AT1 CoCos continue to shine amid rising bond yields

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US 10-year Treasury yields have risen from 0.91% to 1.47% since the end of 2020, accounting for a 62% rise. Not all asset classes behave the same in a rising yield environment. There are various ways to try to cushion portfolios within the bond world in a rising rate environment.

A few approaches one may consider

One method is to buy bonds with shorter maturities that exhibit a lower duration profile and are less sensitive to interest rate risk. A challenge with this approach is that investors typically get paid more yield to go out in the maturity spectrum, and thus an investors risks foregoing higher yields to stay in the shorter end of the yield curve.

Another widely used approach is for an investor to look for bonds that offer higher coupons and yield. This combination could serve as a cushion against principal loss caused by rising bond yields. Investors can use many different strategies to try to cushion a portfolio in a rising rate environment; this blog focuses on an often overlooked asset class, AT1 CoCos. AT1 Cocos have historically shown resilience in a rising rates landscape.

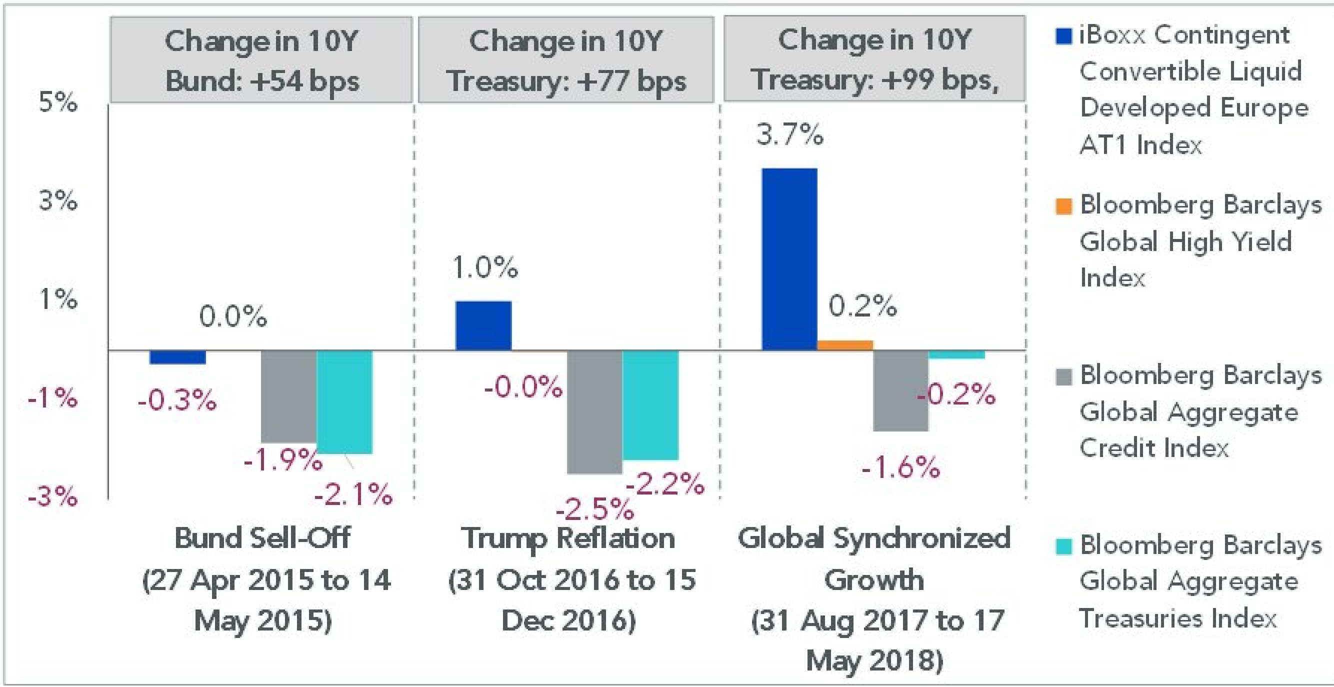
What pocket of the markets is offering yield pick-up?

As of 26 February 2021, the yield to worst (YTW) for the Additional Tier 1 Contingent Convertible (AT1 CoCos) market1 was at 4.14%, providing a yield pick-up relative to the European high yield market2, which was at 2.67%. The yield is comparable to the Emerging Market Debt Hard Currency3 (US dollar-denominated) asset class, which was at 4.31% for the same period. However, AT1 CoCos have a duration profile of 3.37 years which is significantly lower than Emerging Market Debt Hard currency, which exhibit a duration of 10 years. For an investor that is comfortable with the asset class's risk-reward profile, AT1 CoCos is an area of the bond market that can provide a yield enhancement versus other risk assets while maintaining the duration at a lower level.

How have AT1 CoCos behaved in a rising rate environment?

Let's consider a few key events that resulted in large moves in bond yields such as the Great bond sell-off of 2015 captured in the table below as the (Bund Sell-Off), the Trump reflation sell-off of 2016 or in 2017-2018 a period classed as the Global Synchronised Growth era. One can note that not all fixed income assets behaved in the same way during those rising rate periods. Compared to other asset classes, AT1 CoCos were able to show diversification by providing better returns than several different areas of the bond market when government bond yields rose. It is difficult to completely disregard the growing interest in AT1 CoCos with its history of providing portfolios with some cushion in a rising rate environment.

Figure 1: Performance of some Fixed Income assets, including AT1 Cocos, in recent periods of rate increase.



Source: WisdomTree, Bloomberg. All indices are total return and USD-hedged indices. Calculations include backtested data. The iBoxx Contingent Convertible Liquid Developed Europe AT1 Index (USD Hedged) started its live calculation on 09 March 2018.

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

Unless noted otherwise, data has been sourced from Bloomberg as of 4 March 2021. Yield and duration data are as reported by Markit for each respective Markit iBoxx index.

1 considering the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index
2 considering the iBoxx EUR Liquid High Yield Index
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