

Sustainability and Climate On-Demand

“Sustainability Matters in the Bond Market”

Transcript, 12 September, 2025

Mike Disabato (00:00):

What's up everyone? And welcome to sustainability Now, where we cover how the environment, our society and corporate governance affects and are affected by our economy. I'm your host Mike Deto, and we are back from a month long holiday to bring you an episode on the importance of sustainability in the credit market. Thanks as always for joining us. Stay tuned. The bond markets where fixed income investors roam are pretty calm compared to equity markets. The most exciting times are really only during global catastrophes where customers sell their huge portfolios of bonds as quickly as possible, and bond traders raking the profits because they can basically charge whatever they want in those moments. Other times though, things are more orderly, less chaotic, more refined, and unless you are buying credit default swaps and betting on a company to go bankrupt, you typically as a bond investor just really want to control your downside risk and earn your coupon and go on your merry way with some more cash in your pocket.

(01:04):

And the way you do that is ensure you invest in the bonds of companies that aren't going to have a destructive surprise, get a new crappier credit rating, let's say, which makes the bonds less attractive and tanks your investment because you bought that bond when it was much more attractive. Of course you did. Now you're buying high and selling low and that ain't the way to go. Now, the way bond managers assess the risk of their bonds is by using what is called a credit spread. A credit spread is an indication of the risk of loss. It's how risky the bond is compared to what's called the risk-free bond. Like the US treasury security bonds, the US Treasury can print money whenever it wants to, so it's unlikely that it's going to go bankrupt. Now, the tighter the credit spread, the closer the bond is to that risk-free investment and thus the less risky it is considered by the market.

(01:54):

But if I'm an investor, I sort of care a bit less about whether or not a bond's credit spread is tight or wide. Ostensibly, I've already done that analysis before investing in the bond. I care more about the fundamentals of the spread. Why is the bond riskier or safer? And can I benefit from that knowledge? And more importantly for bonds, can I ensure that the spread isn't going to shift on me in the wrong direction? There are many traditional ways in which investors go about understanding why credit spreads are the way they are, but there are alternatives to those ways of understanding

credit spreads. One might argue under appreciated ways to assess credit spreads. That at least is the argument of my guest today, Yaku Malish, who's my colleague and also helps head our fixed income team. He, along with his co-authors, Shichen Wong and Annette Hui, looked at sustainability factors as an alternative to traditional credit spread analysis, and they sought out to see whether sustainability factors were a useful predictor of a company's risk and thus credit. So today, for you all, I called up Bku and asked them what they found out.

Jakub Malich (03:04):

So we looked at over 20,000 bonds over a 10 year period, and we did see that the bonds of issuers with high ESG ratings had lower credit spreads than those from the low ESG rated companies. And also over that 10 year period, they exhibited much lower market volatility.

Mike Disabato (03:25):

Now, this is interesting because historically the uptake for ESG integration by fixed income investors has lagged their equity peers. They just haven't been on board in the same way. But that's starting to change. Bond investors have, especially over the last 10 years, increasingly engaged companies on sustainability issues at scale. Many large investment managers are actually engaging companies at the time of their bond issuance to talk with them about their sustainability profile and the benefits it can have for that issued bond. And the fact that there are benefits is a finding that continues. What we have already shown is true about ESG ratings and the cost of capital higher ESG scores on average experience, lower cost of capital compared to companies with poor ESG scores in both developed and emerging markets. And what Yaku and his co-authors HIN and Annette found is by looking at past performance sustainability risks consistently proved financially material in the credit markets even across different macroeconomic environments. But don't take my word for that. Don't let me convince you just yet. First, we need to understand how they actually figured it out. How did they actually get this finding and present it in the way they have? What was the method that they used? Was it difficult? Was it easy? I needed Yaku to tell me everything

Jakub Malich (04:44):

Naturally. This is the hard part. So that's where we spend the most time, more particularly in trying to isolate all the other influences that we know that they influence both credit spreads and the market behavior of bonds. So some of these factors include, of course, things like sensitivity to interest rates, the credit quality of the issuing company, the liquidity of the bond, how easy it's traded and so on. We would put this into a regression and we try to see again how much of the spread was explained by some of these, what we call traditional fixed income factors, that there is plenty of financial literature out there and empirical data by which we know that these factors do influence the spreads. And again, after knowing how much is explained by that, looking at the residual or the leftover portion, and then again looking at the differences between companies based on the measure of sustainability risk, which is the ESG rating, we would still see that there was a difference. So we used our models and we isolated these factors and how much they contribute to the spreads. And then we only looked at the leftover portion of the spread. We divided the companies by their ESG ratings, and we saw that in this leftover portion, do we still see significant differences between the spreads of, again, the high and the low rated companies? And

we did see that. So it seems that at least when it comes to spreads, the market seems to be pricing in the sustainability related risks, which our ESG ratings measure.

