RBC Global Asset Management
BlueBay Asset Management

Opportunities in Cocos

Marc Stacey of BlueBay Asset Management discusses the fundamentals, supply dynamics and banking sector changes that are lining up to form a compelling case for European bank capital.

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> "From a credit perspective, we believe this is going to be an asset class that delivers positive risk-adjusted returns whereas equities are likely to remain under pressure because banks are still deleveraging and working to raise the amount of capital that they need to hold."

Marc, what are coco bonds and what can they offer investors?

A coco is a bond which sits at the most junior part of a bank's capital structure, but which is senior to the equity. A coco has a mechanism within it that converts the bond into equity or temporarily writes down the bond at a certain capital level.

Cocos typically offer a much higher spread and yield than the rest of the credit spectrum – this is something we think investors should be taking advantage of.

The evolution of banking regulation has a huge influence on the investment case for cocos – do you think future changes will be positive or negative for the asset class?

Basel III provided the regulatory drive that has made banks safer over the last 10 years; the shift to Basel IV should provide visibility over the coming five years. The quantum of capital that banks are likely to hold should increase further and the way risks are modelled should continue to improve, alongside the way liquidity provisions are handled.

As such, we have good foresight on the fundamental trajectory of the asset class, which should continue to deliver robust risk-adjusted returns, whereas bank equities are likely to remain under pressure as the institutions continue to deleverage and capital raise.

We've seen cocos go from zero to become an asset class worth over USD200 billion in just five years. What does this rapid growth mean in terms of bond supply?

This growth dynamic has meant we've received a lot of positive net supply – it was around USD25 billion in 2019 but has been as high as USD45 billion in some years. We're anticipating seeing redemptions of some USD20/25 billion per year for the next four-to-five years. Hence, net supply should come down to around USD5 billion a year.

While supply has been a headwind historically, it's shifting into a tailwind as net supply meaningfully reduces. At the same time, we're seeing growing interest from credit investors on the realisation that banks today are far safer than they've been in the past 10–20 years and the best part of the capital structure to invest in are the additional tier-1 securities (AT1s), where spreads remain elevated.

We're hearing investors becoming nervy about buying into cocos for fear they've missed the top of the market – do you think this is a valid concern or is there more upside to come?

It's always uncomfortable buying risk assets after such a strong run as we saw in 2019. When you look at the investable universe, the S&P500 is trading at 21x earnings and there's some USD12 trillion worth of negative yielding fixed income assets in circulation – valuations are feeling uncomfortable across many asset classes.

We still see notable value in European bank AT1s, in particular versus the rest of the capital structure, which we believe results from the mispricing around the contingent capital triggers that sit within the bonds. Against the attractive valuations, the fundamental trajectory of the asset class is stable to improving and the supply dynamic is becoming more favourable.

Despite 2019's outperformance, yield-hungry investors remain interested in cocos as they offer an investment-grade issue with an outsized yield pick-up due to the subordinated nature of the bonds and the lack of buyer base.

How are you looking to capture these alpha opportunities through 2020?

We're seeing a number of mispricings which we'll be looking to take advantage of. For example, European-denominated bonds are still trading at wider spreads, and given the current cross-currency basis, when you 'swap' these bonds back into US dollars, you can potentially pick up an additional 2.2% – so for the same bank issuer, you can potentially get a 2.2% yield uplift simply by buying the EUR debt over USD.

There are also certain regions that we believe are trading at a wide spread. The UK was one of our key positions for 2019 as we felt a hard Brexit risk was mispriced in the asset class. We've reduced our exposure this year but still see some premium on GBP-denominated debt.

Italian debt also trades at very wide levels due to the political risk that is inherent in Italian assets. We view the risk of 'Italexit' as very low and therefore see an attractive mispricing opportunity here.

What are the three main risks currently on your investment horizon?

1. Coronavirus – front and centre for all markets at the moment and the impact on growth is difficult to quantify.
2. Inflation – a perpetual concern for fixed income investors.
3. European politics – the situation in Italy seems to be improving but it's impossible to tell when instability will occur.

What are the key differences between European AT1s and US preference shares (prefs)?

The main difference for us is the structure – AT1s have a reset function over five-year US Treasuries, whereas US prefs reset over three-month LIBOR so there's no term premium in the US pref market.

European bank AT1s offer a more attractive structure and valuations, in our view.

We're seeing ESG factors influence all asset classes across the bond universe – what are the key points to note in the cocos market and how do you integrate ESG factors when you invest?

Our investment process looks at fundamentals, valuations, technicals and liquidity factors. ESG factors are a core influence across this framework.

Our approach is very forward-looking – when we analyse the external inputs we receive on ESG, they tend to be backwards-looking, and banks tend to score badly in the governance area given their historic weaknesses. But when we look forward, we can see wholesale changes in how banks are managed and regulated. In our view, the 'G' in ESG is far better on a forward-looking basis. This view is echoed by the actions of regulators, which are pushing for climate change stress testing.

We believe ESG factors influence coco yields and spreads, hence they're a key part of our investment methodology.

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