms of their overall ESG and emissions profiles as well as their alignment with the upcoming EU Taxonomy."

This positive approach was particularly useful during the COVID-19 pandemic. "We engaged with green bond issuers during the Spring of 2020 to see whether the scope of their existing green or sustainable bond awareness frameworks could be broadened to project categories that would support the COVID19 mitigation efforts," he adds.

"In one instance, we had a dialogue with the European Investment Bank (EIB). We discussed whether their existing Sustainable Awareness Bonds (SAB) framework, launched in 2018, which had expanded from its original environmental and in particular water infrastructure focus to include social projects, could be used for investments linked to the mitigation of COVID19. Among other applications, this allowed us to support European laboratory facilities and contribute to the conversion of facilities into emergency and intensive care units," he explains.

**Exclusions and Social Bonds**

During the Spring, Länsförsäkringar invested in four social linked bonds aimed at tackling COVID-19 and supporting society. These bonds were issued by the EIB, the Nordic Investment Bank (NIB), the International Finance Corporation (IFC) and the African Development Bank (AfDB). This type of social bonds have been growing in popularity recently, on account of growing economic inequalities and social justice concerns. However, these securities are still some ways off their established green counterparts.

When social assessments go beyond corruption and human rights, they become more detailed, nuanced and qualitative, in comparison to environmental data. "While it is easy to measure $CO_2$ emissions, water intensity or to determine whether a certain river has been polluted by toxic waste measuring progress along certain social issues is not quite as linear," Dreiman says.

Länsförsäkringar's solution to this hurdle has been to use the UN Sustainable Development Goals (SDGs) as a benchmark for investments and engagement. "We prioritise five of the seventeen UN SDGs in our investments and in our active ownership activities. One of them is "Good Health and Well-Being" (SDG 3), which fits very well into COVID-19 considerations," he explains. "In the near future, as issuers start to provide reports on the use of proceeds from social bonds, Länsförsäkringar intends to present measurable contributions to SDG 3," Dreiman adds.

"Following our COVID-19 bond investments, we have maintained an open line of dialogue with the relevant issuers to monitor the use of proceeds in the coming year. The relevant KPIs and data necessary to perform this assessment are not as well developed and established as their green bond counterparts, but work is underway," Dreiman concludes.


Image by Helena Hertz on Unsplash / NordSIP

# Beyond Green Labels

*by* Filipe Albuquerque

*With the rise in popularity of green bonds, industry labels and marketing efforts can muddle the waters and raise the spectre that among the multitude of securities flooding the market, some greenwashing might have escaped into the fray. Now that green bonds have become an accepted reality, asset managers need to be meticulous and quality-oriented in their investment process. These are the ideas echoed by Vishal Khanduja, Vice President and Portfolio Manager at Calvert Research and Management, responsible for managing the sustainable asset manager's Green Bond Strategy.*

*"If it is done right, the sustainable fixed income market is a very effective pathway to efficiently finance transition to a less carbon intensive economy."*

Vishal Khanduja
Vice President and Portfolio Manager
Calvert Research and Management

**The Sustainable Capital Disconnect**

"I joined Calvert Research and Management in 2012, after working for seven years in the investment management arena as a portfolio manager at Columbia Threadneedle and associate director of fixed-income analytics at Galliard Capital," Khanduja says. "Growing up and living in India, there were social and environmental issues that were not quantified, but which we were aware off needed to be solved. As I developed professionally, I became increasingly convinced that to solve any structural problems, such as these, requires channelling finances to address the issue," he explains.

"Unfortunately, there is only so much that can be achieved through pro-bono or charity funds. These challenges require consistent and committed long term funding at a much larger scale, which can only be accessed through investors to facilitate the scale of change necessary to address these problems." However, there was a disconnect between the problem and the solutions according to Khanduja. "Until I joined Calvert, I had not made the connection between sustainability problems and funding. I was aware of microfinance solutions, but those were still very niche and new and inaccessible to the majority of investors."

"Joining Calvert really was that 'light bulb' moment. It helped me realise that a solution was available to provide sustainable solutions and financial returns," he adds. "It showed me it was possible to combine fundamental credit work with additional layer of information from financially material ESG factors provides a more complete assessment of the issuers' risks and opportunities. It just makes prudent investment sense."

