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See the wood, not just the trees

How climate-focused credit investors can help drive real-world change

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It takes Aviva Investors



Green bond funds and Paris-aligned benchmarks are aimed at climate-focused credit investors who also want the simplicity of passive investing. But while they decarbonise portfolios, they exclude the companies in the real economy that need to transition if the world is to meet the Paris Agreement goals. This is why an active approach can be beneficial.

The landmark Paris Agreement of 2015 set a target of limiting global warming to less than two degrees Celsius above pre-industrial levels, and as close as possible to 1.5°C. Sustainability-minded investment-grade (IG) credit investors who want to contribute to this effort have an array of options available: among them are green bond funds and Paris-aligned benchmarks (PABs). They have the advantage of simplicity, but by having a narrow focus on either bond labels or portfolio decarbonisation, they can miss the wood for the trees, namely the broader decarbonisation of whole companies and sectors needed to achieve the Paris Agreement goals in the real world.

As their name indicates, green bond funds are funds invested in green bonds, which can be issued by any organisation, but whose proceeds must be used to finance an environmental or climate objective defined prior to issuance.¹ This can contribute to specific improvements but often ignores an issuer's broader environmental footprint, or whether the company even has climate commitments and a transition plan. In fact, due to the mix of issuers, green bond funds tend to have over 1.5 times the carbon footprint of the IG universe: for example, the weighted-average carbon intensity of the MSCI Global Corporate Green Bond index is 318 tCO₂e/\$m, compared to 196 for the Bloomberg Global Aggregate Corporate index.²

Meanwhile, Paris-aligned benchmarks are designed so the underlying assets are selected, weighted or excluded in such a manner that the resulting benchmark portfolio's carbon emissions are aligned with the objectives of the Paris Agreement. They therefore align portfolios to 1.5 degrees of warming, but do not affect the issuers themselves.³

From an investment perspective, limiting sector and name diversification can also restrict these approaches to satellite allocations for regulated institutional investors with strict mandates. Investors need diversification to mitigate risk, and therefore cannot allocate solely to a few sectors and issuers. The problem of emissions embedded in core IG holdings remains. In addition, green bond funds and Paris-aligned passive solutions are likely to see their performance diverge from that of a traditional IG allocation due to the differing opportunity sets.

In this article, we aim to help investors understand the differences between the low-carbon options on offer from a climate perspective, as well as diversification and performance considerations for a climate-aware IG allocation in the context of risk and return mandates.

The limits of exclusion

Climate-themed IG investing can take several forms. Some can be passive, through a green bond or PAB. Other approaches apply a climate lens to the whole IG universe, which requires bottom-up selection and active management. The latter can offer climate-risk mitigation through investment in transition-oriented companies and firms offering climate solutions.

Investments in passive indices can allow investors to easily tick a regulatory box and decarbonise their portfolio; but they have serious limitations. PABs achieve lower carbon intensity in portfolios by excluding the highest greenhouse gas emitters and reallocating capital to low-impact sectors. Therefore, they tend to leave out huge swathes of the IG credit market. For example, the MSCI Paris-Aligned Benchmark index has 11,367 constituents, versus 16,230 for the Bloomberg Global Aggregate Corporate index.⁴ Some solutions providers also have a high carbon footprint, particularly in their “Scope 3” emissions (indirect emissions that result from the company’s broader value chain), and may be excluded despite helping other businesses reduce their carbon load.

From a credit investor’s perspective, this narrows the pool of investable securities. It also limits support for companies whose transition is vital if the economy as a whole is to achieve a lower-carbon future. It does not incentivise businesses starting from an environmental low point to change and could deny them cheaper capital to invest in the transition. Yet virtually all companies will be impacted by climate change, through physical climate risk or when regulation and customer and shareholder pressure force them to decarbonise their operations and supply chains. They will need to adapt, so simply ruling out high-carbon emitters or investing in green bonds will not deliver the transition.

