

Green Bonds: Moving Beyond the Initial Hype

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The euphoria surrounding the early years of what was then a new and promising asset class has now faded. We revisit the hurdles that have since emerged to investing in green bonds as an asset class and highlight how rethinking Green bond portfolio construction can help unlock the full potential we believe this asset class offers.

Looking Back

The early days: from strength to strength

The 2015 Paris Agreement on climate change was a catalyst for rapid expansion of the green bond market. Consequently, issuance volume doubled every year, consistently surpassing previous records.

By 2021, the green bond market had become less concentrated and more liquid. Not only had it reached a critical size, depth, and granularity, it had garnered strong investor appetite by offering transparency and impact measurability – all at a time when bond yields were close to zero.

Reality check

Enter the rates shock of 2022, in which rapidly rising interest rates severely impacted bond markets, hitting duration heavy portfolios even harder. Coupled with acute credit spread widening, it was the perfect storm to shake up traditional benchmarked green bond strategies.

This may have resulted in something of a wake-up call for sustainability investors as focus around impact credibility gave way to greater scrutiny around performance. This did not help to dissipate the misconceptions that investing in Environmental, Social, and Governance (ESG) strategies might imply sacrificing financial returns. The subsequent underperformance of sustainable equity strategies versus large technology stocks certainly failed to shake this narrative as well.

A new chapter

One cannot ignore that the sentiment around ESG investing seems to have shifted since the early days – ESG fatigue appears to have set in no doubt influenced by regulatory burdens, reporting complexity, and backlash in the US. Meanwhile, flows into SFDR Article 9 funds have declined in recent years¹.



Yet if we fail to look beyond the surface, are we missing out on a prime opportunity at a time when diversified Fixed Income has become increasingly attractive?

¹ Morningstar – [How SFDR 2.0 Could Reshape ESG Fund Flows](#).



Green, Social, and Sustainability Bonds: A Universe Ripe with Opportunities

The green bond market may have reached maturity, with established issuance patterns and fewer surprises in store – but maturity does not mean a less attractive market for investors nor that its full investment potential has already been reached.



One should not ignore the considerable attributes we believe the combined Green, Social, and Sustainability (GSS) bond universe has to offer, as well as alternative investment approaches that could more effectively fit investors' needs.

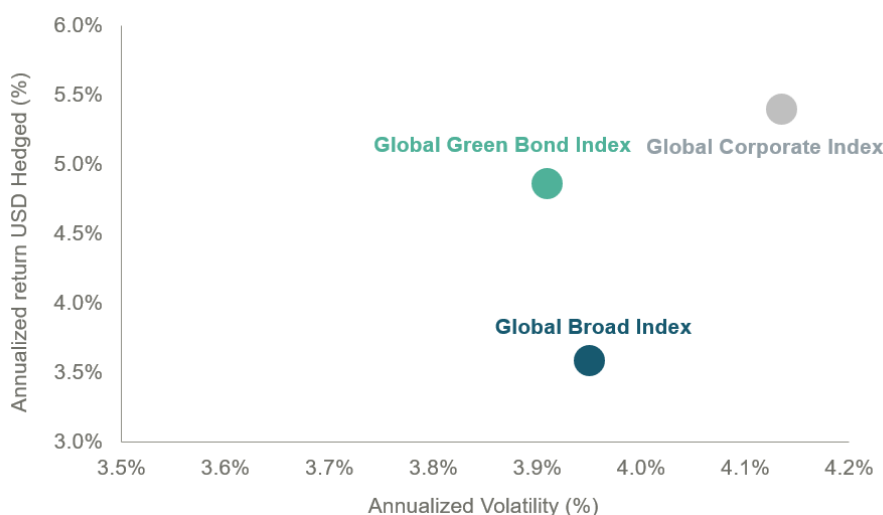
From niche to a global diversified market

Green bonds represent just 60% of the overall GSS market². When taken together with social and sustainability bonds, the combined universe stands at close to US\$4 trillion in market value, exceeding the euro investment grade credit market and offering access to more than 1,100 issuers spread across regions, sectors and currencies.

Green has outperformed conventional

Over the past 3 years, the GSS universe has delivered a better return than the Global broad market, close to that of the Global Corporate market for a lower volatility profile than both universes. This partly reflects the market's larger proportion of credit and higher sensitivity to European interest rates.

Figure 1: 3 Year Annualized Returns (USD) vs Volatility



Source: BNP Paribas Asset Management, Bloomberg as of 30/04/2026.

An alternative asset class

At a time when investors feel more comfortable about credit than sovereign debts, are willing to diversify away from US assets and are worried about the fiscal expansion coupled with monetary policy normalisation in Japan, the GSS Bond universe looks to be the perfect alternative.

No more greenium

We estimate that the greenium now stands at 1bps. While there may still be new issuance premiums, there is virtually no longer a cost premium for choosing to invest sustainably.

