Value without valuation? An example of the cocos market

Abstract:
In this paper, I suggest that financial products simultaneously inhabit two regimes of valuation: calculative and consumptive. There are constant endeavors in the market to develop formal mathematical methods of valuation and to use them as a base for investment decisions. Using the example of contingent convertible bonds (“cocos”), I argue that our understanding of how financial markets function would remain limited if we were to focus only on those formal endeavors. In the case of cocos, stringent mathematical valuation is impossible due to the contingent nature of this product and many future uncertainties. Based on various empirical materials, I demonstrate that the lack of established valuation tools is complemented and compensated by the purposeful efforts to sell this product. Cocos are categorized as simple bonds in order to be sold; they are associated with brands; their risks are marketed in a particular way. This consumptive regime of valuation allows for determining value and investing where formal mathematical valuation is deferred. Thus, incorporating the insight that marketing constitutes markets, the paper sheds light on how financial markets function, and amends the purely calculative perspective of mainstream finance. Furthermore, the paper relates consumptive finance to major issues in critical finance, such as power and governance, risk ignorance and financial illiteracy. More generally, it argues that active selling efforts represent a severe research gap in critical and social studies of finance and should be more clearly outlined and developed.

1. Introduction
How can we explain and describe the valuation process of a new financial product? I would like to discuss this question using the example of “cocos” (the contingent convertible bonds). As a new financial asset, they appeared on the radar screen of investors in the aftermath of the financial crisis of 2007-2009. In an effort to create a more stable banking system, regulators allowed banks to issue hybrid capital securities which can absorb bank losses and create fresh equity capital in a situation of financial distress: if particular negative events happen, for example, if the capital ratio of the bank falls below the specified minimal level or if the share price breaches a pre-set requirement, the cocos can be converted into equities or written down partly or completely. As a compensation for these risks, the buyers of cocos receive a very attractive coupon (usually between 7% and 9%).

As mainstream finance considers valuation to be based on modelling and calculations, it faces a problem in the case of cocos: the mathematically stringent valuation of those products is difficult to impossible due to their contingent nature: It remains unclear if they should be valued as bonds, equities or derivatives. Furthermore, the cocos’ valuation is based on too many future uncertainties which cannot be easily resolved (the more detailed discussion follows in Section 3). As a result, this new product represents a puzzle for mainstream finance: Cocos
apparently possess value because there is a functioning market for them; at the same time, this value cannot be approached by means of mathematics; thus, from the textbook finance perspective, we are confronted with value without valuation. Should rational market participants not refuse to trade and to exchange the asset whose value they do not know? Should the market for this asset not cease to exist at all?

Obviously not. The market for cocos has been prospering recently. In 2013, “European issuance exceeded $14.3 bn […] and is close to $10bn already this year” (Atkins 2014: 24); the total issuance is likely to reach €100bn by year-end 2014 (Gallo 2014). The cocos issues are usually oversubscribed. The most recent example is Deutsche Bank, which “attracted an astounding €25bn worth of orders” for its cocos issue and ultimately increased the size of the offering from €1.5bn to €3.5bn: “Yield-starved investors are clearly cuckoo for coco puffs” (Alloway 2014). Thus, apparently, investments in cocos are possible (and flourishing) even if the strict calculative regime of valuation is deferred. How can we approach this puzzle?

Critical finance studies might provide some help. This field of inquiry (Forslund and Bay 2009; Bay and Schinckus 2012) offers conceptual and methodological tools to formulate and to solve problems which mainstream finance - as a “house without windows” (Keasey and Hudson 2007) - ignores or is not capable to solve. In the particular case of the cocos’ valuation puzzle, critical studies of finance, first, suggest an alternative concept of valuation and, second, allow for using qualitative methods of empirical research to substantiate and to develop this concept (Frankfurter et al. 1994; Bettner et al. 1994). In this perspective, valuation is not understood as a formal science or a calculative exercise but as a discursive practice and a human endeavor. Furthermore, the practice of valuation is contextualized within society, markets and organizations so that the focus is shifted towards the interconnection between the technical and social aspects of valuation. Now, “valuation and calculation at the margins” - understood as valuation and calculation “at different points in time and in different places” (Mennicken and Sjögren 2015) - gain a particular interest. This local focus on the specific valuation practices is not a part of the mainstream finance that rather treats valuation in a very wholesale way.

