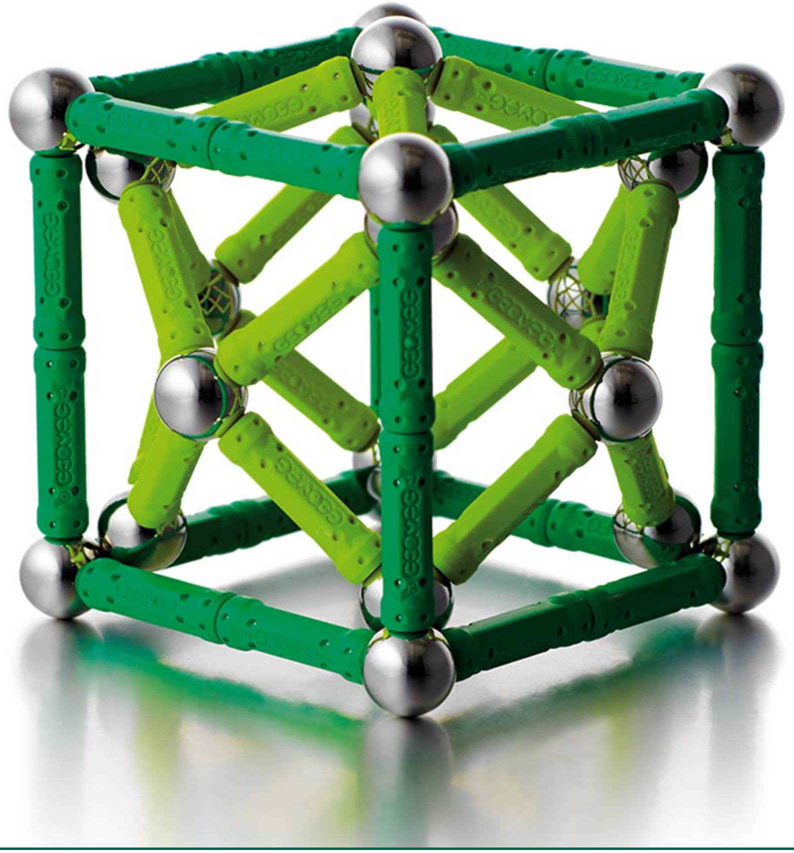

EXPLORING SIGNIFICANT YIELD OPPORTUNITIES IN COCOS

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THE BIRTH OF COCOS – SIGNIFICANT CHANGES ENSURING BANKS ARE FAR BETTER CAPITALISED

Prior to the Global Financial Crisis (GFC)... banks that were in danger of failing were bailed out by the governments of the countries in which they were based.

This circularity made the system unstable, and one of the prime aims of the regulations that have followed since has been **to address the 'Too Big To Fail' problem**, and the link between banks and their sovereign.

The primary method by which this has been achieved is through the banks **de-gearing their balance sheets**, through a combination of reduced balance sheet size and far **greater amounts of equity**. In itself this has made the system more secure than prior to the GFC, however **CoCos** and other measures have also **been introduced to seek further strengthening**.

WHAT IS CONTINGENT CAPITAL?

- Bonds that convert to equity or get written-down when the regulatory capital of the issuer drops below a particular level
- Issuance driven regulatory capital requirements
- Attractive for bank issuers as the coupon payments are tax-deductible and the cost of capital is lower than issuing equity
- For investors the higher rate of interest compared to other types of bonds is appealing
- CoCos are riskier than senior debt, but less risky than the equity of the bank which bears the first losses

BANK CAPITAL STACK
SENIOR FUNDING
TIER 2 (T2) Non–CoCo subordinated debt; Low–trigger CoCos
ADDITIONAL TIER 1 (AT1) Preferred shares; High–trigger CoCos
CORE EQUITY TIER 1 (CET1) Common shares; Retained earnings

Source: Morningstar, average sector yield and volatility, December 2016.

