Ever thought about Financial CoCo bonds?

In a financial environment characterized by about 11 trillion dollars of bonds showing negative returns, and by 87% of the non-USD hard currency denominated existing securities yielding less than 1.50%, Contingent Convertible bonds, with an average yield to maturity of 5.66%, stand out as an attractive investment opportunity for those who are still seeking returns in the fixed income space.

Contingent Convertible bonds, also known as CoCo Bonds or simply “CoCos”, are hybrid bonds issued by financial institutions in order to build up capital reserves providing loss absorption on a “going-concern basis” due to particular stress situations of the Bank. These instruments have been designed in the wake of the latest financial crisis in order to provide a capital buffer and, given their features, they fit in between equity and debt in the capital structure. Indeed, these perpetual bonds are subordinated to the senior ones, which justifies their higher expected yield, and get converted to equity should the Core Tier 1 ratio of the Issuer, defined as the its percentage of equity on risk weighted assets, breach a specific threshold. Since their introduction, CoCo bonds market rose notably, and many financial institutions started relying on these instruments in order to satisfy Basel III capital requirements. As of today, the asset class also represents a valid investment alternative with an attractive risk-return profile.

In relative terms to other debt instruments in the European Financials sector, the expected CoCos Yield to Volatility ratio turns out to be greater than the one realized by senior bonds (Figure 1). Taking this in consideration and thanks to their appealing risk-reward profile, CoCos are therefore to be considered an efficient investment solution in the context of a portfolio.

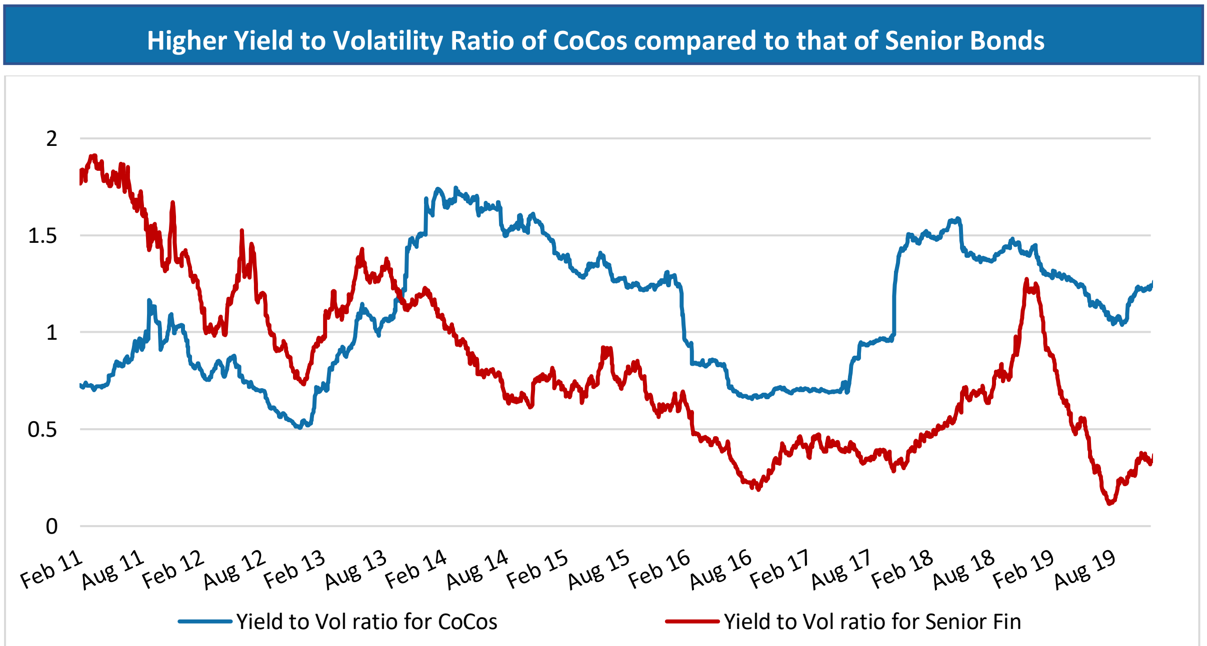

Figure 1. CS CoCos Total Return Index Yield to Maturity (YTM) to Volatility ratio (blue) and Senior Financials Benchmark Yield to Maturity (YTM) to Iboxx Senior Financial Volatility (red). Source: Bloomberg, data as of 31/12/2019.

Furthermore, the comparison among BBB-rated European financial bonds and a similarly rated CoCo bond issued by HSBC, shows clearly how the yield offered by the CoCo is sharply greater (Figure 2) for the same rating bucket.

