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With yields of up to 13 per cent, no wonder investors are turning to hybrids

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With interest rates at a 49-year low, investors are turning to the hybrids market - where attractive yields abound.

With interest rates at a 49-year low, many investors are turning to the hybrid securities market – where double-digit running yields (cash yield on the current price) are available for investment-grade issues (defined as those rated BBB- or higher by Standard & Poor's or Baa3 or higher by Moody's).

Hybrid securities are the centaur of the sharemarket world – they are so named because they are a mix of debt and equity. They are issued by companies to raise capital. They offer investors a predictable rate of return or dividend for a set period, usually until a maturity or conversion date: the return may be fixed or floating, determined by a margin over a market rate, usually the bank-bill rate. The hybrids rank behind traditional debt obligations but ahead of equity.

At maturity, a hybrid may convert to ordinary share, cash, or a mixture of both, or may be 'reset' for another term. But the terms of conversion are up to the issuer.

The major risk associated with hybrid securities is default risk – the risk that the issuer will cease to pay coupons, or be unable to pay the principal upon maturity. Credit ratings reflect this risk.

Also, interest rate movements may affect the value of the hybrid, and price movements of the underlying shares can have a pronounced impact – both positive and negative.

Hybrids are attractive to many retail investors at the moment because they offer a yield premium for the credit rating, augmented, in many cases, by franking benefits; as well as a discount to face value – which in many cases can be expected to close before maturity, when the issuers will redeem the issues at face value. Being unable to access the wholesale corporate bond market, many retail investors will find them the best yields on offer in the marketplace.

At the top of the tree, hybrids rated A- to A+ offer running yields in the range of 6.4–9.8 per cent. Compare that to the crème de la crème of fixed-interest securities, AAA-rated Commonwealth Government bonds, which are trading at about 2.43 per cent on a one-year Commonwealth Government bond, 3.59 per cent on a three-year, 4.15 per cent on a five-year and 4.52 per cent on a 10-year bond.

Hybrid yields comfortably outstrip those available in the similarly-rated corporate bond market, where A and A+ bonds such as Suncorp and Telstra are trading at around 2.00–2.5 per cent over the 90-day bank bill swap rate (BBSW), which is

currently 3.20 per cent, meaning a range of 5.2–5.7 per cent.

In the semi-government bond market issues rated AA+ are trading at about 0.50 per cent over 90-day BBSW, or at 3.7 per cent.

Further up the risk spectrum, hybrids rated BBB-, BBB and BBB+ – that is, still in investment-grade territory – are offering anywhere up to 21.5 per cent running yield.

Brad Newcombe, senior research analyst at specialist fixed-income broker FIIG Securities, says some of the running yields on offer in the hybrid market look "incredibly attractive" at the moment because of the leverage to the bank bill swap rate (BBSW). "The hybrids really got smashed last year: they got hit well after equities. The result is that a lot of these issues are trading at less than half face value. If you've got a hybrid that has halved in value, the running yield on the coupon has doubled. Then, as interest rates come up, you're going to get at least twice the leverage to BBSW if they increase."

There is also the potential "kicker" of the capital gain inherent in the security returning to face value, says Newcombe – which is captured in the yield-to-maturity. "Many hybrids are 'step-up' securities, where there is an automatic interest rate increase if the issuer does not redeem the security on a certain date. Some of these have arrived at call dates and the companies have worn the step-up. Economically, that might still be cheap for the company in the current environment, but we would argue that at some point in time that's going to become very expensive, and the companies will want to redeem their hybrids at face value, which is typically $100.

"For example, we expect the corporate step-up hybrids such as Paperlinx (PXUPA), Multiplex (MXUPA), Ramsay Healthcare (RHCPA), Seven Network (SEVPC), Santos (STOPB) to be redeemed at $100. If you look at that in terms of yield-to-maturity, PXUPA, at $36, is offering a yield to maturity of 48.94 per cent, and MXUPA, at $33.50, is offering 141.90 per cent. They're high-risk hybrids, but with potentially exceptional returns."

Investors who don't wish to take corporate risk to that extent, he says, can stick to the likes of the Westpac Trusts and the CBA PERLS 3. "They're names everyone knows, they're rated A+, they're offering 7–8 per cent, you're getting exceptional returns for relatively low-risk exposures, and you're going to get the face value of those hybrids back at some time in the future."

Steven Wright, head of fixed interest at ABN AMRO Morgans, says some of the more recent bank hybrids have cash running yields of 6.5 per cent, which if you take into account the franking credits, gives a gross yield getting up over 9 per cent – triple the cash rate.

"For the rating of the security, it's a far better yield than an equivalent security. Take the Suncorp-Metway (SUNPB) hybrids. At the market price of $79, that gives you a cash running yield of 6.5 per cent, a grossed-up running yield including franking of about 9.3 per cent (assuming the 30 per cent company tax rate), and if you take into account a return back to $100 at conversion, the yield to maturity rises to about 13.9 per cent. That's pretty good for a security rated A-.

"There are quite a few like that, they look very attractive, and you don't have to go out the risk spectrum to get those kinds of returns," says Wright. "You really don't have to go outside A-. The grossed-up yields start to look extremely attractive, particularly for a super fund paying a pension, where the income is untaxed."

Newcombe says FIIG prefers hybrids that are unfranked, "Say you can get an unfranked issue paying 10 per cent, or a franked issue paying 7 per cent. We would say that it's better to get four quarterly coupons of $2.50 in cash than four quarterly coupons of $1.75 in cash, and then an extra $3 that you don't collect until you file your tax return. We just think it's advantageous generally to have unfranked hybrid issues."

