The Frontier Line

The case for Australian hybrids

Issue 198 | **September 2022**

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About us

Frontier has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice on $600 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

Andrew Kemp
Principal Consultant

Andrew Kemp joined Frontier in 2016 as a Senior Consultant before being promoted to Principal Consultant in 2018. He is the head of the Debt and Currency Team, leading Frontier's fixed income and currency research program. Andrew has around 20 years of experience in the asset management industry both domestically and globally, having worked in Australia, Singapore and the UK.

Prior to joining Frontier Andrew worked for a decade at Alliance Bernstein Australia as a fixed income portfolio manager, spent three years as Head of Fixed Income at DBS Asset Management in Singapore and then joined Chimera Capital as Director of Asset Management, primarily in Singapore. Andrew holds a Bachelor of Commerce (Finance) from Otago University (NZ) and a Graduate Diploma of Applied Finance and Investment from Finsia.

Iain McMahon
Senior Consultant

Iain McMahon joined Frontier in 2019 and is a Senior Consultant in Frontier's Debt and Currency team. He is currently responsible for investment advice and manager research across debt, currency and alternatives strategies. His coverage also includes derivatives advice.

Prior to joining Frontier, Iain spent seven years at J.P. Morgan in a range of risk management functions. Four of these years were based in London providing quantitative and qualitative portfolio analysis as a Market Risk Manager. Prior to working in London, Iain worked on a Sydney trading desk in an operational capacity. He holds a Bachelor of Commerce (Finance) and a Bachelor of Science (Statistics) from the University of Melbourne. He is also a CFA charterholder and a Certified Financial Risk Manager (FRM).

Introduction

Hybrid securities are found across investor portfolios whether retail or institutional, yet their perceived attractiveness can differ. Core fixed interest investors observe the additional risk in hybrids, whereas equity investors are attracted to the additional income and perceived capital stability relative to listed shares. Ultimately hybrids are a mid-risk asset class more closely aligned with the credit asset classes.

In a three-part series we will unpack the various types of hybrid securities, examine the benefits of a hybrid allocation and the risk considerations and offer practical implementation observations. Hybrid securities can take a number of forms and for the purpose of this series we categorise the market into a number of groups broadly represented by; Australian domestic hybrids, global convertible bonds and capital securities.

Frontier's research program monitors the Australian hybrids market and maintains forward looking capital market assumptions specific to hybrids for portfolio modelling. This first paper in our series focusses on the risk and return characteristics of Australian hybrid securities and contrasts these characteristics to traditional debt and equity securities. The intention is to explore the merits of either a tactical or strategic allocation to hybrid securities.

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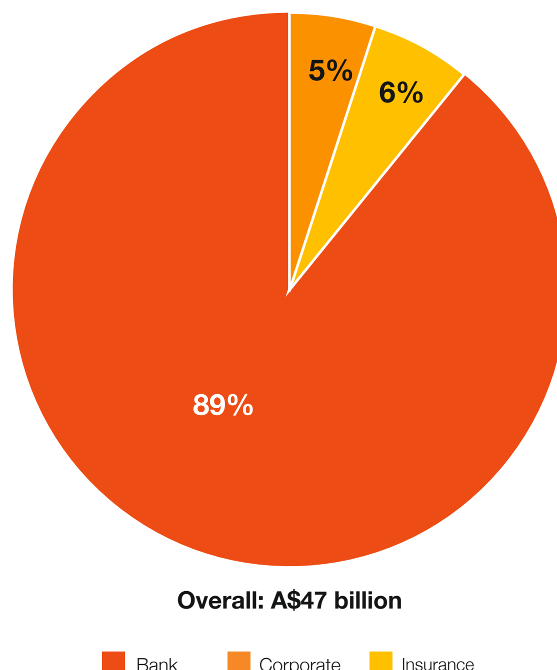
Defining Australian hybrid securities

Hybrid securities are financial instruments which combine elements of both debt (i.e. bonds) and equity securities. They are typically issued by banks seeking various levels of regulatory capital relief, or by other institutions with complex capital structures.

