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Green Muni Bonds:

Responsible investing in a centuries-old asset class

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ARTICLE HIGHLIGHTS

- With a two-century history of serving the public good, municipal bonds are fast becoming an important part of responsible investment strategies, which align environmental, social and governance (ESG) goals with financial ones.
- State and local governments are increasingly turning to municipal "green" bonds to finance climate-change adaptation, infrastructure modernization, and mitigation projects.
- Responsible investing strategies that incorporate municipal bonds may enhance portfolio diversification and offer compelling total return along with direct and measureable environmental and/or social benefits.

Municipal bonds have a long and colorful history in the U.S., having served as a key financial resource for projects benefiting the public good for over two centuries.

New York State issued one of the first notable municipal bonds in 1818, raising $7 million to finance construction of the Erie Canal, which connected the Great Lakes to the Atlantic Ocean.

The successful project inspired governments around the U.S. to quickly follow suit with their own bonds to pay for bridges, roads and waterworks.

Today, municipal bonds are a massive $3.7 trillion market. It is an asset class favored by individual investors and retirees seeking to benefit from a key distinguishing feature, tax-exempt interest income. But investors are increasingly looking at this market—and the closely-related taxable municipal segment representing about 18%[1] of the municipal bond market—for another reason: municipal bonds are a natural fit for responsible investment and "green" initiatives. These types of investments seek to finance projects that provide both financial returns for investors and environmental and other benefits for state and local governments.

Municipalities have been providing socially beneficial and environmentally responsible projects for generations, long before the concept of green investing became a household term.

With this long history of delivering social benefits, municipal bonds have in recent years become an important component of responsible investment strategies that seek opportunities to generate positive environmental, social and governance (ESG) outcomes, along with financial returns. In addition to the inherent social benefits of municipal bonds, investors have long focused on the low default rates, high credit ratings, and strong relative value as compared to other asset classes. Investors seeking to align social values with financial goals may want to consider responsible investment strategies that include municipal bonds.

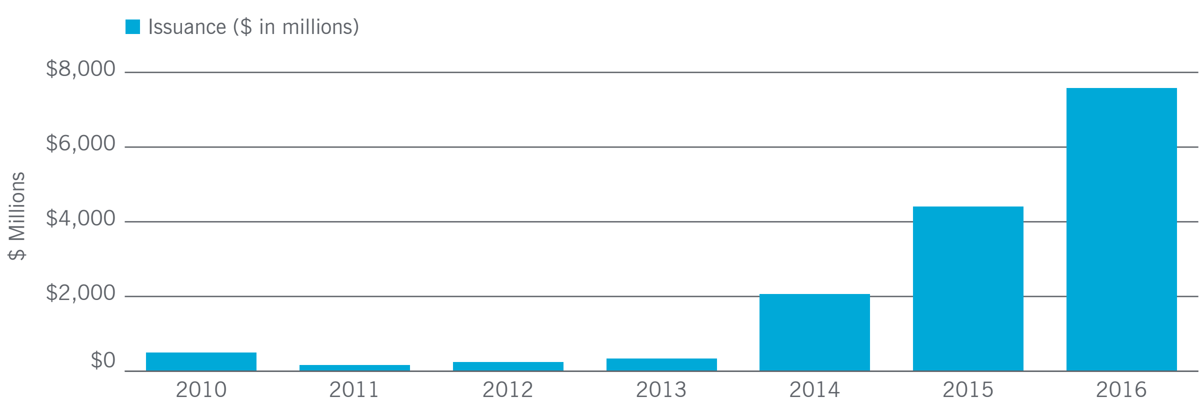
MUNICIPALITIES ARE SEEING GREEN

In most instances, municipalities issue green bonds to fund infrastructure modernization or other projects intended to benefit their local communities. Examples of ESG bond proceeds include community parks, affordable housing and wetland reclamation. Additionally, the use of green bonds, which raise money to finance projects that seek to mitigate and/or adapt to climate change, has expanded dramatically over the last several years. These securities include labeled green bonds and others that do not carry that designation. TIAA Investments has long used its experience and expertise in the municipal market to identify and evaluate municipal securities on the basis of not only their return potential but also their environmental benefit. Given increasing stakeholder demands for action on climate change, municipal issuers have increasingly adopted the green bond label for relevant issues in recent years. According to Bloomberg, U.S. state and local governments have issued $15.3 billion of green bonds[2] since 2010. In fact, 2016 experienced record issuance of $7.6 billion, a 72% increase over 2015, as shown in Figure 1.

It is important to note however, that the vast majority of all municipal securities that have a positive environmental impact do not carry the green bond designation. As a result, we continually analyze a much broader spectrum of issues and issuers for inclusion in our strategies.

The rapid increase in the labeled green bond market has also been fueled by growing investor demand for responsible investment strategies. In the U.S., this market grew from $3.74 trillion in 2012 to $8.72 trillion in 2016—an increase of 133%, according to the Forum for Sustainable and Responsible Investment[3]. By the end of 2016 one-out-of-every five dollars under professional investment management in the U.S. was invested in responsible strategies.

