

Bonds as Tools for Impact: Qualified Proceeds Use Bonds

FROM THE
YRDARM
MARKET COMMENTARY & ANALYSIS

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About Saturna

Saturna Capital, manager of the Amana, Saturna Sustainable, Sextant, and Idaho Tax-Exempt Funds, uses years of investment experience to aid investors in navigating today's volatile markets. Founded in 1989 by professionals with extensive experience, Saturna has helped individuals and institutions build wealth, earn income, and preserve capital.

We are long-term, values-based, and socially responsible investors. We view consideration of environmental, social, and governance (ESG) factors as essential in forming portfolios of high-quality companies that are better positioned to reduce risk and identify opportunities. We believe that companies proactively managing business risks related to ESG issues make better contributions to the global economy and are more resilient.

At Saturna, we believe in making your investment dollars work hard for you and that your interests always come first. Saturna strives to not only offer the best investment opportunities from mutual funds to IRAs, but to match those sound investments with superior customer service.

Please consider an investment's objectives, risks, charges, and expenses carefully before investing. To obtain this and other important information about the Saturna Sustainable Funds in a current prospectus or summary prospectus, please visit www.saturnasustainable.com or call toll-free 1-800-728-8762. Please read the prospectus or summary prospectus carefully before investing.

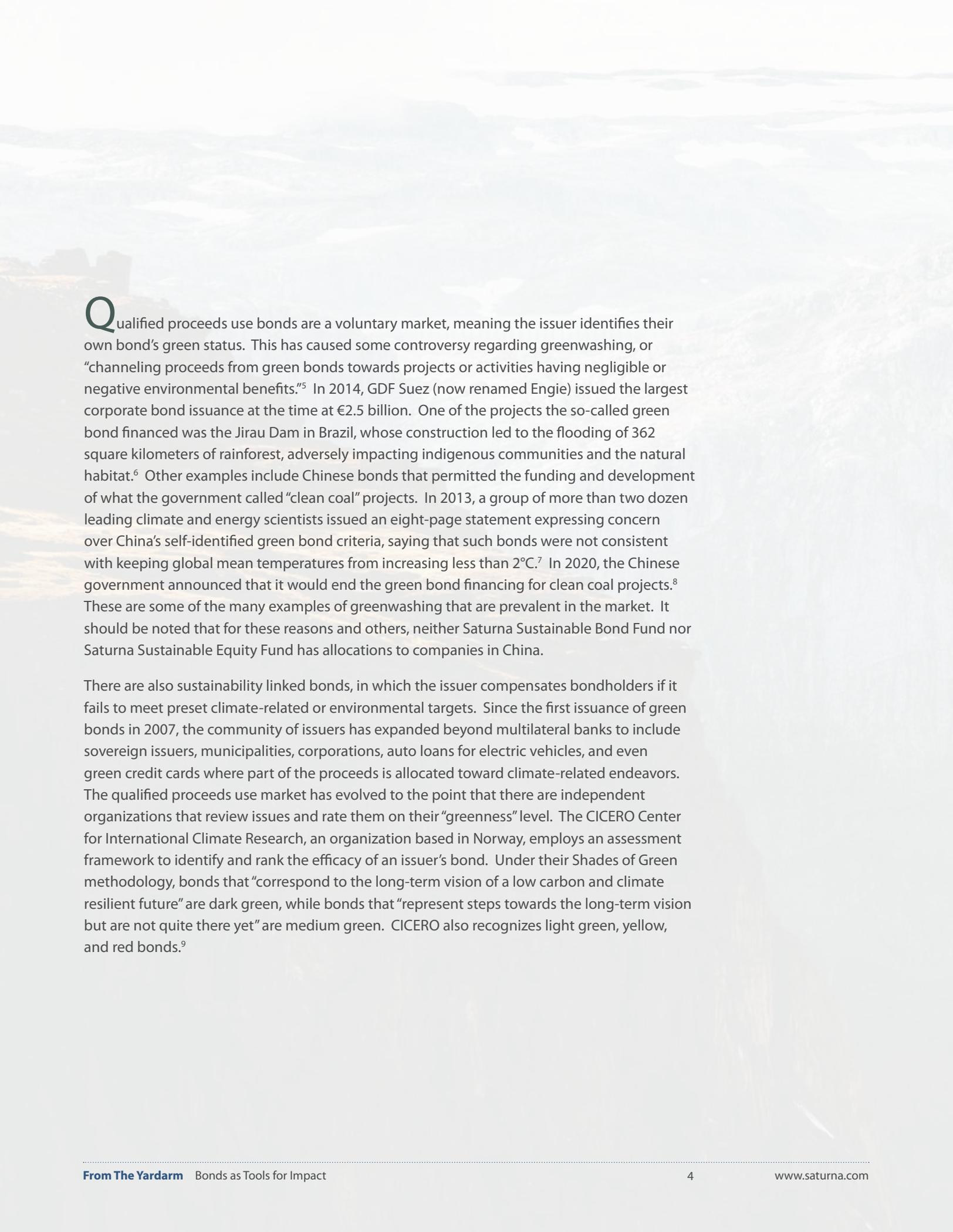
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The global bond market is massive, with \$126.9 trillion outstanding. It is \$2.5 trillion larger than the global equity market cap.¹ Bonds are a major component of building our society, and while they are largely invisible to the average investor, they are woven into the fabric of life on this planet. Sovereign governments use the debt markets to finance spending programs. Local municipalities access the market to build infrastructure such as roads and water systems that serve entire communities. Schools, universities, and hospitals need the debt markets for improvements and expansion. Corporations use bonds to finance new capital expenditures. The debt markets present the investor with a unique opportunity to help build a world that's more sustainable and resilient. Unlike the equity markets, the bond investor can buy securities that direct proceeds to specific projects. They can also finance climate resilient infrastructure and projects that could help the global energy transition. Bondholders also have access to issuers in the primary markets, and can have a voice as to how proceeds should be used and what information should be disclosed. In short, we cannot build a more sustainable planet without the financing mechanisms to do so. Bonds are a critical component to sustainable investing.

