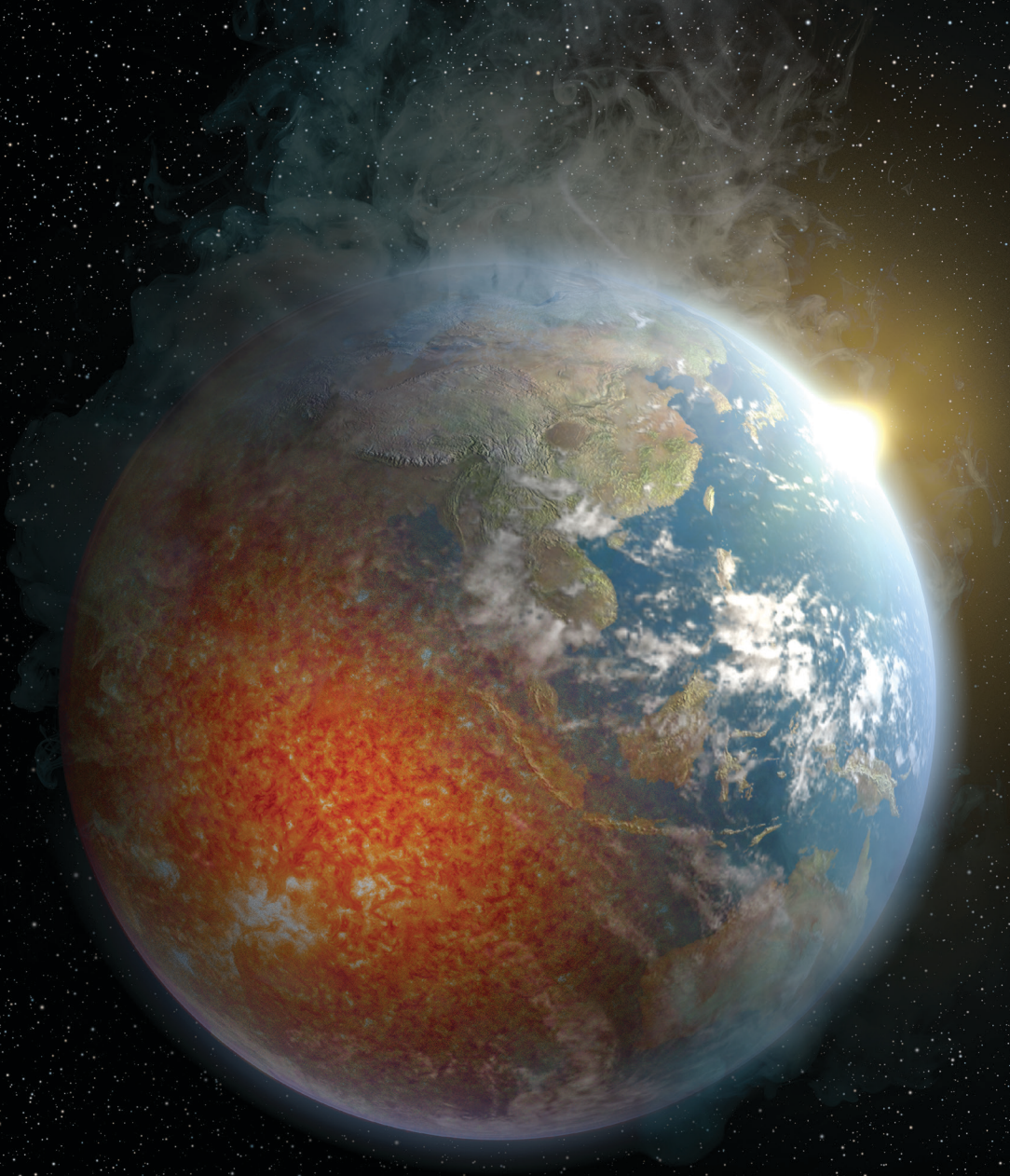
#WhyESGMatters

Bond investing for a sustainable future



HSBC

Did you know?

