INVESTORS SEEKING INCOME FIND "JUICE" LEFT IN THIS TRADE

Bonds have seen a shift in the supply/demand dynamics pushing yields lower in an environment where investors have been seemingly moving into both safe-haven and risk assets in search of portfolio diversification. Investors who have been savvy enough to include a portfolio of diversified fixed income have benefitted year-to-date from positive returns across most fixed income asset classes.

One area of fixed income which has done particularly well in comparison to other asset classes, including its equity counterpart, is AT1 CoCo bonds (AT1 CoCos)—hybrid bonds issued by European banks that sit above the bank's equity within their capital structure. Year-to-date to 28 June 2019, AT1 CoCos (USD unhedged) as represented using the iBoxx Contingent Convertible Liquid Developed Europe AT1 index have returned 10.6% total return meanwhile European bank equities as represented using the STOXX 600 banks index lagged returning only 4.6%. For the same period considering these indices, European bank equities exhibited 17.5% volatility meanwhile AT1 CoCos provided a more modest volatility profile of 4.4%. A similar volatility ratio between AT1 CoCos and European bank equities was exhibited on a 1-year and 3-year basis to 28 June 2019 as noted in Figure 1.

FIGURE 1: RISK-ADJUSTED PERFORMANCE

	Total Return Index	Return (ann., EUR	Volatlity (ann.)	Sharpe Ratio
YTD	iBoxx Contingent Convertible Liquid Developed Europe AT1	9.66%	4.4%	2,23
	iBoxx EUR Liquid High Yield	6.52%	2.3%	2.96
	iBoxx EUR Liquid Corporates Large Cap	5.46%	1.8%	3.06
	STOXX Europe 600 Banks	4.55%	17.5%	0.27
1Y	iBoxx Contingent Convertible Liquid Developed Europe AT1	7.79%	4.3%	1.88
	iBoxx EUR Liquid High Yield	4.56%	2.3%	2.10
	iBoxx EUR Liquid Corporates Large Cap	4.85%	1.8%	2.93
	STOXX Europe 600 Banks	-13.32%	17.4%	-
3Y	iBoxx Contingent Convertible Liquid Developed Europe AT1	9.25%	4.5%	2.13
	iBoxx EUR Liquid High Yield	4.22%	1.8%	2.54
	iBoxx EUR Liquid Corporates Large Cap	2.02%	2.0%	1.19
	STOXX Europe 600 Banks	6.12%	17.3%	0.37
Common performance history (since 31.12.13)	iBoxx Contingent Convertible Liquid Developed Europe AT1	6.46%	6.6%	1.00
	iBoxx EUR Liquid High Yield	3.54%	2.2%	1.67
	iBoxx EUR Liquid Corporates Large Cap	3.16%	2.0%	1.64
	STOXX Europe 600 Banks	-3.05%	22.0%	-

Source: WisdomTree, Bloomberg. As of 28 June 2019. All fixed income indices are total return indices; all equity indices are net total return indices. Calculations include backtested data. Performance of the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index is based on the EUR-hedged version of the strategy. The iBoxx Contingent Convertible Liquid Developed Europe AT1 Index (EUR Hedged) started its live calculation on 09 March 2018. YTD returns are not annualized. Volatility estimates are based on daily returns. The risk-free rate in the Sharpe ratio is proxied by averaging the 3-Month Euribor in the computed period. ***You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.***

This may leave some investors wondering if there is still "juice" in the AT1 CoCo trade and we believe there is.

For starters, if we look at the tone of central bank policy makers as of late, this dynamic has shifted considerably since the start of the year. The European Central Bank (ECB) is set to make use of a variety of tools within its arsenal to boost inflation and growth within the Euro Area with the first phase of the ECB's policy easing expected to be tilted towards an interest rate cut of 10 basis points.

As a potential way to offset some of the negative implications ultra-low policy rates will have on the European banking system, we believe the council members will consider introducing a tiered rate system that could mean the official deposit rate would only apply to a portion of the bank's deposits and somewhat resemble a similar system currently in place in a number of countries including Sweden. This can help mitigate some of the negative implications lower deposit rates could have on bank profitability.

