Goodbody

Wealth Management Quarterly Report
Q3 2023

WEALTH MATTERS

THE SUSTAINABILITY ISSUE

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Investing for future generations

Joe Prendergast, Global Strategic Advisor

Welcome to the Q3 2023 edition of Wealth Matters.

This quarter we are focusing on sustainability.

The pace of economic growth and improvement in global living standards over the past century have been dramatic, most notably for the generations since the second world war. This prosperity has to no small degree depended on an abundance of fossil fuel, which has been readily consumed and fuelled endless innovation. With technology, and especially improvements in healthcare and nutrition, life expectancy has extended, and populations have increased.

The benefits of growth have not been evenly shared, and many parts of the world have not benefited materially at all. Many emerging nations' populations have demand for the same levels of living standards and associated food and energy consumption. The trends of urbanisation and consumerism, the rise of the middle class, the shift from agriculture to industrial production to provision of services, will likely prove relentless. So too then will demand for energy.

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Technology and science more generally have also yielded an awareness of the costs of growth and the related problem of climate change. It is increasingly clear that our prospects for survival depend upon our ability to reduce dependency on fossil fuels, while also continuing to increase living standards globally. The challenge to fulfil the needs of current generations without compromising the needs of future generations is perhaps the clearest definition of, and rationale for, sustainability.

Senior Research Analyst Brian Flavin expands on this theme on page four, showing that the application of sustainability to investment covers a wide range of possibilities, from a starting point of responsible investing through sustainable investments to impact investing – where in some cases profit may be secondary to achieving sustainable or social objectives. Individual client preferences play an important role here and will increasingly be used to determine investor portfolios, so it is well worth everyone's time to consider exactly how one would want their investments to reflect these concerns. There are a wide range of options and many innovations. On page six, Head of Fixed Income Strategy Elizabeth Geoghegan explains how fixed income markets are adapting to the need for a more sustainable present and future, including the arrival of green bonds – expect to see a lot more of these in portfolios over time.

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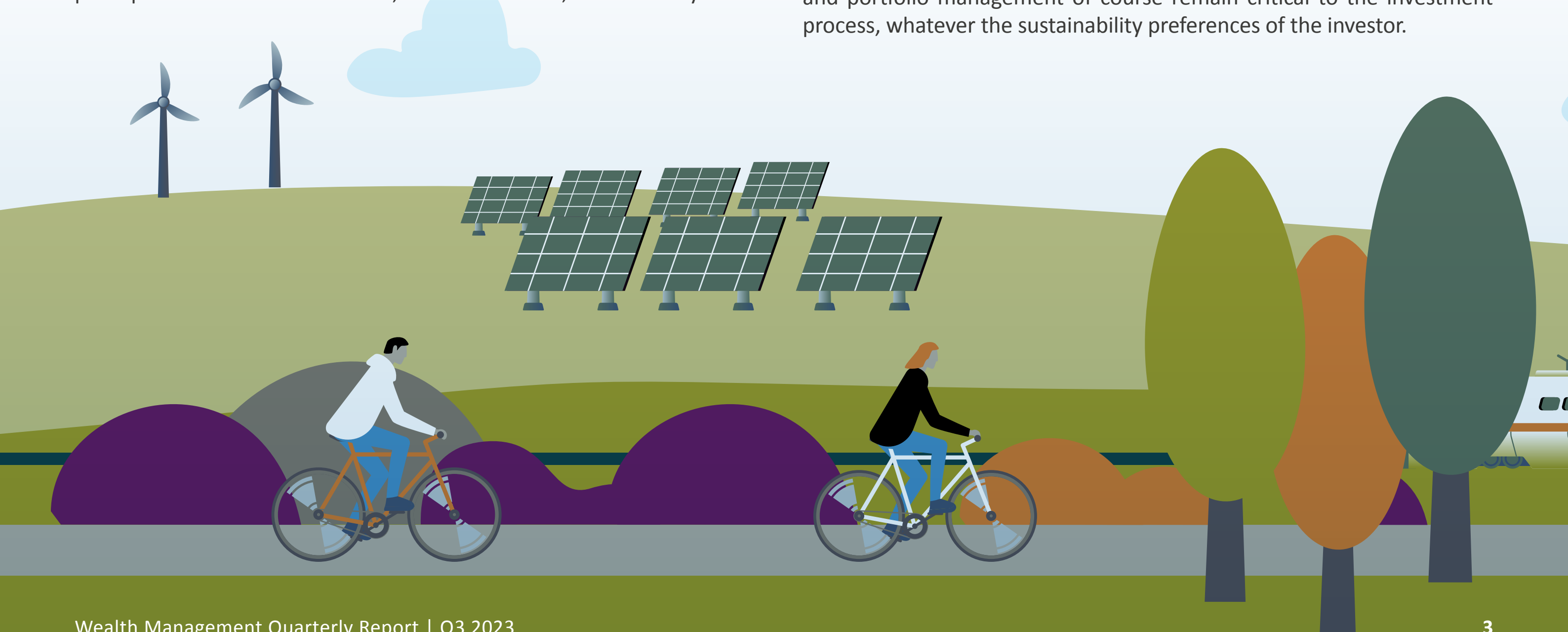
On page eight, Chief Investment Officer Bernard Swords notes the growing belief that there will be no US recession, which also means a lower likelihood of interest rate cuts ahead. And that economic growth may be settling into a sub-par trend, which could limit the potential for earnings growth. As such, this contributes to the current pause in equity markets and keeps us on a cautious footing for now. Traditional investing themes and portfolio management of course remain critical to the investment process, whatever the sustainability preferences of the investor.