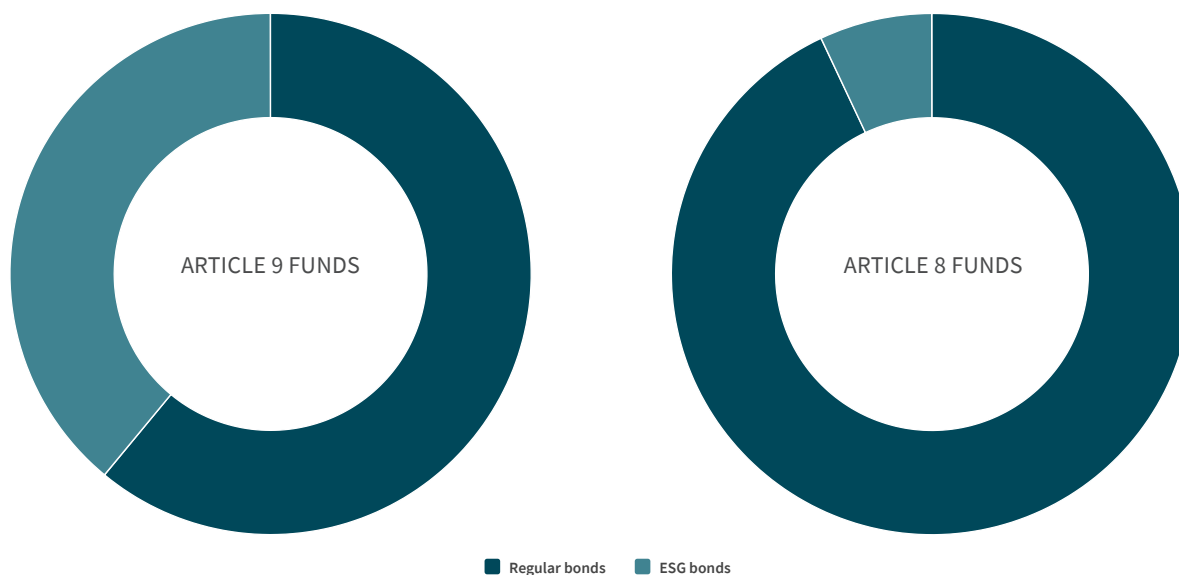
Similarly, green bonds comprise a relatively small investment universe, despite growth in this market over recent years. Therefore, green bond funds can restrict the available opportunities for return and diversification, diverge from core IG funds in terms of their return profile and potentially introduce concentration risk.⁵

In addition, green bonds typically only apply to a small part of a company’s capital expenditure, allowing for higher emissions on the rest of its operations. This also means they tend to be smaller issues, as the use of proceeds must be identified and allocated, which is a more onerous process than for general purpose bonds. However, as capital and interest payments are fungible with the issuer’s traditional bonds, the green bonds may not be as environmentally friendly as they first appear. Looking at the underlying company is key, rather than just the use of proceeds of a particular bond.

Many green bonds also have a lower spread – and thus a lower yield – than comparable “vanilla” bonds. This is the green premium, or “greenium”. And they tend to trade less frequently, since green bond funds can be wary of selling the green bonds they hold, for fear of not being able to redeploy their cash. That makes green bonds less liquid than vanilla ones, making it more difficult for investors to manage their risk exposure actively.

Finally, some ESG funds hold few labelled bonds, be they green, sustainable or otherwise (see Figure 1). For investors wanting to avoid unintended consequences, green bond investing is more complex than making a simple passive allocation, and they need to look under the bonnet of the funds they are allocating to.⁶

Figure 1. Share of ESG bonds in ESG bond funds (per cent)



Note: Percentages refer to the average number of securities within sample.
Source: Aviva Investors, Bloomberg, ABN AMRO, IFR. Data as of May 6, 2022.

For the transition, plans matter

The growing climate threats facing issuers and bondholders, including stranded assets and physical and transition risks, like regulatory fines or changes in consumer preferences, should also be taken into account. Climate risk is often underappreciated by credit investors, but it encompasses the long-term effects of climate change on a company's operations and business model. As such, it should play an important part in any assessment of an issuer's creditworthiness.⁷

