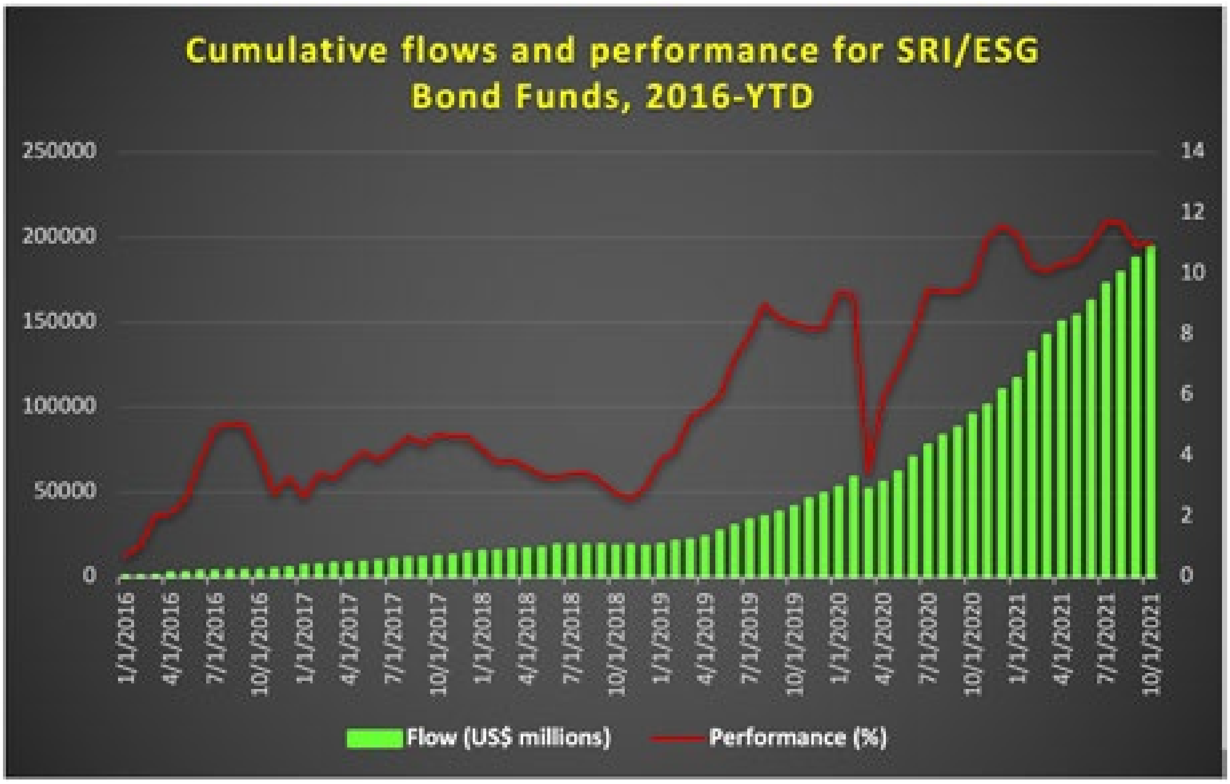
Oil bonds still have fuel in the tank – but how long will it last?

Fixed income markets are abuzz about the spectacular demand for new green bonds – and there's no denying that investors are hungry for these instruments. Flows into fixed income funds with socially responsible investing (SRI) or environmental, social and governance (ESG) mandates have soared. Those tracked by Informa company EPFR have seen their AuM increase sevenfold since the beginning of 2019.



From an environmental perspective, however, some naughty investors have been sneaking back into fossil fuels while the teacher wasn't looking.

ESG-dedicated investors say climate change concerns are rapidly increasing the cost of debt for oil companies. But this is proving a two-edged sword in a market starved for yield. Recent holdings data from the EPFR Fixed Income Barometer suggests being on the wrong side of the 'green premium' is not impacting traditional oil producers like Exxon Mobil and Chevron as much as the climate evangelists hoped and expected.

