FOR PROFESSIONAL AND QUALIFIED INVESTORS ONLY

Expert's View

Green bonds

A simple way to take climate action in fixed income

With rising commitments to climate action - and an increasingly firm hand from regulators - many investors are turning to 'green' bonds to fund pro-climate projects. In this report, we review the key features and drivers of the green bond market and examine their performance and diversification.

Facts and overview

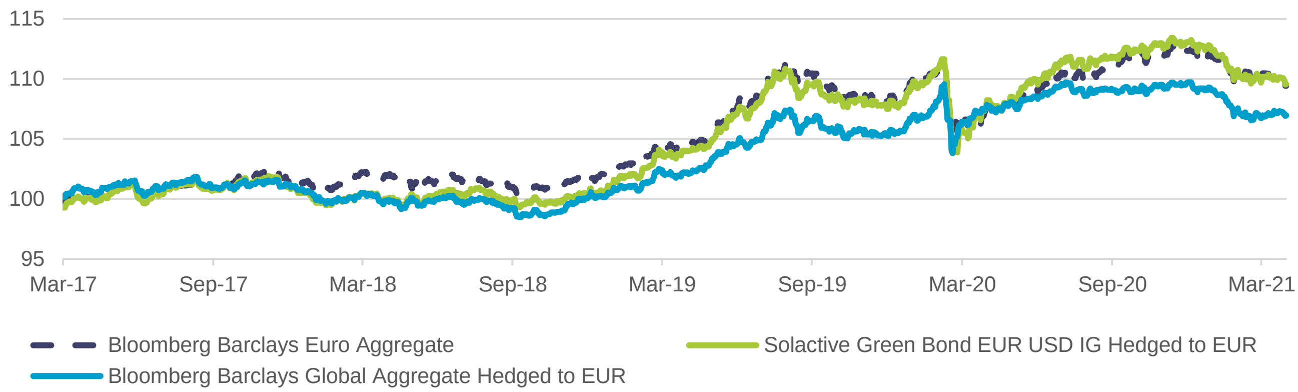
- **Green bonds are designed to raise funds to finance eco-friendly projects.** They are backed by the issuer's balance sheet, and most are investment grade quality.
- The green bond market is small in relation to the overall bond market. However, it is fast growing and fundamental drivers such as the emergence of strong sovereign green bond issuers in the wake of enhanced public policies on climate and green recovery plans are key supporting factors.
- Green bonds are benefiting from **rising investor demand for green assets**, policymakers and companies **aligning with the Paris Agreement goals** to hit carbon emission reduction targets.

Our key takeaways

- In 2020, proceeds of green bonds were mainly invested in **energy, green buildings,** and **clean transportation projects**.
- A higher share of green bonds issued last year came with a **yield level lower than or equivalent to conventional bonds ('greenium')**. This suggests investors are in search of quality, labelled green bonds.
- In a world where issuers' management of climate transition is increasing in importance, companies issuing green bonds are signalling their willingness to be at the forefront of transition, making green bonds overall carry less risks going forward than non-green bonds.

Chart 1: Green bonds – diversification and performance in a fixed income portfolio

Solactive Green Bonds EUR USD performance vs. Bloomberg Barclays aggregate indices



Sources: Lyxor International Asset Management, Bloomberg. Data as at 30/04/2021. Base date 28/02/2017.
Past performance is not a reliable indicator of future returns.

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Summary

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Overview of the green bond market

A fast-growing market

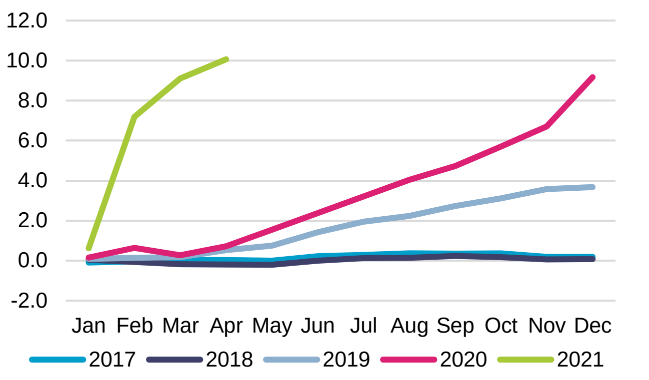
The green bond market is still small, representing 3.7% of current total bond issuance and less than 1% of the global bond market outstanding. However, medium- and long-term fundamental drivers of the green bond market are stronger than ever. Here's why:

First, **investors are paying more attention to ESG- and climate-friendly investments**. A good proxy for this trend is net asset creation in ESG Fixed Income ETFs in Europe. Year to date inflows have already surpassed 2020 net new assets (+€10bn).