In Australia, hybrids can be listed or unlisted and typically promise to pay a rate of return (either fixed or floating) until a certain date, the same way a bond does. Hybrids also have a range of other characteristics and risks, discussed in this paper, and are typically subordinate to other forms of debt in the event of insolvency. Hybrids have higher rates of return than bonds to compensate investors for these risks, and in some cases franking credits are available which can be valuable for certain investors.

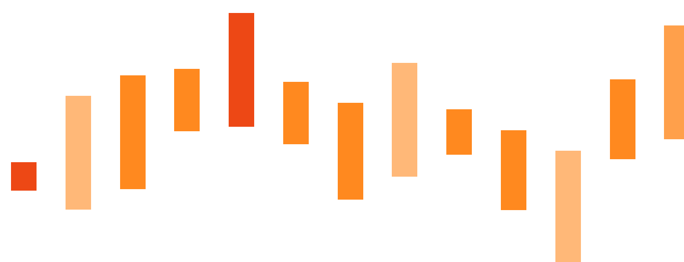
Chart 1: Composition of Australian hybrid issuance by market capitalisation



Overall: A$47 billion

Bank Corporate Insurance

Source: Frontier, ASX



Credit risk: Are all hybrid issuers created equal?

Credit risk is the risk the issuer is unable to fulfill its financial obligations (defaulting on future income and principal payments). It is largely determined by the financial strength of the issuer and will therefore differ across issuers. Issuers of hybrid securities in Australia are typically either domestic banks, insurance companies or corporates.

All else equal, hybrid securities originating from less creditworthy issuers are accompanied by higher spreads as compensation for assuming increased credit risk, yet for the large bank issuers it is typically the level of subordination and structure rather than the credit quality concerns that drive pricing.

Motivations for issuing hybrids differ by issuer

Bank

Satisfy APRA regulatory capital requirements and provide loss buffer on variability in value of assets.

Insurer

Satisfy APRA regulatory capital requirements reflecting funded status (potential variability in value of their liabilities).

Corporate

Provide access to diversified funding (without diluting existing equity, nor increasing debt by the same magnitude as traditional issuance).

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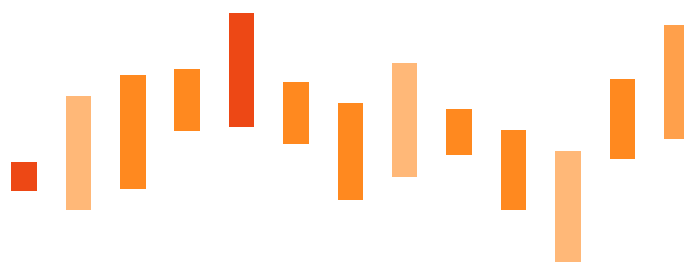
The structuring of hybrid securities can be complex

The Australian hybrid securities market evidences a high degree of heterogeneity in issuance structures. ASX listed floating rate securities are most prevalent. While these structures are often perpetual, they are typically accompanied by callability or convertibility clauses every three to five years. Some structures are also subject to reset/step-up of coupon rates, which impact the income potential of the security. A range of other investor protections exist, ensuring coupons are paid ahead of dividends for common equity holders. These complexity risks are unavoidable and must be reviewed before investing in each security.

Table 1: Characteristics of hybrid structures

	Ordinary shares	Unsecured bonds	ASX hybrids
Legal form	Ordinary share	Debt obligation	Preferred share
Income	Variable dividends	Fixed or floating coupon	Fixed or floating coupon
Franking credits	Yes	No	Yes
Discretionary distribution	Yes	No	Usually no
Term	Perpetual	Fixed	Usually fixed
Convertible	No	No	Sometimes
Embedded option (call/put)	No	No	Sometimes
Reset/step-up	No	No	Sometimes

Source: Frontier, ASX.



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Measuring the risk and return potential of hybrids: What are investors compensated for?