**Sustainable Fixed Income Challenges and Opportunities**

According to Khanduja, there have been three main drivers of growth in sustainable fixed income, which share in common, the fact that all members of society have become more aware of existing problems. "Practically, speaking, the increased incidence and violence of extreme climate events, such as flooding, hurricanes and forest fires, have made companies more cognisant of the scale of financial impact from climate change."

"From an analytical perspective, there is also more and deeper research, information available now to help investors quantify the materiality of sustainable factors to financial returns. Put another way, there has to be a significant (and positive) impact to the ESG impact made by the firm.

From the investor point of view, the increased awareness has left asset owners, such as pension funds, wanting to internalise this new information into their investment decision making to make a long term impact on the sustainability of the planet," he adds.

"If it is done right, the sustainable fixed income market is a very effective pathway to efficiently finance transition to a less carbon intensive economy. The challenges faced by the Green Bond market have changed as the market matures," Khanduja explains. "A few years back, the main challenge was the inability or unwillingness to issue green bonds, as well as spotty overall Green Bond liquidity."

"Although there were some issues at the start of the year due to COVID19, Green Bond issuance has rebounded nicely since then. According to the Climate Bonds Initiative, we now have over 1,000 issuers,

which provide orders of magnitude more liquidity than before and argues for increased future growth." According to Khanduja, the issue is no longer one of quantity, but rather of quality. "Now, the challenge is to ensure investors are doing their work to assess issuers' overall ESG profile rather than just taking every labelled Green Bond."

**The Calvert Green Bond Strategy**

"The need for a focus on quality and selectiveness is at the core of the Calvert Green Bond Strategy", Khanduja argues. The Green Bond strategy was launched in 2011 by Khanduja's co-portfolio manager Brian Ellis and the then CIO of Calvert to model the strategy to provide exposure to green and impact bonds while also delivering a strong total return fixed income profile. The two portfolio managers who are supported by over 50 other investment professionals, including fundamental credit analysts, ESG analysts, fixed income traders, and other PMs. The ESG research is performed by Calvert's dedicated ESG Research team based in Washington, DC.

"We seek income-producing investments in global fixed income markets that are working directly to move to a less carbon intensive economy. Although there are over US$2 billion in total green bond AUM (inclusive) across all Calvert Fixed Income strategies, this specific strategy manages a portfolio of approximately US$650 million," he says. The strategy is available as a separately managed account to institutional investors in the Nordics and globally. "We plan to have a UCITS vehicle ready sometime in 2021," Khanduja adds.

The strategy doesn't have a preference for any single type issuer or impact profile for a green bond, he explains. "First and foremost, we assess how an issuer is managing its overall financially material ESG risks and opportunities, and then we independently evaluate the green bond itself on the strength of its project or purpose, the fundamental credit of the issuer and the relative value of the issue and sector."

Another resource available to investors is the work of the Calvert Institute for Responsible Investment, which helps to evolve Calvert's ESG research process. "The mission of the Institute is to catalyse positive change through our research and the sum of our actions," Khanduja says. "This is accomplished through conducting and publishing industry-leading ESG research with internal and external investment and academic partners, as well as through the efforts of other Institute programs. The Institute serves as a consortium of experts in the field of responsible investing, providing ESG research and thought leadership for investors, corporations, and policy makers."

**Value Beyond Labels**

The Calvert Green Bond Strategy' investment process is based on the belief that risk-return potential can be improved through active positioning in security selection, sector allocation, duration, and yield curve, according to Khanduja. "The alpha generated from these sources is most reliable when focusing on long-term risk-adjusted returns. This requires risk management to be considered throughout the process, from a security's purchase to its sale." According to the portfolio manager, this is when ESG integration comes into play. "When capturing specific investment opportunities, downside risk can be mitigated through strong knowledge of underlying asset values. Integrating financially material ESG information with fundamental credit analysis provides, in our view, a more complete assessment of an issuer's long-term value."

