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Beyond the Green Bond

Summary of Sustainable Euro IG Credit

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New European regulation on transparency, new types of bonds with sustainable 'features', and new types of risks lie along the road to Euro investment grade credit, adding to the existing challenges -- and to the rewards.

If, as we expect, this increased transparency will increase the interest in sustainability in Euro fixed income markets, it will also increase the need for careful fundamental analysis and pricing of risks. It should provide performance opportunities for active and analytical investors.

Explore Close up

CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

A Sustainable Path to Euro Investment Grade Credit.

> **It is our Conviction that companies which embrace sustainability-related opportunities and challenges in combination with financial opportunities and challenges are the most likely to generate value.**
>
> **-Wim van Hyfte, Global Head of ESG Investment & Research**

It is our experience that ESG analysis must always be accompanied by fundamental credit analysis. As markets evolve, so do the details of our approach.

Investment Grade (IG) credit is notably asymmetric, with the rewards going to those who are able to forecast and price risks and avoid credit accidents. Governance, an extra-financial factor, has long been an indicator of credit-worthiness. We believe other extra-financial factors, including environmental and social factors, are already helping identify manage downside risks. (For insight into how we evaluate activities, see our Candriam Exclusion Policy).

'Article 9' investment products[1], for example, must be based on a robust ESG selection process at each step to both achieve and report on pre-disclosed Key Performance Indicators (KPIs). For this purpose, we both integrate extra-financial factors, and exclude certain companies and even sectors. It is worth noting that some national sustainable labels, such as the French *Label ISR* and the Belgian *Febelfin*, increasingly insist on a sector exclusion policy.

The net zero pathway is likely to become a financial risk as well as an extra-financial one, judging by the comments of the annual Davos Forum. We believe a portfolio carbon footprint is a strong step towards more concrete measurement of the financial risk.

This document is a shorter version of Candriam's full white paper, Beyond the Green Bond: A sustainable Future for IG Credit? published in July 2024

1 - Under Article 9 of the European Union SFDR, or Sustainable Finance Disclosures Regulation, these portfolios have distinct sustainability objectives.

What can we see in this evolving environment?

New formats, such as Green bonds and Sustainability-linked bonds, offer not only new opportunities to sustainable investors, but also new information and transparency to all investors as issuers report increasingly useful metrics if they choose to use these new formats.

More transparency, more complexity, more opportunities to evaluate and control risk, more opportunities for active management, and above all, more need for fundamental analysis. The European regulatory framework is increasingly detailed. We believe, this is easier for those managers who already had these methodologies in place.

It is our Conviction that both financial and sustainability performance will soon be at the forefront of Euro IG portfolios.

The Road Ahead.

Transparency through regulation

Transparency is enhancing sustainabilithy across European bond markets. Several long-term efforts including governments, investors, and others are coming to fruition, especially in Europe. In particular we believe the company reporting requirements of the EU Corporate Sustainability Reporting Directive (CSRD) is a game-changer. *In 2024, for the first time, companies in Europe are required to report on sustainability metrics and ESG actions in a comprehensive, comparable, and audited manner.* It will provide comprehensive, comparable, and auditable data for investors and others. It focuses on leading data rather than lagged data, particularly on forward-looking decarbonization plans of companies. Together, the CSRD and the SFDR provide transparency for sustainable investing, and for more effective engagement with issuers. While it is increasing the need of careful fundamental analysis and pricing of risks, we expect this increased transparency will increase the interest in sustainability in European fixed income markets.

Just have a look at the the Financial Sector. It accounts for a whopping 35%[2] of the benchmark index,[3] requiring doubly robust ESG analysis. Based on our own individual company fundamental analysis, only seven of the 17 financial institutions in our European universe are aligned with our Candriam environmental assessment.

Bank regulators, particularly the ECB, are vocal about the need for banks to consider climate risk and to be more transparent about the companies they finance. We think the introduction of a 'climate capital buffer' for banks could be both imminent, and *substantial*.

2 - Source: iBoxx. 35.1% applies to Banks and Insurance cos, but excludes real estate. As of June, 2024.
3 - Based on the iBoxx EUR Corporates (Total Return), frequently used to define European IG Corporate Credit. In this document, 'benchmark' will refer to iBoxx EUR Corporate (Total Return) unless otherwise specified. All data related to the benchmark is as of June, 2024.

