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Trends and opportunities in impact credit

Q&A with Stephen Liberatore and Jessica Zarzycki

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The fast-growing market for impact credit offers investors a rich source of opportunity and diversification.

Nuveen portfolio managers Stephen Liberatore, CFA® and Jessica Zarzycki, CFA® discuss the trends and opportunities, from global issuance and innovative transactions to defining impact and balancing competing objectives. They provide views on the different types of bonds available, highlighting the benefits to investors of diversification, scale and structuring deals as a lead investor.

What issuance trends are you seeing in the sustainable bond market versus the broad bond market?

SL: We're likely to eclipse $1 trillion dollars of issuance this year for bonds labelled green, social and sustainable (GSS). The market will have over $5 trillion of historical issuance, and over $4 trillion of market value outstanding. While GSS labels aren't how we define impact at Nuveen, it's a very good proxy for market growth.

That $5 trillion in issuance shows the maturation of the market. And it allows us to position portfolios to perform, regardless of the market environment, in a broadly diversified way.

We see impact opportunities not just in corporates, but across most bond market sectors, including sovereigns, supranationals, asset-backed securities, residential and commercial mortgage-backed securities, municipals, agencies, emerging markets and high yield.

Are there regional differences?

JZ: Europe is the largest player when it comes to GSS issuance, representing roughly 50% of the labelled market. Some of this higher volume is attributable to government issuance, notably green bonds from Italy, France and Germany. Issuance across Asia is growing, with Australia issuing its first green bond in June this year. But China remains the largest issuer in the region, followed by Korea and Japan.

Today, we see a growing number of emerging market sovereigns and corporates issuing GSS bonds. With the acute need to drive capital to lower-income economies, the GSS market offers a way to increase the investor base. We expect most emerging market sovereigns to focus on sustainability frameworks from which they can issue use of proceeds debt for either green or social projects. Interestingly, we see more and more projects where the green outcomes are reinforcing the social benefits. Examples include loans to women farmers to strengthen their business and implement sustainable agriculture practices, and ceramic water filters that reduce carbon emissions while providing safer drinking water to school children and increase the amount of time teachers and students can spend in their classrooms.

$1 trillion in sustainable bonds are scheduled to mature in 2026. How will that influence sustainable bond issuance?

SL: It's another opportunity for increasing issuance. Even as the market continues to grow, issuers in the U.S. have been a little slower in 2024 to issue sustainable securities. From what we can tell that has been primarily due to issuers' efforts to understand better the characteristics of the Inflation Reduction Act before announcing strategic plans, setting capital spending budgets and determining how they could potentially benefit from this still-new law. As we get closer to 2026, we're likely to see issuers formulate their plans.

How does Nuveen define impact investing in fixed income?

SL: For us, an impact investment has to have a direct and measurable social and/or environmental outcome associated with it. Direct refers to the bond's use of proceeds, and measurable relates to the transparency and relevance of outcome-based impact reporting. But critically, we are investors looking to generate excess return over time; we aren't making grants or deploying concessionary capital. So when we look at a transaction, even if it could be the most impactful transaction we've ever seen, we're not investing if it doesn't have an attractive total return profile.

Where are you seeing the most compelling developments in terms of different financing trends, such as blended finance, debt-for-nature swaps and sustainability-linked bonds?

SL: We're going to see more innovation in this area, and blended finance is likely to be at the forefront of that. Blended finance is using public-private partnerships to create transactions that have some type of de-risking mechanism to make them more attractive to investors.

We've participated in some recent innovative transactions, in which very clear use of proceeds have enabled us to drill down into exactly what the transactions will finance. When we engage with issuers and underwriters to help structure a transaction, we are guided by our focus on use of proceeds and transparent, outcomes-based reporting. Our goal is to determine exactly how our client's capital is going to be used and how we can measure the results.

JZ: A benefit of blended finance transactions is getting access to experts. We speak with the scientists, project managers and government officials to understand not only the environmental impact, but also the economic and social impact. It allows us to learn more about specific topics and disciplines that most asset managers don't maintain expertise in, for example, rhino biology, marine area biodiversity and the science behind carbon reduction versus removal credits.

We're always learning and building our skill sets as we look at new environmental and social projects — how they impact corporations; how they impact governments; and how do we make it better going forward. We want to continue to build out the space so that we're moving from that $1 trillion mark of issuance to $1.5 trillion, to $2 trillion. And then collectively the market can start to meet more of those large-scale sustainable objectives.

Some commentators question whether these transactions constitute concessionary financing. How do you balance the financial payoffs of these structures with their impact objectives?

SL: The way that we evaluate a transaction for impact is whether or not it has a direct and measurable outcome associated with it. The criticisms around debt-for-nature swaps or debt-for-climate swaps seem to ignore that there are not only environmental benefits, but also societal benefits. Debt reduction is tied to economic opportunity.

One of our debt-for-nature swaps, for example, was with Ecuador. The country was able to reduce its outstanding debt burden by over $1 billion dollars net and then reissue at a lower cost because of the blended finance structure associated with the transaction.

Some of those debt savings went to improving fisheries management. Currently, Ecuador cannot sell their catch into the European Union because it doesn't meet EU requirements for legal and sustainable fishing practices. The programs to be launched and funded are increasing the value add of the entire Ecuadorian fisheries management process to the point where Ecuador's fish can be sold into the EU.

In this case, having improved fisheries management can benefit the environment, especially around the Galapagos, and reduce illegal fishing. But it also creates social and economic opportunity by increasing market openness, creating jobs and enhancing livelihoods. And it also helps to improve Ecuador's credit profile with more hard currency reserves and higher tax revenues from the fisheries industry. The entire transaction, if structured correctly, should provide not just environmental benefit, but societal opportunity as well.

