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The sleeping giant

Bond markets are critical in the fight against climate change (part 1)

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Fidelity INTERNATIONAL

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Bond markets are critical in the fight against climate change (part 1)


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Fixed income investors have a vital role to play in accelerating the shift to a net zero world by 2050. In the first of this two-part series, Kris Atkinson and Sajiv Vaid, portfolio managers of our actively managed climate focussed fixed income strategies and our sustainable sterling corporate bond strategy discuss the challenge of climate change for bond investors and how debt markets are uniquely positioned for investors to support the transition to net zero and to influence companies towards net zero.

The enormous challenge of climate change

We believe climate change poses one of, if not the most, significant risk to the long-term profitability and sustainability of companies. Investors are exposed to climate change not only through its direct physical impacts on corporations, but also through transition and disintermediation risks from the move to a low carbon economy.

The physical effects of climate change include extreme weather events affecting agriculture and food supply, infrastructure, precipitation, and water supply. Transition and disintermediation risks concern the ability of companies to plan and execute climate-related changes in their operations, including how they manage policy developments such as the EU Sustainable Taxonomy for economic activities, changing consumer preferences and greater scrutiny of supply chains.

The challenge of mitigating climate change is complex, long term and will require a transformation of the global economy. A key feature of any transition to net-zero emissions is its universality, across energy and land-use systems and throughout the global economy. This universality extends to the investment community.

Why climate change matters to bondholders

Shareholders are not the only ones that lose out when companies misbehave - bondholders are also affected. In fact, while equity investing is about picking winners, credit investing emphasises avoiding the losers, so risk exposure takes precedence. We believe that a company's creditworthiness is directly linked to the way it behaves. An organisation's governance structure, corporate behaviour and its impact on the environment and society, all affect how it will perform.

Credit quality is a complex subject to evaluate, but broadly speaking it is a function of a company's profitability, productivity, industry positioning, cost of capital and future value. These characteristics can be intrinsically connected to sustainability credentials. For example, climate change regulations affect capital expenditure and operating margins, and any breaches of environmental laws can reduce a business's cash flows.

On 29 January 2019, the **Pacific Gas and Electric Company (PG&E)** filed for bankruptcy protection following a series of wildfires between 2015 and 2018. PG&E was blamed for improperly maintaining their power lines and faced potential liabilities of US$30 billion for wrongful death, personal injuries, property loss, business losses, and other legal damages. This case is widely regarded as the first "Climate Bankruptcy" and demonstrates how inadequate governance and controls can impact fixed income investors through legal and reputational events. It is therefore essential for investors to assess the sustainability profile of an issuer within a standardised framework.

If investors do not incorporate climate factors into their investment analysis, they could face more risk events. The IPCC Climate Mitigation report is clear that the economy either significantly accelerates the process of decarbonisation or contends with higher risks of warming related events such as extreme weather. If we experience more extreme weather, all companies will face higher physical risks to their assets, and those companies that fail to keep up with decarbonisation will undergo more intense competition and could fail.

While climate change poses risks that could lead to financial losses, there are also opportunities for creating value. Companies that can develop sustainable solutions such as electric vehicles and renewable energy sources, or adaptations such as flood protection, building reinforcements and new forms of agriculture, can generate above normal cash flows, potentially boosting the value of their securities. Bond investors who understand both the risks and opportunities of climate change are better placed to identify the winners and losers of the transition to a low carbon economy.

Untapped potential

The unfortunate reality is that, when it comes to the climate, global capital markets currently finance more harm than good.

Annual fossil fuel bond issuance still outstrips green bond issues despite the latter's rapid growth. Even with the advances in transparency in the green bond market, most bonds traded on debt capital markets still provide little information about their environmental impacts, with only 10% of global bond issuances in 2021 detailing specific labelling of their ESG benefits.

As it currently stands, the bond market, which trades around US$1 trillion each day, has enormous but unrealised potential in supporting the transformation to a carbon neutral world. However, there is substantial scope for this to change. According to a report by McKinsey, capital spending on physical assets for energy and land-use systems to transition to net-zero is estimated to require up to an additional US$3.5 trillion each year from 2021 to 2050. The bond market has a central role in plugging that funding gap and it also has some specific characteristics that give it an edge in influencing how corporations do business and offer investors a unique way of addressing the climate problem.