Investing in Sustainability at Goodbody

Brian Flavin, Senior Research Analyst

In the article below Brian Flavin breaks down what is sustainability and how it is approached at Goodbody.

What is sustainability?

Sustainability means fulfilling the needs of current generations without compromising the needs of future generations, while ensuring a balance between economic growth, environmental care, and social well-being. When it comes to allocating capital, sustainability translates to considering environmental, social and governance factors ("ESG factors"), in addition to traditional due diligence methods, to help achieve this balance. This is also known as ESG Investing.

Why is it important now?

The concept is not new, but two events in the last 15 years have been major driving forces behind the sustainability movement. The first was the impact of the global financial crisis ("GFC") in 2008. It gave impetus to governance and stewardship principles, the idea being that more engagement between investors and companies should help mitigate or even avoid the governance risks they were exposed to pre GFC. The UK issued the first stewardship code in 2010, which was then adopted by many countries. Since then, investors and companies are increasingly encouraged or required to engage on a broader set of non-financial or ESG factors.

The second event was the Paris Agreement signed in 2015 at the UN's COP 21 meeting. 196 nations agreed to restrain their greenhouse gas emissions to contain future global temperatures. It also co-incided with the introduction of the UN's 17 Sustainable Development Goals ("SDGs"), which are a call to action for all countries to promote prosperity while protecting the planet. The SDGs have a much broader focus in that they recognise that ending poverty must go together with strategies that build economic growth and address a range of social needs including education, health, social protection, and job opportunities, while tackling climate change and environmental protection.

