

# Investment Perspectives

Summer 2021

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# Welcome

## Welcome to our 2021 Summer edition of Investment Perspectives

Both western climates and economies are warming up as inflation surges and we progress towards the normalisation of everyday life on the back of successful vaccination campaigns. The question for investors now is whether this period of overheating is a short-term heat wave or a longer-term shift, such as climate change. The science is less absolute on the current inflationary climate compared to the environmental one, an issue which we are continuing to see rise to the top of agendas.

These intertwining themes permeate throughout this edition of Investment Perspectives as Chris Arcari explores the current inflationary environment and the risk that this momentary surge becomes a momentous shift to a prolonged period of high inflation, in addition to his regular capital markets update.

In the remaining articles, the topic of climate change is discussed as:

- Ross MacLeod covers the Taskforce for Climate-related Financial Disclosures (“TCFD”) and some of the ways we can help you understand and report climate change risk; and
- Penny Cochrane covers the growing emergence of sustainability in fixed income and illuminates some of the key characteristics of these assets, including the concept of the “greenium”.

In addition, I’m pleased to announce that we have been slowly reopening our offices at reduced capacity over the quarter and given the current trajectory of the vaccination programmes, myself and my colleagues are now cautiously optimistic that we will get to see many of our clients face-to-face in the coming months.



David Walker

Chief Investment Officer

david.walker@hymans.co.uk

0141 566 7733

# Capital markets update

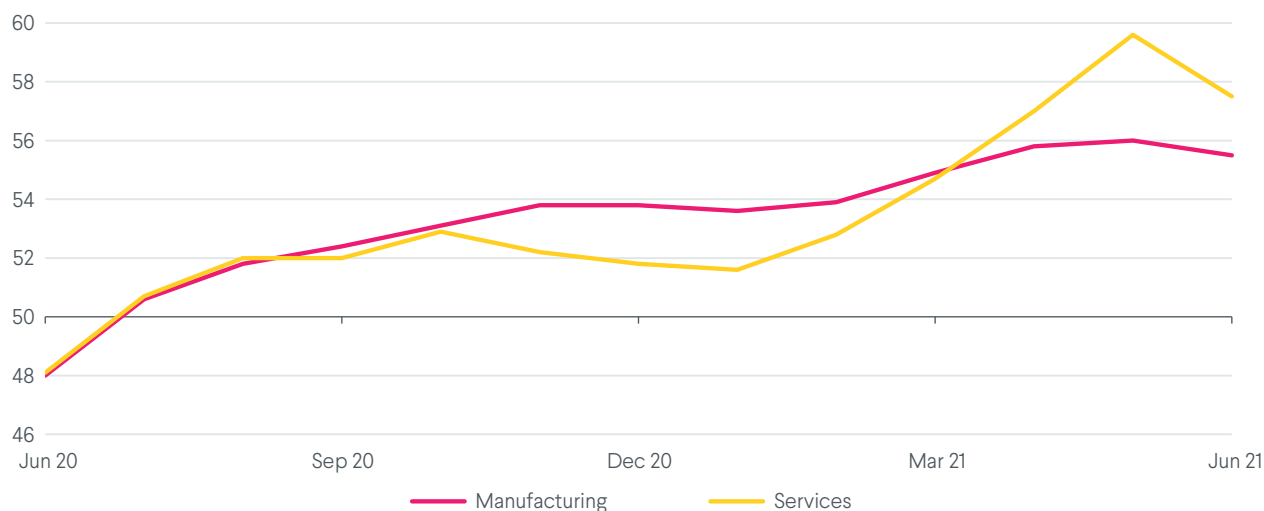
Released: July 2021

**As vaccination campaigns continue at pace, and economies reopen, growth and inflation have surprised to the upside. Equities have risen and credit spreads have fallen, in line with the improving fundamental backdrop. However, sovereign bond yields have fallen, as bond investors perhaps sense an easing of recent momentum.**

Economic data have outperformed expectations, and business surveys, which remain near multi-year highs, indicate the recovery has spread from manufacturing to services (Chart 1). The future output indices are still rising, European growth is yet to reach its peak and the consumer services PMI is also still rising. Global COVID-19 cases are rising once more but remain well below the level recorded during the most recent peak in April this year. Vaccination programmes continue at pace in the major advanced

economies, which should benefit from the easing of lockdown restrictions in the coming months. Global growth forecasts have been revised upwards and are for output to expand by 5.9% in 2021 and 4.4% in 2022. Recent upgrades see output in many advanced economies reaching pre-pandemic levels by the end of 2021, much faster than previously thought. Indeed, forecasts of the level of US output at the end of next year are now higher than they were before the pandemic.

Chart 1: Global Purchasing Managers' Indices



Source: Bloomberg

However, the quarterly pace of global growth is likely nearing its peak and the recent fall in bond yields reveals growing pessimism within markets. Though the absolute level of surveys remains high, the drop in manufacturing and services PMIs in June perhaps suggests an easing of momentum. The pandemic has not gone away either: while vaccines are shown to be effective against the delta variant in preventing serious

disease, efficacy against new strains and the spread of variants in countries with lower vaccination rates poses a downside risk to global demand.

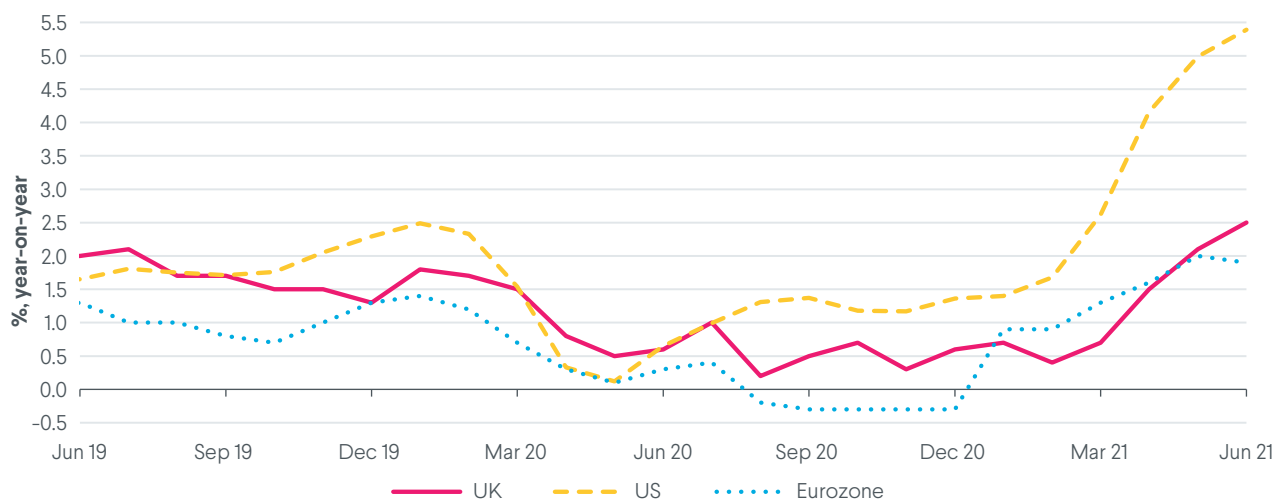
Even if the near-term outlook remains bright, risk markets have taken a lot of good news on board and, in common with bond investors, we believe risks are tilted to the downside.

Surprisingly good growth has been accompanied by surprisingly high inflation in recent months. US inflation rose to 5.4% year-on-year in June (Chart 2), the highest since January 1991. Business surveys highlight the current extent of shortfalls of supply relative to demand and average selling prices for goods and services both rising at unprecedented rates. Most forecasters expect

inflationary pressures to prove temporary. On balance, we would agree, but while a shift to a much higher inflation environment is perhaps unlikely, it is plausible we see some persistence in inflationary pressures. We discuss near-term inflation risks and potential medium term impacts in our second article below:

[Inflation – momentary or momentous?](#)

**Chart 2: Headline CPI inflation**



Source: DataStream

### Government bonds

The Fed surprised markets by suggesting rates may rise in 2023 even as they re-iterated current inflationary pressures are likely transitory. Nevertheless, Treasury yields declined in Q2, perhaps reflecting perceptions the quarterly pace of US growth has already passed its peak. UK yields also drifted lower despite further upwards revisions to growth and inflation forecasts.

An easing of current growth and inflation momentum makes a sharp and disorderly rise in yields less likely, but our assumption of robust growth and a healthy level of inflation may still lead to a quicker tightening of monetary policy and place upwards pressure on yields. In those circumstances, a rise in real yields rather than an increase in implied inflation may be more likely.

