

**HIGH GRADE CAPITAL SECURITIES FUND**

# A unique approach to diversify your IG corporate bond portfolio

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## Abstract

The traditional investment grade (IG) fixed income portfolio comprises “core” investments in Sovereigns and Corporates with some smaller allocations to other sectors such as high yield and emerging markets. In this paper, we demonstrate that IG fixed-income investors could be well served by including an allocation to Capital Securities to their portfolios. Using historical data from 2010 to January 2025, we conclude that an optimal allocation to Capital Securities would amount to a weight of 20%, which would be an overweight relative to a market size of approximately 10% of IG Corporates as of January 2025. By the means of moving regression analysis, we also show that IG EUR Capital Securities have the desirable properties of being an asset class that has delivered consistent positive alpha with a lower beta relative to IG EUR Corporates.

## What are “capital securities”?

These are securities that are issued for “capital” purposes. In other words, they are assigned some “capital” quality by either regulators or rating agencies. For Financials, these are typically bonds that are issued as Tier1 and Tier2 capital of Banks and Insurance companies. For Non-Financials, the motivation for issuance is “equity credit” by rating agencies. Non-Financial Capital Securities are also referred to by the term “Corporate hybrids”. They are considered “hybrids” because they typically receive a 50% equity consideration from the rating agencies that helps the companies bolster their senior debt ratings by managing their leverage ratios. The issuers have to meet certain structural criteria to get the Capital consideration from regulators (EU law in the case of Banks) and from rating agencies. For example, as per EU law, Capital Securities issued by Banks need to have bail-in features and coupon deferability. Corporate hybrids are also deeply subordinated and have coupon deferral features. Due to the subordination features and loss absorption features either through coupon deferral or principal write-down, these bonds are notched down in rating from senior debt.

## Why add IG Capital Securities to your IG portfolio?

Let's consider a fixed income portfolio invested in IG Corporates, EU Sovereign debt, and Pan Eurozone High Yield. We investigate the effect of including EUR Capital Securities to this portfolio.

We have chosen the following Bloomberg indices to do the study:

- Bloomberg Euro Agg IG Corporates: LECPTREU Index
- Bloomberg Euro Agg Treasury: LEATTREU Index
- Bloomberg Pan-European Euro High Yield: I02501EU Index
- Bloomberg Euro denominated IG Capital Securities: I04425EU Index

Source: From 2010 onwards, we have chosen to use data post the Global Financial crisis. See disclosures for index definitions.

### Let's look at the correlation matrix of this group of assets:

#### Exhibit 1A: Correlation matrix

	Euro IG Corp	Euro Treasury	Euro Capital Securities	Euro High Yield
Euro IG Corp	1.00	0.75	0.49	0.48
Euro Treasury	0.75	1.00	0.32	0.20
Euro Capital Securities	0.49	0.32	1.00	0.58
Euro High Yield	0.48	0.20	0.58	1.00

#### Exhibit 1B: Mean return/variance table

	Standard deviation	Mean returns	Returns/Standard deviation
Euro IG Corp	3.02%	2.58%	0.86
Euro Treasury	4.72%	1.99%	0.42
Euro Capital Securities	3.97%	4.39%	1.11
Euro High Yield	4.12%	5.70%	1.39