Second, **regulators around the globe are acting to increase green bond transparency** and leading the way towards commonly accepted green taxonomies and standards. Regulators also increasingly require investors to take sustainability considerations into account. These factors could increase the demand for green bonds and support prices and performance.

Finally, **green bonds are an instrument of choice for policymakers** to support transition policies to achieve climate action and other environmental objectives.

Chart 2: Record year on track for 'green' fixed income
ESG Fixed Income ETFs: cumulative monthly flows (in €bn)



Sources: Lyxor International Asset Management, Bloomberg. Data as at 30/04/2021. Past performance is not a reliable indicator of future returns.

2020: record issuances in a milestone year

The Climate Bonds Initiative (CBI) reported USD 700bn in Green, Social and Sustainability bond issuance in 2020, almost twice the volume issued in 2019 (USD 358bn). The Covid-19 pandemic certainly impacted bond issuance in the first half of the year, yet the bond market proved to be a flexible source of financing to help with both the immediate impact of the virus as well as longer-term recovery plans. While green bond issuance dropped during the first half of 2020 as a result of the challenging market environment, green issuance hit a record-breaking USD 290bn by the end of December.

In 2020, the increase in public sector issuers of green bonds was strong compared to more stable volumes in the private sector. Government-backed entity issuance almost doubled over the year (+78%). Sovereign issuance of green bonds also grew. Egypt, Germany, Hungary and Sweden issued their debut sovereign green bonds, bringing the total number of sovereign issuers to 16. 80% of the overall green bond issuance came from developed markets (vs. 73% in 2019), with Europe representing the largest source in 2020 (48% of overall issuances at USD 156bn). Emerging markets accounted for 16% and supranational entities accounted for the remaining 4%.

Chart 3: Strong growth for public sector issuers
Green bonds issuances by issuers type (USD bn)

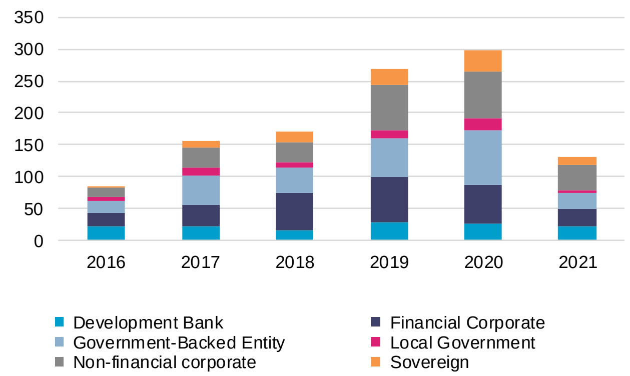
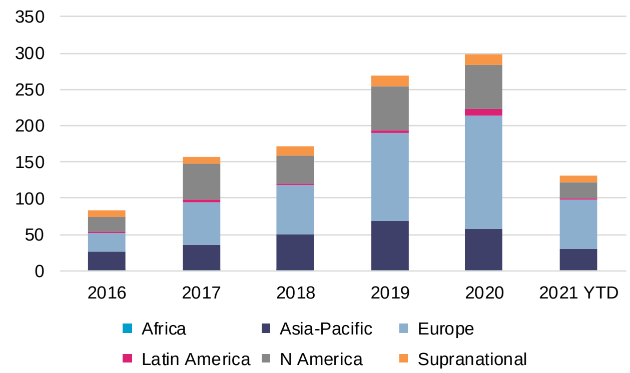


Chart 4: Europe, the dominant issuer in 2020
Green bonds issuances by regions (USD bn)

