

Sustainable investing: beyond the green label

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Eliza McCarthy (00:00):

Hello and welcome to The Ideas Exchange. ASX's regular podcast where we cover investment trends, market updates, and ideas for your portfolio. My name is Eliza McCarthy, business development associate investment products here at ASX. It is our mission to deliver to you the latest in market updates and ideas through the conversations we have with investment experts.

Speaker 2 (00:20):

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Eliza McCarthy (00:47):

Welcome to The Ideas Exchange Podcast, brought to you by ASX. Sustainable investing has become increasingly important part of the investment landscape as environmental, social, and economic trends continue to shape markets, influence risk, and create new opportunities for investors. Joining us today is Jonathon Costello, client portfolio manager for fixed income strategies at Janus Henderson Investors. Jonathon brings nearly two decades of experience across portfolio management, investment research and client strategy with a particular focus on fixed income markets.

(01:20):

In today's episode, we'll explore what sustainable investing means in practice, how sustainability considerations can compliment traditional investment analysis, and whether investors can pursue both strong financial outcomes and positive real world impact.

(01:33):

Jonathon, welcome to the podcast.

Jonathon Costello (01:35):

Thanks, Eliza. Good to be here.

Eliza McCarthy (01:37):

Let's jump right into what does sustainable investing mean today. Sustainable investing means different things to different people. For someone new to investing, what does sustainable investing mean and how should investors think about it today?

Jonathon Costello (01:49):

Well, thanks for the question. I'm glad that you asked that one because it's a good one to address from the outset. One of the biggest misconceptions is that investors must choose between doing good and earning good returns. And sustainability outcomes and investment performance are complimentary rather than competing objectives. A good way to bear this out is to bring about an example and a supermarket. If you think about a supermarket, that's a good example.

(02:13):

A supermarket is a very high revenue business and it runs on thin margins. So if you have a supermarket that's energy efficient, you can reduce electricity costs, which is good for profitability. You can also improve refrigeration by having better seals on the doors, which is going to reduce food spoilage. So that's good to contain expenses, but you're also going to have happier customers who aren't walking around the store wondering why they didn't bring a jumper and they're happy to stick around and buy more. So good from the revenue side as well. So overall they're getting a better experience and revenues and expenses are impacted.

(02:49):

None of this is charity, it's just great business. Sustainably investing works best when sustainably improvements strengthen the economics of the business and that's where good outcomes and good investment returns can align.

(03:01):

Now, we don't buy a bond because of a label on it. We buy it because the borrower can pay us back and because we're being paid enough for the risk that we're taking. A worthy project can still be a poor investment if the structure borrower or the price is wrong. So within our sustainable credit fund, our approach is to seek positive measurable outcomes alongside a market commensurate rate of return.

Eliza McCarthy (03:24):

Absolutely love that use of that supermarket example. What are some examples of sustainability-related factors that can also be financially relevant when analyzing an investment?

Jonathon Costello (03:34):

There's lots of examples, but I'll start with governance. Weigh controls and poor culture, they can lead to things such as fraud, fines, and reputational damage and ultimately higher funding costs for a business. If a business scores poorly on these sorts of metrics and they need to go out to the market and borrow some money, then they're going to have to pay a higher interest rate to do so, which is going to end up reducing the profitability of that business. Beyond governance, social factors are also important and

these can impact both expenses and revenues, if you think about labor market relations as an example. If you're in a business that has really poor work culture, then staff retention is going to be an issue, and this is going to relate to higher costs of hiring. So you've got to put out a job advert and you've got to pay for that, and that's a large expense. But beyond that, training's got to occur, and not only the new staff member needs to be trained, but it's taking another staff member away from their daily job. So productivity is going to be an issue and that's going to impact the bottom line.

(04:33):

So as credit investors, we try and determine a borrower's standing and how this is going to affect cash flow and avoiding bad companies is crucial. But pleasingly, we can also target additional returns by identifying good companies. If a business becomes more resilient and the market hasn't recognized that yet, then the bonds or the stream of cash flows that we've tied up, they're going to become more valuable because the business is inherently less risky now. So that really creates an opportunity for an active credit investor such as ourselves.

Eliza McCarthy (05:03):

Okay. Let's jump to balancing returns and sustainability outcomes. You highlighted in the misconceptions that sustainability outcomes and investment performance are complimentary objectives rather than competing ones. So I guess the question is, can investors genuinely pursue attractive financial returns while also seeking positive environmental or social outcomes?

Jonathon Costello (05:23):

Well, the short answer is yes. And the current environment and markets really makes this discussion particularly relevant. We've come from a low rate environment around COVID period where investors who are trying to seek attractive financial returns really had to lean into risk, increase risk materially to achieve those attractive financial returns and take on illiquidity risk in some cases.

