

Tackling the income challenge

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Income is a universal challenge these days. People are living longer than ever before, retirements are lasting longer, and costs of living are increasing. And in every part of the world, investors are looking for ways to generate more income.

With interest rates in many parts of the world still quite low from a historical perspective, investors may be wise to look beyond traditional fixed income — or at least beyond the traditional ways to gain exposure to fixed income market. Consider that in the last decade the universe of fixed income products was extended not only by the newer ways to weight traditional fixed income securities or select them based on their exposure to a certain factor, but also by newer fixed income securities to choose from.

Smarter Bond Weighting

For example, most traditional fixed income indices are market cap weighted. What this means is that they give more weight to companies, governments and entities issuing more debt — this seems counterintuitive to us. At WisdomTree, we believe it is more logical to weight securities by fundamentals.

In the fixed income space, we believe we can enhance yield by weighting the index constituents based on their yield, rather than by debt issuance. The entities paying higher yields would get higher weights, subject to important constraints that ensure diversification. Using this thinking as a pivot in our index construction process, we can take a broadly followed benchmark, like the Bloomberg Barclays Euro Treasury Bond Index and reweight it in a way that would provide higher exposure to entities paying higher income rather than entities just issuing more debt. It is a valid concern here that higher income can compromise the risk profile vs the benchmark and we address it by optimizing the trade-off between the common bond risk factors and delivering as high a yield as possible within that universe of securities.

The new kid on the block

Additionally, there are new types of fixed income like Contingent Convertible bonds. Known as CoCos, these bonds became popular a few years back in Europe, as Basel III framework encouraged their issuance with the aim of securing the financial health of systemically important banks and avoiding potential system-wide shocks. CoCos were meant to enable banks meet new capital requirements imposed by Basel III and let them absorb potential losses without passing the burden onto the taxpayers. For example, AT1 CoCos, a widely issued type of CoCo in Europe, can be qualified as Additional Tier 1 Capital.

Serving the purpose of their creation, CoCos, as their name suggests, either can convert from bond to equity or can lose part of their principal conditional upon a certain trigger. If a bank's capital ratio, such as

Common Equity Tier 1 (CET1), falls below a pre-determined level, it is referred to as the mechanical trigger. In other cases, when bank's solvency is in question, a regulator's discretion can trigger the conversion to equity or write-down event to support bank's capital adequacy. Most CoCos, being perpetual bonds, i.e. those that don't have a maturity date, if not triggered, will start paying a floating coupon after their indicated call date, typically about five years after initial issuance.

Figure 1. AT1 CoCo features: illustrative example.

Source: illustrative example by WisdomTree

Allure of higher yield

One of the biggest appeals offered by CoCos is their relatively higher yield in comparison to other conventional fixed income securities. Currently the index that tracks liquid AT1 CoCos from developed European countries yields slightly above 6.5%¹, while the figure for some indices which hold European high yield debt stands above 4%².

The higher yield for CoCos, unlike for conventional high yield bonds, stems from the principle of seniority in the capital structure and not from its issuer's credit risk. Coupons of CoCos can be cancelled, their principal can be written-down and they can be converted into equity. For investors to justify their exposure to these potential risks, while holding CoCos, requires a certain reward, translated here into higher yield.

¹ iBoxx Contingent Convertible Liquid Developed Europe AT1 Index as of 05 November 2018, Markit.

² See e.g. iBoxx EUR Liquid High Yield Index as of 05 November 2018 and Bloomberg Barclays Pan-European High Yield Index as of 05 November 2018, Markit and Bloomberg.

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