At the same time, if economic data shows signs of deterioration later this year we could see the ECB re-introduce some form of Quantitative Easing (QE) providing further support for risk assets.

OUTLOOK FOR EUROPEAN BANKS ISSUING AT1 COCO BONDS

Fundamentals are improving

1. **More upgrades than downgrades (refer to Figures 2A and 2B):** In general, European banks issuing AT1 CoCos have benefitted from improving fundamentals with nearly 36% rating upgrades in 2017, 30.2% in 2018 and already 9.3% so far in 2019 [1]. This reflects a positive trend for this segment of European banks as upgrades have outpaced the number of downgrades in the last three years. The long-term S&P outlook in 2019 for the sample of European banks issuing AT1 CoCos show that the sector is largely stable in 2019 with 32 banks noted to have a stable outlook, six as positive and only four have a negative outlook. The average rating of European banks who issue AT1 CoCos is A-, as of end of June 2019. 88% of the Spanish banks in our sample have a stable outlook with an average issuer rating of BBB. S&P have also noted in their publication, "Future rating actions [on Spanish banks] will likely be driven by bank-specific developments rather than system-wide developments." [2]

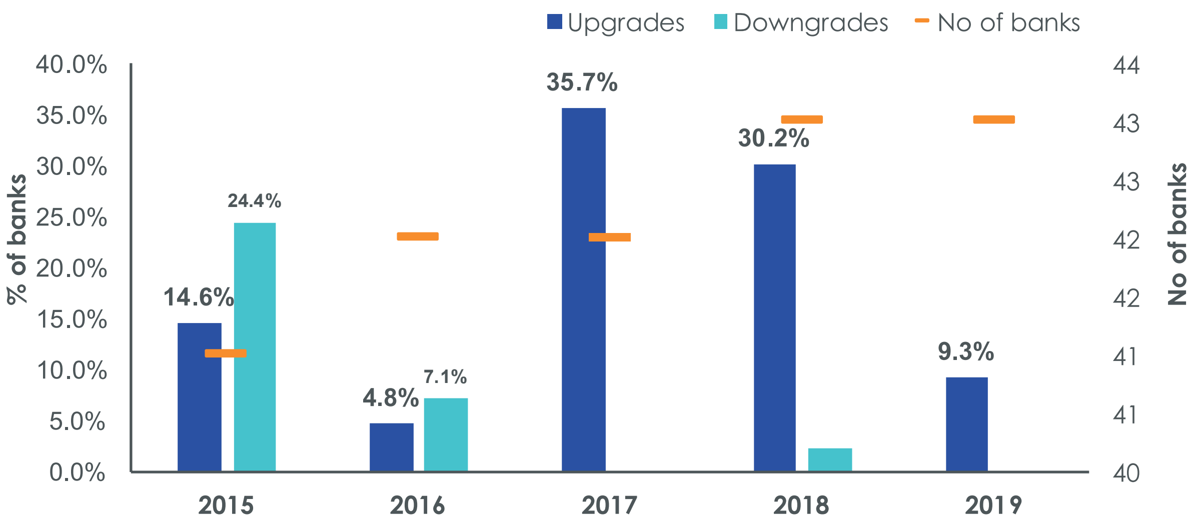
FIGURE 2A: CREDIT RATING OF EUROPEAN BANKS ISSUING AT1 COCOS

Rating	Weight %
AAA	0.0%
AA+	0.0%
AA	0.0%
AA-	5.0%
A+	12.7%
A	25.3%
A-	15.1%
BBB+	19.0%
BBB	21.2%
BBB-	1.0%
BB+	0.4%
BB	0.3%
BB-	0.0%
B+	0.0%
B	0.0%
B-	0.0%
CCC+	0.0%
CCC	0.0%
CCC-	0.0%
CC	0.0%
C	0.0%
D	0.0%