2019

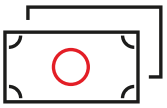
The Economist has named 2019 the "Year of the Vegan"

HSBC's forecast for total green bonds outstanding by the end of 2019[1]

USD565bn

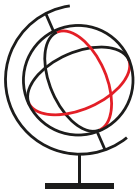
USD38.6bn

Green bond supply year-to-date, up 45.9% year-on-year[2]



51 countries[3]

Green, social and sustainability bonds have been issued



Year when the first green bond was issued

2007

1m people

Displaced by floods in Kerala, India, in 2018

Source: Bloomberg, Dealogic, European Investment Bank, The Economist, HSBC Calculations

Bond investing for a sustainable future

The era of green bonds has arrived. We are seeing the increasing use of bond markets to raise capital to fund the low-carbon economy, especially from the issuance of 'green bonds'.

While many in the fixed income market are grappling with green bonds, others are working out how best to incorporate broader environmental, social and governance (ESG) strategies into their portfolios, a task rapidly growing in importance.

In this second issue of #WhyESGMatters, we discuss green bonds and ESG investing. We believe the supply and demand for green bonds is set to increase, making it even more important for investors to consider the impacts of their investments.

1. Excluding Fannie Mae green multi-family mortgage-backed securities. These calculations take into account bonds that mature in 2019 and take the midpoint of our issuance forecasts
2. As of 20 March 2019
3. As of 29 October 2018

1. Green & ESG bonds – the basics

Green bonds
use their proceeds to fund 'green' or environmental projects

Social bonds
fund social projects to support particular disadvantaged groups

Sustainability bonds
fund both green and social projects

What exactly are green bonds?

A green bond is bond that uses its proceeds solely for the financing or re-financing of 'green' projects. The issuer must also declare the bond to be green and commit to a level of transparency on the bond's use of proceeds.

A green bond should be put together in line with the Green Bond Principles (GBPs), a set of voluntary guidelines created by the International Capital Markets Association (ICMA). According to these principles, a company does not have to be green to issue a green bond, but all of the bond proceeds have to go to green or environmental projects.

Other types of ESG bonds

In recent years, other types of ESG bonds have also emerged to satisfy various ESG investment goals. These bonds fall into the following categories:

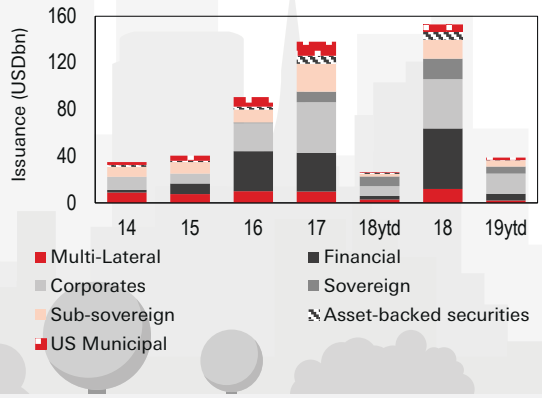
- Social bonds – bonds that (i) fund social projects and (ii) the social projects themselves support particular disadvantaged groups
- Sustainability bonds – bonds that funds both green and social projects

Strong growth in issuance

Green bond supply has continued to see robust growth, with year-to-date[4] issuance of USD38.6bn, up 45.9% on the same period in 2018. This is also an improvement on the 10.7% growth seen in 2018 versus 2017.

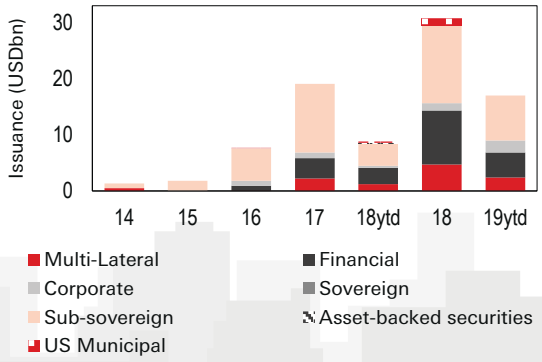
Growth in social and sustainability bonds has been even more rapid, with year-to-date[5] issuance of USD17.0bn, up 93.3% on the same period in 2018.

Figure 1. Annual green bond issuance, by issuer



Source: Bloomberg, Dealogic, HSBC Calculations

Figure 2. Annual social and sustainability bond issuance, by issuer



Source: Bloomberg, Dealogic, HSBC Calculations

4. As of 20 March 2019
5. As of 16 April 2019

2. The next new normal

Investors are increasingly focussed on ESG factors

Both green bond and 'ESG integration' strategies can involve buying green bonds

ESG bonds on the rise

Over the last 18 months, fixed income institutional investors have become increasingly focussed on integrating ESG factors into their investment process, which is intensifying in 2019. A key driver is the planned rollout of ESG scoring methodologies by the ratings agencies Moody's and S&P.