In this paper, I follow the critical finance approach that has been developed so far. For example, Coleman (2014), in the first step, identifies a puzzle in the intellectual edifice of mainstream finance (Why do investment professionals not use classical finance theory?) and, then, drawing on the critical finance literature
and using qualitative empirical materials, offers an explanation. In this paper, I proceed in the same vein. First, I pose a question of how cocos investors cope with the impossibility of precise mathematical valuation so that the market of this product continues its successful functioning. Then, I suggest how to install some “windows” and “doors” into mainstream finance’s house by considering valuation concepts that have been developed in critical finance so far and have gone beyond formal calculations (Section 2). I also draw on the results of the qualitative empirical study I conducted in the EU project “Evaluation practices in financial markets” (EPIFM) (I describe my data in Section 4).

After demonstrating why the precise formal valuation of cocos is not possible (Section 3), I suggest that we focus on the consumptive regime of valuation. By doing so, I shift the focus from efforts to calculate to efforts to sell. Selling is an important factor in producing market participants’ willingness to invest – allowing markets to recognize value and to flourish even if the formal valuation is deferred. Introduction of marketing as an additional regime of valuation sheds light on how financial markets function, emphasizing an important – and previously neglected - element of this functioning.

Indeed, selling is not a well-recognized topic in critical and social studies of finance. There are individual voices that start to point to this severe gap (McFall 2011a, 2011b; Vargha 2011; Lepiney 2011; Harrington 2010; Roscoe 2013): It should be recognized that marketing – among other factors - constitutes markets. The paper at hand would like to tune into this discussion and to empirically develop a case that demonstrates how particular ways of selling cocos enable the very existence of a market for this instrument. In a nutshell, the paper shows how cocos (which are “high yield – high risk” products) are constituted as “high yield – low risk” investment objects in the process of selling. Thus, the demand for cocos develops not because a formal model judges them as “cheap” but because they are presented (made perceivable as) products that guarantee high return for low risk.

Subsequently, in Section 6, the findings are related to the critical finance debate about goals and means of finance, “governance”, “strategic ignorance” and financial illiteracy (Davies and McGoey 2012, Forslund and Bay 2009; Gigerenzer 2015).

Generally, the article suggests that the active efforts to sell should be more clearly outlined as an issue of finance. This study aims to explicitly initiate and support this discussion.
2. Overview of the critical literature on valuation

One of the most persistent puzzles in finance is the puzzle of valuation. How do we determine what a financial asset costs? Famously, mainstream finance believes that at the core of asset pricing and asset valuation is the calculation of “real”, “fair”, “intrinsic” or “fundamental” value. This is supposed to be a correct, or true, value based on macro and micro “fundamentals”. In order to make investment decisions, market participants determine the value of the product, i.e., estimate what the asset is worth today and how much they are ready to pay for this asset. Price, or what an investor effectively pays when buying a security, might deviate from the intrinsic value but always fluctuates around it (Koller et al. 2010: 337). Thus, according to mainstream finance, if one can determine the value, he or she knows the direction and magnitude of the future price movement, as prices are supposed to move towards value (in completely efficient markets, price equals value). Hence, the pursuit of the valuation approach that provides investors with the precise mathematical calculation of the value became the very matter of financial theory and financial modeling.

Importantly, though the mainstream finance admits the flaws and distortions of the established valuation approaches (e.g., the discounted cash flow model or the Black-Scholes option pricing model), it never questions the very possibility of mathematical valuation of assets. For example, Damodaran (2010), the recognized valuation guru, refers in his “The dark side of valuation” to difficulties to determine precise equity values of start-ups, cyclical and commodity companies, financial services, firms with intangible assets, emerging market companies and so on; the whole book, however, is about how to calculate the value nevertheless, i.e., how to adjust the models. More generally, for mainstream finance, all difficulties in calculating the asset value arise due to the imperfection of existing models. The advancement of modelling tools brings investors closer to the crux of the matter – the determination of the “fair” value of every existing asset.

A different perspective on valuation is suggested by critical studies of finance and accounting. According to this literature, mathematical calculation of the value is not at the heart of the valuation process. There is no ultimate point of departure such as “fair” or “intrinsic” value (McGoun 1997). The crucial argument made here suggests that arithmetical calculations are always limited and could never be sufficient by themselves to describe how financial markets function (McFall 2011a). We should rather ask why and how “markets carry on despite the peculiar, mathematically limited and opportunistically versatile, character of human calculation.” (ibid: 149) In other words, while, in mainstream finance, valuation is
an issue of mathematical precision and perfection of formal models, it is by far “more” for critical finance.

This “more” has been captured differently in the critical finance literature. Here, valuation has been understood as a practical, collective activity that is distributed among diverse actors, organizations and technologies in the market (Callon 1998; Callon and Muniesa 2005, Cochoy 2008; Hardie and McKenzie 2007). The concept of “evaluation culture” (MacKenzie 2011; MacKenzie and Spears 2014) was coined to describe how investors produce knowledge about values using theories, models, electronic devices, and narratives. In this literature, attention has been primarily paid to the macro (market or institutional) structures or development of formal tools that enhance calculation of value. Still, this research has underappreciated one important topic at the micro level of inquiry, namely how financial assets get into financial circulation, how they are put on demand, how they are bought and sold. Those processes importantly contribute to how value is determined in the market.

