Seeking Alpha

Contingent Convertible Bonds (CoCos): An Asset Class Worth Looking At?

Sep. 16, 2016 2:49 AM ET
by: Lynx Investment Advisory

Summary

- What are contingent convertible bonds (CoCos) and how are they different from traditional convertible bonds?
- What is the history behind CoCos? Which companies and in what countries are they being issued today?
- Do we recommend investing in CoCos, and if so, in what format?

In our last white paper, we discussed the Brexit vote and its expected fallout. In the paper, we briefly mentioned the increased demand for CoCos in association with investors' ongoing search for yield. Given that these securities are relatively new to many in the investment community, as well as being somewhat complex, we thought we would provide our readers with more detail on the asset class and why we like it.

Let's begin with a definition. A CoCo is a convertible bond issued by banks; like all convertible bonds, CoCos generate a yield and have a strike price at which the bonds are convertible to company stock. Unlike a normal convertible, a CoCo only converts to a company's stock when its capital ratio trigger is hit, which is explained below. It's also important to note the relative margin of safety a CoCo investment provides as compared to its associated stock, which is based on its superior position in the capital structure.

What is the downside in this scenario? The difference between CoCos and their traditional counterparts is related to the conversion process; traditional convertible bonds provide the holder with the option to convert if/when the bond hits its conversion strike price, while CoCos will not convert to equity until its issuing bank's capital ratio falls below a specified level, at which time the bank is forced to convert the bonds to equity. The conversion level is typically based on a percentage of the bank's tier one capital. If the bank's ratio falls below its trigger point, the debt is converted into common stock, while the bank is then no longer required to pay its stock dividends.

Now that we understand what a CoCo is, we'd like to outline why they were created. CoCos came about after the 2008 financial crisis. As a reminder, in order to launch a market recovery, taxpayer money had to be used to finance the failing banks, while, for the most part, bondholders were repaid in full. Therefore, the idea behind CoCos was to transfer the risk of a failing bank from the taxpayer to the bondholder, provided a 2008 like scenario was to reoccur. Though CoCos are relatively new securities, they have been receiving a great deal of attention as investors search for high yielding investment opportunities. To date, the majority of those allocating to the space are a combination of retail investors and small private banks, while the large institutions have tended to remain on the sidelines. It is likely a key reason for the lack of investor interest is tied to the absence of a complete and consistent credit rating policy as it relates to CoCos specifically. Currently, S&P and Fitch have rated a small percentage of the CoCo market; however, there is no consistent or agreed upon rating methodology, which adds volatility to the asset class. Another important point to highlight is that though many of the issuing banks are rated A or above, within rating agency guidelines, CoCos cannot be given a rating higher than BBB+.

From a bank's perspective, CoCo coupon payments are tax deductible, while they also serve as tier 1 capital from the regulators' standpoint. Please see Table 4 for a CoCo yield chart, as well as Table 1, which provides the largest CoCo issuers today. As is apparent, to date most issuers are foreign banks, with UK at the top of the list (Table 2), which explains why these bonds fell in value following Brexit.

