FOCUS

Hunting for yield in safe grounds

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Subordinated debt offers an attractive balance between risk and return, and a range of positive characteristics, namely attractive yield, IG credit quality of issuers, liquidity, and the ability to absorb the impact of interest rate increases.

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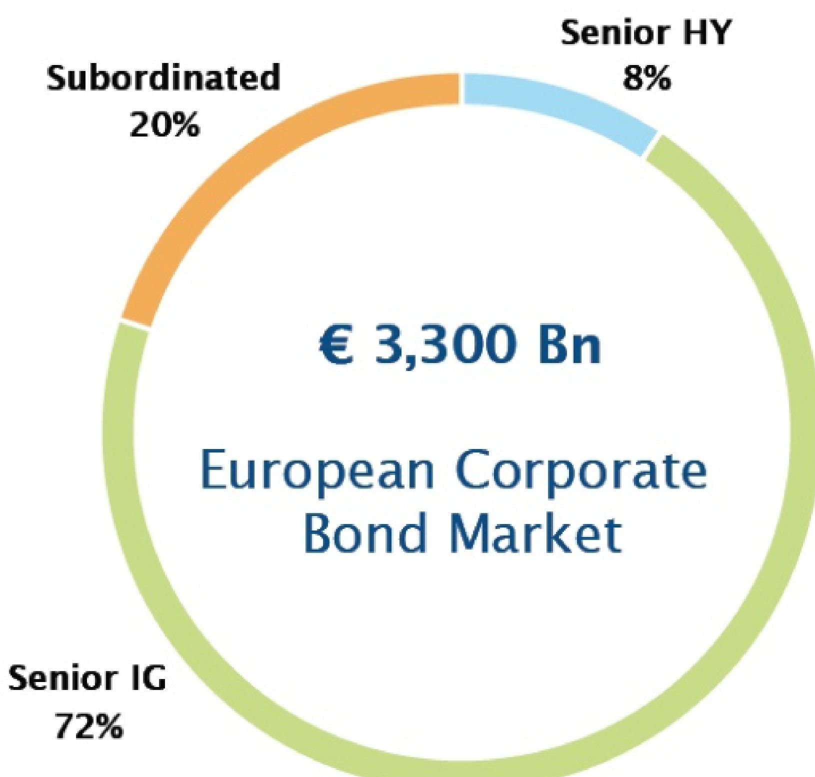
“Subordinated debt provides investors with high yield like carry, solid credit & liquidity profile, diversification within a fixed-income portfolio, and the support of strong fundamentals.”

Nomadism, originating from the Greek word « νομάς », meaning roaming about for pasture is by far the oldest human subsistence method, and the most efficient strategy for exploiting scarce resources. Within fixed income markets the equivalent search for resources, or yield, was never as intense, and well thought moves are crucial for a successful result.

Over the past few years, investors have turned to risker strategies as the European fixed income markets continue to provide low or negative yields due to supportive monetary policy from the European Central Bank, and volatility levels that remain at historical lows. Luckily, the relatively new asset class of subordinated debt offers an attractive balance between risk and return, and a range of positive characteristics.



The European subordinated bond market is more than twice the size of the senior High Yield one and offers a variety of investment instruments, namely Contingent Convertibles and Tier 2 debt issued by banks, Tier 1 & Tier 2 debt issued by insurances and hybrids issued by non-financial companies. These instruments rank lower in the hierarchy among the debt owed to the company's holders and exposed to specific risks such as coupon deferral or cancellation and loss absorption, but at the same time they are issued by highly rated companies and compensate investors with higher yield.

	EUROPEAN SUBORDINATED	EUROPEAN HIGH YIELD (excluding Subordinated)
MARKET SIZE	€ 670 Bn	€ 350 Bn
AVERAGE ISSUE SIZE	€ 1000 Mn	€ 600 Mn
AVERAGE BOND RATING	BBB-	BB-
AVERAGE ISSUER RATING	A-	BB
PREMIUM VS SENIOR IG BONDS	120 bps	180 bps

Source
BofA-ML Indices. Date as at: 31 December 2016

The subordinated debt universe is characterized by high issuer rating distribution with 95% of issuers being rated investment grade. This comes as no surprise as banks, re-capitalized and de-risked by doubling their core equity over the past 10 years, while at the same time decreased Risk-Weighted Assets and Non Performing Loan ratios. Within insurances, improvements in capital composition and solvency ratios lead to rating upgrades.

Issuer rating distribution.
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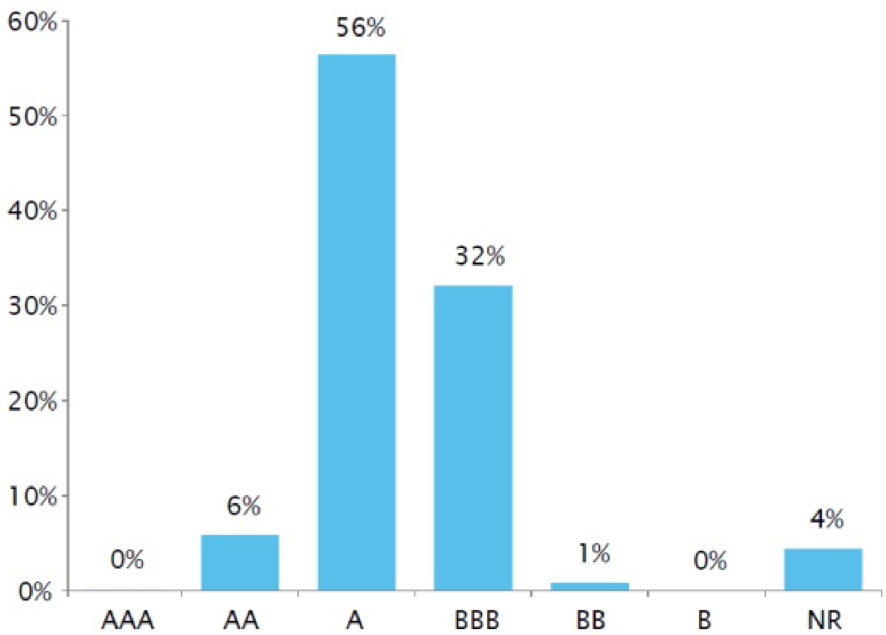

Source
Bloomberg, ICE BofA-ML. Date as at: 31 October 2017

The asset class offers attractive relative value vs. high yield, and mispricing opportunities as there is much higher spread dispersion when compared to senior investment grade bonds, with the added benefit of lower duration exposure. Finally, an additional benefit of subordinated bonds is their ability to absorb the impact of interest rate increases, due to their embedded high risk premia, and therefore perform well versus other fixed income strategies in periods of rising rates.

In overall, as with the nomadic lifestyle, the subordinated debt asset class does not come without risks, but compensates investors by providing diversification within a fixed-income portfolio, high carry (high yield like) with solid credit & liquidity profile, and a long-term story driven by structural recapitalization of financials and supportive central bank activity.

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