1 Our sample is based on European banks within the Markit indices issuing AT1 CoCos.

2 Source: "S&P Global Ratings: Spanish Banks 2019 Outlook: On A Firmer Footing", 8 March 2019.

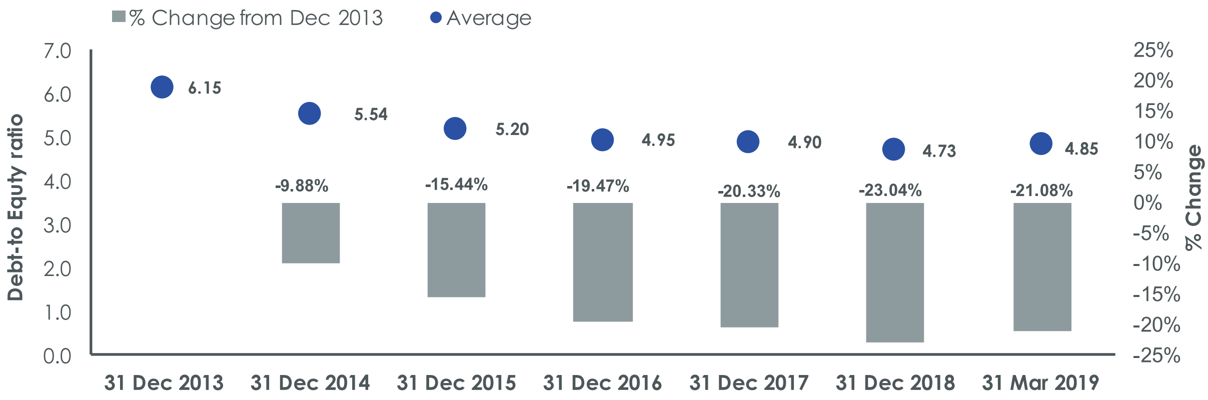
FIGURE 2B: HISTORICAL QUARTERLY RATING UPGRADES/DOWNGRADES.



Source: WisdomTree, Bloomberg. Period from 31 December 2014 to 28 June 2019. Credit rating distribution is as of 28 June 2019. ***The universe of banks*** *is represented by the banks from European countries within the iBoxx GBP Contingent Convertible Index, iBoxx EUR Contingent Convertible Index and iBoxx USD Contingent Convertible Index as of 28 June 2019. Banks that do not have historical rating data available for 2 consecutive quarters in Bloomberg as of a given quarter end are disregarded in the aggregate figures for that quarter.* ***Rating*** *is the S&P long-term local currency issuer credit rating reported by Bloomberg.* ***Upgrade*** *is an improvement in the rating as of a given quarter end as compared to a previous quarter end.* ***Downgrade*** *is a deterioration in the rating as of a given quarter end as compared to the previous quarter end.* ***Rating upgrades/downgrades*** *are based on quarterly data within each given year.* ***Weight(%)*** *in the credit rating distribution is based on the market value of AT1 CoCo bonds compared to the total market value of the AT1 CoCo bonds within the considered universe of banks. . The market value of AT1 CoCo bonds are aggregated at the issuer level and computed based on WM Reuters rates.* ***No of banks*** *is the maximum number of banks per quarter in a given year with existing ratings data from Bloomberg. % of banks is the percent of banks experiencing either upgrade or downgrade as compared to the* ***No of banks in that given year. You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.***

2. **Leverage ratio for evaluating capital structure (refer to Figure 3):** The Debt-to-Equity ratio provides a general indication of how aggressive banks have been in financing their growth with debt and the amount of additional strain they are loading onto the income statement via extra interest payments to bondholders. Given our sample of annual data represented in Figure 3, the Debt-to-Equity ratios of European banks issuing AT1 CoCos have fallen by 23% from 2013 to December 2018 with a modest uptick of 2.5% in the 1Q of 2019.