**Chart 3: UK 10-year yields**



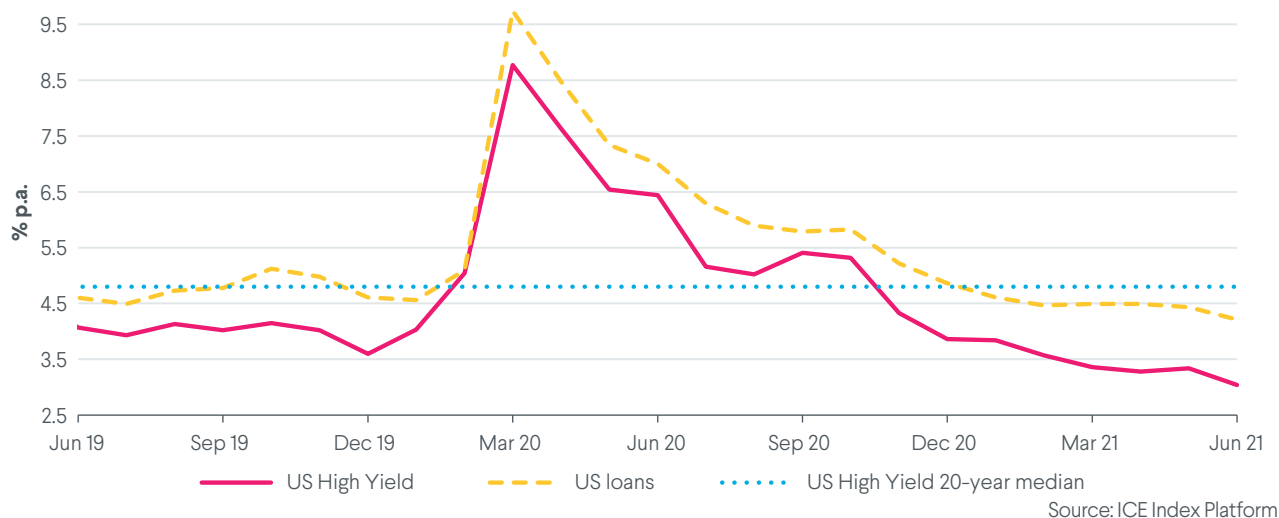
Source: Bloomberg

Real yields still look very low relative to nominal yields (Chart 3), even though the UK index-linked bond market benefits from substantial ongoing demand from price-insensitive UK institutional buyers. Implied inflation looks expensive at terms up to 10 years, with UK RPI inflation unlikely to average 3.6% p.a. over the next 10 years, and at the longer end of the curve, given the RPI premium over CPI is expected to fall close to zero after 2030.

## Credit

As corporate earnings rebound, leverage levels are falling, and interest coverage is rising. Realised defaults are already falling and forecast defaults are expected to fall below median levels by the end of the year. Despite near-term fundamental support and tailwinds from ongoing investor demand for yield, we maintain a degree of caution in light of very low spreads, which have ground tighter and are at levels which indicate modest forward-looking returns.

Chart 4: Speculative-grade credit spreads



Given potential upwards pressure on yields over the near to medium term, which may see them rise more than current market pricing suggests, we prefer floating-rate assets. This is reinforced by relative value: asset-backed securities continue to offer a reasonable spread pick-up over similarly rated investment-grade corporate bonds, as do loans and private credit over fixed interest speculative-grade bond markets (Chart 4).

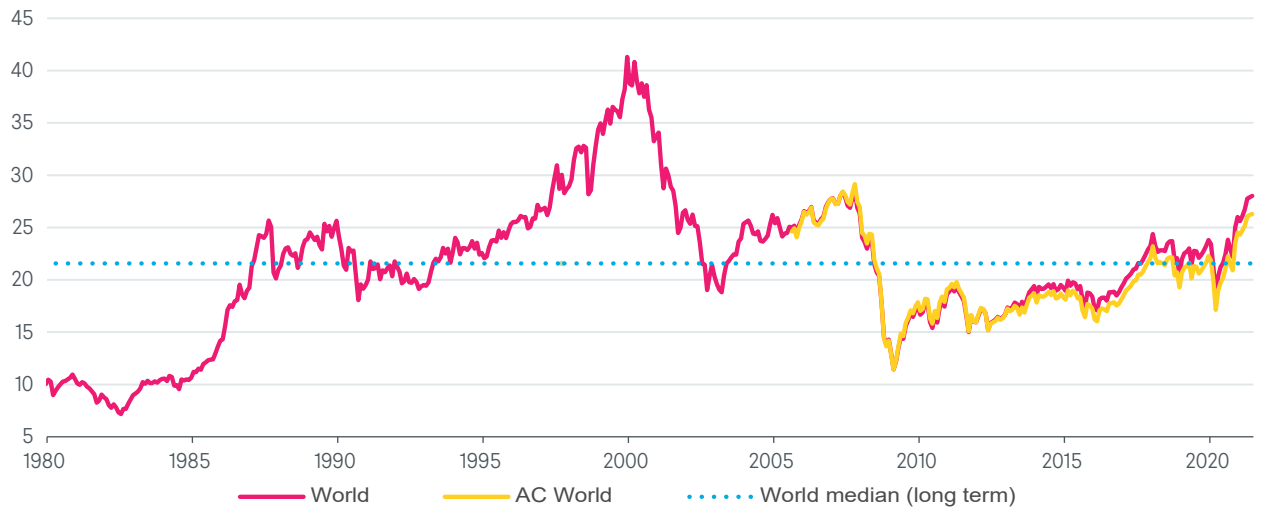
## Equities

Global equities have risen 7.1% since the end of March on the back of the improving economic outlook. Year-on-year earnings per share (EPS) growth for US companies was 64% in Q1, the strongest since 2010, and 4-week earnings momentum, as indicated by the number of forecast upgrades versus downgrades, remains positive. To some extent, the increase in analysts' 2021 estimates is an acceleration of an earnings

recovery previously expected over a longer period, but the forecast level of end-2022 earnings has also risen over the last 3 months and is now expected to be close to 28% above end-2019 levels.

However, recent fundamental improvements have to be seen in the context of valuations that are already very stretched. Our preference is to look at valuation metrics that are little affected by short-term cyclical variations in earnings. Chart 5 shows a price-earnings ratio based on the average level of inflation-adjusted earnings over the previous 10 years, as a guide to the underlying trend. Valuations, on this measure, have rarely been higher over the past 40 years or so. Even allowing for persistent low real yields, future returns are likely to be modest in absolute terms. This and the hint that growth, and consequently earnings, momentum may have peaked, prevents us from holding a more positive view.

Chart 5: MSCI World and AC World cyclically adjusted price-to-earnings ratio



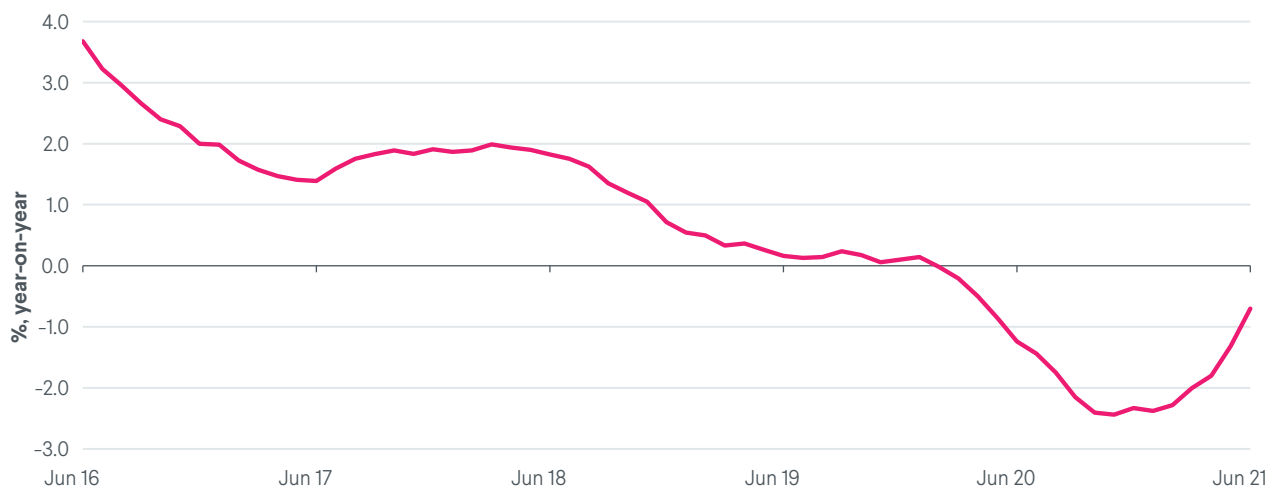
Source: DataStream

## Property

Rolling 12-month metrics for the UK Monthly Property index have improved significantly as March 2020 values fall out of the comparison. Capital values, in aggregate, have risen over the past 12 months (Chart 6), largely due

to the strength of industrials. However, while the pace of declines has slowed, retail capital values are still lower than they were a year ago and the pace of declines has increased in the office sector in recent months.

