A greener shade of bond?

With climate change perhaps the biggest issue the world is facing, growing numbers of investors worldwide are choosing to put their money in vehicles which support the environment, such as green and sustainable bonds.

The market for sustainable investments generally has soared in recent years, with more than $35 trillion invested globally. Meanwhile the market for green bonds doubled in 2021 to more than half a trillion US dollars.

Green bonds finance environmental projects, such as wind farms and solar power parks. Governments also issue green bonds as a source of financing large scale green infrastructure projects – the UK issued its inaugural green gilt in 2021 to fund renewable energy investment, clean transport, and climate change adaptation.

While the green bond market contracted by 7% in 2022 – due in part to Russia's invasion of Ukraine triggering an energy crisis that caused global economic turmoil, rather than a reduced commitment on climate change – experts expect to see a return to growth in green bond markets in 2023.

Kenny Watson, Fixed Income Investment Manager of Liontrust's Sustainable team says: "The energy crisis has only highlighted how essential it is to develop alternative, renewable sources of energy and become more energy efficient, while regulation, environmental targets and investors will all continue to drive demand for green bonds."

But does this mean that all green bonds will be a good investment? One thing to be aware of is the unique structure of green bonds.

Although the proceeds of green bonds are used for green projects, the debt is serviced by the issuing firm. EDF, for example, has several green bonds outstanding, with proceeds allocated to renewable energy projects complying with ICMA principles. EDF, however, also has considerable exposure to nuclear and coal energy elsewhere. This may be a deterrent for some investors so it's important to check carefully.

As the market for green bonds has proliferated, so too have accusations that some issuers are engaged in 'greenwashing' – overstating or misleading investors about the environmental credentials of a company or financial product, such as a green bond.

In response to these concerns around greenwashing, the Financial Conduct Authority is currently consulting on a system for classifying sustainable investment funds – the Sustainability Disclosure Requirements and labelling regime (SDR). This aims to clamp down on greenwashing by introducing three mutually exclusive classifications for sustainable funds.

- **Sustainable improvers:** must improve sustainability over time with pre-determined measurable improvements in sustainability profile.
- **Sustainable focus:** at least 70% of assets must meet with a specified standard or be exposed to specific sustainability themes.
- **Sustainable impact:** must have pre-determined measurable real world (positive) impact.

In February this year, European regulators also reached a provisional agreement that would set high-quality standards for green bonds – the EU Green Bond Standard (EUGBS). Under the EUGBS, firms issuing green bonds would have to ensure that a minimum of 85% of the cash raised is allocated to projects that meet the green standards laid down in the EU Taxonomy (such as Technical Screening Criteria, Do No Significant Harm and Minimum social safeguards).

It is key for investors considering green or sustainable bonds to think about the following when choosing where to put their money:

- **Use of proceeds –** these should be designated for green projects.
- **Process for project evaluation and selection** – issuers should provide transparency of the project's sustainability objectives and process.
- **Management of proceeds** – this should be held in a distinct sub-account and tracked throughout the life of the project, with a high level of transparency for investors.
- **Reporting** – should be kept up to date and readily available, describing the amounts allocated to the projects and the expected environmental impact.

Ultimately, a good bond for investors will be measured by the interest they receive (the coupon) and the capital repayments, all of which will depend on the financial health of the issuing firm.

Another option for investors to consider is sustainability-linked bonds (SLBs). With SLBs, issuance proceeds are not ring-fenced to green or sustainable purposes (unlike 'use of proceeds' green or sustainable bonds) but may also be used for general corporate purposes. They are guided by the sustainability-linked bond principles set by the International Capital Markets Association. While these are voluntary and only constitute best practice – similar to green bond principles – they are designed to promote integrity and transparency in the sustainable finance sector.

With SLBs, issuing firms commit to making improvements in sustainable outcomes within a set period. If they fail, then the coupon paid to investors typically steps up 25 basis points as a penalty. As examples, retailers such as Tesco, H&M and Ahold have all issued SLBs with targets such as reducing carbon intensity, increased recycling of textile materials and cutting food waste.

As the drive to tackle climate change and move towards a sustainable future becomes more urgent, the need for investment to finance this also grows. Green and sustainable bonds have a key role to play in this, provided investors do their homework first.

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For a comprehensive list of common financial words and terms, see our glossary at: https://www.liontrust.co.uk/glossary

Key Risks

Past performance is not a guide to future performance. The value of an investment and the income generated from it can fall as well as rise and is not guaranteed. You may get back less than you originally invested.