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Nothing contingent about CoCos as returns add fuel to wealth portfolios

Lloyd Harris, co-fund manager for the Old Mutual Financials Contingent Capital Fund, which launched in August 2017, has recently been touring Asia to highlight its attractions. His message was that for Asia's wealth advisers and their Asian high net worth clients, these are safe, high yielding, liquid investments.

AT A HUBBIS GATHERING OF WEALTH MANAGEMENT EXPERTS IN JUNE, Harris explained that the Old Mutual Financials Contingent Capital Fund (the Fund) invests exclusively in contingent convertible bond issues (CoCos) issued by larger banks and also by a selection of insurance companies. He noted that from 2015 to 2017 European CoCos delivered returns of over 30%, including a 6% annual yield and that the Fund currently yields around 7.75% in US dollars.

"In our view," Harris claimed, "even though issuance totals some €140 billion already, we are at the early stages of the development of the asset class. We think that CoCos are still misunderstood, undervalued, under-owned, and thus present a fascinating investment opportunity for Asian wealth management portfolios."

CoCos are not a new asset class, having been around for 15 or more years. But they have moved into the mainstream since the global financial crisis (GFC), due to high issuance volumes from leading name banks and Harris expects that market to be worth around €250 billion within a few years.

The market has also been promoted by regulators eager to see a dramatic improvement in the stability of the financial sector, compared with the period of lax practices - and supervision - before and during the GFC.

CoCos became especially popular from 2014 onwards to help banks meet Basel III capital requirements. The bonds were increasingly seen as an ideal product for the issuers as they have an embedded option that allows banks to meet capital requirements and limit capital distributions at the same time. Harris' core message was that CoCos offer a unique combination of high yields from high-quality issuers, low volatility, diversification across a wide range of leading financial sector names, ample liquidity, and continually expanding investor demand.

Spreading the CoCos message

"While CoCos have been around for many years, there are many investors that have not yet appreciated their key features and therefore their appeal," Harris told the assembled wealth managers at the Hubbis gathering. "Simplistically, a CoCo is a perpetual debt security that converts to equity, but only when a bank is under extreme stress."

Harris and his colleagues anticipate continuing robust growth in issuance. He put CoCos in a

historical context, explaining that while there has been some issuance of CoCos prior to the GFC - for example, a famous issue came from Japanese mega-bank MUFG - CoCos were widely encouraged by regulators and banks after the GFC to address the problem of 'too-big-to-fail'. He explained that regulators required banks to strengthen by raising more equity and wanted to create within the capital structure one more layer of loss-absorbing features.

He reported that the total CoCo market stands at more than €170bn currently, with an expectation that it will surge to around €250bn within the next few years, due to the popularity of the instrument for the issuers and investors.

The issuers - mostly the larger capitalisation banks as well as some insurance companies - are investment grade names, typically with single-A ratings.

And as to the formation of the Fund - which began life in August 2017 and has a size of just over US$254 million - the portfolio at end April this year comprised 27.3% paper rated BBB, then BB debt stood at 46.3% and B-rated paper was 8.6% of the Fund holdings, with the balance comprising unrated paper and cash.

Looking under the CoCos hood

Harris then highlighted further key detail of the mechanics of the CoCo structure. By way of example, Harris referred to a leading global name bank with a capital ratio of 14%.

"If," he said, "under a stress scenario, that ratio was to drop to 7%, then the CoCos the bank has in issue - around US$23 billion of paper in total - would automatically convert into equity."

LLOYD HARRIS
OMGI

However, Harris said while such a calamitous drop in the capital ratio is possible, the probability of that happening is extremely low.

"Dropping from 14% to 7% would indicate some sort of catastrophic bank-related or economic or financial crisis," he said. "Typically, for a very solid, global bank like the one I have cited here, their capital ratio might deviate by only about 10 to 20 basis points a quarter, in other words hardly any movement at all."

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"Investors in the debt of the financial sector today are buying exposure to a financial sector

that has also been the beneficiary of a fairly draconian response from the global regulators since the GFC," Harris elucidated. "In Europe, for example, the authorities do not want the contingent risk of having to bail out any of the banks, so they have driven the banks to become much safer."

