Climate-focused investing – why the 'green bond' label isn't enough

By Thomas Leys.

Anyone at a farmers' market loading organic vegetables into their organic cotton tote bag is probably feeling good about doing such positive things for the environment. They're not using plastic, they're shopping local and supporting organic farming.

It would therefore horrify them to learn that, according to researchers, the greenhouse-gas emissions per vegetable delivered in a tightly packed lorry are generally lower than those of vegetables driven in a farmer's truck. And that organic cotton bag? Without pesticides, far more plants, water and resource are needed to produce the item. So much so, that shoppers must use it a staggering 20,000 times to have the same accumulative environmental impact as one single-use plastic bag.1

Being truly 'green', sustainable, or aligned to net-zero goals, is complicated. It's definitely not as simple as buying something with a virtuous label.

What are 'green' bonds?

In a bold initiative, the European Investment Bank issued the first 'green bonds' in 2007. Since then, the appetite for such bonds has soared: $3.5 billion (bn) worth were issued in 2010; by 2020, the value of new green bonds issued was $305bn.

These bonds are designed to direct capital towards projects with a positive environmental impact. This money is supposed to be used to mitigate the causes of climate change and build a greener future. As the Climate Bond Initiative puts it: "The green bonds era has begun—mobilising bond markets as a low-cost financing tool will be essential for the realisation of a low-carbon and climate-resilient economy."

Certainly, green bonds have had some positive environmental effect. However, relying solely on these instruments to solve the world's environmental problems is wishful thinking.

There aren't enough

The data reveals that not all sectors – and certainly not all the relevant sectors – are issuing enough green bonds. For example, the energy sector's operations cause 9% of all human-made greenhouse-gas emissions; the fuel it produces creates another 33% of global emissions. According to the International Energy Agency, to achieve a 1.5 degree Paris-agreed pathway, we should develop no new oil or gas fields. Given this, the energy sector should surely be utilising green financing? In 2020, the sector issued a little more than $1bn in green bonds, but raised $215bn in traditional bonds. That means less than 1% of the total debt raised was 'green'. This year's figures are similar.

Lack of oversight

Currently, there's not enough oversight to measure the differences green bonds make. A bond can be called 'green' even if it doesn't require a company to reduce emissions. Yes, there is 'impact reporting',

which may require the company to disclose project emissions. However, this doesn't necessarily translate into any company-wide commitments to reduce emissions.

In the property sector, companies are permitted to use refinancing debt to purchase 'green' buildings built a decade ago. In reality, no one builds or develops any new properties.

In the automobile sector, cars only have to emit less than 50g of CO2 per kilometre to be considered sustainable under new EU regulations, and only until 2026. And manufacturers sell plug-in hybrids as a low-carbon alternative to traditional vehicles. Policymakers consider these vehicles eligible for green bond status. However, recent research suggests hybrid vehicle can emit 2.5 times more CO2 than official tests indicate. 2

The risk of companies 'greenwashing' is also considerable, especially in emerging markets. According to the Climate Bonds Initiative, almost 8% of the green bonds issued in 2020, nearly $9bn, did not meet 'green' labelling standards.

Doing the homework

The only way to uncover the reality of green bonds is by doing the necessary research. Scrutinising the use of proceeds, impact reporting and alignment with recognised standards is important. The issuer's overall ESG credentials are also crucial. For example, in our view a utility company that doesn't have coal phase-out plans issuing a green bond to finance renewable projects raises serious questions.

That said, there are many good green bonds out there. Energias de Portugal is a vertically integrated electric utility that's a transition leader: 54% of its outstanding euro debt is green – a strong indication of its desire to transition to a low-carbon world. In our view, the company has an excellent track record of reducing emissions, and continues to raise the bar. This year, it set the target to reduce scope 1 and 2 emissions by 90% by 2030.

We previously highlighted some of the auto sector's shortcomings. However, as with any industry, some companies are doing better than others. Take Volvo. As of last year, every new car it sells will be a hybrid or full electric vehicle (EV). It has pledged a climate-neutral production by 2025 and value chain by 2040. It has set science-based targets, while its green bond framework offers extremely detailed disclosures around its exclusions criteria. We think these measures set a high bar for other automakers looking to issue green bonds.

At the country level, we have Chile. Here, the government is enacting aggressive decarbonisation policies and carbon budgets to support a net-zero economy by 2050. In 2019, Chile was the first Latin American country to issue a green bond that directs proceeds towards climate resilience projects. These include flood-defence infrastructure, efficient irrigation systems and upgrades to water-waste management – all essential in addressing the physical risks of climate change.

What does this mean for investors?

Asset managers can also play a crucial role. By developing bond funds that seek to help the transition to net zero, they can help channel capital where it's needed most. For investors, this creates opportunities to put their money to work in areas of greatest need, while still seeking to secure their own financial futures.

Policymakers are also helping. For example, in March the EU initiated its Sustainable Finance Disclosure Regulation. This compels financial market participants and advisers to provide more detailed sustainability-related information. The goal is to give investors the critical information they need to make decisions in line with their sustainability goals.

Final thoughts…

It's important not to avoid sectors in a knee-jerk fashion. No matter the sector or company, in the transition to a net-zero economy, we must ensure capital is allocated where it's required and where it can have the biggest impact. No one should be left behind.

Companies selected for illustrative purposes only to demonstrate the investment management style described herein and not as an investment recommendation or indication of future performance.