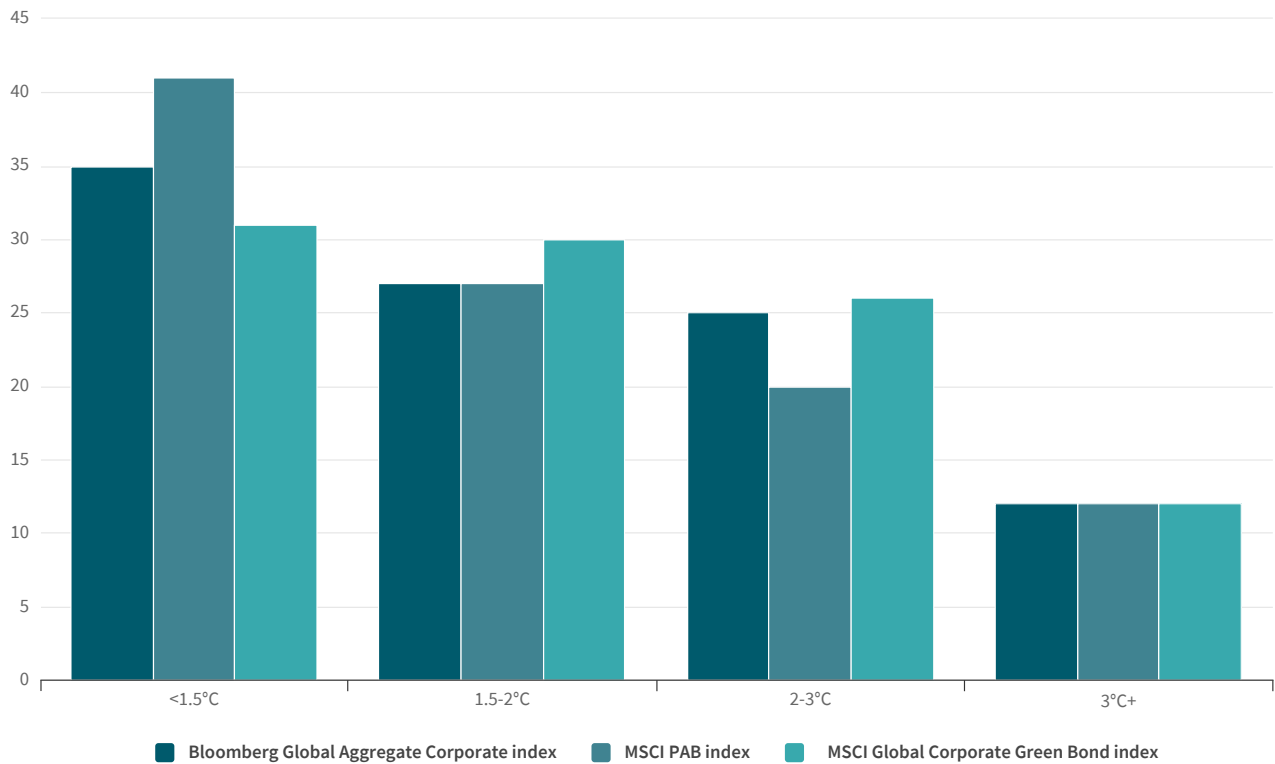
Meanwhile, indices tend to rely on backward-looking metrics, with corporate climate reporting often lagging or incomplete. As a result, benchmarks that only include low-carbon companies are not necessarily inherently sustainable. For example, in January 2023, over 120 passive funds, mostly tracking PABs and climate-transition benchmarks, downgraded from Article 9 (products that have a sustainable investment objective) to Article 8 (funds that promote "environmental and/or social characteristics").^{8,9}

And passive approaches that replicate these benchmarks offer limited protection to investors from climate risk, as they do not take investee companies' transition and adaptation plans into account. While PAB companies may offer a lower carbon footprint in portfolios today, not many more than in the broader market are on track for future warming of less than two degrees (see Figure 2).

Achieving real-world change requires tackling the highest-emitting sectors, encouraging companies to transition to greener business models by engaging with them and influencing the cost of capital of true leaders and laggards based on their transition plans.

Active strategies can use bottom-up analysis and security selection to invest in solutions providers and transition leaders – companies that are improving their resilience to climate change – across sectors. That creates a broader opportunity set while mitigating exposure to climate risk and supporting the real-world transition. Such an approach can be forward-looking, by focusing on issuers’ commitments through initiatives like the Science-Based Targets (see *On target: Why SBTs trump net zero at changing behaviour*).¹⁰ For example, our Climate Transition Global Credit strategy has highly selective investments in North American utilities because they are further behind on transition planning than European peers.¹¹

Figure 2. Percentage of constituents aligned with less – or more – than two degrees of warming



Source: Aviva Investors, MSCI, Bloomberg. Data as of March 28, 2024.