Mostly sunny with some clouds

The Fixed Income Barometer provides investment professionals a snapshot of bond ownership at issue and issuer level, highlighting the preferred characteristics of popular securities. It shows Exxon and Chevron bonds received consistently healthy inflows over the 12 months ending September 2021.

For bonds maturing in 2025, Chevron received net positive flows in all 12 of those months that totaled around $241 million of inward investment.

It is a similar story for Exxon, which received positive inflows every month -- totaling around $60 million – for notes maturing in 2023. There were two months of outflows for those maturing in 2022, but overall that issue still attracted around $199 million over the period.

In the week ending 27 October 2021, EPFR tracked bond funds recorded their 33rd consecutive inflow and 42nd in the year to date, beating the last full-year record set in 2019.

ESG fund managers have clearly been discarding traditional oil companies from portfolios, but this mainly applies to active managers. EPFR's data shows this continuing with two active funds removing Exxon Mobil from their portfolio in September, and two screening out Chevron.

Meanwhile, passive funds are simply sticking to their mission to track a whole index such as the S&P500, which includes the oil majors.

The journey to renewable energy…

There are several underlying factors which could slow the trend of divestment investment from oil companies.

The first one is simple: investors understand that the road to decarbonization will be long. They know the forces of supply, demand and regulation will eventually push traditional fossil fuel companies to embrace clean energy. Yet many believe that, as the economy makes this transition, those with the deepest pockets including oil majors will be best-placed to invest in the innovation and development necessary to become green energy leaders.

Another factor is the increasing popularity of engagement, which looks to support companies' transitions towards ESG rather than simply removing them from portfolios. With this approach, active ESG investors may hold Chevron and Exxon deliberately to try and influence such a change.

Last, but not least, most of the world still runs to a large degree on fossil fuels. So, perversely, as supply shrinks faster than demand the profitability of legacy energy companies increases.

Impact of passive investing

So why is new money still gushing into oil bonds when much of the world is saying we should stop funding fossil fuel companies?

One factor is the increasing dominance of lower-cost, passively managed and exchange-traded funds (ETF), many of which have little or no ESG screening in their selection process.

A breakdown of holdings in the EPFR Barometer shows by far the biggest holders of Exxon bonds are passive ETFs, which hold twice as much Exxon debt as passive non-ETFs and seven times as much as active funds. Similarly, the ratio of Chevron holdings in passive versus active funds is 43:1

As the overall bond market has been buoyant, this wave of passive money creates a rising tide that floats all boats, including oil majors.

...along a long and uneven road

Bond investors' cash is not available evenly across the oil industry. Large producers may benefit from the passive effect, but small and mi-cap plays are finding it harder.

For example, recent analysis by Aegon Asset Management shows a bond deal by Ithaca Energy is still trading slightly below issue level, despite a healthy 9% coupon, well-invested low-cost asset base and significant cash generation.

Investors are still hungry for yield, so they are unlikely to keep ignoring such bounty unless mandated to. But Ithaca's challenges do signal a waning interest in hydrocarbon investment and the limited funds willing to invest in them, according to Aegon.

We don't yet know the extent to which oil companies will embrace the transition to clean energy, so its timeline is far from certain. The holding value maturity of Exxon and Chevrons' bonds reflect this uncertainty. The EPFR Barometer shows this clustering between now and 2030, with little beyond that for either company.

So the forces lining up against oil production have not yet compelled investors to exclude oil bonds that mature before 2030 — especially while these companies are making good money from oil price rises.

Beyond 2030, their viability is less certain, especially if they fail to invest sufficiently in the transition to net zero. If that happens, the environmental risks are likely to intensify and the cost of credit to steepen significantly.

In the meantime, energy companies are being urged to invest their profits in the paths to a net-zero carbon future. Whether they respond, or simply return the profits to shareholders, remains to be seen.

About EPFR Fixed Income Barometer

The EPFR Fixed Barometer provides investment professionals with a current snapshot of bond ownership.

at an issue and issuer level, highlighting the preferred characteristics of securities most popular with both active and passive fund managers.

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