In the US as well, there has been a quite radical reformation of balance sheets, business practices and regulatory supervision.

European focus, dollar denomination

The Fund focuses exclusively on Europe and the US. The UK weighting was 35.2% at the end of April, and Europe was at almost 59%, with a small balance in paper issued by Australian banks. Virtually all the holdings are the single-A, large capitalisation banks, with a sprinkling of insurance companies.

The Fund is denominated in US dollars, but houses paper split roughly evenly between dollars, Euros and UK sterling. "Dollar issues are the most liquid, followed by euros, and third most liquid paper is denominated in sterling," Harris noted. "However, the direct inverse is true if we look at value, as we typically find the most value in sterling CoCos, then euros paper, and then from dollar CoCos."

CoCos are known as AT1, or additional tier 1, and sit above the equity and below tier 2 or senior funding. "From a regulatory perspective," Harris elucidated, "CoCos are loss-absorbing because the coupons can be switched off, or the bonds can be converted into equity or written down when the regulatory capital of the issuer drops below a certain level."

He also explained that from the banks' perspectives, as issuers, CoCos are appealing as the coupon payments are tax-deductible. "The cost of capital of CoCos is much lower than the cost of issuing new equity," Harris noted.

Investors buy into well-rated issuers

And from investors' perspectives, these instruments offer a high yield - the Fund yield was 7.75% at end April - which is very favourable compared to high yield bonds. "But," Harris further explained, "as I noted, CoCos are actually issued by high-quality issuers, high-quality banks. To obtain high income from high-quality issuers is appealing to investors, even though the paper is not senior debt. However, CoCos are considerably less risky than the equity of the bank, which bears any first losses."

Harris noted that huge amount of pure bank equity raised in Europe since 2007, which totals more than €600 billion. "To put things into perspective, this tells you how healthy or how strong the banking system is now compared to before

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the GFC." And he reported that for this kind of quality issuer, the typical default rate is just 10 basis points. "Investing in CoCos is an attractive opportunity, but the key point is that you have to select quality issuers."

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If they do not, Harris noted, they must issue more equity instead and that costs roughly twice that of contingent capital, largely because CoCos are tax-deductible to the issuers.

This means that when the banks can issue CoCos, they do so. For example, in recent weeks, HSBC has issued another $4.5bn of CoCos to bring their total outstanding in this class to the equivalent of $23bn.

Names such as Santander and Caixabank both issued in March. Harris noted that as each issue is usually at least $1 billion, these are large, liquid deals.

Growing market, rising liquidity

"Liquidity is a key feature," Harris added, "as these are far more liquid than a high yield bond issues, which are generally far smaller deals with less outstanding in total, whereas for example with HSBC's CoCos there is huge liquidity and it is therefore very easy to trade in and out and also to hedge."

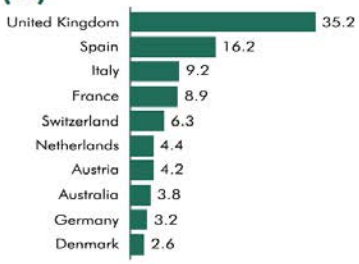
Harris explained that the CoCo bonds are more correlated to equities than they are to debt, with a correlation, for example, of 0.4%

TOP 10 BOND HOLDINGS (%)

BANCO SANTANDER S.A.	7.3
HSBC HOLDINGS PLC	6.2
BARCLAYS PLC	5.9
UBS GROUP AG	5.6
CREDIT AGRICOLE	4.7
INTESA SANPAOLO S.P.A.	4.5
UNICREDIT S.P.A.	4.5
BAWAG GROUP AG	4.1
NATIONWIDE BUILDING SOCIETY	3.9
ONESAVINGS PLC	3.6

Please note due to rounding of figures they may not add up to 100%.

