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"Bank bonds: 'yes', but best if subordinate"

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by Isabella Della Valle

What sort of impact could the outcome of the British referendum have on the bond segment?

A British exit from the European Union would have limited effects on the bond segment. The monetary authorities (European Central Bank (ECB) and Bank of England) constantly oversee the market and have promised unlimited liquidity if the feared Brexit scenario comes to pass. We expect volatility on the credit market, which should be grasped as an opportunity to buy. The heaviest impact would probably be on the pound: it has already been weakened but could suffer a further fall, which the analysts put at between 5 and 10%.

Janet Yellen has cooled expectations of a rise in US interest rates. What's your view on that?

It's the umpteenth delay in a slow and laborious normalisation process. However, we feel that US rates will go on rising: if not in July, then in the autumn. The market knows it, and the slow pace of the adjustment won't cause any upsets there. In fact it would confirm that the United States are ready to lead the global economy out of the economic crisis.

Which segments of the bond market is it worth investing in today?

Sadly, we have to recognise that bonds, as an asset class, have very little to offer. 40% of government bonds in the euro area have negative yields, which means they'll result in a loss for investors (even before calculating tax and fees!). However, there are some sectors and little "gems" from which it's still possible to extract value. We're concentrating on the high-yield sector or on subordinate financial issues. In some areas it's possible to obtain returns of 3.5% to 8%, while sticking with reliable issuers with very low credit risk.

Once commodity prices have stabilised, we wouldn't object to venturing into the emerging markets, where volatility remains high but where there's no lack of opportunities. Our working method is based on a bottom-up company analysis by our analysts and managers: we buy securities because we're happy with them, not because they're part of some benchmark.

It's a lengthy process that requires a full understanding of the business model and a careful analysis of the management's credentials. We usually go for companies with stable business and predictable cash flows.

And what do you think of the Italian and European banking sectors?

The sector is under pressure for three different reasons: economic stagnation, negative rates (which in effect are a hidden tax 0n banks) and tight regulation. Although I hope to see some improvement, these factors will continue to have a negative impact on banks and will require extreme measures. They'll need to improve in terms of efficiency (by cutting jobs, alas) and, in the most difficult cases, in terms of boosting their capital. We're seeing this in Italy, where both issues are, sadly, highly topical, but we're seeing it abroad too (for example, the recent capital increase by Popular in Spain, or the speculation on that of Deutsche Bank).

But are there any opportunities ?

From shareholders' perspective the scenario continues to hold many unknowns (which are reflected in banks' severe under-performance in the stock market). However, from the point of view of credit there are still some very interesting opportunities: the strict regulation means that banks are becoming increasingly safe (albeit not very profitable) by reducing their risk appetite and leveraging levels. We don't think the ECB will repeat the bail-in experiments that were tried in Italy and Portugal. So we like band bonds, especially subordinate bonds. With "CoCo" (Contingent Convertible) products you can find average returns of 8%, even just sticking to primary issuers. That's a premium of over 2 points compared with the same banks' yields from share dividends.

How would you assess the Atlante fund?

Atlante is a very important experiment that illustrates the strength of the Italian banking system. Seven years of zero growth (from 2008 to 2014) have left their – heavy – mark on our banks, with the numbers of non-performing loans multiplying. Unfortunately, the problems came to light at the worst possible time, just as the new European regulation (the BRRD) came into force and prevented state aid. Which was really bad luck, if you think that in 2012 Spain obtained 100 billion (the equivalent of 10% of its GDP) in aid to save its banking system.

Under the new rules, however, Italy has hardly been able to invest anything at all. Aid from the Interbank Fund (which could have managed the Banca Marche/Etruria/Carife differently) was banned, and support from CDP was limited to just 500 million. But the credit world, led by the leading banks and Foundations, managed to react and joined forces to support the smallest and most fragile banks: with an aid programme self-funded by the system itself, something that was quite unique in global terms.

What do you think of the ECB's corporate bond purchase initiative? What does it mean, and what impact will it have on the market in general and on Italy in particular?

The purchase of corporate bonds is the umpteenth taboo that the ECB, under Draghi, has broken: a central bank ready for anything to drag the economy out of the quicksands of deflation. It's excellent news for the economy, including Italy's, but the markets have been more than one step ahead, with the average return on European corporates plummeting to below 1%.

