New tricks for Bonds – impact investing

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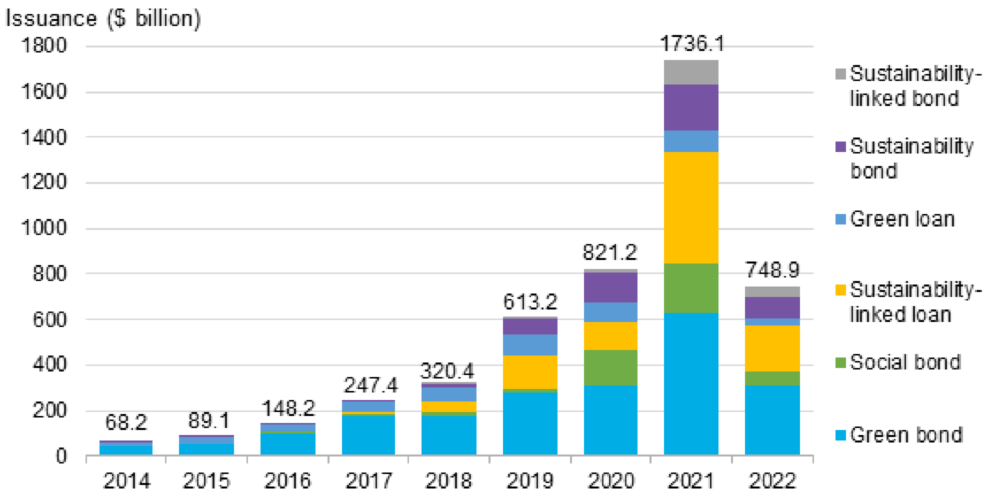
Some products find uses that are far more worthwhile than they were originally designed for. Before being used to freshen your breath, Listerine was originally intended as an antiseptic, Coca-Cola was a morphine substitute, and bubble wrap was designed to be wallpaper! Bonds have always been used to provide steady returns and as a counterweight to equities in portfolios, but now they're finding new uses in impact investing.

When people think of impact investing, they tend not to think of bonds. They mainly think of the shares of exciting new companies at the forefront of new technologies. However, in the future, their first thought will be of public debt markets. Through them, investors can access many more issuers than in listed equity, opening areas that aren't typically available to equity investors. The fixed income universe is far bigger than public equities. The global bond market is approximately $128tr[1], far larger than the market capitalisation of public equity ($105.8tr).

Bonds are issued by a wide range of entities, including governments, government agencies, supranationals, charities and corporates. Many of these do not issue in public equity markets. This means that fixed income investors can get access to a far wider range of social and environmental outcomes than by investing in equities. This is often overlooked by multi-asset investors, with most simply relying on equities or alternative assets like closed-ended infrastructure or Real Estate Investment Trusts (REITS).

Another big advantage of bonds is that they can be more targeted than equities. The bonds and their proceeds can be ring-fenced by subsidiaries so that funding is allocated to specific projects. This has led to the development of a whole new asset class: sustainable finance, a broad area incorporating green bonds, social bonds and sustainability bonds. The asset class has grown at a tremendous rate, with $1.7tr bonds issued in 2021 and a further $750bn issued in the first half of 2022.

Figure 1: Issuance of Sustainable Debt



Source: BloombergNEF

These bonds have covenants built into their prospectuses that direct proceeds into social and environmental causes. This development is changing the ability of investors to access impact investments and most of these bonds can be attributed to helping the UN's Sustainable Development Goals.

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Investors can help issuers of sustainable debt to drive down their funding costs and raise money for positive causes via much lower refinancing rates. This will become increasingly important as the funding requirements for social and environmental causes are likely to balloon in the future. For example, the bill to help the world deal with risks from climate change is estimated to reach between $140- 300bn per year by 2030[2]. Debt markets are pivotal to meeting these costs, and investors can help achieve these goals.

Where 7IM comes in

7IM is unique among multi-asset investors in that it already has significant exposure towards bonds.

We use a factor-based approach that diversifies the factors that the Strategic Asset Allocation loads on. This typically leads us to hold a more diversified range of fixed income securities than our competitors, including high yield and emerging market debt. We are structurally tilted to access a broad range of fixed income investments.

This has helped us benefit from the development of fixed income products in the ESG sector over the last few years. We were early-stage investors in funds focused on emerging market debt, social bonds and high yield.

There are two ways in which the Sustainable Balance fund accesses impact investments through fixed income. We invest in green bonds that have been issued in emerging markets. Compared with developed markets, the yields on offer are higher, the bonds typically have lower duration and the impact case is stronger. Emerging markets need a vast amount of capital to transition to a lower-carbon world and the private sector is best placed to provide it. These bonds can be used in various ways, including low-carbon transport, retro-fitting building to make them more energy-efficient and building renewable energy.

We also have exposure to projects closer to home, such as social bonds that are issued to support social projects in the UK. While most sustainable finance is linked to environmental projects, social bonds can be such a powerful tool to help social causes. For example, the African Development Bank issued $1bn of social bonds to help the fight against Covid in 2020. The projects we tap into cover areas that are so important in the current climate, such as social housing or access to finance and education in the UK.

We think bonds have some useful new tricks and these will be pivotal to supporting the Sustainable Development Goals in the future. Investors' mindsets will increasingly look at what positive impacts their bond exposure is having and we believe the construction of our portfolios gives us an edge.

[1]https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Secondary-Markets/bond-market-size/#:~:text=As%20of%20August%202020%2C%20ICMA,tn%20corporate%20bonds%20(32%25).

[2]https://unepdtu.org/publications/the-adaptation-finance-gap-report/