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Investment Grade Fixed Income | Responsible Investing

Trends Behind the Growth in Sustainable Bonds

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Boston - Vishal Khanduja was one of three keynote speakers at a Morgan Stanley Investment Management forum on standout trends in sustainable bond investing. Here, in excerpts from that discussion, Vishal offers his perspectives on the growth of this asset class, what sets Calvert's management philosophy apart, and how we look at issues in the green bond market.

"Calvert was one of the first asset managers to launch a green bond strategy in 2011. Our length of time in this market and our two-pronged approach to evaluating labeled bonds are key differentiators from other managers."

The growth of impact or labeled bonds, which include green, social or sustainability-linked bonds, has boomed over the past two years. In 2021, the issuance of impact bonds reached $1 trillion — over 68% higher than 2020's $606 billion and almost triple 2019's $326 billion.[1] So far in 2022, however, green bond issuance has moderated amid rising interest rates and inflation.

What drives the appeal of these bonds for investors is, in part, the tremendous insight they provide into an issuer's sustainability agenda and how their investments are helping to achieve impact.

Labeled Bonds: More Room to Run

Green, social or sustainability-linked bonds are unique in the fixed-income market in that they direct capital to specific projects designed to address sustainability issues. Growth in the U.S. labeled market has been exponential, but even more exciting is the area's potential for further expansion.

Consider that in Europe, about 27% of investment-grade new issues and close to 20% of high-yield new issues were labeled in 2021. In the U.S., by contrast, only 6% of U.S. investment-grade issuance and only 3% of the high-yield universe were labeled that year.[2] The potential for growth in places like the U.S., with deeper and more liquid markets, may result in greater diversification opportunities. If five utility companies, for example, are issuing green bonds, then an investor can select the one(s) they think can deliver the most impact.

How Calvert Evaluates Sustainable Bonds

We believe a portfolio manager's philosophy and approach to environmental, social and governance (ESG) integration plays a key role in issuer selection and achieving attractive risk-adjusted performance. When evaluating fixed-income issuers, we look at ESG information that we believe is financially relevant to their specific industries. Sustainability concerns that apply to a metals and mining company or a money center bank may not be relevant for an IT or energy company, so the weights and relevancy of different types of factors will vary by industry.

That's our basic philosophy, and we've built a robust research and engagement

process to fill out that philosophy. We believe this type of analysis helps us avoid surprises and inconsistency in performance as well as unwanted tracking error within portfolios.

Green Bonds: The Issue-Level Dive

Calvert was one of the first asset managers to launch a green bond strategy in 2011. Green bonds are those whose use-of-proceeds target specific, measurable environmental or climate-related goals, such as energy efficiency or clean transportation.

Our length of time in this market and our two-pronged approach to evaluating labeled bonds are key differentiators from other managers. First, we look at the issuer and why sustainability is important for that company. Second, we look at the issue level —what are the proposed projects being financed, how do they affect the company's bottom line, and what sustainability metrics will be applied? Today, that issue-level assessment has become very important, particularly for green bonds.

Recently, we invested in the green bond of a major U.S. telecommunications provider for our green portfolio. Proceeds of the issue will be used to support several of the issuer's environmental goals, including obtaining 50% of its energy from renewable sources by 2025. These goals also include reaching scope 1&2 carbon neutrality, — i.e., carbon neutrality in its facilities, vehicles and energy purchases — by2035.

We also acquired a portfolio position in the issue of a special purpose entity of a sustainable home improvement lending company. Proceeds of the issue will be used as collateral for loans for residential solar installations.

Bottom line: The growth of the sustainable bond market offers fixed-income investors a wide variety of instruments and market segments, allowing them to diversify away from issuers or subindustries where ESG risks may appear unmanageable.

1. Green bonds have specific environmental or climate-change goals, while social bonds have specific societal goals, generally to address public-sector problems. Sustainability bonds included both green and social bonds; they are expected to provide environmental and social benefits for an identified target population. Sustainability-linked bonds have financial and/or structural characteristics that are tied to predefined sustainability/ESG objectives.

2. Environmental Finance, "Sustainable Bonds Insight 2022."

Learn more from Morgan Stanley Investment Management's fixed income leaders about "Key Trends to Watch in Sustainable Fixed Income" here.

Investing involves risk. There is no guarantee that any investment strategy, including those with an ESG focus, will work under all market conditions. Investors should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Fixed income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income.

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