A firm specialising in strategic value

Banor Capital Limited is a UK-based independent investment management firm authorised by the Financial Conduct Authority. The firm, in which Banor SIM holds a stake, was set up in London in 2011 by a team of finance professionals and is headed up by CEO Giacomo Mergoni. Banor Capital specialises in value strategies and manages segments for Banor SICAV and Aristea SICAV, two Luxembourg-based umbrella funds that have gained notable recognition at the international level. The funds cover a range of investment strategies, markets and asset classes and are distributed in Italy and in other European countries.

FRANCESCO CASTELLI
BANOR CAPITAL

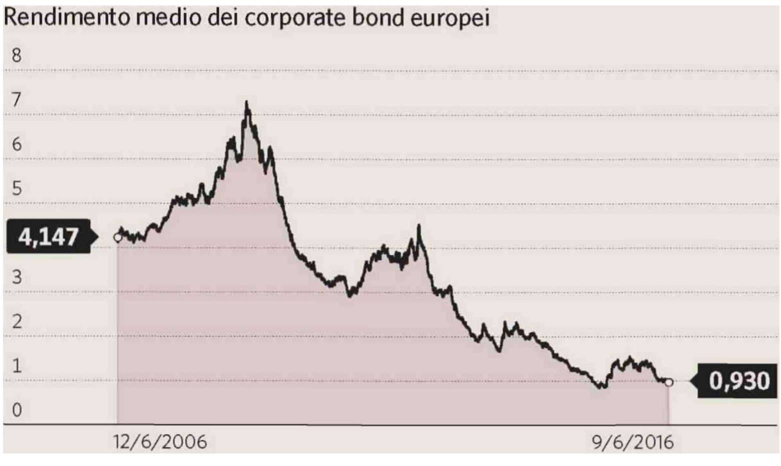
Head of fixed income

Francesco Castelli is married with two children and lives in London. He is head of fixed income at Banor Capital, and manages the Banor Sicav Euro Bond Absolute Return and Aristea Sicav Enhanced Cash funds.

With over 15 years' experience, Castelli previously worked in groups such as Zurich Investments, Sanpaolo IMI and Kairos Partners. He has an economics degree from Università Commerciale "Luigi Bocconi" and qualified as a Chartered Financial Analyst (CFA) in 2003. He is a regular guest on the CNBC channel, with frequent appearances in recent months to discuss Italian banking issues.

The snapshot

Performance:
Average yield of European corporate bonds



The yield of Contingent Convertible (CoCo) subordinate bonds continues to offer a significant premium compared with the return on bank shares. While the premium can largely be explained by the complexity of the instruments, it makes them highly appealing. Most issuers are top rate and, as Deutsche Bank has recently shown, ready to do whatever it takes to continue paying the coupon. High yields, without the uncertainty posed by shares (in the form of cuts in dividends or capital increases).

Recommended securities

ISSUER	MATURITY	COUPON	RATING	ISIN	INDICATIVE YIELD
Italia BTP	10/2020	1.25	BBB	IT0005058919	0.10 + Infl.
Bayer Ag*	07/2075	3.0	BBB	DE000A11QR65	3.10
Banca Popolare di Milano Scarl**	03/2021	7.125	B+	XS0597182665	0.208333333
Amazon.com Inc***	02/2023	2.06	A	US023135AL05	0.178472222
Constellation Brands Inc.***	05/2023	4.25	BB+	US21036PAL22	0.16875

NOTES: * Perpetual, call in 2020; ** subordinate LT2; *** in US dollars

There's not much value left in BTPs; for liquidity management we prefer BTP Italia, which offers a better premium than traditional equivalents that don't have inflation cover. The industrial hybrid products of sound issuers like Bayer and LT2 subordinates like Popolare Milano are excellent forms of diversification, if managed professionally. There are excellent opportunities in the USA too, for investors who can manage the exchange risk properly. Amazon offers a decent return, with a very low level of risk. In the high-yield sector, Constellation Brands, a leader in alcohol marketing in North America, is a very sound company, in spite of its rating.

The comparison

Performance of Tier 1 subordinates and European banks