The insightful study by Karpik (2010) elaborates this point for consumer markets of singularities such as wines, songs, movies etc. He stresses that singularities are characterized by quality uncertainty; they are promises whose value cannot be formally calculated (as mainstream economics suggests). Karpik points out that consumers of singularities, facing radical uncertainty, form their judgments about value by relying on social networks, ratings, routines but also on advertising and branding. Karpik does not apply his analysis to finance; however, there are important parallels that are worth discussing. Financial products are also nothing else than contingent promises about the future (Lepinay 2011: 174). These contingencies, while making the precise mathematical calculation of the value impossible, open various possibilities to form the investors’ judgment about the value of a financial instrument. Judgments about value are formed while contingencies about the financial product are used – “exploited” – to present, to explain, and to demonstrate this product to a client – enabling his or her choice and action. This issue has not been explicitly discussed in finance science so far. Indeed, “there is little research on how financial products were marketed and actually sold to investors and to borrowers” (Vargha 2011: 217).

Nevertheless, there are voices in social studies of finance that start to point to the importance of selling efforts in finance. Thus does McFall (2011a: 152) stress: “At the core markets necessary involve a contest of powers, levelling motivations to sell against motivations to buy, with different resources on both sides”. Those resources are crucial for determination of value and the smooth functioning of
markets. Carruthers and Stinchcombe (1999: 375) point out that value should not just be determined (calculated) but also successfully communicated because “[v]alue that is difficult to discern, or hard to communicate credibly to a large number of potential buyers, […] makes an asset illiquid”. For them (ibid: 357), liquidity - and the functioning of the markets more generally - is therefore “a matter of how to create a public consensus about value”.

Thus, particular mechanisms must be activated that allow the buyers and sellers of assets to interact in such a way that investments become possible. In other words, financial markets must mobilize tools that do not necessarily produce exact valuation but more generally enable action. To stay liquid and to function, markets do not need people who do perfect math, but, first of all, people who are willing to act, i.e. to invest. This willingness to act must be socially produced and supported in the markets every time anew.

In this respect, Dewey’s idea that has been recently revived in Hutter and Stark (2015) - “value is a quality that has to be performed” – seems to be corroborated. If we want to understand the valuation process of a new financial asset, we have to keep in mind that “new products, styles and practices come to be selected and positioned as valuable in communities, organizations and markets” (Hutter and Stark 2015: 5). New assets should be first performed as “stable investment objects” and only then may formal mathematical calculation of the value become relevant (Hägglund 2002). Formal valuation is one of the possible technologies that help to stabilize an investment object, for example, to “create” a company as an investment opportunity (ibid: 2), as a sellable asset. Consequently, so Hägglund (ibid: 4), we should “direct attention towards the formation of the investment object, rather than the calculation that is necessary to put a price on this object”.

Interestingly, Hägglund introduces an important factor for constructing an investment object. He calls it “energy” (an investment product should be “energized” with “interested actions”) and quotes Latour (1996): “Something that does not evoke such an interest passes away”. In the similar vein, Zaloom (2009: 248) describes “the yield curve as a simultaneously epistemic and affective object” and McFall (2011a: 4) pleads “for the sentimental as a component rather than a contaminant of economic calculation”. “Affective” and “sentimental” are here not so much about panic or euphoria, which rather disturb markets, but an important element of market functioning in the situations in which mathematical valuation is difficult or impossible.

What is looming here, I would say, is the consumptive regime of valuation. In this regime, financial instruments are not “just there”, are not the objects of investors’
independent and sovereign choices based on value calculation. They are first of all subject to purposeful, “energizing”, “interest evoking” selling efforts – like consumer products. Harrington (2007: 22) has already pointed to the “investing as shopping” behavior on the side of amateur investors whom she describes as highly susceptible to selling arguments. What we have to understand is: “How does one arrive at needing a certain financial plan [or product]?” (Vargha 2011: 217). McFall (2011b) illustrates this point by describing how life insurance was established as a sellable investment object. She shows that, in this market, statistics was not persuasive enough and had to be translated into “a calculable marketing argument” that goes beyond probabilistic calculus. Importantly, this marketing argument could be understood “not just by ‘any competent judge’, but by any prospective consumers” (ibid: 677). This translation is crucial if we want to apprehend how the consumptive regime of valuation functions.