Mike Disabato (06:21):

So that is the process. And if we relate that back to what I opened with on fixed income investing, where investors want to understand why credit spreads are the way they are to both avoid downside risk and understand if they have a good investment ID on their hands when the market maybe has an appropriately allocated risks, what yin's co-authors findings translate to is in the past, the sustainability factors that make up our ESG ratings can be used to understand why a company has a tighter credit spread than a competitor. They can be used basically to understand the credit spreads themselves, which is the name of the game for fixed income investing. So let's go through an example of why that might be the case. Why might the underlying factors of an ESG rating lead to a tighter credit spread and help investors understand why that credit spread is the way?

Jakub Malich (07:12):

So maybe if you consider two very similar companies operating in the same industries, having roughly the same business model, maybe very similar financial strength, but that one of the companies, let's say has a history or being involved in some environmental issues such as maybe its products led to pollution of the environments and the companies were fined for that. Or maybe companies that handle a lot of sensitive client data have history of not very strict data privacy policies, which led to some data leaks, right? Which again, regulators globally penalize very strictly. So imagine you have these two similar companies. One of them has these issues or at least had them in the past, and you are still suspecting that maybe they can grapple with them in the future. And you have the other company that has no history of this and it seems like their policies and programs are actually structured well to deal with these risks. So once again, their financial strength being equal, which would you consider more risky? I think more people would probably say that the one with all these extra, what we call sustainability related issues, that they would probably see this company as the more riskier of the two, which should reflect in the credit spreads of its bond, right? So it'll have to pay investors a higher premium for them to be willing to assume those risks.

Mike Disabato (08:38):

What might be some of the pitfalls of this? I think it's easy for us to fall into this assumption that our sustainability factors are useful in understanding a company's risk. But what might have gone wrong with that assumption? What might you all have missed? And did you implement any guardrails, ensure that you didn't mistake something for nothing?

Jakub Malich (08:58):

I think the biggest issue is always making sure that there are no other factors that are actually biasing or influencing your results. And you are attributing the qualities to some data that actually is not responsible for any of this, but it's really caused by the other factors. So to deal with that, we introduce some additional tests in our paper. So first of all, we utilized our, what we call a transmission channel framework. And that is the kind of the mechanism that we established how we would expect the sustainability to influence the company's business. So really how much profits

it can generate, how easy it can repay debt, basically if it has more robust stable business model. And how this ultimately leads to the valuation or differences of securities between the companies that are doing better on these issues and not. We also expect them to go more easily through different market environments, and we expect them to have stronger risk management, which should mean that they should be less frequently involved in different negative incidents, and there should be lower company specific risk associated with their securities in the market. So this is what we tested. And on all of these metrics, we found that again, the companies with the high ESG ratings performed much better than the companies with low ESG ratings. So this is another kind of check that we introduced to tell us that really there can be, if not causality, certainly a correlation between company with a stronger sustainability profile and its fundamental and market performance.

Mike Disabato ([10:42](#)):

So those transmission channels that Yaku mentioned can be more formally thrown into three buckets. And here's kind of what the buckets mean. There's the cashflow channel where high ESG rated firms showed in their research stronger competitiveness, profitability and debt servicing capacity. And what that translates into is lower leverage and better credit quality. There's the systematic risk channel where bonds from higher ESG rated issuers had lower sensitivity to market wide shocks, meaning they had less volatility and a lower overall cost of capital. Then there's the idiosyncratic risk channel where high ESG rated companies had fewer negative incidents like scandals or governance failures. And that just meant the companies themselves were less risky bets. And it was with these transmission channels that they really were able to say that sustainability risks and opportunities influenced bond performance. And that's even after Shin, Annette and Yaku controlled for all necessary factors.

([11:41](#)):

And the thing is, that might all sound kind of obvious to you as a listener, that these companies that are better cashed up, let's say, are going to perform better overall. But you have to remember, and this is the point I want to leave you with, sustainability risks are not fully captured by traditional credit ratings. They aren't looking at sustainability factors when creating those ratings. So what does that mean? It means there is this undervalued aspect of the market with regards to sustainability data that can be utilized to possibly better understand a company's risks and credit spreads. It's as simple as that. And that's it for the week. I wanted to thank you so much for listening. I wanted to thank Yaku for talking to me about the news with the sustainability twist. If you like what you heard, don't forget to rate and review us. That always helps us on the podcast lists and subscribe wherever you get your podcast. Don't forget to subscribe to sustainability now, not our old name, ESG now. Thanks again and talk to you next week.

Speaker 3 ([12:49](#)):

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