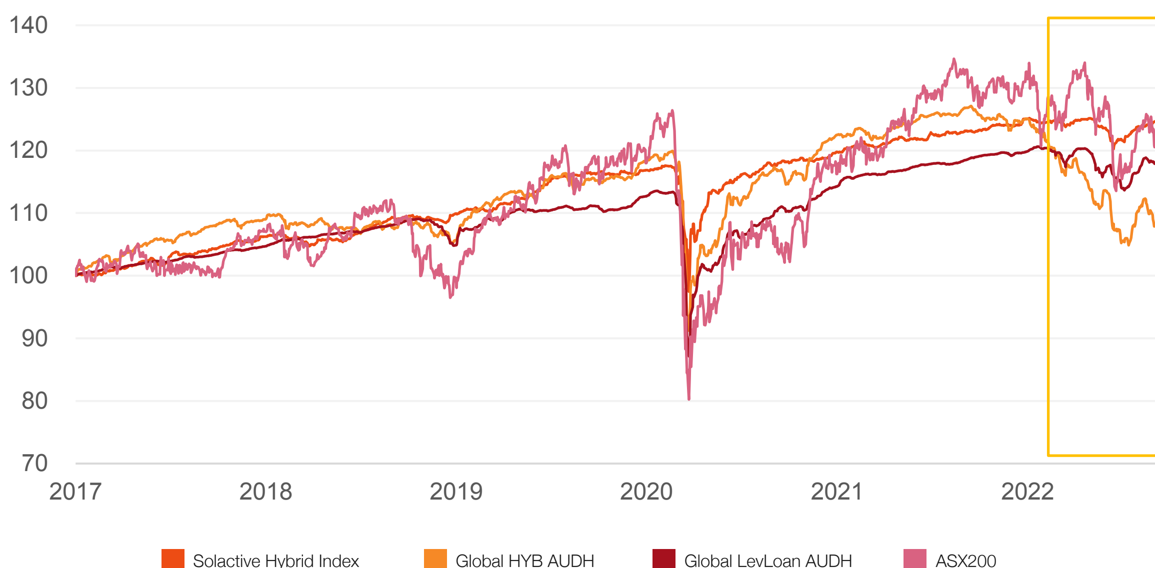
Market risk: 'equity like' in stressed environments; 'bond like' in normal conditions

Market risks and performance are highly dependent on the underlying structure of each hybrid security and the prevailing market environment.

- Debt obligations have limited capital appreciation potential (i.e. bound by a par value) but provide coupon income. Their prices are impacted by interest rate risk (and changing market yields). This impact is dependent on whether they are fixed or floating. Floating rate hybrid issues are most prevalent and interest rate risk (duration) is typically modest.
- Hybrid securities are either listed on exchange (i.e. ASX) or traded 'over the counter'. Their prices are therefore susceptible to shifts in market sentiment and supply/demand factors. This manifests in higher levels of sensitivity to equity markets than traditional bonds, resulting in greater price dislocation during market stress. This was evident during the initial COVID-19 period, when hybrid securities exhibited a pronounced drawdown comparable in magnitude to underlying equity markets.
- In 2022 hybrid securities have performed better than comparable credit asset classes (e.g. high yield bonds) less effected by rising rates given their floating rate bias, and widening credit spreads.

Given the equity sensitivity and drawdown potential, Frontier regards hybrid securities as an inappropriate allocation for a traditional fixed income configuration (which is predicated upon defensiveness). For institutional investors, these securities are more likely to reside within an Alternative Debt allocation, alongside comparable mid-risk credit assets.

Chart 2: Drawdowns align with other asset classes, yet some divergence notable in 2022



Source: Frontier.