A portion of our sustainable fixed-income holdings are invested in qualified proceeds use bonds. The issuer of a qualified proceeds use bond earmarks the proceeds of the bond toward a designated objective, such as a climate-related or environmental project. In some cases, a qualified proceeds use bond could be classified as a "green bond." The first green bond was issued by the European Investment Bank (EIB) in 2007.²

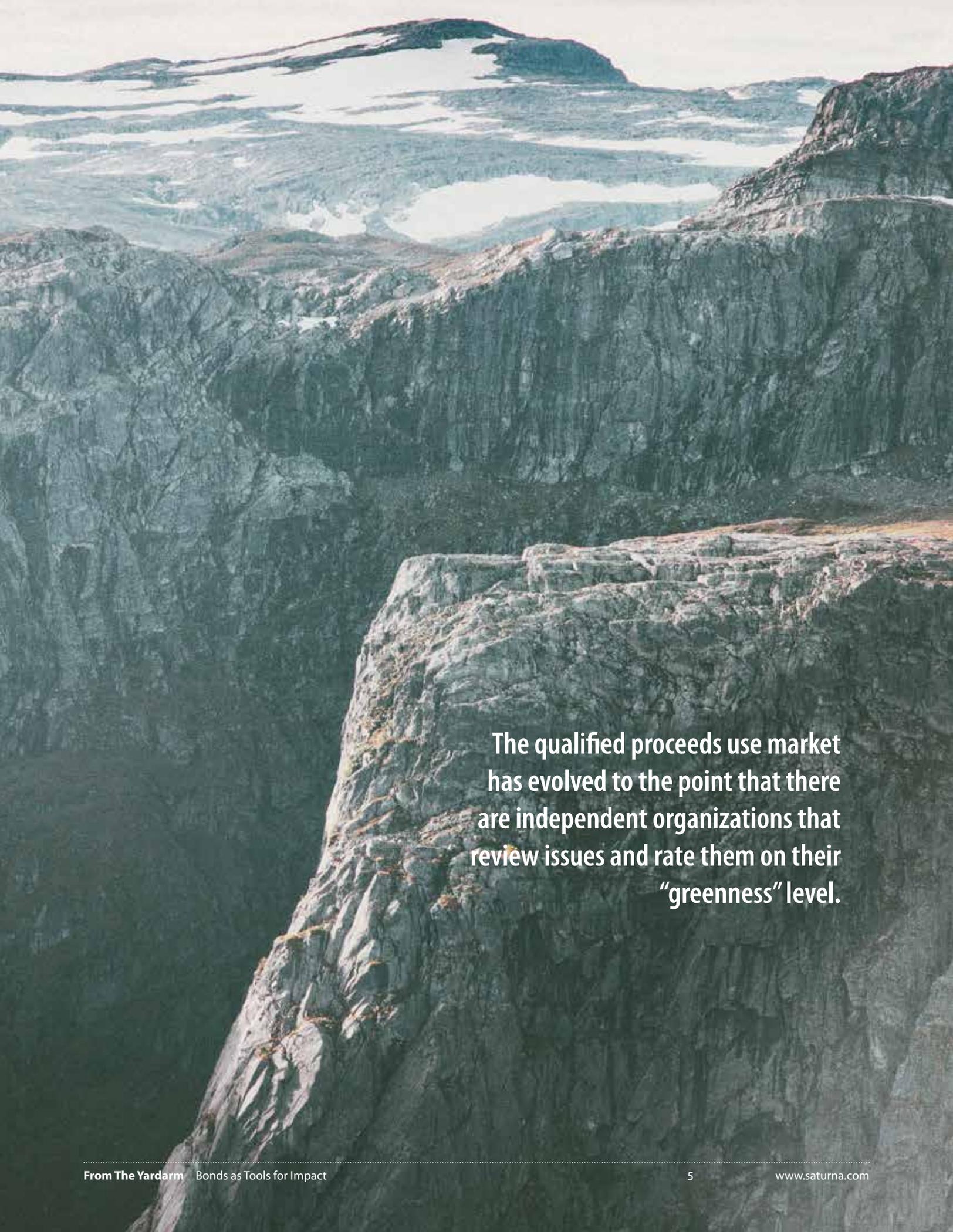
Since that first green bond, the market has rapidly evolved to incorporate other types of qualified proceeds use bonds. There are social bonds, where the proceeds are earmarked for projects that will bring social benefits, and sustainable bonds, which are meant to simultaneously address both environmental and social objectives. The Climate Bonds Initiative, an international organization promoting the development and best practices for the qualified proceeds use market, reported at year-end 2021 that cumulative issuance of qualified proceeds use bonds exceeded \$2.8 trillion, with over \$1.1 trillion issued in 2021 alone.^{3,4}

