Could AT1 CoCos offer the winning combination of an attractive risk-reward profile and portfolio diversification?

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Ayush Babel
Director, Quantitative Research

Prof. Wim Schoutens
Professor at the University of Leuven, Belgium

In this blog, we explore how Additional Tier 1 Contingent Convertibles i.e., AT1 CoCos, could provide enhanced returns per unit of risk while providing diversification benefits, making them a potential candidate for core portfolio allocation.

Attractive risk-reward profile

The risk compensation for investors in AT1 CoCo bonds comprises various components. Alongside smaller risk compensations for extension risk, regulatory risk, and liquidity, the primary portion stems from potential losses in the event of an AT1 CoCo trigger in which case CoCos can be converted into equity of the issuing financial institution or have their principal written down. This may result in your investment losing some or all the original amount invested. Moreover, coupon payments on some CoCos are entirely discretionary and can be cancelled. Such triggers represent extreme occurrences, manifesting in highly unusual circumstances, often termed as tail-events, akin to the default of a financial institution. In the case of default, bondholders would experience losses with compensation for these losses, typically reflected in the corresponding Credit Default Swap (CDS).

A comparison between the CDS spread and the AT1 CoCos' spread illustrates the compensation for similar extreme circumstances. The historical comparison below showcases the average AT1 CoCos spreads against average subordinated CDS spreads within the financial sector.

Figure 1: European Banks AT1 CoCos OAS vs. Europe IG Subordinated Debt CDS

Source: WisdomTree, Bloomberg. European Banks AT1 CoCos OAS to Treasury Curve refers to I31415 Index OAS on Bloomberg and Europe IG Subordinated Debt CDS refers to SUBFIN CDSI GEN 5Y Corp on Bloomberg. From 1 January 2015 to 22 November 2023. Historical performance is not an indication of future performance and any investment may go down in value.

The CDS spread comprises two key factors: the probability of default (PD) and the loss given default (LGD). While estimating the LGD for subordinated debt entails uncertainty, a common estimate hovers around a 20% recovery rate. To fairly compare the CDS spread and the AT1 CoCos spread, we normalise the CDS

spread to a zero-recovery rate. Similarly, one might argue for a comparable normalisation for CoCos. We will make a conservative evaluation of CoCos, assuming the AT1 CoCos spread accounts already for a full loss. Our observation reveals that the ratio of AT1 CoCos spread to (rescaled) CDS spread fluctuates around a level of 2.7 over the years.

Figure 2: Ratio of European Banks CoCo OAS to Europe IG Subordinated Debt CDS

Source: WisdomTree, Bloomberg. European Banks AT1 CoCos OAS to Treasury Curve refers to I31415 Index OAS on Bloomberg and Europe IG Subordinated Debt CDS refers to SUBFIN CDSI GEN 5Y Corp on Bloomberg. From 1 January 2015 to 22 November 2023. Historical performance is not an indication of future performance and any investment may go down in value.

This signifies that investors receive nearly triple the risk compensation for events situated in the same extreme tail-end of possibilities. For the year 2023, these ratios notably surpass the long-term averages, currently with levels around 3.3, indicating significantly higher compensation for risk than has been seen historically.

Diversification advantage

Because of their unique structure, AT1 CoCos provide potential diversification benefits with low correlation to other major comparable investible universes. Therefore, AT1 CoCos not only provide greater returns per unit of risk but could also help in lowering overall portfolio volatility.

Figure 3: AT1 CoCos correlation with other asset class subgroups

Source: WisdomTree, Bloomberg. Period from 25 Sep 2020 to 30 Sep 2023. Based on weekly returns and includes backtested data. All Indices are in their base currency (specified in the table). All fixed income indices are total return, all equity indices are net total return. AT1 CoCos EUR H is the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index (EUR hedged), EUR HY is the iBoxx EUR Liquid High Yield Index, EUR IG is the iBoxx EUR Liquid Corporates Large Cap Index, EUR Govt is the iBoxx Euro Sovereign Overall Index, UK Gilts is the FTSE Actuaries UK Conventional Gilts All Stocks Total Return Index, UK IG is the iBoxx GBP Liquid Corporates Large Cap TRI Index, STOXX 600 Banks is the STOXX Europe 600 Banks Index, STOXX 600 is the STOXX Europe 600 Index, USD HY is the iBoxx USD Liquid High Yield Capped Index. You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.

Conclusion

Based on these points, we are confident that Contingent Convertibles (CoCos) present a distinctive blend of an appealing risk-reward profile and the potential for effective portfolio diversification, positioning them as a consideration for core portfolio allocation. Their low correlation to other major asset class subgroups can lower overall portfolio volatility and minimise potential drawdowns. Despite being relatively recent additions to the financial landscape, CoCos have weathered various challenges, such as the impact of the COVID-19 pandemic and aggressive interest rate hikes, demonstrating remarkable historical resilience.

The heightened potential rewards relative to unit of risk may stem from several factors, including the relative lack of awareness surrounding CoCos, presenting a potential opportunity that's ripe for exploration.

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