

SUSTAINABLE INVESTMENT OPPORTUNITIES WITHIN FIXED INCOME

By James Rich, Chairperson of the Sustainable Investment Committee







Key takeaways

- *The secular shift toward sustainability presents numerous opportunities to invest alongside long-term sustainability megatrends within corporate credit, structured securities, sovereign and municipal bonds.*
- *Opportunities exist across five key sustainability pillars—climate change, eco solutions, resource efficiency, health and well-being and sustainable growth. Furthermore, these opportunities align with the United Nations Sustainable Development Goals.*
- *Sustainable fixed income investing requires a tailored, research-intensive approach to assess the sustainability and economic potential for various fixed income sectors and issuer types.*
- *Incorporating sustainability into a core fixed income strategy may provide competitive returns along with creating a positive impact on the global economy, environment and society.*

Opportunities to align with sustainable megatrends

A secular shift toward sustainability is underway, bringing with it an evolution of business practices, products and services¹. Consumers are demanding sustainable products and services and investors are prioritizing asset allocation to sustainable companies. As a result, sustainability, once more of a burden for some industries imposed by government regulations, has become a competitive advantage for other companies. Combatting climate change is just one example. Sustainability efforts extend to other initiatives too, including selling healthier, unprocessed foods, utilizing recycled materials as inputs, improving access to affordable healthcare, and enhancing the quality of education. These changes in the global economy present numerous opportunities to invest alongside what we view as long-term sustainability megatrends (Exhibit 1).

Exhibit 1: Examples of sustainable megatrends

	Sustainable Megatrend	Key Industries Affected		Description
	Alternative Energy	Utilities	Energy	Coal generation is expected to decrease from 30% to 17% ² . Alternatives will likely increase, a trend we expect will continue to accelerate. Alternatives, such as solar, wind and geothermal, are renewable and carbon-free. Demand for fossil fuels from utilities may decline as a result.
	Vehicle Electrification	Automotive Transportation	Energy	Regulation changes have largely driven this shift so far, but citizens are increasingly demanding it. Hybrid and electric vehicles are expected to grow to 30% of light vehicle sales volume globally by 2030 ³ . Demand for gasoline from cars may decline as a result.
	Energy Efficiency	All		Reducing the energy intensity of virtually every part of the global economy. From green buildings to smart meters to mass transit to cloud-based computing to energy-efficient paint, innovation and investment opportunities in this area appear to be boundless.
	Sustainable Agriculture	Agriculture Food & Beverage	Consumer Products	Current “factory farm” food system trades off long-term maintenance of the environment for short-term agricultural production. Recent studies suggest that ancient farming methods such as crop rotation and multi-cropping generate competitive yields ⁴ while promoting soil health, limiting water pollution and improving farmer incomes.
	Healthy Food	Food & Beverage Agriculture	Consumer Products Grocers	Evidence continues to mount that ultra-processed, sugar-saturated foods that have dominated grocery store shelves for decades are harmful to humans' health. Consumers have taken notice and are demanding healthier options and more of basic foods like vegetables, fruit, nuts, meat and fish.
	Affordable Housing, Education and Healthcare	Homebuilders Building Products Real Estate Education	Hospitals Pharmaceuticals Healthcare	As populations climb globally, so does the need to ensure that quality housing, education and healthcare remain accessible to lower and middle-income world citizens. Each is a critical component of preserving a harmonious society.

¹Source: Aegon AM US - The Secular Sustainability Shift - April 2019.

²Source: US Energy Information Administration's Annual Report 2019.

³Source: Boston Consulting Group (BCG) estimates.

