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CoCo Bonds: Digging out relative value trades to magnify alpha

Diquel Dos Santos
Head of Fixed Income Quantitative Research

Since their launch in 2009, Contingent Convertible bonds — or CoCos — have grown into a mature, liquid market that plays a critical role in bank capital structures. The post-crisis regulatory framework took time to stabilize, but once banks standardized issuance and investors adapted to new rules, CoCos established themselves as a permanent feature of the financial landscape.

The market faced a major test in March 2023 with the collapse of Credit Suisse, which briefly shook confidence. Yet by the end of that year, CoCos had rebounded strongly: issuance resumed, spreads tightened, and investors were reassured by regulators' renewed clarity on loss-absorption hierarchy. Today, the market benefits from stronger banks, higher rates, and clear regulatory guidance.

For investors, however, the real challenge is not simply owning CoCos — it's how to extract performance beyond the market. At Candriam, this is the mission of our Subordinated Financials ("Sub Fins") strategy that invests in the various layers of the capital structure of financial institutions . This strategy combines deep fundamental research with tactical opportunities that generate alpha.

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Our approach focuses on two types of tactical trades:

- **Relative Value trades**, which compare bonds across issuers, maturities, or capital structures to identify pricing anomalies.
- **Extension Risk trades**, which take a view on whether a bond is likely to be called or extended as it approaches its call date.

In recent years, low extension risk has meant the bulk of alpha opportunities come from **Relative Value trades**. These require two things:

1. Choosing the right instruments to compare (CoCos, Tier 2 bonds, or even CDS).
2. A framework to identify when an instrument looks cheap or expensive versus peers.

To solve this, we developed a proprietary quantitative Relative Value model in partnership with our portfolio managers. This framework is deployed across multiple credit strategies, helping us rank and prioritise opportunities.

In the sections that follow, we'll outline the key features of CoCos, show how we apply our model, and share examples of trades implemented in the **Sub Fins strategy.**

From bail-out to bail-in: The role of CoCos in bank capital

CoCo bonds – more formally known as Additional Tier 1(AT1) securities – have become a vital part of bank capital structures since their launch. Their purpose is straightforward: to absorb losses when a bank comes under stress, protecting depositors and senior creditors while maintaining systemic stability.

For banks, issuing CoCos is driven by regulation. Under Basel III[1] (and Solvency II for insurers), regulators required banks to build more resilient capital structures by issuing loss-absorbing securities. For investors, this created a new hybrid asset class: part bond, part equity, with the potential for attractive spreads but also unique risks.

a. The capital structure in context

To understand where CoCos sit, think of a bank's capital structure as a ladder of risk. At the top, safest instruments like **Senior Preferred debt** rarely suffer losses. At the bottom, **Common Equity Tier 1 (CET1)** is the ultimate shock absorber. In between, layers such as **Tier 2 bonds** and **AT1s** create a structured sequence of 'who takes the hit' when a bank runs into trouble.

This framework, often described as 'bail-in' (private investors bear the losses) rather than 'bail-out' (taxpayers), underpins why CoCos exist and why their pricing reflects both yield and risk.

1 - Basel III - European Commission

Capital Role	Description	Capital layer
Pure Funding	Not designed to absorb losses	Senior Preferred OpCo
Gone Concern	Designed to written down in case of banks default, thereby creating new equity capital for the bank	• Senior Non-Preferred OpCo • Senior HoldCo • Tier 2
Going Concern	Designed to absorb losses if a bank is stressed, but continues to operate and is a viable business	• AT1 / RT1 • CET1 (Equity)

b. Key features of CoCos

AT1 bonds combine characteristics of both equity and debt:

- **Loss absorption:** Either through conversion into shares (dilution) or principal write-down (avoiding shareholder dilution but reducing bondholder value).
- **Triggers:** Losses can be imposed when capital ratios fall below regulatory thresholds or at the discretion of regulators (the so-called Point of Non-Viability). In practice, regulators are likely to act before formal triggers are breached.
- **Perpetual maturity:** CoCos have no fixed end-date, but issuers typically include call options (first callable after five years).
- **Coupons:** Discretionary and non-cumulative, usually fixed-to-floating, resetting after the first call. Importantly, they have no 'step-up' features that would incentivize early redemption.

c. Related Instruments

When assessing relative values in AT1s, investors must also look at closely linked instruments:

- **Tier 2 Bonds:** Senior to AT1s, with fixed maturities and mandatory coupons. Regulatory recognition as Tier 2 gradually phases out in the last five years before maturity.
- **Financial CDS:** Since the 2014 reform, the CDS markets have split into Senior, SLA (senior loss-absorbing), and Subordinated categories. While no CDS directly references AT1s, the Subordinated Financial CDS is most correlated to AT1 spreads and is a useful comparison tool in Candriam's framework.