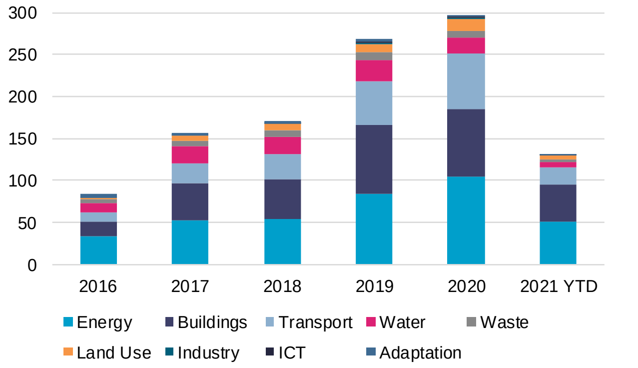


Source: Climate Bonds Initiative, 17 May 2021. Past performance is not a reliable indicator of future returns.

In 2020, Energy, Buildings and Transport represented 85% of the total proceeds from outstanding green bonds (see chart 5 opposite). Energy, Transport, and Land Use were the only categories to expand over the year. Sovereigns and government-backed entities supported 26% YoY growth in Transport, of which almost half of the allocation originated from France (USD 14.8bn). Investments in Renewable Energy grew 19% YoY and almost half of that (46%) came from financial and non-financial corporates.

As an example, Société du Grand Paris. the largest French issuer of green bonds in 2020, priced seven bonds worth USD 12.5bn. The Société du Grand Paris was established in 2010 by the French Government to construct the Grand Paris Express, which expands the Parisian metro and rail transport network. The network is powered entirely by electricity and is compliant with the CBI's low-carbon transport criteria. By the end of 2020, the entity had 13 green bonds outstanding.

Chart 5: Energy, Buildings and Transport dominate UoP
Use of proceeds by projects (USD bn)



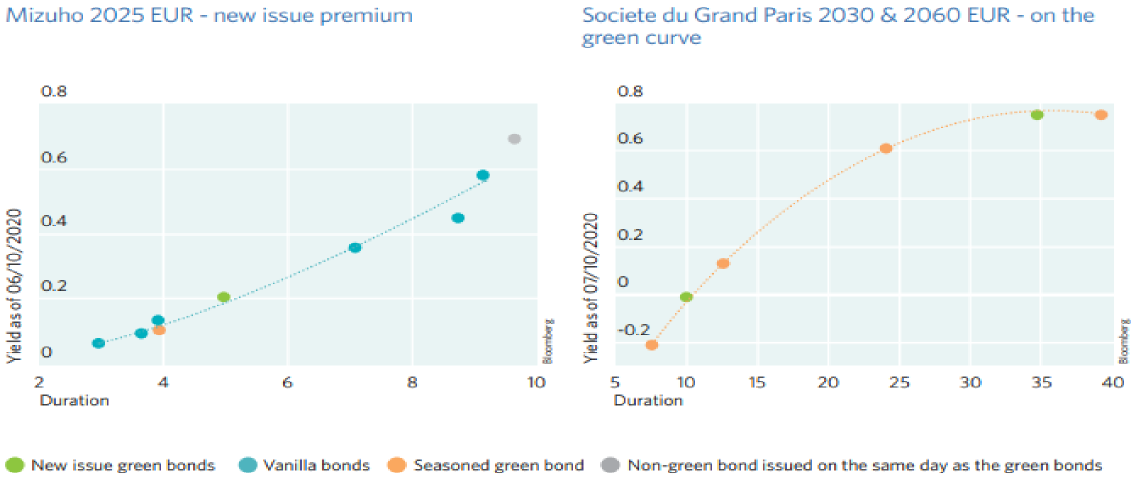
ICT: information technology and communication
Source: Climate Bonds Initiative. Data as at 17/05/2021.

The 'greenium' debate

Issuing a green bond provides benefits to the issuer compared to traditional bonds. Green bonds not only finance an issuer's operational and product transition towards carbon footprint reduction and Paris Agreement objectives, but they also enhance corporate visibility and strengthen relations with stakeholders. This has raised a debate about a potential 'greenium' and whether investors should be ready to pay a higher price for a green bond.