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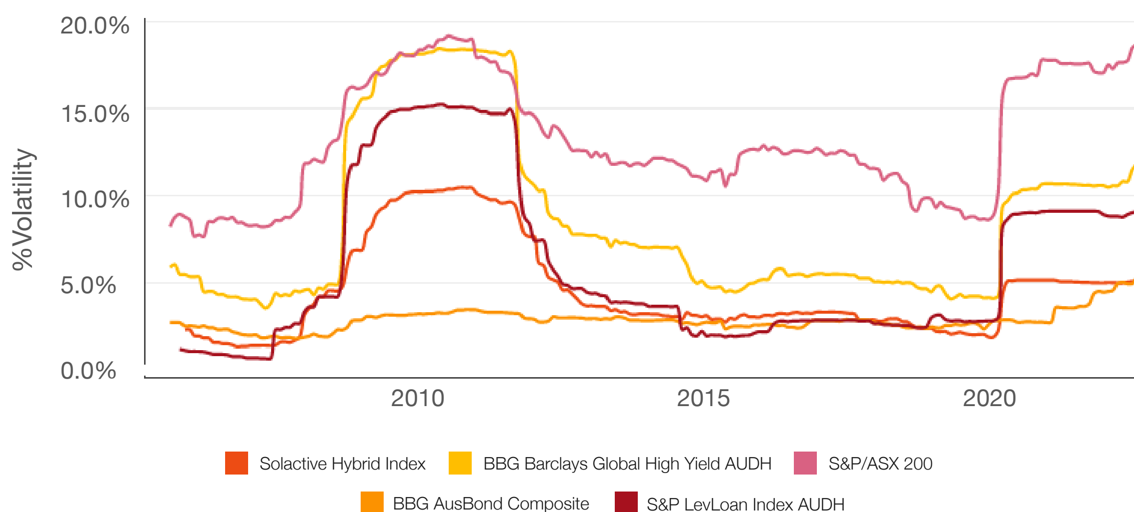
Market risk: Volatility versus other asset classes

The risk relativities between hybrid securities and mid-risk credit assets are relevant for all investors looking to make efficient allocation decisions. The volatility of hybrid securities is broadly comparable to other sub investment grade credit allocations (namely leveraged loans and high yield bonds). For strategic allocations, the return outlook for hybrid securities relative to credit should be a key consideration for investors. For more tactical allocations the extent of price dislocation observed in hybrid securities relative to credit should also be considered given this can significantly improve the total return available.

Chart 3: Three year rolling volatility of Australian hybrid securities



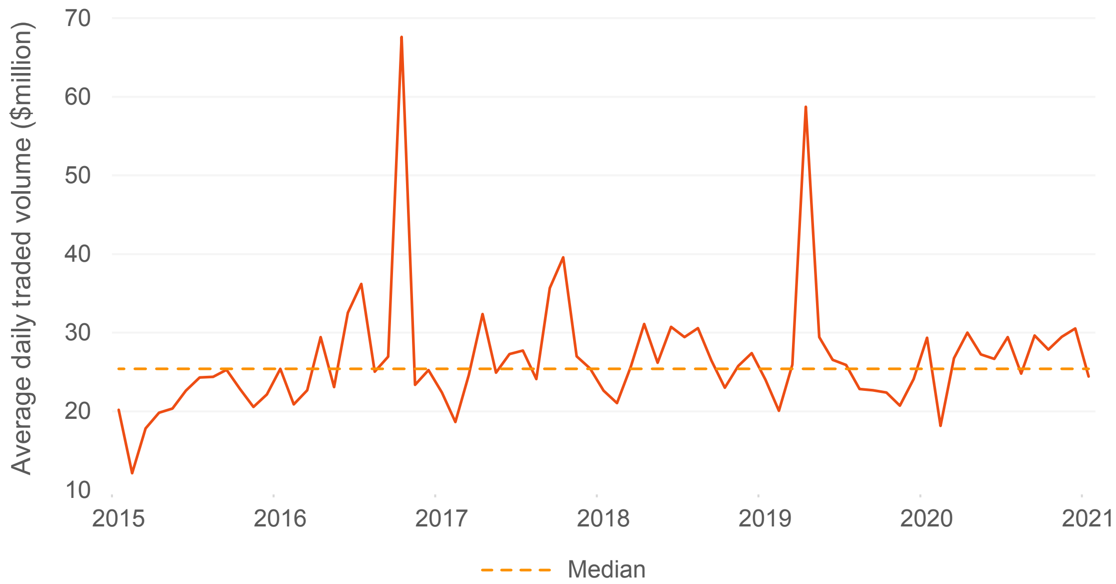
Source: Frontier, Bloomberg. Volatility calculated using monthly return series (underestimating market volatility during COVID-19). Aus Hybrid Index is represented by a blended return series using Solactive and Evans & Partners benchmarks.

Liquidity risk: The difficulty of tactical implementation

While issuance of hybrid securities has grown in recent years, hybrids still account for a relatively small proportion of the Australian debt market (at approximately A$47b of outstanding issuance). Liquidity risk is therefore a key concern, which is evident in modest average daily trading volumes (of approximately A$30m compared to over A$10b in US high yield) and wider bid-ask spreads (particularly in comparison to traditional debt and equity instruments).