The bits of research that exist on this topic suggest that financial products as “investment objects” are performed in the interaction between sellers and clients: It is about “the collective, situated calculation in financial selling” (Vargha 2011: 216). The market devices used in this situation have “power effects”: Investors are governed through regimes of knowledge, particularly through marketing knowledge (Roscoe 2013). While being susceptible to selling arguments (being “docile bodies” in Foucault’s sense (ibid)), investors as clients start to see market opportunities and risks – “come to understand markets” (ibid) – in a particular way. For example, the technologies of explanations and demonstrations of products to clients pave the way for the creation of “strategic ignorance” of risks. As Lepinay (2011) describes in the case of structured products, clients’ needs and preferences are formed in the process of selling and “educating” clients so that particular risks become visible while others are hidden and rendered negligible. This is a flexible, interactive process. The actively created ignorance of risks helps market participants to compensate for their limited knowledge of exact mathematical value of assets, to jump over the gorge of non-knowledge allowing markets to function. In this sense, ignorance can be considered as a resource, “a productive force” of markets (Davies and McGoey 2012). At the same time, willing investors who are “made” to ignore risks become exposed to severe financial losses. This raises a question of their better formal education (financial illiteracy) and protection, on the one hand, and of social justice and moral responsibility of those who sell, on the other hand.

The paper sets out to contribute to this discussion on financial markets as products of selling efforts. First, in what follows, this relatively new theoretical perspective will be supported and developed empirically. The consumptive regime of valuation
in the cocos market will be analysed in depth. Moreover, the paper aims to enhance our understanding of how financial markets function. It promotes the theory of financial markets which incorporates the crucial insight that *marketing constitutes markets*, i.e., that the ways financial markets are sold determine the value of financial instruments.

3. Data

The paper is based on the open qualitative research method approach. It draws on two sets of primary empirical data. The first set contains twelve semi-structured, in-depth interviews that were conducted with financial market professionals in the initial explorative phase of the EU project “Evaluation practices in financial markets” (EPIFM). Nine respondents manage equity and bond funds as well as balanced portfolios in the leading German asset management companies; they are responsible for both mutual funds and clients’ money. One respondent is the head of credits in a big investment company; the other one is responsible for a rather small equity fund in an investment boutique. The last but not least important interview partner was Ralf Frank, the chief executive of the German Association for Financial Analysis and Asset Management (DVFA). The respondents are located in Frankfurt/Main. All interviews were conducted face to face and lasted between 1 and 1.5 hours. They were digitally recorded and transcribed in full.

During the interviews, I used a semi-structured interview guideline. The initial guideline was designed to gain an understanding about how the valuation process is structured as a part of individual and organizational decision-making, how it is integrated into the daily routine of managers as well as into the institutionalized investment process, which theoretical tools are applied and which role judgment, intuition, social relations and networks play in the valuation. However, already in the second interview of this series (with the head of credits of a big German investment company) the issue of “impossibility of valuation” came up and cocos were discussed as a case in point. Subsequently, I adjusted the initial interview guideline and raised the question about the impossibility of valuation in financial markets in all subsequent interviews. The case of cocos was explicitly discussed as an example. Thereby, I collected data about how asset managers approach the difficulties of asset valuation in general and cocos’ valuation in particular. The motives of cocos’ buyers (primarily, institutional clients in this case) were discussed in detail.
Secondly, in order to better understand the existing formal valuation techniques that circulate in the cocos market, I drew from the available pieces of academic research (scientific articles, working papers and conference presentations). Research provided by the various investment houses was also very insightful. Finally, the professional financial press, notably *Financial Times* and *Handelsblatt*, was used as an element of triangulation.

The evaluation of materials included coding and categorising (Corbin and Strauss 2008).

**4. The failure of the calculative regime of valuation**

In this section, I will briefly explain why no ultimate solution for the problem of the formal mathematical valuation of cocos has been found so far. The academic world as well as market participants are equally irresolute about how to value contingent convertibles. Various formal suggestions have been developed and circulated in scientific journals and at conferences. “The existence of different valuation methods should not be a surprise because a coco is a hybrid security sitting between equity and debt on the balance sheet of the bank. A CoCo valuation model can find its roots both in equity derivative or fixed income mathematics.” (Spiegeleer and Schoutens 2011: 13)

Institutional investors draw on existing suggestions from academia to develop an individual valuation technique, an *idiosyncratic formal model* to roughly estimate “if a particular coco bond is fairly valued” (interview with the Head of Credits, asset management company, Frankfurt/Main):

> We built our model. The others build different models. There is no standard model around here.