Green or 'ESG integration'?

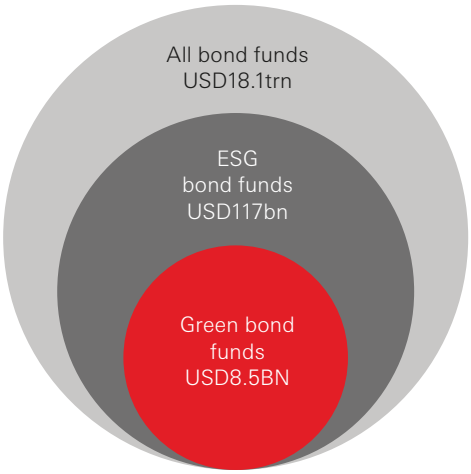
We see two differences between a green bond strategy and an 'ESG integration' strategy:

- Green bond investors focus on the bond issue and how the bond's proceeds are spent; while the ESG approach focuses on the issuer, the entity issuing the bond
- According to the Green Bond Principles, firms do not need to be green to issue green bonds; however, an ESG investor would seldom buy a security from a firm with a poor ESG score

Importantly, both strategies involve buying green bonds. While many green bond funds have been created over the past few years, we still calculate less than USD10bn of dedicated green bond funds, as show in Figure 3.

We forecast the green bond market to increase to USD565bn in size by the end of 2019, with another USD107bn of social and sustainability bonds outstanding[6]. Given the robust growth and increasing focus on ESG, we believe it is important for investors to be attuned to these developments.

Figure 3. Green bond funds only a small part of the market



Source: Lipper IM, Environmental Finance, Bloomberg, HSBC calculations
Note: Shows institutional funds only, dates in brackets give year of inception. Fund sizes as of October 2018. All bond funds defined as Bond, Money Market and Mixed Asset (40% bond) in Lipper reporting.

6. Excluding Fannie Mae multi-family green mortgage backed-securities. These calculations take into account bonds that mature in 2019 and take the mid-point of our issuance forecasts.

3. What factors are more important, E, S or G?

"G" and "S", key drivers for government bonds

When conducting ESG analysis on sovereign bonds, we believe more weight should be given to governance and social issues than to environmental, as they are more immediately relevant than environmental issues.

Social factors can be seen as shaping a government's ability to pay its obligations, while governance more impacts willingness to pay. Environmental factors impact a state's ability to pay, but for the most part we see these as more medium-term issues.

