How do AT1 CoCos compare to other risk assets?

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When one thinks about the risks of investing in bonds, two key aspects that spring to mind are the issuers willingness and ability to repay the debt. These two questions take a different form depending on which asset class one considers within fixed income.

Emerging Market Sovereign Bonds

When considering default risks, some investors may want to understand the issuers:

Ability to repay debt: For Emerging Market Sovereign bonds (EM Sov) an investor considers the fundamental aspects of the country such as strong economic growth, stable currency, ability to generate revenues (i.e. operative tax collections), contained debt burden and improving demographics when determining its ability to repay its debt. Strength in these areas is likely to help provide the support for future economic growth and will help support the EM Sovereigns' ability to repay its debt.

Willingness to repay debt: Typically, an EM government's willingness to repay debt can be related to its leadership in power or the political system in place. It important to remember that a government may decide not to repay its debt even if from a fundamental standpoint it has the **ability to repay debt. Political risk** is one aspect that should not be overlooked when considering EM exposure and this aspect is usually considered when rating agencies assign a credit rating.

For investors considering EM Sov local currency exposure instead of hard currency exposure, there is also the impact of **currency depreciation** on bondholders. An EM sovereign can choose to depreciate their currency and not technically cause a default or credit event to debt holders. Therefore, investors should take these into consideration when comparing the risk-reward trade-off between EM Sov debt and other types of fixed income risk assets.

High Yield Bonds

Following a similar stream to the above, issuers that are rated high yield by the credit rating agencies have obtained this rated based on their ability and willingness to pay interest and repay principal as agreed with bondholders. A high yield or non-investment grade rating is assigned to issuers that are at greater risk of defaulting on interest or principal repayments and issuers will typically pay investors a **higher coupon** than investment grade rated issuers to attract investors to buy their issuance. A bond is considered non-investment grade if its credit rating is below BBB- by Standard & Poor's and Fitch or Baa3 by Moody's.

Default rates for high yield issuers will typically rise when the economic backdrop is negative as it puts pressure on their ability to repay bondholders as was the case during the 2008 financial crisis. Risk is usually reassessed and the option-adjusted credit spread (OAS) that investors expect for high yield bonds can rise considerably as we noted in the US high yield bond market considering the ICE BofAML US High Yield Master II OAS index (US HY index) as a reference for the asset class. The US HY index peaked at nearly 2000 basis points above US government bonds in November 2008. This was a stark rise considering the OAS for the US HY index is currently around 398 basis points as of the end of October 2019.

Convertible Bonds

Convertible bonds are an interesting asset class because they are essentially fixed-income debt instruments that provide interest payments but can be converted into a predetermined number of common stock or equity shares. The conversion feature from bond to stock can be done at certain times during the bond's life as outlined in the bond documents and is typically at the **discretion of the bondholder.**

From an issuers' standpoint, the advantage to issuing convertible bonds is that in many cases the issuer can offer the bonds at a lower coupon rate than it would have to pay on a straight bond without convertible features. The ability of the bondholder to convert the bonds into equity allows them to potentially benefit from the upside potential available with equity holdings. Stereotypically, the more valuable the conversion feature, the lower the yield that can be offered to investors.

From a credit rating standpoint, greater than 50% of convertible bond issuance are non-rated bonds with the remaining portion mainly split between high yield and investment grade bonds[1]. Convertible bonds are typically issued by firms with low credit ratings and high expected growth. Issuers such as Tesla Motors issued a large amount of convertible bonds back in 2014, a period when they had reported low to negative earnings in years prior, which allowed them to offer lower coupons to investors than issuing straight fixed rate bonds at the time. The coupon payment on their convertible bonds ranged from 25 basis points to 125 basis points. A level much lower than they may have achieved otherwise with another type of bond issuance given their weak fundamentals at the time.

Additional Tier 1 Contingent Convertible Bonds

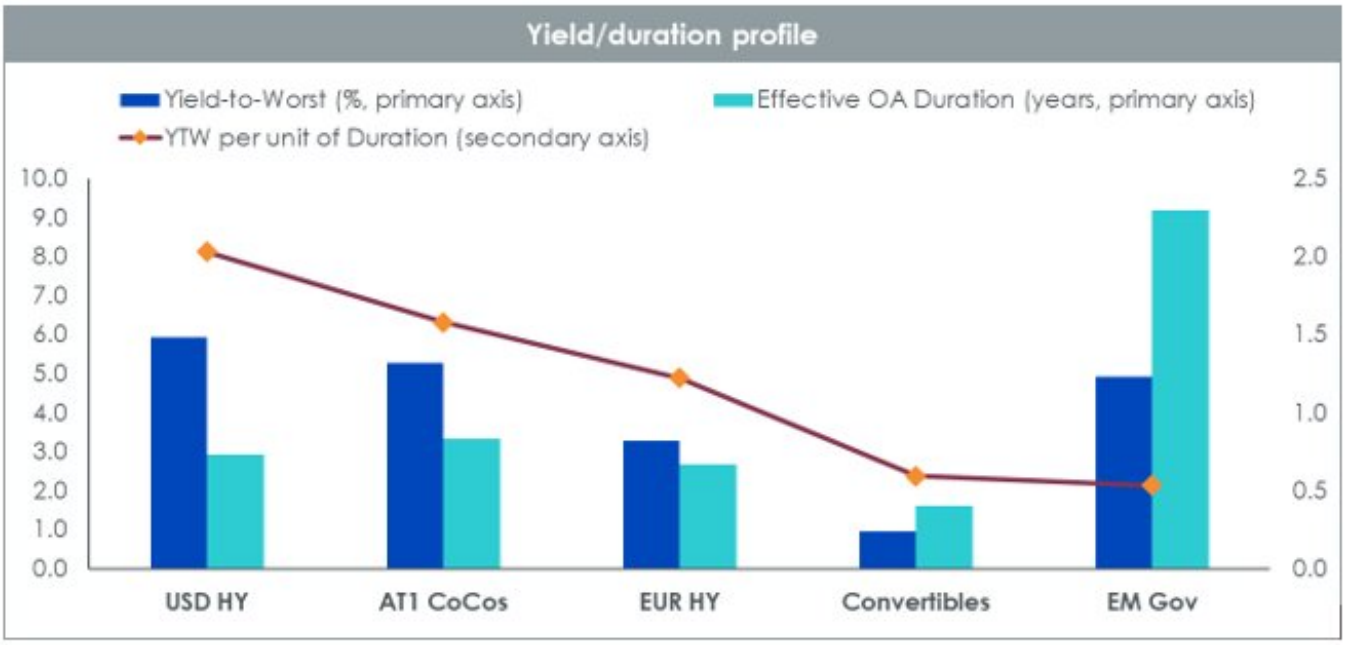
Additional Tier 1 Contingent Convertible Bonds (AT1 CoCos) is an asset class that evolved as a way to reduce systemic risk in the global banking system following the 2008 financial crisis. AT1 CoCos are usually issued by European banks to help raise capital in order to meet more stringent Basel III capital requirements in comparison to the Basel II requirements that were in place during the crisis.

