Returns and real impact: the green-bond opportunity

The Generali Investments SICAV Euro Green & Sustainable Bond – one year on

Fund managers Mauro Valle and Fabrizio Viola reflect on a tumultuous first year and explain why they are more excited than ever about the future of this growing market.

As the Covid-19 pandemic struck, the past year was a momentous one for markets and the first real test for green bonds. But the Generali Investments SICAV (GIS) Green & Sustainable Bond came through the year in good shape, and its managers are looking forward with confidence as the asset class evolves.

A baptism of fire

GIS Euro Green & Sustainable Bond has now come through its first full year – and what a year it was. The sub-fund launched in December 2019, so in its initial months, it was exposed to the full force of the Covid-19 pandemic and its extreme economic impact.

Green bonds are issued by governments, supranational organisations and companies to fund specific environmental projects. They have obvious appeal to investors interested in environmental, social and governance (ESG) concerns.

As the green-bond asset class only really came into being after the global financial crisis, the Covid-19 pandemic is its first real test. But we're pleased to report that both our sub-fund and its asset class have proved equal to the challenge.

Grace under pressure

At the start of 2020, we were looking forward to a good year. It's fair to say that things didn't play out as we expected, given the massive volatility produced by the pandemic. Credit spreads widened and risk assets fluctuated wildly. But green bonds were less volatile because their investors are less inclined to panic selling. That makes sense: given their inherently long-term focus on sustainable projects, green bonds are the last bonds that investors should want to sell. Green bonds also rebounded more strongly than other bonds after March.

Overall, both the benchmark index and our portfolio coped very well, and the sub-fund delivered returns in line with our initial expectations. The index and the sub-fund each returned more than 4% for the year – outperforming traditional fixed income market[1].

A rapidly growing market

At present, the market for green bonds is small and segmented. Green bonds currently account for only around 3% of global issuance, and demand far outstrips supply. Primary issues are massively oversubscribed, and specific bonds can be hard to find in the secondary market. This can make it a difficult market for most investors to access.

The market is growing fast, however, and has roughly doubled in size every year. The ratio of corporate bonds to government and supranational issues is also steadily increasing.

Easy access and a rigorous investment process

GIS Euro Green & Sustainable Bond is designed to give investors convenient access to the asset class, along with the opportunity of adding alpha through active management. The sub-fund has at least 70% of its net asset value in dedicated green bonds included in the Bloomberg Barclays MSCI Green Bond Index, with the other 30% to be used at the managers' discretion.

It's important to note that the portfolio's off-benchmark holdings may not be 'green bonds' in the strictest sense, but they are still entirely appropriate for ESG-focused investors

The issuers of all bonds in the portfolio must pass our stringent ESG and proprietary ethical screens. These filters are designed to exclude controversial stocks by filtering out issuers that have poor ESG rankings or engage in improper behaviour. Importantly, we consider not only the 'E' and 'S' in ESG, but the 'G' (governance) too. In doing so, we take into account these companies' attitudes to staff, suppliers and customers.

We monitor our universe on a daily basis. We have two main sources of information in this: our internal ESG-analysis team and independent external providers, licences agreement with Sustainalytics and MSCI.

Underpinning this is the formal commitment that the Generali Group made to green investments in early 2018. Through this commitment, Generali aims to advance environmental protection, respect for human rights and clear and transparent governance. This commitment builds on Generali's establishment of its proprietary Ethical Filter[2] for investments in 2006 – the same Group Ethical Filter that is applied in the GIS Euro Green & Sustainable Bond sub-fund.

Watching out for greenwashing

An important issue here is 'greenwashing' – the use of green credentials to burnish companies' reputations and obscure their real behaviour. Some green-bond issuance amounts to greenwashing, so we need to be vigilant. Identifying greenwashing is not always straightforward, however. Not every company with a poor 'E' rating is greenwashing if it issues green bonds.

Some might be funding their transition into greener companies – think about some oil firms, for example.

So in our research, we need to audit both companies' financials and their green credentials.

This is hard work, but the pressure on companies to engage in greenwashing is increasing as investors become more ESG focused. We need to match this with greater scrutiny. Over time, the problem should decline simply because greenwashers will not be able to go to the market to finance themselves.

2021 and beyond

So, after an unprecedented year, what happens next? We expect around €600 billion of new issuance in 2021, sustaining the trend of the market's doubling in size each year. This supported by investors' growing focus on ESG, and on the environment in particular, and by governments' declared ambition to "build back better" after the Covid-19 crisis.

Most obviously, the European Union will issue green bonds as part of its recovery plan for Europe, with €225 billion of planned issuance over the next six years. The German government issued its first green bond in September 2020, the UK government is set to enter the green-bond market in 2021, and even Italy has declared its willingness to tap this segment.

Over time, this rise in issuance should reduce the 'greenium' that investors currently pay for green bonds. This is the premium caused by a shortage of supply as investors increasingly favour green bonds over their conventional equivalents. So as green bonds go mainstream, they should offer investors higher yields.

Meanwhile, sentiment towards green bonds has improved considerably since the start of last year, because the Covid-19 pandemic has underlined the importance of the social and environmental aspects of ESG. This has accelerated corporate issuance: virtually all specialist property developers in the Eurozone are now active in issuing green bonds to fund the construction of new environmentally friendly buildings.

Banks are now issuing green bonds for various purposes, including the provision of green loans to small and medium enterprises. This trend looks set to accelerate. We are also seeing innovations in other industries; one Italian toll-road operator is looking to issue a green bond to improve the safety of motorways, for example.

Creative asset classes such a sustainability-linked bonds are another area to watch. Sustainability-linked bonds differ from green bonds in that they are not necessarily used to fund ESG-related projects, but instead penalise the issuer for failing to meet its sustainability targets and/or ESG objectives – chiefly through an increase in the coupon paid to bondholders.

Given these trends, we can easily envisage GIS Euro Green & Sustainable Bond doubling in size in the near future. We believe it offers an attractive means of accessing this exciting asset class – and of achieving both good returns and a positive impact on our planet.

At Generali Investments we gather the Generali Group's primary investment companies through a multi-boutique platform, leveraging specialized skillsets to create and share enduring value with our clients both inside and outside the Group.

We are backed by and shares the strong Generali Group Commitment to Sustainability, a combination of ESG criteria, ethical parameters and guidelines that establish a benchmark companies in the Group aspire to meet and, wherever possible, exceed. This commitment started in 2006 and is designed to have a significant impact on economies in which the Group operates.

FOOTNOTES

1 The index full name is Bloomberg MSCI Barclays Euro Green Bond Index. Source: Generali Investments Partners S.p.A. Società di gestione del risparmio as of 31.12.2020. Past performance provides no guarantee for the future.

2 Applying the Group Ethical Filter is part of the discretionary evaluation of the investment manager and the results of such evaluation are confidential.

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