



Hybrid power

Assess the risks of hybrid securities against their price says Peter Freeman

INTEREST RATES MAY HAVE RISEN IN the past six months but investors who need income are still being offered relatively modest rates on bank deposits. Even online accounts are paying only 5% or so without any bonus, while getting much more than 6% for one year on a quality term deposit is often difficult.

In these circumstances it is likely some income investors will be looking to boost their overall cash flow by directing part of their money to stock exchange-listed income securities.

While these include relatively straightforward securities such as corporate bonds and convertible notes, there is also the option of buying what are generally referred to as hybrids (see report at right).

Examples range from those issued by such mid-tier companies as Gunns and Transpacific Industries (ASX hybrid codes GNSPA and TPAPA respectively) to those issued by the major banks, such as ANZ and Westpac (ANZPA and ANZPB and WBCPA and WBCPB).

But Brad Newcombe, a senior research analyst with fixed interest firm FIIG Securities, cautions that anyone who invests in hybrids at the moment needs to focus carefully on whether the return is sufficient to compensate for the risks involved.

According to Newcombe, only a relatively small number are worth considering. Two possibilities are the Australand Assets Trust (AAZPB) and Multiplex Sites Trust (MXUPA), he says. The limited choice reflects two things – a strong rise in the price of hybrids and the continued risk of a double-dip global recession.

Nine months ago, when Savvy Investor first spoke with Newcombe, virtually all



NEED TO KNOW

How the securities work

The vast bulk of listed hybrid securities offer investors an interest rate set at a margin above the so-called bank bill swap rate, a rate that is just a bit higher than the Reserve Bank's official cash (currently 4.5%).

Most also incorporate the option of converting the securities into ordinary shares at a set time in the future using a conversion formula. In this way they incorporate the features of both debt securities and equities, hence the name hybrids.

That hybrids are far from being safe and steady investments was highlighted by the global financial crisis, which hit them hard. It also showed that the market is not very deep – they don't attract many investors,

which can make it hard to sell hybrids at a reasonable price.

In a number of cases it also reminded investors that the income payments can be suspended by the issuing company. This option is even available in the case of the Commonwealth Bank's PERLS or Perpetual Exchangeable Resettable Listed Securities.

What's more, like many hybrids, PERLS are non-cumulative – if an income payment is missed it is not added to later payments.

Finally, should the company issuing the hybrids fail, investors holding them – while ranking ahead of shareholders – have to get in line behind depositors and other creditors when it comes to getting their money back.

hybrids were trading at attractive discounts to their issue prices and so were offering very high yields and the potential for longer-term capital gain.

Not any more, with most mainstream hybrids recently trading at a premium, which means you have to pay more than their issue price, something that is rarely if ever advisable.

Given the risks associated with all hybrids, buying at a reasonable discount – say around 20% – is the only way to have a chance of getting really good value.

Not that this is a recipe for automatic success. This is because the discount is often due to a fundamental problem with the security. For example, this is the case at present with the hybrids issued by listed rural services group Elders.

Its hybrids (ELDPA) are trading at a 40% discount to the issue price but this partly reflects the financial difficulties of its parent company, which forced it to make a big capital raising, resulting in income payments on its hybrids being suspended until November 2011.