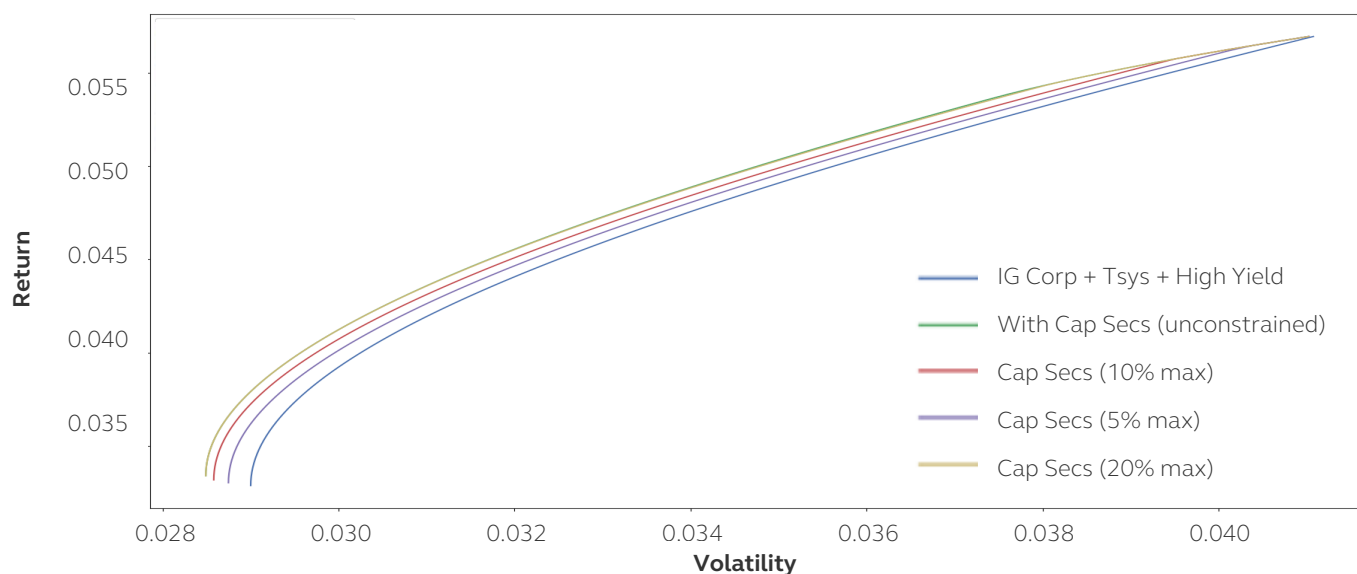
Source: Bloomberg. Data dates range from 1 January 2010 – 24 January 2025.

From Exhibits 1A and 1B, it can be observed that the correlation of Capital Securities to IG Corporates is similar to the correlation between High Yield and IG Corporates.

We then went through an exercise of constructing efficient frontiers for two portfolios:

- A “traditional” fixed income portfolio comprised of three assets: IG Corporates, EU member states Treasury debt, and Pan-European High Yield.
- A second portfolio that adds Capital Securities to the “traditional” portfolio above.

## Exhibit 2: Efficient frontiers – Allocation to EUR fixed-income assets



Source: Bloomberg. Data dates range from 1 January 2010 – 24 January 2025.

From Exhibit 2, it can be seen that even a 5% allocation to Capital Securities improves risk adjusted returns as it shifts the efficient frontier to the left. The approximate optimal allocation to EUR Capital Securities is about 20% as seen in Exhibit 2 (at 20% allocation the yellow and unconstrained green lines converge).

From a sizing perspective, the size of the IG EUR Capital Securities universe (I04425EU) is €277B, while the IG EUR Corporate universe (LECP TREU) is €2,826B. Therefore, Capital Securities are about 10% of the IG Corporate universe.

## Regression analysis

We did a moving regression study between IG EUR Capital Securities (I04425EU) and IG EUR Corporates (LECP TREU) using a three-year moving window.

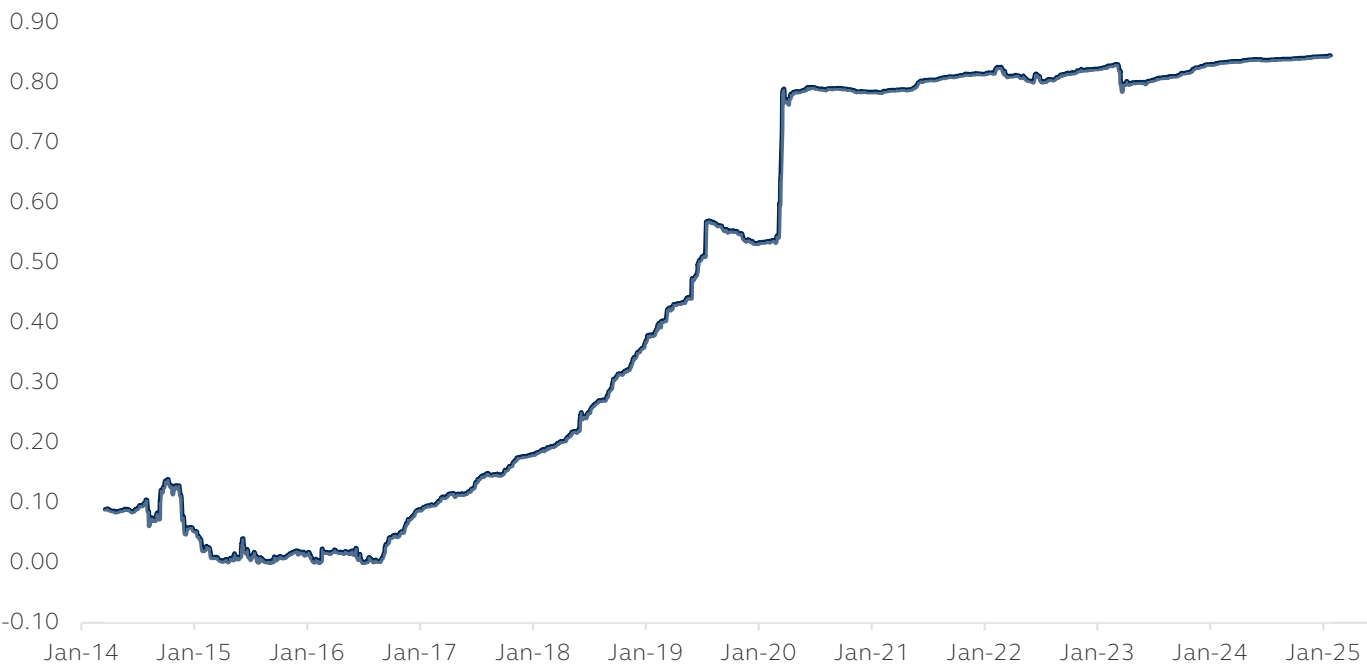
**Methodology:** At every point in time (daily), a regression using the past three years of log return history was run with IG EUR Corporates as the independent variable and IG EUR Capital Securities as the dependent variable. The resulting coefficient (Beta) and correlation are plotted.

