Alternative Bonds: Introducing CoCos

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Scope
Elston ETF Research focuses on ETFs listed on the London Stock Exchange. All tickers relate to London listed securities. Our target audience is UK asset managers and intermediaries.

About Elston
Elston aims to be the UK's leading independent ETF specialist. We provide ETF Research, ETF Portfolios and Indices to asset owners and asset managers.
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All data is at 31st March 2018 unless otherwise stated

SUMMARY

- WisdomTree has recently launched an ETF (**COCB**) providing access to Contingent Convertible Bonds.
- Contingent Convertible Bonds or "CoCos" have both bonds and equity-like characteristics.
- CoCos pay an attractive income with higher credit quality than traditional high yield bonds, and have additional diversification benefits.

What are CoCos?

Following the 2008 financial crisis, banks had difficulty issuing traditional debt securities, and had to sit on a large amount of capital to ensure their balance sheet strength was maintained.

CoCos were created as the issuing banks flexible friend. This is because are designed to absorb losses when the balance sheet of the issuing banks weakens below a threshold level.

Losses can be absorbed by the CoCo converting into equity or suffering a write-down of its principal value making it more flexible than traditional bank securities. To offset the risk of loss, CoCos are issued with a higher coupon than traditional bank bonds.

Accessing CoCos

Whilst bond funds may include CoCos, direct access to CoCos as a targeted allocation was previously only available to institutions who could meet minimum issuance sizes from one or more issuer.

By accessing CoCos using an ETF, the minimum investment becomes accessible, and the ETF is diversified across 29 CoCos from 24 different issuers.

Why include CoCos in a portfolio?

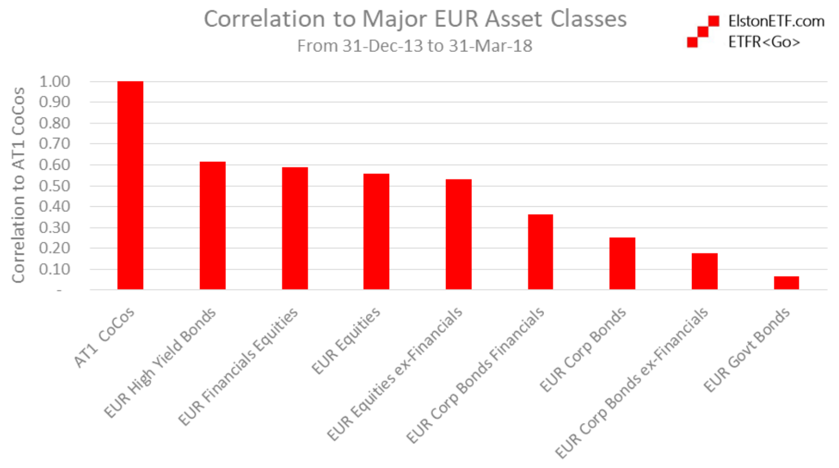
Convertibility into the issuing bank's shares means that CoCos provide an exposure that has both bond and equity-like characteristics.

When there is higher risk of balance sheet stress, CoCo's behave more like equities.

When there is lower risk of balance sheet stress, CoCo's behave more like bonds.

CoCos' moderate correlation to equities and low correlation to Corporate and Government Bonds makes them a useful diversifier from a portfolio construction perspective.

Fig.1. Correlations to major asset classes



Source: Elston ETF Research, Bloomberg data, Markit

By having both equity-like and bond-like characteristics, CoCos are less correlated with both, offering a diversification benefit.