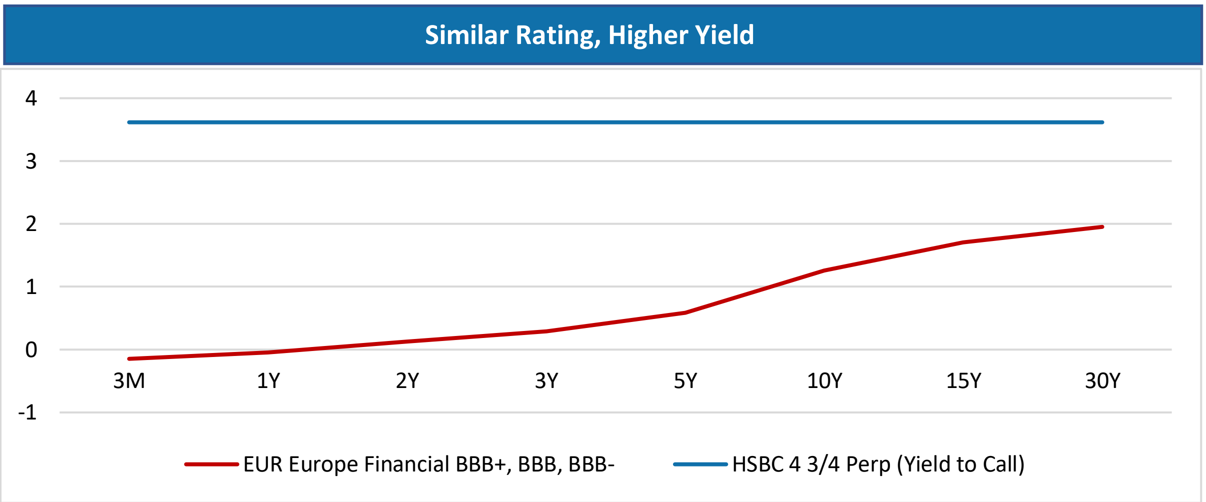

Figure 2. BBB-rated European financial bonds and HSBC issued CoCo bonds yields compared. Source: Bloomberg, data as of 31/12/2019.

Investing in CoCo bonds can be increasingly efficient for institutional investors such as insurance and pension funds, which value investments to be undertaken by assessing their risk in terms of solvency capital requirements as for example under Solvency II directive.

Solvency II directive aims to ensure that insurance companies hold a certain level of capital based on the resources necessary to meet their commitments in the following 12 months in any market scenario. The amount of this capital is determined by analysing different types of risk to which the company's assets are exposed.

In this respect, CoCos can be an efficient tool, as an investment in this asset class can be implemented in such a way as to obtain equal or lower capital levels than similarly rated bonds would, against higher expected returns.

Although CoCos are not directly mentioned within Solvency II directive, given their features they can be included in the Hybrid Instruments category, which are subject to spread risk, or credit risk. This risk is mainly assessed according to the following two factors: instrument rating and duration. Concerning the rating, we already showed how efficient CoCos are in performance terms when compared to bonds having a similar rating. With regards to the duration factor, CoCos, although being a perpetual financial instrument without a specified maturity, they still could benefit from the duration “bucketing” applied by the standard model, even if assessed in a conservative way. Required capital for CoCo bonds spread risk, which offer greater returns when compared to other debt instruments, should not anyway differ from that required for a senior bond with same rating and duration.

Also, CoCos potentially entail equity risk, i.e. a risk bound to movements in the equity market, due to the chance of having such title converted into equity upon the occurrence of specific market conditions. This risk can be factored in a solvency assessment by taking a conservative approach, as this risk module is not directly requested for this specific asset class.

Analysing these securities from an equity risk perspective, CoCo Bonds seem also particularly efficient compared to an investment in equities as, while CoCos and the European Banks Index (SX5E) showed a highly correlated trend, the former had shown a much lower beta (around 16%) to the latter in the last 5 years.