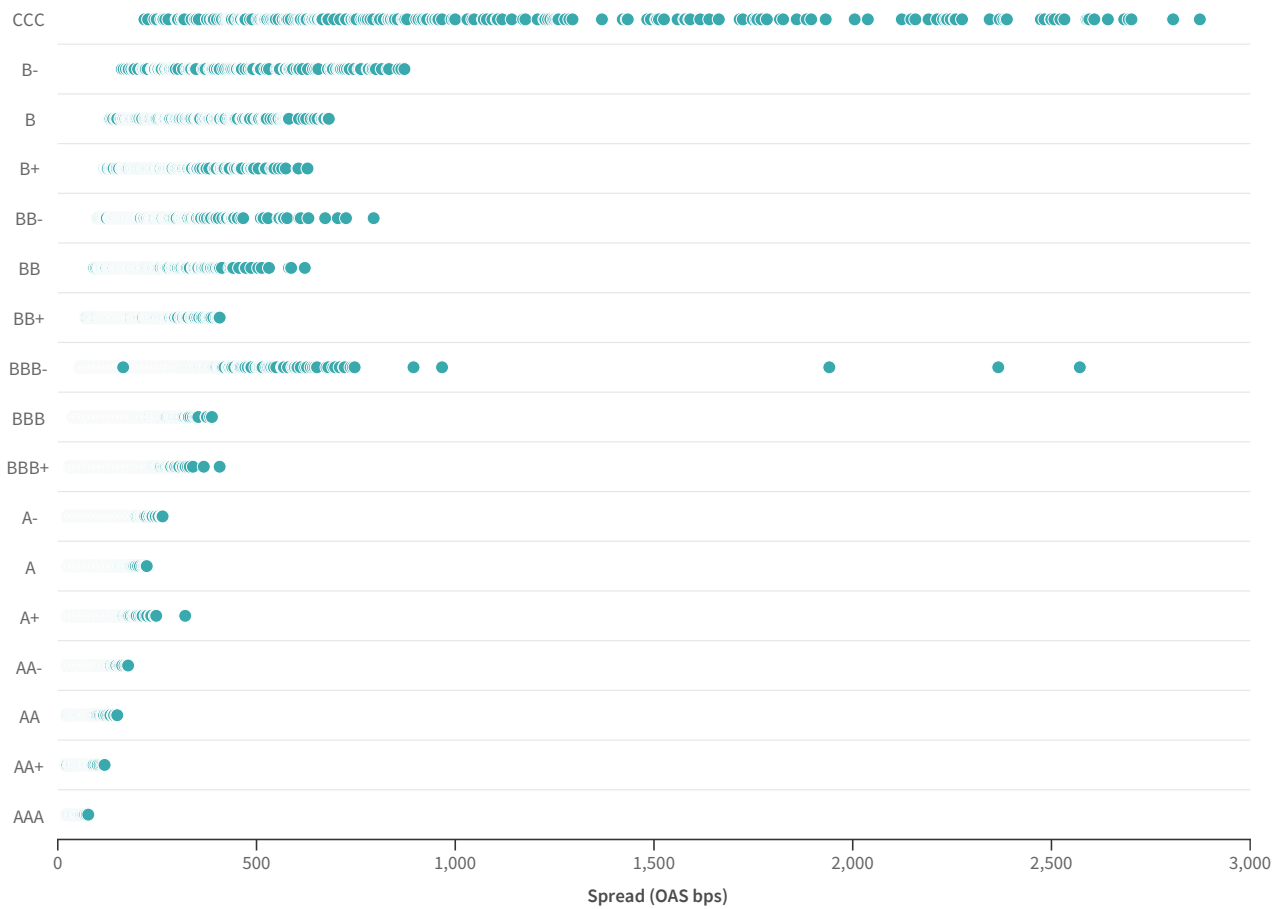
The benefits of a core IG approach

In parallel with a robust climate-transition approach, broad-based, active, climate-aware strategies can be designed to have all the portfolio characteristics and use the same portfolio construction methodology as core IG, with significant potential risk and return benefits.