While the new-issue premium (the extra yield a buyer receives for a new bond) is a standard feature of the bond market, a bond may be issued with a higher price (i.e. a lower yield compared to outstanding debt). This is known as a new-issue concession and defined as a 'greenium' when present in a green bond. CBI data show that, between 2016-2019, a 'greenium' only materialised in 22% of EUR green bond issuance and 14% of USD issuance. However, this trend has changed more recently. Of the 54 green bonds issued in 2020, 79% (26 out of 33 bonds) priced at a 'greenium' (i.e. priced inside their yield curve) in H2 2020 versus 52% in H1 2020 (11 out of 21 bonds). This was the highest rate on record and the best evidence that investors are in search of quality, labelled green bonds.

Chart 6: New issuances and the 'greenium'



Source: CBI Report "Green Bond Pricing in the Primary Market: H2 (Q3-Q4) 2020", March 2021

As an example, the inaugural German sovereign issue in early September 2020 recorded a strong oversubscription with a 5.5 bid-to-cover ratio. The German green bond was priced at just one basis point (0.01%) yield below the yield on the equivalent conventional 10-year bond. Germany repeated this exercise in early November 2020, issuing a EUR 5bn green 'twin bond' of its 5-year federal government bond. The green BOBL (Bundesobligation, or federal government bond) priced with a 1.5bp 'greenium' and showed consistently lower yield compared to its vanilla twin until the end of 2020.

An analysis from the European Commission's Joint Research Centre suggests that green bond issuance could lead to lower long-term financing costs and could have a positive impact on the corporate bond pricing over the short term.

2020: a positive year for performance

Below we focus on the characteristics of Solactive green bond indices, comprising EUR and USD issuance in excess of EUR 300m. This liquid, yet representative, universe is smaller than the overall green bond universe covered by the CBI, only allowing bonds that have been defined by the CBI as eligible constituents.

In 2020, the Solactive Green Bond EUR USD IG index posted a positive performance (+3.53%) thanks to the strong performance of Treasury and Government related bonds at the height of the Covid-19 crisis. The spread impact was most important for corporate bonds, led mainly by its carry portion, while the yield curve impact was most important for the government-related allocation. The weaker USD also hampered overall performance of the index (-2.02%).

Table 1: 2020 performance analysis *(Solactive Green Bond EUR USD IG Index)*

2020	Average weight	Yield curve impact	Spread carry impact	Spread change impact	Total (before ccy impact)	Currency	Total performance
Total	**100.0%**	**4.21%**	**0.86%**	**0.51%**	**5.58%**	**-2.02%**	**3.53%**
Treasury	14.7%	1.00%	0.06%	0.23%	1.29%	0.00%	1.29%
Government-related	42.4%	1.86%	0.29%	0.08%	2.23%	-0.98%	1.25%
Corporate	38.7%	1.29%	0.49%	0.19%	1.97%	-1.02%	0.95%
Securitized	4.2%	0.07%	0.02%	0.01%	0.10%	-0.02%	0.08%

Sources: Bloomberg, Lyxor International Asset Management, data as at 31/12/2020. Past performance is not a reliable indicator of future performance.

Since the beginning of the year, the index's performance has been affected by the general rise in bond yields as global activity recovers. The general steepening of government bond yield curves has affected the government-related portion of the allocation the most (-1.57%). Other index components such as Corporate and Securitized had a much more limited contribution in the downside (-0.34% and -0.07% respectively).

Table 2: 2021 year-to-date performance analysis *(Solactive Green Bond EUR USD IG Index)*

2021 YTD	Average weight	Yield curve impact	Spread carry impact	Spread change impact	Total (before ccy impact)	Currency	Total performance
Total	**100.0%**	**-3.72%**	**0.19%**	**0.46%**	**-3.07%**	**0.36%**	**-2.70%**
Treasury	16.3%	-1.16%	0.01%	-0.02%	-1.17%	0.00%	-1.17%
Government-related	40.0%	-1.57%	0.06%	0.21%	-1.30%	0.16%	-1.14%
Corporate	39.4%	-0.92%	0.11%	0.27%	-0.54%	0.20%	-0.34%
Securitized	4.4%	-0.08%	0.00%	0.01%	-0.07%	0.00%	-0.07%

Sources: Bloomberg, Lyxor International Asset Management, data as at 30/04/2021. Past performance is not a reliable indicator of future performance.