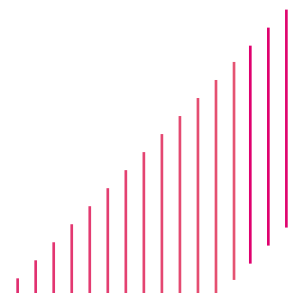
Chart 6: UK commercial property nominal rental growth



Source: MSCI IPD

There have been some signs of improvement in property fundamentals. Nominal rents are rising on a monthly basis, (although the recent rise in inflation means that real rental growth is falling). The Royal Institute of Chartered Surveyors UK Commercial Market Survey points to healthier signs with occupational demand and rent expectations continuing to improve. Rent collection should improve with economic recovery (although vacancy rates have risen).

While these signs might point to more sustained improvements, uncertainty over post-pandemic conditions remains high, both in the short-term, as government support is withdrawn, and long-term, as work and retail patterns evolve. Initial and reversionary yields remain low versus longer-term averages and suggest modest absolute returns, even allowing for low government bond yields. As a result, we remain cautious.



## Conclusion

The economic backdrop remains strong but the quarterly pace of global growth is likely to ease beyond Q2. Meanwhile, the spread of virus variants in countries with lower vaccination rates and the potential for vaccine resistant strains poses a risk to global demand. Though the most acute current inflationary forces will likely prove transitory we expect some modest upwards pressure may persist.

That is an outlook more fundamentally supportive of equities than bonds and credit. While valuations are elevated, suggesting future returns from equities are

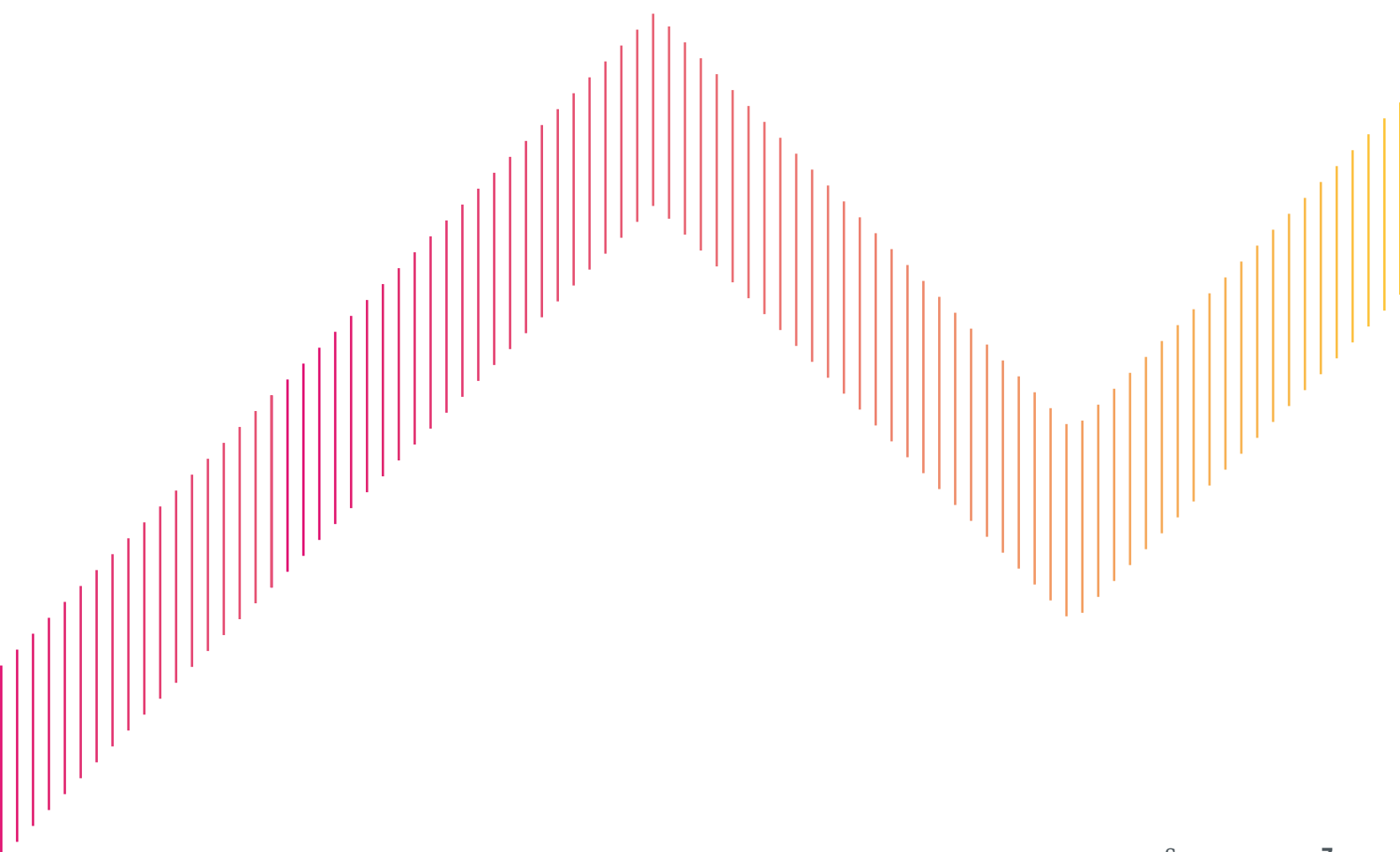
likely to be modest, that is no less true of other markets, while equities offer some upside exposure. In both investment and speculative-grade credit markets, we have a fundamental preference for floating versus fixed-rate assets: in addition, investment-grade asset-backed securities continue to offer a reasonable spread pick-up versus similarly rated corporate credit, as do loans and private credit versus fixed-rate speculative-grade bonds. There are tentative signs of improvement in UK commercial property market fundamentals, but still elevated levels of both short-and long-term uncertainty keeps us cautious for now.

## Chris Arcari

Senior Investment Research Consultant

[chris.arcari@hymans.co.uk](mailto:chris.arcari@hymans.co.uk)

0141 566 7986



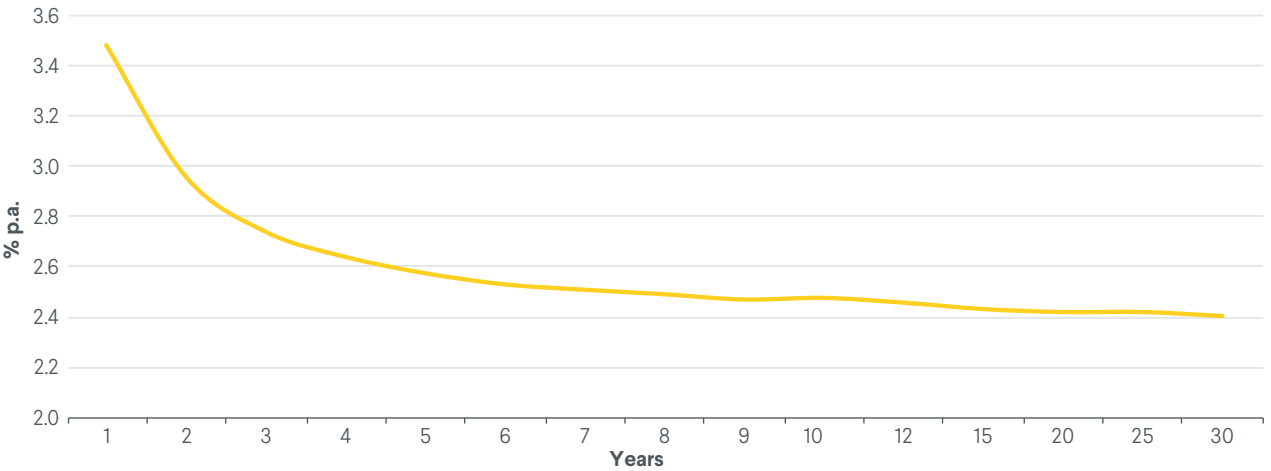
# Inflation: momentary or momentous?

