Cocos: Not to be ignored

- *Cocos have performed positively this year, however, risk premiums have room to decline and carry remains a powerful driver of returns going forward.*
- *Cocos are no longer a 'niche' asset class and should be thought of as an alternative to HY or EM asset classes*

Market Insight

Marc Stacey

Portfolio Manager

November 2017

Contingent convertible bonds (cocos) have provided double-digit returns so far this year, how much value is left?

The ICE Bank of America Merrill Lynch Contingent Capital Index (COCO) returned 5.8% in 2014, 6.9% in 2015, 7.3% in 2016, and 14.5% so far this year[1]. At a broad asset class level, you could argue that until this year you were merely paid the carry on the asset class, and only now are we starting to reap the rewards of capital appreciation and declining risk premium.

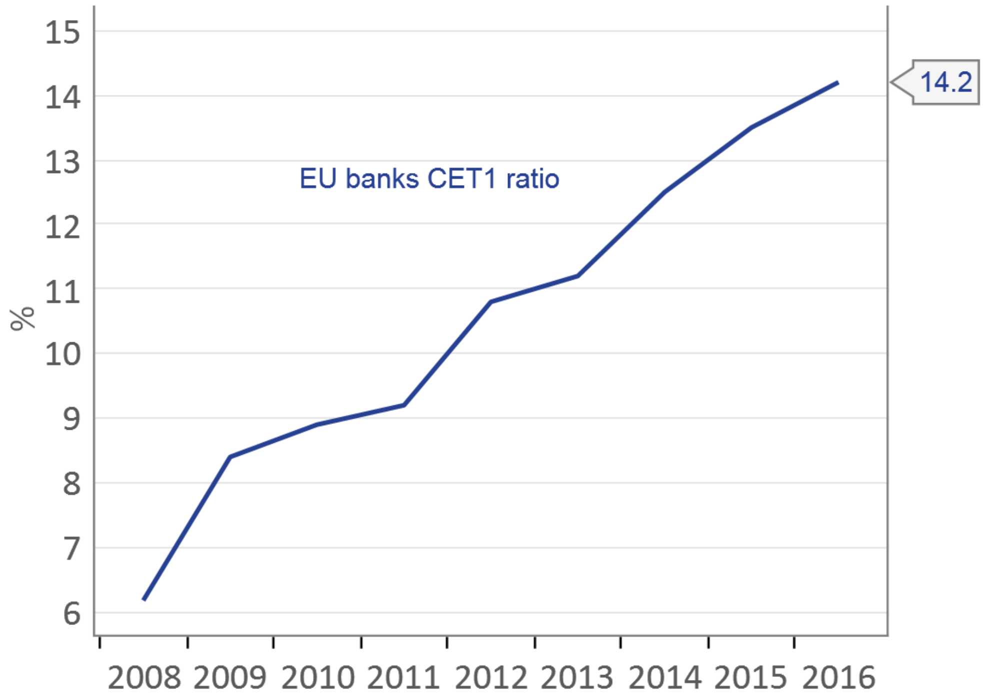
[1] 31 October 2017

Are risk premiums likely to decline further?

Yes. We believe cocos continue to be a structurally attractive investment from both a fundamental and technical backdrop.

From a macroeconomic perspective accommodative monetary policy continues to be a tailwind, aiding asset prices, particularly in the banking sector. Further, European growth and political stability continue to surprise investors who are underinvested in the region. More specific to this asset class, regulation continues to be a driver of improving fundamentals. Capital levels continue to be driven higher, stress testing has become more frequent and robust, liquidity provisions have been stringently applied and risk taking behaviour subdued. Taking Common Equity Tier 1 (CET1) ratios as an example, they are eight percentage points higher than in 2009 with no signs of that trend receding, making banks a more secure investment (from a capital standpoint) for bondholders than at any point post the Global Financial Crisis.