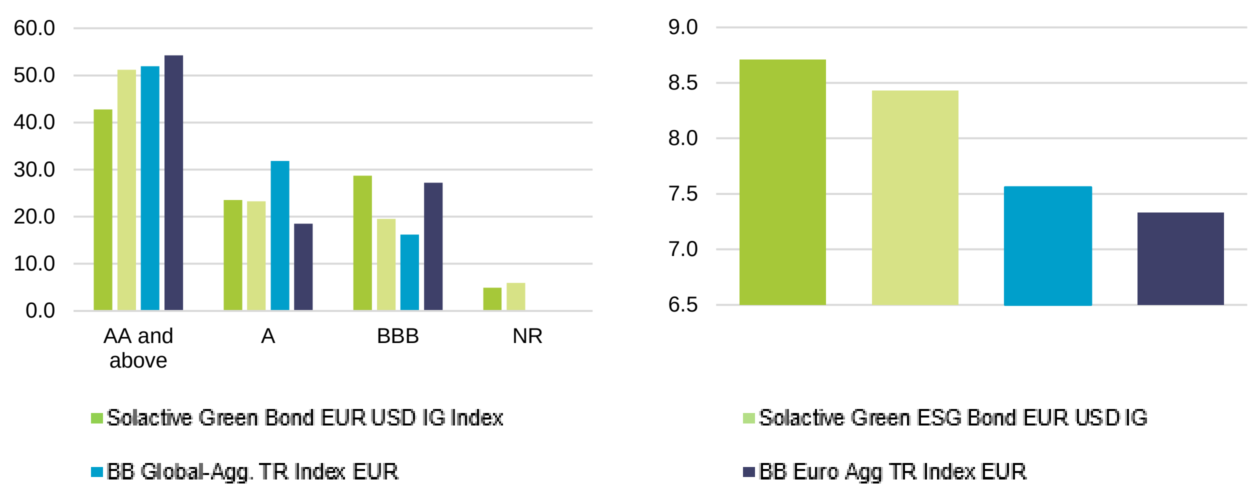
Green bonds in a fixed income allocation

Beyond the non-financial interests of investors, the case for green bonds begins with the rationale for holding any fixed income investment in a portfolio: income and risk levels compared to other portfolio holdings.

We see that green bond indices share some similarities with the global bond market. Both include all issuer types across countries and currencies and are skewed towards high-quality bonds (at least 45% of Solactive's green bond indices' holdings are rated AA and above – see chart 7). The yield profile is similar to broader bond indices, and the duration is slightly higher due to the nature of assets and projects financed such as infrastructure ones.