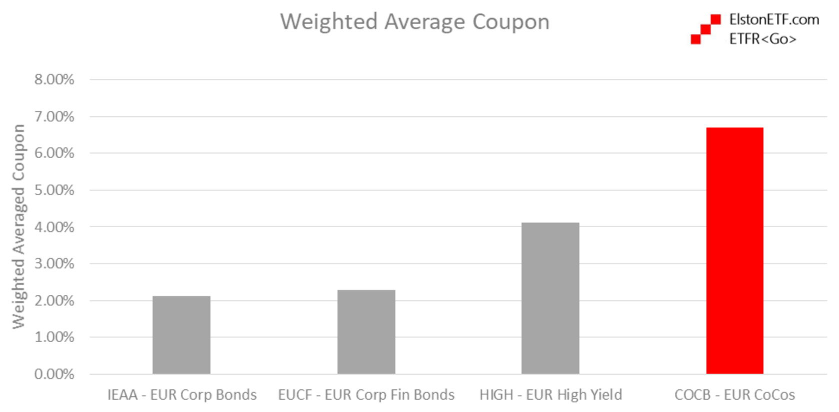
Because of their attractive coupon, CoCos offer more income than high yield bonds…

…even though the Credit Quality of a CoCo is actually higher.

Bigger income & better credit quality

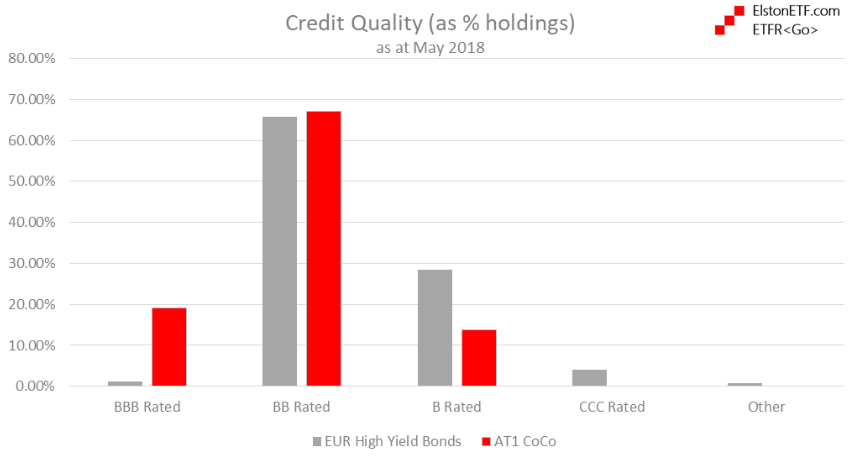
CoCos have an attractive income to reward risk taken, but a better quality credit rating compared to traditional High Yield Bonds.

Fig.2. Income Profile



Source: Elston ETF Research, latest provider factsheets

Fig.3. Credit Profile



Source: provider data, Elston ETF Research

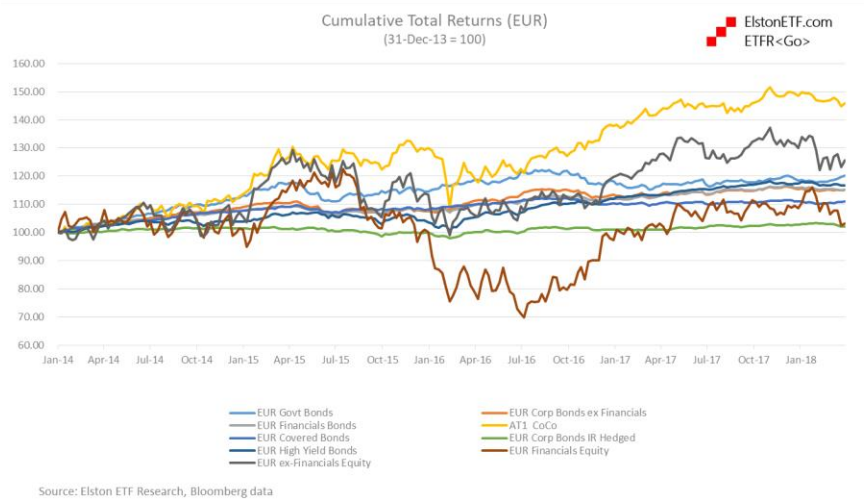
Furthermore, in terms of counterparty risk, CoCos are only issued by large banks that are well regulated with high capital ratios.

EUR CoCos have outperformed both EUR equities and bonds since 2013

How about performance?