The strategy combines macro and microeconomic analysis to inform its investment decisions. "Our top-down process evaluates macroeconomic performance and expectations against our monetary and fiscal policy expectations. This drives our duration and yield curve positioning," Khanduja says. "We then assess the fundamentals of three broad categories of economic balance sheets: sovereign, corporate, and consumer. This informs our broad views on sector allocation, which are then more granularly informed by our bottom-up security selection at the industry level. While our top-down view is essential, a larger part of the investment process is focused on bottom-up analysis."

"Once our broad sector allocation preferences are established, we rely on our team of ESG and fundamental credit analysts to generate the best risk-return ideas in those sectors." According to the portfolio manager, ESG analysis allows him to focus his investment universe. "This opportunity set is further refined allowing us to choose only those securities which meet our ESG criteria and our proprietary green bond criteria." However, Khanduja's options are not limited to bonds labeled as green by third-party providers. "Instead, our 'Three Pathways to Green' research process focuses on green projects, solutions providers, and environmental leaders that we independently review through our proprietary green bond analysis. We focus on their issuance history and consider their ability to tackle their bonds' target environmental challenges."

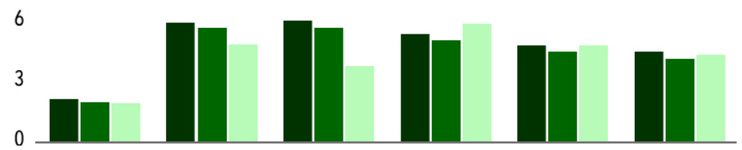
These considerations notwithstanding, the strategy's assessment is conducted on an ongoing basis and investments are differentiated depending on their financial and ESG performance, according to the portfolio manager. "In the portfolio construction process, ESG factors may affect how views are ultimately expressed. For example, an issuer with poor or significantly weakening ESG performance may warrant a shorter duration position and/or one with more seniority in the capital structure. While the core of our investment process focuses on those issuers that are adequately managing their material ESG risks and opportunities, portfolio managers will further tilt the portfolio towards those issuers with better overall ESG performance and impact metrics consistent with fiduciary goals."

**A Safe Haven**

"The twofold goal of the strategy is to provide both a strong fixed income risk adjusted returns while also providing impact/green exposure. It has performed within our expectations."

The quality of the green bond portfolio also appears to have paid dividends during the crisis. "The strategy has performed well during the crisis as the high-quality nature of the strategy means that it benefited from the global flight-to-quality move in the first half of 2020," Khanduja concludes.

Composite Performance (as of 30/9/2020)




| | QTD | YTD | 1 year | 3 years | 5 years | since inception |
|---|---|---|---|---|---|---|
| Gross | 2.14 | 6.02 | 6.09 | 5.44 | 4.80 | 4.52 |
| Net | 2.07 | 5.78 | 5.77 | 5.13 | 4.49 | 4.21 |
| Benchmark | 1.77 | 4.91 | 3.80 | 5.91 | 4.86 | 4.36 |

"Past performance is not a reliable indicator of future results.
Source of all data: Calvert Research and Management, MSCI, 30/09/2020, unless otherwise stated.
ICE BofAML Green Bond Index tracks the performance of securities issued for qualified "green" purposes. Qualifying bonds must have a clearly designated use of proceeds that is solely applied toward projects or activities that promote climate change mitigation or adaptation or other environmental sustainability purposes as outlined by the ICMA Green Bond Principles. General debt obligations of corporations that are involved in green industries are not included. The index includes debt of sovereign, quasi-government and corporate issuers, but excludes securitised and collateralised securities. Qualifying securities must have an investment grade rating, at least 18 months to final maturity at the time of issuance, at least one month remaining term to final maturity as of the rebalancing date and a fixed coupon schedule. Qualifying securities may be denominated in specified developed market and emerging market currencies. Securities denominated in a qualifying emerging market currency must settle on Euroclear.
Debt securities are subject to risks that the issuer will not meet its payment obligations. Low rated or equivalent unrated debt securities of the type in which a portfolio will invest generally offer a higher return than higher rated debt securities, but also are subject to greater risks that the issuer will default. Unrated bonds are generally regarded as being speculative.
Composite data and statistics is supplemental to the composite's GIPS® report contained herein. Please refer to the following material for the GIPS® report and the important additional information and disclosure: http://funds.eatonvance.com/includes/loadDocument.php?fn=30734.pdf&hk=61B90AC3EA3F-67447DEEA73EE3FF9408&all"

