Understanding green bond performance in market setbacks

Green bonds have gained a reputation for providing better downside mitigation than their conventional peers. But this year, green bonds' defensive performances were mixed. What does this mean for investors?

By *Erin Bigley* and *Tiffany Wong*

We believe that the greater performance dispersion we've seen so far in 2022 makes a strong case for an active approach to investing in green bonds. With so many green bonds outstanding today, investors need sharper insights to help differentiate among them and to better understand each bond's performance characteristics.

Getting a grip on the greenium

Green bonds have typically been more highly valued than their conventional counterparts, and consequently have generally traded at somewhat higher prices and lower yields.

Expressed differently, a green bond typically exhibits a negative yield premium to conventional peers, also known as a greenium. When a green bond's greenium gets bigger (the negative yield premium becomes more negative), it outperforms comparable conventional bonds. So growth of the greenium is positive for a green bond's performance.

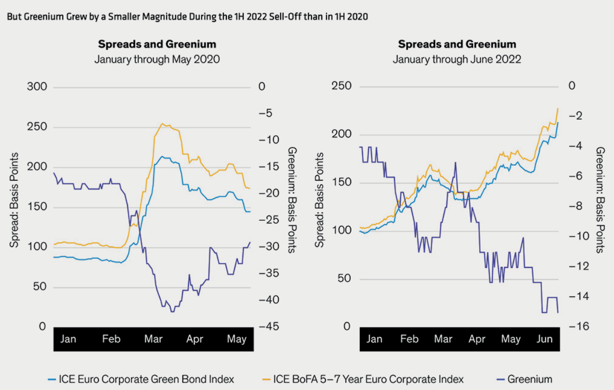
While in the 2020 risk-off period greeniums grew in lockstep, in 2022 greeniums moved to a lesser extent (see Figure 1) and with greater dispersion. In a minority of cases, green bonds didn't outperform at all.

Market data across a hundred representative euro-denominated corporate bonds show significant dispersion in performances across green bonds in the year to date. Although 80% of issuers saw their greeniums become more negative in the first half of the year (thus outperforming their conventional counterparts), 20% didn't. They so displayed no favorable downside mitigation characteristics (see Figure 2).

What's more, of the 80% of green bonds that saw their greenium increase, the magnitude of the changes differed materially, ranging from a few basis points (modest downside mitigation) to half a percentage point (strong downside mitigation).

This market behavior makes a compelling argument for an active approach to green bond investing and reinforces the idea that not all green bonds should be regarded as equal. In fact, we recently set out a comprehensive framework to analyze green bonds and other ESG-labeled structures.

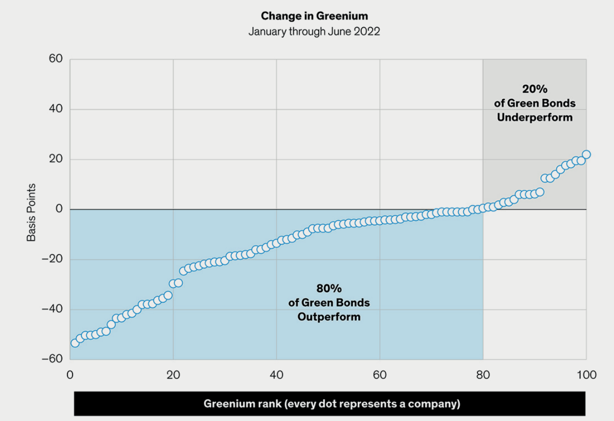
FIGURE 1: GREEN BONDS CAN STILL PROVIDE DOWNSIDE MITIGATION



Historical analysis does not guarantee future results.
Green bonds are represented by the ICE EUR Corporate Green Bond Index; investment-grade bonds are represented by the ICE Bank of America 5–10 Year Euro Corporate Index.
Greenium refers to pricing benefits based on the logic that investors are willing to pay extra or accept lower yields in exchange for sustainable impact.
As of June 30, 2022

Source: Bloomberg, ICE Green Bond Index data and AllianceBernstein.