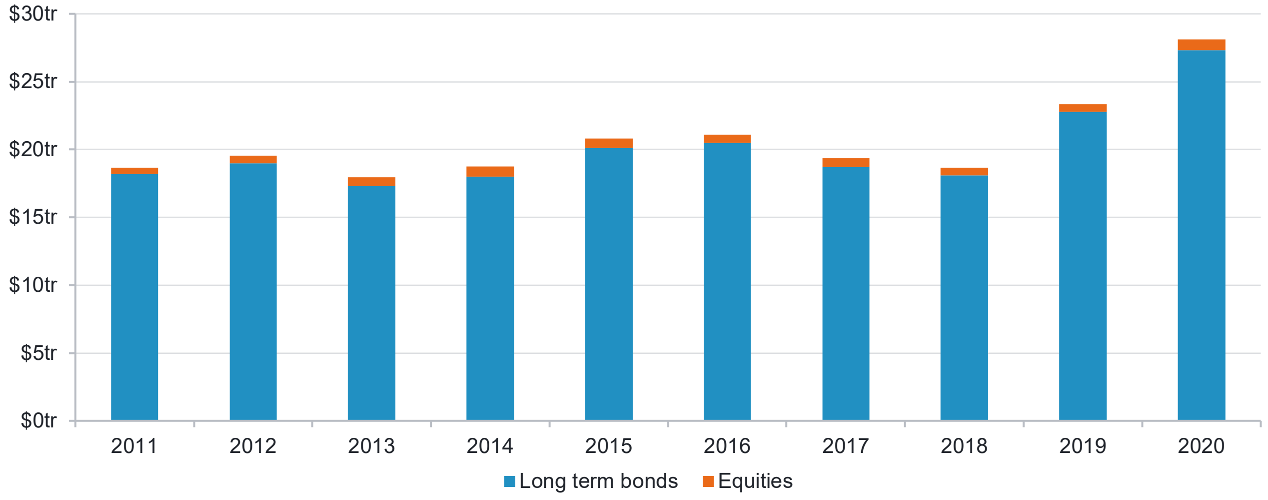
The sleeping giant

It is often thought that equity markets play the foremost role in urging issuers to become more sustainable, and bond markets are more marginal actors. However, we believe fixed income investors have a vital role to play and in some ways are better positioned than equity markets to exert pressure and promote positive change. The size of the bond market, frequency of bond issuance, breadth of issuer type, possibility of targeted capital deployment via sustainable debt instruments are all unique advantages bond investors have in addressing climate change.

Size of the bond market: The bond market is bigger than the equity market. The Securities Industry and Financial Markets Association (SIFMA) estimated that at the end of 2020, global bond markets were worth US$123.5 trillion compared to the equity market's US$105.8 trillion. In the US, bonds outstanding are US$47.2 trillion compared to equities valued at US$40.7 trillion.

Frequency of issuance: Companies tap bond markets for new issues far more regularly and in greater size than equity markets. This facilitates a close relationship between fixed income investors and corporate executives, giving bondholders frequent touch points with which to influence management teams.

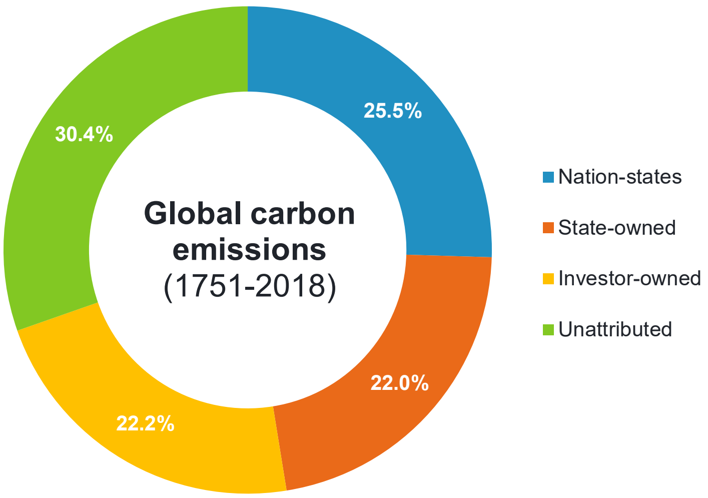
Bond issuance dwarfs equity issuance



Source: SIFMA, July 2021.

Breadth of issuer type: Bond markets also comprise public and private businesses, in contrast to equity markets, which are only involved with listed companies. In addition, governments, local authorities, and supernational institutions issue debt, not shares. This is important given non-listed entities are responsible for significantly more carbon emissions than public companies.

Publicly listed companies are responsible for less than a quarter of total emissions



Source: The Climate Accountability Institute, December 2020.

Targeted capital deployment: Fixed income markets also provide capital at the issuer and asset level, allowing investors to deploy capital in more targeted ways and monitor how the capital is being used through covenants and other metrics. This gives bondholders a much broader and diverse counterparty profile than shareholders.

Sustainable debt instruments: Bond markets also provide investors with the ability to invest in securities designed to finance specific projects (such as green bonds, social bonds and sustainability bonds) or align with client interests via sustainability linked bonds.

In the second part of this series, we will discuss the practical steps and strategies required to incorporate climate risks in bond investing, including engagement case studies.

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