HERMES

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INVESTMENT NOTE **30 JUNE 2014**

HERMES CREDIT: COCO RISKS UNDERAPPRECIATED

Fraser Lundie and Mitch Reznick, Co-heads of Hermes Credit, warn that when it comes to cocos (contingent convertible bonds) investors need to be highly selective, as their risks seem underappreciated by the market and are not always accurately factored into valuations.

Given their equity-like features, at first glance cocos offer outstanding value for fixed income investors seeking yield in otherwise expensive credit markets.

Flexible, liquid, and supposedly able to stave off a banking crisis, contingent convertible bonds – or cocos – are securities born of regulators' design. Placed deep in the capital structure, cocos are intended to release emergency capital when a bank's core equity falls below a set level.

But we believe the risks of the asset class – many of which stem from their equity-like characteristics – may be underappreciated by the market and are not always accurately factored in to valuations. Some cocos will not be converted into equity, but instead simply written off on a permanent or temporary basis – so investors need to be aware of both trigger points and outcomes.

In many cases, even the most equity-like cocos are priced closer to credit than to equity. The current popularity of cocos has increased contagion risk, with a trigger event likely see many investors attempt to simultaneously exit the coco market.

What happens when a coco is triggered or a bank falls foul of the regulator? The steep fall in the price of bonds issued by Groupama, the European insurance and banking group, in October 2012 provides a warning. Its bonds declined by 18% in one day when the company announced it would cancel coupons. If the instrument was a coco, investors may have been stuck without a coupon for a number of years.

Worse, because so much money has flowed into cocos, the first trigger event may spur investors across the market to reduce their exposure to the hybrids. In such a collective exodus, the danger is that there is insufficient liquidity in the market to absorb what could be a one-way trade out of these names. Contagion risk could see the securities rapidly fall in value amid one or more trigger events.

For US banks, preference shares perform a similar role to cocos and are favoured by the Federal Reserve as a means of building capital buffers. The securities are typically callable after 10 years, have non-cumulative coupons, and are issued out of the holding companies overseeing banking groups. As relative-value investors, we compared the dollar Wells Fargo 5.85% perpetual preference share, which is callable in 2023, with the BBVA 9% dollar perpetual coco, callable in 2018.

The securities displayed similar valuations, but the Wells Fargo preference share has more bondholder-friendly terms. It offers less capital appreciation, but is less volatile and generates a higher Sharpe Ratio in both price and yield terms and should therefore deliver a better risk-adjusted return.

The coco market is thriving. Abundant issuance, regulatory backing and investor demand have made it one of the most popular and talked about credit trades of the past year. Banks from Barclays to Santander now issue hybrid securities with the aim of making their balance sheets more resilient. But the opportunities it provides are balanced by risks, such as sudden-death write-down, coupon cancellation and contagion.

While we are not against the asset class, the nature and risks of cocos has compelled us to be extremely selective in this market. As with any debt security, it is imperative to assess and price as many risks as possible. However, we are not convinced that in all cases the risks of these instruments are fully priced in.

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Notes to Editors:

Hermes Fund Managers
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