Tell us about some of the transactions in which Nuveen has been a lead investor. What's the benefit to our clients?

SL: We've been the lead investor in some unique transactions — the Vietnam emissions reduction bond that provided clean water to rural school students in Vietnam; the Ecuador debt-for-nature swap; the wildlife conservation bond which funded protections and breeding programs for the endangered black rhino population in South Africa; a reforestation bond that provides capital to acquire previously deforested parts of the Amazon, which is the first public fixed income market transaction to remove carbon from the environment.

Being a leader in this space, we're often contacted prior to these deals becoming more widely known. We can express our views on what we would need to see in a transaction for us to participate.

Getting involved in the structuring allows us to represent our investors. We're able to obtain the most optimal structure, the appropriate data and reporting, and access to relevant experts so that we have the best possible understanding and knowledge of what is occurring.

JZ: The power of no can be just as important. We've said no to transactions that did not meet our direct and measurable impact framework. And we then saw subsequent deals with tighter, better structures as a result.

A good example has been our non-consensus view around sustainability-linked bonds (SLBs). They don't meet our direct and measurable requirements, so we have not been a participant in the space. We were amoung the earliest investors to identify numerous weaknesses of the structure that have called the SLB label's credibility into question. And now, SLB issuance may have peaked. Despite the labelled market growing about 5% year-over-year, year-to-date SLB issuance is down roughly 50%

The social bond market seems to have grown slower than other areas. Why is that and how might it change in the future?

SL: I think a lot of it has to do with the nature of what is measurable. The impact metrics for green bonds are better understood by both issuers and investors. If you're investing in a hydro power project, a geothermal facility or a wind farm, you can expect metrics like megawatt hours of power produced, estimates of the number of homes that would be powered from that particular project, and estimates of greenhouse gas emissions avoided.

Social impact is a much broader opportunity set and it's more difficult to find specific measurements. But that is changing. Since the onset of Covid, issuers have become more thoughtful and creative about measuring outcomes, for example, calculating the number of people given access to additional health care or the number of individuals who benefit from access to fresh food. There are now more metrics for social issues that are acceptable to issuers and investors.

What is Nuveen doing to help grow this area of the market?

SL: We're very active in the social market. We have been the lead investor in five of the six transactions from IIX, Impact Investment Exchange, which is the leader in orange bond investing. Orange bonds refer to gender-equality outcomes, with the capital raised targeting women who are living in underserved markets around the world. The label comes from the color of Sustainable Development Goal 5 for gender equality. Jessica and I are on the steering committee of the Orange Bond Initiative.

We've also been involved with many different types of affordable housing transactions across sectors, whether it's in the mortgage-backed security space with Fannie Mae and Freddie Mac in the U.S. or in the commercial mortgage-backed space where we've worked with both small and large developers.

What we're doing in the social space is similar to what we've done in the environmental bond space. When we began impact investing in bonds, I was on the initial executive committee of the Green Bond Principles, helping to write those guiding principles for green bond issuance. Jessica and I are again sharing our expertise and insight on a variety of different industry working groups across a range of transaction types. We're very active in helping to shape the market so that it represents what our investors are looking for.

We are hopeful that by sharing our knowledge, an ever-increasing number of transactions that meet our impact investment framework will be executed in the market. As active total return managers, this increases our opportunity set to potentially generate excess return over time.

JZ: How we invest and the projects we invest in are hopefully pushing the market forward, driving capital into areas that need it today. Our clients are telling us to support outcomes that are feasible now, and not get caught up in labels or overwrought taxonomy regimes.

Why hasn't the transition bond market taken off yet?

SL: I think it's a higher bar when we use the word transition. We think that equates to a true change in either the issuer's business model and/or its industry.

We've looked at every transition bond, and only invested in one — Marfrig, a Brazilian protein company. The proceeds from that issuance were used to establish satellite monitoring of cattle that the company either owns or is considering purchasing. That way, they can avoid cattle that have been on deforested Amazonian rainforest. This is a transition bond because if Marfrig can do it, then other protein companies operating in Brazil could do the same thing. That's a really high bar, and I think that's why transition bonds haven't really taken off as much as people had originally expected.

Describe the distinguishing features of Nuveen's recently launched global credit impact strategy.

JZ: The strategy invests solely in impact securities. All the portfolio's investments will qualify under Nuveen's impact framework, using our direct, use of proceeds approach with measurable outcomes, and focused on our four impact themes: affordable housing; community and economic development; renewable energy and climate change; and natural resources.

We chose a well-known, conventional, corporate bond benchmark. We believe the strategy has the potential to outperform this benchmark and peers, given the breadth and depth of the impact bond market. The maturation of the market enables us to invest across sector, quality and currency dimensions and position the portfolio for where we are in the credit cycle.

We will mainly focus on investment grade corporate issues and help drive large-scale capital towards the issuer's energy transition, which will often have positive societal co-benefits. In addition, we will invest in other asset classes including mortgage-backed securities, asset-backed securities, municipals, emerging markets, high yield, supranationals and agencies. We'll invest in innovative blended finance transactions spanning environmental and social outcomes.

Traditional active fixed income investing techniques, such as asset allocation, security selection, yield curve positioning and currency, will remain key drivers for performance. We believe the strategy will fit not only sustainable mandates, but also into traditional asset allocation models.

For more information, please visit nuveen.com.

Endnotes

Data sourced from Sustainable Bonds Insights 2024, Environmental Finance.

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