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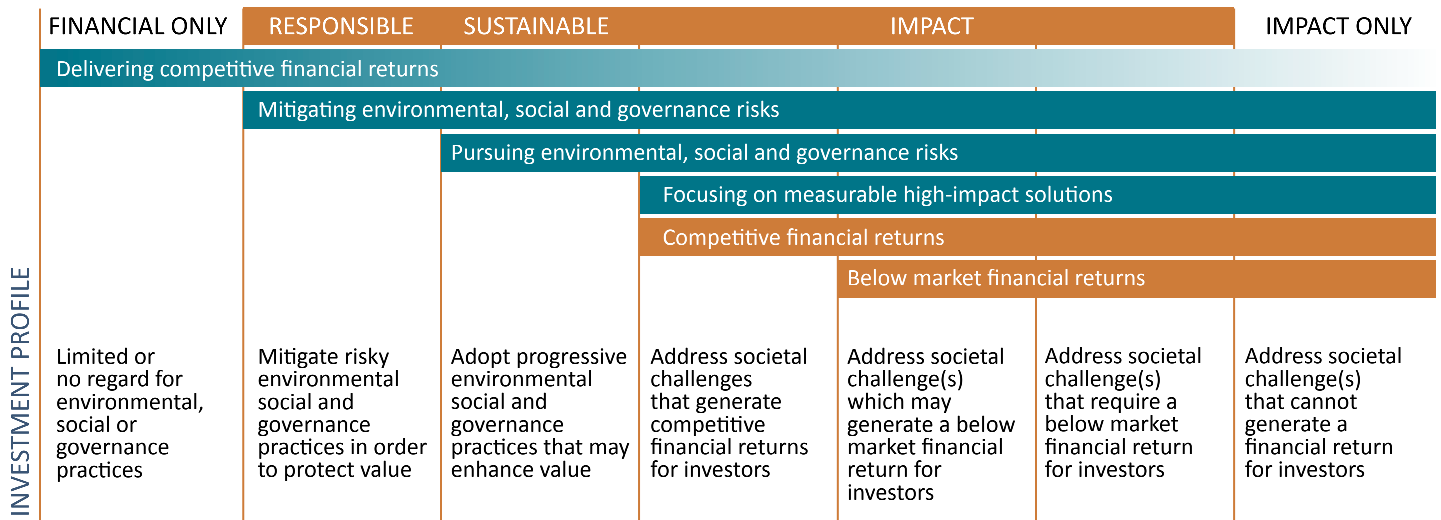
The EU's Sustainable Finance Action Plan, which incorporates its sustainable regulatory framework in place today, is derived from the EU's commitments made in 2015 at COP 21 and to the SDGs.

Figure 1: A Spectrum of Capital



Source: Social Impact for Investment: Building the Evidence Base (2015) OECD

What does it mean for my investments?

There are a variety of opinions when it comes to ESG Investing. A framework offered by the OECD illustrates a way to think about this – as a spectrum of capital (Figure 1 above). At one end of the spectrum, there is traditional financial investing where the emphasis is on delivering returns with limited or no regard for ESG consideration. At the opposite end, there is “impact only” investing where generating environmental or societal benefits is the main objective, even at the expense of financial returns. In between, there is responsible and sustainable investing.

The Goodbody Wealth Management investment process currently sits in the Responsible Investing bracket. This means that, in the ordinary course of our investment decision making process, and to the extent data is available to us, ESG factors are used as a risk mitigation tool in addition to traditional methods. The objective is to future proof our clients’ portfolios against emerging sources of risk that are difficult to quantify without compromising on long term returns. For example, businesses that emit increasing levels of CO2 are exposed to much higher carbon costs in the future, which will affect profitability and investor returns. But there are also other ESG factors to consider such as businesses that lack diversity and inclusion or businesses with weak supply chain management.

However, we also have specific processes and sustainable models that can cater for client preferences and sensitivities to detailed ESG factors. This allows us to allocate clients’ capital towards activities that generate social and environmental benefits, if required.

Green Bonds and Sustainable Investing

Elizabeth Geoghegan, Head of Fixed Income Strategy

In 2023, bonds are back and going green, but how green are they and how do they work?

Traditional investing delivers value to investors by translating investor capital into investment opportunities that carry risks commensurate with expected returns. Sustainable investing builds on traditional investing by integrating environmental, social, and governance-related (ESG) insights. In many ways, sustainable investing can be seen as part of the natural evolution of the investment world. There is a growing recognition among industry participants that some ESG factors can be considered economically important, especially in the long term, and as such, it is important to incorporate material ESG factors into fundamental investment analysis.

How can it be applied to assets – equity and fixed income?

