SYZ WEALTH MANAGEMENT

FOCUS

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THE STRONG OPPORTUNITY IN SUBORDINATED DEBT HAS LIVED UP TO EXPECTATIONS

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SUMMARY

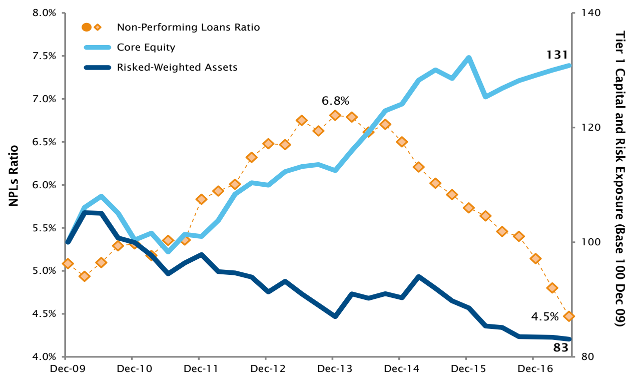
- The financial crisis of 2008-2009 was a game changer for fixed income investors as it created new opportunities, especially for credit specialists
- The real impact from the financial crisis was not immediate, but rather became increasingly visible in the months and even years well after equity markets had started to recover from their extreme losses
- In August 2016, SYZ Asset Management decided to launch a dedicated fund on European Subordinated bonds that just reached EUR 100mn in size
- Our Milan-based corporate bonds specialists, who had been managing assets in this space since 2003, identified a unique opportunity in subordinated debt, brought on by the financial crisis and its collateral impact on regulation and financing behaviour
- To date, the strategy has performed strongly and prospects in this growing space remain attractive

A STRUCTURAL OPPORTUNITY IN THE AFTERMATH OF THE FINANCIAL CRISIS

The impact that the financial crisis had on banks was profound. Huge losses driven by a strong increase in non-performing loans (see chart 1 below) resulted in banks retracting from many of the traditional activities, including making loans to anyone other than the highest quality issuers. At the same time, pushed by stricter regulatory rules, financial institutions entered a structural balance sheet restructuring through improvement in both capital structure and asset quality. Finally, the need for financing for non-financial companies did not cease as a result of banks exiting the market, rather the space was occupied by other players, such as institutional investors hunting for attractive return opportunities.

All these factors have significantly impacted the subordinated bond market, which has experienced a strong evolution since 2008 in terms of size, liquidity, bond features and regulatory environment. Most investors have played the bank recapitalization theme through equities, which has risen strong over recent years. By most measures, one can make the case that equity valuations on banking stocks are at or even above fair valuations.

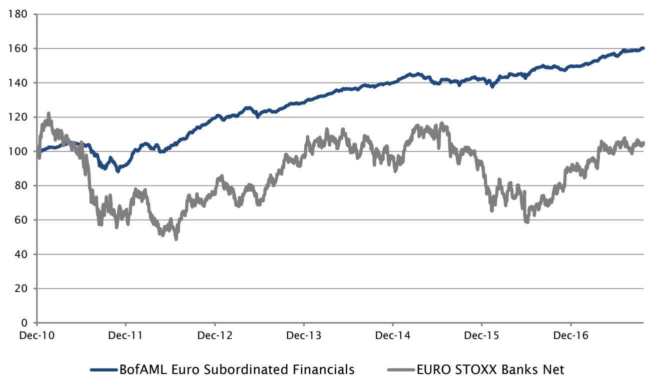
Chart 1: The impact of non-performing loans on banks' balance sheets forced dramatic changes in business (lending) practices and regulatory intervention to save banks from collapse



Sources: Bloomberg, SYZ Asset Management
Data as at: 29 September 2017

However, the same is not the case for subordinated debt, which is a new sub-asset class and relatively unknown and inaccessible to investors. Consequently, the opportunity in subordinated debt remains very attractive, notwithstanding the fact that this is now a growing sub-asset class, with issuance being carried out by both financial and non-financial companies.

Chart 2: Investing in European financial assets via subordinated bonds was first much safer, but also more rewarding than trying to time the recovery in equities



Sources: Bloomberg, SYZ Asset Management
Data as at: 25 October 2017

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WHAT WE SAW IN THE SUBORDINATED BOND MARKET IN 2017

Almost everything the team expected materialised during this first year of life of our stand-alone subordinated debt strategy. Repricing of subordinated debt and hence its positive performance was driven by strong and improving macro and fundamental factors. Improved risk-taking sentiment as well as an increasing knowledge and interest from investors for the sub-asset class supported bids. While the knowledge gap did indeed narrow, due to investor sentiment as well as simply a need to find attractive yields in “riskier” parts of the capital structure, material informational asymmetries persisted, which allowed active and expert investors to deliver strong returns.

From a top-down perspective, Europe enjoyed a positive and accelerating economic cycle with inflation remaining subdued. Supporting this trend was a monetary policy that remained extremely accommodative as policymakers waited for more stable and consistent pressures mount on consumer prices. This moderate, but positive growth scenario was also reflected in credit fundamentals, where issuer margins rose at a business level and leverage decreased since the second half of 2016.

On the political risk front, results from Dutch, French, UK and German elections stemmed the tide of populist and anti-European movements. Consequently, political risk had decreased (until the Catalonia independence event), as well as their associated risk premiums. An abatement of these macro risk factors have contributed to an improvement in sentiment towards riskier assets, including subordinated bonds.