Michael Saba, head of equity derivatives at Evans & Partners, cautions against focusing on the yield to maturity, because investors can't assume that all step-up securities will be redeemed. "When these issues were done, the step-up rate was set during the bull market, and spreads were very narrow – the step-up penalties were roughly 1 per cent for banks and 2–2.5 per cent for industrial companies.

"Now in this environment, that's frankly not much of a disincentive: we've seen two issues come up to the step-up date – Australand and Gunns – and both have chosen to step-up rather than repay. In an environment in which funding is incredibly difficult, it's quite an escape clause for companies to keep the financing in place and just pay the extra coupon, because it then becomes an undated security, with the company having the option to pay back at any distribution date.

"I think there are a number of step-ups – for example, Fairfax FXJPB), Futuris (FCLPA) and Paperlinx (PXUPA) – where investors can see that the companies are under stress on the balance sheet, and funding is tight, and who knows where it will be when it gets to the step-up date. A lot of investors just aren't willing to take the bet that they'll be repaid, and they've shied away from them."

But Saba believes that the hybrid sector is "going to have a massive year," for a host of reasons. "There are two main things going on. As cash rates have come down these things have become a massive alternative, because investors getting 2–3 per cent in the bank are looking for alternatives, and hybrids have come on to the radar screen.

"Going forward, equities probably won't be as popular, and there will be asset allocation decisions to interest-rate-style securities – whether that be bonds, corporate bonds, hybrids."

Saba also believes that hybrids will become the "de facto corporate bond sector" in the Australian market. "The corporate bond market in Australia is terrible, spreads are wide, hardly anybody's making markets, you can't issue into it, fixed-interest fund managers per se are all struggling, retail investors can't access it directly. I think issuers are starting to realise, why not tap the huge retail investor base that exists in hybridland, and list these kinds of securities so you get more transparency as well. I really think we're going to see this segment become the marketplace for corporate bond issuance."

Tabcorp Holdings Limited appears to agree: last month, it launched the Tabcorp Bonds, an ASX-listed fixed-income security, priced at 4.25 per cent above the 180-day bank bill rate: at 31

March 2009, this implied an initial interest rate of 7.39 per cent a year. The Tabcorp Bonds offer closes on April 24.

"Tabcorp is the first genuine retail corporate bond that has come along, an issue ranking equally with senior debt, with no equity component at all," says Saba. "It's the closest thing to a corporate bond that has been listed in the hybrid market for a long time. Rather than being unsecured, it's unsubordinated, it ranks along with senior debt, so it's a lot higher up the tree than a hybrid."

Wright agrees that the Tabcorp Bonds issue is likely to spark strong interest. "Even though it's not a bank, and it's a BBB+ issue, it's going to be very attractive, because it's very simply a cash yield: all your return is cash, there's no franking credits or anything like that. Investors like that simplicity."

Newcombe says FIIG's top five picks at the moment are:

IAG Finance New Zealand (IANG), price $63.48, rated A-: running yield of 6.70 per cent and a yield to maturity of 59.06 per cent, which he describes as "exceptional return for an A- rated security";

Macquarie CPS Trust (MQCPA), price $95.00, rated BBB: running yield of 12.10 per cent and a yield to maturity of 13.74 per cent, which he says is "particularly valuable for the high fixed-rate coupon";

Southern Cross Airports Holding Corporation (SAKHA), price $59.99, rated BBB-: running yield of 9.32 per cent and a yield to maturity of 26.35 per cent, and "excellent value for low risk";

Seven Network (SEVPC), price $80.00, unrated: running yield of 8.33 per cent and a yield to maturity of 26.35 per cent, and FIIG's "preferred corporate hybrid, due to low risk and high potential reward: likely to be redeemed at face value at step-up date of 31 May 2010."

Westpac TPS Trust (WCTPA), price $75.00, rated A: running yield of 6.72 per cent and a yield to maturity of 11.20 per cent, the highest of the major bank hybrids.

Saba likes:

Orica Limited (ORIPB), price $65.40, rated BBB-: running yield of 6.85 per cent and de facto internal rate of return (yield to maturity) of 20.70 per cent

Commonwealth Bank PERLS 3 (CBAPB), price $177.00, rated A+: running yield of 4.72 per cent and de facto internal rate of return (yield to maturity) of 5.12 per cent

Woolworths Limited (WOWHB), price $87.90, rated BBB: running yield of 4.91 per cent and de facto internal rate of return (yield to maturity) of 6.96 per cent

Macquarie Airports (MAZPA), price $102.85, rated A+: running yield of 6.30 per cent and de facto internal rate of return (yield to maturity) of 12.09 per cent.

Wright's top picks are:

ANZ Bank CPS (ANZPB), price $93.00, rated A+: running yield of 7.44 per cent and yield to maturity of 8.65 per cent.

Commonwealth Bank PERLS 4 (CBAPB), price $171.49, rated A+:

running yield of 5.85 per cent and yield to maturity of 10.07 per cent.

Suncorp-Metway CPS (SUNPB), price $79.99, rated A-: running yield of 9.29 per cent and yield to maturity of 13.89 per cent.

Westpac SPS (WBCPA), price $95.00, rated A+: running yield of 7.03 per cent and yield to maturity of 8.14 per cent.

Macquarie Airports (MAZPA), price $100.86, rated A+: running yield of 6.42 per cent and yield to maturity of 13.23 per cent.

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