Why this matters for investors

Understanding the regulatory logic and mechanics of CoCos is the foundation for effective relative value investing. At Candriam, we use these capital relationships to directly inform the structure of our trades in our Sub Fins strategy. By comparing AT1s against peers like Tier 2 bonds and CDS, we can identify potential mispricing and capture excess return for investors.

Finding alpha in CoCos: Candriam's relative value edge

At Candriam, our approach to CoCo bonds is built on a simple but powerful principle: **the spreads of AT1s and related instruments usually move in sync — and when they don't, there is likely an opportunity.** Pricing gaps are often temporary and tend to revert, creating fertile ground for relative value trades.

To harness these opportunities, our portfolio managers combine **quantitative tools** with **fundamental conviction.** The framework rests on two pillars: selecting the right peers for comparison and modelling the relationships to detect anomalies worth trading.

a. Dynamic peer selection

Not every CoCo can be compared with every other. To judge whether an AT1 bond looks expensive or cheap, we use four lenses to determine the most relevant peers:

- The closest CoCo bond from the same issuer and currency (similar maturity).
- The closest Tier 2 bond from the same issuer and currency.
- A peer group of CoCos from other issuers in the same currency and maturity bucket.
- The 5-year Subordinated Financial CDS of the same issuer.

This process is dynamic — the peer set evolves with the market universe at each point in time. Importantly, we apply it not just to AT1s but also to RT1s from insurers, broadening the opportunity set.

b. Modelling and trading signals

Markets are noisy, but relationships between spreads tend to be stable over time. Our quantitative models attempt to identify when a bond diverges too far from its peers and flag it as a potential trade.

While academics often model spreads using linear regressions, our portfolio managers bring a key insight from experience: investors in the CoCo market think in terms of spread ratios, rather than linear differences. Extensive back testing supports our view that this ratio-based (log-linear) approach is more effective for CoCos.

The outcome is straightforward for the portfolio team: when spreads deviate beyond our internally determined threshold, the model generates a long or short signal. These signals are then cross-checked against market conditions and our fundamental views before implementation:

Signal	Event
Inpout	$ZS_t \geq T \Rightarrow \boldsymbol{Long\ CoCo}$ $ZS_t < -T \Rightarrow \boldsymbol{Short\ CoCo}$
Output	ZS_t crosses zero (mean-reversion)

ZS_t = Z - Score of the residuals of our model

We also incorporate additional specific conditions to trigger trading signals, reflecting the typical in-house practices of our portfolio managers. Their effectiveness has also been validated through our backtesting protocol, which we will present in the next section.

c. Backtesting Protocol and Main Results

To validate the framework, we ran a seven-year back test (2018–2024) across CoCos, RT1s, Tier 2 bonds, and CDS in EUR, USD, and GBP. The results were consistent across currencies, issuers, and instruments:

- **High hit ratios:** Long-Short trades succeeded 75–85% of the time (during the historical test period).
- **Strong performance:** Both Long-Only and Long-Short strategies delivered attractive risk-adjusted returns during the period of the backtest.
- **Realistic trade horizon:** Average trade duration of 2–3 months, in line with actual market dynamics.

The full results of the backtest can be viewed here:

Average duration is measured in months ZScore Threshold = 2		EUR	USD	GPB
AT1 Peer	Hit ratio	80,37%	79,82%	75,00%
	Sharpe(TR)	3,51	3,89	5,31
	Nb Signals	72	150	20
	Avg Duration	70	45	60
Tier 2 Peer	Hit ratio	77,24%	75,81%	80,62%
	Sharpe(TR)	4,03	4,07	5,56
	Nb Signals	101	81	21
	Avg Duration	62	48	44
CDS Peer	Hit ratio	88,66%	86,64%	89,76%
	Sharpe(TR)	7,66	3,74	5,00
	Nb Signals	71	120	21
	Avg Duration	58	56	51
Peer Index	Hit ratio	71,77%	70,21%	69,34%
	Sharpe(TR)	0,27	1,37	2,44
	Nb Signals	96	169	22
	Avg Duration	71	52	67