Figure 1: Issuance of municipal green bonds* has soared



*Data includes municipal bonds labeled as green bonds or issued for renewable energy.
Source: Bloomberg

WHAT THE BONDS PAY FOR

While green projects are not exclusive to governments, public agencies are frequently behind significant green initiatives. For example, the South Davis Sewer District in Utah issued bonds in 2017 for a project to convert organic waste into renewable natural gas for sale to power plants. The $43 million project is expected to generate enough electricity to power 25,526 average U.S. homes and reduce carbon dioxide emissions equivalent to taking 36,515 cars off the road.

Municipal bonds can also serve one or more responsible investment goals—not just environmental or climate change initiatives. For example, San Francisco issued bonds in 2017 to replace the Hunters View public housing project with a mixed-income development. Part of a $2 billion public housing initiative, Hunters View will create 750 new housing units and neighborhood retail, community, and recreation facilities.

MUNICIPAL BONDS ARE MORE THAN TAX-EXEMPT INCOME VEHICLES

While municipal bonds have become an important and growing component of responsible investment strategies, they also have appeal in a diversified fixed-income portfolio. Because of their unique properties, municipal bonds can improve portfolio diversification, potentially enhancing returns while reducing certain kinds of risk. Given their tax-advantaged status, tax-exempt municipal bonds generally have lower yields than corporate bonds of similar credit quality. When the tax savings are considered, however, the yields[4] of municipal bonds can be comparable with bonds that have higher coupons.[5]

Moreover, because municipal bonds are often backed by taxes and revenue collected from critical public services (e.g., water and sewer services), they tend to have a lower risk of default than corporate bonds and other types of non-government debt.[6] Our strategies also include many taxable municipal securities that offer the same benefits listed above but with higher yields that reflect their non-advantageous tax status. These types of municipals are more often appropriate for taxable strategies.

HOW DO MUNICIPAL BONDS FIT IN A RESPONSIBLE INVESTMENT STRATEGY?

In the current environment, it may be harder for investors to research, purchase and hold individual municipal bonds. The inefficient and negotiated municipal market can make it difficult for retail investors to obtain the best valuations. Buying or selling individual municipal bonds is generally more expensive for individual investors given the over-the counter nature of fixed income markets which rewards larger transactions with better pricing. For most individual investors or retirement savers, accessing bonds usually requires investing in mutual funds. Given the rapidly increasing appetite for responsible investing over the last few years, the fund industry has launched many competing ESG-themed funds across all asset classes including for stocks, bonds and even alternatives such as real estate and private equity.

Advisors with clients interested in responsible investment fixed-income funds, should look at the types of bonds that different funds invest in. Not all funds and strategies are the same. At TIAA Investments, we believe municipal bonds are a key component of a responsible investment fixed-income strategy. They offer many more opportunities for investing in ESG-themed projects with direct and measureable impact, while also providing compelling risk and return attributes.

COMPETITIVE RETURNS

It is a common misconception that responsible investing requires sacrificing investment returns. We believe that Socially Responsible Investing and competitive performance are not mutually exclusive—and can be well aligned with experienced managers. Analysis of returns for responsible investments compared to non-responsible investment strategies supports this view. A study published in 2016 by Barclays, for example, showed that ESG factors produced a small positive return in corporate bond portfolios[7]. Bond portfolios with strong ESG attributes—measured by either MSCI or Sustainalytics—outperformed low-ESG portfolios over a seven-year period, 2009-2016. The study also found that companies with high ESG scores often had higher credit ratings.

Many responsible investment strategies, including TIAA's, are benchmarked to common market indexes—allowing direct performance comparisons. Investors should carefully evaluate the investment choices that are available, as not all strategies and managers use the same approach. It is also important to understand the benchmark used to measure performance and what that means for a portfolio's potential risk and return characteristics over time.

CONCLUSION

Green bonds can help align financial goals and social values

A responsible investment bond strategy that invests in a variety of bonds—including "green" municipal bonds—can offer opportunities for investors seeking to meet their long-term investment goals while aligning with their principles and social values. However, as with any other investment opportunity, it is important to understand responsible investment approaches thoroughly to ensure that they fit with your investment goals and risk profile. If you have questions about the role of municipal bonds and responsible investing in a diversified portfolio, contact your advisor for more information.

For more information,
contact your Global Investment Advisory Services representative, or visit us at nuveen.com

ENDNOTES

1 Relative size of the taxable municipal bond market is based on the S&P Taxable Municipal Bond Index as a proportion of the S&P Municipal Bond Index.

2 Data includes municipal bonds labeled as green bonds or issued for renewable energy.

3 Data includes sustainable, responsible, and impact investing assets in the U.S.

4 Tax-equivalent yields.

5 Note that municipal bond mutual funds generally seek income exempt from regular federal income taxes; however, some income may be subject to state and local taxes and to the federal alternative minimum tax. Capital gains, if any, are subject to tax.

6 Moody's Investors Services, "U.S. Municipal Bond Defaults and Recoveries, 1970-2015," May 2016.

7 Sustainable Investing and Bond Returns: Research study into the impact of ESG on credit portfolio performance, Barclays Bank PLC, 2016.

RISKS AND OTHER IMPORTANT CONSIDERATIONS

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Please note that events affecting states and municipalities may adversely affect municipal bond mutual fund investments and performance. These events may include severe financial difficulties and continued budget deficits, economic or political policy changes, tax base erosion, state constitutional limits on tax increases, and changes in the credit ratings assigned to state and municipal issuers of debt instruments.

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