THE CASE FOR A DIVERSIFIED AT1 COCOS EXPOSURE

May 2019

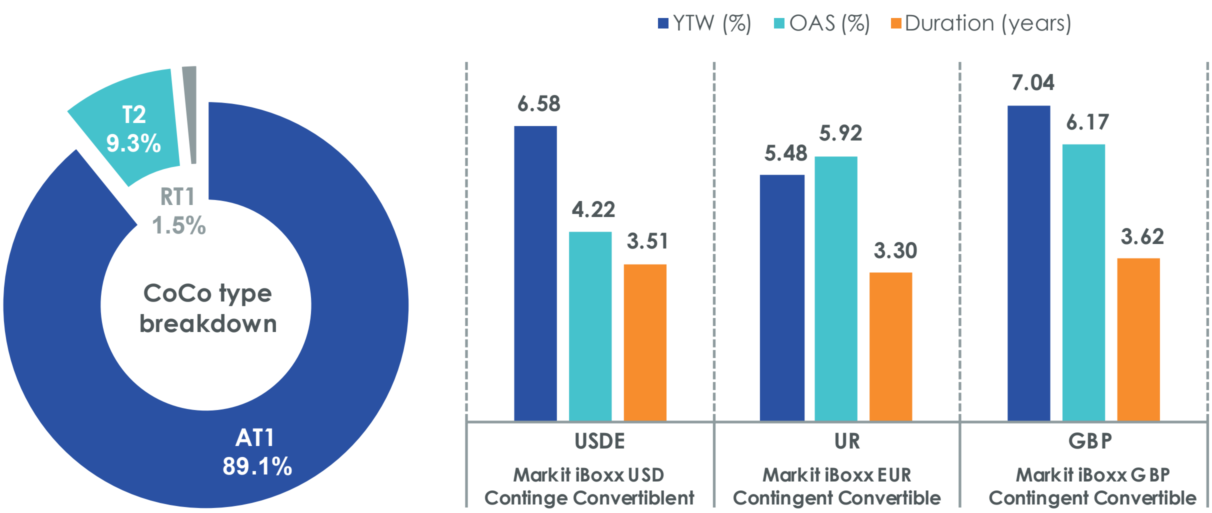
Additional Tier 1 Contingent Convertible bonds (AT1 CoCos) are issued by banks to help them meet their Core Tier 1 Capital requirements set by regulators. The 2008 financial crisis highlighted the weak capital position many banks had at the time and more importantly indicated the need for regulatory change in the banking system with the aim of potentially preventing systemically important banks from having to be bailed out by taxpayer money in the future. Basel III regulation forced banks to strengthen regulatory capital ratios by allowing banks to issue AT1 CoCos, which are meant to help limit the financial risk faced by taxpayers via bail-in provisions. A notable change to the regulation was to strengthen the definition of new regulatory capital with capital elements limited to the highest quality to ensure it consists of elements that can absorb loss. AT1 CoCos for example, are hybrid instruments that will typically require banks to maintain a certain common equity tier 1 (CET1) ratio above a certain trigger level. If triggered, CoCo bonds are then converted into common equity or completely or partially written down. This is aimed at helping the bank rebuild its capital adequacy, should it fall below a level that threatens the bank's viability. Regulators usually review the bank's capital ratio, defined as the percentage of a bank's capital to its risk-weighted assets, along with other measures to determine the bank's balance sheet strength.

Snapshot of the CoCo universe

As reflected in Figure 1 using the Markit iBoxx CoCo indices, AT1 CoCos are the largest form of bank CoCos issued in the market accounting for approximately 89.1% versus Tier 2 capital (T2) at only 9.3% of the CoCo universe. AT1 CoCos are situated above common equity and below T2 securities within the bank's capital structure. Banks can issue AT1 CoCos denominated in either US dollar, Euro or Sterling. More importantly, issuance patterns indicate the growth of the Euro and GBP denominated segments of the universe with US Dollar, Euro and GBP now accounting for 60.6%, 31.2% and 8.2%, respectively[1]. Investors that are considering an allocation may want to consider a diversified approach that gains access to this broad universe consisting of AT1 CoCos denominated in all three currencies.

