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A DISCUSSION OF HYBRID SECURITIES

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By guest contributor Elaine Li, analyst, Atchison Consultants

We have recently seen some robust discussions by commentators and investors in response to ASIC Chairman Greg Medcraft's view about hybrids and their suitability for Australian retail investors. Mr Medcraft was quoted as saying that hybrid securities were a "ridiculous" product for retail investors. We think given these comments it would be an opportune time to have a closer look at hybrid securities in the context of their suitability as an investment proposition for retail investors.

The basics

Hybrid securities are financial instruments which feature both debt and equity characteristics. These characteristics impact the performance of the hybrid securities, with a significantly higher volatility of returns compared to what standard "vanilla" unsecured debt investments typically provide. This volatility reflects the greater credit risk taken on as well as the volatility from the equity exposure and listing on the stock exchange. (Many Australian hybrids, but not all, are listed on the ASX. Some are issued in offshore markets.)

Under Basel III rules, capital used by authorised deposit-taking institutions may include the following sources which are ranked in order of security of capital.

- Deposits
  - Retail
  - Wholesale
- Senior Debt
  - Senior secured/covered bonds
  - Asset-backed securities
  - Senior unsecured
- Tier 2 Capital
  - Subordinated debt
  - Hybrid
- Tier 1 Capital
  - Tier 1 compliant hybrid capital (i.e. subordinated contingent perpetual/"CoCos")
  - Equity capital (common equity tier 1)

Hybrid securities can be thought of as consisting of two components:

- a fixed income component and
- an equity component

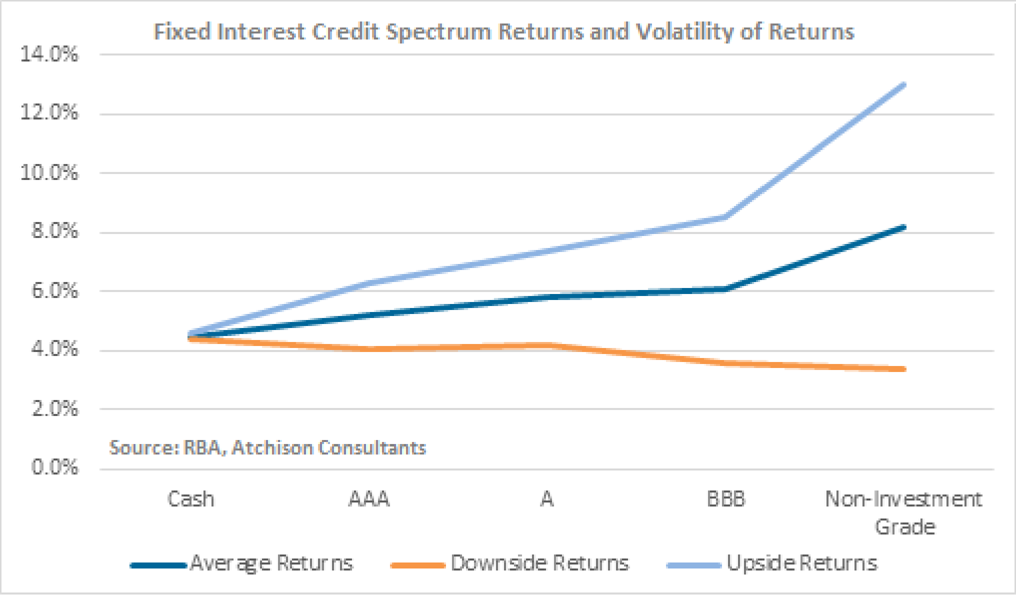
Consequently, returns and risks of hybrid securities resemble a combination of returns and risks of fixed income and equities.

Within a company's capital structure, hybrid securities are ranked lower than debt securities, which indicates hybrid securities will carry a higher level of credit risk. Being part-equity, hybrids' returns are expected to exhibit greater volatility. In other words, returns on hybrid investments will vary more from year to year.