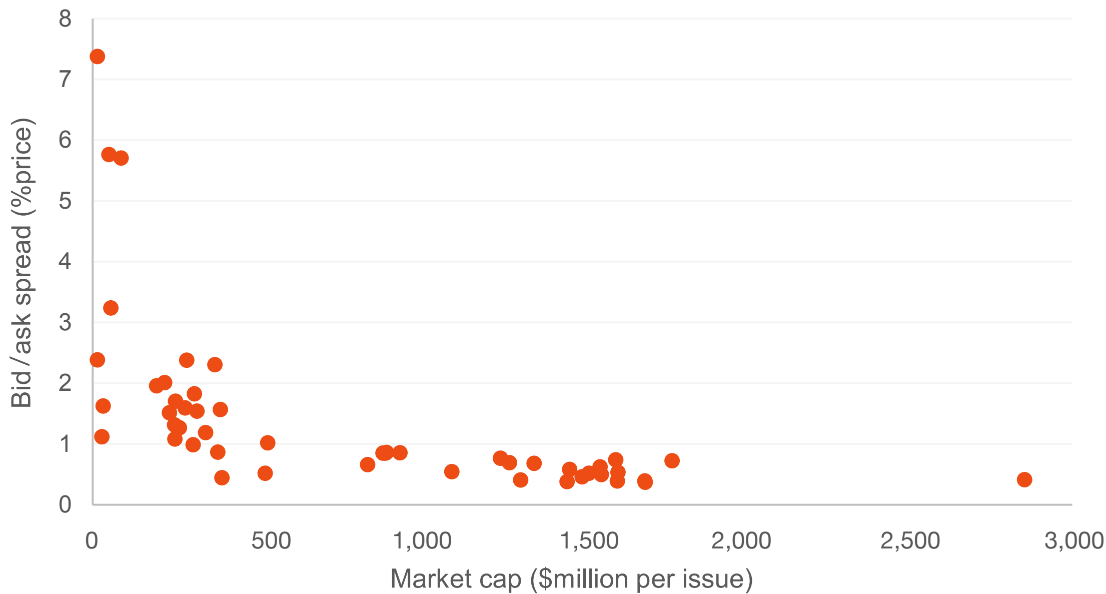
Given the limited turnover, strategic held-to-maturity investments are most common for institutional investors. This means the entry level is a critical consideration for long-term holders. Investors who can access primary market issuance will also likely be able to source significantly larger sized parcels. Tactical tilts for larger investors may be more difficult, with sizing more conducive to retail participation. Turnover does however increase in stressed environments and it is these instances where additional allocations can be accumulated for tactical buyers.

Chart 4: Traded volumes of listed Australian hybrids are modest, with higher volumes observed in periods of stress



Source: Frontier. Bloomberg. Calculated using monthly volumes and volume weighted average prices.

Chart 5: Average bid-ask spreads of Australian hybrids during March 2020 (COVID-19)



Source: Frontier. ASX. Maximum bid-ask spreads observed were temporarily several multiples higher (~5x) intra-month.

Varying degrees of liquidity exist between each hybrid security, with bank-issued hybrids typically evidencing higher market capitalisation and tighter bid-ask spreads on account of their larger issuance sizes. Depending on the underlying security and market environment, highly asymmetric bid-ask spreads or even the absence of a liquid two-way market may be possible. This behaviour during peak market stress is broadly consistent with that observed in other sub-investment grade credit markets. Investors should be aware the ability to always enter/exit investments at a 'fair' price may not be possible.