SUBORDINATED DEBT REMAINS A COMPELLING, GROWING AND ATTRACTIVE OPPORTUNITY GOING FORWARD

The subordinated debt market, albeit not very new, is still developing in Europe and therefore is not yet efficient – which is a perfect environment for an active and specialist investor. In particular, a number of the attractive features of this market that existed at the time we launched our fund remain so today.

1. Growing market size with good liquidity

Over the past years the subordinated market has experienced significant growth, with bonds issued by European companies reaching the notable size of EUR 660bn of face value. This number compares with High Yield bonds which account for EUR 320bn when excluding subordinated bonds. Moreover, liquidity has also improved given the large cap nature of issuers and average outstanding amount – around EUR 850mn.

2. Attractive yields & valuations

Subordinated bonds offered a very attractive carry, with an average yield of above 4% and a spread of around 350 bps, compared with 1% yield and 100 bps offered by euro investment grade corporates and 4.5% yield and 400bps spread by high yield instruments. Those spreads come along with a higher degree of dispersion when compared to senior debt, leaving more space for credit specialist to identify mispricing opportunities and generate performance. One year later spreads continue to show attractive numbers, as premiums remains around 250bps, and an even better relative value, as they have just started to close the gap with high yield investments.

3. Strong credit rating (compared to high yield)

When compared to high yield investments, subordinated bonds issuers’ ratings fall within investment grade: while bonds are split between investment grade (66%) and high yield (34%), issuers are normally large cap financial institutions and corporates, of whom, 95% belong to the investment grade space.

4. SYZ has credit specialists who can find strong value propositions

The management team knows the European credit market inside-out and has a particular edge on the niche subordinated sub-segment. The team started to invest in subordinated bonds in 2009 in their broader European corporate portfolio[1]. They have developed different valuation models allowing to exploit price inefficiencies in the various sub-segments of the subordinated debt space.

FUNDAMENTALS HAVE CONTINUED TO BE SUPPORTIVE OF STRONG RETURNS

From a bottom-up point of view, bank fundamentals have continued their positive trends; namely that capitalizations have improved while risk solvency has decreased. Many European institutions launched capital increases during the year that were swiftly absorbed by equity markets. These capital raises had a positive impact on issuers’ subordinated instruments as banks were able to shore up their capital positions that removed doubts on banks’ abilities to meet their liabilities, including making debt repayments, but also dealing with any future losses on NPLs either to due to defaults or write-downs/offs.

Overall risk-weighted assets and non-performing loans ratios have also decreased at a steady pace, with the latter having fallen over 30% in a three-year period. Thus, at a systemic level, the embedded riskiness of subordinated instruments has decreased. Moreover, this theme has legs as the structural recapitalization of the European financial system is still on-going with several institutions

[1] OYSTER European Corporate Bonds

needing, and in many cases obliged by regulators, to further fulfill capital requirements. The opportunity in subordinated debt still has a long way to go and given regulatory requirements on lending, the opportunity looks to become a fixture of fixed income markets going forward.

From a top-down perspective, growth figures in the E.U. continue to improve. The latest annual growth rates figures show an expansion of over 2% and future prospects looks steady. Core inflation also has been gradually rises and supports the gentle path of recovery that the E.U. has experienced since 2014[1]. An improving macroeconomic environment will provide a further boost to financials companies and have positive impacts on related equities and bonds.

A STRONG FIRST YEAR OF PERFORMANCE FOR THE OYSTER EUROPEAN SUBORDINATED BONDS FUND

The fund posted a +10.4% return (R EUR share class) since its launch at the end of August 2016 to the 31st of October 2017. Not only has the absolute return been attractive, but on a relative basis, the fund is 2.4% ahead of the BofA Merrill Lynch Euro Subordinated Financial Index[2] and ranks in the 9th percentile of its Lipper peer group (Lipper Bond Europe High Yield) since inception.

Performance in the fund has principally been a function of 3 key drivers:

1. The management team took advantage of the favorable credit environment to overweight the most dynamic and highest yielding part of the subordinated market: contingent convertibles (CoCos) and hybrids. Those instruments were the most rewarding over the period, despite being the most volatile though.
2. In order to mitigate interest rate risk and to smoothen the overall volatility of the fund, the duration of the portfolio was kept on average 1 year below that of the index. The purpose of this tactical call was not to add extra interest rate noise on top of credit risk.
3. Security selection has been important. Given that for many investors subordinated bonds are a new and relatively unknown part of the fixed income capital structure, price inefficiencies could be found allowing the management team to buy interesting bonds at discounted prices.

[1] Source: Trading Economics. Data as of 25.10.2017
[2] The fund's comparison index since inception.

OUTLOOK FOR 2018 AND BEYOND

At this point in the calendar year, European subordinated bonds have proven to be one of the better-performing fixed income assets of 2017. In our view, the strong run experienced so far is far from over and further attractive gains should be available to investors. On both an absolute valuation and relative to other fixed income assets basis, there are compelling reasons to expect that subordinated debt will extend its attractive 2017 year-to-date performance going forward. That said, being nimble, active and a credit expert will be a key to outperformance and risk management. Fixed income investors today are challenged and the paradigm has certainly changed compared to years past. However, attractive returns can be found under the right conditions, and for us, subordinated debt is a space where opportunities are ripe.