Transparency through new bond formats

Sustainable debt (GSS bonds), including green bonds, social bonds, sustainability bonds, and sustainability-linked bonds, has grown from less than €30 billion globally in 2015[4] to €3.3 trillion by December 2023, of which €1.8 trillion are issued by Euro corporates. At Candriam, we believe that not only should the bond finance an environmental or social project, but the issuing company must also be aligned with our holistic ESG approach. If the parent issuer is not headed in a sustainable direction, this bond is a *No Go* for our sustainable portfolios.

GSS bonds provide investors with new tools which could enhance the sustainability of the entire Euro corporate credit market. These bonds finance specific projects with positive environmental or social impacts. Under the voluntary guidelines of the ICMA (International Capital Market Association), and soon under the new EuGB (EU Green Bond Standards), issuers commit to four pillars, Use of Proceeds, strictly defined Project Selection, Management of Proceeds, and transparent and comprehensive Reporting. The EuGB also provides for a label for Euro green bonds. To qualify for the label, the standards are mandatory rather than voluntary, and must be audited.

Sustainability-linked bonds are a newer format which offer a commitment for the sustainable performance of the overall company. While Green and Social bonds channel investments into specific projects, they are not always a commitment at corporate level.

The issuer sets a KPI and a time horizon, also called a Sustainability Performance Target (SPT). If the issuer fails to achieve the target the issuer typically pays a 25 bps increase in the coupon interest rate. Think of this as insurance for the higher level of risk that the bond carries if the issuer misses a target. This is the beginning of a way for the bond market to price ESG risks. We expect SLBs will drive deeper integration of ESG considerations across the entire market, including among non-sustainable investors. Sustainability-Linked Bonds are in their early stages, and lack standardization. Investing in SLBs demands a higher level of ESG expertise. Importantly, the targets must be sufficiently ambitious.[5]

Based on these benefits, it seems sensible to include at least a minimum of green bonds within credit portfolios.

Measurement: portfolio carbon footprint and portfolio carbon beta

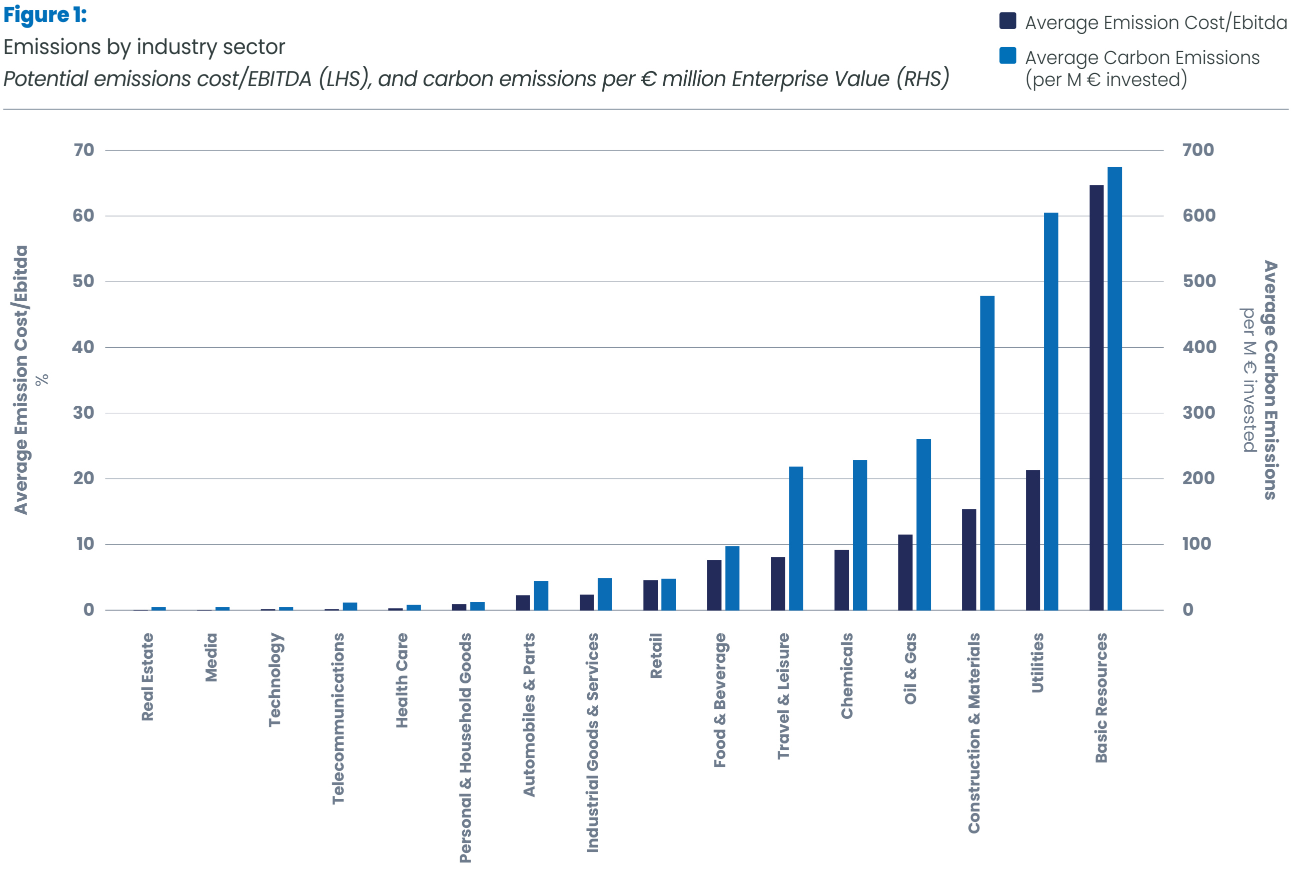
The carbon footprint of a portfolio measures not only the carbon impact of the strategy but also its carbon *risk*, including Financing Risk if investors demand a higher rate for high-carbon companies, Reputational Risk, Stranded Assets Risk, and Policy Risk, for example, the implementation of carbon taxes.