COUNTRY BREAKDOWN (%)



CREDIT RATINGS (%)

BBB	27.3
BB	46.3
B	8.6
Not Rated	14.9
Cash	2.9

to the S&P 500. "Correlation to US Treasuries meanwhile," he added, "is minus 0.31, so CoCos also have an important structural feature, as they offer a partial hedge to a rising rate environment."

This is because government bond yields are so low, while the credit spread above that on the CoCos might, for example, be as much as 10 times the government yield portion. The credit spread component is therefore very large. "This is a risk asset class that behaves a lot more like an equity holding, but it pays a fixed income."

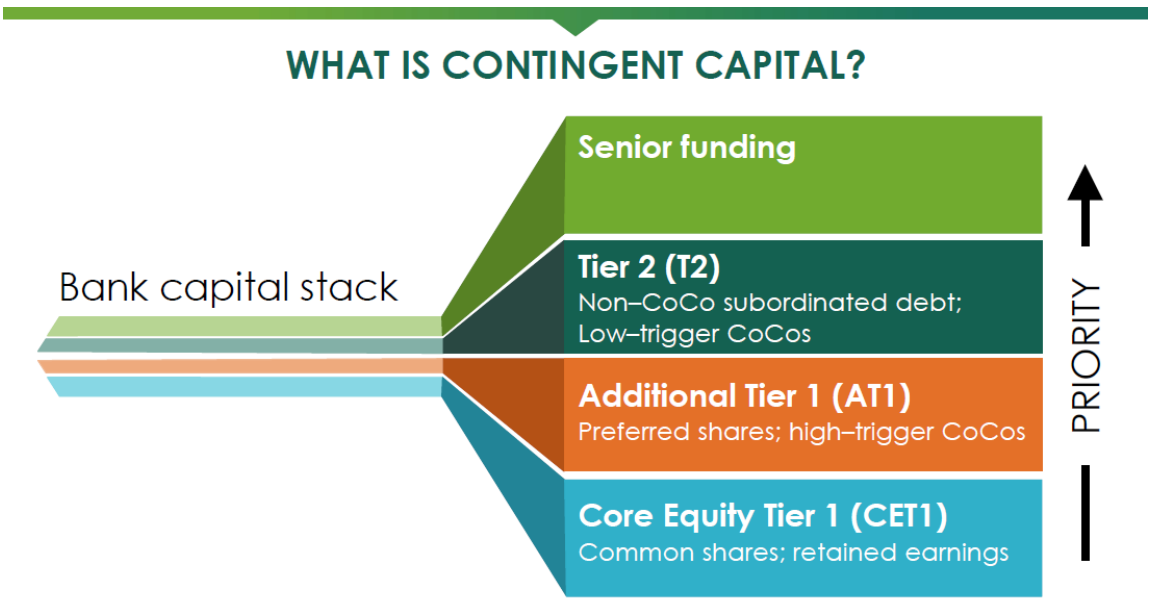
Investor protection against rising rates

CoCos therefore to some extent insulate investors against rising interest rates. As perpetual instruments they have a spread over the prevailing interest rate, so for example at resets, they reset to their original spread - for example, 6% - but based on whatever interest rate is then prevailing.

Harris elucidated: "For a particular CoCo issue with an initial spread of 600 basis points, set when the interest rate was 1% the coupon is therefore 7%. Hypothetically, five years later at reset in case the interest rate is at 2%, there is a reset if the CoCo has not been called. Then the coupon payment will become 600 basis points plus the prevailing interest rate, in other words, it becomes 8%."

Harris then went into further detail about the yields. "An equity investor holding bank stock might expect dividends of 3% to 4% and capital gains of 6% to 7% each year. If we look at contingent capital, we are getting about 70% of that expected 10% return or roughly 7%, but we are achieving that at 15% of the volatility of bank equity."

"There is also a huge difference between contingent capital and high-yield," he added, "as in the contingent capital, you are dealing with A-rated banks functioning in



a very tightly regulated industry. You then look at high-yield and see substantially lower ratings while quite a lot of contingent capital paper is rated investment grade in its own right."