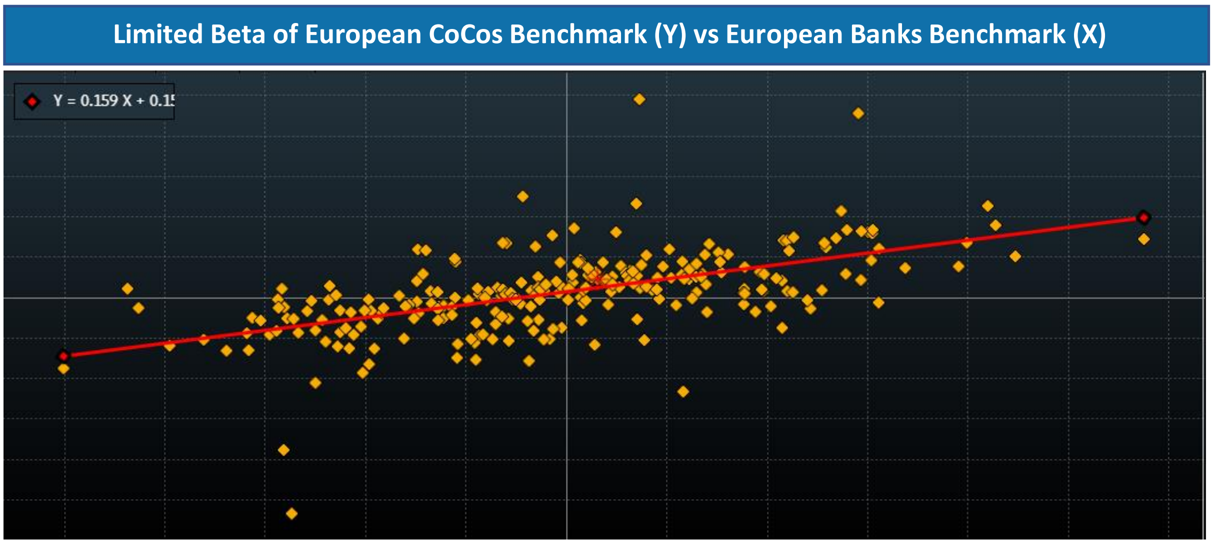

Figure 3. Source: Bloomberg, data as of 31/12/2019.

This results in a risk-return profile of CoCos better than Equities in several cases, as highlighted on Figure 4. Furthermore, we did not consider the greater consistency of returns offered by CoCos compared to stocks of Financials (total return of 42.56% of European CoCos Index vs. -11.66% of the equity benchmark in the last 5 years), and that the banking sector has undertaken, in the last years, an important consolidation process in order to reduce the once higher financial leverage; this new scenario should make an investment in the sector more sound with greater protection on income generated by bond like securities compared to capital appreciation of equity.

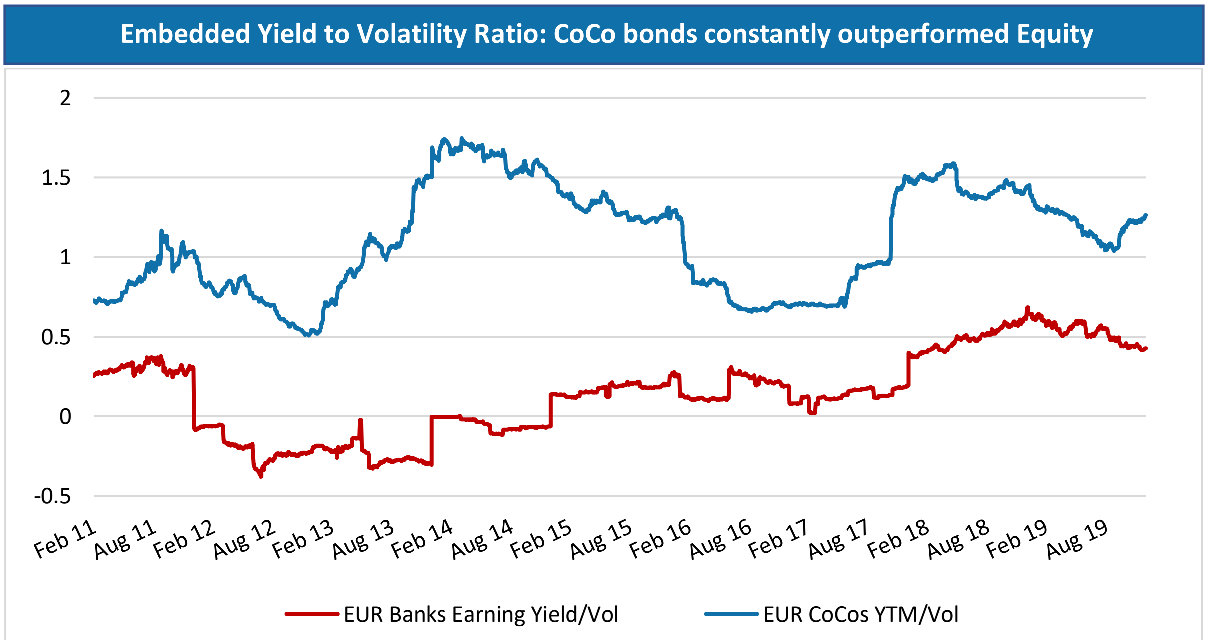

Figure 4. Earning Yield/Volatility and Yield/Volatility ratios respectively of European Banks Equity and European CoCos. Source: Bloomberg, data as of 31/12/2019.