# Icelandic Finance Goes Green

*by* Andri Guðmundsson and Ásgeir Kröyer

*Despite the COVID-19 pandemic, the land of ice and fire has seen sustainable bond issuance in 2020 dwarf all previous years, with three new issuers coming online and record amounts of issuance both domestically and internationally. Icelandic finance is going green.*

Andri Guðmundsson
Managing Director, Corporate Finance
Fossar Markets

Ásgeir Kröyer
V.P. Corporate Finance
Fossar Markets

Photo by Tomáš Malík on Unsplash

**A history of fixed income in general**

Looking back to the previous global crisis, Iceland seems unrecognisable. Inflation is 3.5% (18.6% in January 2009), the currency is stable and the stock market is back to its pre-great moderation bubble levels. Unemployment (6.8%), while on the rise, is still below the Euro-zone average (8.3%). Indeed, the effect of the COVID-19 pandemic is mainly visible in the steep decline in GDP in Q3 (10.4%).

The total size of the listed Icelandic bond market is ISK2,761 billion (approximately US$20.8 billion), equivalent to 94% of Iceland's GDP. According to the Central Bank of Iceland, the Treasury (28% of market) and the state-owned Housing Financing Fund (25% of market) are the largest borrowers in the fixed income market.

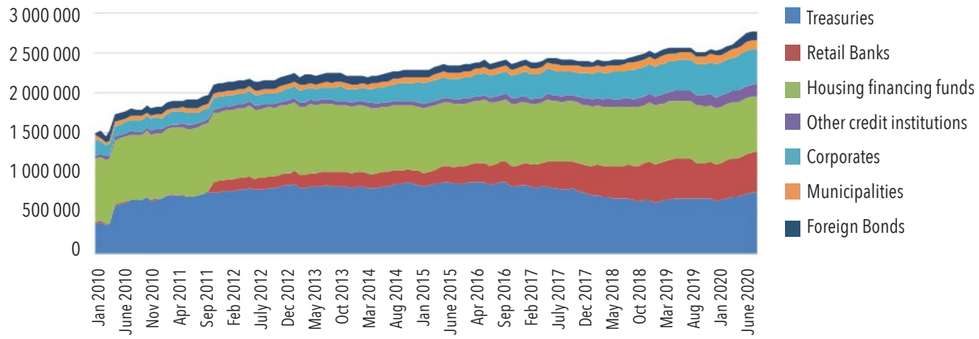
While corporates have not been an active part of the market historically, they have been gaining considerable traction in the past years, going from 7% of total market at the beginning of 2010 up to ISK439 billion, or 16% of total current market share. In addition, the retail banks have been increasing their share since late 2011 with covered bonds issues and now account for ISK508 billion or 8% of total market share.

The Republic of Icelandic currently has a long-term credit rating of A from Fitch/S&P and A2 from Moody's while other larger issuers such as the main retail banks have long-term credit ratings of BBB. As a rule, other issuers do not have credit ratings, but there is a general requirement that all issued bonds be listed on the Nasdaq Iceland bond exchange. There is generally ample after-market liquidity for issued bonds.

While the majority of borrowers issue in local Icelandic currency, the Icelandic government along with the energy companies, largest retail banks and a handful of others also issue in euro, US Dollar and Nordic currencies. A good portion of the dollar issues reflect the fact that energy sales to large-scale industrial and commercial clients are in based in US currency.

Types of listed bonds in Iceland

Position in ISK million

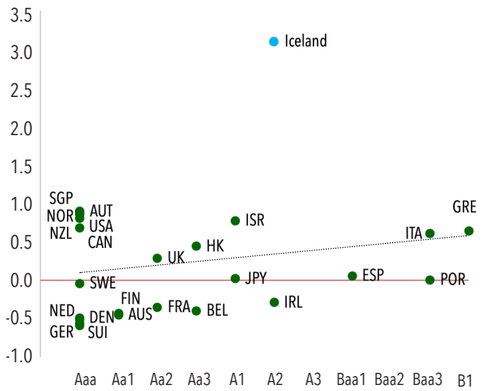



Source: Central Bank of Iceland

Apart from government treasuries, the Icelandic bond market is primarily driven by longer-duration inflation-linked bonds which reflect the local investor appetite. That appetite is in turn driven in large part by the local pension funds as Iceland has one of the strongest pension systems in the world where assets account for a staggering 187% of GDP.