[1] The CoCo Market is represented by the iBoxx GBP Contingent Convertible Index, iBoxx EUR Contingent Convertible Index and iBoxx USD Contingent Convertible Index. Breakdowns are based on the percentage of the market value in US Dollars of the outstanding CoCos. T2 are contingent convertibles issued as part of Tier 2 Capital. RT1 are Restricted Tier 1 capital bonds issued by insurance companies similar to AT1s issued by banks.

FIGURE 1: COCO MARKET: KEY FIGURES



Source: WisdomTree, Markit. Data as of 31 March 2019. CoCo Market statistics is as of 01 April 2019 to reflect post-rebalance figures. YTW is yield-to-worst, OAS is option-adjusted spread, Duration is effective option-adjusted duration. The CoCo Market is represented by the iBoxx GBP Contingent Convertible Index, iBoxx EUR Contingent Convertible Index and iBoxx USD Contingent Convertible Index. Breakdowns are based on the percentage of the market value in US Dollars of the outstanding CoCos. T2 are contingent convertibles issued as part of Tier 2 Capital. RT1 are Restricted Tier 1 capital bonds issued by insurance companies similar to AT1s issued by banks. You cannot invest directly in an index. **Historical performance is not an indication of future performance and any investments may go down in value.**

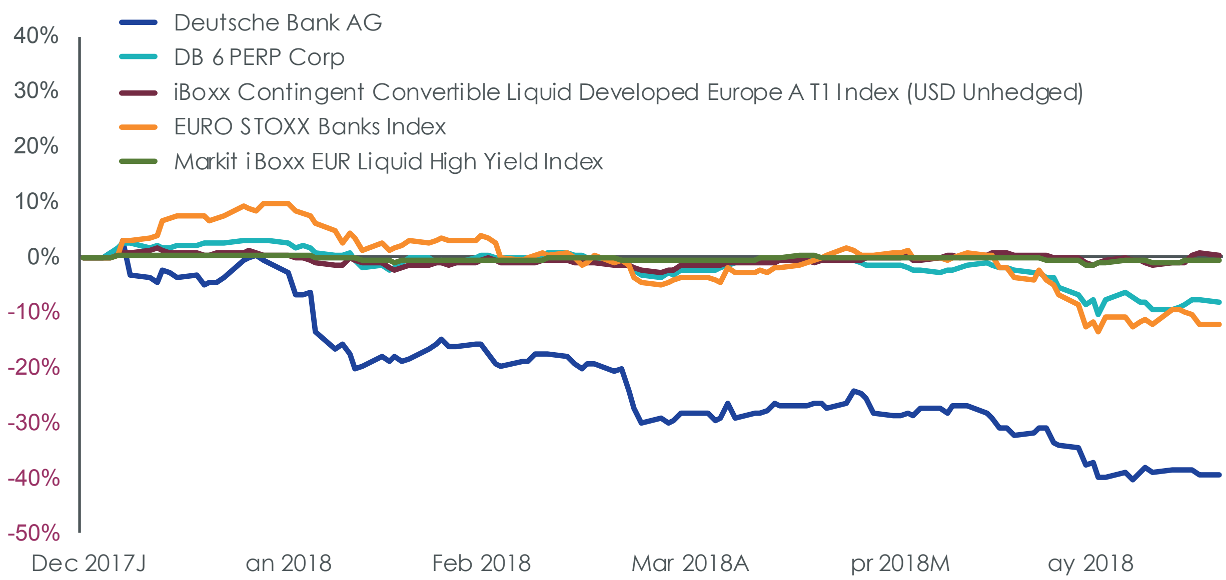
WHY A DIVERSIFIED INDEX EXPOSURE COULD MAKE SENSE?