The users of such idiosyncratic valuation models of cocos as well as finance academics explicitly refer to particular impediments in valuing cocos. First of all, cocos bear huge uncertainty, rendering their valuation very difficult. Buergi (2012: 3) explains:

> The fair price of a contingent convertible is determined by various factors, which stand in interdependent relationships. Like every convertible bond, the coco can be decomposed into a bond and an equity part. As long as the coco has not been converted yet, it actually behaves like a normal straight bond paying a periodic coupon and redeeming at maturity. The risk of conversion could be compared to a default risk with no recovery at all. If the coco is converted, the value of this bond part correspondingly would become zero. But on the other hand, in such a case the value of the equity part no longer is zero but becomes...
positive. How many shares the coco investors receive and how much they are worth is determined by the conversion ratio and the stock price at the time of conversion. Summing up, both parts’ expected value depends for most part on the probability of conversion. If the probability of conversion is very low, the bond part accounts for the most of the coco's total value, whereas the proportion of the equity part is rather low. Vice-versa, the same is valid for a high probability of conversion.

However, the determination of the probability of conversion is a very tricky and uncertain enterprise. The uncertainty is, first of all, related to the various triggers that activate the mechanism of conversion. Currently, there are cocos with three types of triggers on the market - accounting trigger, market trigger and regulatory trigger. All of them bear different types of uncertainty.

In the case of the accounting trigger, i.e., when the tier-1 capital ratio falls below a particular pre-set level, the issuer can manipulate (“steer”) the disclosed capital ratio using various tricks of the balance sheet politics (e.g., through the definition and determination of non-performing loans). Furthermore, regulations concerning tier-1 capital ratios keep changing: In 2013, banks reported their capital ratio according to the Basel 2.5; from 2014, the Basel III (phase-in) is determinent; from 2019, it will be Basel III fully-phased; clearly, capital ratios will stay volatile in years to come and remain a very uncertain conversion trigger (Frank 2014). Thus, “no two banks’ capital requirements will be the same under the new regulations…” This means there is limited use in applying a formulaic approach to ranking the risks of a [coco] bond” (Thompson 2014: 24) and calculating their value. Valuation of cocos with an accounting trigger is also aggravated due to the difficulties of monitoring capital ratios as the relevant data are published only at the end of the quarter or of the half-year.

Though market triggers such as market capitalization or spreads are easier to monitor, they are even easier to manipulate, especially if the market becomes illiquid. Some researchers (Flannery 2009; McDonald 2011; Berg and Kaserer 2014) point out that the design of cocos might lead to strong incentives on the side of banks and their shareholders to manipulate the share price and even to force conversion.

In the case of the so called regulatory trigger, the regulator can judgmentally decide if the bank reached the point of non-viability (PONV) and trigger the cocos’ conversion into shares or write them down. The conditions under which regulators can exercise their power to activate the loss absorption mechanism are often not clear. Thus, also cocos with a regulatory trigger are subject to high uncertainty.
There are also “minor” triggers - such as the cancellation of the coupon prior the “major” trigger event - which are also essential for cocos’ valuation but difficult to estimate (interview with the head of credits, asset management company, Frankfurt/Main).

Moreover, the determination of the equity price to which cocos might be converted is nearly impossible. That leaves open the crucial parameter of every cocos valuation model - how much money investors get, or are left with, in case of conversion - remains under-determined.

In sum, all those uncertain factors influence the value of coco bonds in an unpredictable manner. Note that, in most cases, not the holder of cocos but the issuing bank or the regulator can decide – and, thus, influence and manipulate – when the bond should be converted or written down. Two major determinants of the cocos valuation – the probability of conversion, on the one hand, and the value of the coco at conversion, on the other hand - cannot be modeled straightforwardly, rendering the determination of the “fair” value of this instrument impossible.

It should be noted that the relative valuation of cocos is also difficult. The key condition for relative valuation is to find similar assets and to compare their valuation to each other; however, in the case of cocos this is not a trivial task. When comparing the already issued tranches of cocos to each other (within the asset class), one will notice that all banks designed their cocos differently (e.g., the trigger level of capital ratio varies between five and seven percent (Institutional Money Magazine 2014)), impeding the straightforward bond-to-bond comparison – and the valuation modeling in general. The bond manager (asset management company, Frankfurt/Main) explains:

There is no unified format. Rather, every land, every regulator has its own ideas. The trigger levels are different: there are some with seven [percent], some with five, there are some with eight. And there have been nine or ten issuances, all of them are different. The market is nascent, just establishes itself.

The relative valuation is also difficult because, as already mentioned, it is not completely clear to which asset class cocos belong. Still, many investors apply relative value analysis, comparing various cocos tranches to other subordinated debts (Gallo et al. 2014: 2); this approach is - though handy - not very convincing in light of the discussed peculiarities of contingent convertibles.