Recently, there has been little international inflow into the domestic bond markets. Our view is that this is set to change in the coming years due to strong country fundamentals and credit ratings as well as high bond yields in a maturing corporate credit market. Having spent the last decade returning to a new financial normal and as a prime producer of green energy, we believe the stage is set for Icelandic sustainable fixed income to shine in international markets.

Developed 10 Y yields vs. Moody's ratings




Source:Bloomberg, Fossar Markets

**Sustainable Bonds: The New Standard**

With 100% of all electricity production in Iceland generated from renewable energy sources, Iceland has long been a global leader in environmental awareness and the use of green energy. The City of Reykjavík, one of the cleanest cities globally, is the only capital in the world using 100% geothermal energy for district heating. Iceland has an abundance of green infrastructure suitable for sustainable financing. It is not surprising that the leading issuer of green bonds is the energy sector.

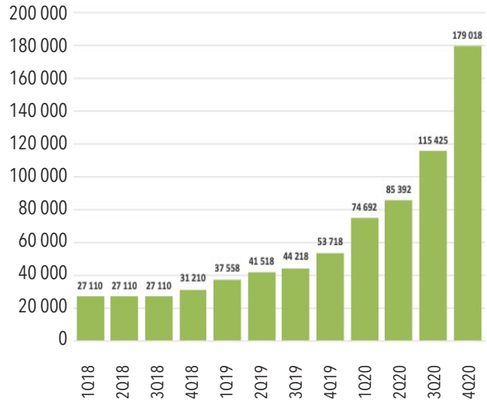
Today, the other main sectors driving sustainable bond issuance in Iceland are banking and real-estate followed closely by municipalities. Following the first inaugural issuance of Icelandic green bonds in 2018, and despite slow international growth in 2019, the stock of outstanding green debt expanded over three-fold in 2020. To date, approximately ISK179 billion (US$1.3 billion) worth has been issued of Icelandic sustainable bonds, ISK72 billion (US$533 million) of which, domestically.

The first Icelandic green bond was issued by the National Power Company (Landsvirkjun) in March of 2018 and sold to US and UK institutional investors in a US private placement. This was followed by the inaugural domestic green bond issue by the City of Reykjavík late in 2018.

The year after, two new issuers of green and social bonds came to the market. Reykjavík Energy (Orkuveita Reykjavíkur) completed its first green bond issue in February of 2019 and Reykjavík Social Housing debuted the first Icelandic social bond in November 2019. Despite COVID19, 2020 has thus far been a very successful year for sustainable finance in Iceland, with three new issuers and record issuance year-to-date.



Total Accumulated Issuance (ISK million)




Source:Nasdaq, Fossar Markets

The Municipality Credit Fund issued its first green bond in February of 2020 and real-estate company Reginn issued its first green bond in June 2020. Finally, November saw one of the largest banks in Iceland, Íslandsbanki, sell its first sustainable bond to investors across Europe in addition to issuing domestic green bonds.

Apart from the bonds issued by the National Power Company and Íslandsbanki, all of the green bond issues were mainly sold to domestic institutional investors, with Icelandic pension funds leading the way. All of the issues were oversubscribed and favourably priced. All issuers base their green bond and financing frameworks on the ICMA standard with second opinions from either CICERO or Sustainalytics. Of the second opinions reviewed by CICERO, The City of Reykjavík and Reykjavík Energy both received Dark Green ratings and Reginn a Medium Green. All of the domestic bond issues are listed on the Nasdaq Sustainable Bond Market.

Since their inaugural green/social bond launches, many of the above borrowers have regularly issued new bonds based upon their existing green bond or financing frameworks, making green and social bond their standard borrowing vehicle.

