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Greg Stock: There's opportunity in bank debt for 'risk aware' investors

By Perpetual Asset Management

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A deep understanding of risk is tantamount to success in credit markets, even when investing in highly rated bank debt, says Perpetual's GREG STOCK

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- Look for 'risk aware' credit and fixed income managers
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VOLATILE, eventful years like 2023 – where we saw a run of US bank failures – can result in investment managers becoming very risk averse around assets such as bank debt.

But investors should not be put off bank credit as an asset class.

Instead they should look for managers who focus on *understanding* risk, argues Greg Stock, Perpetual's head of credit research and a senior portfolio manager in the asset manager's credit and fixed income team.

"Part of our philosophy around managing money is to be risk aware," Stock says.

"Some investors are risk-seekers, others are risk averse. But if you are *risk aware* as an active manner, you have an edge in achieving strong risk-adjusted returns."

Last year was a reminder of the risks in bank capital structures, Stock says.

A series of US bank failures such as Silicon Valley Bank and First Republic Bank unsettled markets and bank customers.

"Risk aversion towards bank debt was driven largely by overseas jurisdictions, particularly the United States with the regional banking crisis.

"That led people to think more about how banks should be regulated – and how extensively they actually are regulated.

"It emphasised the importance of understanding inherent risks in bank balance sheets, property exposures and interest rate risk management.

"The risk aversion culminated in the demise of Credit Suisse and the subsequent takeover by UBS."

That meant some "tier one" securities – high-ranking, equity-like hybrid securities issued by banks to raise capital for lending activities and other operations – were written off.

"The rest of the debt securities within the Credit Suisse structure were assumed by UBS," Stock says.

"That's a reminder of the risks inherent in 'tier one' securities, and their place in the capital structure.

"It's a reminder that where you are in the capital structure is important. You need to know your institution and its jurisdiction.

"Last year also showed us that diversification is important."

With those lessons in mind, Greg says there's opportunity for investors in bank debt.

"While spreads [between government bonds and bank debt] were wider last year, they are still decent on a historical basis," Greg says. "There's still potential for good, running yield".

Neutral view on credit

Perpetual's broad view on credit is neutral, Greg says, adding that the interest rate tightening cycle is at, or close, to an end.

"With higher base rates and spreads elevated, it's a good opportunity for investors to gain exposure to capital-stable, investment-grade yield in their portfolios – and banks are a good way to do that.

"Australia's banks are well regulated. They are well capitalised, and credit risk, funding ratios, and interest rate risk management are all sound."

With the experience of 2023 in mind, Greg says he favours subordinated debt in the banks.

"It can be written off at a point of non-viability by the regulator, but beneath it you have the 'tier one' hybrid securities and all the equity," Greg says.

"Both senior debt and subordinated debt in the major banks, and some of the other banks in the system, potentially offer good value."

About Perpetual's Credit and Fixed Income team

Perpetual offers a range of cash, credit and fixed-income solutions and are specialists in investing in quality debt.

We take a highly active approach to buying and selling credit and fixed income securities and invest extensively across industries, maturities and the capital structure.

Find out more about Perpetual's Credit and Fixed Income capabilities

Want to find out more? Contact a Perpetual account manager

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