(05:46):

Higher bond yields have changed that. If you're looking mid-September, got risk-free yields, government bonds often the benchmark yield as a comparator is the 10-year, that's currently sitting at its highest level in around 15 years. High yields, risk-free, that's great for investors, but you can also earn meaningful income from high quality liquid credit without necessarily moving so far out the risk spectrum. And sustainable credit strategies can then direct that capital towards qualifying people and planet outcomes while retaining the same focus on credit quality and appropriately compensating investors for risk.

(06:22):

If you're looking across our credit funds, similar to the government bond yields, we're seeing the highest level of yields in around 15 years. And for our sustainable credit fund, we're seeing the highest yields since the fund's inception. So seeking positive outcomes within credit. We also have around \$3 billion worth of labeled bonds, and that's really in support of positive environmental and social outcomes.

(06:46):

For investors, they should be encouraged by the fact that diversification across borrower types is growing. You're seeing sector diversification, regional diversification, diversification across currencies, and the rapid growth across this part of the market. A good example for investors to think about is major international development banks. These groups, they promote socioeconomic growth in developing countries and building physical infrastructure. They come to market often and there's some great opportunities for investors to participate.

Eliza McCarthy (07:15):

Okay. How do you approach situations where a company appears financially attractive but doesn't align with the strategy sustainability framework?

Jonathon Costello (07:22):

Well, this is a great question because it highlights sustainability doesn't replace investment discipline. We might find a company that offers an attractive yield, but if that doesn't meet the sustainability criteria required for the strategy, then it's not going to be eligible for inclusion in our portfolio. The reverse is also true and we're not going to invest simply because something has a green label. Both tests have to be passed. And this is important because investors are relying on us to deliver both objectives, not just one.

(07:49):

Of course, there are instances that we choose not to lend to issuers based on sustainability concerns, and in some cases, we will undertake active stewardship in an effort to influence a company's behavior. What this means is we can engage with management on material risks and encourage stronger governance and improve practices, and this is going to lead to better long-term outcomes for both issuers and also stakeholders.

Eliza McCarthy (08:11):

You mentioned the green label before, and we've all heard of greenwashing. What should investors look for when assessing whether a sustainable investment strategy is supported by a robust process rather than simply a marketing label?

Jonathon Costello (08:23):

Well, for the uninitiated, one way to have a quick look is to look at the portfolio constituents of a sustainable fund. If you can see some portfolio constituents that are clearly at odds with the defined criteria, then that's an immediate red flag. But I'd encourage investors to look beyond the marketing material and ask a few extra questions. First off, is the process clearly defined? Secondly, are the sustainability criteria measurable and what can and can't be held? And third, does the manager regularly report on outcomes?

(08:53):

Sustainably investing can be quite difficult to work through, but it must be repeatable and transparent. Investors should be able to see how the decisions are made and whether the fund is actually delivering and what it says it will do. If you can't explain the process clearly, then that's usually a big red flag.

Eliza McCarthy (09:09):

If we could please expand on that, where does this sustainability lens fit within the decision making process?

Jonathon Costello (09:15):

Across all our strategies, we're looking at investments with a quality before price investment philosophy. What that means is we need to be certain of the fundamental strength of the business, and sustainability lens is part of this assessment. Perhaps I can bring this to life through an example.

(09:31):

If you think about sustainably investment lens when you're buying a home, you might first ask whether the home is comfortable to live in, whether it reflects your needs and values. Perhaps it got solar on the roof and lots of water tanks, so it's energy efficient and it's good for the environment, but that's not enough. You still need to be very comfortable about the foundations of the house and the structure and the quality of the build. Perhaps even the tiles are cracked and you're going to have to replace the roof and take the solar panels off. So the sustainable side of it's not the only thing that you need to think about. You got to be really conscious of the foundations of the house, and that really comes... In credit investing, that's the fundamentals first.

(10:09):

In the same way, an investment can have an appealing sustainability story, but also needs sound fundamentals, sustainable cash flows, and a robust investment process. A green label doesn't compensate for weak foundations.

Eliza McCarthy (10:21):

Okay. When we were discussing the investment can have an appealing sustainability story, but it also needs sound fundamentals, what actually differentiates a company or issuer that may be positioned for long-term success from one that simply has a compelling sustainability story?

Jonathon Costello (10:36):

A compelling sustainability story is easy one to find, but long-term success is much harder. Unfortunately, sustainability outcomes alone don't repay debt. And as investors, we need confidence in the fundamentals. So to understand the resilience of cash flows, balance sheet strength, access to funding, and the ability of an issuer to withstand periods of market stress is really important.

(10:56):

The lesson here is that both dimensions matter. A company can have a positive social or environmental contribution, but if the underlying business model isn't sufficiently resilient, then investors can still face significant losses. And that's why our process starts with credit fundamentals and then incorporates sustainability analysis. We're looking for businesses that can deliver both sustainable outcomes and sustainable financial performance.

Eliza McCarthy (11:20):

Can you share an example of a sustainability-related risk or opportunity that investors may overlook if they're only focused on traditional financial metrics?