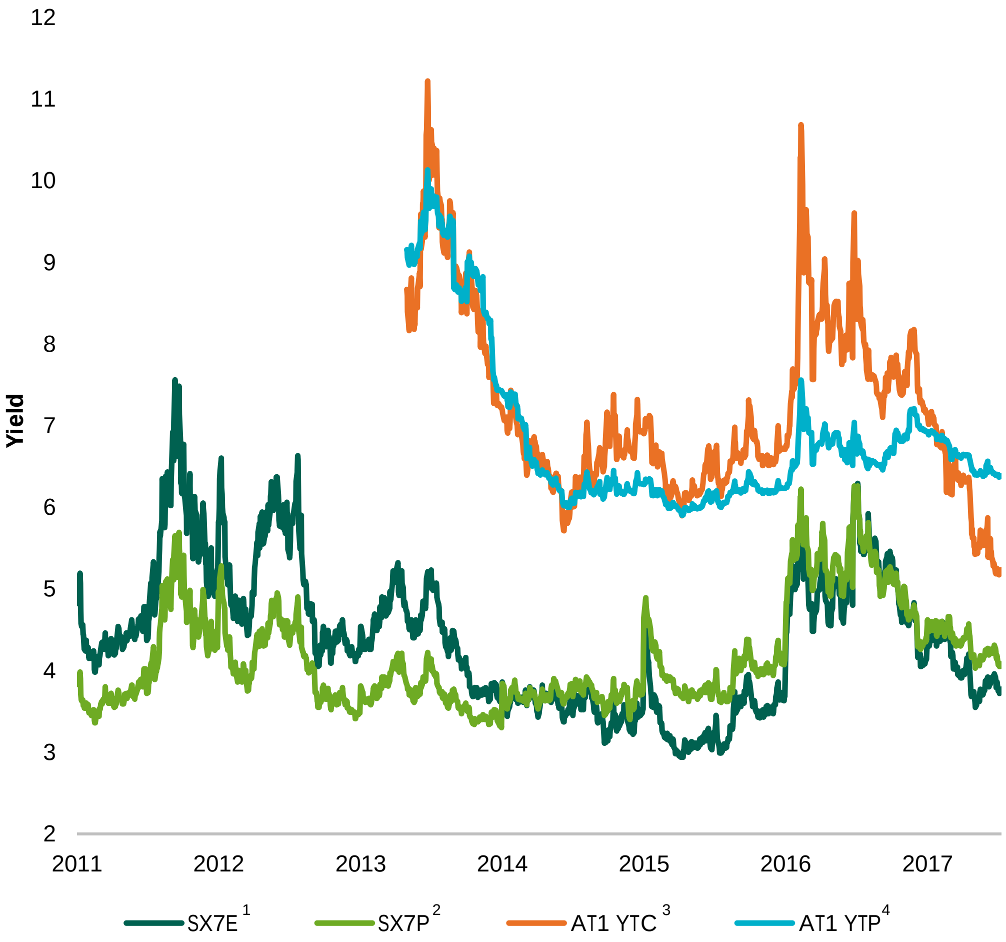
WHY COCOS?

- High yield and low volatility vs financial stocks
- Exposure to the financial sector
- Focused primarily on the US, UK and Europe
- Income diversifier
- A growing asset class