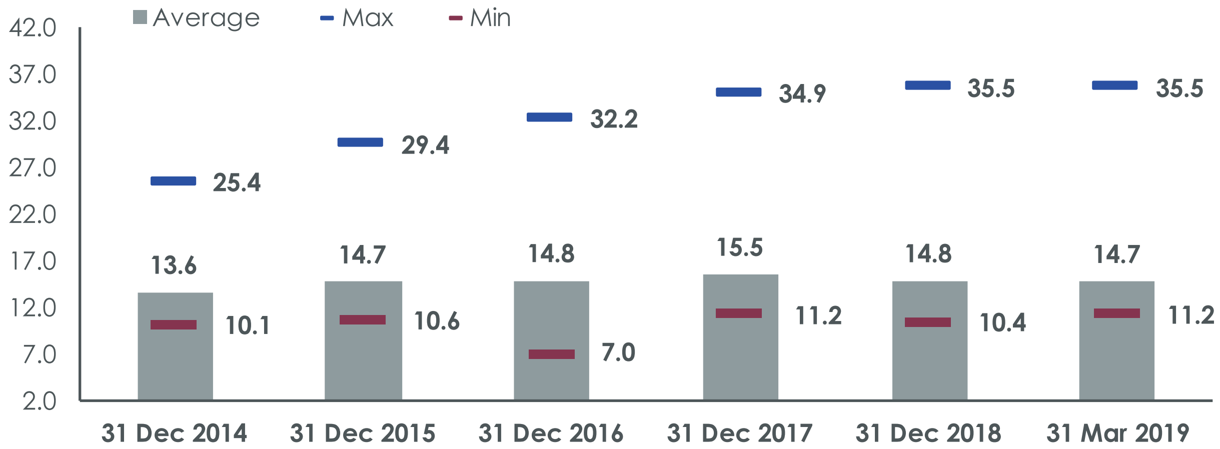
FIGURE 3: AVERAGE DEBT-TO-EQUITY RATIO AND % CHANGE FROM DECEMBER 2013 ACROSS EUROPEAN BANKS ISSUING AT1 COCOS.



Source: WisdomTree, Bloomberg. Period from 31 December 2014 to 31 March 2019. The universe of banks is represented by the banks from European countries within the iBoxx GBP Contingent Convertible Index, iBoxx EUR Contingent Convertible Index and iBoxx USD Contingent Convertible Index as of 28 June 2019. Banks that do not have available data on Bloomberg as of a given date reflected on the Figure are disregarded in the aggregate figures for that date. Average is computed by averaging debt-to-equity ratios across banks in the considered universe with available data as of dates reflected on the Figure Debt-to-equity ratio is total debt to total equity ratio as defined and reported by Bloomberg. ***You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.***

3. **Capital ratios have been increasing:** The Common Equity Tier 1 ratio (CET1) is a bank's Common Equity Tier 1 divided by its total risk weighted assets. Maintaining adequate reserves of capital is important for banks in order to help absorb unexpected losses that may impact a bank's operation. Following the 2008 financial crisis, regulators noted that banks had not been adequately capitalised to withstand an extreme market downturn as experienced during the Lehman crisis. As such in 2013, the European Union (EU) adopted a legislative package to strengthen the regulation of the banking sector and to implement the Basel III agreement in the EU legal framework. Basel III was implemented to set international standards to review and monitor the capital adequacy of banks by raising the minimum allowable capital requirements and limiting the type of capital that a bank may include in its different capital tiers and structures. As per the Bank for International Settlements, from 1 January 2015 the higher minimum CET1 requirement increased to 4.5%. As noted in **Figure 4,** the average CET1 ratio of European banks issuing AT1 CoCos has been well above this minimum requirement since 2014 sitting on average at 13% or higher.