Year-to-date, we have seen aggregate issuance of approximately ISK46 billion worth of sustainable bonds domestically. This accounts for approximately 12% of total issuance in local currency, making Iceland one of the leading countries worldwide in green and social bonds per market share. In addition, we have seen a record ISK80 billion issued internationally.

**Policy and Regulation Spur Sustainable Debt Market**

The drivers of sustainable fixed income growth in Iceland reflect global trends. On the retail front, investors have in the past years become increasingly aware of environmental issues and choose to prioritize their investments accordingly. Institutional investors such as pension funds are correspondingly under increased pressure to integrate ESG considerations into their investment portfolios.

There are also two additional Iceland-specific drivers worth mentioning. First, the Icelandic government has a clear policy for the country to become carbon neutral by 2040, with 48 specific action points to be implemented in the coming years. Although not implemented in legal regulation yet, these goals have already begun influencing various policies and discussions in Iceland, spurring large industries to action.

The second point is that in mid-2017, a new legal framework regarding ethical goals in pension funds' investments was rolled out. Although these goals are not specifically defined in the framework, this action nevertheless led the pension funds to integrate ESG considerations into their day-to-day investment operations, placing more emphasis on non-financial information. This created a considerable demand for local sustainable investments.

As a result, we have seen a tremendous change in Iceland regarding sustainability awareness in the past four years, be it on the government front or from individual investors wanting to find green investment options for their savings. This is a trend we believe will only get stronger in the coming years.

**Mainstreaming Sustainable Finance**

Looking ahead, we expect the momentum we have seen thus far in the sustainable fixed income market to continue to build across various sectors. We expect the other power and utilities companies to move more towards green financing as a baseline and we are already seeing interest from other municipalities in issuing green and social bonds.

We also expect the remaining real-estate companies to follow suit, obtaining market-standard certifications for their buildings in order to issue green financing frameworks and that it is merely a matter of time before other local banks follow in issuing sustainable bonds in the European marketplace. New sectors such as the seafood industry, are also interested in transitioning to sustainable finance. Finally, as part of the carbon-free 2040 goal, the Icelandic government has now established a working group reviewing a potential government green bond issuance.

2020 has been a record year for Icelandic green and social bonds, but we believe that this will continue to build even further in the coming years. Sustainable finance is becoming mainstream in Iceland.

Image by Jeremy Thomas on Unsplash

# ESG Excess Returns for All Seasons

*by* Filipe Albuquerque


Florian Cisana
Head UBS ETFs & Index Funds
Strategic Markets EMEA
UBS Asset Management


The growth of the exchange traded fund (ETF) market has simplified access to diversified investment opportunities and created more ways to build ESG integrated portfolios. At the end of June 2020, the global sustainable ETF market counted almost 400 products with more than US$100 billion in assets under management (AUM), according to UBS ETF analysts Davide Guberti and Philippe Kybourg[1]. This represents an almost eight-fold increase in the number of funds since 2015 and a 400% increase in AUM during the same period.

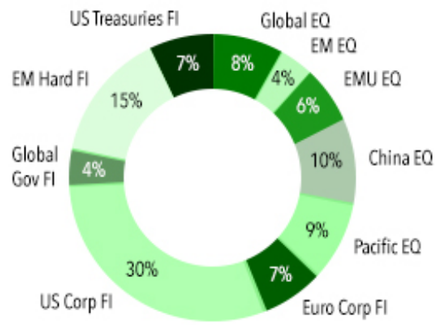
Often times, the appeal of sustainable (ESG) ETFs lays in their positive social and environmental impact. Additionally, ESG ETFs may possess the ability to provide better returns while better mitigating downside risk than standard non-ESG ETFs. Recent research finds evidence in support of this hypothesis, but also that ESG fixed income indices can be built to provide investors with defensive opportunities for excess returns in times of rising spreads.

## ESG Outperformance

One of the main engines of the growing demand for ESG products has been the emergence of evidence supporting the hypothesis that they provide a better risk return trade-off than standard investments. A recent comparison by UBS' Guberti and Kybourg shows that the same holds true when a ESG ETF portfolio is compared with its traditional core version.