Released: June 2021

Global inflation is rising as economies re-open following the most severe economic shock since the great depression. Most forecasters suggest the surge in inflation pressures will prove transient, dissipating towards the end of 2021. Markets do not expect a sustained rise in inflation either – market expectations are for inflation to remain above target, but do not suggest current pressures will persist (Chart 7). However, the balance of risks around the inflationary

outlook have shifted to the upside. Inflation running persistently hot may not be disastrous for economies but may still have implications for interest rates, yields and valuations, relative to current levels. A more profound shift to a high inflation environment is potentially more disruptive for both the global economy and markets. In this article we consider the risk of a momentary surge in inflation becoming a momentous shift to a prolonged period of high inflation.

Chart 7: US inflation swaps



Source: Bloomberg

## Background

A rise in US inflation was anticipated, but April's 4.2% year-on-year increase in headline CPI greatly exceeded expectations. US headline CPI was boosted by a

recovery in oil prices but core CPI, which excludes volatile elements such as food and energy, also outstripped expectations, rising 3.1% (Chart 8).



Chart 8: Realised US Inflation

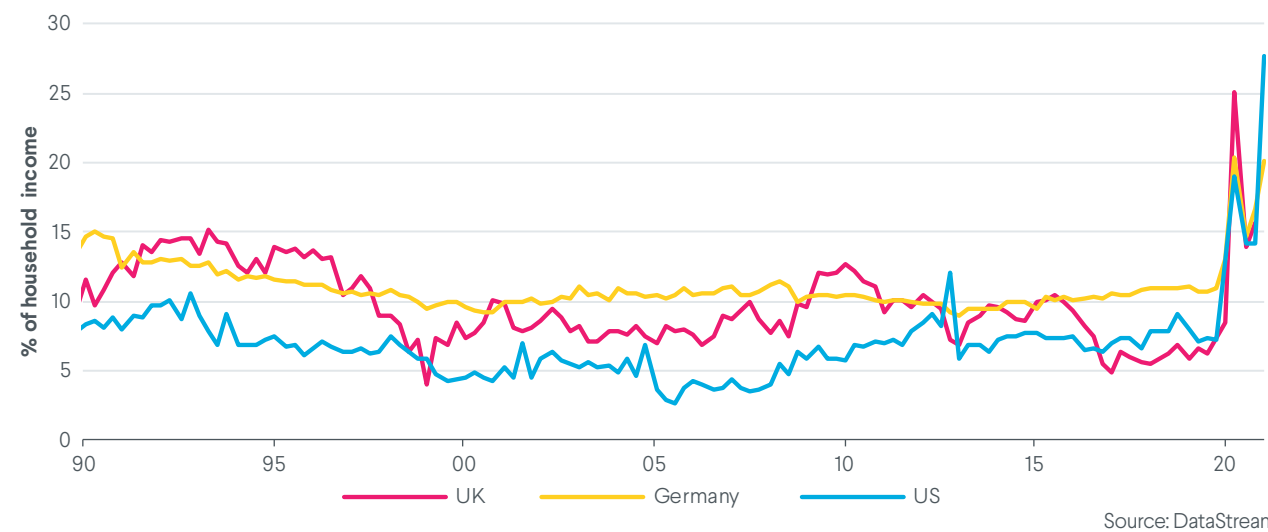


Source: DataStream

Indeed, inflation is rising sharply across the world with a notable increase in the global median inflation rate in April. Recent Purchasing Managers Index surveys for the major advanced economies highlight businesses facing supply shortages and difficulties filling vacancies. Across the board, surveys are showing extensive shortfalls in supply relative to demand and average selling prices for goods and services rising at unprecedented rates.

Recent inflation readings largely reflect base effects, relating to the timing of last year’s lockdowns, and price hikes due to pandemic-induced shortages. While there remains a great deal of uncertainty as to how long it will take global business and trade to return to normal functioning, most forecasters expect the inflationary spike to prove temporary: supply-chain pressures should dissipate, companies have scope to increase production and the one-off boost to consumer spending from stimulus cheques and pandemic savings (Chart 9) will likely pass, and temporarily more generous US unemployment benefits will expire.

Chart 9: Personal savings as a proportion of income



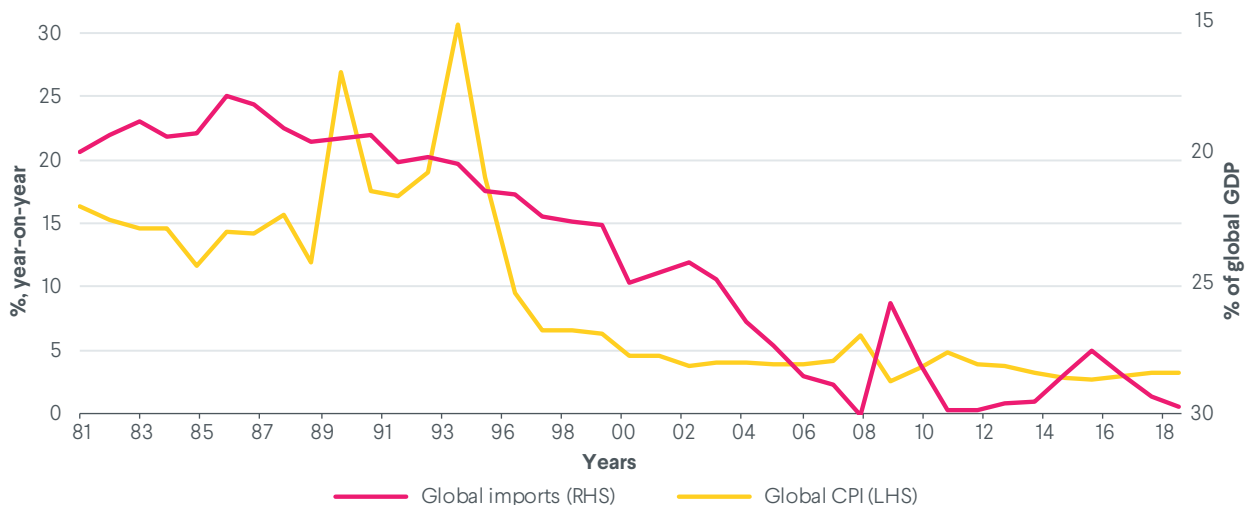
Source: DataStream

## “Low-flation” of the last three decades

Inflation in most advanced economies has been on a declining trend for the past three decades, owing to a number of structural factors including globalisation, anchored inflation expectations, demographics, and advances in technology:

- Globalisation and advances in technology have greatly reduced input costs over the last 30 to 40 years – a massive shift in manufacturing to lower-wage labour markets has greatly reduced manufacturing costs. Greater competition has been a consistent deflationary force – global imports as a share of global GDP increased rapidly between the 1970s and the Global Financial Crisis (Chart 10).