Example 1: AT1 CoCo index exposure versus individual AT1 CoCos and bank equities

For a universe of bonds which has most recently celebrated its sixth birthday on January 2019, we can use this short history to make inferences about how the universe has behaved thus far. It is interesting to note that when individual issuers within the universe have faced market price pressure on the back of negative sentiment a diversified index of AT1 CoCos has shown better resilience. In Figure 2, we consider the example of Deutsche Bank AG (DB) back in December 2017-2018 when DB's share price fell to a multi-year low. The company faced share price pressure after its financial struggles were brought to light following their announcement of a series of job cuts and replacement of their CEO in attempts to accelerate their corporate turnaround. At the same time, the drawdowns on Deutsche Bank's AT1 CoCo bonds were less severe meanwhile the AT1 CoCo Index remained virtually flat over this period using the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index as a benchmark. It is notable to observe that even the EURO STOXX bank equity index faced greater volatility during this period than the AT1 CoCo Index. The AT1 CoCo index has historically exhibited approximately only one-third of the annualised volatility present within the EURO STOXX bank index when considering a period since 31 December 2013 [2].

[2] Source: WisdomTree, Bloomberg. Period from 31 December 2013 to 31 March 2019. Performance of iBoxx CoCo Liquid Developed Europe AT1 is based on the EUR-hedged version of the strategy. Calculations include backtested data. Volatility estimates are based on daily returns.

FIGURE 2: DEUTSCHE BANK - CUMULATIVE PERFORMANCE IN EURO



Source: WisdomTree, Bloomberg. Period from 29 December 2017 to 18 June 2018. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.**

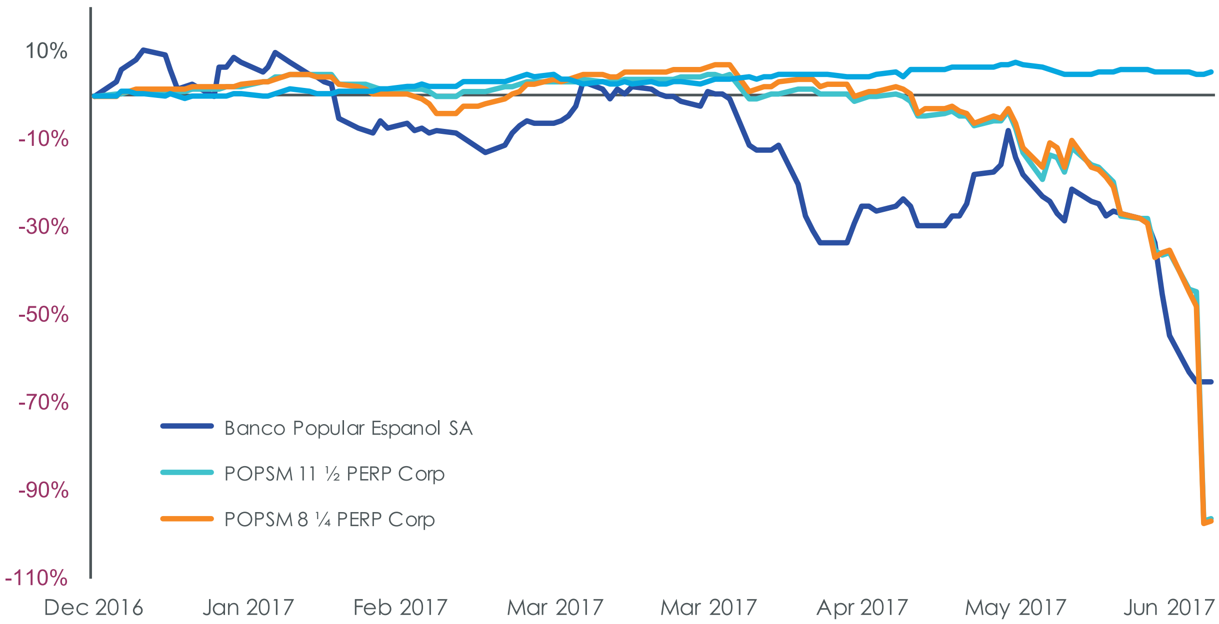
Example 2: Banco Popular AT1 CoCos impact on the AT1 CoCo Index