## Exhibit 3A: Moving regression coefficient (three-year history), X: LECP TREU, Y: I04425EU



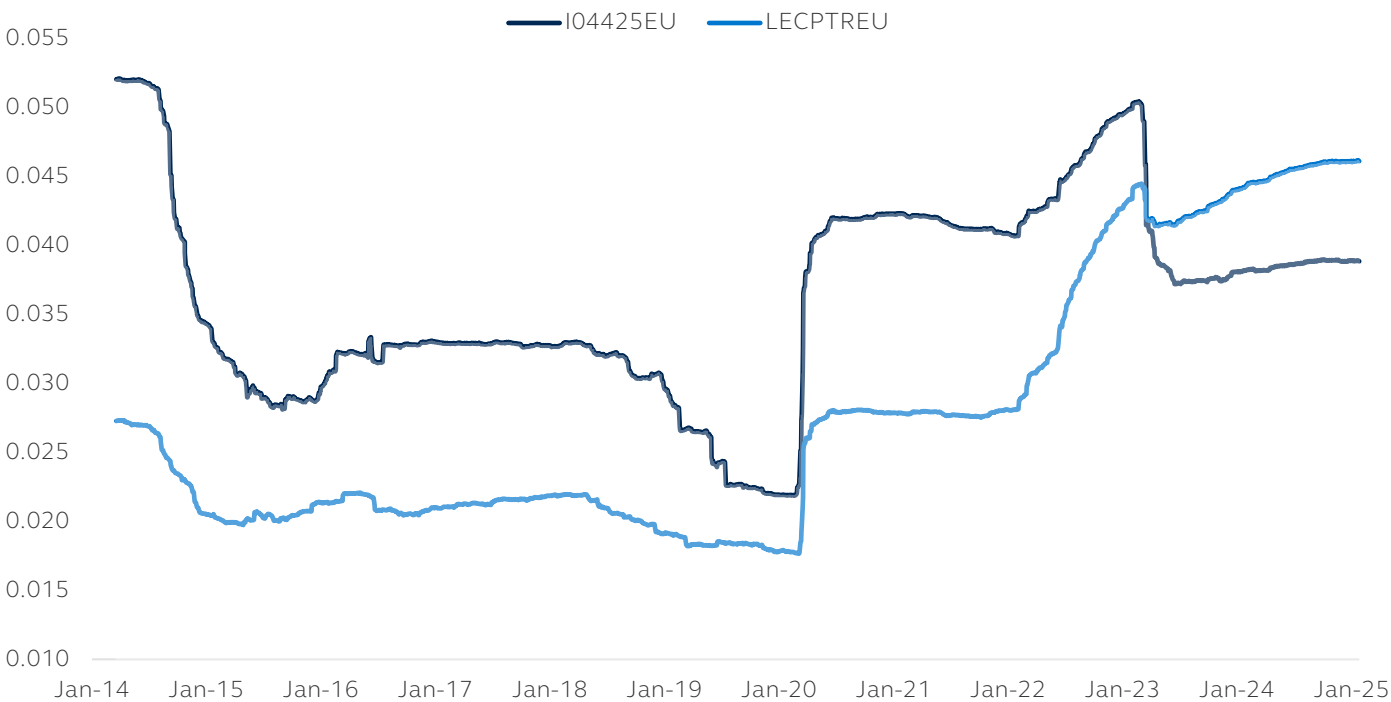
Source: Bloomberg. As of 24 January 2025. See disclosures for index definitions.