Jonathon Costello (11:27):

Environmental issues are often an easy thing to focus on because they're highly visible and that's an easier one, but again, governance is one that's often overlooked. Many of the largest credit losses historically have come from governance failures. Poor oversight, weak risk controls or a culture that encourages excessive risk taking can eventually lead to fines and litigation and often funding pressures, which can lead to insolvency. So these risks might not be obvious in today's earnings numbers, but they can have a significant impact on bondholders, and that's why governance is such an important part of the process.

Eliza McCarthy (12:04):

Now let's talk about the Janus Henderson Sustainable Credit Active ETF with the ticker GOOD. For investors hearing about the strategy for the first time, what is GOOD and what is it designed to achieve?

Jonathon Costello (12:16):

GOOD is the ticker for the Janus Henderson Sustainable Credit Fund in an active ETF format. And you can buy it on the ASEX just the same as you would buy any share. What sits underneath it is a portfolio of loans to companies and institutions around 100, and they're chosen by our credit team here in Australia. Within the ETF or the fund, two things matter for most listeners, and the first is income. Portfolio is currently yielding around 6% as at mid-September. And in round numbers, 10,000 invested is generating around \$600 a year, which is paid out monthly.

(12:48):

Second is quality because yield on its own tells you very little. For the ETF, the average credit rating is currently sitting at around A plus, and that's the high quality end of the market. If you think about the big banks, utility companies, infrastructure, development banks, and across our pooled strategies, we haven't experienced one single default since inception. That's over a 30-year history, so really speaks to the high quality nature of the universe.

(13:16):

For the strategy, we set ourselves a target of beating the benchmark by 0.75% a year gross of fees. Since inception, we've been able to double that at 1.2% a year above the

benchmark net of fees. And alongside that, performance objective being achieved, we've been able to invest at least 80% of the money directed towards things like renewable energy generation, affordable housing, healthcare, and disability support. Alongside that performance objective, we've been able to invest at least 80% of money towards things like renewable energy generation, affordable housing, healthcare, and disability support.

(13:54):

The way I'd frame it is for someone at home, defensive part of your portfolio, a part that's meant to play a defensive role, not let you stay up at night, and it's doing two jobs instead of one. For investors, a straightforward way of explaining it is GOOD aims to make the defensive part of a portfolio work in two ways. First, producing income, and second, directing capital towards more sustainable outcomes. For retirees or income-focused investors, that combination may be relevant because regular income and capital resilience can be just as important as long-term growth. Appropriateness will, of course, depend on each investor circumstances, objectives and tolerance for market fluctuations.

Eliza McCarthy (14:37):

Okay. Where are you currently seeing some of the most compelling long-term strategies within sustainable credit?

Jonathon Costello (14:43):

One of the things that we're watching closely is the enormous investment required to upgrade the world's infrastructure, and whether that's renewable energy generation, electricity networks, data centers supporting AI, or more energy efficient buildings, all of these trends require significant capital. There's a lot of ways to access this thematic as a bond investor, and we're primarily accessing this at the most defensive end of the spectrum. We're looking for borrowers with proven resilient business models. The increased electricity demand from data centers and the transition to renewables has resulted in significant investment into electricity and utility infrastructure, and this has been a dominant driver of CapEx around the AI supercycle.

(15:24):

A good example of an opportunity within this sector of the market is Meridian Energy. Meridian is a large 100% renewable energy distributor and also generator. It's 51% government owned, as I mentioned, 100% renewable energy and is benefiting from increase in demand for electricity. This sort of business offers more than 6% yield, and it's really an established business with a resilient cash flow stream.

Eliza McCarthy (15:53):

Okay. Thank you for that, Jonathon. Where could GOOD potentially fit with an investor's broader portfolio and what role could it play?

Jonathon Costello (15:59):

Well, GOOD is a solid credit fund and it's got a proven strong track record of performance. As at mid-September, it's yielding more than 6%, so it offers a good

source of regular income. And even if you took the sustainability label off it, it still stacks up in its own right as a high performing, high quality, liquid, diversified credit fund. So while the sustainability label is attractive to those wanting to direct their capital towards companies and projects that positively contribute to the environment and people in it, it's also really well suited to any investor that is focused on achieving an attractive total return outcome for a safe, defensive fixed income strategy.

Eliza McCarthy (16:35):

Today's final question, in one sentence, can investors pursue returns and positive impact?

Jonathon Costello (16:40):

Yes, they can, as long as every single investment passes two tests. It has to do something good and it has to be a good loan.

Eliza McCarthy (16:48):

Great. Jonathon, thank you for joining us today and sharing your insights. For listeners interested in learning more about the Janus Henderson Sustainable Credit Active ETF, ASX: GOOD, including fund information, product disclosure statements, and investment resources, visit the Janus Henderson investor's website. Thank you for listening to The Ideas Exchange Podcast. Until next time.

Speaker 2 (17:08):

Are you keen to learn more? Why not visit the ASX blog, asx.com.au/blog for a wide range of articles, videos, and insights from ASX experts, listed companies, and investment professionals.

Speaker 4 (17:36):

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