Regulation continues to drive stronger bank fundamentals



Source: Moody's, Credit Suisse, as at end 2016

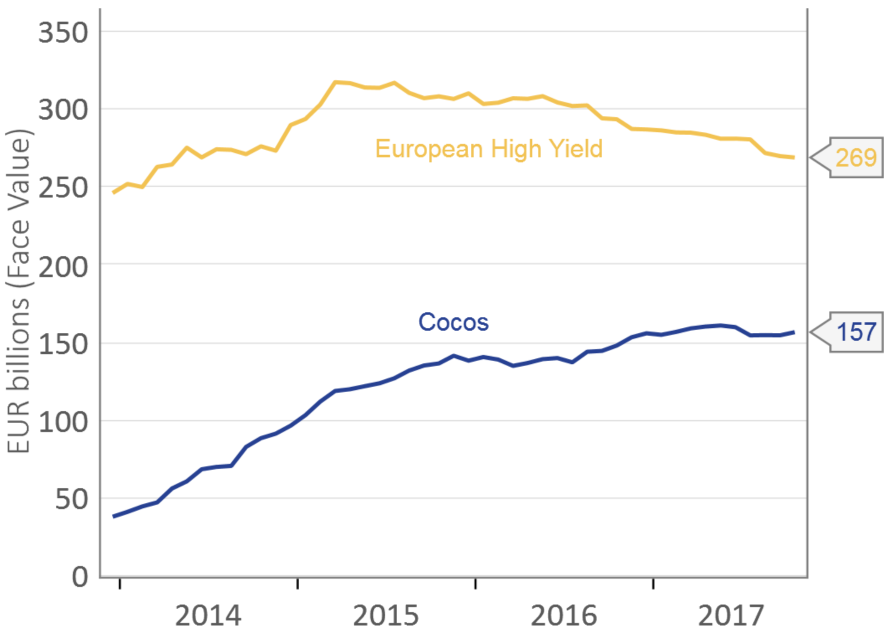
Last but not least, 'carry' remains a powerful driver of returns. We believe the coupons on offer are attractive (relative to peer asset classes) and will continue to supplement returns, just as they did during 2014-2016. Even today, the BlueBay Financial Capital Bond strategy provides approximately 6% of yield or 'carry'.

But aren't cocos considered a niche asset class?

This perception is changing. Cocos only emerged after the Global Financial Crisis, so it is understandable that investors have yet to fully familiarise themselves with the asset class. However, cocos have undergone rapid growth since, both in terms of market size and investor adoption.

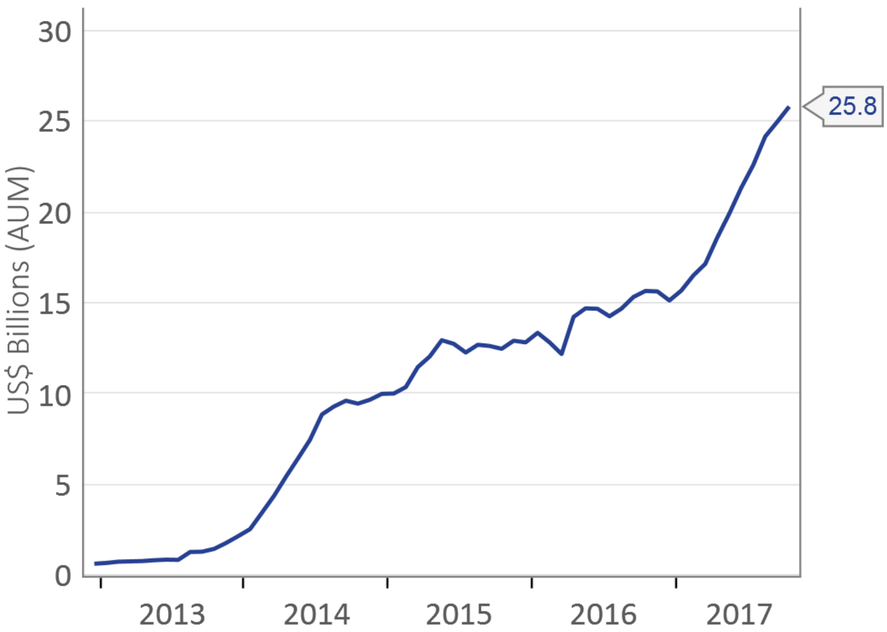
In terms of current market size, the face value of the COCO index has tripled since mid-2014, to €155 billion and continues to grow rapidly. To put this into context, the more mature European high yield bond market, as represented by the ICE Bank of America Merrill Lynch Euro High Yield Index, has a face value of €269 billion – and the gap between the two indices is steadily closing. The same can be said for investor appetite too, with fund's specialising in financial capital investing (under the UCITS framework) having amassed over US$25 billion in AUM from near obscurity five years ago. Cocos are firmly on the path to becoming a core component of the fixed income asset class.

The coco market has been growing steadily…



Source: Bloomberg, ICE BAML indices, as at 31 October 2017

…so have UCITS fund's specialising in financial capital

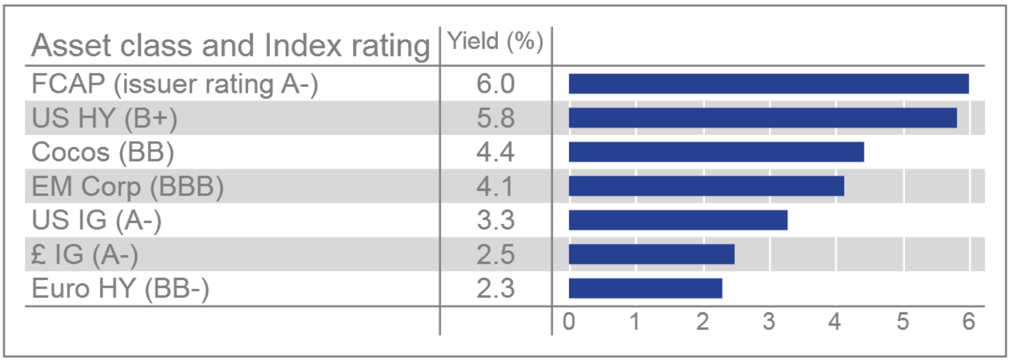


Source: Morningstar, BlueBay custom UCITS financial capital peer group, as at October 2017

How do cocos compare to other fixed income asset classes such as emerging markets or high yield, which provide similar yields?