**Exhibit 3B: Moving correlation (three-year history), X: LECPTREU, Y: I04425EU**



Source: Bloomberg. As of 24 January 2025. See disclosures for index definitions.

**Exhibit 3C: Moving volatility (three-year history)**



Source: Bloomberg. As of 24 January 2025. See disclosures for index definitions.

### Exhibit 3D: Moving regression alpha (three-year history), X: LECPTREU, Y: IO4425EU



Source: Bloomberg. As of 24 January 2025. See disclosures for index definitions.

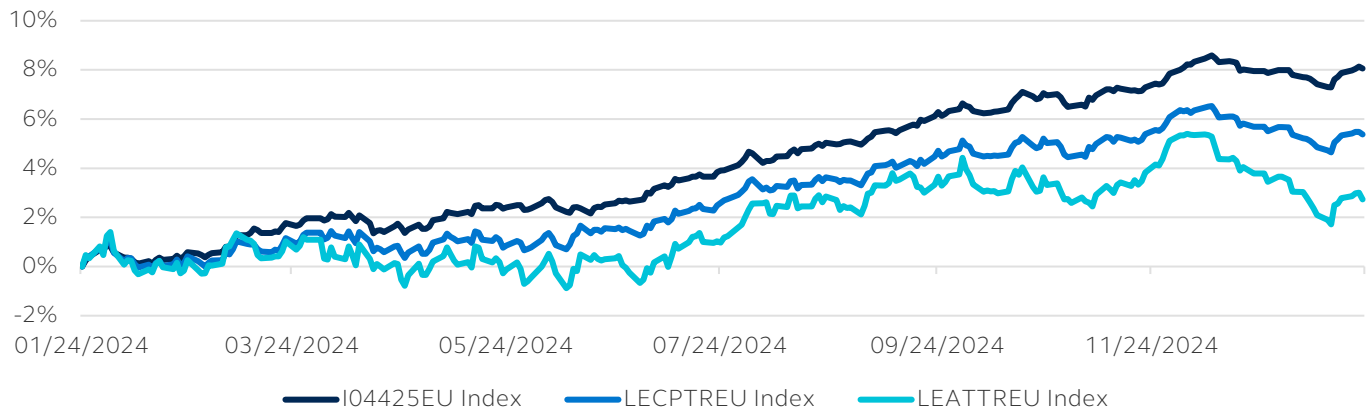
#### Observations from Exhibits 3A, 3B, 3C, and 3D:

- From Exhibit 3A, it can be observed that the IG EUR Capital Securities has a beta that is mostly <1 relative to IG EUR Corporates. This beta has moved lower in recent years. This implies that on average, downward moves in IG EUR Corporates typically result in lower losses in IG EUR Capital Securities given the lower beta and positive alpha (intercept).
- From Exhibit 3B, it can be observed that IG EUR Capital Securities had become more closely correlated with IG EUR Corporates over time.
- From Exhibit 3C, it can be seen that the volatility (standard deviation) of IG EUR Capital Securities had moved lower relative to IG EUR Corporates, similar to the move in beta.
- From Exhibit 3D, it can be seen that IG EUR Capital Securities had a consistently positive alpha relative to IG EUR Corporates. Therefore, it had the desirable properties of being an asset class that delivers consistent positive alpha with a lower beta.

## Historical performance discussion

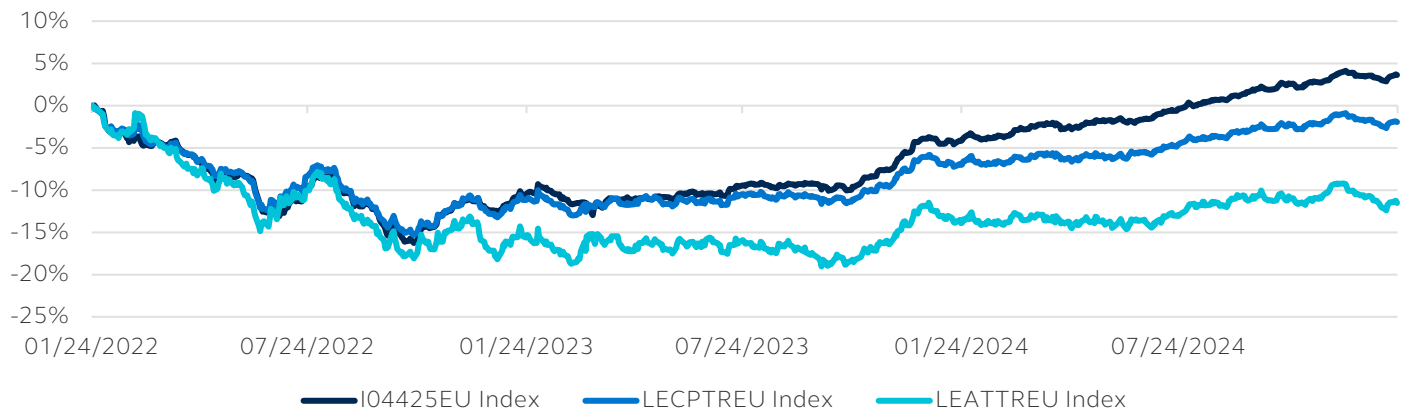
Let's compare historical performance for Capital Securities relative to IG Corps and Treasury debt.