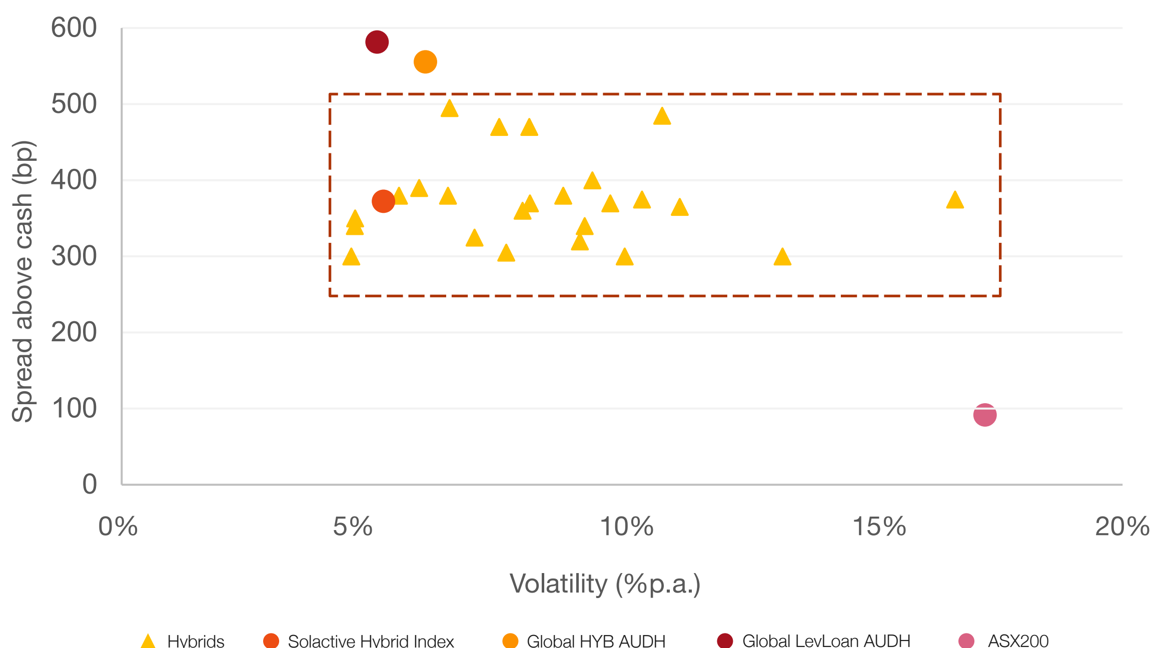
Regulatory changes may impact parts of the bank hybrids market – ASIC's design and distribution obligations for issuers

ASIC's regulatory guidance extends to selected banking products including primary market hybrid issuance. The impact of this guidance is heightened governance requirements by issuers concerning the suitability of product design for consumer outcomes. Issuers must also take reasonable steps to ensure their product is distributed within its defined target market. Accordingly, the willingness of banks to sell bank hybrids in the new issue market to non-advised retail investors may be lower under the new regulations. This means a more sophisticated 'wholesale' investor base will own new bank hybrids. While hard to be definitive on the impact of these regulations, the lower retail ownership may reduce the subsequent 'flight to quality' selling in stressed environments in the future.

Relative value: are there better opportunities in other credit asset classes right now?

Hybrid credit spreads differ by issuer, structure, and other characteristics which means certain segments offer better value than others. In the current market environment spreads across credit asset classes are either at or above long-term averages and this is also somewhat true of parts of the hybrids market. Recent performance of the hybrids market has been superior to other credit asset classes and accordingly the observed credit spreads have not widened to the same magnitude. This has been good for relative returns but should give investors pause for thought as they look ahead.