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Qualified proceeds use bonds are a voluntary market, meaning the issuer identifies their own bond's green status. This has caused some controversy regarding greenwashing, or “channeling proceeds from green bonds towards projects or activities having negligible or negative environmental benefits.”⁵ In 2014, GDF Suez (now renamed Engie) issued the largest corporate bond issuance at the time at €2.5 billion. One of the projects the so-called green bond financed was the Jirau Dam in Brazil, whose construction led to the flooding of 362 square kilometers of rainforest, adversely impacting indigenous communities and the natural habitat.⁶ Other examples include Chinese bonds that permitted the funding and development of what the government called “clean coal” projects. In 2013, a group of more than two dozen leading climate and energy scientists issued an eight-page statement expressing concern over China’s self-identified green bond criteria, saying that such bonds were not consistent with keeping global mean temperatures from increasing less than 2°C.⁷ In 2020, the Chinese government announced that it would end the green bond financing for clean coal projects.⁸ These are some of the many examples of greenwashing that are prevalent in the market. It should be noted that for these reasons and others, neither Saturna Sustainable Bond Fund nor Saturna Sustainable Equity Fund has allocations to companies in China.

There are also sustainability linked bonds, in which the issuer compensates bondholders if it fails to meet preset climate-related or environmental targets. Since the first issuance of green bonds in 2007, the community of issuers has expanded beyond multilateral banks to include sovereign issuers, municipalities, corporations, auto loans for electric vehicles, and even green credit cards where part of the proceeds is allocated toward climate-related endeavors. The qualified proceeds use market has evolved to the point that there are independent organizations that review issues and rate them on their “greenness” level. The CICERO Center for International Climate Research, an organization based in Norway, employs an assessment framework to identify and rank the efficacy of an issuer’s bond. Under their Shades of Green methodology, bonds that “correspond to the long-term vision of a low carbon and climate resilient future” are dark green, while bonds that “represent steps towards the long-term vision but are not quite there yet” are medium green. CICERO also recognizes light green, yellow, and red bonds.⁹



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A Critical Approach to Green and Sustainable Debt

Saturna recognizes the lack of standardization in the qualified proceeds use bond space, and critically analyzes investments that are potentially green or sustainable. Audits and independent party opinions verifying use of proceeds and reporting are viewed favorably. Issuer-reported green or sustainable bonds without these opinions are met with additional scrutiny. We look at the following aspects of a bond for our analysis:

- **Use of proceeds:** We evaluate the use of proceeds stipulated in the bond documents. We consider the process for allocating funds alongside the permissible projects. Potential project impact is considered alongside contribution to the SDGs.
- **Allocation and tracking of bond proceeds:** Generally, we favor issuers that effectively allocate funds and have dedicated resources to monitor spending. We consider the framework for deploying proceeds and the process for evaluating acceptable projects. Placing bond proceeds in a separate account is also viewed favorably.
- **Ongoing impact reporting and disclosure:** Reporting on proceeds allocation and funded projects alongside ongoing impact data.
- **Issuer quality and commitment:** The green or social bonds of issuers who don't perform well overall in the integrated ESG analysis are not considered "sustainable" investments. The escalating popularity of qualified bond issues has incentivized some issuers to take advantage of heightened investor demand by labeling the self-identified issue as "green" without implementing a strategic or managerial commitment. Our process seeks to delve beyond the headline announcements, ascertaining both intent and anticipated outcome to address potential greenwashing.

Qualified Proceeds Use Bonds

As of March 31, 2022, 24.9% of the holdings in the Sustainable Bond Fund were deemed qualified proceeds use bonds. One year earlier, 25.0% of the Fund's holdings were deemed qualified proceeds use bonds. There was a green bond in the Fund that matured on March 30, 2022, one day before the end of the quarter. If that bond been included in the first quarter's report, the Fund would have had a 25.7% exposure to qualified proceeds use bonds.

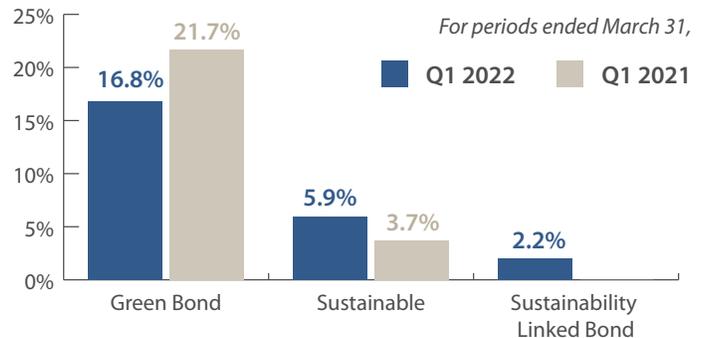
Examples:

The Women's Livelihood Bond (WLB) Series from Impact Investment Exchange (IIX) include a pari passu "(equal footing)" guarantee by the United States Agency for International Development (USAID) on 50% of WLB's principal.¹⁰ USAID is backed by the full faith and credit of the US government, with a mission to "advance the economic, political, social, and environmental well-being of the world's most vulnerable people."¹¹ We are proud of the Sustainable Bond Fund's ability to make a positive contribution to the world's first gender-lens impact security in Southeast Asia while obtaining competitive returns

for our investors with its unique credit enhancements. There are currently five WLB bond tranches, labeled WLB1 through WLB5. We are delighted by our partnership with IIX's efforts, which have generated a social return on investment (SROI) of \$4.00 on its WLB3 bond tranche. SROI is a financial measure used to express how much social impact is made by one invested dollar. This means every dollar invested in the WLB3 bond has generated an SROI of \$4.00.¹²

The Sustainable Bond Fund holds a sustainability linked bond issued by Odfjell, a specialized Norwegian-based liquid and bulk shipping company. In January of 2021, Odfjell issued a sustainability linked bond that provided an additional payment to bondholders of 1.5% of the note's par value if they did not meet their Sustainable Performance Target (SPT) to reduce its controlled fleet emissions by 50% between 2008 and 2030.¹³ Odfjell's SPT exceeds the target of the International Maritime Organization (IMO); in 2011, IMO adopted a mandate requiring all shipping companies to reduce their carbon emissions by 40% for the same period.¹⁴

Sustainable Bond Fund: qualified proceeds use bonds



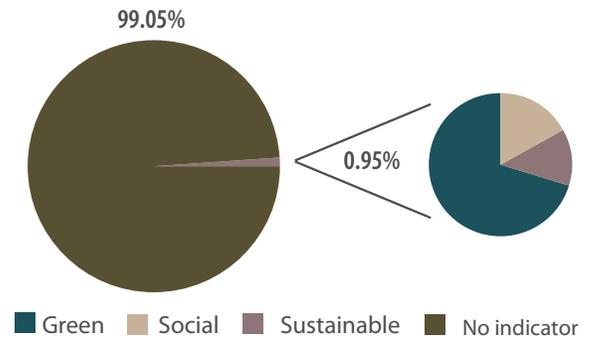
Going Forward

Currently, only about 1% of total debt outstanding is specifically labeled qualified proceeds use.