On the 6th of June 2017, the European Central Bank's (ECB) bank oversight authority declared Banco Popular (BP) as "failing or likely to fail" based on the deterioration of its liquidity position. In particular, the regulator deemed Banco Popular (BP) at the Point of Non Viability (PONV) and put the bank into resolution. The Point of Non Viability is usually the point at which regulators decide a bank is no longer able to function. PONV trigger events are basically a forward looking and preventive tool used by the regulator when they believe that absent converting some or all the contingent capital securities to ordinary shares or writing them down to zero that the bank would become Non Viable. One of the requirements for AT1 CoCos to count towards the bank's regulatory capital ratios under Basel III, is that these instruments must be able to be written down to zero or converted to equity. In this instance, BP's sale to Santander was initiated following the PONV judgement and consequently, two AT1 CoCos (€1.25bn notional) were cancelled as indicated in Figure 3. Both CoCos were not included in the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index (AT1 CoCo index) as they were not rated by either S&P, Moody's or Fitch. As noted in Figure 4, the bank's shares were negatively impacted meanwhile the AT1 CoCo index was barely affected by this event.

FIGURE 3: RESOLUTION FOR BANCO POPULAR: IMPLICATIONS

Non-Capital Instrument Liabilities	Retained
Senior Unsecured Debt	Retained
Tier 2 Regulated Capital	Converted to equity for a total value of €1
Tier 1 Regulated Capital	Cancelled
Common Equity Tier 1 Capital	Cancelled

FIGURE 4: BANCO POPULAR: CUMULATIVE PERFORMANCE IN EURO

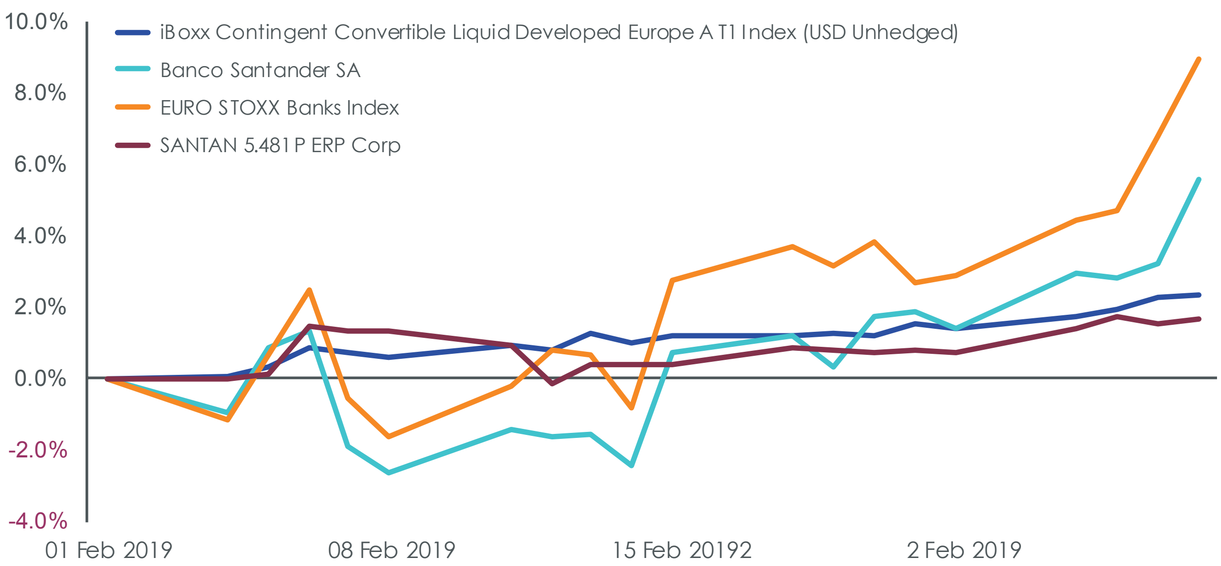


Source: WisdomTree, Bloomberg. Period from 30 December 2016 to 08 June 2017. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.**