Chart 10: Global CPI and global trade



Source: DataStream

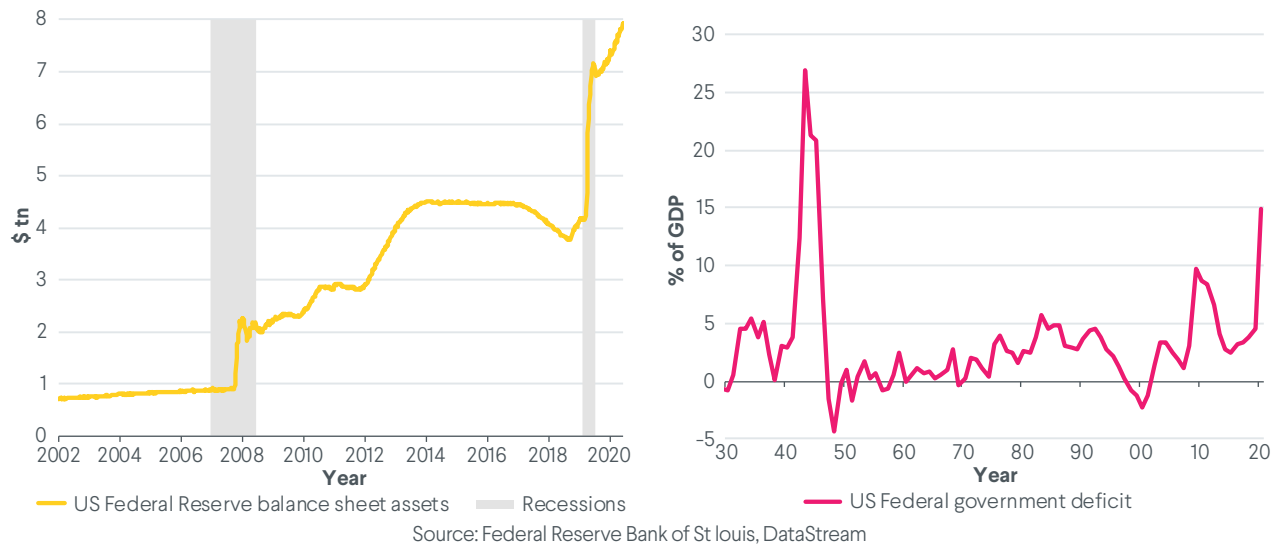
- The introduction of independent central banks and inflation targeting have led to lower and more predictable inflation expectations in recent decades. However, if government commitment to control inflation lacks credibility then shifts to a higher inflation environment are more likely.
- Ageing populations in advanced economies have placed downwards pressure on inflation over the last 40 years by lowering expectations of future growth and increasing levels of savings. While retiring “baby boomers” are starting to place downwards pressure on savings, increasing life expectancy will offset this to an extent as people save more for retirement during their working lives.

## Why this time could be different

Some of these factors are expected to remain in place, but some commentators point to reasons why the risk of a shift to a higher inflation environment has increased, including central bank policy, de-globalisation, and the possibility that current labour shortages become more ingrained. As central banks expect the current rise in inflation to be temporary, they are adopting a less pre-emptive stance. Additionally, following a decade of undershooting targets, central banks are likely to tolerate a degree of overshoot – in August 2020 the Fed officially

adopted a new Flexible Average Inflation Targeting framework, allowing inflation to overshoot to make up for periods of below-target inflation. Coordinated monetary and fiscal policy responses, particularly in the US where we believe the risk of a more persistent policy overshoot is greatest, are unprecedented. Major central bank policy interest rates remain at record lows and central bank balance sheets have rapidly expanded while budget deficits have swelled (Charts 11&12).

Charts 11&12: US Federal Reserve Bank balance sheet and US Federal government deficit



At a time when policy remains unprecedentedly loose, the consequences of error could not be greater: If inflation expectations become de-anchored and workers demand wage rises, central banks may have to raise rates more aggressively down the line to stave off a self-fulfilling inflationary spiral.

The pace of globalisation has slowed since the Global Financial Crisis and a reversal seems unlikely. The creeping protectionism of the 2010s seems to be gaining

momentum as global political tensions increase. Additionally, the pandemic has placed global supply chains under fresh scrutiny which may lead to reshoring, potentially increasing input costs.

A further medium to long-term upside risk to inflation would be if labour shortages prove more sustained than expected and short-term wage pressures become ingrained.

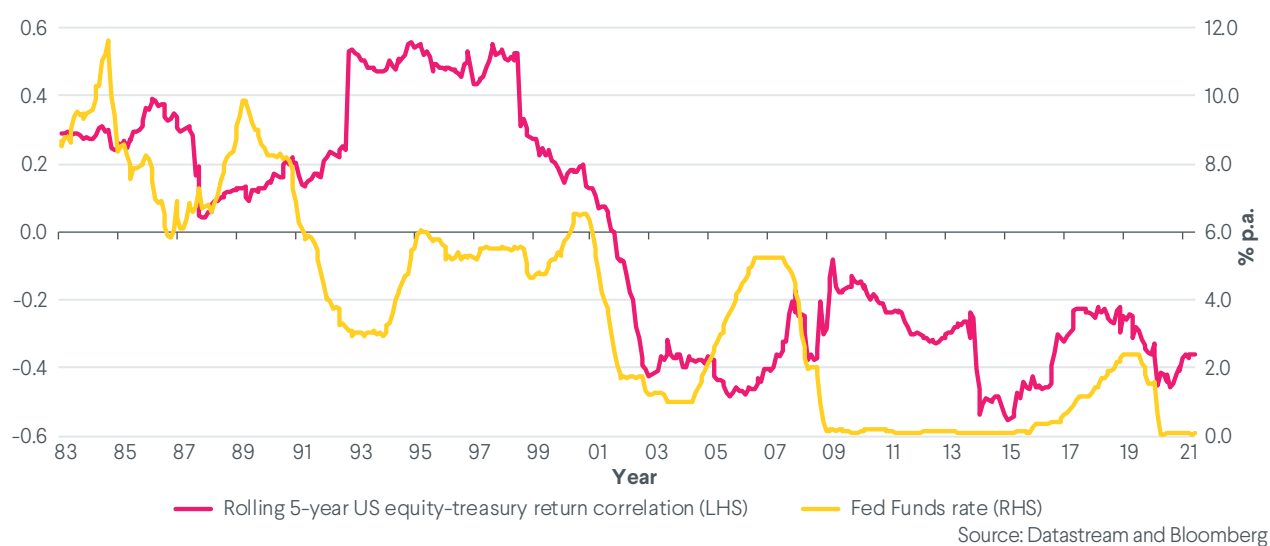
### What a shift to a higher inflation environment would mean for the economy and markets?

In the past, central banks have not been able to reverse profound and persistent rises in inflation without causing recessions and large increases in unemployment. The trade-off between unemployment and inflation (the Phillips curve) has weakened in recent decades. A re-emergence of this relationship would require more interventionist central bank policy to control inflation. Given levels of government and non-financial corporate debt, large interest rate rises could severely impact the financial system.

A high inflation environment may pose challenges for portfolio construction as correlations between equities and sovereign bonds have historically been more positive in higher inflation/interest rate environments (Chart 13), reducing diversification and making a traditional balanced portfolio more susceptible to the economic cycle.



Chart 13: US equity-treasury correlation and Fed Funds rate



A more persistent rise in inflation and subsequent rate rises would dent government and corporate bond prices, pushing up yields. Yield rises may potentially increase refinancing risk, particularly for speculative-grade credit and hard currency emerging market debt issuers. Higher inflation may also negatively impact equity earnings while higher government bond yields would weight on valuations, particularly in longer-duration sectors, such as technology.

### Conclusion

Inflation was always expected to rise in 2021 as economies emerged from lockdowns, but recent inflation prints have surpassed expectations as global supply and labour shortages exacerbate base effects. Structural forces, particularly demographics, will continue to weigh on inflation over the longer-term but unprecedented monetary and fiscal policy, a slowdown in globalisation, and more patient central banks pose upside risks of a shift towards a higher inflation environment. Consensus expectations are for more severe inflationary pressures to ease as we enter 2022 and for inflation to return to levels not dissimilar to those of the past few decades. However, there has been a clear shift from the tail risk being one of deflation to one of high inflation, a scenario that could have profound consequences for the global economy and markets.



**Chris Arcari**

Senior Investment Research Consultant

chris.arcari@hymans.co.uk

0141 566 7986

# TCFD: Supporting clients in understanding and reporting on climate change risk

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**With the government having just published its consultation response alongside the final TCFD regulations and statutory guidance for pension schemes, this article explores some of the analysis that can be carried out to support TCFD reporting requirements.**

## Metrics

The requirements under the Taskforce for Climate-related Financial Disclosures (TCFD) means that trustees will need to calculate their scheme's greenhouse gas (GHG) emissions, disclosing:

- the total GHG emissions of the scheme's assets;
- the total carbon dioxide emissions per unit of currency invested by the scheme;
- one additional climate metric that is neither an absolute nor an intensity metric.

The extract below shows an example of analysis that we have produced for clients through MSCI's ESG Manager, a leading provider of ESG data and analytics. This allows us to understand in detail the environmental (as well as social and governance) characteristics of any portfolio of listed assets. While this generates the required TCFD emissions metrics, climate and wider ESG metrics are increasingly being used by investors seeking ways to manage risk and capitalise upon opportunities.

