

Can AT1 CoCos be the better way to play the European bank trade?

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When deciding which asset class to choose an investor should consider what part of the capital structure to invest in and how it could potentially perform. Figure 1 provides an illustration of a banks' capital structure.

Figure 1: Bank capital structure

Source: Illustrative example by WisdomTree

Within the bank's capital structure, Additional Tier 1 Contingent Convertibles (AT1 CoCos) fall below subordinated debt and are considered hybrid instruments which, if triggered, can be converted to equity or written-down. Importantly, this conversion or write-down would tend to occur at a time when it is more advantageous to the issuer than to the investor—hence the “yield premium” that is required in order to create an attractive risk/reward proposition for investors. Banks pay a significant yield premium over more senior debt to compensate AT1 CoCo investors for the additional risks that they bear¹. For issuers, CoCos are attractive because the coupon payments are typically tax-deductible, and the cost of capital is lower than it is for a share capital increase.

Bank equity is essentially at the bottom of the capital structure and therefore provides investors with the least amount of security in times of crisis as it will be the first part of the capital structure to absorb losses. As such, investors would aim to be compensated for taking on these additional risks. While the history of AT1 CoCos as an asset class is relatively young given that the phase-in of the Basel III regulatory standards on European banks started after 1 January 2013, we can already observe how the asset class behaves relative to equities.

How has performance for AT1 CoCos compared to European bank stocks?

Figure 2: Cumulative performance since common inception

Source: WisdomTree, Bloomberg. Period from 31 December 2013 to 28 February 2019. The fixed income index is a total return index; the equity index is a net total return index. Performance for the iBoxx CoCo Liquid Developed Europe AT1 (ticker: IBXXCCL7) is based on the EUR-hedged version of the index. The MSCI Europe Banks Net Return EUR Index (ticker: MXEUOBK). Calculations include backtested data. Volatility estimates are based on daily returns.

You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.

2018 was a challenging year for European bank equities with investor sentiment turning very quickly in particular when European politics were in the headlines. Last year carried several concerns for the sector including money laundering scandals in Denmark and the Netherlands, tax law changes in Spain and among other things political turmoil in Turkey and Italy. Share prices for European banks on average fell 24% in 2018 if we use the MSCI Europe banks index as a benchmark. To put this into perspective, this is more than twice the drop seen in the MSCI Europe index which fell by nearly 11%. In comparison, European bank AT1 CoCos have been much more insulated from the political noise with the asset class reflecting significantly lower volatility than its equity counterpart. From a volatility perspective, AT1 CoCos have exhibited less than a third of the volatility experienced in European bank stocks over multiple periods including YTD, 1-year, 3-year and since common inception date of the indices as indicated by Figure 3.

Figure 3: Returns and volatility – AT1 CoCos index versus European Bank Equities index

*Source: WisdomTree, Bloomberg. Period from 31 December 2013 to 28 February 2019. The fixed income index is total return indices; the equity index is a net total return index. Performance for the iBoxx CoCo Liquid Developed Europe AT1 (ticker: IBXXCCL7) is based on the EUR-hedged version of the index. The MSCI Europe banks index (ticker: MXEUOBK). Calculations include backtested data. Volatility estimates are based on daily returns. *YTD returns are not annualised.*

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For investor portfolios, allocating to AT1 CoCos instead of European bank equities has translated into taking exposure to European banks which offer attractive yields meanwhile doing so using an asset class that adds significantly lower volatility to their overall portfolio. One important distinction when considering investing in AT1 CoCos for European bank allocations is that not all indices provide the same exposures as some indices include AT1 CoCos of Australian and/or emerging market banks. Therefore, to eliminate the unwanted exposure we are using the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index for the analysis which only includes AT1 CoCos which are rated and backed by developed Europe financial institutions.

Can AT1 CoCos offer a yield pick-up?

The dividend yield for European bank equities using the MSCI Europe Banks index as a proxy was 5.55% at the end of February 2019 and compares favorably to the MSCI Europe index which was only 3.73% for the same period. Clearly European banks are offering greater yield than exposure to large and mid-cap equities across 15 developed countries in Europe as represented by the MSCI Europe index. On the other hand, AT1 CoCos offered a Yield to Worst (YTW) of 6.49% during this period and are slightly higher in the bank's capital structure which leads us to believe there is some value to considering this part of the capital structure when aiming to capture the yield-pickup available in the European bank sector.

Figure 4 - Top 10 AT1 CoCo issuers - capital ratios

Source: WisdomTree, Markit, Bloomberg. Data as of 31 December 2018. The strategy is represented by the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index. Maximum trigger level is represented by the maximum trigger observed across all CoCo issues of a given issuer. The CET1 ratio is the Common Equity Tier 1 Capital ratio. You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.

Potential risk to consider when investing in AT1 CoCo

- CoCos can be converted into equity of the issuing financial institution or have their principal written down.
- The behaviour of the relatively new CoCo bond market has not been tested in a systemic financial crisis, thus the price and liquidity of CoCos may degrade under such circumstances.
- Coupon payments on some CoCos are entirely discretionary and can be cancelled.
- This list does not cover all risks. Further risks are disclosed in any relevant product KIID, Factsheet and Prospectus & Communications Surveillance.

Conclusion

For investors considering an allocation to European banks, it could make sense to move up on the capital structure and invest in the AT1 CoCo universe which offers a yield pick-up to European bank equities while demonstrating significantly lower volatility. One way to invest in the asset class could be using a strategy that captures exposure to a diversified index such as the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index that includes AT1 CoCos that rated and backed by developed Europe financial institutions.

1 As AT1 CoCos are relatively new complex investments, investors may experience a reduced income rate and principal loss is possible.

2 Yield to Worst for AT1 CoCos is based on the iBoxx CoCo Liquid Developed Europe AT1 index as at 28 Feb 2019 using a duration weighted.

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