Chart 7: Green bonds indices share some similarities with Aggregate bond indices

Credit rating breakdown (in %) *Average duration (in years)*

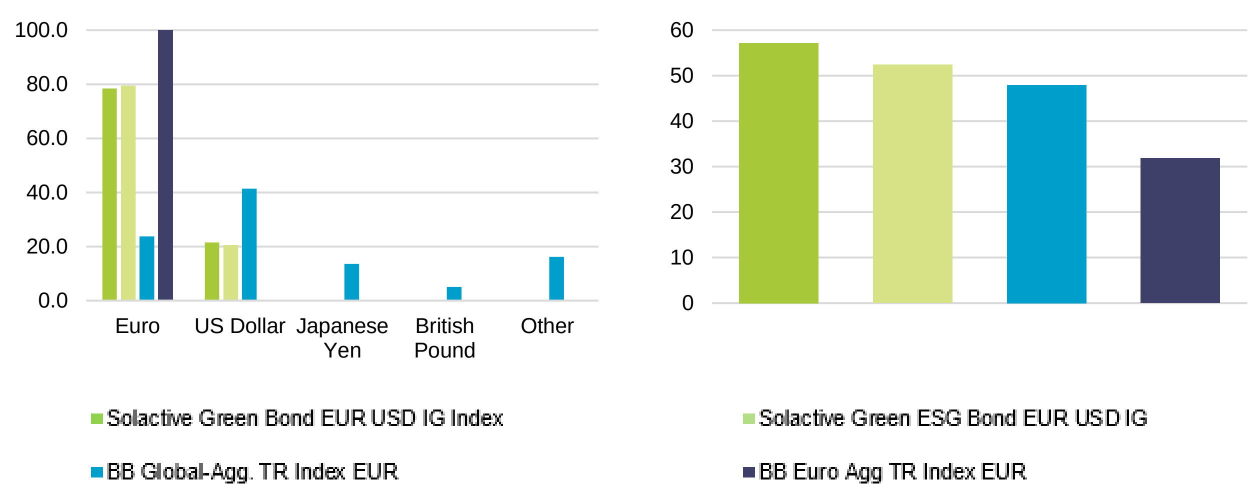


Average rating of the most conservative rating from agencies (S&P, Moody's, Fitch)
Source: Lyxor International Asset Management, Solactive, Bloomberg Barclays, data as at 30/04/2021. Past performance is not a reliable indicator of future returns

Given the overall high quality of the green bond universe, the primary risks faced by a green bond investor are interest rate risk and currency risk.

Chart 8: Green bonds investors can be exposed to currency and interest risk

Currency breakdown (in % of market value) *Average spread (in bp)*



Source: Lyxor International Asset Management, Solactive, Bloomberg Barclays, data as at 30/04/2021.
Past performance is not a reliable indicator of future returns

On the positive side, an allocation to **green bonds can be a source of portfolio diversification**. Table 3 shows the risk/return profile of green bonds compared to global aggregate indices. While the Solactive green bond index shares some similarities with the euro aggregate, it has some differences with the global aggregate index. Table 3 also shows maximum drawdown for each index over the past six years including and excluding data from the Covid-19 market downturn.

Table 3: Risk analysis Green bonds vs Aggregates

	Solactive Green Bond EUR USD IG Hedged to EUR	*Bloomberg Barclays Euro Aggregate*	*Bloomberg Barclays Global Aggregate Hedged to EUR*
Period 1: Apr 2016 – Apr 2021			
Max Drawdown	*-7.0%*	*-5.4%*	*-5.2%*
From peak	*06/03/2020*	*03/09/2019*	*09/03/2020*
To bottom	*19/03/2020*	*18/03/2020*	*19/03/2020*
Annualised volatility	*3.5%*	*3.1%*	*3.0%*
Sharpe ratio (rf=0)	*0.53*	*0.61*	*0.4*
Period 2: Jan 2015 – end Feb 2020 (Pre Covid-19 crisis)			
Max Drawdown	*-4.4%*	*-5.1%*	*-5.0%*
From peak	*07/09/2016*	*15/04/2015*	*08/07/2016*
To bottom	*10/03/2017*	*10/06/2015*	*10/10/2018*

Source: Lyxor International Asset Management, Solactive, Bloomberg Barclays, data as at 30/04/2021.
Past performance is not a reliable indicator of future returns.