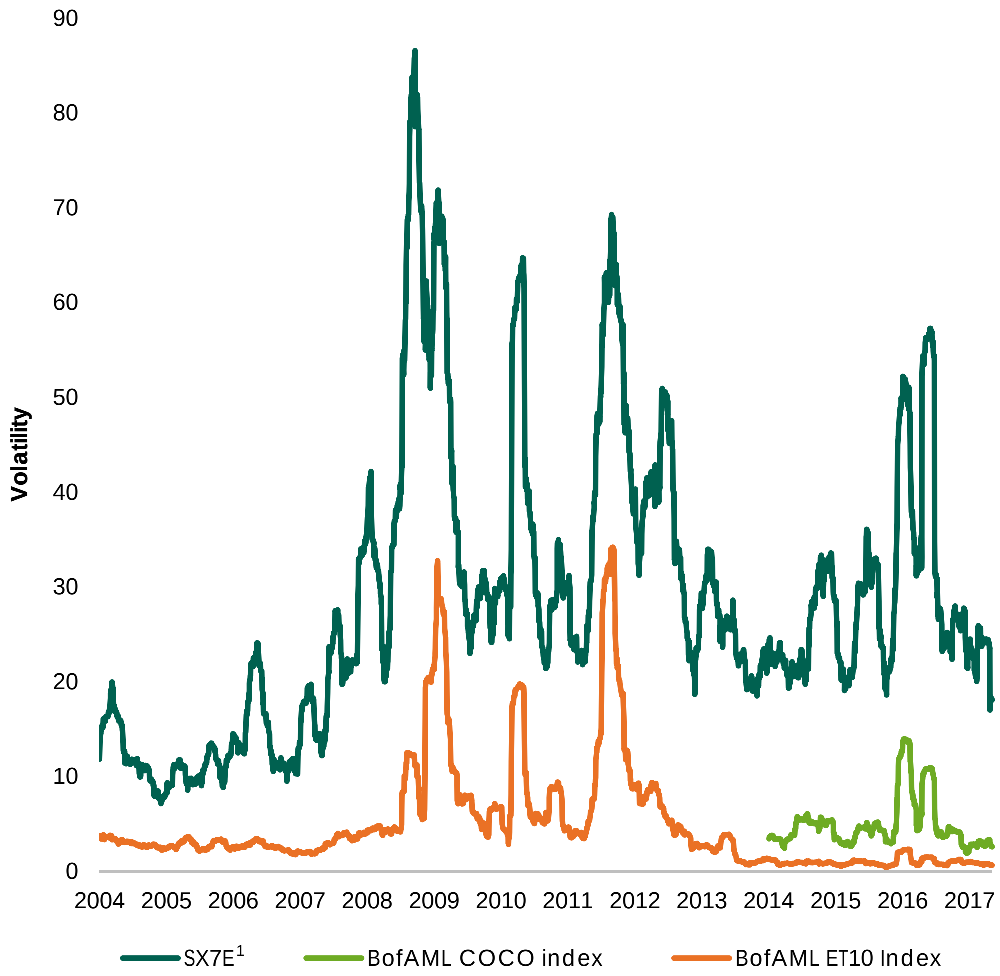
HIGH-INCOME FROM HIGH-QUALITY ISSUERS

MORE YIELD, LESS VOLATILITY
THAN FINANCIAL STOCKS

YIELD STILL COMFORTABLY IN EXCESS OF EUROPEAN BANK EQUITY

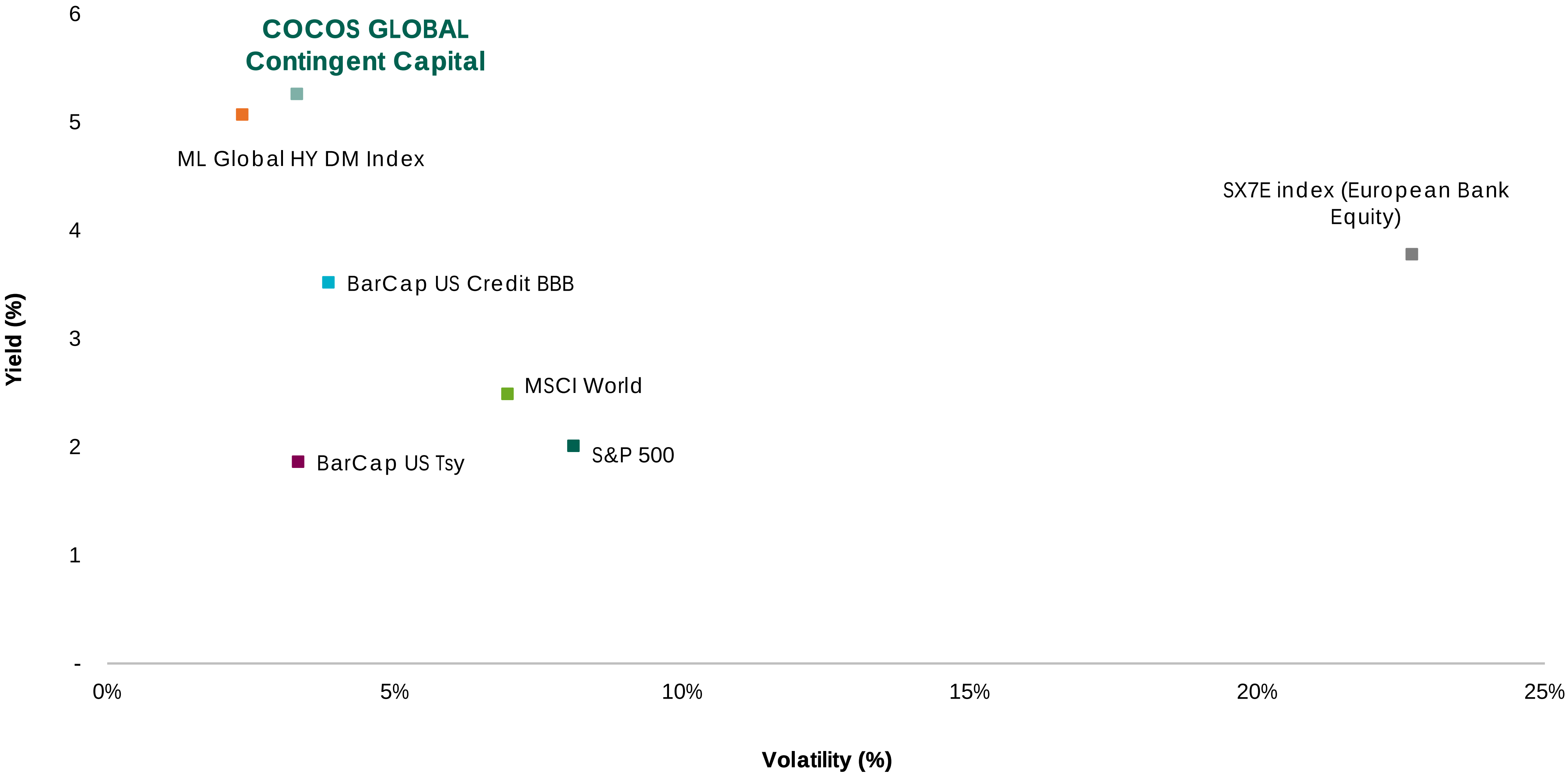


VOLATILITY OF BANK STOCKS VS COCOS



Source: Bank of America as at 11 July 2017. [1] Euro Stoxx Banks (European Monetary Union). [2] Stoxx Europe 600 Banks. [3] Additional Tier 1 Yield to Call. [4] Additional Tier 1 Yield to Perpetuity.

WHERE IN THE INCOME SPECTRUM DOES A COCO FUND SIT?



Source: Morningstar, Bloomberg, Barclays, average sector yield and volatility, 8/10/2007 to 06/10/2017.

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AN UNCORRELATED ASSET CLASS

CORRELATION WITH COCOS BENCHMARK

Barcap US Corp High Yield	Euro Stoxx Financials	MSCI World	S&P 500	Bloomberg Barclays Sterling Aggregate Corporate	Bloomberg Barclays Sterling Gilts	Bloomberg Barclays US Treasury
0.66	0.63	0.57	0.39	0.10	0.01	-0.31

COCOS ARE TRUE HYBRIDS, EXHIBITING GREATER CORRELATION TO EQUITIES THAN BONDS

Source: OMGI, as at April 2016.

