BlueBay
Asset Management

Why pension funds should be allocating to European banks

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Cocos provide access to an asset class with improving prospects and policymaker support, yet with a highly attractive yield. We believe it is hard to find risk-adjusted returns that look quite so compelling anywhere else.

- With yields collapsing, deficits growing and the outlook uncertain, finding assets that will benefit, rather than suffer, from the current policy response, is a growing problem.
- We believe bank-issued coco bonds address these macro challenges and should increasingly be finding themselves on the radar of pension-fund allocators.
- Following a decade of reform, the European banking system has entered the current crisis from a position of strength.
- In our view, cocos have the potential to offer investors the best of both worlds – equity-like returns through fixed-income instruments.

Covid-19 has created huge challenges for the economy and society that will be felt for years to come. The fiscal and monetary response to the crisis has been unprecedented and provided a lifeline to many. While undoubtedly necessary, the unintended consequences of these measures are significant for UK pension funds.

Funding constraints remain the biggest single challenge for pension funds, and this has been exacerbated by the response to the crisis. As of June, the combined deficit of UK defined benefit pension schemes sat at GBP174.3 billion, with 66.8% of all schemes in deficit versus 58.6% just a year ago. Real yields have collapsed, driven by quantitative easing, which has pushed USD15.5 trillion

of global assets into negative-yielding territory, creating a double whammy for the industry, with both liabilities increasing in value and asset-return expectations collapsing.

Over the past decade, the trend has been for funds to de-risk their portfolios by favouring Gilts and corporate bonds over equities, illiquids over liquids and trackers over active. However, with yields collapsing, deficits growing and the outlook uncertain, finding yield and assets that will benefit, rather than suffer, from the current policy response, is a growing problem.

We believe contingent capital bonds or 'cocos' issued by banks – more commonly held in the realms of sophisticated asset managers and hedge funds – fit the bill for these issues and should increasingly be finding themselves on the radar of pension-fund allocators.

Why banks?

The European banking system provides 80% of the credit to the European economy. As the crisis has unravelled, we have witnessed a unique alignment of fiscal, monetary and regulatory actions, all designed with the mindset that banks are the conduit of ensuring the policy actions taken from a monetary and fiscal perspective reach the real economy.

The importance of the banking system's role in helping the economy recover from the crisis cannot be underestimated and this has not been lost on regulators and policymakers. Regulators have ensured that banks benefit from capital relief and support measures to ensure they have no concerns about solvency and stand willing and able to provide as much credit to the economy as it demands.

Aren't banks a bit risky, particularly during a recession?

In the aftermath of the global financial crisis (GFC), regulators spent the best part of a decade driving banks to have better liquidity, hold more capital and engage in less risky activities through greater capital charges levied on perceived 'risky' activities.

This decade of reform has meant the European banking system has entered this crisis from a position of strength. While we are undoubtedly now entering into an environment where the sector will be tested, we remain confident that European banks will emerge from this far better and more resilient than the market expects. Additionally, we believe that the importance of banks in the monetary transmission mechanism and provision of credit, will ensure ongoing policy support from regulators to ensure that this position of strength is maintained.

The cost of this decade of reform and unprecedented support has been meaningful for bank equity holders, who have picked up the tab of increased capital requirements and dividend bans. Conversely, in our view, it has presented a rich potential opportunity for bank credit investors willing to do their homework.

Where is the sweet spot to benefit from the policy environment?

The coco market is a product of the financial crisis of 2008/2009. These are hybrid debt instruments issued by banks that were designed by regulators to act as shock absorbers if financial institutions ran into trouble again.

We believe cocos offer investors the best of both worlds – equity-like returns through fixed-income instruments – and appear to be the sweet spot in playing to the strength of the banking system and policy support without potentially suffering the costs of this support like equity holders.

The coco premium

Almost 25% of coco bonds for the European banking sector are investment grade-rated, the rest are considered high yield (although typically issued by investment-grade-rated banks). Despite this, they don't feature as part of these benchmarks due to their unique characteristics.

With the rise of passive investing and ETFs, any instrument that doesn't tick a box, or fit within a pre-defined benchmark, frequently trades with a significant discount and often may present a mispriced opportunity to potentially exploit. In our view, it is hard to think of an asset class where this is more apparent than the market for cocos.

With deficits growing and the outlook uncertain, finding yield and assets that will benefit, rather than suffer, from the current policy response, is a growing problem. We believe cocos fit the bill for these issues.

Fitting the bill

For pension fund managers that are not constrained by benchmarks and are in search of attractive risk-adjusted returns, there is a potential opportunity to invest in this asset class and gain exposure to a sector which, in our view, has improving prospects and policymaker support, yet with highly attractive yield.

When you survey the risk spectrum, we believe it is hard to find risk-adjusted returns that look quite so compelling.

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