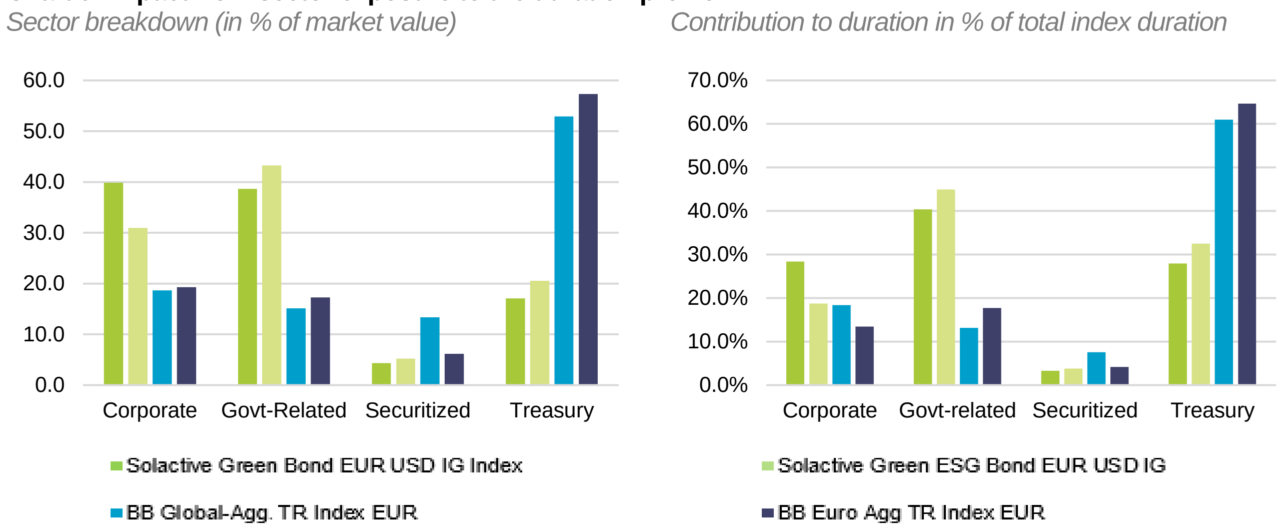
The difference in sector exposure is a source of higher decorrelation of returns. As an example, supranational issuers (government-related) represent around 40% of the green bond universe versus only 15% of the Global Aggregate Index. Such a difference in sector allocation can lead to significant differences in sector contribution to overall index duration, as shown in Chart 9 below.

Table 4: Solactive Green Bonds EUR USD IG Index – sector & currency breakdown (% market value)

	Total	Corporate	Government-Related	Securitised	Treasury
Total	**100.00**	**39.9**	**38.7**	**4.4**	**17.1**
Euro	**79.0**	28.0	29.7	4.2	17.1
United States Dollar	**21.0**	11.9	9.0	0.2	-

Source: Lyxor International Asset Management, Solactive, Bloomberg Barclays, data as at 30/04/2021.
Past performance is not a reliable indicator of future returns.

Chart 9: Impact from sector exposure to the duration profile



Source: Lyxor International Asset Management, Solactive, Bloomberg Barclays, data as at 30/04/2021.
Past performance is not a reliable indicator of future returns.

As a result, while aggregate indices and green bond indices share some similarities (overall credit rating and duration), the breakdown of sector and currency exposure clearly differentiates between the two index structures.

Therefore: while green bonds are not a perfect replacement for a broader bond allocation, **they can be a useful hedge against climate-related risks in a fixed income portfolio**. As has been explained, green bond issuers directly address climate risk factors as the issued bond's proceeds are directly tied to eligible green projects only.

In a world where environmental risk considerations are taking greater importance, including green bonds in a fixed income portfolio allocation can be a simple way to take direct climate action.

Table 3: Related indices for an allocation to green bonds

Index Exposure	Index name & investment objective	Bloomberg ticker
Green bonds	**Solactive Green Bond EUR USD IG Index** The Solactive Green Bond EUR USD IG Index, a benchmark of EUR and USD denominated investment-grade green bonds issued by sovereigns, supranationals, development banks and corporates. The index constituents are labelled green bonds defined as eligible for index inclusion by the Climate Bonds Initiative (CBI), an independent not-for-profit organisation dedicated to the promotion of investments for a low carbon and climate-resilient economy.	SGREENIG Index
Green bonds (ESG screened)	**Solactive Green ESG Bond EUR USD IG TR Index** The Solactive ESG Green Bond EUR USD IG TR Index is a rules-based, market value weighted, total return index designed to mirror the investment grade green bond market of instruments denominated in Euro or U.S. Dollars after screening its issuers for ESG criteria including fossil fuel and nuclear involvement, controversial business activities, and UN Global Compact compliance. The index is based on the Solactive Green Bond EUR USD IG Index.	SGRESGIG Index

Source: Lyxor International Asset Management

For more information on Lyxor ETF's ESG range please contact your Lyxor ETF sales representative.

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