One asset manager (equity asset manager, Frankfurt/Main) neatly summarizes the discussion by asking: Given all those uncertainties can we reasonably value them? I share the thesis: we cannot reasonably determine the value.
Importantly, while institutional investors nevertheless make constant efforts to develop valuation models for cocos, private investors do not even bother with formal valuation. The head of credits (asset management company, Frankfurt/Main) said:

You know, I believe, many investors who buy those instruments do not have any model to justify the price. Those instruments are sold massively to private investors.

In fact, there are data that suggest that at least a fifth of investors in the cocos market are private clients (Gallo 2014); the Dealogic documents that retail investors and private banks even account for 52% of the market. Though the concrete numbers vary depending on the data source, the important role of retail investors is striking and was confirmed in the interviews. This means that a big share of cocos was bought by investors who even do not try to attach numbers to value and risks. The reason for this is their inability to understand the financial mathematics behind the various valuation techniques that circulate in the cocos market and academia (Buergi 2011).

Against the background of these considerations, the pertinent question arises: How do investors decide to buy cocos, how do they decide there is value – without valuing this asset exactly or not valuing it at all? How does investing become possible?

5. The consumptive regime of valuation

When I tried to discuss cocos in the interviews as a specific, or even unique, case of value without valuation, my interview partners became skeptical. They replied that valuation in their markets is impossible as well. “What is the value of an equity?” asked the equity fund manager. The bond fund manager also said in the interview:

You do not have to go to the extreme [e.g., cocos] – the very normal bonds are difficult to value nowadays because everything does not depend on market conditions but on the political decisions of the ECB.

The actual situation in the bond market is exceptional and cannot be approached with formal models, according to my interview partner. The other bond manager referred to the difficulties of estimating the recovery ratio of some government bonds, for example, of Ukrainian or Greek bonds: “Everything here depends on political arbitrariness”.

Those observations suggest that the problem of “impossible valuation” in financial markets is rather ubiquitous and should constantly be solved: “That would point to
an interesting feature of 'impossible valuation' as the feature that categorizes financial instruments and defines investment ecologies, at the level of institutional investors for instance: equity fund managers have a mandate over the impossible valuation of shares, fixed income over bonds, arbitrageurs over volatility...This way non-knowledge [of value] is not merely a phantom but rather becomes a central feature of the architecture of markets” (Olivier Ah-Hot, ex-bond trader, private correspondence). How do market participants cope with this non-knowledge?

In the due course of my empirical analysis, I identified two ways of coping – “neglect” and “consumption”.

For some institutional clients, the impossibility of precise mathematical valuation of cocos is the definite impediment to invest in this asset. The inability to assess risks properly compels those investors to be very cautious and makes them neglect the cocos market. Usually, there is an institutional prohibition that legitimizes the “neglect” decision.

However, many investors cannot allow themselves to ignore this asset class because, in the current low-yield environment, they face severe difficulties to meet their performance targets. Asset managers respond to this yield appetite of clients. Responding to the clients’ needs, they start to form preferences and to “educate” clients:

Currently, everybody has a problem to generate a particular return. If a client comes, we usually say ‘Listen, we manage your money, we can make 0.3 percent return for you, no problem’. The client says then ‘Sorry, it is not enough. I need two percent.’ Then we have to say: ‘Ok, we cannot achieve two percent risk-free.’ Then he says ‘But I really need them’. Then we have to explain that there is a particular probability that it works but we have to take risks. There is always this pressure. Hence, we need risky assets (the bond manager, asset management company, Frankfurt/Main).

The willingness to invest in cocos depends on if and how clients are “educated” about risks in the concrete situations of interaction with their advisors or asset managers. Here, the investment object “emerges” as an object of consumption that is marketed in a particular way. Importantly, in this consumptive regime of valuation, all uncertainties that defer the mathematical valuation of cocos offer a chance for selling. Let us discuss some examples.

The impossibility to clearly classify cocos as bonds, equities or derivatives in formal modeling opens the opportunity to sell them as bonds: They are bonds that offer a lucrative yield. Indeed, yield is the prime selling argument allowing for the
very simple mathematics that everybody understands (7% coupon is higher than zero). The marketing idea behind cocos is that – in normal times – cocos behave like bonds and that normal times depict the most likely scenario. As a result, the probability of cocos conversion is undervalued or neglected. There has been no history that proves the opposite.

Selling cocos as bonds, investment advisors construct them as “high yield – low risk” products and induce clients to overlook or underestimate the complexity and risks of this product. In fact, roughly 70% of participants in the RBS survey on the cocos market named yield as the major stimulus to be invested in cocos and around 40% indicated that they invest in cocos because they consider the conversion unlikely (Gallo 2014: 2).

