SUSTAINABLE FIXED INCOME SECURITIES: POISED TO OUTPERFORM?

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You have likely seen headlines in the financial press this year disparaging the performance of ESG fixed income investments. Exhibits 1 and 2 illustrate why: overall fixed income performance has declined during 2022 with the total return of the Bloomberg MSCI US Aggregate ESG Weighted Index underperforming the total return of its non-ESG counterpart, the Bloomberg US Aggregate Bond Index, year-to-date by about 20 bps.

Exhibit 1: Overall performance declined 1H 2022

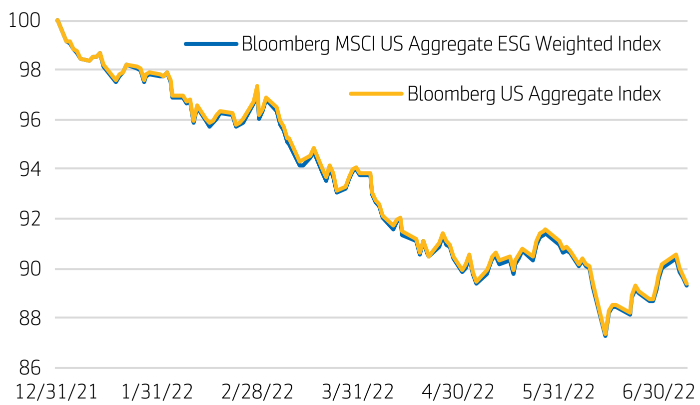
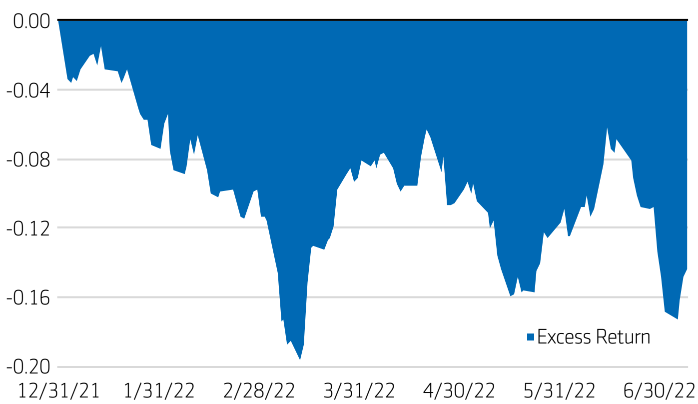


Exhibit 2: ESG aggregate underperformed non-ESG counterpart



Source: Bloomberg as of July 8, 2022. Returns normalized as of December 31, 2021. Excess return represents the total return of the Bloomberg MSCI US Aggregate ESG Weighted Index minus the total return of the Bloomberg US Aggregate Bond Index.

There are several probable reasons for this underperformance.

1. **Energy outperformed.** Some of the least sustainable-friendly sectors in the US aggregate index, such as integrated energy and independent energy, have performed the best. Oil prices rose from $75/barrel at year end 2021 to above $120/barrel in early June 2022 amidst the Russia-Ukraine situation. Many of those energy companies are not represented in the ESG aggregate index.

2. **Demand slowed.** While demand for sustainable investments outstripped supply in 2021, most investors have focused their efforts on stopping the bleeding in their overall portfolios in 2022 rather than continuing to march toward a more sustainable portfolio, thus reducing demand for ESG-specific issues.

3. **Duration mismatched.** Duration mismatches can easily be managed by portfolio managers, but at the index level, the ESG aggregate index began the year about 0.12 years longer option-adjusted duration relative to the US aggregate index. Normally that would be insignificant; however, in a year like 2022 where the 10-year Treasury rose by almost 200 bps from the beginning of the year to its peak a couple weeks ago, it's made a difference.

Headwinds become tailwinds?

As we start the second half of 2022, each of these headwinds may be poised to flip to tailwinds. Oil prices have already dropped to about $100/barrel as fears of a recession, and with it the potential for declining oil demand, take hold in the markets. More importantly, little has accelerated the desire to transition away from traditional energy to renewable energy sources more than Russia's invasion of Ukraine, particularly in the European Union. And lastly, if the Fed successfully slows inflation, with or without a recession, the markets will likely transition to pricing in a recovery in 2023 or 2024, allowing investors to refocus their efforts on the long-term sustainability of their portfolios. And if there is a recession, let's not forget that the ESG aggregate index outperformed the US aggregate index by almost 40 bps during the pandemic-induced recession of 2020. If any or all the above are true, sustainable fixed income investments may be poised to rally as we head toward the end of 2022.

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