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SPECIAL REPORT

Responsible Investing

A review of the Derivatives Forum Frankfurt 2021

Industry matures to meet growing demand for ESG investing

Environmental, social, and corporate governance (ESG) investing has long been embedded in equity markets. However, the approach is gaining significant traction in fixed income markets with the unstoppable rise of sustainable bond issuance and asset managers' increasing desire to apply ESG to their credit portfolios. As the market grows, an institutional ecosystem is being constructed to support it, solving some of the challenges investors face today.

According to Moody's, sustainable bond issuance reached record volumes of USD 491bn (EUR 411bn) last year. That number is expected to exceed USD 650bn (EUR 545bn) this year, comprising USD 375bn (EUR 314bn) of green bonds, USD 150bn (EUR 125bn) of social bonds, and USD 125bn (EUR 104bn) of sustainability bonds.

BloombergNEF estimates that the total sustainable debt market exceeded USD 730bn (EUR 618bn) last year, an increase of 29% from 2019. Other estimates put the total market size as high as USD 1tr.

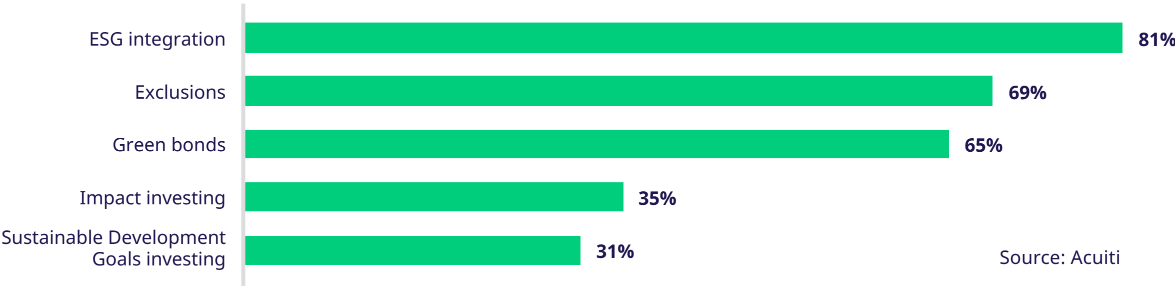
Governments worldwide are ramping up issuance programs, with the U.K. planning to sell GBP 15bn (EUR 17.5) of green bonds this calendar year in two "green gilt" issuances. Meanwhile, the EUR 750bn Next Generation EU recovery fund has earmarked 30% for green investments.

Corporations are also issuing green bonds and other instruments tied to specific sustainability projects. In addition, a vibrant market is developing for sustainability-linked bonds issued with coupons linked to specific key performance indicators (KPIs) around ESG targets. These instruments provide corporations with more flexibility in the use and disclosure of issuances than sustainable bond issuances while also enabling them to attract investment from credit investors with ESG mandates.

Investors are increasingly integrating ESG strategies into portfolio selection with similar exclusions or best-in-class strategies that mirror their approach to more established asset classes. In doing so, they join pioneers such as Kames Capital, now part of Aegon Asset Management, which has long applied ESG to credit investment.

A survey by Acuiti commissioned by Eurex last year found a broad mix of approaches among asset managers to ESG investing in fixed income, with ESG integration topping the list, followed by exclusions and green bond strategies.

What type of ESG strategies does your organization implement in fixed income?



"ETFs and ETF derivatives began as pure OTC instruments. An electronic market has developed and it did so alongside the OTC" says Lee Bartholomew, Head of Fixed Income and Foreign Exchange Product Development at Eurex. "This mix contributed to a healthy ecosystem with strong liquidity."

"Within Europe, it was important for the ETFs derivatives markets to have lit markets to create transparency, which allows pockets of the value chain such as securities lending to develop. When you are looking at ESG, it is not a case that one instrument or approach is better than others but critical to create a portfolio of products that builds a complimentary ecosystem that will better facilitate trading strategies and mitigate risk in things like portfolio strategies."

Currently, the amount of trading in ESG derivative products for fixed income is limited, as investors predominantly execute portfolio trades. This is likely to remain the dominant trend until portfolios become "ESG enough" to accommodate all inflows into the asset class, says Abel Elizalde, Global Head of the Credit Market Strats Team at Goldman Sachs.

"Once that process is complete, the focus will become less about portfolio construction and more about directionality, managing views, inflows, [and] outflows. That will lead to greater use of ETFs, futures, and other directional products to manage risks," he predicts.

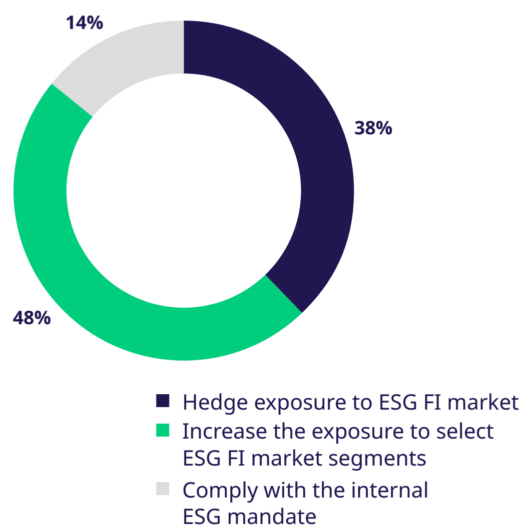
Dennis Hänsel, Global Head of ESG Advisory at DWS, says: "Clients are increasingly asking us to integrate ESG into fixed income and the market is developing very quickly. Previously, we had typical portfolio products based on exclusion and now we are observing a trend to multi-dimensional ESG approaches with best-in-class approaches for all investments. However, we are increasingly looking to use ETFs and derivatives to provide greater flexibility to our ESG portfolios/solutions in terms of risk management and alpha."

"For new products, we have a clear ESG default position. So, all new products we trade must incorporate ESG factors. We need the derivatives for risk management and then we can start to offer flexible and bespoke solutions where we manage market risk and in- and outflows with derivatives without changing the underlying ESG investments as we currently do very efficiently on the equities side."

Research by Acuiti last year found strong demand from asset managers for the product and indications of a natural two-way market with different firms planning to use listed futures on bond indices to hedge exposures in the ESG fixed income market and to increase exposure to select ESG fixed income market segments.

Among the respondents from the top 50 European asset managers by AUM, 38% said they would use the future to hedge exposure. In contrast, 48% would use it to increase their exposure and 14% would predominantly use it to comply with an ESG mandate.

What would be the main purpose for using a listed future on a bond index?



Source: Acuiti

Elizalde identifies four factors that will drive buy-side involvement in the market. "Firstly, there is the appeal of the product, which, in ESG, is clear," he says. "Second, is how the products are priced and whether there is upside from doing so. Then, there is the question of how big the market is in terms of AUM. Finally, there is liquidity and how easily investors can hedge, move risk, and execute overlays."

"We have gone through the first three phases, and now we have to build liquidity and show investors that there are enough derivative alternatives to manage risk effectively. That is the biggest challenge for ESG in fixed income today."

Launching any new futures product is a challenge. Doing so on an ESG-benchmark in a market with no deep, existing listed liquidity pools will be an even greater one. Still, Hänsel says that if the market comes together to trade the products, it will create a new opportunity for asset managers and their clients.

"In 2020, ESG futures in equities became liquid enough for us to use them to handle market risk," he says. "When we see the same liquidity and standardization on the listed side in fixed income, I strongly believe that our clients will use them."

"They are looking for more innovative ESG products and investments, and we must show them that it is possible to get all the exposure they need to meet their sustainability targets."

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