CoCos have outperformed EUR bonds and equities, both excluding and including Financials exposure.

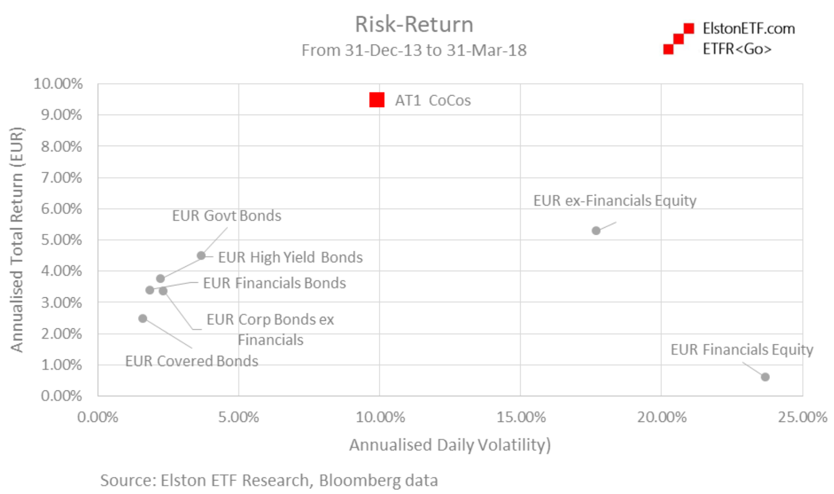
Fig.4. Total Returns



Risk profile is between equities and bonds with strong risk-adjusted returns

CoCos are positioned between equities and bonds in respect of realised volatility, but with better risk-adjusted returns.

Fig.5. Risk-Return



1. Good risk-adjusted returns.
2. Diversifiying power
3. High income with better credit quality.

Summary
In summary, CoCos have offered solid risk-adjusted returns (Sharpe Ratio), and have a low correlation to bonds from a diversification perspective and a higher income with better credit quality relative to traditional high yield bonds.

ETFs Referenced in this report

Elston Exposure	Index Strategy	Representative ETF	Ticker
EUR Inflation Linked Bonds	Bloomberg Barclays Euro Government Inflation-Linked Bond Index	iShares € Inflation Linked Govt Bond UCITS ETF	IBCI
EUR Govt Bonds	Bloomberg Barclays Euro Treasury Bond Index	iShares Core € Govt Bond UCITS ETF	IEGA
EUR Corp Bonds	Bloomberg Barclays Euro Corporate Bond Index	iShares Core € Corp Bond UCITS ETF	IEAA
EUR Corp Bonds ex Financials	Bloomberg Barclays Euro Corporate ex-Financials Bond Index	iShares € Corp Bond ex-Financials UCITS ETF	EEXF
EUR Financials Bonds	Bloomberg Barclays Euro-Aggregate: Financials Index	iShares € Corp Bond Financials UCITS ETF	EUCF
EUR Alternative Bonds	iBoxx Contingent Convertible Liquid Developed Europen AT1 TRI (USD Unhedged)	WisdomTree AT1 CoCo UCITS ETF USD	CCBO
EUR Alternative Bonds	Markit iBoxx € Covered	iShares € Covered Bond UCITS ETF	ICOV
EUR Alternative Bonds	Bloomberg Barclays EUR Corporate Interest Rate Hedged Index	iShares € Corp Bond Interest Rate Hedged UCITS ETF	IRCP
EUR Alternative Bonds	Markit iBoxx Euro Liquid High Yield Index	iShares € High Yield Corp Bond UCITS ETF	HIGH
EUR Financials Equity	STOXX® Europe 600 Banks	iShares STOXX Europe 600 Banks UCITS ETF (DE)	EXV1
EUR ex-Financials Equity	EURO STOXX 50 ex-Financials Index	iShares EURO STOXX 50 ex-Financials UCITS ETF	EXFN
EUR Large Cap Equity	EURO STOXX® 50	iShares Core EURO STOXX 50 UCITS ETF	CSX5

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