This type of approach can allow investors to take climate considerations into account in their core IG allocation, rather than as a niche or thematic investment, because harnessing a broader universe allows such strategies to deliver performance and lower volatility in line with broad IG credit strategies. And it allows for easier like-for-like comparisons across IG managers.

For instance, it gives investors more arbitrage opportunities, and allows them to harness such characteristics as new issue premia and to avoid the more expensive parts of the secondary market. As we discussed in a recent article, we are seeing more dispersion between issuers in 2024 (see Figure 3), which should create opportunities to outperform through fundamental analysis, security selection and robust portfolio construction (see Credit spreads and climate solutions).¹²

Figure 3. Spread dispersion within the credit universe



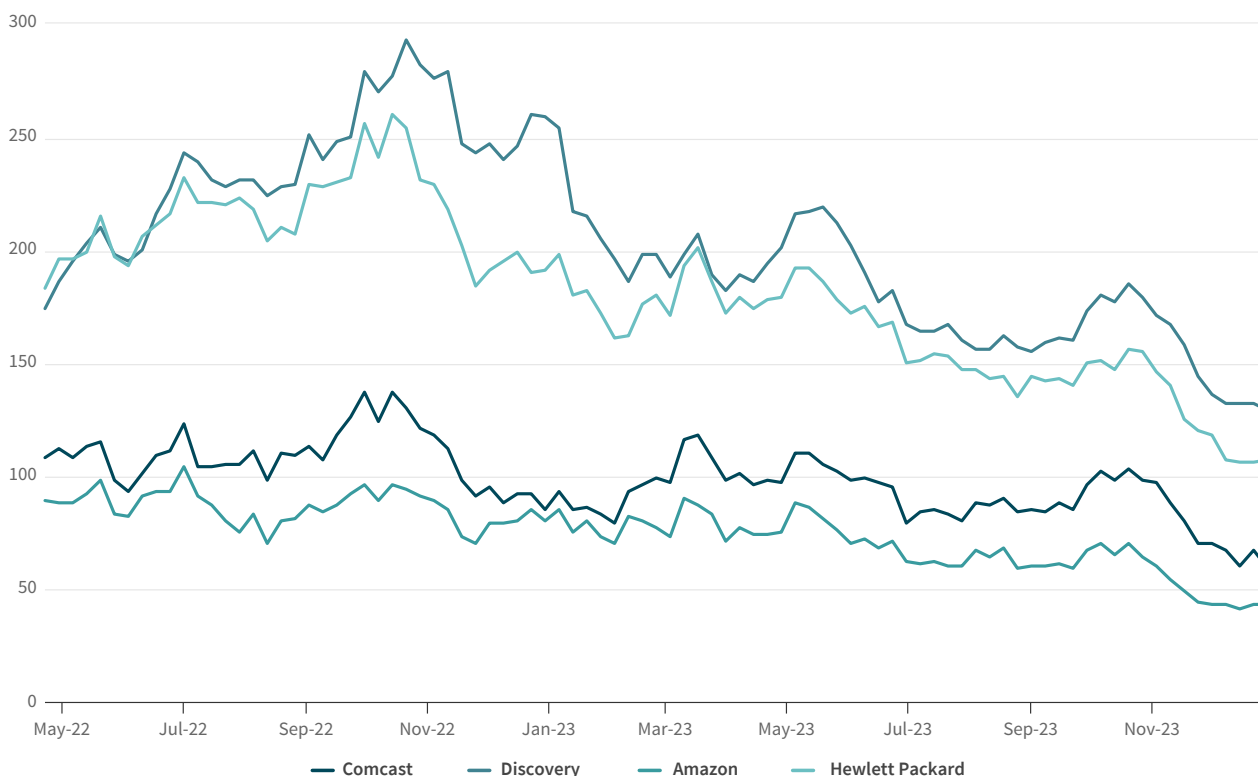
Source: Aviva Investors, Bloomberg, BoAML Global investment-grade index. Data as of March 31, 2024.

