

# UP FROM UNDER

Hybrids tend to be marketed as debt instruments, but they have equity features – so they too sank during the financial crisis.

Report: Katja Buhner

● Hybrids were meant to offer the best of both worlds: equity characteristics to benefit from a rising sharemarket and debt traits to shield from a downturn. But this reputation faltered during the global financial crisis as the turmoil in global markets pushed the value of most listed hybrids under water.

Hybrid securities provide an income stream through the steady payment of coupons, or distributions, and are listed on the Australian Securities Exchange. They often contain an equity component that provides the option to convert into shares or get the original investment back in cash at a set date.

Hybrids were sold off during the crisis amid concerns the securities wouldn't be redeemed when they fell due or distributions would be cut.

Of the 30-odd hybrid securities listed on the ASX, two-thirds are trading below their face value. Fixed-income experts say the asset class is appropriately priced at present, but many are still wary of the instruments.

"Like a lot of levered risk, hybrids were significantly underpriced before the GFC and investors weren't being paid for the risk they were taking," Perpetual head of credit Michael Korber says. "I'd say they're closer to their

intrinsic value now rather than being cheap."

He says that because hybrids are close to the bottom of the capital structure, there is a high probability of volatility in strong credits, like the banks, and loss among some of the weaker corporate names.

"Hybrids are a highly leveraged play and that's how people should treat them in their portfolio," he says. "They're not a fixed-income substitute."

There are several kinds of hybrids. Income notes and income securities either have no maturity date or a long period until maturity. They typically pay a floating rate of return and are unlikely to be repaid at payment dates.

Step-up preference shares are the most common type of hybrid. While also paying a floating coupon, if they are not redeemed on their first call date, the interest rate steps up to a higher rate to compensate investors and penalise issuers.

As there is no major benchmark index tracking hybrids returns, it's difficult to compare their performance against other asset classes.

FIG Securities director Brad Newcombe says leading bank hybrids are offering annual returns of 7.5 per cent, compared with returns on regional banks of between 8 and 10 per cent.

Returns for stepped-up property trusts range between 10 per cent and 12 per cent, while corporate hybrids can deliver returns in excess of 15 per cent, he says.

UBS wealth management head of investment strategy George Boubouras says despite attractive returns, hybrids are not a substitute for fixed-income exposure.

If not a replacement for debt, Newcombe says hybrids could be substitute for equity in a portfolio. "In a lot of instances, you're getting equity-like, double-digit returns for lower risk because hybrids sit higher up the capital structure," he says.

While losses on hybrids pale in comparison with those on the sharemarket during the credit crisis, the falls still startled some investors.

A hybrid by Elders is currently trading at \$41, while another by Ramsay Health Care is fetching \$93. Both have a face value of \$100.

UBS has strict limits on hybrid exposures, Boubouras says. For investors with a moderate risk tolerance expecting a balanced return of about 9 per cent, the weighting to investment-grade hybrids is 4 per cent. He describes hybrids as deeply subordinated securities that tend to be marketed as income assets when they in fact have a lot of equity components.

Newcombe says the stepped-up hybrids, such as Multiplex Sites and Gunns Forests, offer the best value with running yields of 12 per cent.

Returns could also be boosted by interest rate rises and capital upside as companies redeem securities that are trading at a discount, he says.

Newcombe adds that retail bond issuance will gradually replace hybrid securities as investors favour simpler structures and securities with a set maturity date that sit higher up in the capital structure. **BRW**

## HYBRID SECURITIES: A SAMPLING

Company name	Last sale \$	Coupon % pa	Conversion/ Maturity date	52-week high \$	52-week low \$	Face value \$
ANZ Banking Group	102.80	5.60	Dec 15, 2016	103.40	99.00	100
Australand Assets	83.40	9.64	Undated	90.50	58.00	100
Bendigo & Adelaide Bank	99.10	6.16	Nov 1, 2012	102.60	95.00	100
Gunns Forests	66.50	6.92	Undated	81.00	50.55	100
Multiplex Sites	74.50	8.74	Undated	86.90	51.99	100
Seven Group Holdings	80.60	6.79	May 31, 2010	88.99	75.20	100

Source: AFR