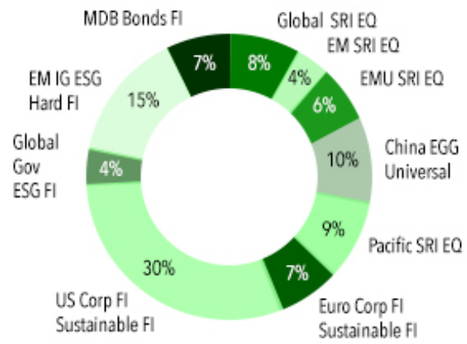
The analysts designed two portfolios made up of 56% fixed income securities. Using the data and calculation methodology MSCI ESG Research, the authors show that the ESG portfolio also vastly outperforms its standard counterpart in terms of underlying weighted average carbon intensity (102.8 tons $CO_2e$/USDm sales vs 160 tons $CO_2e$/USDm sales) and ESG quality scores (6.8 vs 5.3).

Core sample portfolio

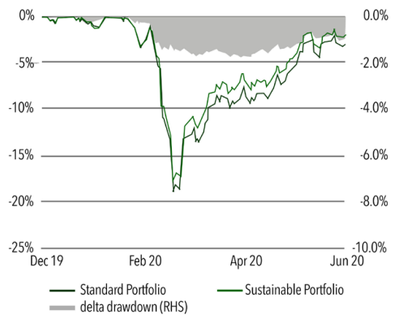



For illustrative purposes only

Sustainable sample portfolio



Drawdowns comparison between standard and sustainable portfolio




Source: Bloomberg, UBS Asset Management
Data from 31 December 2019 to 30 June 2020.

The ESG integration was able to generate an ESG portfolio that outperforms in terms of risk/returns.

The sustainable portfolio outperformed its standard counterpart by 221 basis points (bps) between October 2017 and September 2020. This is equivalent to an average outperformance of 68bps per year. In parallel, the sustainable portfolios also exhibited lower volatility, while also experiencing lower levels of drawdowns during the first half of 2020 when the outbreak of COVID-19 rocked global financial markets

## Constructing an ESG Fixed Income Index

The appeal of ESG fixed income products is particularly strong in Europe. According to Guberti and Kybourg's assessment, European ETFs represented 51.6% of total global sustainable AUM and 47.3% of all products by June 2020. This popularity is echoed in Morningstar's 2020 Global Landscape[2] report on passive sustainable funds which reports passive sustainable funds in Europe had growth to US$188 billion by the end of June 2020, 9.2% of all passive assets in the region[3].

Responding to the high investor demand for ESG ETFs, the Swiss asset manager set up a new ETF tracking the J.P. Morgan EMU Government ESG Liquid Bond Index, which is an ESG version of its pre-existing J.P. Morgan EMU Government Liquid Bond Index.

Based on the Euro-denominated government bonds of Eurozone countries held by the benchmark index, there is an ESG filtering applied in order to identify those issuers with a better ESG profile, based on J.P. Morgan's proprietary ESG score system¬ - JESG. The scoring system aggregates the ESG ratings of Sustainalytics and RepRisk, to track a country's ESG risk based on trends, events and daily news.

The constituents of the reference index are then reweighted based on categorizing normalized ESG scores into 10 bands (1 being the best and 10 the worst). Bands 6-10 being excluded and those in bands 1-5 being selected and reweighted. Higher-rated ESG sovereigns are promoted, while reducing bonds with lower ESG ratings.

The index applies a minimum 6-month holding period before an issuer can return to its previous higher JESG band. However, trend movements in JESG bands are reflected without delay. Finally, if an instrument is categorized as a "green bond" by the Climate Bonds Initiative, the security will receive a one-band upgrade.

Index Criteria - J.P. Morgan EMU Government ESG Liquid Bond Index

| | |
|---|---|
| Instrument type | Includes: Fixed-rate and zero-coupon bond<br>Excludes: Floating-rate bonds, Capitalization/ amortizing bonds, bonds with callable, Puttable, or convertible features |
| Issuer type | Eurozone countries |
| Remaining matuarity at inclusion | > 13 months |
| Amount outstanding | EUR 1 billion |
| Currency | EUR denominated |
| Credit quality and rating | The lowest rating of S&P, Moody's and Fitch; there is no credit rating screening for the EMU Government ESG Liquid Bond Index. However, currently all bonds have investment grade status |
| Weighting | Market capitalization based weighting, subject to adjustments based on JESG scores. Instruments categorized as 'green-bond' will recieve a one-band upgrade |

Source: J.P. Morgan, UBS Asset Management. Data as of June 2020.