A crucial cornerstone of ESG integration is the engagement between investors and entities. This process naturally lends itself more to equity investing over fixed income investments. Equity holders are stakeholders of an entity and hence play a role in proxy voting and shareholder engagement. In contrast, the application for bondholders is a little more nuanced, especially when considering how to apply sustainability considerations for sovereign bonds. However, whilst retail investors may not engage directly with sovereigns, one area that is increasingly interesting is that of green or labelled sovereign bonds.

What are green bonds?

The idea behind green bonds is that the proceeds or money raised through issuance is specifically allocated to projects that positively affect the environment or contribute to the fight against climate change. Green bonds can be issued by sovereigns, sub-sovereigns, supranational entities, corporates and commercial banks. Green bonds can also be referred to as labelled bonds, which is a broad term which collectively describes green, social or sustainability-linked bonds. Similar to green bonds, social bonds, will have strict criteria surrounding their use of proceeds. Sustainability-linked bonds differ slightly from green and social bonds, as their proceeds are not used to finance particular projects but rather finance the general functioning of an issuer with explicit sustainability targets. These targets are linked to the conditions of the bond.

Green bonds continue to grow in popularity as they offer investors with non-financial interests the opportunity to get the best of two worlds: gaining exposure to bonds and contributing to the fight against climate change. At the end of 2022, the green bond market surpassed the $2trillion level. In first half of this year, the sale of green bond issuances hit a new record, surpassing the previous record set in H2 2021. Among these issuances was a record green bond sale in April, a €10bn green bond issued by Italy. Other notable trends were seen in the banking sector, which accounted for almost one third of the record issuance in the first half of this year.

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As noted, a bond is labelled green based on the condition that the proceeds are allocated to green projects. In Europe, when issuing a new bond, the issuer will follow a framework which sets out the conditions pertaining to the 'greenness' of the bond. The ICMA Green Bond Principles ("GBP"), is a set of voluntary guidelines that outline transparent and unified disclosures on bonds' environmental objectives and estimated impact. This can be distilled into four key components which pertain to the use of proceeds, project evaluation, the management of proceeds and reporting. The conditions surrounding the use of proceeds are a significant cornerstone of the framework. The GBP explicitly recognise several broad categories of eligibility for Green Projects which cover areas from Green Buildings to Clean Transportation. The principles also recommend an external review for heightened transparency.

What are the risks?

The credit profile and risks of green bonds are, in general, the same as for standard bonds from the same issuer. The main consideration for investors looking to invest in green bonds will be the duration aspect. Bond prices are inversely related to interest rates, meaning that a rise in yields will lead to a fall in bond pricing. Duration measures a bond's sensitivity to interest rate moves and is significantly linked to the maturity of the bond. As such, short maturity (low duration) bonds are less sensitive to interest rate moves relative to long maturity (long duration) bonds. Linking this back to green bonds, this has important implications. Typically, a green project will have a long-term timeline and hence the bond issued to finance this project will also have a long-term maturity. As a result, the green bond market typically has a longer duration profile than the overall market, meaning that investors looking to invest entirely in green bonds may have to accept additional duration risk. Of course, there are some shorter maturity green bonds available and, as time passes and the market grows, the opportunities will increase further.

Short maturity (low duration) bonds are less sensitive to interest rate moves relative to long maturity (long duration) bonds. Linking this back to green bonds, this has important implications. Typically, a green project will have a long-term timeline and hence the bond issued to finance this project will also have a long-term maturity.

What does it mean for investors?

Adding an allocation to green bonds within a diversified portfolio offers investors the ability to tilt their investments towards contributing to the fight against climate change. More specifically, within Europe, there is an increased focus on MiFID client sustainability preferences. These preferences are linked to three key areas: EU Taxonomy which is linked to environmental investments, EU SFDR which defines sustainable investments related to the environment and/or social issues and Principle Adverse Indicators which link key measures to the UN Sustainable Development Goals. While the evolution of these areas is ongoing, there is a growing acceptance among fund managers that European Government Green Bonds, which satisfy certain criteria, can be classified as a Sustainable Investment in line with EU SFDR. Expect to see more green bonds in portfolios over time.