While it is true US high yield (US HY) and emerging market corporates (EM Corp) provides not too dissimilar headline yields, the picture changes once we factor in risk, regulation and the market environment. This culminates into three broad arguments:

- At index level, cocos pose a higher credit rating than US HY, (BB versus B+), and the BlueBay Financial Capital Bond Strategy (FCAP) has an average issuer rating of A- (due to its bias towards 'national champion' banks).
- The financial sector operates in a highly regulated industry, and the same cannot be said for US HY and EM Corps which are more liable to cyclical factors.
- As interest rates rise, net lending margins improve boosting bank profitability. Rate rises are typically detrimental to EM and HY asset classes as it strains profitability and results in higher refinancing costs.



Source: Bloomberg, ICE BAML indices, as at 20 November 2017.

What risks do cocos bring and how does this compare to other forms of subordinated bank debt?

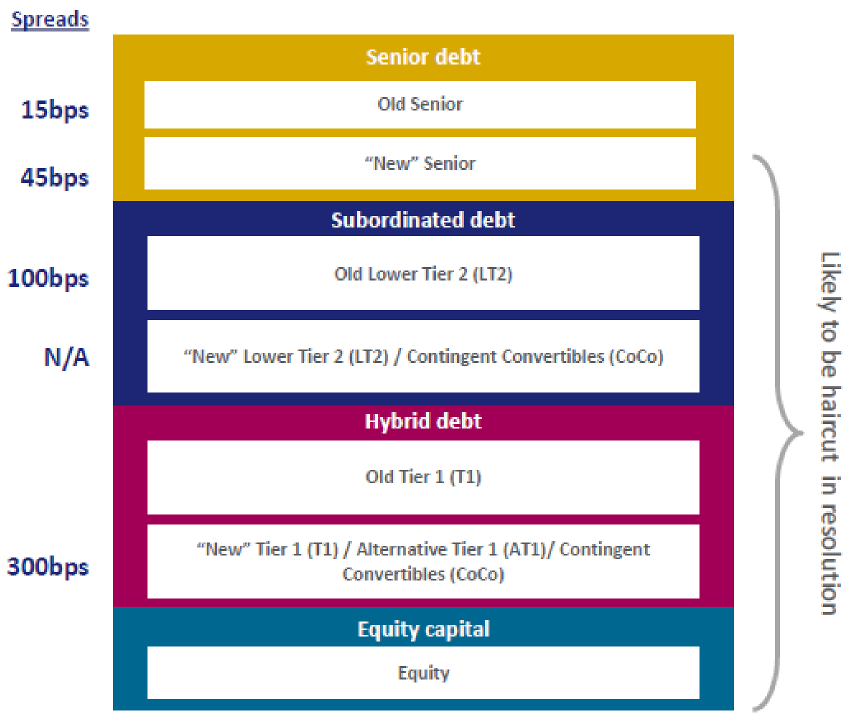
The risks to cocos are firstly from the loss of coupon, and then secondly from the loss of principal. These are the two risks investors need to be vigilant against in issuer selection. This was evident in the recent Banco Popular 'work out', which demonstrated that weaker, poorly capitalised banks can be resolved without sector and broader market implications. Moreover, the dispersion between weaker and stronger credits creates plenty of alpha opportunity potential so as long as good bottom-up credit calls are made.

Banco Popular also demonstrated that in reality, if one invests in a bank that is deemed 'likely to fail' by the regulator they are going to realise large losses across the capital spectrum: Equities, AT1, T1, LT2 and senior non-preferred debt. Basically, it did not matter if you are invested in the 'new' coco debt or the 'old' legacy instruments, the outcome was the same.

So there's an arbitrage opportunity?

We believe there is. Take for example, a 'national champion' French bank. Its coco trades 200bps wider than its LT2 peer, yet both are likely to be haircut in a resolution. This discrepancy is largely due to technical factors such as cocos not yet being included in traditional credit indices. From a fundamental perspective, we believe the differential should be closer to ~75bps. So over and above the attractive yield there is still the potential for good capital appreciation and compression within the capital structure

French 'national champion' bank example



Source: Bloomberg as at August 2017