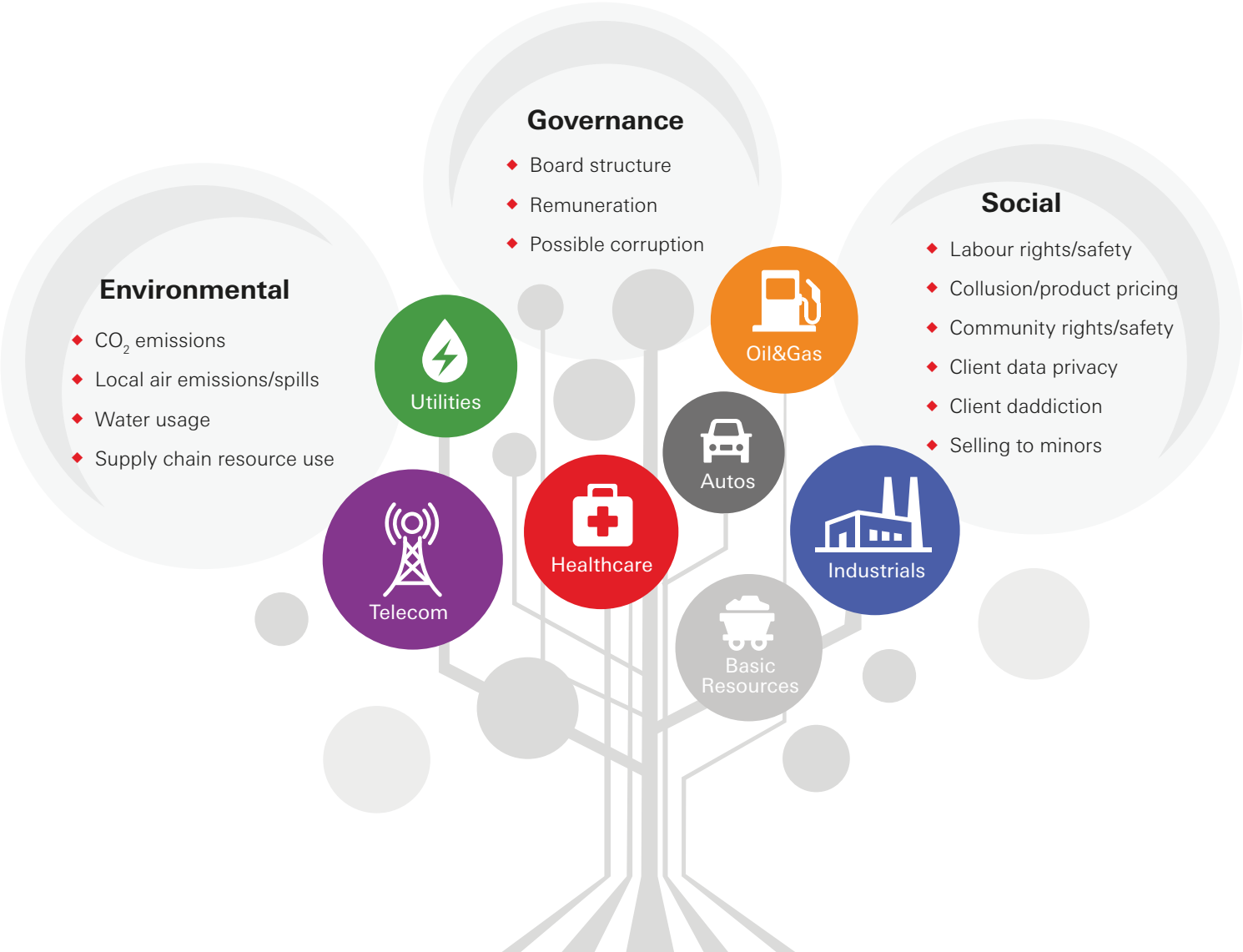
Measuring ESG impact in corporate bonds

We analyse the E, S and G factors to analyse corporate credits that we think are relevant to seven different economic sectors. We think three governance factors are relevant to all the sectors, however different environmental and social factors are relevant for the different sectors.

For Basic Resources, Industrials, Oil and Gas and Industrials, we think that CO_2 emissions, local air pollution, water usage and supply chain resource use, plus labour rights, product pricing, community rights and safety are relevant.

But for Healthcare and Telecoms water usage, product pricing, client addition and selling to minors are more important, we think. These results are summarized in the following table.

Figure 4. Key ESG factors by Industrial Sector



4. Can green bonds outperform?

Green can outperform non-green

Our analysis shows evidence that green bonds can outperform non-green bonds issued by the same entity, at least in the developed market space (less so in emerging markets).

We think this is because most dedicated green bond funds are focused on buying developed market green bonds. However, we are seeing growth in green bond funds focusing on emerging market green bonds and, if this trend continues, in time, this could help emerging market green bonds to outperform.

Reaching for green yields

We believe benefits from investing in green bonds can come from both environmental aspects ('green impact') and yield. On the environmental side, green bonds can deliver impact around mitigation (CO_2 emission reduction) and adaptation to climate change.

Green bonds might also achieve yield outperformance if there is a surplus of green bond demand versus supply and the greenness of the bond may also help the issuer (and its bonds) outperform.

Green bonds can outperform non-green bonds issued by the same entity

Benefits from investing in green bonds come from the environmental impact

Green bonds might also achieve yield outperformance

Conclusion

Green bonds are now embedded in capital markets as a means to finance the low-carbon economy, with the integration of ESG factors into portfolios on the rise. We believe that increased focus by issuers, investors and rating agencies on ESG considerations will lead to increased supply and demand for green bonds, making them increasingly more important to consider when making investment decisions.

Disclosure appendix

Additional disclosures

1. This report is dated as at 1 May 2019.
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