**Table 1: Carbon Metrics for Fund A vs. Fund B**

|                                  | Total Carbon Emissions (000s Tons) | Carbon Footprint (tCO2/\$m invested) | Low Carbon Transition Score | Sustainable Development Goal 13 Alignment | % Of Portfolio with ties to Fossil Fuels |
|----------------------------------|------------------------------------|--------------------------------------|-----------------------------|---|--|
| Fund A                           | 154                                | 154.2                                | 7.5                         | 7.2                                       | 21%                                      |
| Fund B                           | 164                                | 174.8                                | 8.0                         | 7.2                                       | 18%                                      |
| <i>Fund A relative to Fund B</i> | -10                                | -20.6                                | -0.5                        | 0.0                                       | 3.0%                                     |

Source: MSCI ESG Research

This type of analysis helps trustees understand both the absolute and intensity metrics and compare and evaluate the risks exposures at Fund level and across individual mandates. In this instance the emissions performance of Fund B is worse than Fund A at this point – though these metrics tell us nothing about future emissions performance.

As well as backward-looking metrics, the analysis can compare more forward-looking risk factors such as a low carbon transition score. This seeks to identify leaders (and laggards) by measuring companies' exposure to and management of risks and opportunities related to the low-carbon transition. A company with significant exposure to fossil fuels, and making no attempt to de-carbonise, is likely to be vulnerable to carbon taxes and stranded assets. This will be reflected in a less favourable score than a similar company that is adapting its business model to a lower-carbon economy.

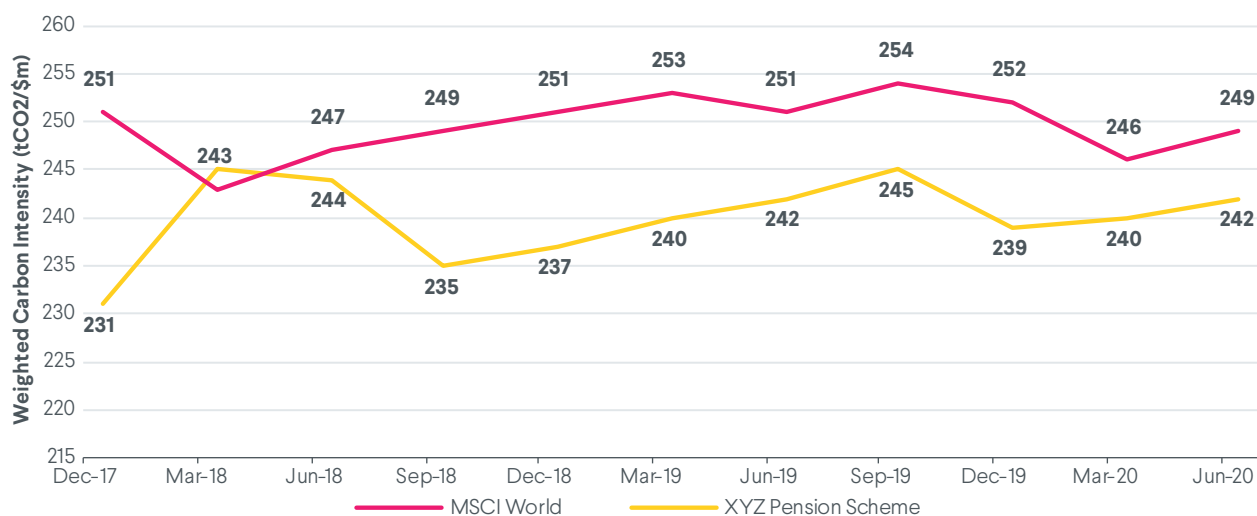
Armed with such information, trustees can engage with investment managers to understand more about individual company scores; and investment managers can challenge the management of companies with poor climate or wider ESG-related scores.

### Investment Strategy and Targets

Considering a range of climate metrics not only supports disclosure requirements but supports decisions on strategy and target-setting. TCFD requires trustees to assess the impact of the climate-related risks and opportunities they have identified in the scheme's investment strategy, and, for DB schemes, their funding strategy.

Trustees must recognise climate-related risks and opportunities in the context of their strategic asset allocation; and how climate change might impact investments over time. Climate metrics play an important role in supporting this requirement.

Chart 14: Carbon Intensity



Source: MSCI ESG Research

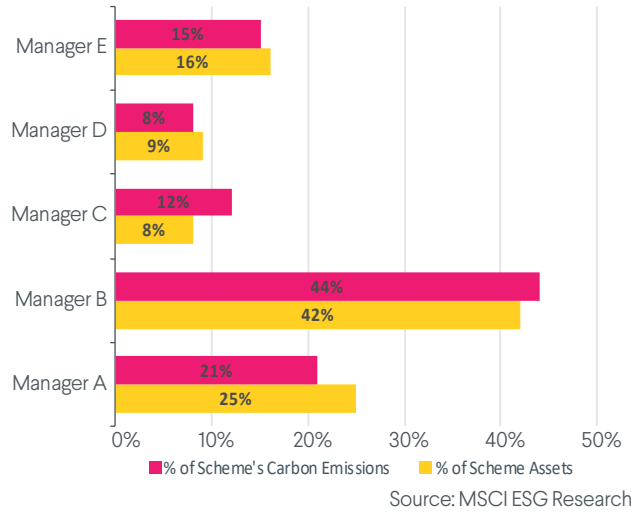
The graph above shows the evolution of a hypothetical scheme's carbon intensity relative to that of the MSCI World Index. This type of analysis can help to monitor a Fund or manager's progression in reducing carbon

intensity but also how this compares to the wider index, which we would expect to decarbonise in the coming years.



We can also explore the contribution to the scheme's total investment emissions from each portfolio manager, as shown in the following example:

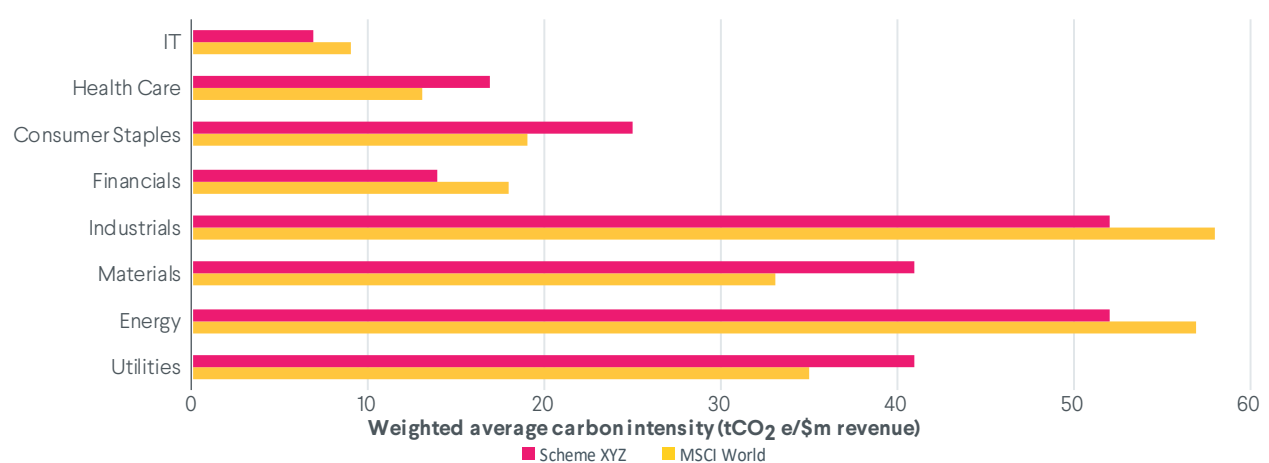
**Chart 15: Weighted Carbon Intensity by Manager**



In this case, Manager C contributes 12% of total emissions, despite representing only 8% of scheme assets. This information can underpin discussions with investment managers to understand why that might be. Perhaps, for example, the manager is of the view that some of the companies they hold, while high emitters at present, are leaders in supporting a green energy transition – and, as such, are worth retaining.

This sort of analysis can also be explored at a more granular level, as shown in the sector breakdown chart below, which highlights that four sectors contribute around 75% of this scheme's total emissions. We also observe that stock selection decisions are resulting in higher emissions (relative to benchmark) in 4 out of the 8 sectors. This helps identify the largest sources of emissions, which can be monitored over time. It also addresses TCFD requirements for setting and measuring performance against at least one of the metrics described above.

**Chart 16: Sources of Carbon Emissions by Sector**



## Scenario Analysis

Inextricably linked with investment strategy, scenario analysis is a useful tool in understanding and managing risk. We have been conducting climate scenario analysis for clients for some time and are launching further enhancements to our modelling in 2021.

For TCFD reporting, pension schemes must consider at least two scenarios where there is an increase in the global average temperature; in one of these scenarios, the temperature increase must be within the range 1.5 degrees up to and including 2 degrees above pre-industrial levels.

