

When “good” bonds yield more

Issuers that combine environment, social responsibility and governance are rewarded by the market. Here's how

by **Patrizia Puliafito**

Sustainability is more and more often the centre of attention of the investment world. Investors are increasingly more interested in products that integrate ESG criteria (environment, social responsibility and good corporate governance). Asset managers are in a frenzy to prepare themselves for the new challenges. According to some recent findings provided by the Global Sustainable Investment Alliance, worldwide, the products built according to sustainability criteria in the past two years have increased by 34%, reaching a net worth of over \$30,700 billion (or 38% of total volumes). Europe is at the top of the leader board with \$14,000 billion, followed by the USA (\$12,000 billion) and Japan (\$2,000 billion). In Europe, Morningstar has identified 2,800 funds that can be labelled as socially responsible or sustainable. But we have only just begun. Exponential growth is expected for the future. So, with the objective of clearing a few things up, Banor SIM and the Politecnico di Milano School of Management carried out two studies to verify how much ESG factors influence portfolio return, for both equities and bonds. The result was positive in both cases, demonstrating that ESG factors have become fundamental in the process of selecting securities. Essential also for analysing issuers, but with some differences. “The research carried out last year,” explained Angelo Meda, Banor SIM Research Manager, “highlighted that investors expect long-term value from shares, and that it was the specific combination of the two value strategies (look for undervalued securities with slow and constant growth, Ed.) and ESG that generated the best results, compared to alternative or passive strategies. As regards bonds, the subject of this year's study, it was shown that investors are more interested in short-term return, and therefore place more importance on the issuer's solvency, which is determined by good governance practices, achieved by respecting the environment and social responsibility. This confirms the importance of all three ESG factors, whose impact on the issuer and financial instrument must be assessed individually.”

In practice, in the bond market, investors are interested in the relationship between ESG and credit risk, or how environmental, social and governance factors can influence the solvency of the issuers.

Those with a high ESG rating appear to be less risky in the short- and mid-term, and this effect is again due to good governance. Meda added: “It was also noted that investors' interests and related research drivers vary based on the type of instrument and issuer, distinguishing between corporate and sovereign bonds.”

Companies

In particular, as regards corporate bonds, various studies show how a high ESG rating can reduce the cost of debt. In fact, high ratings in the environment category lead to a rating improvement, and companies most mindful of corporate and social responsibility issues are rewarded with good yields. “There are no significant differences in the yields when considering only the ratings for the environment and social categories, whereas the governance component makes a difference and is responsible for the significant part of the differential yield”, explains the study.

For the research, 536 bonds listed between January 2014 and December 2018 placed on the European markets by large and medium-sized companies, with listed and non-listed risk capital, were examined. Convertible bonds and those placed by banks and real estate investment companies were excluded from the analysis.

In order to study the relationship between ESG ratings and returns on equities and bonds, the Khan approach used on the American market was used. Namely, a series of relevant indicators was defined for ESG purposes (materiality principle) for every economic macro-sector, achieving a standardised measurement of the ESG rating for every company. The issuing companies were then divided into two groups based on their high or low ESG rating.

The market performance was then measured in terms of total returns. By checking for the financial rating and the duration of the bonds using an algorithm, it was seen that the bonds of companies with a high ESG rating offered a better price premium compared to those of companies with a low ESG rating, in both investment grade and high-yield categories, with a lower funding cost.

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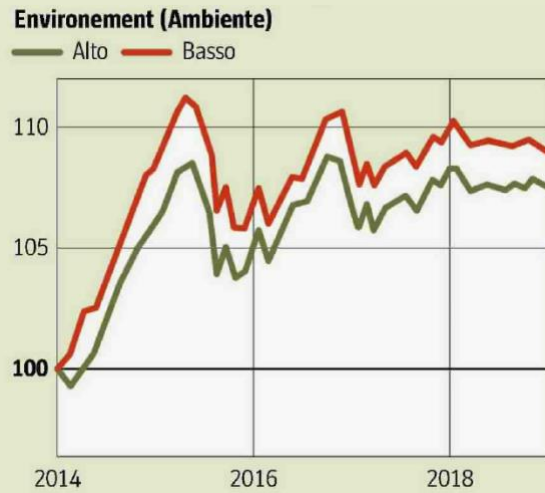
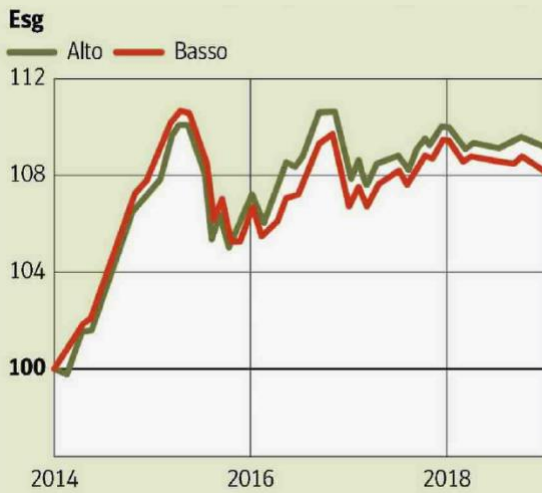
Banor SIM
Massimiliano Cagliari, founder of Banor SIM, which carried out the research on ESG assets



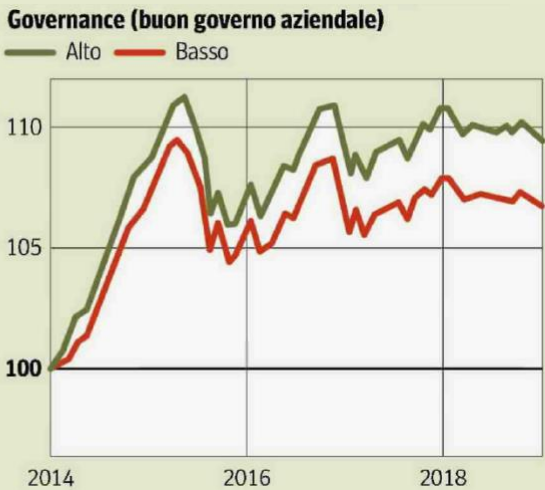
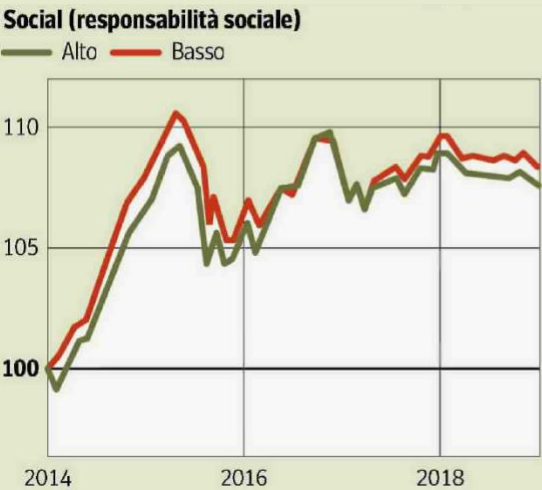
PoliMi
Giancarlo Giudici, professor at the Politecnico di Milano School of Management

The comparison

Yields for the most reliable (investment grade) bonds according to ESG rating. In the first summary graph, the ESG bonds win overall. By analysing the individual parameters, a clear victory is only had in the case of good governance



Source: Banor SIM and Politecnico di Milano School of Management



Esg	ESG
Environnement (Ambiente)	Environment
Social (responsabilità sociale)	Social (Responsibility)
Governance (buon governo aziendale)	Governance
Alto	High
Basso	Low