# AT1 bonds: better value than they were, but still too much thematic risk

**As 'Additional Tier 1' bonds defy their prosaic label and grab headlines in the wake of Credit Suisse's collapse, Donald Phillips explains why the Global Fixed Income team has avoided this source of thematic risk.**

Since launching bond funds with Liontrust five years ago, we've often described our credit process as based on avoiding large accumulations of thematic risk. Bond indices can often be negatively selected in this regard – the most heavily indebted sectors and companies have the largest weightings in the index.

We don't view a neutral weighting versus the index as the default position for someone with no investment view to express. The energy sector, for example, is a big part of indices, particularly in the US. If you are equal weight against this large part of the index, are you really expressing no view on such a highly thematic factor (the oil price) and cyclical sector?

Even if you did want to take a positive view on the oil price, are bonds – with limited upside and 100% downside – the best way to express such a bet?

Anyway, talking about the energy sector in bonds is *so* 2021. The most recent poster child of thematic risk in bond funds is the 'AT1' additional tier one bonds issued by banks.

It was just under 14 years ago that the first 'contingent capital' bank bonds were created. Their initial beginnings arose from exchanges out of banks having other bond-based capital securities that regulators deemed no longer fit for purpose, i.e., did not absorb losses in the way that regulators wanted them to. The label "contingent convertible," or cocos for short, reflected certain contingent conditions (usually a fall in tier 1 equity ratios below a certain threshold) under which the bond automatically converted into equity. At the time, there was huge debate about whether these were bond-like instruments, and they never made their way into mainstream indices (which has implications for the liquidity of these bonds during periods of market stress).

As time progressed, the regulators decided that the cocos were still too bond-like in nature and gradually features have changed such that it is easier for this tranche of the capital structure to absorb losses. The whole point of this is to add extra layers of protection, beyond equity capital, to deposit-holders and the taxpayer.

Due to outdated market conventions, this sub-asset class is still sometimes referred to as cocos although it should really be called AT1. This 'tier one' may sound like the best tier, but while it is the most valued from the regulator's perspective it is the riskiest for a bondholder.

Some of the AT1 universe are still cocos (e.g. UK banks) in that when the bank gets stressed the bonds convert to equity. Other parts of the AT1 universe have more onerous terms for bondholders, having write-downs in the bond documentation rather than conversion. These write-downs can be partial or full, and they can be temporary or permanent.

In the recent case of Credit Suisse's distressed sale to UBS, the documentation for its AT1 bonds had a full and permanent write-down provision. The extraordinary support the Swiss authorities granted

to Credit Suisse enabled the triggering of full AT1 tier of about SFr16bn. One complaint from AT1 holders is valid: Why did the Swiss National Bank and Swiss supervisory body (FINMA) not completely wipe out shareholders? We would suggest that it was to save face on the international stage and to persuade the board to vote for the deal, avoiding a temporary nationalisation, but we may never know.

The EU and UK authorities were very quick to respond on the morning after Credit Suisse's resolution, saying they would respect the capital structure; this does not mean that AT1 would have fared any better if an EU/UK bank got into trouble, merely that equity would be completely written off first.

We disagree with any notion that, in general, AT1 investors didn't understand these instruments and hadn't read the documentation. However, we do think they had become over-priced during a period of low volatility that is unlikely to be repeated. We have had less than 1% in these type of bonds in strategic portfolios, zero in our absolute return strategy and less than 4% in our high yield strategy to which their equity-like characteristics best apply.

However, now that many AT1 bonds have plunged to offer double digit yields, they look better value than for some time. We would even suggest that we think AT1 bonds will offer decent returns in the years ahead for investors who carefully stock pick – but they will be volatile.

Such bonds also represent a large, thematic source of risk – one which we will continue to largely avoid. The last few weeks' events have served as a reminder of the interconnected nature of the banking sector, and AT1 bonds are now a lightning rod for the issue.

Much like energy bonds in 2020/2021, given the asymmetric payoffs – particularly for this tier – the better thematic bet would seem to simply be to own shares.

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