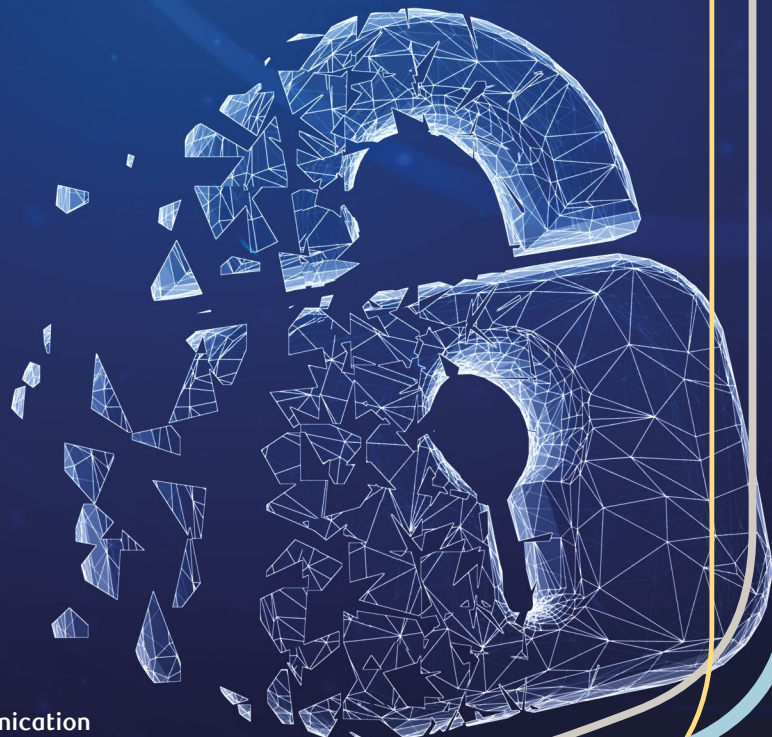




RBC BlueBay
Asset Management

Unlocking enhanced returns from subordinated debt

For Professional Investors Only | Marketing Communication



Russell Vincett
BlueBay Portfolio Manager
RBC BlueBay
Asset Management

Published October 2023

“Subordinated debt from solid investment grade issuers should offer better risk/reward than senior debt of high yield issuers with historically higher default rates.”

Russell Vincett, BlueBay Portfolio Manager, discusses how investors can pick up an attractive yield in the subordinated debt of European best-in-class issuers.

As investors look for enhanced returns in credit, the traditional approach is to take more credit risk through investments in emerging markets, high yield, or longer-duration assets. These, however, come with increased interest rate sensitivity, default risks, and FX fluctuations, among other risks.

However, the compelling fourth alternative is to selectively invest in the subordinated debt of Europe’s best-in-class, investment grade and sometimes national champion issuers. Here, investors can pick up significant yield for the same issuer credit risk as they move down the capital structure.

The pickup in yield from these lower-ranked securities more than compensates for the structural, subordination and extension risk, considering the extremely low default rate of strong investment grade companies. Yields available are relatively high, but the interest rate duration sensitivity is low because of their callability.

Yield opportunities but caution needed

At a time when we are approaching a peak in global interest rates, hybrid investments can enhance the yield profile of portfolios, and the pickup of subordinated debt to senior issues is at attractive levels compared to historical figures. However, investors should approach the asset class with some caution since the level of volatility can be significantly higher than in senior debt. If the market decides to price in more rate hikes, then longer-dated instruments will be more vulnerable than these shorter-dated callable instruments.

Conversely, given the spread differential, if the market sees a soft landing alongside a peak in Federal Reserve rate hikes, the outperformance in subordinated debts over senior could be material. Subordinated debt from solid investment grade issuers should offer better risk/reward than senior debt of high yield issuers with historically higher default rates. In this scenario, name selection would be key to outperformance.

Identifying sector opportunities

At this point, we prefer hybrids in defensive sectors less exposed to recessionary headwinds. We like healthcare, telecommunications, and utilities. We also favour newer vintage high coupon, high reset hybrids as we believe they will prove more resilient in any downturn. That said, in credits where we consider the extension risk to be low, there are some older and lower coupon hybrids trading so much wider than newer vintages that they also provide interesting opportunities.

We also like subordinated bank capital, which remains a structurally attractive investment with improving credit fundamentals and favourable policy and regulatory tailwinds. The subset of subordinated bank debt, specifically Additional Tier 1 (AT1) capital, debt took a hit when Credit Suisse AT1s were written down to zero, and all bank AT1s repriced spreads wider. Since then, most bank AT1s have been called, as issuers and regulators have taken an investor-friendly approach to call decisions to ease investors' sensitivity to the asset class. We expect this to continue, and we should continue to see AT1 spread levels decrease.

The future

In our opinion, subordinated debt from investment grade issuers represents an attractive investment opportunity. The overall performance across economic cycles is strong due to the higher yield nature of the asset class with the pickup of subordinated debt/corporate hybrids to senior issues at attractive levels compared to history.

At a time when we are approaching a peak in global interest rates, we believe that hybrid investments are a useful way of enhancing the yield profile of portfolios.