The brand of the cocos’ issuer, the degree of its familiarity to investors, also plays a significant role: The banks with established brands like UBS or Deutsche Bank are rather not expected to have difficulties with their capital ratio or the share price (though the financial crisis of 2008 teaches quite the opposite). Big famous banks are associated with financial solidity and solvency. Harrington (2007: 22) already recognized the role of brands in dictating investment choices, particularly pointing to amateur investors who buy or avoid stocks on the basis of brand associations: “People buy stocks in much the same way they buy consumer products like jeans and cars”, she reports.

The strong orientation towards brands also explains some peculiarities in the geographical structure of the cocos market, an interesting recurring theme across all interviews: there are clear geographical differences among the countries in the appetite for cocos, and this appetite has to do with the “nationality” of issuers, the magnitude of their marketing activities and trust in their brands. Though the variations in risk aversion between cultures are also important, the tendency to buy local brands is quite strong in the cocos market. A bond portfolio manager (asset management company, Frankfurt/Main) explains:

The Swiss banks are leaders in the cocos market. They received much stricter capital requirements from the local regulator and were allowed to fulfill them using the contingent convertibles. As a result, the Swiss banks became forerunners for this product. It is also why the Swiss banks market cocos much more aggressively, talk about them… And the client buys not because he needs it but because marketing suggests it to him. It is like with mobile phones. Why do so many people have an iPhone? Normal mobile would do as well. But if everybody says “this is the best, the coolest, you must have it”, they just want to have it.
Interestingly, German investors have been quite reluctant to buy contingent convertibles so far, supposedly because – up until the recent issue by the Deutsche Bank - there has been only one small national issue (by Münchener Merkur Bank, EUR 4m). Germans traditionally love their home brands and trust them. They famously lost a lot of money investing in the corporate bonds of small and medium-sized companies (Mittelstandsanleihen); they bought them because the German small and middle-sized businesses are positively connoted to investors and stand for seriousness, solidity and success; furthermore, the classification of such financial instruments as bonds (Anleihe) also helped to perceive them as rather secure, as an instrument with a favorable risk-return profile (Handelsblatt 2013).

Thus, the selling strategy translates the radical uncertainties about unfavorable events that influence the value of cocos into perceived impossibilities of those events and makes investments attractive. Here, the efforts to strictly calculate the probabilities of a trigger event are replaced by narratives about why conversion of cocos will rather not happen, why the regulator is not interested to pull the trigger, why coupon cancellation is rather unlikely, why big banks will rather fulfill requirements on their capital ratios and so on. This marketing-driven argumentation about cocos enables “jumping” over the gap of the unknown mathematical valuation. Simple yield comparisons, favorable classifications and brands help to establish an “investment object” that is “energized” by the clients’ interest and demand.

6. Consequences for the critical finance perspective

The above discussion of selling strongly recalls the post-crisis debate about dangers of risk ignorance and financial illiteracy of investors. Similar to the situation before the financial crisis of 2008, we are facing a (yet small) market segment where risks are relentlessly underestimated. This happens – similarly to 2007-2009 - because complex financial products that evade the straightforward formal valuation can be sold as simple and not risky (think of CDOs and ABSs). More generally, one can recently observe that hybrid capital becomes more and more risky but is marketed as more and more secure to investors who lack fundamental knowledge about those products. The above discussion about cocos suggests that we should pay attention to some nuances of this argumentation.

Selling efforts aim to make investors feel knowledgeable to a degree that they become confident in investing. An insightful study by Hadar et al. (2013) – with references to research in marketing and decision-making theory – demonstrates
that investors’ *subjective knowledge*, i.e. their *feeling* more or less knowledgeable about particular investment options, induces them to take more risk or to invest in complex products. At the same time, Hadar et al. stress “that providing consumers with relevant but complex product information can sometimes enhance their objective level of knowledge while paradoxically diminishing their subjective level of knowledge” and, hence, their willingness to invest.

Those considerations have consequences for the critical finance discussion of “strategic ignorance” and financial illiteracy. The socially produced ignorance of risks is based on *making investors feel secure and knowledgeable*. This ignorance, thus, represents, on the one hand, a danger of a severe financial loss for investors; on the other hand, it can be interpreted as an asset, a resource of the market, and not “a liability that can and should be overcome through increased education and access to information” (McGoey 2014).