TCFD requires schemes to carry out scenario analysis to investigate the potential impact of climate risk on assets and liabilities, and to test the resilience of the investment and funding strategies. Consideration needs to be given not only to what might happen to asset prices, but also liability values, sponsor covenants, asset allocations, buy-in or buy-out plans and more.

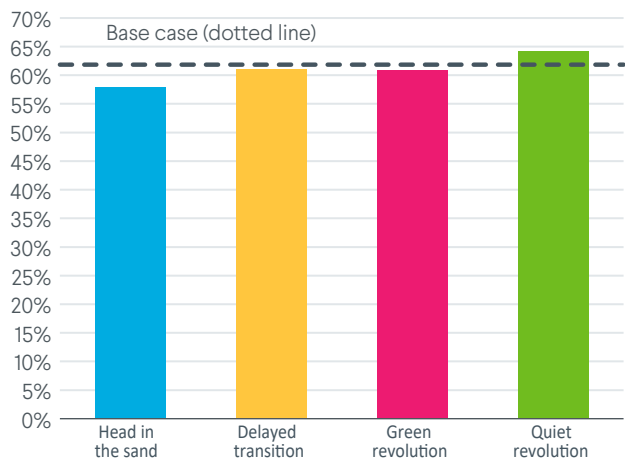
While most trustees will be familiar with asset liability modelling, climate scenario modelling may be less familiar. We set out below an example of our enhanced modelling capabilities which allow us to carry out projections based on four climate change scenarios and explore how the likelihood of the scheme achieving its funding objective is affected, and demonstrating the resilience of any chosen strategy.

Four indicative climate scenarios that could be modelled are as follows:

- **Green revolution:** 2100 temperature pathway at or below 2 degrees higher than pre-industrial levels. Immediate, significant action from policymakers (e.g. carbon tax increases) and market participants to adapt to a lower-carbon economy. While costly to implement in the short term, longer term costs associated with climate change are reduced or avoided.
- **Delayed transition:** Shorter term inaction followed by more extreme and disruptive action than may otherwise have been needed. Carbon pricing is implemented, with prices rising higher and faster than under a smoother transition. The 2100 temperature pathway is still at or below 2 degrees.
- **Head in the sand:** No transition. 2100 temperature pathway above 2 degrees. Little government or market action until pervasive fears that the world is on track for a more than 2 degrees temperature increase sparks market uncertainty and price dislocation. Despite this, there remains a lack of co-ordinated policymaker efforts to mitigate the impacts. Accordingly, there is increased likelihood of acute physical impacts on businesses and communities.
- **Quiet revolution:** A smoother transition, achieving the same outcomes as the Green revolution, but without turmoil in financial markets.

The graph below shows the likelihood of a hypothetical scheme being fully funded after 20 years in each scenario, with the base case shown as a dotted line.

**Chart 17: Likelihood of being fully funded in year 20**



These are hypothetical examples, and no single scenario should be used in isolation to inform investment or funding strategy decisions. However, this approach helps us to answer critical questions underpinning investment and funding strategies, such as:

- How resilient is the strategy to climate stress?
- What might climate risk mean for projected deficits; is the sponsor covenant strong enough to support higher contributions?
- Can the investment strategy be adjusted to improve its resilience?

While useful from a governance perspective (and to meet TCFD requirements), we don't know what path climate change will take, so it makes sense to consider a range of scenarios.

## Conclusion

Climate change is a material financial risk which should be considered by all pension schemes. The TCFD framework will become compulsory for larger pension schemes from October this year. Regardless of whether a scheme falls into scope or not, the framework provides a comprehensive means of integrating climate risk into all stages of investment decision-making.

Climate metrics and scenario modelling are a helpful way of understanding risk exposures and the potential impact that climate risk factors can have on pension funds. As such, it is worth considering what analytics can be most effective in helping your scheme understand climate risk, identify key areas of focus, as well as meeting regulatory requirements.

**Ross MacLeod**  
 Investment Consultant  
[ross.macleod@hymans.co.uk](mailto:ross.macleod@hymans.co.uk)  
 0131 656 5228





# Sustainability in fixed income

Released: August 2021

Sustainability in fixed income is a rapidly evolving market. Despite being in its nascency, 2020 was a significant year with Green, Social and Sustainable bonds (“GSS”) and Sustainability-Linked Bond (“SLB”) issuance reaching multiples of previous years, and 2021 is forecast to expand exponentially. This article serves as an introduction to this growing sector of the market.

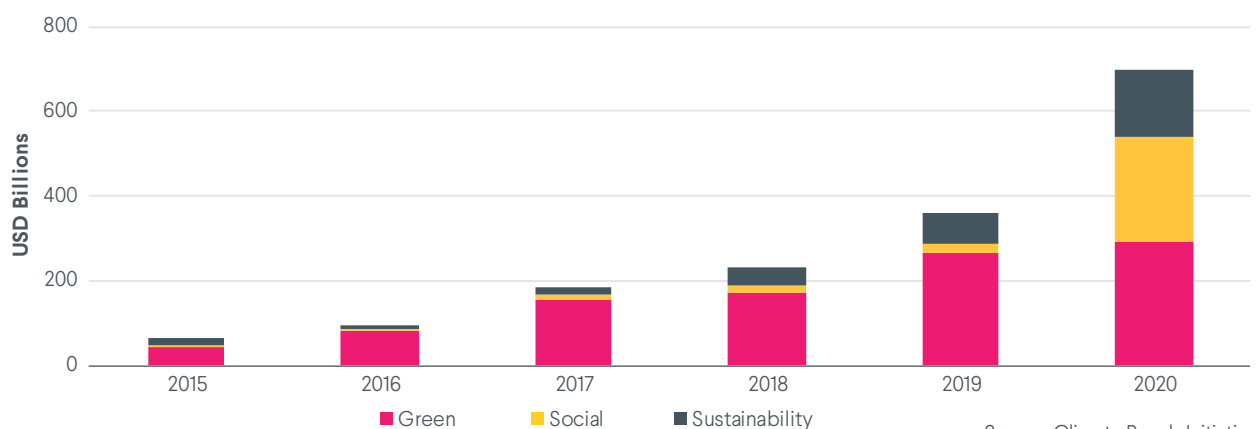
The key difference between GSS bonds and SLBs is the use of proceeds (“UoP”). GSS bonds must have a specific UoP to finance green and/or social projects, whereas SLBs can be for general corporate purposes, but with a potential step up or down in coupon linked to achieving KPIs of broader sustainability metrics.

While there is no regulatory oversight, key market guidelines have been issued by the International Capital Markets Association (“ICMA”) covering GSS and SLBs, and most bonds fit within these standards.

## GSS bonds

GSS bond issuance is growing strongly with \$700bn issued in 2020 (Chart 18), approximately 5% of global issuance. While green bonds remain the largest issuance, social bonds have grown in response to the pandemic. There has also been an increase in sustainable bonds, which are a combination of green and social projects in one instrument.

Chart 18: Green, social, and sustainability bond issuance



It is important to note that despite ICMA standards in place, there is no enforceability: if an issuer doesn't deliver in funding green or social projects, there is no impact other than reputational on the issuer.

## Green bonds

In 2007 the green bond market was launched with a green bond issued by the European Investment Bank. The green bond market is currently dominated by a few sectors where eligible projects can easily be identified, such as energy, buildings and transport, but new sectors are issuing as well and diversification by sector is becoming easier.

The UK Government has announced that it will issue its first green gilts during 2021 in order to fund low carbon projects, with the first issuance expected in September.

## Social bonds

Social bonds are bonds issued with a specific UoP that finance projects with a positive social outcome. The first social bond was offered in January 2015 by the Spanish bank Instituto de Credito. Its objective was to help finance small and medium sized enterprises in economically depressed regions of Spain, with unsustainable companies explicitly excluded. Social bond issuances in 2020 were up a massive 1,022% compared with the previous year, primarily driven by the COVID-19 response<sup>1</sup>.

<sup>1</sup> Climate Bonds Initiative, Sustainable Debt: Global State of the Market 2020

## Sustainability-linked bonds

As mentioned, UoP is not a determinant in defining SLBs. Instead, issuers select sustainability-linked key performance indicators (“KPIs”), which are predefined and should be considered material to the issuer’s business model. There are financial and/or structural features to these bonds that vary depending on whether these KPIs are met. Typically, this equates to a step-down in interest rate, or coupon, if the company achieves its KPIs, and sometimes also a step-up in coupon if it does not.