Lagarde: No More Ground to Cover

Bernard Swords, Chief Investment Officer

Since the middle of the year there have been some interesting developments in world markets.

Top of the list is the apparent change of mood in the developed world central banks. There has also been a crack in the US bond market as longer dated yields hit new highs for the year. The property market in China came back under the spotlight as major property developers hit solvency problems.

Central bank hikes

Let's start with central banks. Over the last 18 months, financial markets were very uncertain about where and when interest rates would peak in the euro area and the US. It now looks like we are almost there. The European Central Bank (ECB) President, Christine Lagarde, when asked whether more interest rates were needed, consistently said 'we have more ground to cover'. After the last council meeting, Lagarde was asked 'do you have more ground to cover?' she answered no. The ECB is now close to a pause. In the US, Chair Powell from the Federal Reserve said that interest rates are now well above the neutral level. Real interest rates look to be well into positive territory. It looks to us as if both central banks want to pause. One more hike is expected in the US and the euro area. If inflation behaves itself, then that could be it for this cycle.

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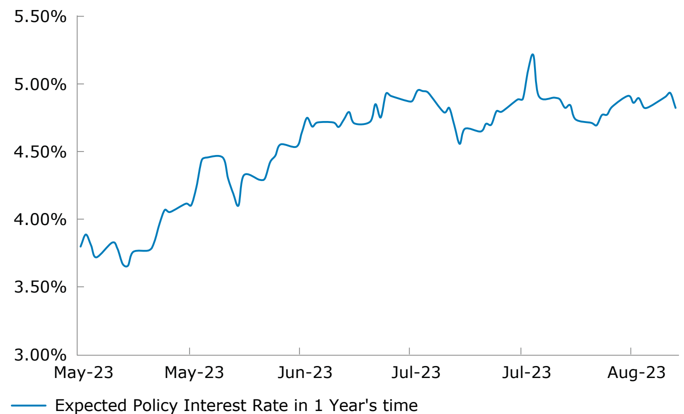
Battles in the US bond market

Bond markets do not seem too happy about this. The US bond market in particular has had to deal with several issues. A downgrade of government debt by a rating agency, a larger deficit than expected, hence a larger supply of bonds and a Treasury Department which had to rebuild its cash deposits after the debt ceiling debate. However, a bigger influence has been the rise in expected interest rates. Interest rates in one year's time are now expected to be close to where they are today, i.e., no interest rate cuts over the next 12 months. In the second quarter of the year, equity markets removed the belief that there would be a recession in the US. Now we are seeing the bond market doing the same thing.

We view this as a positive development. The belief that central banks would be cutting interest rates by the third quarter of next year due to sluggish economies made us nervous about fixed income markets. We felt that rate expectations were too ambitious, especially as economies were proving more resilient than expected. The fixed income market now seems to be pricing in a more realistic, neutral outlook.

Interest Rate Expectations in the US



Source: Bloomberg.

Chinese property market woes

The Chinese property market is back in focus as two major developers hit liquidity problems, with Evergrande Group filing for bankruptcy in its US operations. The problem stems from a weak residential market in China where new home construction in 2023 is down nearly 5% and prices fell at the last reading, all on a year-on-year basis. The government and central bank are working to limit the damage to the broader economy. Expect more property and lending announcements which could lead to a bounce in the local market. Chinese property developers being in financial difficulties has been a recurring story over the last few years and indicates that there is a bigger underlying problem that has not been solved. Our funds have low exposure to the region, and we will keep it that way.

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Both developments are feeding into equity markets and causing the current pause, which we expect to continue. The rising belief that no US recession would appear drove equity markets higher in the second quarter. Markets are now dealing with the further implication of that: no interest rate cuts in 2024. Moreover, the forecasted growth rate is sub-par, and so the earnings outlook will be challenged. We maintain our cautious view of equity markets.

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