Source: Candriam, 30/06/2025

This consistency strengthens our confidence in our framework indicating that the model is well-calibrated, free from overfitting, and capable of performing in practice with a solid degree of robustness.

d. Why this matters for investors

The Candriam framework is designed to do the heavy lifting: scanning a large, complex universe of CoCos and related instruments - today spanning **over US $ 300 billion and 450 billion in outstanding face value, respectively for AT1 and Tier 2 bonds**, across nearly 150 **issuers globally**[2] - to identify potential mispricing and generating signals. But the final decision always rests with our portfolio managers, who apply their judgment, conviction, and fundamental analysis.

We believe this combination of quant insight + fundamental analysis + human discretion is what turns data into alpha in our Sub Fins strategy..

2 - Bloomberg data

Case studies:
Turning signals into trades

How do we put this into practice? At Candriam, trading signals are never implemented blindly. They are **interpreted through the lens of fundamental analysis and portfolio manager conviction**. The result is a discretionary overlay that adapts quantitative signals into real-world investment decisions.

In our **Sub Fins strategy**, which is benchmarked , Long–Short signals are generally translated into **Overweight–Underweight positions**, rather than pure pair trades. Below we highlight two recent examples that show how the process works in practice.

a. Intra-Issuer Relative Value Trade

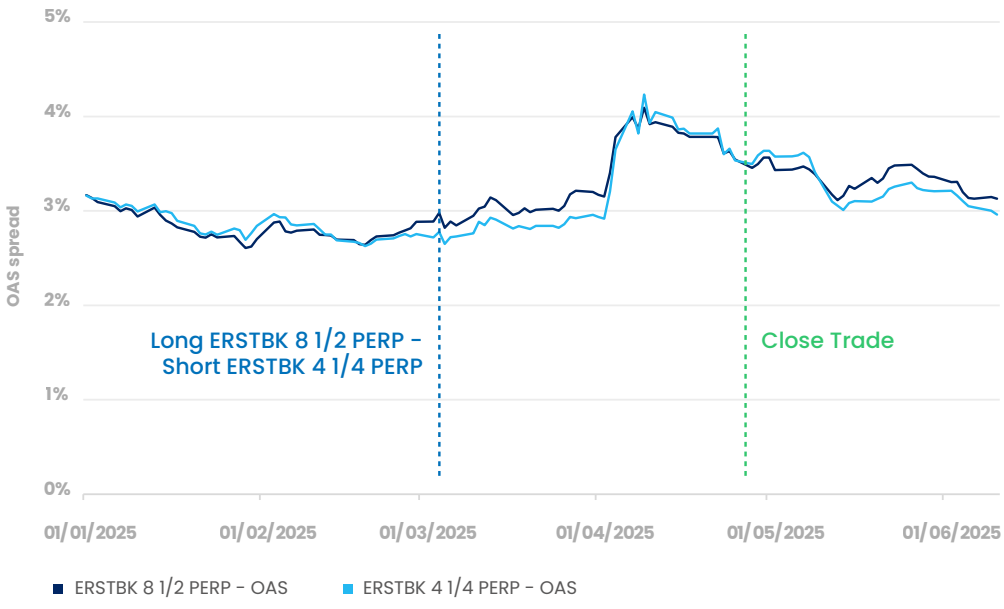
In March 2025, our model flagged an opportunity within the Austrian bank, **Erste Group Bank AG:**

- **Long:** ERSTBK 8 ½ PERP (AT1)
- **Short:** ERSTBK 4 ¼ PERP (AT1)

Both AT1 bonds had very similar durations and call dates, making them highly comparable. Crucially, the long position offered a higher coupon and more attractive reset features — a situation which our desk typically finds attractive.

The trade was implemented as an overweight of the higher-coupon bond and an underweight of the lower one. A closing signal appeared in April, but our portfolio managers determined that spreads had further to run. By June, spreads did indeed widen further.