4 - Candriam, Bloomberg.
5 - Indeed, insufficiently clear or ambitious targets are a primary consideration for Candriam proxy voting on all topics. See the Candriam Voting and Engagement Report.

Policymakers are exploring strategies to limit GHG emissions, and carbon pricing is a widely-discussed approach. The EU Emissions Trading Scheme (EU ETS), a cap-and-trade system established in 2005, sets an emissions maximum which decreases over time. Companies exceeding their allowance must buy additional rights from companies with a surplus. As of June 2024, the monetary value was €66.6 per metric tonne of CO_2 equivalent.[6] If emissions were suddenly explicitly levied at that price how would that impact margins and credit quality of each issuer?

Our analysis shows that for some low-margin carbon-intensive sectors, the carbon levy could exceed half the average EBITDA. If this 'tax' is part of the operating costs, we found that 20 companies in the Euro IG investment universe would experience EBITDA declines of more than 30%!

Figure 1:
Emissions by industry sector
Potential emissions cost/EBITDA (LHS), and carbon emissions per € million Enterprise Value (RHS)



Source: Candriam, iBoxx, Trucost, Bloomberg.

At issuer level, carbon risk analysis should include not only the current footprint, but also the positioning of each company relative to its Sector Decarbonization Approach scenario (SDA), its future decarbonization efforts, and other elements. Among issuers with poor carbon footprint scores, there are differences in strategies that are important to capture from an ESG perspective.

Consider the example of utilities, which account for 11% of the Euro benchmark, but a disproportionate 25%-30%[7] of the global emissions of CO_2. It is not enough to identify use of coal or gas. We need to know how capital spending is allocated to solar, wind, etc and *how* each company will reach its long-term emissions and energy mix targets, not to mention the risk of stranded assets.

6 - June, 2024.
7 - Source: Trucost and Candriam, EPA.

This is why we prefer to consider carbon footprint exposure as a 'systemic' carbon risk and at portfolio level. At portfolio level we believe the carbon footprint can provide a good proxy of the 'carbon beta' of a portfolio, that is, sensitivity of the portfolio value to carbon emissions.

Given the financial risks associated with the net-zero transition, ***we recommend sustainable portfolios target a below-average beta for carbon risk. We propose a target carbon beta of 0.7, or 30% below the credit market.*** This target also aligns with thresholds set by some of the benchmarks of the EU Climate Benchmarks Regulation.

Overcoming portfolio challenges

Concerns of sustainable investing include the risk of green-washing (including 'social-washing') and the risk of underperforming the broader market although transparency regulation in the EU is helping to reduce greenwashing risk.