Example 3: Banco Santander did not call their Euro denominated AT1 CoCo bonds

Banco Santander announced on 12 February 2019 that they would not call their 6.25% €1.5bn AT1 CoCo issue with the first call date on 12 March 2019. The announcement was made right at the deadline for a decision and was made after the new issuance of $1.2 billion US Dollar denominated AT1 CoCos by the bank a week prior. While the market had speculated that the bank would call the bonds, under Basel III for bonds to be eligible as AT1 capital of the bank they must meet several specified criteria which also govern issuer behaviour. One notable criterion as per Basel lll is that the Bank must not exercise a call unless they replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank. Therefore, one consideration that may have been at the forefront of the bank's decision is whether the reset coupon on the existing bonds was more economically viable than the coupon rate that could be achieved in the market via a new issuance. This will certainly play a role in future issuer behaviour as was the case when Banco Santander decided to recently call their $1.5 billion-dollar AT1 Cocos with first call on 19 May 2019 nine weeks after it skipped calling the euro AT1 CoCo bonds. In this example where Banco Santander did not call the AT1 CoCo bonds, the bank's euro denominated AT1s cash price fell nearly 6% from par value in January and bounced back to almost par on the 11th February 2019 when the market expected them to be called. While the individual Santander AT1 CoCo bonds and share price were impacted, the AT1 CoCo index showed greater resilience drawing from the diversified issuer and currency exposure within the index. On 12 February 2019, the AT1 CoCo index had only 1.25% exposure to the Banco Santander 6.25% €1.5bn AT1 CoCo issue with the first call date on 12 March 2019 and at the same time exposure to Santander was roughly 6%, below the index issuer cap of 7.5%. This highlights some of the benefits inherent in gaining exposure to AT1 CoCos via a diversified index exposure.

FIGURE 4: BANCO SANTANDER - CUMULATIVE PERFORMANCE IN EURO



Source: WisdomTree, Bloomberg. Period from 01 February 2019 to 28 February 2019. **You cannot invest directly in an index. Historical performance is not an indication of future performance and any investments may go down in value.**

AT1 CoCos are a relatively new asset class with issuance across US dollar, Euro and Sterling now in aggregate at nearly $206 billion as of 29 March 2019 [3]. While some institutional investors have decided to buy individual AT1 CoCo bond issues, we have noted that a diversified index with exposure to the broad universe as exhibited by the iBoxx Contingent Convertible Liquid Developed Europe AT1 Index (AT1 CoCo index) can provide greater resilience during periods of issuer volatility. For investors tactically allocating to AT1 CoCos to access the higher yields available within the asset class, yield to worst YTW) of 6.53% as of 31 March 2019, an exchange traded fund can be a more diversified way to gain access to the universe rather than taking individual issuer bets. Specifically, the WisdomTree AT1 CoCo Bond UCITS ETF seeks to track the performance, before fees and expenses of iBoxx Contingent Convertible Liquid Developed Europe AT1 Index. The exchange traded fund invests in AT1 CoCos which are rated, backed by developed Europe financial institutions and screened for liquidity with each individual issuer exposure capped at 7.5% mitigating the impact that any one issuer may have on index performance.

POTENTIAL RISKS

+ CoCos can be converted into equity of the issuing financial institution or have their principal written down. This may result in your investment 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 circum stances. 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

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

WisdomTree AT1 CoCo Bond UCITS ETF - GBP Hedged

[3] Source: WisdomTree, Markit. Data as of 29 March 2019. AT1 CoCos market is represented by the constituents of the iBoxx GBP Contingent Convertible Index, the iBoxx EUR Contingent Convertible Index and the iBoxx USD Contingent Convertible Index.

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