

Big returns carry a risk

Investors should be prepared for a variety of yield rates from hybrids, writes **John Wasiliev**.

Investors should be wary about expecting sizeable capital gains from hybrid securities on a regular basis. There can be good reasons why hybrids trade at a discount to their issue price.

The main one, says Brad Newcombe from FIGG Securities, is that the issuing company may not be able to pay distributions.

When Elders and PaperlinX suspended distributions their prices retreated between 40 and 55 per cent of their issue price.

The PaperlinX hybrid recently resumed distributions and the price rallied subsequent to this announcement.

Elders is not expected to resume paying income until December next year. When it does, the running yield is expected to be about 25 per cent, says Newcombe.

The reason it is potentially a high-risk investment is that the company has indicated it will not be making up the June 2009 distribution it missed from the recently raised \$550 million of new capital.

This refinancing has nevertheless reduced the company's financial risk.

PaperlinX has now completed its refinancing and offers a running yield of about 12 per cent with the potential for large capital gains when the security is either redeemed on June 30, 2012, or is stepped up to pay an even higher coupon.

A second reason some hybrids

are discounted relates to money raised when interest rates were lower. Since the global financial woes struck, interest rates for those wanting to raise capital have increased sharply.

They only needed to pay between 1 and 2 per cent above the bank bill rate before the global credit crisis. But many borrowers now pay 4 per cent or more.

Newcombe says hybrids that only pay 1 to 2 per cent above the bank bill rate were regarded as paying an inferior return, which resulted in prices being discounted so that the returns match the income being paid by higher paying investments.

A fair return at the present time for many bank hybrids is considered to be about 3 per cent above the bank bill rate, with a higher rate expected from corporate hybrids. Any investments paying less have been discounted to bring them into line.

Among the banks, the Commonwealth Bank's PERLS 3 are a long-standing buy. The securities recently attracted analyst recommendations that led to a price rally, which reduced their appeal.

A similar security offered by Westpac – the Westpac Trusts (WCTPA) – is also attractive.

In the medium-risk group, Seven Network hybrids recently stepped up its income to pay 4.75 per cent over the bank bill rate. At a current price of less than \$80 – which equates to a running yield of more than 12 per



Brad Newcombe issues a word of caution on yields. Photo Glenn Hunt

Elders is not expected to resume paying an income until December next year.

cent – it is ranked as a buy by FIGG securities.

As far as strategies for including hybrids in a portfolio are concerned, both Matthew Scholten of Godfrey Pembroke and Tom Murphy of Family Office Research & Management reckon they should be treated as long-term buy and hold investments.

Scholten favours major bank hybrids and is also comfortable with offerings by second-tier banks like Suncorp and Bank of Queensland for their higher potential yields.

He reckons capital gains should be treated as an extra benefit that is received when the investment either matures or is sold.

Investors with reasonable savings like a do-it-yourself super fund might own six to eight different hybrids with individual investments representing 2 to 3 per cent of their portfolio.

Hybrids that pay franked dividends are especially attractive for small super funds, in particular those in pension phase that can claim the tax credits as extra income, Scholten says.

Murphy says the most important thing from a hybrid is reliable income which is why he avoids any that look like they won't pay their income.

He sees hybrids as being mainly for comfortably-off investors rather than very wealthy ones. That's because it is easier to buy and sell smaller parcels of hybrids than large holdings.

Assess individual products before buying

There are different categories of hybrids. And individual hybrids within each category can have different features.

This means each hybrid should be assessed independently before purchase so you know what you are buying, says FIGG Securities senior analyst Brad Newcombe.

You must also understand the business that issues the hybrid, says Clime Investment's John Abernethy. That means knowing how it makes money and generates the cash to service its debts.

Below are the main hybrid categories.

Income notes and securities

These are true perpetual securities and were the original hybrid.

They have no maturity date, or a long maturity. They usually pay floating rate income on a quarterly basis and while the issuer normally has the option to call – or redeem them for their face value – on any payment date, it is unlikely they will ever be redeemed. The only way to get

your money back is to sell them on the market.

The prices of perpetuals have been adversely affected by a more difficult interest rate environment for borrowers, but the risks of not being paid income are very low.

Examples: Bendigo Bank (BENHB), Macquarie Group (MBLHB), National Australia Bank (NABHA) and Suncorp Metway (SUNHB). The Macquarie product is ranked as offering the best value.

Reset preference shares

These are typically fixed rate preference shares with a coupon rate set for a defined term, normally five years. At the end of this period, either the preference shares are redeemed or a new fixed coupon rate is set. Most of these investments have gone through at least one reset, which is fully franked.

A feature of these hybrids is an option for holders to request their money back at the end of five years. This means the prices are trading at close to the issue price as there is little risk investors will get their money back.

Examples: Bendigo Bank RPS

(BENPA), Bank of Queensland (BOQPA), IAG Reset Preference Shares (IAGPA) and, Suncorp Metway RPS (SUNPA).

Converting preference shares

These hybrids are preference shares that convert into the ordinary shares of the issuer after a defined period of time, assuming certain conditions.

Most offer the issuer the option of redeeming them for cash, but

You must also understand the business that has issued the hybrid.

equity conversion is usually the default option.

These are the most likely hybrids to be issued in the future, especially by banks as they satisfy the capital rules for banks.

Most offer reasonable value for more conservative investors.

Examples: ANZ (ANZPA & ANZPB), Westpac (WBCPA & WBCPB) and Commonwealth Bank PERLS 4 & 5 (CBAPB & CBAPA).

Step-up preference shares

They are the most common type of hybrid issued by companies and normally pay a floating rate coupon over the bank bill swap rate with a redemption date after a defined period, such as five years. If these securities aren't redeemed at the first call date, then the coupons "step up" to a higher rate to compensate investors for non-redemption. They then become perpetual in nature.

When they were originally issued, the idea was that the step-up would increase the cost of funding to a rate that encouraged the borrower to redeem the investments. However, higher

interest rates resulting from the credit crisis made a number of them still competitive at the stepped-up rates.

Examples: Elders SPS (ELDPA), Fairfax SPS (FXJPB), Goodman Plus (GMPPA), Orica SPS (ORIPB), and Woolworth's Notes (WOWHB).

Stepped-up preference shares

Stepped-up preference shares have passed the step-up date and pay a higher coupon above the original coupon. They are perpetual, although the issuer can redeem them on any future coupon payment date. Some are trading at reasonable discounts with the higher income they pay and the possibility they could be redeemed when interest rates are more favourable – identifying them as opportunity investments.

Examples: Multiplex Sites (MXUPA), Australand Assets Trust (AAZPB) and Gunns Limited (GNSPA). One addition at the end of May was the Seven Group hybrid (SVWPA) with its recently stepped up 4.75 per cent income return above the bank bill rate. John Wasiliev