One performance fear stems from the inescapable arithmetic that sustainable investing reduces the size of the investment universe, typically by 10% to 40%.[8] The usual concern is that the smaller choice of securities may reduce some of the financial return potential – perhaps one could call it an 'ESG premium'. For Candriam, the weighted average spread difference between our Sustainable universe and the overall IG market is close to 0 (roughly -2 bps) for similar duration.[9] This means that in the long-run (eg, held to maturity) and assuming the same downgrade or default risk between the two universes, there is no reason for our Sustainable universe to underperform the wider iBoxx benchmark.

When looking just at Green Bonds and their friends, the universe is very tiny compared to the overall broader Euro market – just 16%. Do investors pay a 'greenium'? That is, do they accept lower returns for these specialty bonds? Academic studies have had a range of different conclusions, but our work shows that any greenium is modest.

As sector exclusions are becoming indisputable in a Sustainable universe, the question is not whether there is a bias relative to the broader market, but how large is the bias. We examined sector return correlations for equities and bonds, using prices for the Eurostoxx 600 equity, and sector spread correlations within the iBoxx Eur corporate bonds. In credit, sector exclusion creates less bias, as measured by tracking error, than for equity, and the difference was stark.

Nerds will find additional detail our full white paper, *Beyond the Green Bond: A Sustainable Future for IG Credit?*

8 - Source: ISR label, Peers flagships, European Securities and Markets Authority final guidelines on fund names.
9 - Candriam, Bloomberg.

The Candriam Sustainable Analytical Process

We analyse each issuer and each issue before including it in any portfolio. For all portfolios, this includes some integration of ESG factors. For Sustainable portfolios, the process involves additional depth. ESG analysis must always be accompanied by fundamental credit analysis.

Our combination of both positive and negative analyses always us to identify growth opportunities which can enhance cash flow, and risks which might impair future creditworthiness or even strand assets.

The state-of-the-art in finance has come a long way since Candriam first established our in-house ESG Research Team in 2005.[10] We and many other investors work continuously to improve availability and transparency of investment-relevant extra-financial information. We continuously enhance our analytical approach for improved transparency, client needs, and regulator changes.

Our process consists of four pillars:

Norms-based Analysis

Controversial Activities Analysis

Negative Screening

Positive Screening

Business Activities Analysis

Stakeholder Analysis

More detail is available in our Transparency Codes.

Over time, we expect that the European SFDR classifications will provide more internationally-harmonized definitions, but for the moment, classification is subject to the interpretation of each asset manager.

The main risks of the Sustainable Euro IG strategy are :

- **Risk of capital loss:**

There is no guarantee for investors relating to the capital invested in the strategy in question, and investors may not receive back the full amount invested.

- **ESG Investment Risk:**

The non-financial objectives presented in this document are based upon the realization of assumptions made by Candriam. These assumptions are made according to Candriam's ESG rating models, the implementation of which necessitates access to various quantitative as well as qualitative data, depending on the sector and the exact activities of a given company. The availability, the quality and the reliability of these data can vary, and therefore can affect Candriam's ESG ratings. For more information on ESG investment risk, please refer to the regulatory documents.

10 - The following year, 2006, Candriam became a founding signatory of the UN PRI.

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Close up

Conclusion: Sustainable *performance*?

Increasing transparency, especially in the EU, increasingly allows us to actually measure the sustainable performance of a portfolio, as well as the financial performance. This includes the growing offerings of instruments *specific to fixed income*[11] (such as green, social, and sustainable bonds). Carbon footprint is becoming a reliable proxy for transition risk. Transition risks include the impact of decarbonization objectives set by major European credit investors (such as the ECB and financial institutions committed to net-zero).

Our society, and therefore our economy and financial markets, face major challenges including climate change, aging populations, resource scarcity, food security, water availability, and more. Financial markets are a key part of funding the solutions. Because *sustainable money* is, and will be, key to these societal issues which threaten our economy, it is important to maximize its risk-adjusted performance. How does this apply to managing a sustainable IG portfolio?

We believe that sustainable strategies in Euro investment grade credit can both offer societal benefits, and enhance financial performance.

We are happy to be judged on both.

11 - Equity is issued once. It is difficult to change (articles of incorporation, etc) and increases in equity value do not generate new cash to the firm. New issuances of equity are rare. Bonds mature and New bonds finance growth. New bonds can be issued in new formats.