Chart 6: Dispersion of hybrid spreads relative to credit and equity income



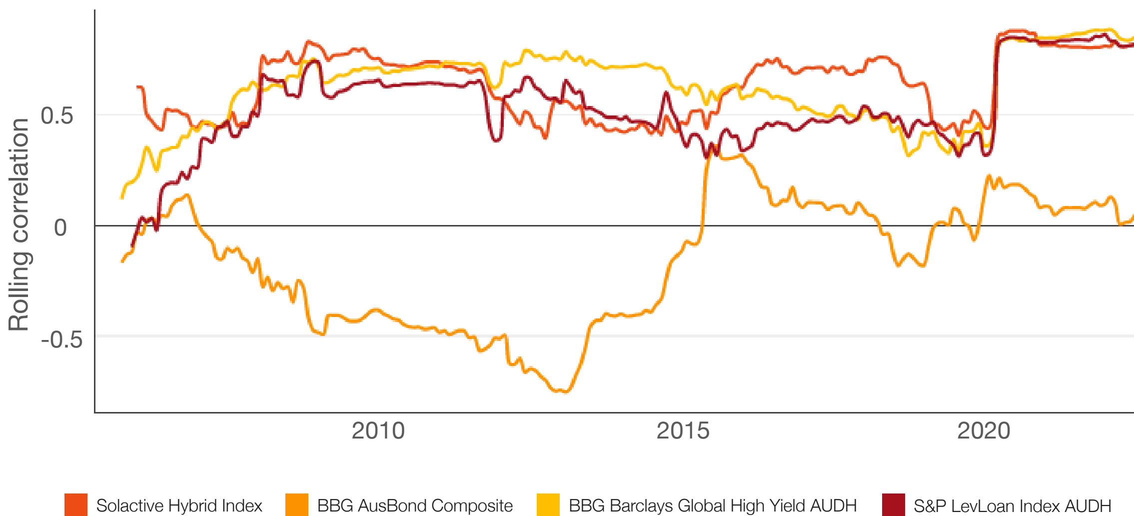
Source: Frontier, Bloomberg. Volatility calculated using 5-year lookback and daily returns. ASX200 spread is indicative of annualised implied dividend yield less cash.

Correlation to equities

Australian hybrid securities evidence marginal diversification from equities but there remains a degree of directionality with equity markets. This diversification is broadly comparable with other liquid mid-risk asset classes. There is a tendency however, for all these assets to become increasingly correlated to equities in periods of market stress.

Current hybrid market performance has been aided by relatively buoyant equity market returns. Accordingly, this has proven to be a tailwind for hybrid securities which have sidestepped much of the interest rate and credit spread widening that has been so impactful for returns in other credit asset classes. Whether this can continue remains to be seen.

Chart 7: Three year rolling correlation versus S&P/ASX 200



Source: Frontier, Bloomberg. Solactive Hybrid Index is represented by a blended return series using Solactive and Evans & Partners benchmarks.

The final word

Hybrid securities are a mid-risk asset (with both debt and equity characteristics) and therefore are not substitutes for a traditional fixed income allocation.

They evidence greater complexity, higher sensitivity to equity market performance and lack the defensive properties of government bonds. The inclusion of hybrids in a balanced portfolio, should therefore be considered in the context of other mid-risk assets, including credit and subordinated debt.

The ability to source institutional sized allocations in the primary market is considered an advantage when investing in Australian hybrids. Secondary market liquidity can be modest making position re-sizing problematic for institutional investors. A range of managed funds and ETFs are available with varying liquidity terms offered.

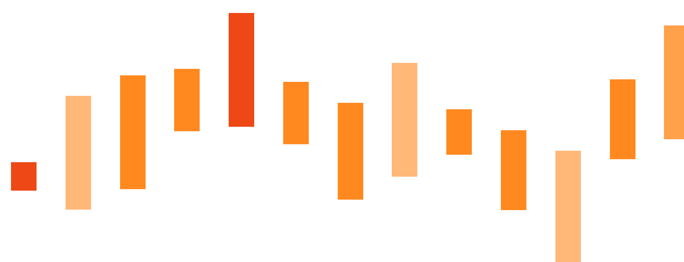
From a tactical perspective, periodic equity market driven dislocations can occur, strengthening the return potential for nimble investors. In such instances, return enhancement is composed of both income potential (exceeding cash by some margin) and likely capital appreciation as prices recover. Historically price recovery following stressed periods partially reflects the strength of balance sheets (i.e. credit risk) of Australian issuers (which are typically well capitalised, government supported banking institutions). Australian hybrid securities are also typically floating rate instruments more conducive to the recent increasing interest rate environment.

The forward outlook for hybrids remains uncertain and the correlation to equity markets highly susceptible to risk sentiment. However, parts of the hybrid market have certainly begun to reprice recently to more attractive levels. This repricing has been amplified in other segments of the corporate credit market where valuations have also improved within historical ranges.

In conclusion, we support investments in Australian hybrid securities, albeit note that more prevalent and scalable implementations include Australian hybrids as a subset of a broader credit portfolio.

Want to learn more?

If you want to learn more about Australian hybrids can help. Please reach out to your consultant or a member of the Debt and Currency Team.



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