Table 1

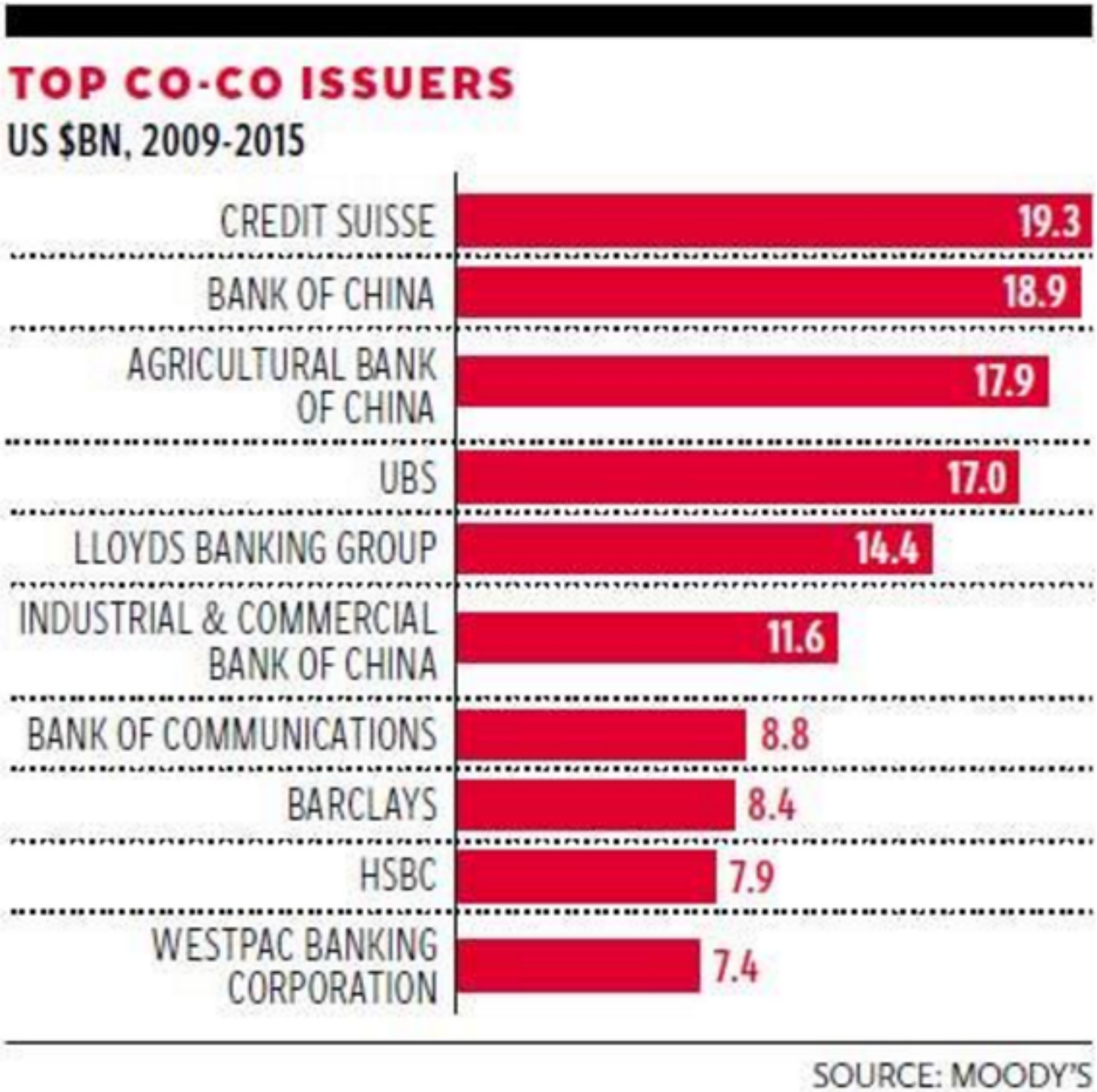
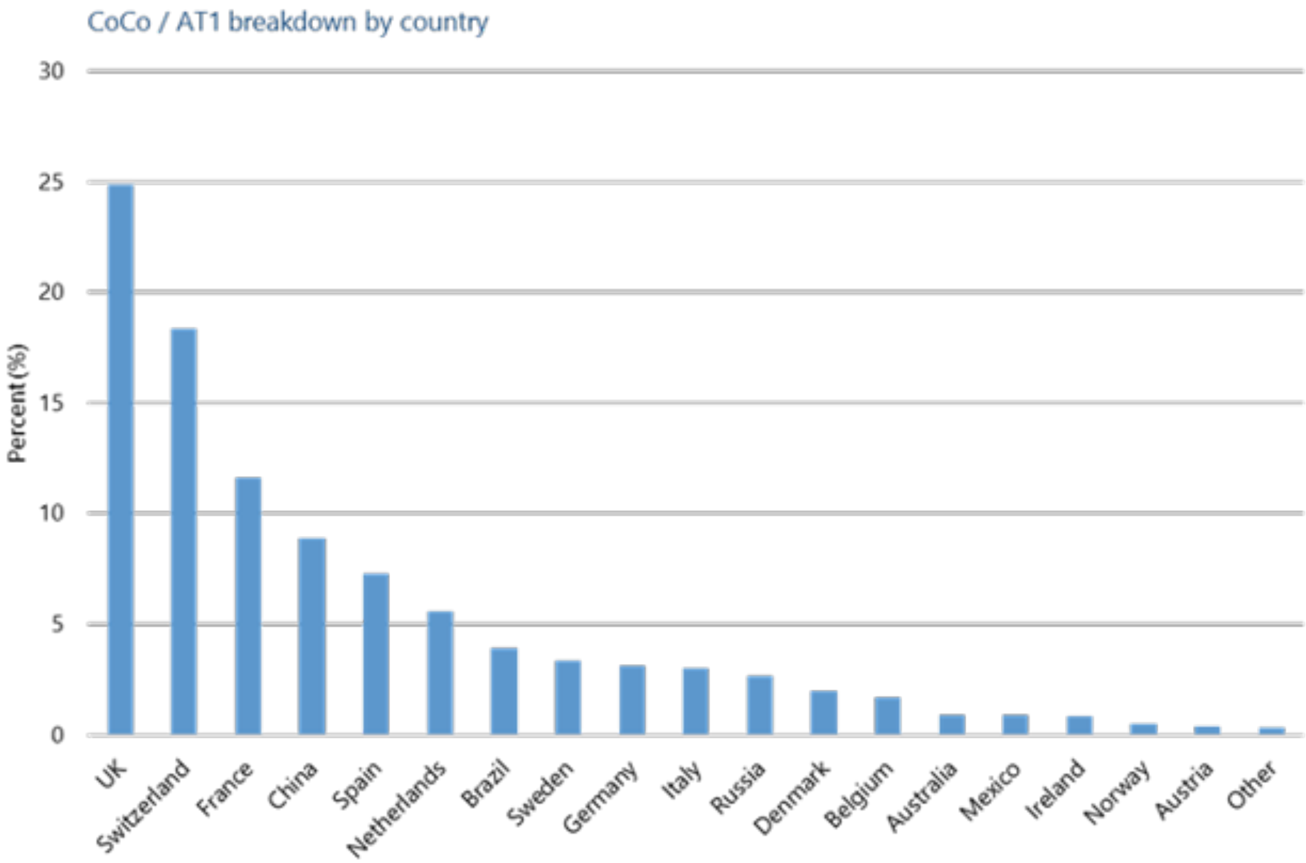