² Source: BNP Paribas Asset Management, Bloomberg as at 27/02/2026 (Green, Social and Sustainability bond market ex CNY, excl. outstanding <US\$300mio).

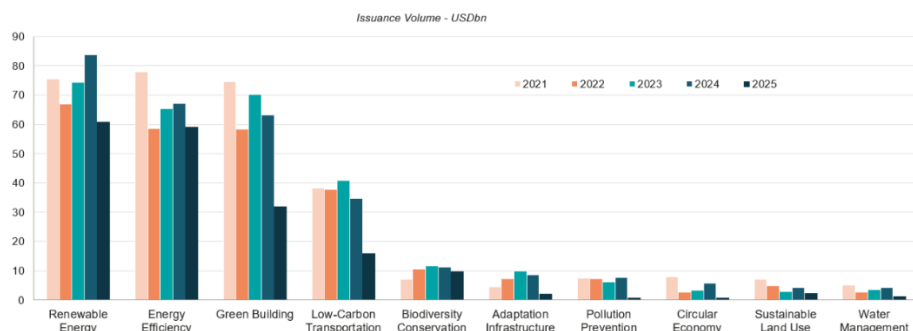


A credible decarbonisation tool and more

With over a decade of history, green bonds can now firmly demonstrate that they help issuers decarbonize. Studies from the BIS³ and from LSEG⁴ confirm the link between green bond issuance and decarbonization, highlighting how green bond issuers have decarbonized faster than non-green issuers – strong argument to strengthen the credibility of green bonds for Net Zero investments.

While climate is a dominant allocation theme among green bond projects, new themes have continued to emerge. From blue bonds to biodiversity bonds, to resilience bonds – thematic bonds that have emerged in recent years showcase the versatility of these instruments and the ways they can be instrumentalized to address evolving sustainability concerns.

Figure 2: Allocation of Green Bond Proceeds by Project Category by Issuance Year (Green Bond Index)



Source: BNP Paribas Asset Management, Bloomberg, LGX as of 31/12/2025.

Finding The Right Strategy to Extract Value Potential

While we believe the market is undoubtedly an attractive one - particularly at a time when yields are at historical highs and diversified strategies are an ally amid current uncertainty - we also need to acknowledge that investors may struggle to find the right balance between risk-adjusted return objectives and sustainability ambitions.

Solving the global aggregate conundrum

The traditional approach to investing in green bonds has been to develop a pure green solution, generally benchmarked against a green bond benchmark. This method was particularly appropriate when the market's depth did not allow for much customization.

Yet this solution quickly confronted investors with a tracking error dilemma. With over 200bps of tracking error between a global aggregate benchmark and a green bond benchmark, the green benefits can appear too risky for most - even if this tracking error actually delivered better results over the past 3 years.

Other ways exist, especially as the market has become more mature. We provide two examples below.

The easy way: Combining green bonds with us treasuries

- The Green bond market has historically offered investors a higher allocation to credit and a tilt towards euro rates compared to a global Aggregate benchmark. These characteristics have been the key driver behind performance divergence between both universes over the past decade and a source of tracking error.
- Combining 25% US Treasuries with a traditional green bond allocation offers investors a simple means to tilt one's portfolio towards a global aggregate-like structure (i.e. more US rates sensitivity and less credit exposure).
- This would result in a portfolio that is still 75% Green and easy to implement. It would have a lower yield than a 100% Green bond portfolio yet would be in line with a Global Aggregate benchmark for a tracking error that is divided by 2.
- One might argue though that this solution might efficiently address the Tracking Error dilemma. Yet it does not offer compelling evidence of ability to outperform, especially as the combined portfolio has lost its yield advantage. The solution also dilutes the impact potential one finds in traditional pure green strategies.

³ Bank of International Settlements – [Growth of the green bond market and greenhouse gas emissions](#).

⁴ LSEG Analysis - [Decarbonisation in Portfolio Benchmarks](#) - September 2025



The tailored way: Matching a global aggregate benchmark through GSS bonds

This approach would enable a Green bond portfolio to be built with a Global Aggregate benchmark while implementing active views that could generate a similar level of tracking error as that of a conventional green bond portfolio to its green bond benchmark (i.e., circa 70bps).

This would entail two key levers:

1 - Enlarging the opportunity set by including social and sustainability bonds.

- Social and sustainability bonds can offer attractive opportunities from an impact and investment perspective.
- Sustainability bonds – debt whose proceeds can be invested in both green and social projects – is now a dynamic and fast-growing US\$980bn market. Primarily a USD market, it offers access to a wider variety of sovereign and industrial issuers, notably appealing to Emerging Market issuers.