FIGURE 2: RISING PERFORMANCE DISPERSION WARRANTS DILIGENT DIFFERENTIATION



Historical analysis does not guarantee future results.
Green bonds are represented by the ICE EUR Corporate Green Bond Index. Investment-grade bonds are represented by the ICE BofA 5–10 Year Euro Corporate Index. Chart assumes that greeniums are measured by the average spread of all the bonds in a ticker versus all the green bonds for a ticker. The extreme tails on top and bottom are cut off.
As of June 30, 2022

Source: Bloomberg, ICE Green Bond Index data and AllianceBernstein.

Bond market changes drive more differentiated performances

Does that mean that green bonds' defensive characteristics are eroding? Not necessarily. We think that green bonds can still offer favorable risk-mitigating characteristics relative to their conventional peers, but investors need to allow for several changes in bond markets that result from the increasing popularity of responsible investing. Although these will likely impact the size of the greenium, they are also helping to create a larger, broader universe of green bonds.

These are the four most notable trends in the green bond market:

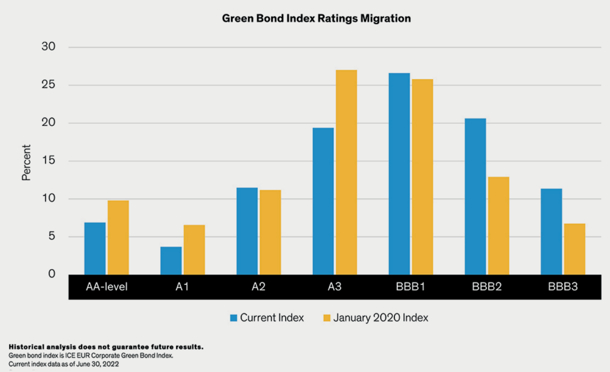
1. **Increased issuance**
   Green investing is moving into the mainstream. As the market matures, we have seen a significant increase in green bond issuance resulting in less scarcity value being assigned to some of these bonds, creating a more balanced dynamic between supply and demand.

2. **Wider sector representation**
   Higher issuance has also led to green bonds being issued across a wider range of sectors. Accordingly, the composition of the green bond universe has also changed over time: more skewed to cyclical sectors, less skewed to more stable sectors like utilities. This may have resulted in a higher sensitivity to changes in the growth environment in the first half of 2022 than during the first half of 2020.

3. **Lower average ratings**
   Increased issuance has created greater depth and diversity in the green bond market, not only across sectors but also across quality tiers. This has resulted in a lower average rating for green bonds (see Figure 3) and consequently higher credit sensitivity. This may have contributed to a decrease in the resilience of green bonds overall during risk-off periods in 2022.

4. **Wider investor base**
   Investor demand has changed too. The buyer base has expanded for green bond structures. Demand is consequently no longer driven solely by investors with longer-term horizons, such as institutions. More investors are embracing responsible investing and responding to changes in the regulatory environment, such as in the context of the SFDR in the EU.

FIGURE 3: GREEN BONDS INCLUDE MORE BBB-RATED ISSUES SINCE 2020



Source: Bloomberg, ICE Green Bond Index data and AllianceBernstein.

Over time, we would expect investors to become less willing to pay a greenium for weaker structures, particularly where the use of proceeds is only loosely linked to eligible green projects, or where the issuer and its industry could be more susceptible to greenwashing allegations. Conversely, strong issues should be more likely to continue to attract a buyer base willing to pay a greenium for quality bonds. These include, for instance, green bonds that have full EU Taxonomy alignment and whose issuers have very strong sustainability credentials.

We think that investors can still find green bonds with defensive characteristics. But we have also observed that the breadth and depth of the green bond market has significantly increased. That means investors need to differentiate more rigorously between green bond structures, based on careful evaluation of the characteristics of each individual issue. ■

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SUMMARY

Green bonds have traditionally outperformed their conventional counterparts.

In 2022 the defensive performances of green bonds have been mixed.

That does not necessarily mean that green bonds' defensive characteristics are eroding.

Changes in the market can be attributed to the increased issuance of green bonds, a wider sector representation, lower average ratings and a wider investor base.

A careful evaluation could help investors differentiate between green bond structures.

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