PHILO CAPITAL ADVISERS

Risk in hybrid securities alarms ASIC

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Retail investors chasing yield by investing in complex hybrid securities may be taking on more risk than they bargained for, says the Australian Securities and Investment Commission, which is widening its focus on the fast-growing segment to include the intermediaries who sell them.

Hybrids are financial instruments that combine equity-like and debt-like characteristics.

They offer a regular interest payment, like bonds, but there are a variety of terms and conditions that can move the hybrid a lot further along the risk spectrum, until they begin to resemble equity more than fixed interest.

Features such as long and extendable maturity dates, the potential to defer interest payments and triggers for conversion into ordinary shares suggest there are hidden risks behind the attractive headline rates.

ASIC is not suggesting that hybrids are "dodgy", but that less sophisticated investors may not be able to judge the amount of risk they are taking on, and whether they are being compensated properly for that risk.

ASIC is also concerned that despite the complexity of the products, it is retail investors, and those managing their own super in particular, who have embraced hybrids.

Companies have sold more than $18 billion worth of ASX-listed hybrids between late 2011 and mid-2013, ASIC reports, with the vast majority to individuals.

Even more concerning for the regulator, is that two-thirds of these retail investors have been buying them for their self-managed super funds.

When you start putting the elements together – investors, searching for income, loading up on complex securities that offer attractive high yields – a worrying picture emerges.

When you add the fact that the "smart money" has mostly stayed away, alarm bells start ringing, not just in the halls of the regulator, but also among seasoned market observers, such as Challenger's head of retirement income solutions, **Jeremy Cooper**.

"When you see a lot of individual investors swimming outside the flags, and the institutions are not out there swimming with them, you get nervous," Cooper says.

The relative lack of institutional investors in the hybrids sector is enough to suggest the issuers – primarily the banks – can get away with offering lower yields than the riskiness of the hybrid warrants.

"It's been a big concern of ours for quite a long time," says **Hugh Dive**, head of listed equities at Philo Capital Advisers.

"If you look at the two most recent issues by ANZ and Westpac in July, they were sold with very attractive headline rates, but the investors were not getting compensated for the amount of time that they were locking up their money."

Of course, these are ASX-listed products, so investors can buy and sell them in the secondary market. But Dive points out that they need to be valued initially against the alternatives – in this case other 10-year unsecured senior debt offered by the banks.

Research by Philo Capital suggests that the hybrids market as a whole looks "very" overvalued against what they believe is fair value (see chart).

Dive says these recent issues from ANZ and Westpac were only "a whisker" above ordinary equity in terms of the protection to holders.

He argues that investors would be better off buying the banks' ordinary shares at about 8.2 per cent, including franking credits. The hybrid issues offered 3.40 percentage points above the bank bill swap rate (which sits at about 2.53 per cent).

The corporate cop's latest report is boldly headlined: "ASIC continues crackdown on hybrids" and follows similar warnings issued in August 2012 and November 2011.

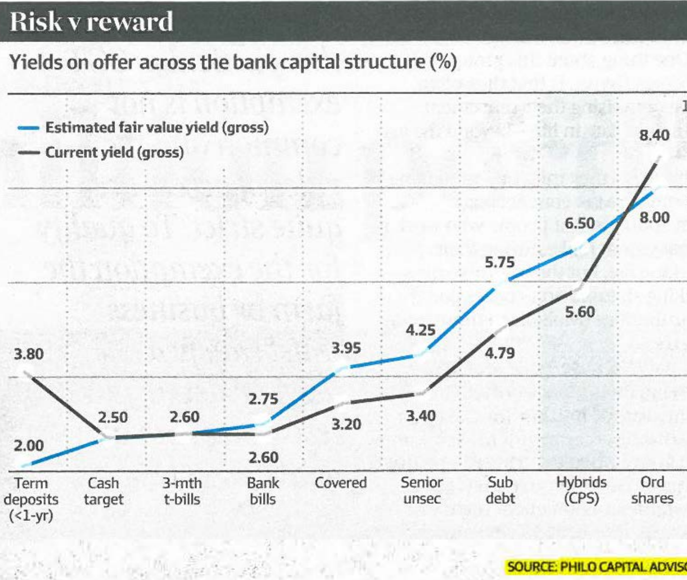
Central to the findings is the view that the naming conventions of hybrids are far too opaque and although ASIC is doing a lot of hopping up and down, there is no actual evidence of shady or outright illegal practices.

ASIC says it is examining "possible misleading conduct in the sale of hybrids", particularly in sales materials rather than the actual issuance documentation.

Potential offences include "inappropriate labelling of hybrids and unwarranted comparison of hybrids to different, less risky products", such as covered bonds or senior debt, and "spruiking the potential higher returns of hybrids and the brand name or reputation of the issuer without balancing that with the risks of the product".

ASIC is also looking into ways to ensure investors understand the risks involved, possibly including the requirement that they pass a quiz before handing over their money.

And, yes, says ASIC, there might soon be an app for that.



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