Active investing enables such robust portfolio construction approaches, which we use across our global investment-grade strategies. Importantly, given the asymmetric nature of fixed income, they prioritise downside protection. Disciplined portfolio construction can also generate alpha (excess return achieved over the relevant benchmark, rather than beta, which captures the direction of the overall market), leading to more consistent outperformance through the cycle. Our portfolio construction approach follows three core investment beliefs: avoiding a beta bias, portfolio optimisation and an alternative approach to allocating risk (see *Boxing Clever: Portfolio construction in investment-grade credit*).

We avoid beta biases, as these can lead analysts to favour lower-quality or even off-benchmark issuers that may struggle in volatile conditions. Then, our portfolio optimisation process aims to maximise portfolios' expected excess return while maintaining the same level of volatility as the investment-grade benchmark. We use custom sectors to finely assess risk and volatility, run optimisations to identify the most efficient areas to allocate risk (see Figure 4), and define the optimal carry on bonds – which can help reduce a portfolio's volatility without sacrificing returns (see Figure 5).¹³

For example, Figure 4 shows that Comcast's risk profile is far closer to Amazon's than to Discovery's, a seemingly similar company in the same sector. Therefore, switching from Comcast into Discovery gives an allocation an entirely different risk profile. While these are purely illustrative examples and not necessarily on bonds we own, they show how such analysis can help investors identify higher and lower risk-adjusted returns in companies within the same sector.

Figure 4. Inefficiencies in traditional sector groupings (basis points)

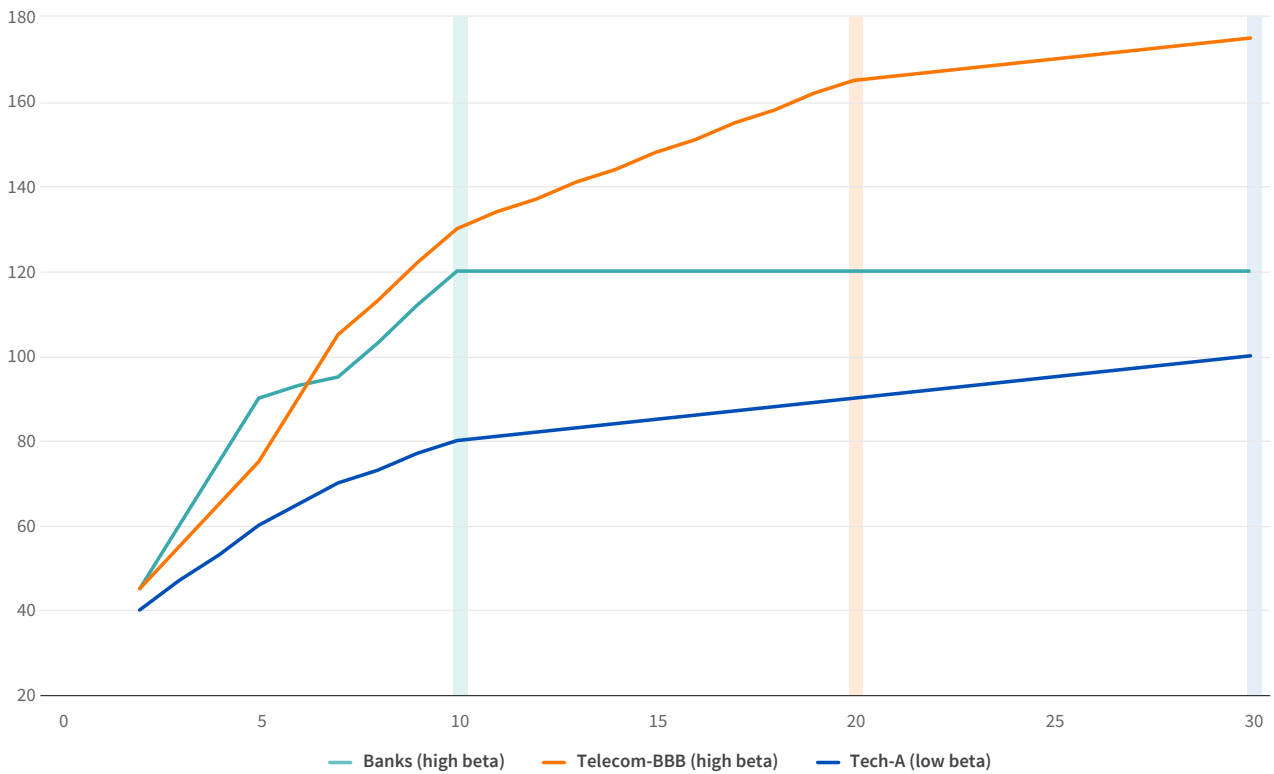


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Source: Aviva Investors, Bloomberg. Data as of December 31, 2023.