### Exhibit 4: One-year performance history



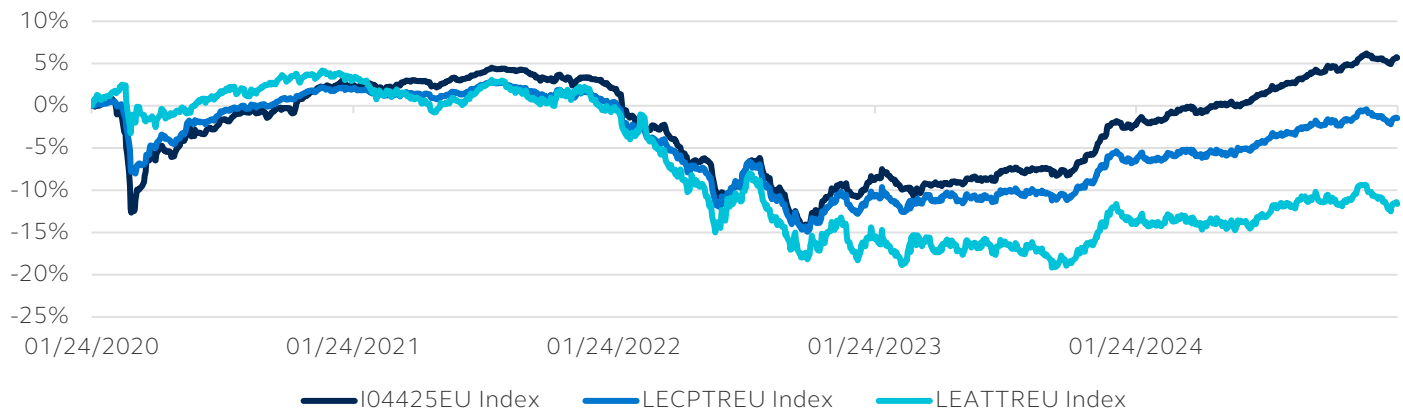
Source: Bloomberg. As of 23 January 2025. See disclosures for index definitions.

### Exhibit 5: Three-year performance history



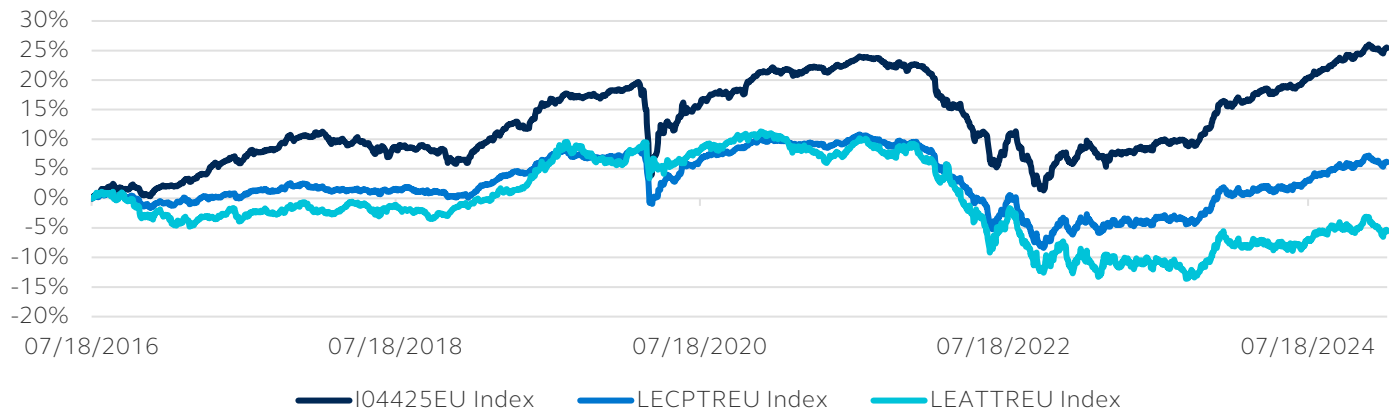
Source: Bloomberg. As of 23 January 2025. See disclosures for index definitions.