COCOS: A STRUCTURE THAT INSULATES THE INVESTOR AGAINST RISES IN INTEREST RATES

	0 years	5 years	10 years	15 years
	ISSUANCE	RESET	RESET	RESET
ISSUANCE SPREAD	600bp	600bp	600bp	600bp
ILLUSTRATION OF RISING RATES	1%	2%	3%	4%
TOTAL	**7%**	**8%**	**9%**	**10%**

As interest rates rise, fundamentals for banks improve (they reprice loans faster than deposits).

CoCos are correlated to equities rather than bonds.

For illustrative purposes only, to show effect of a hypothesized rising rate scenario.

THE BANK OF ENGLAND 2017 STRESS TEST

PERHAPS THE MOST STRINGENT…

UK RESIDENTIAL HOUSE PRICES TO FALL BY

33%

UK COMMERCIAL REAL ESTATE PRICES TO FALL BY

40%

GDP TO FALL IN THE UK BY

4.7%

STERLING TRADE-WEIGHTED INDEX TO FALL BY

27%

LOSSES OF

£50bn

OVER THE FIRST TWO YEARS

MINIMUM RATIO REACHED		PASS/FAIL
NATIONWIDE	12.3%*	✓
SANTANDER	9.7%*	✓
HSBC	8.9%*	✓
LLOYDS	7.9%*	✓
STANDARD CHARTERED	7.6%*	✓
BARCLAYS	7.4%*	✓
ROYAL BANK OF SCOTLAND	7.0%*	✓

BASED ON BANK PROJECTIONS, THE STRESS SCENARIO WOULD REDUCE THE AGGREGATE CET1 CAPITAL RATIO ACROSS THE SEVEN BANKS FROM 13.4% TO A LOW POINT OF 8.3%, WELL ABOVE AT1 TRIGGER LEVELS

