Opportunities on financial debt amid today's quest for yield and regulatory shifts

Julien de Saussure, fund manager of Edmond de Rothschild Signatures Financial Bonds

Why invest in subordinated financial debt today?

We believe there are 3 main reasons that warrant exposure to this bond segment:

• Regulatory changes emerged after the financial crisis. They aim to improve capital buffers, solvency and liquidity for banks (Basel 3) and insurance companies (Solvency 2) and are good news for lenders. Companies are still adjusting their capital structure to meet new regulatory requirements and issuing new quasi-equity instruments to replace previous instruments by calling them in early.

• Last autumn's stress-test result provided improved visibility on the direct exposure of these establishments to certain risks.

• Europe's QE programme, unveiled on January 22, should also be favourable to subordinated financial debt, as it will reduce funding costs for banks, the main beneficiaries of this accommodating monetary policy.

With today's low interest rates set to last, we estimate that financial debt offers a potentially attractive yield of 6% for 2015[1].

Can we still opportunistically exploit the theme of former bank and insurance company debt disappearing?

This theme has helped drive the segment's performance for several years. These bonds still have an attractive risk/return profile and their potential volatility and drawdown is, in our view, limited overall. They represent the base of our portfolio.

We are closely scrutinising new structures from banks. Basel 3 compliant T1 securities have now become Additional Tier 1 Contingent Convertibles (AT1 Coco). True, they are riskier than the old generation but they also come with much more generous yields of 5-8%[2].

Regulatory transition should continue to create new opportunities:

in banks, by the end of 2015, Total Loss Absorbing Capacity (TLAC) requirements for systemic G20 banks should prompt the creation of a new intermediary Tier 3 tranche (between Tier 2 and senior debt).

in insurance companies, Solvency 2 should come with new Tier 1 structures, i.e. contingent convertibles but with a more attractive risk/return profile than bank CoCos.

We are, in fact, continuing to raise insurance weightings in the portfolio. Transition from Solvency 1 to 2 represents fresh opportunities, which differ from banking logic – witness the wave of purchase and exchange operations on the market at the end of 2014.

Ultimately, transition is creating new opportunities and will continue to do so.

> "Regulatory transition continues to create interesting opportunities."

What is the fund's current positioning?

The fund benefits from active management based on high convictions, which aims to capture opportunities on the global financial bond markets, especially in the subordinated debt segment.

The fund acts opportunistically, focusing on market segments that offer the most attractive risk/return profile. The fund's investment process is designed to suit the specific nature of the asset class. Our team has a deep understanding of the regulatory landscape and a long experience of bond markets. Edmond de Rothschild Signatures Financial Bonds I have posted an annualised performance of +7%[3] since inception and assets under management have recently moved above €700m.

• The portfolio is currently composed of 120 positions and 60 issuers. The top 10 holdings represent close to 40% of assets, an indication of our strong convictions on major companies.

• We place great importance on diversification:

by instrument type, i.e. exposure to insurance companies for performance (as seen above) but also to CoCos, which help further diversification.

by geographical zone. The portfolio is still largely invested in European bonds, mainly in core countries but Basel 3 is also being introduced in other countries like China, Australia, Canada and the US.

We have in recent months taken steps to diminish any impact from market stress. This has helped us to cushion losses during volatile periods in the second half of 2014.

Lastly, we keep a close eye on liquidity, a key issue for investors. We have decided to limit long-dated bonds: close to a third of the portfolio, for example, could be called in maximum 2 years. This strategy means that we have consciously chosen to be exposed to reinvestment rather than liquidity risk.

Company Profile:

Asset management is one of the Edmond de Rothschild Group's two strategic businesses. The Group was founded in 1953 and has been chaired since 1997 by Baron Benjamin de Rothschild. An independent, family-owned group that also specialises in private banking, the group has €135.7bn under management and employs 2,900 people in 30 offices throughout the world. With 6 investment hubs in the world (France, Switzerland, Germany, Hong Kong, Luxembourg and the UK), Edmond de Rothschild Asset Management is positioned as a multi-specialist investment firm. Its offer seeks long term performance through active investing and strong convictions based on a tradition of constant innovation. This builds on recognised areas of expertise such as European and US equities, corporate debt, multi manager, currency overlay, asset allocation and quantitative asset management.

Edmond de Rothschild Asset Management had close to €45bn under management at 30 December 2013 and employed 550 people, including 100 investment professionals.

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1 The targeted yield is based on Edmond de Rothschild Asset Management's market assumptions and in no way constitutes a guaranteed yield.
2 Source: Bloomberg. Data at 28/02/2015.
3 Past performance is not a reliable indication of future returns and is not constant over time. Data as of end of February 2015 for the I share of the fund. Launch date of the I share: 10/03/2008. Source: Edmond de Rothschild Asset Management (France)

2 March 2015. Data concerning the fund EdR Signatures Financial Bonds and Edmond de Rothschild Asset Management at 27/02/2015. Non binding document. This document is for information only.
Glossary: Subordinated debt is reimbursed after senior debt when a company is liquidated. It is consequently riskier than senior debt but generally offers a better yield. 2. Tier 1 and Tier 2 debt is hybrid subordinated debt: maturities are long and sometimes perpetual and coupons may be suspended if the issuing company runs into difficult times. Contingent convertibles have fixed or perpetual maturities which may absorb some of a company's losses or be converted into equity when the issuing company's capital falls below a predefined threshold. AT1 are perpetual debt instruments with no obligation of reimbursement. They are subject to a loss absorption or conversion-to-equity mechanism with a capital ratio trigger.
Main investment risks of the fund: capital loss risk, discretionary management risk, credit risk, interest risk, liquidity risk, risk from investing in speculative securities. The fund is classify in category 4, in line with the nature of securities and geographical zones in the «objectives and investment policy» section of the key investor information document (KIID).

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