Intra-Issuer Relative Value Trade



Past performance is not indicative of future returns

Source: Candriam, 30/06/2025

b. Inter-Issuer Relative Value Trade

In January 2025, our model highlighted a potentially attractive trade between two Dutch financial institutions:

- **Long:** ASRNED 4 5/8 PERP (RT1) - ASR Nederland, a major local insurance group
- **Short:** ABNANV 4 ¾ PERP (AT1) - ABN Amro, a banking group with more international reach

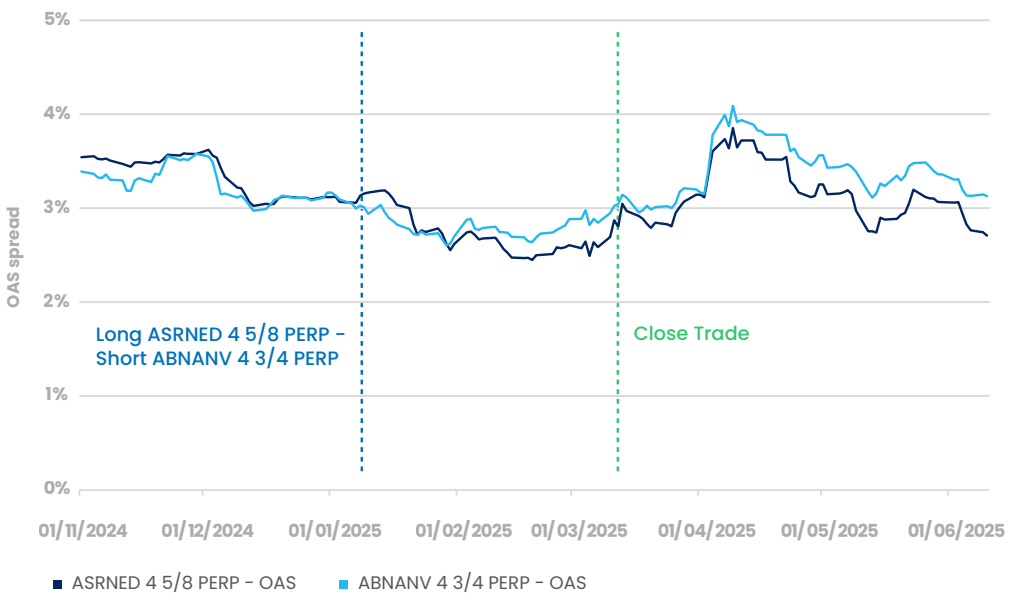
The two instruments had near-identical ratings, coupons, and call dates, making the relative value gap interesting. The position was implemented by going long the ASR RT1 and reducing exposure to the ABN Amro AT1.

By March, the model generated a closing signal — but also uncovered a new opportunity:

- **Long:** ABNANV 5 ¾ PERP AT1 (call 2033)
- **Short:** ABNANV 4 ¾ PERP AT1 (call 2027)

Rather than treat them separately, our portfolio managers consolidated the two signals into a single, more coherent position. In practice, this meant closing the ASR bond and shifting that capital into a structure that was long the higher-coupon, longer-dated ABN Amro AT1 and short the shorter-dated ABN Amro AT1. The effect was to streamline the trade, express a stronger conviction in ABN Amro, and extend the portfolio's duration exposure to the bank while still managing relative value risk

Inter-Issuer Relative Value Trade



Past performance is not indicative of future returns

Source: Candriam, 30/06/2025

Conclusion:
Turning complexity into alpha

The CoCo market is vast , technical, and often misunderstood. Identifying true relative value opportunities requires more than data processing — it requires a framework that can filter, compare, and highlight the trades with the greatest potential.

At Candriam, our quantitative models do exactly that. They scan the market for anomalies, generate signals, and provide the foundation for disciplined decision-making. But the real edge comes from our portfolio managers' discretion — applying judgment, fundamental research, and market experience to decide when and how to act.

This blend of quantitative insight and human conviction has already delivered strong results. In practice, the models highlight mispricing across a wide universe, while our portfolio managers decide which trades to implement, how to size them, and when to close them. In Candriam's benchmarked Sub Fins strategy this disciplined process has helped us consistently outperform the benchmark — capturing alpha from relative value opportunities while containing risk in one of the most complex segments of fixed income.

Looking ahead, we believe CoCos will remain a fertile ground for alpha. With stronger banks, clearer regulation, and robust liquidity, the opportunities for relative value trades are as compelling as ever. At Candriam, we stand ready to capture them for our clients.

Risks

All investments in our Sub Fins strategy involve risks. The main risks associated with investing in the strategy are :

- Risk of capital loss
- Interest rate risk
- Credit risk
- Risk associated with investing in CoCos
- Risk associated with derivative financial instruments.

The risks listed are not exhaustive and further details on risks associated with investing in the strategy are available in the regulatory documents.