Rothschild & Co
Asset Management

Does it still make sense to invest in subordinated financial bonds?

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Subordinated financial bonds are a unique asset class and a historic performance driver for our Fixed Income expertise, with particularly attractive characteristics in the current environment.

Solid fundamentals for highly regulated players

Looking at valuation levels and fundamentals, we are convinced that financial subordinates bonds are a prime market segment. At equivalent ratings, these securities offer an excess return compared with those from other sectors and, over the past two years, we have seen a clear outperformance. We believe that the window of opportunity is particularly attractive, especially given the levels of volatility. We are looking to capture this volatility because we are confident about the fundamentals of issuers.

Particularly in Europe, these are healthy. Banks are implementing share buyback programmes, profitability is high, solvency levels are good and the players are in a position to withstand a recessionary shock. What's more, unlike before the last major financial crisis, European banks no longer have cross-shareholdings, which limits the risk of impairment in the event of a player going bankrupt. Similarly, to counter liquidity and counterparty risk, the world's main central banks have unlimited swap [1] agreements to cope with a drying-up of the markets, particularly the euro-dollar market.

High solvency and renewed profitability in Europe

Every two years, the ECB conducts stress tests to assess banks' preparedness and resilience in the event of a financial or economic shock. In July 2023, following the collapse of Credit Suisse, the ECB raised its already high stress assumptions: a doubling of the unemployment rate, two successive years of recession, a fall in commercial and residential property prices, interest rates and credit spreads [2] shock, etc. Following these tests, no capital increase was deemed necessary under the most pessimistic scenario. Whether in terms of solvency, profitability or liquidity, the fundamentals of the European banking system have never been so solid. Moreover, the latter is offering visibility on its operating and net profitability, beating consensus estimates quarter after quarter. Peripheral‘ countries are even making a “comeback", particularly banks in Southern Europe. The clean-up of their bad debts has also encouraged a resumption of consolidation in the sector.

Risk factors currently under control in the United States

In the United States, Donald Trump's return to power raised fears of deregulation of the financial sector, but the appointment of Michelle Bowman, considered to be moderate, as Vice-Chairman of the Fed in charge of banking supervision, tempered this risk. Much to the dismay of the current US President, the US Federal Reserve is also taking a very cautious approach to monetary policy, leaving the Fixed Income markets exposed to a rate risk. Jérôme Powell recently indicated that inflation could be more persistent and that a rate hike could not be ruled out. Expectations of a more accommodative monetary policy have even receded in recent weeks.

Although the Silicon Valley Bank case is still fresh in people's minds, the risk of bankruptcy linked to a rise in interest rates is coming under increased monitoring. The Fed has drawn conclusions from this event and has put in place measures to counter it. The Bank Term Funding Program now allows it to buy back at par securities that have been written down due to interest rate risk. We also believe that the risk of deposit flight is limited and confined essentially to the ‘small’ regional banks.

An investment universe to express your convictions

In addition to banks, the universe of subordinated financial bonds is broad and diversified. Among its sub-sectors, we are paying particular attention to listed and mutual insurers. Their profitability is attractive, even if it is lower than that of the banking sector, and their solvency is very good. There are many investment opportunities, particularly through refinancing.

The market for contingent convertible bonds (CoCos)[3] is also growing, and we are no longer a niche market. This segment is large enough to express convictions. There is strong investor demand, the market is dynamic and there are many large issues. These securities offer an excess carry compared with High Yield [4] bonds for very comfortable

fundamentals, with issuers generally benefiting from higher ratings. We believe it is a good time to be exposed to them.

Know-how at the heart of our Fixed Income expertise

All these factors make financial subordinated bonds an asset class worth considering, especially in the current environment. The volatility that is likely to continue to drive the markets will be a source of opportunities. However, while these securities still offer an attractive premium, it is becoming necessary to be selective within the capital structure.

We have long-standing expertise in analysing and managing this type of bond. They have historically played an important role in the allocation of most of our Fixed Income strategies; for example, they account for half the allocation of our flagship R-co Conviction Credit Euro fund. At the end of 2021, we launched R-co Conviction Subfin, a fund invested exclusively in this market segment. Much more than a simple diversification tool, this investment solution provides direct exposure to one of the main performance drivers of our credit management.

Más información sobre los fondos

R-co Conviction Subfin

R-co Conviction Credit Euro

Consulte este documento en nuestro sitio web

(1) A financial derivative, swaps are contracts between two parties to exchange cash flows for other cash flows over a given period.
(2) The difference in yield between a bond and a loan of equivalent maturity considered to be ‘risk-free’.
(3) Halfway between a share and a bond, their characteristics are similar to those of convertible bonds. These securities are issued by banks to strengthen their capital base. They can be converted into shares as soon as the equity ratio falls below a defined threshold, providing a cushion in the event of financial stress. Because of the higher risk of loss associated with their potential conversion, they offer higher yields than ‘conventional’ bonds.
(4) High-yield bonds are issued by companies or governments with a high credit risk. Their financial rating is below BBB- on the Standard & Poor's scale.

Disclaimers

R-co Conviction Credit Euro

Recommended investment horizon: 3 years SRI : 2/7

The risk indicator assumes you keep the product for 3 years. The actual risk can be significantly different if you choose to exit before maturity, and you may get back less. The synthetic risk indicator provides an assessment of the level of risk of this product compared to others. It indicates the likelihood of this product incurring losses in the event of market movements or if we are unable to pay you. We have classified this product as being in risk category 2 out of 7, which is a low risk class. This reflects primarily its positioning on private debt products while maintaining a sensitivity between 0 and +8. In other words, the potential losses from the product's future performance are low, and if markets were to deteriorate, it is very unlikely that our ability to pay you would be affected. This product does not include any protection from future market performance or a capital guarantee, so you could lose some or all of your investment.

R-co Conviction Subfin

Recommended investment horizon: 3 years SRI : 2/7

The risk indicator assumes that you hold the product for 3 years. The real risk may be very different if you opt to exit before maturity, and you may get less in return. The synthetic risk indicator enables you to assess the level of risk of this product compared with others. It indicates the likelihood of this product incurring losses in the event of market movements or our inability to pay you. We have classified this product in risk class 2 out of 7, which is a low risk class and mainly reflects a discretionary management policy that exposes the portfolio to the bond markets in a diversified manner over the medium term. In other words, the potential losses linked to the future performance of the product are low and, if the situation were to deteriorate on the markets, it is very unlikely that our ability to pay you would be affected. As this product does not provide protection against the vagaries of the market or a capital guarantee, you could lose all or part of your investment. Other materially relevant risks not taken into account by the indicator: credit risk, liquidity risk, impact of techniques such as derivatives. For more information on risks, please refer to the fund's prospectus.

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Más información en: www.am.eu.rothschildandco.com

(1) Fuente: Rothschild & Co Asset Management, 31/07/2026.

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