Inflation and rates typically decline during recessions, meaning bonds tend to deliver total returns superior to their yield levels. (UBS)

Sustainable bonds — How to create a more resilient portfolio

21 November 2022, 4:21 pm CET, written by UBS Editorial Team

The UBS Chief Investment Office (CIO) believes that investors in sustainable bonds will receive returns that are comparable with otherwise identical traditional bonds.

Sustainable bonds, which include green and social bonds, represent a sustainable alternative to both high-grade bonds (from supranational and many government issuers, with the highest credit ratings) and investment grade (IG) corporate bonds (from corporate issuers, with mid to high credit ratings). Sustainable bonds have an identical claim against the issuer as non-sustainable bonds do, as well as the same credit rating/default risk. They therefore typically offer the same yield and similar performance.

Sustainable bonds can be issued as senior unsecured, subordinated (hybrid), or secured (covered) bonds. With the sustainable investment market growing rapidly in recent years, labeled sustainable bonds have gone from being an innovation to a diversified and liquid asset class. Individual sustainable bonds should continue to perform in line with non-sustainable bonds from the same issuer. Performance differences on an index level are mainly attributable to the different characteristics of the indexes.

Sustainable bonds face the same market constraints as traditional bonds. Since the beginning of this year, interest rates and credit risk premiums have increased strongly. Bond yields reflect the expectation of further steep interest rate hikes from central banks and decent carry yields make positive total returns more likely over the next 12 months, in our view. Several countries are in recession, and it remains a significant risk case for many others. Inflation and rates typically decline during recessions, meaning bonds tend to deliver total returns superior to their yield levels.

Credit spreads also increase in recessions, but to a lesser extent for IG bonds compared to riskier high yield or emerging market bonds. In line with traditional fixed income investing strategies, we think sustainable bond investors can lock in a decent yield by selecting solid and more defensive issuers, with the potential to perform better than expected and outperform equities in a downside economic scenario.

We additionally see select opportunities in sustainable bonds with shorter tenors and somewhat higher credit risk than benchmark indexes. Selectivity and short tenors should result in lower volatility, and an inverted yield curve in US dollars offers higher levels of income, in our view. The typically long-term investment horizon of sustainable investors may also lessen volatility in such exposures.

Takeaways for investors

- We believe that investors in sustainable bonds receive returns that are comparable with otherwise identical traditional bonds.
- The sustainable bond market continues to grow, and new issuers and issues provide additional choices for investment portfolios.
- Given the rise in rates volatility and increased growth concerns, spreads on green, social, and sustainable bonds have increased by around 80 basis points this year to roughly 155bps, compared to a long-term average of 73bps. We think the asset class offers attractive yield levels and refer to our investment research on sustainable bonds for specific ideas.

For more on COP27 and adding diversification to your portfolio, see the full report Sustainable Investing Perspectives: Sustainable bonds, COP27 and the energy treaty, and value exposure 10 November 2022.

Main contributors: Amantia Muhedini, Antonia Sariyska, and Michaela Seimen Howat

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