FIGURE 4: AVERAGE MIN AND MAX CET1 RATIOS ACROSS EUROPEAN BANKS ISSUING AT1 COCOS



Source: WisdomTree, Bloomberg. Period from 31 December 2014 to 31 March 2019. ***The universe of banks*** *is represented by the banks from European countries within the iBoxx GBP Contingent Convertible Index, iBoxx EUR Contingent Convertible Index and iBoxx USD Contingent Convertible Index as of 28 June 2019. Banks that do not have available data on Bloomberg as of a given year end are disregarded in the aggregate figures for year. Average is computed by CET1 ratios across banks in the considered universe with available data as of dates reflected on the Figure If for a given bank, data is not available as of dates presented on the Figure then most recent to that date data is used in the analysis.* ***You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.***

Valuations remain near the index average for the sector

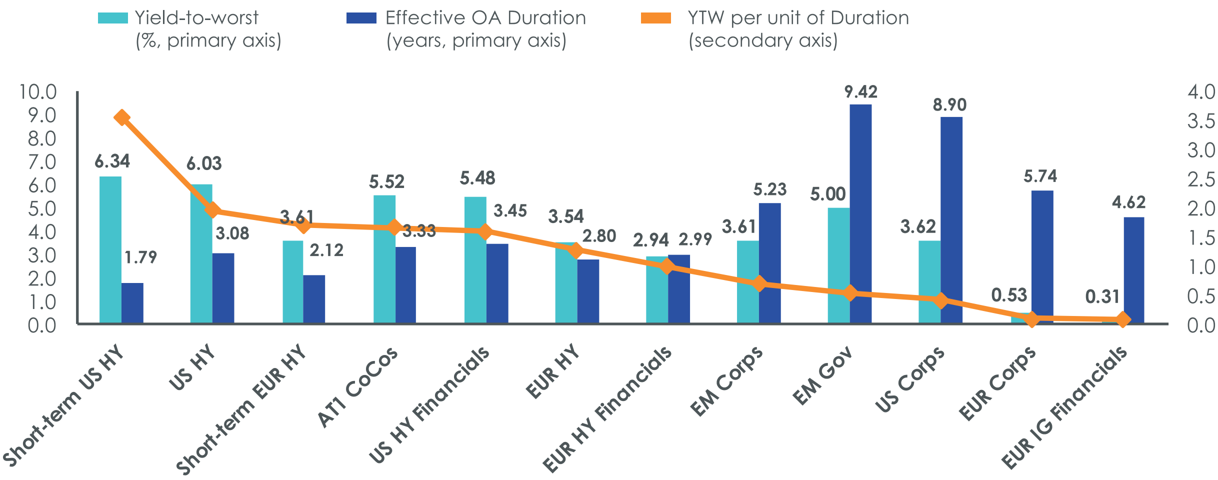
1. **Yields are around the index average** level having come down from the recent December 2018 peak but remain above the lows seen in January 2018 using a broad index capturing exposure to AT1 CoCo bonds issued by European banks and denominated in USD, EUR and GBP (iBoxx Contingent Convertible Liquid Developed Europe AT1 Index) **(refer to Figure 5)**. Given current valuations are near the index average, we believe the income component of AT1 CoCos will be the greater driver of total returns this year meanwhile the asset class will continue to see strong support from investors demanding higher yield as the ECB positions itself for lower rates and the possibility of Quantitative Easing which can provide further support for risk assets. Option adjusted spread (OAS) is currently around 453 basis points for this broad index which benefits from having exposure to all currencies and in particular from EUR and GBP denominated AT1 CoCos that exhibit higher OAS than the USD denominated AT1 CoCo bonds.

FIGURE 5: YIELD TO WORST OF AT1 COCOS

Source: WisdomTree, Markit. Period from 02 January 2014 to 01 July 2019. Yield is yield-to-worst. The strategy is represented by the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index. Calculations include backtested data. ***You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.***

2. **AT1 CoCos offer higher yield pick-up than both European High Yield bonds and Emerging Market debt (EM) exposure (refer to Figure 6).** Yield per unit of duration for AT1 CoCo bonds is near the levels seen in US high yield and surpasses the yield pick-up available in EM Sovereign USD debt and EM Corporates. AT1 CoCo bonds offer over 52 basis points yield pick-up to EM Sovereigns with around 6 years less of duration risk. Even compared to Euro High Yield (using the iBoxx EUR Liquid High Yield Index), AT1 CoCos offers 1.98% greater yield with only modestly higher duration, 3.33 years duration versus 2.80 years duration for Euro High Yield as referenced in **Figure 6.** This is an interesting yield pick-up considering the average issuer rating of European Banks issuing AT1 CoCos within our sample is A- and the fundamentals of European banks as noted above by S&P generally appear on the stable path.