TOP CO-CO ISSUERS
US $BN, 2009-2015
CREDIT SUISSE
19.3
BANK OF CHINA
18.9
AGRICULTURAL BANK OF CHINA
17.9
UBS
17.0
LLOYDS BANKING GROUP
14.4
INDUSTRIAL & COMMERCIAL BANK OF CHINA
11.6
BANK OF COMMUNICATIONS
8.8
BARCLAYS
8.4
HSBC
7.9
WESTPAC BANKING CORPORATION
7.4
SOURCE: MOODY'S

Table 2



Source: PIMCO

Table 3 provides issuance year to date against previous years. Though it's been strong this year, 2015 was a much more robust year, which we believe is due to the combination of the scare that Deutsche Bank would miss a CoCo coupon payment in February, which created a domino effect within the industry, as well as the Brexit outcome.

Table 3

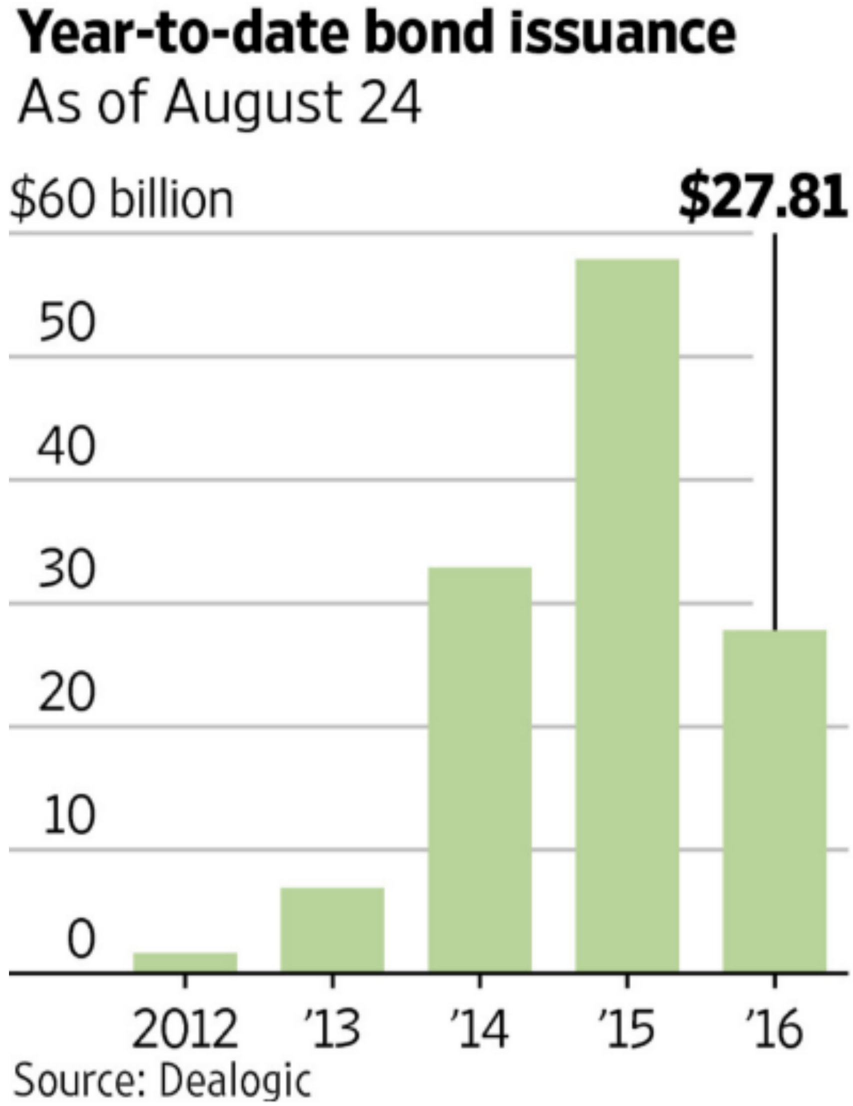
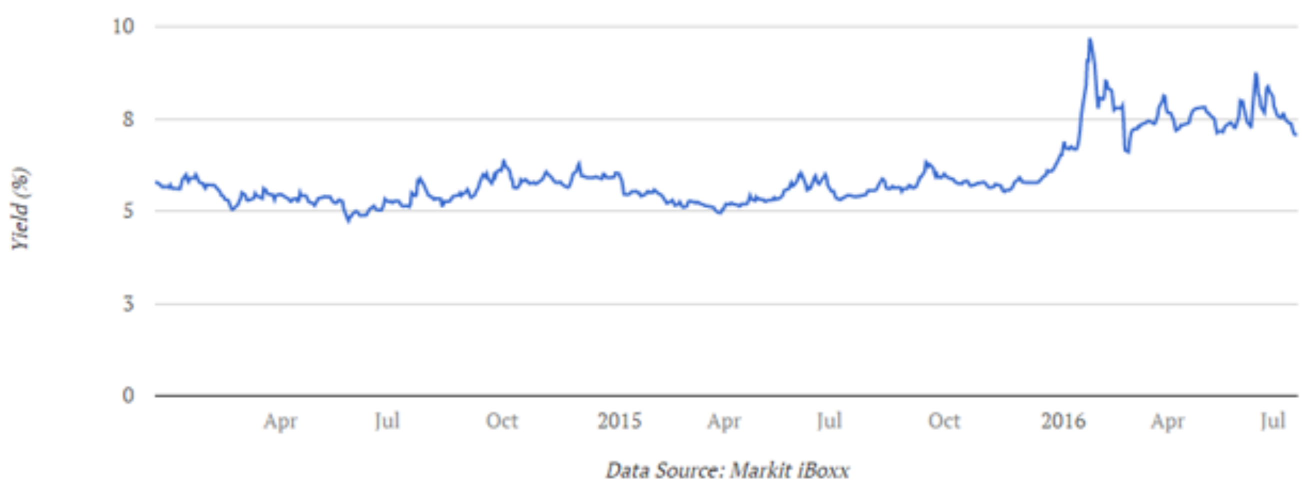