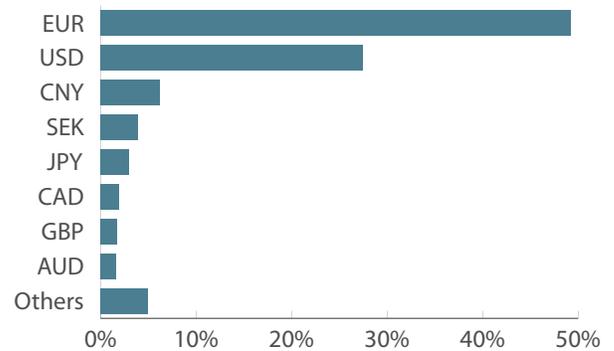
The pie chart, “Overall Global Bond Market,” details the qualified proceeds use and currency breakdowns of the bond market in 2021. Even within the small category of the sustainable bond market, US dollar-denominated bonds accounted for only 27.5% of total debt outstanding, as shown in “Currency Breakdown of ESG Bond Market — 2021.” If an investor is seeking sustainable bonds, a global strategy would have access to a much larger pool of debt securities. Issuance in this space has grown rapidly; both 2019 and 2020 saw growth of more than 60%. Europe and the US account for most issuance, but we expect green, social, and sustainable bonds to track the overall global bond market, with emerging market economies issuing more debt with specific use of proceeds.

A sustainability-minded investor must look outside of the labeled sustainable bond market for investment opportunities, not only due to the relatively small size of the market but also for the lack of consistency in standards for what constitutes qualified proceeds use bonds. Even issuers of green bonds can have serious governance or social detractors that could ultimately impact their underlying creditworthiness and subsequent returns.

Overall Global Bond Market



Currency Breakdown of ESG Bond Market – 2021



About the Authors



Elizabeth Alm CFA®

Senior Investment Analyst and Deputy Portfolio Manager

Elizabeth Alm CFA, Senior Investment Analyst, joined Saturna Capital in April of 2018. Originally from Connecticut, she graduated from New York University with degrees in Economics and Anthropology including field work completed in Luxor, Egypt. Prior to joining Saturna, Ms. Alm spent 11 years at Wells Fargo Asset Management as a senior research analyst focusing on high-yield municipal bonds. As part of her previous role, she also worked on the management of several municipal SMA strategies. Ms. Alm is a Chartered Financial Analyst® (CFA®) charterholder.



Patrick Drum MBA, CFA®, CFP®

Senior Investment Analyst and Portfolio Manager

Patrick T. Drum, Senior Investment Analyst and Portfolio Manager, joined Saturna Capital in October 2014.

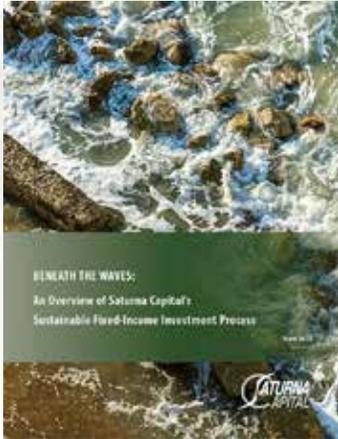
He is a former adjunct professor of finance for the Sustainable MBA Program at the Bainbridge Graduate Institute (BGI) currently known as Presidio Graduate School. Mr. Drum holds a BA in economics from Western Washington University and an MBA from Seattle University Albers School of Business. He is a Chartered Financial Analyst Charterholder, a Certified Financial Planner®, and holds a Sustainability and Climate Risk (SCR®) Certificate through the Global Association of Risk Professionals.

Prior to joining Saturna Capital, Mr. Drum led environmental, social, and governance (ESG) research and was director of fixed-income portfolio management since 2007 with a private account group at UBS Institutional Consulting Services specializing in investment management for global conservation and national wildlife park endowments as well as sustainable-social screened client portfolios. He is a former Chair of the United Nation's Principles for Investment (UNPRI) Fixed Income Outreach Subcommittee and a current member of the UNPRI's Bondholder Engagement Working Group (BEWG), an advisory committee working to elevate important ESG considerations and best practices among issuers and investors.

