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Sustainability makes a bond rich

A high ESG rating for the issuing company yields up to 466 more basis points. A study by Banor and the Politecnico di Milano

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■ A bond issued by a company with a high sustainability rating performs better than bonds from companies with a low ethical rating. This is one of the more interesting conclusions reached by the research conducted by Banor Sim and the Politecnico Milano School of Management. The study conducted by Giancarlo Giudici, Matteo Bonaventura and Leonardo Isella investigates the relationship between the ESG (environment, social and governance) rating and the yield spread for bonds on the European markets.

METHODOLOGY AND ANALYSED SAMPLE

There were 536 bonds analysed, all of which are listed on European markets: 209 bonds are rated as investment grade and 327 are speculative grade (high yield). The selection of bonds focused on those underlying two Barclays ETFs, and the period of observation was from January 2014 to December 2018. Convertible bonds and bonds issued by real estate investment companies and special purpose vehicle companies were excluded from the study. The assessment of the sustainability of the issuing companies was done using the SASB Foundation method.

HOW MANY BASIS POINTS?

Getting straight to the point, the question is, "What is the difference in basis points between a company with a high ESG rating and one with a low rating?" The researchers used a very detailed method, propensity score matching, which enabled them to compare bonds with similar characteristics for rating, duration and other contractual clauses. The result? The matching procedure is highlighted in the graphs on this page. Over the 4 years that were analysed, in the investment grade segment, there is an advantage of 110 basis points in the cumulative yield for companies with a high ESG rating compared to those with a low rating. This difference rises to 466 basis points when the comparison is made between high yield bonds.

GOVERNANCE AND DEFAULT RISK

Bonds supporting the letters E (environment) and S (social) will be disappointed, as the true star of the Banor-Politecnico research is governance. For both of the bond categories, "what makes the difference," as the researchers wrote, "and what accounts for the difference in yield," is G for governance. What is the explanation for this? For bond investors (see also the interview below), "The concern is to avoid company default, and therefore considerations linked to the environment and social responsibility do not appear to be central". And also: "Good governance is, on the other hand, perceived as a fundamental factor for generating higher yields and reducing the risk of insolvency".

DISCOUNTED COST OF RAISING CAPITAL

Good practices in corporate governance, therefore, keep companies safe, and for investors this, "can be a sign of lower agency costs and lower risk of opportunistic behaviour and better monitoring".

What is the consequence? "A positive differential yield for bonds with a higher ESG rating, under efficient market conditions and for the same value of other parameters such as rating and maturity," highlighted the researchers, "can be explained as a 'discount' that investors have been prepared to accept on yield". All of this on the basis of best practice in corporate governance. Environmental and social responsibility, on the other hand, concluded the researchers, "do not yet seem to be perceived as indicators of greater solvency".

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The comparison

THE SELECTION OF BONDS AND THE USE OF MATCHING

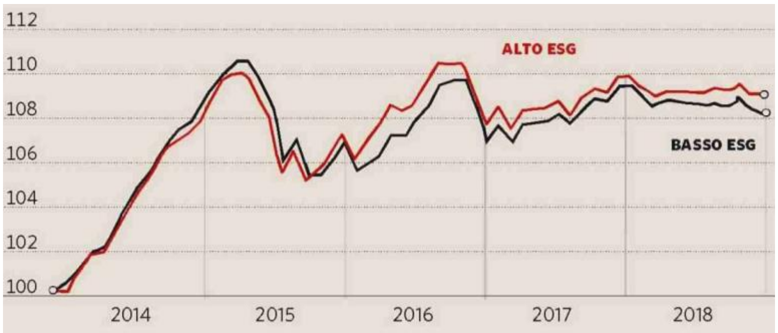
The propensity score matching method involves a comparison between two bonds that are similar in rating, maturity and other characteristics. This involved, as a consequence, a reduction in the sample of bonds analysed at the beginning, going from 536 to 372 (146 investment grade bonds and 226 high yield bonds); the number of issuers was also reduced from 146 to 107.

INVESTMENT GRADE BONDS

Market performance of investment grade bonds from the sample matched by issuer ESG rating (1/1/14 = 100). Sample: 146 bonds

	CUMULATIVE PERFORMANCE					
ESG rating	**2014-2018**	**2014**	**2015**	**2016**	**2017**	**2018**
Low	7.7%	8.3%	-1.4%	0.0%	2.5%	-1.6%
High	8.8%	7.8%	-0.6%	0.5%	2.1%	-1.0%
Difference High vs. Low (bps)	110	-50	78	47	-38	60

Cumulative yield of the investment grade bonds from the sample matched by ESG rating



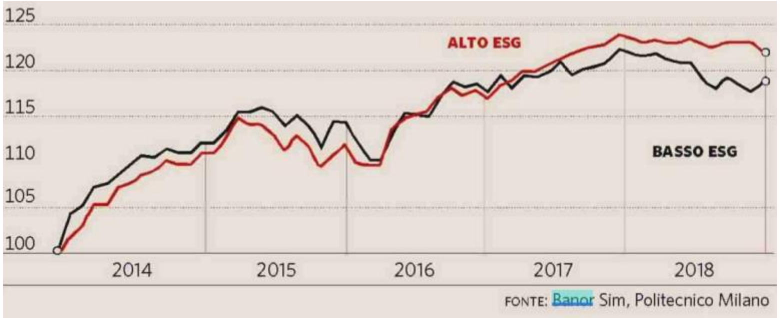
ALTO ESG	**HIGH ESG**
BASSO ESG	**LOW ESG**

HIGH YIELD BONDS

Market performance of high yield bonds from the sample matched by ESG rating of the issuer (1/1/14 = 100). Sample: 226 bonds

	CUMULATIVE PERFORMANCE					
ESG rating	**2014-2018**	**2014**	**2015**	**2016**	**2017**	**2018**
LOW	16.3%	11.8%	2.0%	3.0%	3.5%	-4.4%
HIGH	20.9%	10.8%	0.9%	4.5%	5.6%	-2.0%
DIFFERENCE HIGH VS. LOW (BPS)	466	-98	-109	149	210	238

Cumulative yield of high-yield bonds from the sample matched by ESG rating



ALTO ESG	**HIGH ESG**
BASSO ESG	**LOW ESG**
FONTE: Banor Sim, Politecnico Milano	SOURCE: Banor Sim, Politecnico di Milano