### Exhibit 6: Five-year performance history



Source: Bloomberg. As of 23 January 2025. See disclosures for index definitions.

## Exhibit 7: Ten-year performance history



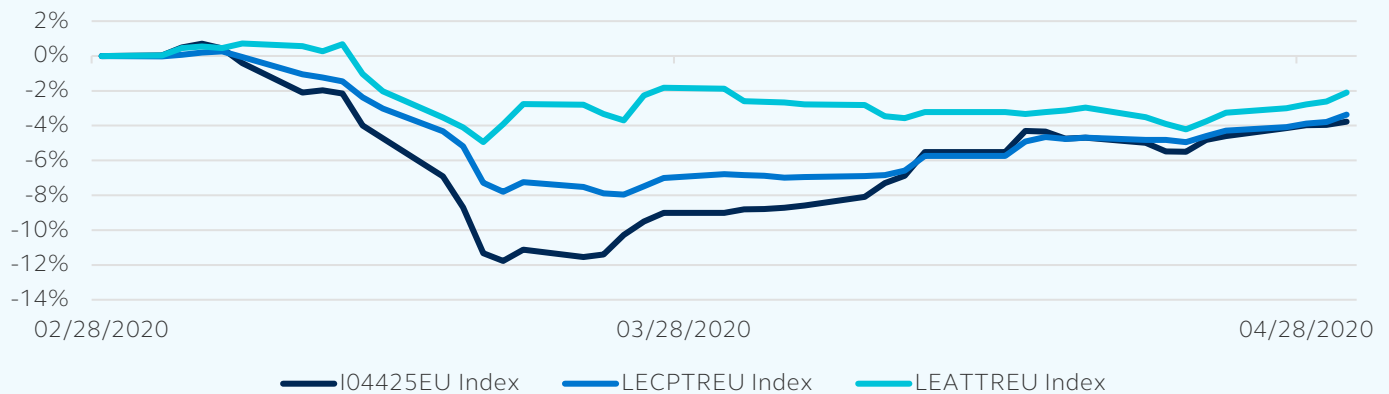
Source: Bloomberg. As of 23 January 2025. See disclosures for index definitions.

From Exhibits 4-7, it can be seen that IG Capital Securities have outperformed IG Corporates and EU Treasuries over the past 1, 3, 5, and 10 years.

## Periods of drawdown

### Exhibit 8: COVID-19

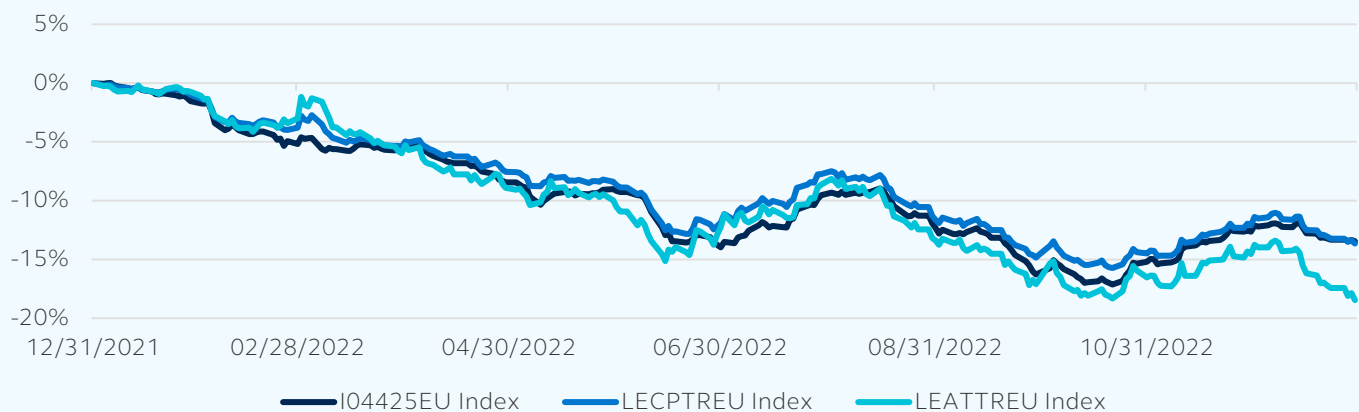
In periods of stress, Capital Securities can behave with “higher beta” with the index being down over -11% at the bottom of the sell-off relative to -8% for IG Corporates.