⁴Source: <https://royalsocietypublishing.org/doi/full/10.1098/rspb.2014.1396>

A proprietary sustainable investing framework

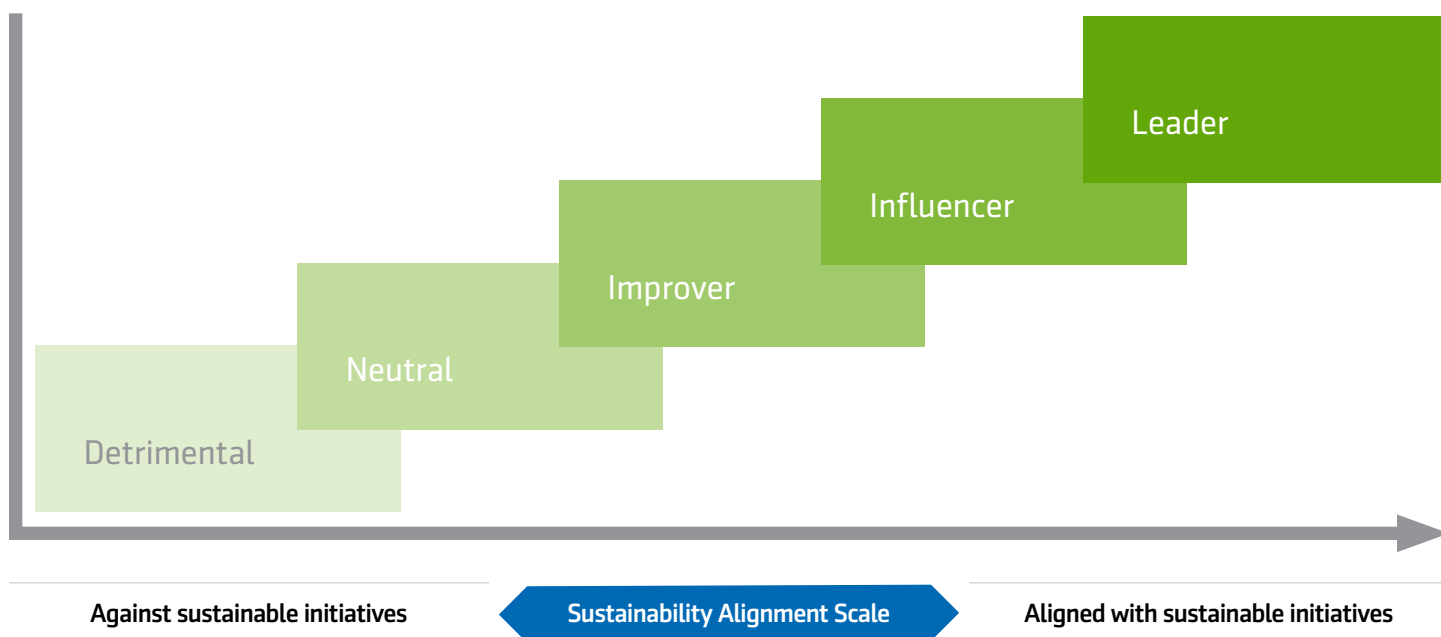
In an effort to align a fixed income portfolio with these and other sustainable megatrends, we developed a proprietary process to assess the sustainability and economic potential of fixed income investment opportunities.

Our process goes beyond the traditional information available and applies the proprietary research conducted by our corporate, structured and emerging markets analysts. We believe the insights provided by our traditional research and Responsible Investment teams helps us to make better-informed decisions on sustainability for our clients. Over the years, our seasoned research analysts have developed a keen understanding of issuers' products and services, as well as the industries they operate within. When they need additional clarity on the sustainability of an issuers' operations, they utilize our Responsible Investment team to tap into decades of combined sustainability-specific expertise.

Sustainable investing also requires a tailored approach for each fixed income sector and issuer type. Corporate, structured and sovereign issuers each present unique challenges that must be dealt with individually. For corporates, we assess the percentage of revenues, products and services, and/or assets, tied to sustainable initiatives to determine sustainability. For securitized, we look for collateral contribution or organizational support for sustainability. For sovereigns, we consider each country's capital usage, sustainability trends and health and wealth levels relative to its income per capita. For municipals, we evaluate the mission, mandate and revenue base of each issuer for alignment with sustainability trends. Irrespective of the issuer type, we also consider whether or not the issuer has material operations or outstanding controversies that are against sustainable initiatives.

In the end, we assign issuers to one of five categories: Leader, Influencer, Improver, Neutral and Detrimental, which are based on the perceived level of alignment with the sustainability megatrends (Exhibit 2). Within our [Sustainable Fixed Income](#) strategy, the Leaders, Influencers and Improvers are eligible for investment candidates.