FIGURE 6: YIELD TO WORST PER UNIT OF DURATION ACROSS FIXED INCOME ASSET CLASSES



Source: WisdomTree, Markit. Data as of 01 July 2019 to reflect post-rebalance figures. Yield is yield-to-worst, Effective OA duration is effective option-adjusted duration. ***AT1 CoCos*** *is the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index,* ***US HY*** *is the iBoxx USD Liquid High Yield Index,* ***EUR HY*** *is the iBoxx EUR Liquid High Yield Index, US Corps is the iBoxx USD Liquid Investment Grade Index, EUR Corps is the iBoxx Euro Liquid Corporates Index,* ***Short-term EUR HY*** *is the iBoxx EUR Liquid High Yield 0-5 Index, Short-term US HY is the iBoxx USD Liquid High Yield 0-5 Index, EUR IG Financials is the iBoxx EUR Liquid Financials Index,* ***EUR HY Financials*** *is the iBoxx EUR Liquid High Yield Financials Index, US HY Financials is the iBoxx USD Liquid High Yield Financials Index,* ***EM Corps*** *is the iBoxx USD Liquid Asia ex-Japan Corporates Large Cap Investment Grade Index,* ***EM Gov*** *is the iBoxx USD Liquid Emerging Markets Sovereigns Index.* ***You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.***

Investors need to evaluate the risk-rewards balance for the asset class

While investors can receive a yield pick-up relative to other asset classes, investors should familiarise themselves with the features of AT1 CoCo bonds to determine if the risk rewards balance makes sense within the context of their portfolio goals. Below are some risks to consider about the asset class:

+ CoCos can be converted into equity of the issuing financial institution or have their principal written down. This may result in an investor losing some or all of the original investment amount. The behaviour of the relatively new CoCo bond market has not been tested in a systemic financial crisis, thus the price and liquidity of CoCos may degrade under such circumstances. Past performance is therefore not a suitable indicator of future performance.
+ Coupon payments on some CoCos are entirely discretionary and can be cancelled. As a result of this uncertainty around coupon payments, CoCo products may be more volatile, and their price may rapidly decline in the event that coupon payments are suspended.
+ Some CoCos may be callable bonds, which means that such callable bonds can be redeemed by the issuer prior to the bond's maturity. This may result in the investor not receiving the invested capital back on the specified call date or at any date at all. Some CoCos are issued as perpetual instruments and only callable at predetermined levels upon approval of the competent regulatory authority. It cannot be assumed that these perpetual CoCos will be called on a call date. CoCos are a form of permanent capital. The investor may not receive return of principal as expected on call date or indeed at any date

+ This list does not cover all risks. Further risks are disclosed in the KIID and Prospectus & Communications Surveillance

Demand should be supportive of the asset class

Investors searching for yield in the current low yield environment could provide support for AT1 CoCos. Demand for the asset class continues to be driven by stable money investors as a large bulk of holders within AT1 CoCo bonds are asset managers with mandates to hold the subordinated debt of banks. This contrasts with fast money investors, such as hedge funds, that may create more price volatility in an asset class when taking short tactical positions.

Furthermore, with exchange traded funds (ETFs) now tracking exposure to AT1 CoCos, there is greater support for the asset class as a broader set of investors can now gain access. As demand for yield continues, we believe this asset class is well positioned to continue to see price support although we will likely see periods of volatility driven by geopolitical risks and market uncertainty that can drive investors into greater exposure to safe-haven assets.

Related products:

WisdomTree AT1 CoCo Bond UCITS ETF - USD

WisdomTree AT1 CoCo Bond UCITS ETF - USD Acc

WisdomTree AT1 CoCo Bond UCITS ETF - EUR Hedged

WisdomTree AT1 CoCo Bond UCITS ETF - USD Hedged

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