2 – Identifying and closing structural benchmark gaps through a customized and active management approach

- Structural differences exist between the Global Green and Global Aggregate indexes leading to several gaps in a green bond solution that would need to be filled including gaps in: USD issuances, MBS, Japan Government Bonds, and exposure to China.
- The GSS bond market now has sufficient breadth and diversity to be able to address these gaps. For example, to bridge the USD gap the inclusion of social and sustainability bonds would enlarge the USD segment of the investible universe. Increasing exposure to high-quality quasi-sovereign debt issued in USD could be a low tracking error alternative to US Treasuries which are not present in green bonds.

A custom portfolio designed to close these gaps could achieve a tracking error relative to a global aggregate benchmark that is comparable to the tracking error a traditional green portfolio would have to its green benchmark,

Seeking higher risk-adjusted returns through an unconstrained approach

For investors less concerned about tracking error and more focused on optimizing risk-adjusted returns, flexibility might be the answer.

Unconstrained, non-benchmarked approaches are well known in the conventional bond market yet are a rarity among GSS Bond strategies. They afford strategies with the freedom to invest across segments regardless of their index weighting.

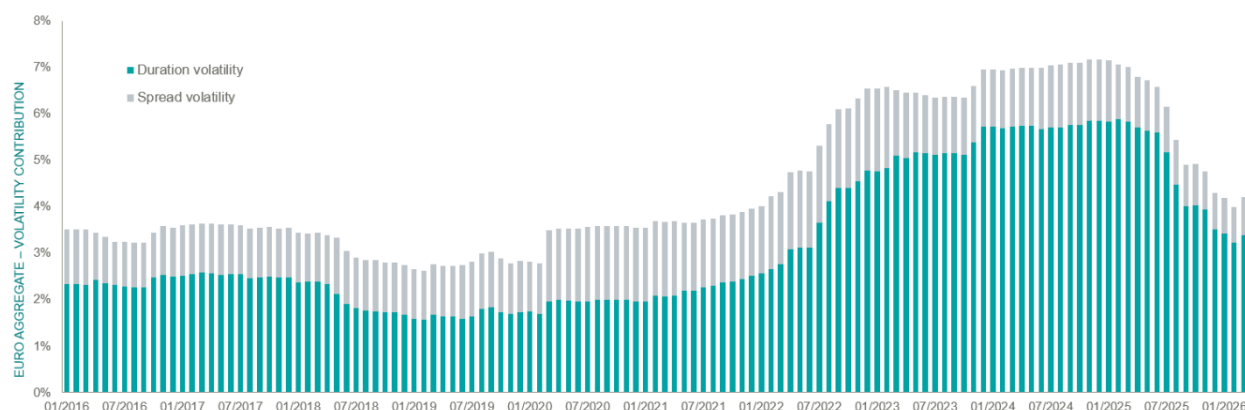
An unconstrained GSS bond strategy may offer investors a viable means to avoid having to choose between the aims of maximising return, limiting drawdowns and delivering positive impact. Two key attributes can bring this forward: flexible duration management and broad leeway in asset allocation.

Agile duration management amid market volatility

There has been a historic increase in bond market volatility, predominantly stemming from interest rates. While this can pose a challenge for investors, we believe this could also create potential opportunities to seek returns.

Having a significant leeway to calibrate duration can be critical in terms of not only aiming to protect the attractive yields the universe provides – limiting downside risk across cycles – while keeping the amplitude to capture the upside when rates rally.

Figure 3. Rates volatility - the new normal for fixed income



Source: BNP Paribas Asset Management, Bloomberg as of 30/04/2026.



Using the breadth of an unconstrained allocation

On a stand-alone basis, the green bond market offers a broad spectrum of segments to invest across – from investment grade and high yield to sovereigns and credit, as well as developed and emerging markets. Including social and sustainability bonds can enhance the richness of the market, allowing a strategy to tap into the specificities of each segment while also broadening impact potential.

An unconstrained approach allows investors to seek out the most attractive opportunities wherever they lay, with greater freedom to adjust allocation according to evolving market views. Crucially, it also affords the possibility of significantly investing in underrepresented segments, such as high yield or emerging market debt.

In a landscape marked by escalating geopolitical tensions, increasing global fragmentation, and persistent fiscal pressures fueling market volatility, agile duration management and flexible asset allocation are crucial to seize opportunities and transform volatility into competitive risk-adjusted returns. The depth and highly diversified nature of the GSS bond market make it an ideal environment for implementing such strategies.

Conclusion

The green bond market has entered a new stage, having evolved into a deep and mature investment universe. With the greenium having virtually disappeared, investors can access potentially attractive opportunities at market-equivalent valuations while maintaining meaningful environmental but also social impact thanks to the expansion of the social and sustainability bond markets.

As the market has expanded, so too have the tools available to investors. Whether addressing common investor concerns like global aggregate tracking error or the search for enhanced risk-adjusted returns, investors can now have access to a broader range of portfolio construction approaches tailored to different objectives and risk appetites. These can require proposing more custom solutions and applying strategies used in conventional markets.



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