Source: Bloomberg. As of 23 January 2025. See disclosures for index definitions.

### Exhibit 9: Increase rate increase, 2022

Over 2022, the loss in Capital Securities was similar to the loss in IG Corporates.



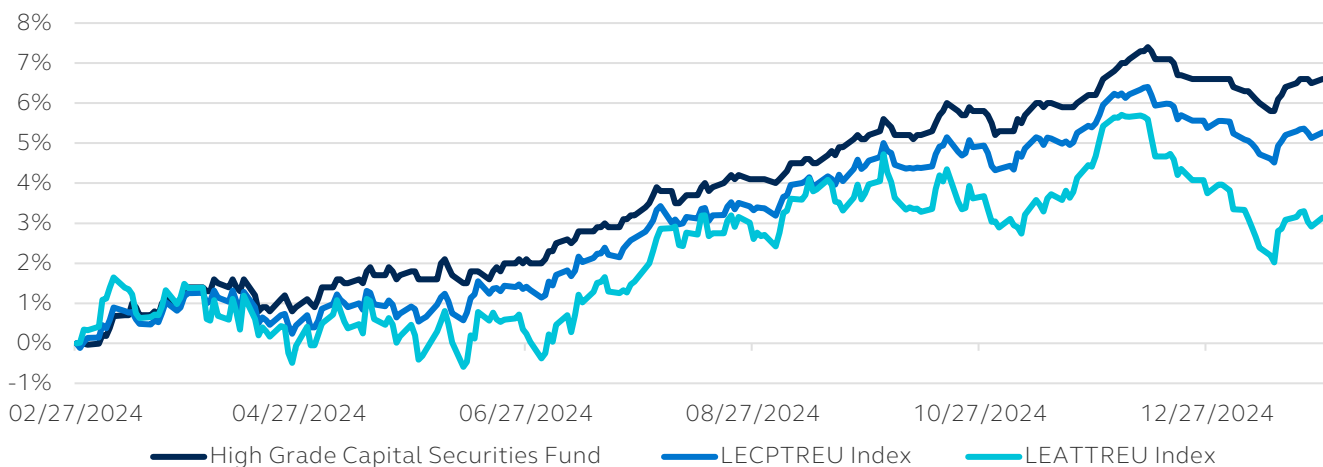
Source: Bloomberg. As of 23 January 2025. See disclosures for index definitions.

## The Principal High Grade Capital Securities Fund

- The Fund is positioned as an IG portfolio of Subordinated Capital Securities denominated primarily in EUR. The objective is to pick up yield over IG Corporate portfolios by investing in IG Subordinated debt.
- The Fund is diversified across the investment universe of Capital Securities via investments in Banks, Insurance, and other Corporates.
- There are no investments in Bank or Insurance Tier1 Capital: No CoCos or RT1s.
- The Fund has 55 unique names with 91 securities.
- As of 31 December 2024, the Fund has a yield-to-maturity of 4.42%, yield-to-call of 3.90, duration of 4.11, and price of 100.65.
- From an industry perspective, the Fund has 49.74% in Banks, 20.61% in Insurance, and 24.85% in primarily Utilities and Energy companies as of 31 December 2024.
- 100% IG at the security level with an average rating of BBB+.
- The Fund is Europe centric with the only non-European investment being 3.84% in the U.S.. The countries invested in include UK, France, Netherlands, Sweden, Spain, Ireland, Denmark, Norway, Belgium, Italy, Switzerland, Germany, Finland, and Austria.
- We continue to look for opportunities to diversify the portfolio away from Financials by looking to invest in high quality hybrid issuance from Corporates.

## Performance of the Fund

### Exhibit 10: Inception-to-date performance of the Fund



Source: Bloomberg. As of 23 January 2025. The Fund's I Shared EUR Accumulation share class is being shown. See disclosures for index definitions.

From Exhibit 10, it can be seen that a “traditional” fixed-income portfolio of IG Corporates and EU Treasuries would have benefitted from an allocation to the Principal High Grade Capital Securities Fund.



## Outlook

We would expect coupon income in our strategies to continue to be elevated despite a central bank easing regime.