The SLB market started in September 2019 with an issuance by Enel, an Italian utility, linking its bond coupon to the company’s percentage of installed renewable generation capacity. And the trend is even moving across to the leveraged loan and private debt markets. In Q1 2021, sustainability-linked loans comprised 40% of issuance in the European leveraged loan market<sup>2</sup>.

However, there are criticisms of SLBs which should be examined, namely that companies choose their own KPIs, and are perhaps not setting KPIs that are ambitious enough, thus ensuring a high likelihood that their interest rate steps down (or does not step up). It also sets up a strange dynamic between issuer and investor where the investor receives a higher return if the issuer fails to meet its KPIs.

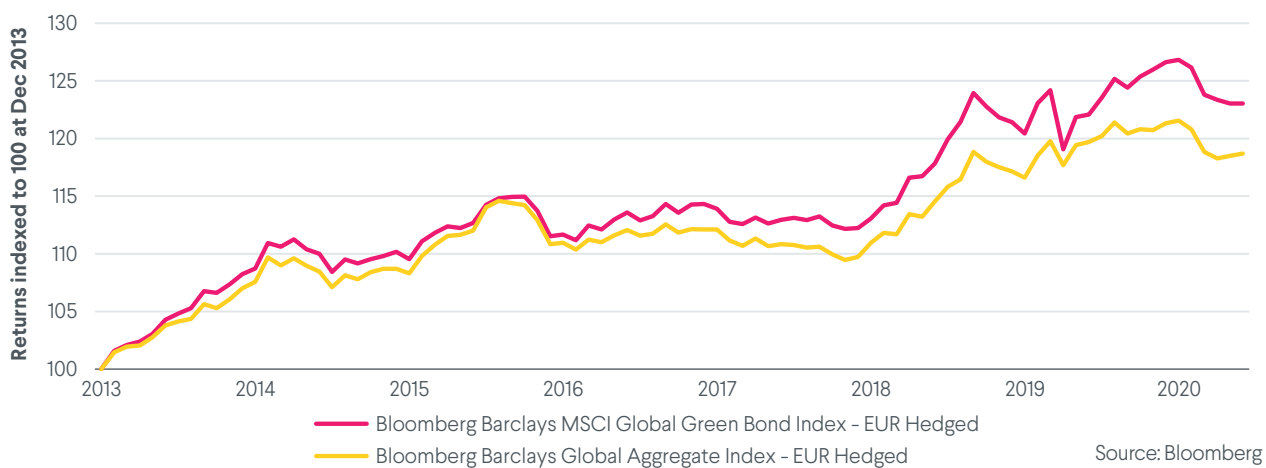
## Greenium

A new term for investors, the ‘greenium’ refers to the spread premium of equivalent conventional bonds over green bonds, i.e. the overall yield that investors give up. The greenium is not homogenous and depends on a number of factors including maturity, credit rating and seniority of the bonds. Historically, the greenium has been fairly volatile but appears to have settled down during the course of 2020 and, as it is driven by demand, it is expected to lessen as the market grows.

The concept of a material greenium is now more myth than fact. Comparisons of green bonds to conventional bonds show only a moderate greenium, albeit this does increase in sectors where there is greater scarcity of green bonds.

However, demand in the market means the ability to sell GSS and SLB bonds remains elevated relative to conventional bonds levels, for GSS bonds in particular. In addition, money in sustainable debt may be expected to see less outflows and as allocations to sustainable fixed income grow, it should exhibit lower volatility in market stresses.

Chart 19: Performance vs “regular” bonds



<sup>2</sup> Reorg, European Leveraged Loans Embrace ESG Margin Ratchets in 2021, April 2021

The Bloomberg Barclays MSCI Green Bond Index has outperformed the Bloomberg Barclays Global Aggregate Index by 0.5% p.a. since inception of the former in January 2014, suggesting that sustainable investing can be done without compromising return.

It is important to note this is not a true 'like for like' comparison: some of the biases of the green bond universe drive the difference in performance between the two indices. The indices are similar in duration but the green bond index has a lower rating (A vs AA). Green bonds have been dominated by debt issued in Euros and is underweight US dollars relative to the global index; according to Amundi, 67% of issues YTD were Euro-denominated<sup>3</sup>. The green bond universe also has a higher proportion of corporate debt and less government debt relative to the global bond universe. In practice, many investors to date have taken an active approach and may not need to hold bonds to maturity so they have the potential to benefit if sustainable bonds become more expensive relative to conventional issues.

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<sup>3</sup>Data as of end April 2021

## Accessing the market and impact on portfolio

GSS are essentially conventional bonds with a specific use of proceeds, whereas SLBs are corporate bonds just with a potential step up or down in coupon. Therefore, investors can access both types of bonds through a conventional bond portfolio although there are specialised sustainable managers who are able to offer investors specific portfolios tailored to their specifications. Credit analysis is completed on the issuer as would be expected, with an additional layer of due diligence to assess their sustainable credentials and avoid greenwashing (i.e. labelled as green, but no real link to sustainability).

The GSS and SLB trend is a growing signal of companies' commitment to environmental or social causes. The sustainable market is quickly growing and is expected to comprise 5% of the overall bond market within a few years.

Finally, it is important to note that a green bond portfolio may not necessarily reduce the headline carbon intensity of an overall portfolio in the shorter term. When measuring the carbon intensity of a portfolio, there is no credit given specifically to the purpose of the green bonds, instead the footprint for the underlying issuer comes through in the data. However, over the long-term, alignment of companies to financing more green projects should reduce any issuer's carbon footprint.



**Penny Cochrane**

Investment Research Consultant

[penny.cochrane@hymans.co.uk](mailto:penny.cochrane@hymans.co.uk)

0207 082 6381

# Market returns to 30 June 2021

|                          | Yield<br>% p.a. |         | Returns to 30 June 2021<br>(sterling, % p.a.) |         |         |
|--------------------------|-----------------|---------|---|---------|---------|
|                          | 31-Mar          | 30-June | 1 year  | 3 years | 5 years |
| <b>EQUITIES</b>          |                 |         |   |         |         |
| Global                   | 1.8             | 1.7     | 25.0  | 13.3    | 14.4    |
| UK                       | 2.9             | 2.8     | 21.5  | 2.0     | 6.5     |
| Developed markets ex UK  | 1.7             | 1.6     | 25.4  | 14.4    | 15.2    |
| Emerging markets         | 2.0             | 2.0     | 24.5  | 10.3    | 12.0    |
| <b>BONDS</b>             |                 |         |   |         |         |
| Conventional gilts       | 1.2             | 1.0     | -6.2  | 3.0     | 2.0     |
| Index-linked gilts       | -2.1            | -2.2    | -4.0  | 4.9     | 4.6     |
| Sterling corporate bonds | 2.2             | 2.0     | 2.9   | 5.4     | 4.7     |
| High yield (US) *        | 4.9             | 4.6     | 15.6  | 7.2     | 7.3     |
| Emerging market debt**   | 5.0             | 5.0     | 7.5   | 6.7     | 4.9     |
| <b>UK PROPERTY</b>       |                 |         |   |         |         |
| UK PROPERTY              | -               | -       | 9.1   | 3.3     | 5.2     |
| <b>GOLD*</b>             |                 |         |   |         |         |
| GOLD*                    | -               | -       | -1.0  | 12.2    | 6.0     |
| <b>OIL*</b>              |                 |         |   |         |         |
| OIL*                     | -               | -       | 82.4  | -1.8    | 8.7     |

\* Return in \$ +Hard currency

Source Datastream:

FTSE All Share  
FTSE World Developed ex UK  
FTSE All World

FTSE Emerging Markets  
FTA Govt All Stocks  
FTA Govt Index Linked All Stocks

iBoxx Corporate All Maturities  
BofA ML US High Yield Master II  
JPM GBI-EM Diversified Composite

UK IPD Monthly  
Credit Suisse Hedge Fund  
Gold Bullion LBM  
Crude Oil BFO M1 Europe

If you would like to find out more about any of the topics discussed in this publication, please contact your usual Hymans Robertson consultant or:



David Walker  
david.walker@hymans.co.uk  
0141 566 7733



Mark Baker  
mark.baker@hymans.co.uk  
0207 082 6340



Andy Green  
andy.green@hymans.co.uk  
0131 656 5151

London | Birmingham | Glasgow | Edinburgh

T 020 7082 6000 | [www.hymans.co.uk](http://www.hymans.co.uk)

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