Mr. Drum's past experience also includes business valuation at Moss Adams and portfolio management at Washington Mutual Bank. Mr. Drum is a member of the Board of Trustees to the Museum of Glass in Tacoma and a member of Rotary.

More by Elizabeth Alm and Patrick Drum

Beneath the Waves: An Overview of Saturna Capital's Sustainable Fixed-Income Investment Process



In this white paper, we provide investors with an overview of Saturna Capital's sustainable fixed-income investment process. We aim to help elevate investors' awareness of how we explicitly integrate environmental, social, and governance (ESG) considerations into our investment approach of constructing globally diversified fixed-income portfolios. Essentially, our intention is to help clarify the "what," the "why," and the "how" of our investment process, and how Saturna can achieve the strategy's investment objectives of capital preservation and current income.

The Saturna Sustainable Funds 2022 Impact Report



Our team created a data set unique to Saturna Capital regarding how our investments align with the SDGs. We created this resource by examining every single corporate social responsibility report or impact report for the holdings in the Saturna Sustainable Funds. We looked at which issuers reported on specific SDGs and how they reported on each goal. We split company reporting into three categories, from most comprehensive to least comprehensive.

Available at www.saturna.com

Footnotes

- ¹ <https://www.sifma.org/wp-content/uploads/2021/07/CM-Fact-Book-2022-SIFMA.pdf>
- ² Bajpal, Prableen. "Green Bonds on the Rise." Nasdaq, July 2, 2021. <https://www.nasdaq.com/articles/green-bonds-on-the-rise-2021-07-02>
- ³ "About us." Climate Bonds Initiative. <https://www.climatebonds.net/about>
- ⁴ Jones, Liam. "Sustainable Debt Tops \$1 Trillion in Record Breaking 2021, with Green Growth at 75%: New Report." Climate Bonds, April 25, 2022. <https://www.climatebonds.net/2022/04/sustainable-debt-tops-1-trillion-record-breaking-2021-greengrowth-75-new-report>
- ⁵ Malhotra, Sanya. "Green bonds: Is it green finance or greenwashing?" DownToEarth, August 11, 2020. <https://www.downtoearth.org.in/blog/energy/green-bonds-is-it-green-finance-or-green-washing--72755>
- ⁶ Brightwell, Ryan. "How green are green bonds?" Climate 2020, September 14, 2016. <https://www.climate2020.org.uk/greengreen-bonds/>
- ⁷ "New unabated coal is not compatible with keeping global warming below 2°C." European Climate Foundation, September 18, 2013. https://sites.tufts.edu/cierp/files/2018/02/Unabatedcoal_final.pdf
- ⁸ Shepherd, Christian and Weinland, Don. "China to stop green bond financing for 'clean coal' projects." Financial Times, May 29, 2020. <https://www.ft.com/content/253f969c-37e0-42cd-9cdf06a5262fffe>
- ⁹ CICERO Shades of Green Company Assessments. CICERO Center for International Climate Research, 2018. https://static1.squarespace.com/static/5bc5b31a7788975c96763ea7/t/60b75b8f08cf5e0e9980a449/1622629266804/CICERO_SHadesofGreen_factsheet_CompanyAssessment_v5-new.pdf
- ¹⁰ IIX: Impact Investment Exchange Pte Ltd. <https://wlb.iixglobal.com/>
- ¹¹ "Mission, Vision and Values." USAID: United States Agency for International Development. <https://www.usaid.gov/who-we-are/mission-vision-values>
- ¹² Women's Livelihood Bond 3." IIX: Impact Investment Exchange Pte Ltd. <https://wlb.iixglobal.com/wlb-3/>
- ¹³ Sustainability-Linked Finance Framework. Odfjell, December 21, 2020. <https://d3grzk40ejrt1i.cloudfront.net/1610004396/odfjell-sustainability-linked-finance-framework-21-dec-2020.pdf>
- ¹⁴ Press Briefing: "2021 marks a decade of action since IMO adopted the first set of mandatory energy efficiency measures for ships." International Maritime Organization, July 15, 2021. <https://www.imo.org/en/MediaCentre/PressBriefings/pages/DecadeOfGHGAction.aspx>

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Ownership of Securities Mentioned

As of September 30, 2022, Odfjell comprised 1.89% of Saturna Sustainable Bond Fund's portfolio.



1300 N. State Street
Bellingham, WA 98225-4730
www.saturna.com

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