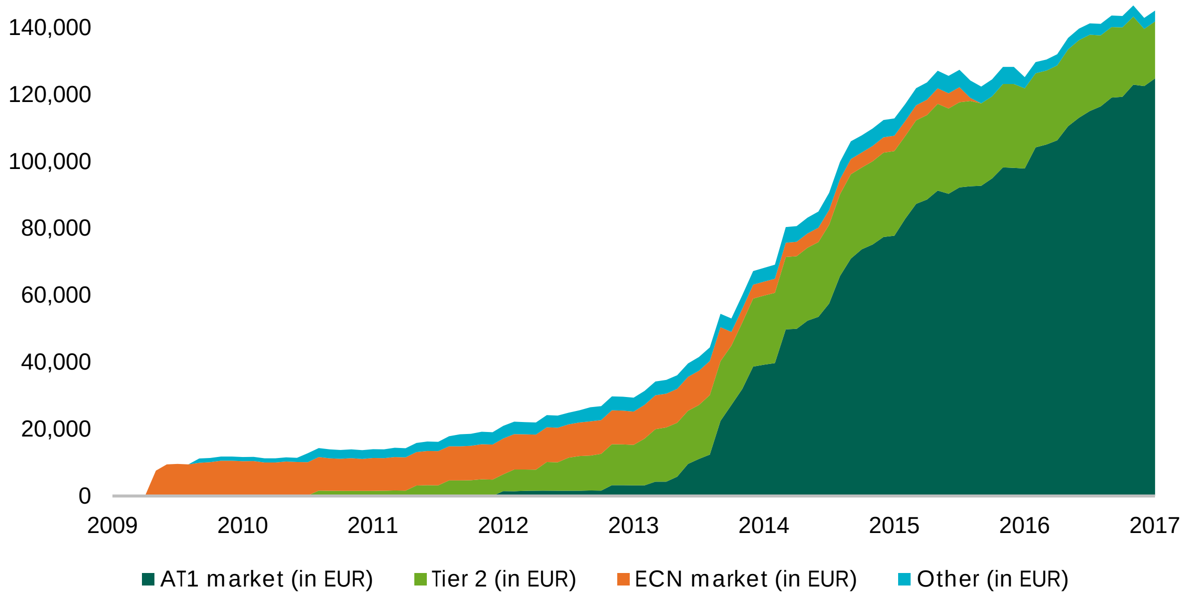
Source: Bank of England, 'Stress testing the UK banking system: 2017 results', November 2017. *Projected CET1 capital ratio in the stress scenario.

THE OPPORTUNITY: IG ISSUERS, HIGH YIELD INCOME

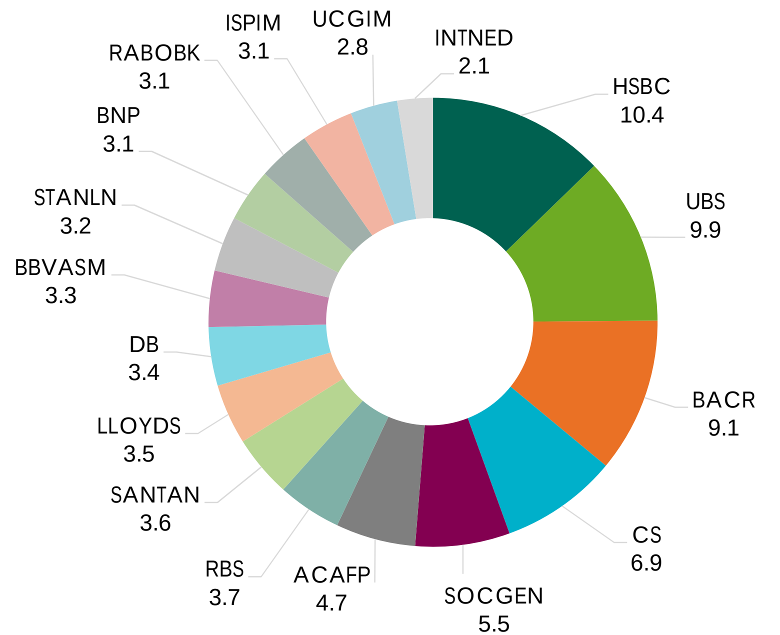
- A GROWING ASSET CLASS[1]
- C.€140BN IN ISSUE FROM EU BANKS[1]
- MARKET MATURITY EXPECTED C.€250BN[1]
- GROSS YIELD ~6%[1]
- AVG ISSUER RATING A[1]
- AVERAGE RATING BB+[1]
- UNDERVALUED ASSET CLASS DUE TO COMPLEXITY[1]

[1] Averages of the index constituents.

INCREASING ISSUANCE (EUROS MN)



BENCHMARK WEIGHTINGS (%): HIGH QUALITY



Source: BofA Merrill Lynch Global Research. Banks – The Contingent Capital Primer 11 July 2017.

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MEET THE PORTFOLIO MANAGERS

LLOYD **HARRIS**
CREDIT

ROB **JAMES**
EQUITIES

SECTOR EXPERTISE

CREDIT

- COVERING FINANCIAL CREDITS SINCE 2007
- LEAD FINANCIALS ANALYST AND BOND FUND MANAGER
- PREVIOUSLY AT DEUTSCHE BANK

EQUITIES

- COVERING FINANCIAL EQUITIES SINCE 1989
- ESTABLISHED SENIOR FINANCIALS EQUITY ANALYST
- PREVIOUSLY OF AVIVA INVESTORS AND INSIGHT

A WEALTH OF KNOWLEDGE AND EXPERIENCE

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Hong Kong

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