- Our outlook for return in EUR Capital Securities is constructive despite several headwinds facing the Eurozone.
- Projected growth for the Eurozone in 2025 is anemic. This, along with other weakening economic indicators such as manufacturing and labor should allow the European Central Bank (ECB) to be more aggressive with rate cuts relative to the U.S. Federal Reserve.
- European Central Bank (ECB) rate cuts should help stimulate lending in the Eurozone which should be positive for Financials. Rate cuts should bolster underlying economies and support bank asset quality. It should also ultimately be supportive of valuation for Bank Tier2 and AT1.
- Credit is strong; non-performing loans (NPL) and inflation should be contained.
- The market is pricing in a steep yield curve as a result of ECB rate cuts. This should be supportive of bond prices as they roll down the yield curve. A steep yield curve should be constructive for demand for the product as we would expect capital to exit the short end of the curve and look for yield in strategies such as ours.
- Absolute yields are still near decade long highs despite recent spread tightening. Coupon income should continue to be elevated despite a Central Bank easing regime. Bonds that are callable in 2025 were issued at a time when interest rates were lower than today and spreads higher. Therefore, these bonds should get called and replaced with higher coupons thereby growing income. This would position our strategies in the unique position of being able to grow coupon income in a Central Bank easing cycle.
- As a note of caution, credit spreads could come under pressure if European economies are stressed by the imposition of tariffs by the incoming Trump administration. A deflationary environment due to tariffs for instance, could result in spreads widening into lower rates. European economies will be faced with a difficult choice if the U.S. withdraws its support to NATO. Europe will be forced to spend more on defense, and this will affect fiscal balances. Consequently, the Eurozone will be forced to run fiscal deficits far more than its 3% limit. The ECB could help fund this by embarking on another asset purchase program. Such a scenario should be constructive for credit spreads and total return.
- Given lower projected growth rates in the Eurozone, supply expectations for 2025 are mostly muted. Therefore, we do not expect there to be a supply driven drag on credit spreads.

Appendix

Regression summary between X: LECPTREU Index and Y: I04425EU Index.

OLS Regression Results						
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Dep. Variable:	Euro Capital Securities			R-squared:	0.254	
Model:	OLS			Adj. R-squared:	0.253	
Method:	Least Squares			F-statistic:	1334.	
Date:	Mon, 03 Feb 2025			Prob (F-statistic):	9.08e-252	
Time:	08:52:22			Log-Likelihood:	18542.	
No. Observations:	3931			AIC:	-3.708e+04	
Df Residuals:	3929			BIC:	-3.707e+04	
Df Model:	1					
Covariance Type:	nonrobust					
=====						
	coef	std err	t	P> t	[0.025	0.975]
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const	0.0001	3.46e-05	2.980	0.003	3.52e-05	0.000
Euro IG Corp	0.6664	0.018	36.528	0.000	0.631	0.702
=====						
Omnibus:	1402.835		Durbin-Watson:		1.313	
Prob(Omnibus):	0.000		Jarque-Bera (JB):		37935.116	
Skew:	-1.110		Prob(JB):		0.00	
Kurtosis:	18.056		Cond. No.		528.	
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Source: Bloomberg. Data dates range from 1 January 2010 – 24 January 2025.

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### **Risk considerations**

Investing involves risk, including possible loss of principal. The market value of debt securities is affected by changes in prevailing interest rates and the Fund may be exposed to credit risk by investing in debt securities. Default risk and liquidity risk associated with investment in below investment grade securities. Contingent Convertible Securities risk is due by the substantially greater risk that these instruments may have compared to other forms of securities in times of credit stress and may result in a material loss to the Fund. Currency hedging may reduce but will not remove risk. Hedging will incur more transaction costs and fees which will affect overall return.

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### **Indices represented**

- Bloomberg Euro Aggregate Corporate Total Return Index Value Unhedged EU (LECP TREU) is a benchmark that measures the corporate component of the Euro Aggregate Index. It includes investment grade, euro-denominated, fixed-rate securities.
- Bloomberg Euro-Aggregate Treasury Index (LEATTREU) is a benchmark that measures the Treasury component of the Euro-Aggregate. The index consists of euro-denominated, fixed-rate, investment grade public obligations from member states of the European Union.
- Bloomberg Euro High Yield Index (IO2501EU) measures the market of non-investment grade, fixed-rate corporate bonds denominated in Euro. Inclusion is based on the currency of issue, and not the domicile of the issuer. The index excludes emerging market debt.
- Bloomberg Capsec Euro Denominated Total Return Index Unhedged EUR (IO4425EU) represents Euro-denominated Capital Securities.

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