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A niche product with solid returns: hybrid and subordinated bonds with investment grade rating

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It has been half a year since the launch of the new hybrid bond fund. Reason enough for us to talk to Roman Swaton, Senior Fundmanager.

Six months have passed since the launch of the fund. The performance to date has been +4.26%* (source: Erste AM, as of 31 May 2017).To what factors do you attribute the positive development of the fund?

Swaton: The environment for hybrid and subordinated bonds is stable. Positive economic indicators and company earnings growth lend support to the market segment. After the elections in France, investors feel relief, given that France is responsible for the largest part of investment grade hybrid bond issues (which, at 38%, also applies to ERSTE BOND CORPORATE PLUS). In the wake of the elections, the returning trust of market participants was clearly noticeable in demand, with spreads narrowing further. We do not envisage similar yield movements for 2017 anymore and expect only a limited number of new issues for the coming months. The market should therefore continue to support hybrid bonds. We continue to expect a dividend yield of 2% p.a. for the fund.

Roman Swaton, Fondsmanager des ERSTE BOND CORPORATE PLUS

*In euro; does not take into account the load of 2.5%, taxes, or other costs diminishing return such as individual account and depositary fees. Inclusive of the management fee. Past performance is not indicative of future development.

What are the biggest challenges for the fund in 2017? How are you handling them?

Swaton: As long as the ECB supports the market, the current challenge is the possible downgrade of hybrid bond issuers and the resulting limitations when it comes to portfolio diversification. Put differently, there are currently 29 issuers of hybrid bonds that qualify for investment by our fund. This investment universe would shrink in the event of a rating downgrade of one or more companies. For example, at the moment this scenario affects Bayer (pharmaceuticals). Bayer is in the process of taking over Monsanto. Depending on how the buyer funds the acquisition, it may come with a rating downgrade. But we have positioned ourselves very flexibly in order to overcome such challenges. Firstly, we allocate a strategic 25% into subordinated bonds from the financial sector. This universe contains 49 issuers and thus constitutes a good complement. And secondly, our terms and conditions allow us to hold up to 10% worth of high-yield bonds. However, we are currently not making use of this particular option.

What are the advantages of ERSTE BOND CORPORATE PLUS relative to a direct investment?

Swaton: Most new hybrid issues are very inaccessible to retail investors due to the terms and conditions of the bond and the high minimum investment. This is particularly true for large-caps with good ratings. These issuers can find sufficient numbers of investors and often exclude retail investors categorically. ERSTE BOND CORPORATE PLUS gives investors the chance to invest in this niche bond segment all the same. The fund acts as institutional investor and only buys hybrid and subordinated bonds with investment rating.

Opportunities	Risks to be aware of:
• Chance of attractive yield • Focus on bonds with good to very good rating (investment grade) • Possible foreign exchange risks are hedged • Innovative fund concept • Diversification due to broad investment across bonds from a vast array of issuers • Professional fund management	• Rising interest rates can lead to capital losses • Rating downgrades can cause declining prices (and thus losses). The investor bears the issuer risk of the companies in the fund • Increased default risk of subordinated bonds relative to senior bonds • Maturity extension, coupon moratorium, or early calling can cause capital losses • A change in the regulatory framework can come with negative effects on the fund performance • The fund invests in a niche segment and is therefore ideally mixed into a larger portfolio. Please ensure a sufficient degree of diversification in your portfolio • Capital losses are possible

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