Enhanced returns from defensive investments such as hybrids or bonds, can be achieved through exposure to term, credit and liquidity factors, with each factor contributing to a required premium above the cash rate.

Credit risk is defined as risk of permanent capital loss, reflecting the security of capital provided by the borrower. In Australia, prime security is provided by Government (AAA-rated) and the spectrum of credit rating is from prime through various investment grades to non-investment grade (BB+ and below). Given identical term and liquidity, securities with higher credit risk are usually priced in a way as to generate higher expected returns. However, this comes at a price; the range of returns is wider.

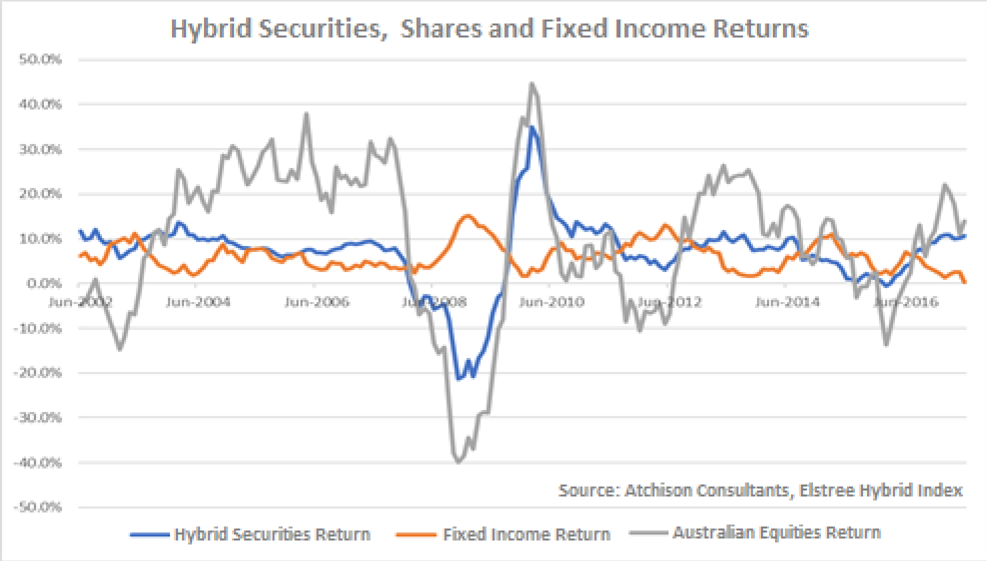
The chart below the average yield/return, variation in yield/return and consequential volatility of returns from securities (3 year tenors) with varying credit ratings.



While bonds and hybrids share some similarities, bonds and hybrids vary in terms of pricing, volatility of returns and liquidity. Bonds are principally traded on the over-the-counter (OTC) market where direct access and price transparency is not readily available to non-market participants. In contrast, listed hybrids are directly available to the general public, are priced continuously on the stock exchange and they are subject to constant price fluctuations. Bonds can be an illiquid asset as was evident during the GFC when distressed sellers could not attract buyers for some securities. In contrast, listed hybrids are relatively liquid assets, reflecting access to a broader number of participants. All of the above divergences will contribute to very different short-term returns between bonds and hybrids.

The chart below shows the returns of hybrid securities, fixed income securities and Australian equities over the last 15 years.

Rolling Annual Returns (15 years to June 2017)



Over the assessed periods, the average return of hybrid securities has always been in between the returns of fixed income securities and Australian shares. However, strong positive correlations were seen between hybrid securities and Australian equities when share prices experienced significant changes, which was evident over the period of 2008 to 2010. This behaviour was the result of hybrids' conversion clauses which contained maximum conversion ratios.

In summary, hybrid securities normally show mixed features of fixed income securities and equities. Retail investors must consider the equity conversion characteristics and its impact on the defensive nature of the asset, particularly in periods of market stress.