Within the bank's capital structure, 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—hence the "yield premium"** that is required in order to create an attractive risk/reward proposition for investors**.**

Investors of AT1 CoCos tend to analyze the fundamentals of the issuers when considering the instrument as banks with strong fundamentals and capital reserves are typically less inclined to require the use of the conversion mechanism. If we consider the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index as a benchmark for the asset class, most of the AT1 index is made up of the debt of large European banks whose senior bonds are currently of investment grade credit rating. Notably 24%[2] of the index is composed of bonds rated BBB by the rating agencies and issued by globally systemically important banks (GSIBs).

Generally, European banks issuing AT1 CoCos have benefitted from improving fundamentals with nearly 36% rating upgrades in 2017, 30.2% in 2018 and already 9.3% so far in 2019 [3]. This reflects a positive trend for this segment of European banks as upgrades have outpaced the number of downgrades in the last three years. The long-term S&P outlook in 2019 for the sample of European banks issuing AT1 CoCos show that the sector is largely stable in 2019 with 33 banks noted to have a stable outlook, seven as positive and only six have a negative outlook[4]. The average rating of European banks who issue AT1 CoCos is A-, as of end of September 2019.

As referenced in figure 1, plotting the above fixed income risk assets by yield offered per unit of duration highlights the differing yield pick-up available across these asset classes.



Source: WisdomTree, Markit, Bloomberg. Data as of 01 October 2019 to reflect post-rebalance figures. Yield is yield-to-worst, Effective OA duration is effective option-adjusted duration. Markit indices use duration-adjusted market value weighting for the yield figure. The AT1 CoCos is the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index, US HY is the iBoxx USD Liquid High Yield Index, EUR HY is the iBoxx EUR Liquid High Yield Index, EM Gov is the iBoxx USD Liquid Emerging Markets Sovereigns Index and Convertibles is represented by the constituents of the Bloomberg Barclays Global Convertibles Composite Total Return Unhedged USD.

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

While these instruments offer differing profiles in terms of compensation, it is also interesting to note in **Figure 2** the correlation matrix of these risk exposures. One can see that there are benefits to having broad exposure to risk assets within fixed income specifically when assets are not perfectly correlated as diversification can help improve the potential risk/reward profile of investor portfolios under different economic outcomes.

Source: WisdomTree, Bloomberg. Period from 31 December 2013 to 30 September 2019. Based on monthly 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), US HY is the iBoxx USD Liquid High Yield Index, EUR HY is the iBoxx EUR Liquid High Yield Index, EM Gov is the iBoxx USD Liquid Emerging Markets Sovereigns Index and Convertibles is represented by the constituents of the Bloomberg Barclays Global Convertibles Composite Total Return Unhedged USD. You cannot invest directly in an index.

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1 Bloomberg. Data as of 31 October 2019. Rating represents generic quality rating as reported by Bloomberg based on the conservative average of Moody's, S&P and Fitch expressed in Moody's nomenclature. Moody's, S&P and Fitch are the three main credit rating agencies that assign credit ratings, which rate a debtor's ability to pay back debt by making timely principal and interest payments and the likelihood of default. Moody's assigns bond credit ratings of Aaa, Aa, A, Baa, Ba, B, Caa, Ca, C, with WR and NR as withdrawn and not rated. Standard & Poor's and Fitch assign bond credit ratings of AAA, AA, A, BBB, BB, B, CCC, CC, C, D. Ratings below Baa3 by Moody's or BBB- by S&P and Fitch are considered non-investment grade. Contingent convertible market is represented by the constituents of the Bloomberg Barclays Global Convertibles Composite Total Return Unhedged USD.

2 WisdomTree, Markit. Data as of 30 September 2019.

3 WisdomTree, Markit. Data as of 30 September 2019. Our sample is based on European banks within the Markit indices issuing AT1 CoCos considering S&P credit ratings.

4 Bloomberg. Ratings outlook data as of 6 November 2019. Our sample of issuers is based on European banks within the Markit indices issuing AT1 CoCos considering S&P credit ratings as of 30 September 2019.

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