Finally, the efficiency of an investment in this asset class can be maximized with a strategy investing in CoCos selected to offer the best risk-return profile on the market combined with a partial (or total) hedge on the equity risk through effective tail-hedging strategies while still maintaining an overperformance target compared to a basket of traditional bonds.

For instance, adding to a portfolio of CoCos derivatives to hedge the equity systemic and idiosyncratic risk, would allow to mitigate such form of risky exposure, still maintaining an overall positive carry effect from the positions within the portfolio, greater than that offered by traditional bonds.

As an example, Cocos can be invested in a diversified and efficient format through an exposure implementing the strategy designed for Valeur Hybrid Credit. This strategy invests in a portfolio of Banks CoCo bonds selected to offer the best risk/return profile systematically employs hedging strategies aimed at mitigating both systemic and idiosyncratic risk linked to equity market movements, with a target return of Euribor + 400bps and an extremely contained realized "live" volatility (last 6 months)compared to the investment alternatives discussed above (see Figure 5 below):

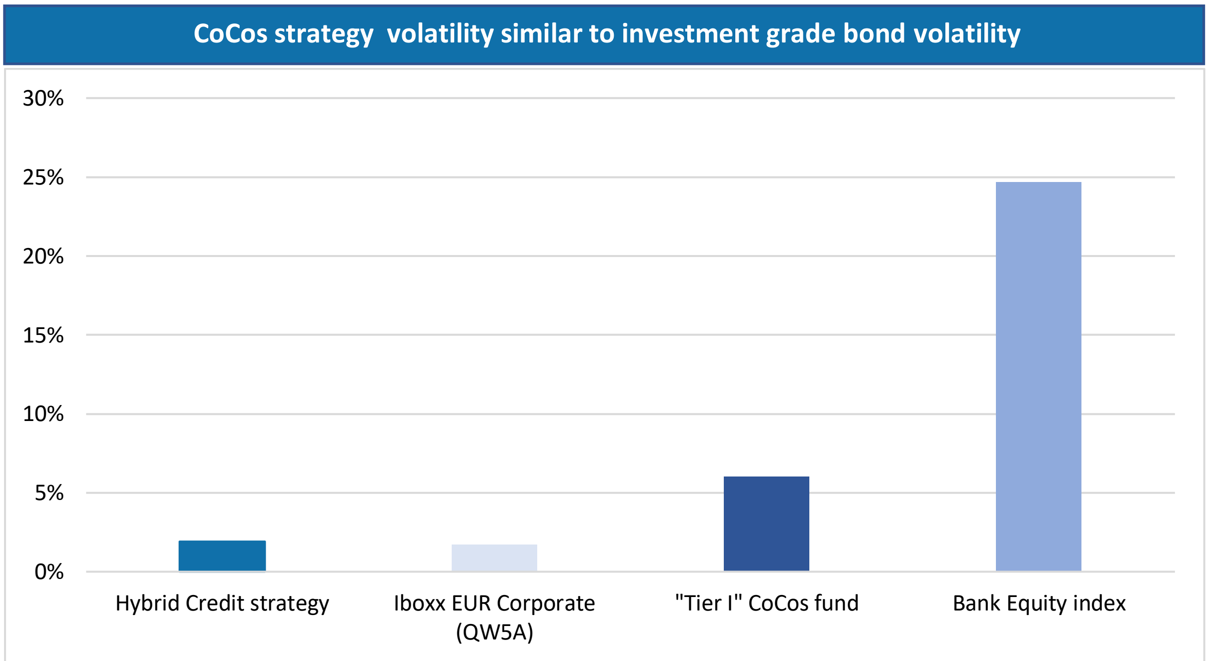

Figure 5. Source Bloomberg, data as of 31/12/2019.

In conclusion, in a market environment where it is more and more complicated to seek attractive yields without taking on excessive risk, an investment in a diversified portfolio of CoCos through an appropriate strategy would allow to gain exposure to this specific asset class that currently offers an interesting risk-return profile, and will eventually benefit from lower risk thanks to an adequate diversification and the implementation of hedging strategies.

Such an investment can result even more attractive when compared to other market instruments, especially for those institutional investors who makes Solvency considerations when allocating within their portfolios.

Nicola Mauri and Simone Poli