The index includes bonds worth €1 billion or more issued by Austria, Belgium, Finland, France, Germany, Ireland, Italy, Netherlands, Portugal and Spain.[4]

## Defensive Outperformance

The performance of the JPM EMU Government ESG index is particularly interesting and an example of how not to be fooled by first impressions. According to the analysis conducted by the UBS ETF analysts, between July 2015 and June 2020, the annual return and the yield-to-maturity of the ESG index marginally underperformed its benchmark by 6 basis points.

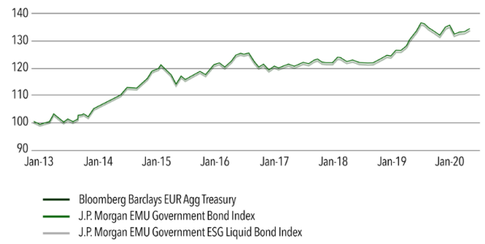
The slight underperformance is driven by a high level of correlation between the ESG rating and the sovereigns' credit ratings. Therefore, as a by-product of the ESG selection, the credit quality is slightly improved, reducing the weight of higher-yielding credit buckers (e.g. weight of BBB decreases from 40% to 34%).

Unsurprisingly, the index shines during times of crisis when spreads to European Government bonds widen. During all eight of the intra-EMU spread widening periods identified by JP Morgan since 2015, the EMU Government ESG index delivered excess returns versus the standard EMU index. The defensive positioning provided by this index is particularly relevant for the Euro-zone, a region plagued by regular concerns about coherence and intergovernmental solidarity.

"As part of our strong commitment to sustainability, we aim to offer our clients a wide variety of ESG ETF exposures. The UBS ETF EMU Government ESG ETF is an important addition to our product shelf and allows investors to make use of the risk-diversifying characteristics of European Treasuries while incorporating sustainability in their portfolio. Furthermore, the ESG screening offers a better credit score at a similar performance level to the standard benchmark and therefore provides a good alternative for a fixed income investment in euro-denominated government bonds", says Florian Cisana, UBS ETFs & Index Funds, Strategic Markets EMEA.

Performance of JPM EMU Govt ESG compared to Bloomberg Barclays EUR Agg Treasury

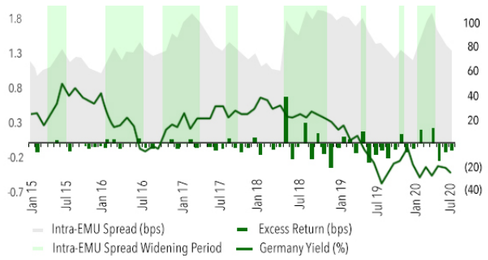
Period from January 2013 to June 2020




Source: J.P. Morgan, UBS Asset Management Data as of July 2020. This period covers the full backtest data available

Excess return EMU ESG index during intra-spreads cycles

LHS: German Bund Index Yield (%),
RHS: 1) EMU ESG Liquid Index excess return over the EMU Index (bps) and 2 Intra-EMU spreads over Germany (bps)




Source: J.P. Morgan, August 2020.

[1] UBS ETF On Track Magazine Q2.2020: https://www.ubs.com/se/en/asset-management/etf-institutional/research/on-track-magazine.html
[2] Desclee, A., Dynkin, L., Maitra, A., and Polbennikov, S. (2016) ESG Ratings and Performance of Corporate Bonds. The Journal of Fixed Income, Summer 2016, 26 (1) 21-41
[3] https://www.morningstar.hk/hk/news/205231/passive-sustainable-funds-the-global-landscape-2020.aspx
[4] https://www.etfstream.com/features/europe-leads-the-way-with-esg-passives-amid-favourable-regulatory-backdrop/

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