Year-to-date bond issuance
As of August 24
$60 billion
$27.81
50
40
30
20
10
0
2012
'13
'14
'15
'16
Source: Dealogic

Table 4

Contingent Convertible Index Yields



Before we offer our investment opinion and approach as it relates to CoCos, it's important to mention the latest legislation being discussed with regards to the asset class. Currently, EU law places CoCo coupon payments on par with the issuing bank's stock dividend and employee bonus payments. In an attempt to protect CoCo investors and dampen volatility, a proposal is being floated that would require banks to fully pay the coupon prior to honoring any stock dividends. Additionally, staff bonuses would not be paid until the coupon payment has been met. While these modifications have yet to be approved, we view the discussion and possible enactment as a positive for the asset class. We also expect the CoCo issuance to go up as traditional bank subordinated debt is retired under Basel III, bringing increased liquidity to the market. The emerging methodology to rate CoCos will further broaden the investor base.

As for our opinion, why do we believe CoCos are a good investment today? The simple answer is that though the downside scenario may appear rather hairy at times, the yields these securities are offering right now are very attractive as compared to those of traditional convertible bonds, as well as many other fixed income products. The risk is further reduced by the aggressive quantitative easing policies of the European Central Bank, which have been designed to create a smooth functioning credit market. We believe a CoCo allocation, sized correctly (specifically a small allocation given CoCos' low overall issuance and thin daily trading volume), provides the potential for both a relative and absolute risk-adjusted return beyond what most other asset classes can offer today. Please also be aware that given the associated risks, the selected portfolio manager must be very comfortable and highly skilled in terms of the credit research and diligence required to construct a portfolio of sound CoCo investments. As for an investment idea, we will only recommend these bonds in a fund format, and within that fund, CoCos should make up a relatively small allocation given their volatile nature. Specifically, we like the Cohen & Steers Select Preferred and Income Fund (MUTF:CPXIX), while we also find similar strategies housed in a closed-end fund structure appealing, provided they trade at an attractive discount and remain relatively conservative in terms of leverage.

Hopefully, this paper has provided a bit of insight into the asset class itself and outlined why we believe there's an opportunity in contingent convertible bonds today.

Disclosure: I am/we are long CPXIX.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.