The classification of cocos as a bond and support of cocos’ associations with the brand simplify the complex matter of valuation and contribute to the increase of subjective knowledge of market participants, their feeling knowledgeable; one could say that this strategy contributes to producing the illusion of knowledge. Astonishing facts can be found in the aforementioned RBS survey on cocos in this respect: “We asked investors to rate their understanding of cocos relative to the rest of the market. […] The survey showed investors are slightly guilty of hubris, with 90% of respondents rating themselves higher than the market. They cannot all be right” (Gallo et al. 2014: 1). In this situation, financial illiteracy that is frequently understood as a lack of statistical and mathematical skills might deserve less prominence in the debate because it is related to formal *objective knowledge*. All the efforts to introduce clients to complex possibilities of formal valuation of cocos might not change their willingness to invest. Their hubris will stay, and thus their engagement in the cocos market will continue. Thus, it is important how financial (il)literacy is framed and related to *subjective knowledge*.

In other words, it is crucial to understand not just which information circulates in the market (enough? correct?) but the factors that influence subjective knowledge as well as if and how this information influences investors’ *feeling knowledgeable*. For example, one should ask why all the warnings about cocos in the professional investment circles as well as in the financial press have not advanced to change the attitude of investors. In January 2014, for example, the RBS warned in a research note that many cocos had been mispriced, arguing that investors were ignoring the threat of being wiped out or converted into shares altogether; cocos differ in their risk characteristics from the regular bonds because one has to account for how they
behave in extreme stress situations. The *Financial Times* published a number of articles warning that “cocos are not bonds in nature” and that “we shouldn’t be marketing these to traditional bond buyers” (Thompson 2014: 24, my emphasis). Furthermore, cocos bond prospectuses usually provide very detailed information about the risks of investing in this particular asset class. Obviously, the financial press and prospectuses do not represent relevant channels through which subjective knowledge – and thus willingness or neglect to invest - is influenced. Selling efforts succeed more in this respect.

Importantly, the asymmetries in “seller – buyer” relationships do not necessarily relate to asymmetry of knowledge but to asymmetry of power. The findings of the paper about a dispersed, non-unified nature of formal valuation of cocos suggest that nobody in the market is in possession of knowledge about how to value this financial instrument. Here, we are confronted with a “symmetry of ignorance” which is characteristic for the situation of radical uncertainty (Karpik 2010: 30). But exactly this symmetry offers the opportunities to “govern” potential buyers by suggesting options for how to make sense of markets and products. Through using these opportunities, i.e., by suggesting product classifications, enhancing brands, visualizing risks and advertising financial instruments and services, power in markets is exerted – power to create and determine value in the *consumptive regime of valuation*.

### 7. Outlook

Discussing the case of the cocos market, the paper pointed to the importance of marketing and selling efforts in finance. It demonstrated that cocos simultaneously inhabit two regimes of valuation: calculative and consumptive. On the one hand, investors endeavor to find a formula for cocos valuation. The paper argues that our understanding of how the market for this new product functions would be insufficient if we were to focus only on this formal issue. It is important to pay attention to the consumptive regime of valuation in which investors behave like consumers and are susceptible to marketing efforts. Or, as the chief executive of the German Association for Financial Analysis and Asset Management (*DVFA*), Ralf Frank, suggested in the interview:

> To understand all this, we need a much stronger footing in consumer research because what is important is how things are really bought.
This has never been a question that bothered “high finance”. The paper argues, however, that it should. Though the precise mathematical valuation of all financial products is impossible, the case of cocos markets shows with a particular clarity how selling arguments complement - and compensate for - the lack of established valuation tools. Selling behaves like a “parasite” using the holes in the insufficient formal valuation as opportunities to influence potential buyers. It informs investors’ subjective knowledge and willingness to invest much stronger than formal calculation – and, by doing so, enables the market.

The paper clearly points to the under-researched field in critical and social finance – how marketing constitutes financial markets – and argues that this field deserves the attention of future research. Necessary are investigations that illustrate how consumptive regimes of valuation develop and penetrate attitudes and communication in the markets at various levels to enable investment activities. The interplay between selling efforts, formal valuation, objective and subjective knowledge should be in the focus of this research, contributing to our understanding of how market participants come to neglect or appreciate particular financial products and to form their value.

Certainly, future research should aim to overcome some limitations of the research design of the study at hand. My investigation is primarily based on the interviews with asset managers who buy (or refuse to buy) cocos for their clients. To move beyond this one-sided position, it is important to conduct interviews with other groups involved into cocos valuation, i.e., academics who develop valuation models, clients who buy (or not buy) this instrument, and financial advisors who effectively sell cocos. Ideally, selling efforts should be investigated in the very situation of selling (advising clients) based on participant observations, though, admittedly, the field access in this area is particularly difficult. Furthermore, more exact attention should be paid to “governance” and the behavior of amateur investors.

More generally, it is crucial that critical finance further opens itself to the currently prospering research on ignorance and critical marketing studies. In this alliance, the “consumptive finance” perspective discussed in this paper would certainly contribute to a better understanding of how financial products and their risks are evaluated in modern financial markets.
8. References