“In our opinion, subordinated debt from investment grade issuers represents an attractive investment opportunity.”

This document is a marketing communication and it may be produced and issued by the following entities: in the European Economic Area (EEA), by BlueBay Funds Management Company S.A. (BBFM S.A.), which is regulated by the Commission de Surveillance du Secteur Financier (CSSF). In Germany, Italy, Spain and Netherlands the BBFM S.A is operating under a branch passport pursuant to the Undertakings for Collective Investment in Transferable Securities Directive (2009/65/EC) and the Alternative Investment Fund Managers Directive (2011/61/EU). In the United Kingdom (UK) by RBC Global Asset Management (UK) Limited (RBC GAM UK), which is authorised and regulated by the UK Financial Conduct Authority (FCA), registered with the US Securities and Exchange Commission (SEC) and a member of the National Futures Association (NFA) as authorised by the US Commodity Futures Trading Commission (CFTC). In Switzerland, by BlueBay Asset Management AG where the Representative and Paying Agent is BNP Paribas Securities Services, Paris, succursale de Zurich, Selnaustrasse 16, 8002 Zurich, Switzerland. The place of performance is at the registered office of the Representative. The courts at the registered office of the Swiss representative or at the registered office or place of residence of the investor shall have jurisdiction pertaining to claims in connection with the offering and/or advertising of shares in Switzerland. The Prospectus, the Key Investor Information Documents (KIIDs), the Packaged Retail and Insurance-based Investment Products - Key Information Documents (PRIIPs KID), where applicable, the Articles of Incorporation and any other document required, such as the Annual and Semi-Annual Reports, may be obtained free of charge from the Representative in Switzerland. In Japan, by BlueBay Asset Management International Limited which is registered with the Kanto Local Finance Bureau of Ministry of Finance, Japan. In Asia, by RBC Global Asset Management (Asia) Limited, which is registered with the Securities and Futures Commission (SFC) in Hong Kong. In Australia, RBC GAM UK is exempt from the requirement to hold an Australian financial services license under the Corporations Act in respect of financial services as it is regulated by the FCA under the laws of the UK which differ from Australian laws. In Canada, by RBC Global Asset Management Inc. (including PH&N Institutional) which is regulated by each provincial and territorial securities commission with which it is registered. RBC GAM UK is not registered under securities laws and is relying on the international dealer exemption under applicable provincial securities legislation, which permits RBC GAM UK to carry out certain specified dealer activities for those Canadian residents that qualify as “a Canadian permitted client”, as such term is defined under applicable securities legislation. In the United States, by RBC Global Asset Management (U.S.) Inc. (“RBC GAM-US”), an SEC registered investment adviser. The entities noted above are collectively referred to as “RBC BlueBay” within this document. The registrations and memberships noted should not be interpreted as an endorsement or approval of RBC BlueBay by the respective licensing or registering authorities. Not all products, services or investments described herein are available in all jurisdictions and some are available on a limited basis only, due to local regulatory and legal requirements.

This document is intended only for “Professional Clients” and “Eligible Counterparties” (as defined by the Markets in Financial Instruments Directive (“MiFID”) or the FCA); or in Switzerland for “Qualified Investors”, as defined in Article 10 of the Swiss Collective Investment Schemes Act and its implementing ordinance, or in the US by “Accredited Investors” (as defined in the Securities Act of 1933) or “Qualified Purchasers” (as defined in the Investment Company Act of 1940) as applicable and should not be relied upon by any other category of customer.

Unless otherwise stated, all data has been sourced by RBC BlueBay. To the best of RBC BlueBay’s knowledge and belief this document is true and accurate at the date hereof. RBC BlueBay makes no express or implied warranties or representations with respect to the information contained in this document and hereby expressly disclaim all warranties of accuracy, completeness or fitness for a particular purpose. Opinions and estimates constitute our judgment and are subject to change without notice. RBC BlueBay does not provide investment or other advice and nothing in this document constitutes any advice, nor should be interpreted as such. This document does not constitute an offer to sell or the solicitation of an offer to purchase any security or investment product in any jurisdiction and is for information purposes only.

No part of this document may be reproduced, redistributed or passed on, directly or indirectly, to any other person or published, in whole or in part, for any purpose in any manner without the prior written permission of RBC BlueBay. Copyright 2023 © RBC BlueBay. RBC Global Asset Management (RBC GAM) is the asset management division of Royal Bank of Canada (RBC) which includes RBC Global Asset Management (U.S.) Inc. (RBC GAM-US), RBC Global Asset Management Inc., RBC Global Asset Management (UK) Limited and RBC Global Asset Management (Asia) Limited, which are separate, but affiliated corporate entities. ® / Registered trademark(s) of Royal Bank of Canada and BlueBay Asset Management (Services) Ltd. Used under licence. BlueBay Funds Management Company S.A., registered office 4, Boulevard Royal L-2449 Luxembourg, company registered in Luxembourg number B88445. RBC Global Asset Management (UK) Limited, registered office 100 Bishopsgate, London EC2N 4AA, registered in England and Wales number 03647343. All rights reserved.

Published October 2023



RBC BlueBay
Asset Management