Hybrid Bonds: Yielding Sustainability

Market Insights by Nicolò Bocchin, Head of Fixed Income, AZ Fund Azimut's fund management company in Luxembourg

Over the last 10 years hybrid bonds have become mainstream fixed income instruments for both retail and professional investors. Can you give a quick overview of the asset class?

Hybrid bonds started back in 2006 to be issued by companies belonging to basically three sectors traditionally with high investment schemes like the telecom, utilities and some industrial companies. A major change took place in 2013 when the regulators and major rating agencies introduced new rules and the obligation of a prospectus for each issue. One of the major advantages for the issuer is that a hybrid bond features both equity and bond characteristics (50% debt & 50% equity) which tend to improve the issuers' credit ratios and prevent a rating downgrade. Conversion into equity is not possible and the coupon can only be deferred, but not cancelled, which is a significant difference in comparison to contingent convertible bonds issued by the banks (commonly known as CoCos). Courtesy of the new rules, there are now multiple sectors issuing hybrid bonds (more recently real estate and pharmaceutical), leading to a much more diversified issuer base and a total market that has grown from initially €20 billion to currently €140 billion, and gradually extending to other sectors.

What is Azimut's exposure to the hybrid markets?

We were among the first asset management companies to recognize the tremendous opportunity of this asset class. In 2013, Azimut set up the first hybrid bond fund for private investors in the world. It was indeed the first instrument enabling the participation to the asset class by individual investors who had to face high minimum investment limits for single issues (i.e. higher than € 100k) hence forsaking the potential to build diversified investment portfolios. The fact that our idea was right has been proven by the inflows: the Fund raised € 1 billion in the first 3 months after its inception and then reached almost €2.2 billion in assets afterwards, also benefiting from opening to institutional investors. Azimut is now one of the largest institutional investors participating in this market. The Group is very involved in the global community of market participants and attends conferences regularly and round tables to discuss the future of the asset class.

How did you develop and diversify the exposure to hybrid bonds over the years?

Since its launch, the first fund has been managed consistently with a very flexible approach to underlying duration. The managers have always favored the portfolio exposure to a high merit of credit and usually picked investment grade rated issuers, thus underpinning its inherent quality. Shortly after the launch, we decided to add an additional layer to our exposure, in particular under the principles of sustainable responsible investing (SRI) driven by the conviction that was to become more significant for global investors. We have therefore decided to integrate ESG (environmental, social, governance) factors in the investment process. Therefore in 2014, Azimut launched an ESG compliant hybrid bond fund (Azimut Sustainable Hybrid Bonds), in line with the "first mover"attitude proven by the Group over the years. This has also been accompanied with a portfolio construction including issues from financial sectors – banking and insurance - with the view of increasing diversification and adding yield, always under the compliance with ESG principles.

Nicolò Bocchin

Nicolò Bocchin is the Head of Fixed Income of AZ Fund, the fund management company of Azimut Group in Luxembourg. AZ Fund is the global product factory of the Azimut Group with AUM in excess of EUR 28 billion pooled across UCITS funds incorporating more than 90 investment strategies distributed in Europe and globally through proprietary distribution and third party channels. The Luxembourg investment management team comprises of 11 investment professionals with a broad expertise covering equities, fixed income, macro, commodities and alternative strategies. Nicolò joined AZ Fund in 2018 to supervise investments across Sovereign and credit markets through multiple strategies. Before joining Azimut, Nicolò was a senior portfolio manager at a leading Italian asset management firm for more than 16 years. Nicolò holds a BA in International Finance from the European School of Economics and a Certificate in Investment Banking from the NYU.

What is the profile of the investment portfolio and what are the pillars of the investment process?

There are currently more than 200 issuers in our credit model portfolio, including issuers of hybrid bonds and CoCos. After screening for ESG criteria, we have an investment universe of roughly 125 companies, which turns out to be approximately 100 issuers if we add the IG barrier. However the investible universe is rapidly growing. Our investment portfolio currently holds about 100 issuers in the fund, matching our philosophy of a very high diversification. More than 60% of the issues are investment grade (usually hybrid bonds are rated two notches below the issuer) and the rest is High yield. We believe that the rating of the issuer is more important than issues itself; hence we opted to gain exposure to sub-investment grade assets. In the near future, we expect to add to the underlying diversification of the portfolio. We might use short positions on interest futures as a hedging instrument against duration risk. This is still a market dominated by Euro issuers (almost 80% of the market) with the rest almost equally split between USD and GPB. We would normally fully hedge the non-Euro currency exposure. The portfolio has a current 3.0% yield-to-maturity with a duration of 4.5 and an average rating of BBB. The fund is managed by 3 investment professionals based across the 3 Group European product factories in Luxembourg, Dublin and Milan, bringing longstanding experience and expertise in credit markets.

What is the rationale for investing in funds with a focus on sustainable hybrids?

We believe that Azimut manages one of the very few sustainable hybrid bonds available in the market, which adds to the potential of diversifying existing investment portfolios. The asset class offers one of the most attractive risk/return propositions for individual and institutional investors, especially outside of Europe. If we were to find a comparable asset class away from Europe, also in consideration of the underlying regulatory framework, we would look at the US preferred shares market as the closest proxy. We believe that it is a perfect fit for long term investors such as pension funds or insurance companies that are more inclined to invest in a buy and hold strategy. Based on a broader perspective, the asset class caters well to the needs of global investors looking for a stable, low risk and SRI compliant investment opportunities. In conclusion, by understanding the dynamics and relative risk/return profile of the structure and choosing to allocate into sustainable hybrid bonds, the investors can take advantage of the attractive yields offered by the high-quality issuer that they cannot attain from the same issuer's "conventional" bonds offering lower coupons due to lack of convertibility and conditionality.

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