Meanwhile, owning riskier carry at the front end of the curve and higher-quality carry at the long end tends to be the most efficient way to reduce volatility in the portfolio without giving up expected returns (see Figure 5). It typically provides downside protection during periods of market stress, while the excess carry collected at the front end of the curve bolsters performance.

Figure 5. Finding the optimal carry



For illustrative purposes only.

Source: Aviva Investors, Bloomberg. Data as of December 31, 2023.

This approach creates a structural allocation of risk that avoids beta biases and means investment ideas must prove their mettle – only the best ones get included in portfolios.

Good governance

For long-term investors, another advantage of active investing is the possibility of engaging with issuers, on both corporate performance and climate efforts. According to research by McKinsey, the funding needed to have a chance of limiting global warming to 1.5 degrees is an astounding \$275 trillion by 2050, or \$9.2 trillion per year.¹⁴

Around a third of firms in the credit universe are unlisted, and many of the world's largest carbon emitters are state-owned or controlled, meaning much of that climate finance will be funded through sovereign and corporate bonds. That limits the opportunity for engagement through equity ownership, whereas credit investors can help influence these organisations and drive the low-carbon transition. For instance, bondholders can express their opinion at every new bond issue and withhold cash if countries or companies' actions fail to live up to expectations.

Finally, active investing can help investors mitigate the risk of exposure to stranded assets, not just through the normal IG work of investing in companies with strong and stable balance sheets or engagement, but also through bottom-up assessments of issuers' climate risk exposure and transition plans. A 2024 study by the Potsdam Institute for Climate Impact Research found that global annual damages from warming temperatures and changes in weather patterns are estimated to be \$38 trillion, with a likely range of \$19-59 trillion in 2050.¹⁵

Some companies are ill-prepared for change, which will increase the risk of damage, through lack of adaptation, as well as the danger of seeing their assets stranded as tougher regulation comes in. If they must make wholesale adjustments and dispose of significant assets over a short timeframe, it could impair their balance sheets and increase their cost of capital. That is likely to be far costlier than well-planned, incremental change.

Thorough issuer analysis can identify those dangers early on, allowing investors to take steps to mitigate their risk of exposure. As a result, they can favour companies whose transition models are first class.¹⁶ Even better, some firms with ambitious climate commitments purchase dirtier companies and improve their environmental footprint. For instance, T-Mobile stuck to its ambitious Science-Based Targets after acquiring Sprint in 2020, and in 2023 announced a net-zero target by 2040 across its Scope 1, 2 and 3 emissions.^{17,18}

Using a broad investment universe can allow investors to benefit from a core global IG approach with robust portfolio construction and long-term risk and return benefits. But it can also enable them to help drive real-world change beyond achieving net zero for their portfolios alone. Looking beyond passive green bond funds and PABs can help investors see the whole wood, and not just the trees.

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Key risks

Investment risk

The value of an investment and any income from it can go down as well as up and can fluctuate in response to changes in currency and exchange rates. Investors may not get back the original amount invested.

Credit and interest rate risk

Bond values are affected by changes in interest rates and the bond issuer's creditworthiness. Bonds that offer the potential for a higher income typically have a greater risk of default.

Derivatives risk

The fund uses derivatives; these can be complex and highly volatile. Derivatives may not perform as expected, which means the fund may suffer significant losses.

Illiquid securities risk

Certain assets held in the fund could, by nature, be hard to value or to sell at a desired time or at a price considered to be fair (especially in large quantities), and as a result their prices could be very volatile.

Sustainable investing risk

The level of sustainability risk may fluctuate depending on which investment opportunities the investment manager identifies. This means that the strategy is exposed to sustainability risk which may impact the value of investments over the long term.

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