Exhibit 2: A proprietary approach to categorizing issuers' sustainability profile



Source: Aegon AM US. Simplified chart for illustrative purposes only.
























Investment opportunities across five sustainability themes

While the United Nations' Sustainable Development Goals (SDGs) are a useful tool to help determine sustainability, in practice the goals were not designed for private investment. Rather, the SDG mandate was essentially written to spur governments to make policy changes that in turn, prompt private investors to move in the right direction. We view the SDGs as one of the many tools to support sustainable investment practices, but they are not the solution in itself. Instead, we believe it's important to have a way to independently assess sustainability.

Using a five-pillar scheme to categorize opportunities, we've identified investment candidates across various fixed income sectors including corporate credit, structured securities and sovereign bonds that tie to sustainable megatrends (Exhibit 3). Moreover, we found that many of these opportunities also connect to the Sustainable Development Goals.

Sustainable investment opportunities

Opportunities to align fixed income portfolios with sustainability initiatives exist across many sectors

Sustainability Pillar	Climate Change	Eco Solutions	Resource Efficiency	Health & Well-being	Sustainable Growth
Investable areas	<ul style="list-style-type: none"> • "Green" buildings • Recycling and composting services 	<ul style="list-style-type: none"> • Renewable energy • Hybrid/electric vehicles • Cloud-based computing 	<ul style="list-style-type: none"> • Use of recycled inputs • Sustainable agriculture • Water services 	<ul style="list-style-type: none"> • Nutritious, sufficient food • Personal hygiene • Medicines and vaccines • Educational services 	<ul style="list-style-type: none"> • Affordable housing • Mass transit • Stable, effective sovereign governments
Sector examples	<ul style="list-style-type: none"> • Environmental • SASB CMBS • REITS • Green bonds 	<ul style="list-style-type: none"> • Technology • Automotive • Solar ABS 	<ul style="list-style-type: none"> • Agriculture • Paper/packaging 	<ul style="list-style-type: none"> • Consumer products • Pharmaceuticals • Student loan ABS 	<ul style="list-style-type: none"> • Agency MBS • Sovereigns • Transportation
Related Sustainable Development Goals*	      		  	     	     

Source: Aegon AM US. *The Sustainable Development Goals were developed by the United Nations in 2015 to serve as a blueprint for achieving 17 goals related to achieving a more sustainable future.

Pursuing better outcomes

While the potential for competitive financial returns may be a benefit of investing alongside the secular sustainability shift, another benefit may also be the positive impact investors can have on the global economy, environment and society. Actively choosing to invest in sustainable issuers may help to lower issuers' cost of capital and reduce the return hurdle required for the continued development of their sustainable products, services and business practices. This could have the follow-on effect of encouraging issuers to continue their sustainable ways because the market rewards them for doing so. On the other hand, actively choosing to avoid unsustainable issuers may have the opposite effect: it raises issuers' cost of capital and ultimately discourages them from continuing their unsustainable ways.

Evaluating impact and engaging with issuers

On the surface, the ability to make an impact as a lender may be hard to grasp. Contrary to equity investors, fixed income investors don't have ownership in a company and lack the ability to vote or force a company to change. However, bondholders can still make an impact by providing financing to issuers with sustainable products, services or business practices. The flow of capital toward sustainable issuers may lower the cost of capital for sustainable issuers, thus encouraging sustainable practices and making a contribution toward a more sustainable world.

While the effect may be negligible when sustainable fixed income strategies have few investors, as the movement multiplies and more investors embrace sustainable strategies, the broader impact has the potential to be meaningful. Additionally, if investors are proactively engaging with issuers and are encouraging them to pursue sustainability by helping them finance their sustainable initiatives (i.e., through the issuance of green, social and sustainable bonds), the potential will continue to grow.

Related literature

[The Secular Sustainability Shift](#)
[Enhancing ESG Integration: The Value of an Independent Research Assessment](#)
[Three Reasons to Invest Responsibly](#)
[Electric Power Sector to Drive Success of Electric Vehicles](#)
[Global Emissions Standards Driving Hybrid and Electric Vehicle Growth](#)
[A Solution to the Plastic Problem Presents Risks to the Chemical Industry](#)
[How we Incorporate ESG](#)

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