High yield but better than high yield paper

Harris pointed to the high-yield index, with an average rating of single-B, while CoCo paper sits considerably higher at BB+. Moreover, he noted that some 14% of high yield paper is CCC or below, one level above default.

"And you are dealing with vastly different companies that issue high yield and those issuers are not being forensically supervised by regulators," Harris observed. "In the financial sector, capital ratios have risen, in other words, the loss-absorbing capacity of the banks has improved dramatically."

He added that risk-weightings - the amount of capital a bank must hold against every asset - have also risen. "And today," he explained, "we have a risk-weighted leverage ratio for the banks, whereas before it was a simple leverage ratio, hence the troubles a firm such as Lehman Brothers found itself in a decade or so ago."

Additionally, Harris explained that CoCos are a regulatory-encouraged asset class. "If the capital ratio drops at any particular bank and they have CoCos in issue the coupons are automatically switched off, and equity dividends too, as well as employee bonuses. So, the hypothetical 14% ratio for the global bank I mentioned earlier, should that drop to 8%, this automatic switch off process takes place."

Harris explained that initially, the regulator did not declare this automatic switch off point for each issuer, but since 2016 the regulators have made this transparent.

Transparency for financial modelling

"The switch-off point is very close to the crisis point," he said, "in other words extremely unlikely, which gives investors considerable comfort," he explained. "Moreover, the buyers can create their 'what if' models for investing based on a clear switch-off threshold. Each bank has its own switch-off point to aid the accuracy of these models. And remember that all this is set in a financial sector whose capital ratios, business practices and regulatory supervision is streets ahead of the lax practices and dubious supervision of a decade or more ago."

Harris highlighted as an example the case of UniCredit, one of Italy's largest banks, which hit such a crisis point during 2016 and that in late December that year then raised €13 billion in fresh equity. "Unicredit had CoCos outstanding at the time, but instead of allowing the automatic switch-off of coupons, dividends and bonuses it avoided triggering their CoCos by raising a large amount of fresh equity."

That series of events shows just how important these instruments are to the banks, Harris explained. "Unicredit knew how vital it was

to retain market access to different classes of debt and as a hybrid, perpetual instrument, this CoCo structure is vital for the issuers as well as the regulators."

Two into one will go

The presentation then turned to the Fund's investment strategy. Harris was previously lead manager of the Old Mutual Corporate Bond Fund from 2015 onwards. And for this Fund he has partnered with co-fund manager Rob James.

"Because of the hybrid nature of the asset class," Harris explained, "I work with Rob James and we divide analysis and assessment of the two sides of the equation - the credit side focusing on downside protection, and the equity side requiring in-depth analysis of the banks' strategies, profitability and other metrics."

"We stick firmly to a focus on downside risk and to selecting the best in class names, first and foremost," he reported. "Credit fundamentals, management quality and strategy - we meet them twice a year on average - and profitability are all key elements that with our hybrid debt and equity fund manager approach we can handle very well."

Other key factors Harris cited are liquidity of the bank assets and of the instruments themselves, as well as regulatory developments, as the banks are, in essence, leveraged versions of the economies in which they operate, so the macro backdrop needs to be quite strong.

The stature of the bank's balance sheet is also a key feature of the selection of the CoCo paper. Reserves with which to pay coupons and dividends are vital. "This Fund is not about buying into situations that might become distressed, it is about completely avoiding such scenarios," Harris elucidated. "We hold a diversified portfolio of around 50 holdings, generally larger banks, but with a few smaller, highly capitalised names. With mainly European names and a few US names, we have solid diversification. We are on top of every development that might affect the issuers or the CoCos outstanding."

And the selection process is also carefully considered. "We have adopted a four-step portfolio selection process to choose the most appropriate CoCos for the fund," Harris added. "It is very effective, and that has helped us outperform the benchmark significantly."

Harris and James are eager to spread the message to wealth advisers and HNW investors across Asia that are seeking safe, yield-enhancing investments to diversify their portfolios. "We are spreading the CoCos message in this region," Harris concluded, "this is an asset class that ideally suits well-structured HNW portfolios." ■

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