RBC Global Asset Management

Unlocking enhanced returns from subordinated debt

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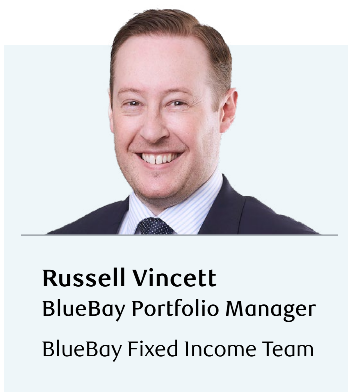

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"Subordinated debt from solid investment grade issuers should offer better risk/reward than senior debt of high yield issuers with historically higher default rates."

Russell Vincett, BlueBay Portfolio Manager, discusses how investors can pick up an attractive yield in the subordinated debt of European best-in-class issuers.

As investors look for enhanced returns in credit, the traditional approach is to take more credit risk through investments in emerging markets, high yield, or longer-duration assets. These, however, come with increased interest rate sensitivity, default risks, and FX fluctuations, among other risks.

However, the compelling fourth alternative is to selectively invest in the subordinated debt of Europe's best-in-class, investment grade and sometimes national champion issuers. Here, investors can pick up significant yield for the same issuer credit risk as they move down the capital structure.

The pickup in yield from these lower-ranked securities more than compensates for the structural, subordination and extension risk, considering the extremely low default rate of strong investment grade companies. Yields available are relatively high, but the interest rate duration sensitivity is low because of their callability.

Yield opportunities but caution needed

At a time when we are approaching a peak in global interest rates, hybrid investments can enhance the yield profile of portfolios, and the pickup of subordinated debt to senior issues is at attractive levels compared to historical figures. However, investors should approach the asset class with some caution since the level of volatility can be significantly higher than in senior debt. If the market decides to price in more rate hikes, then longer-dated instruments will be more vulnerable than these shorter-dated callable instruments.

Conversely, given the spread differential, if the market sees a soft landing alongside a peak in Federal Reserve rate hikes, the outperformance in subordinated debts over senior could be material. Subordinated debt from solid investment grade issuers should offer better risk/reward than senior debt of high yield issuers with historically higher default rates. In this scenario, name selection would be key to outperformance.

Identifying sector opportunities

At this point, we prefer hybrids in defensive sectors less exposed to recessionary headwinds. We like healthcare, telecommunications, and utilities. We also favour newer vintage high coupon, high reset hybrids as we believe they will prove more resilient in any downturn. That said, in credits where we consider the extension risk to be low, there are some older and lower coupon hybrids trading so much wider than newer vintages that they also provide interesting opportunities.

We also like subordinated bank capital, which remains a structurally attractive investment with improving credit fundamentals and favourable policy and regulatory tailwinds. The subset of subordinated bank debt, specifically Additional Tier 1 (AT1) capital, debt took a hit when Credit Suisse AT1s were written down to zero, and all bank AT1's repriced spreads wider. Since then, most bank AT1s have been called, as issuers and regulators have taken an investor-friendly approach to call decisions to ease investors' sensitivity to the asset class. We expect this to continue, and we should continue to see AT1 spread levels decrease.

The future

In our opinion, subordinated debt from investment grade issuers represents an attractive investment opportunity. The overall performance across economic cycles is strong due to the higher yield nature of the asset class with the pickup of subordinated debt/ corporate hybrids to senior issues at attractive levels compared to history.

At a time when we are approaching a peak in global interest rates, we believe that hybrid investments are a useful way of enhancing the yield profile of portfolios.

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Portfolio Manager Perspectives

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