THE CASE FOR HBRD

BetaShares
Active Australian Hybrids Fund (managed fund)
(ASX Code: HBRD)

NOVEMBER 2017

A Better Way to Invest in Hybrids: the Case for the BetaShares Active Australian Hybrids Fund (managed fund) (ASX CODE: HBRD)

Due to their attractive franked income returns, usually relatively low capital volatility, and ready availability through the Australian Securities Exchange (ASX), hybrid securities have been a popular choice with Australian retail investors over recent years. Hybrids are unique in that that they have both bond and equity features and, as such, provide a unique diversification opportunity to investors along the risk-return investment spectrum.

That said, compared to traditional bond and equity investments, hybrids are relatively more complex securities to understand and value, and trade in a relatively less liquid market dominated by retail investor activity. Accordingly, it would seem to make sense for many investors to gain access to the unique risk and return features of hybrids through a professionally run, actively managed fund, as this provides not only diversification and risk management benefits, but better buying power and expertise to take advantage of market mispricing opportunities over time.

With this in mind, BetaShares has teamed up with one of Australia's leading managers in this asset class, with particular expertise and a good track record in trading within the local hybrids market. The result is the BetaShares Active Australian Hybrids Fund (managed fund) (ASX Code: HBRD).

Hybrids: attractive returns with only moderate capital volatility

Hybrid securities are neither traditional bond investments nor equities. As the name implies, they share the risk and return features of both to varying degrees, depending on the specific terms and conditions attached to the hybrid security in question.

Compared to traditional bonds, for example, hybrids usually offer less security of regular income returns, less certainty of when capital will be returned, and greater "credit" risk given they rank only above shareholders in the capital structure. Indeed, particularly with regard to hybrids issued by Australia's banks, investors face some risk of full or partial capital loss in the (unlikely) event that a major bank suffered severe financial difficulty.

That said, hybrids are still relatively less risky than shares, as they are higher in the capital structure, and generally offer greater prospect of regular income payments and repayment of capital at a future date. They also offer franking credits like shares, which are not available via bond and cash investments.

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THE CASE FOR HBRD

CHARACTERISTICS OF HYBRIDS VS. OTHER INVESTMENTS

Relative certainty of income payments and capital return

High — Moderate — Low

	Bonds	Hybrids	Shares
Income payments	Obligation to make regular known payments. If not made the bond defaults	Usually regular known payments. Can be paused at discretion of issuer	Many but not all shares offer sheduled regular dividend payments, though timing and amount remain at discretion of company
Capital Return	Obligation to return initial investment capital (bond's "par" value) at fixed future maturity date	Usually does not have fixed maturity date (known as "perpetual" hybrid). Capital can be returned at issuer discretion at set future "call" dates or converted to shares	No return of capital from issuer.
Term to maturity	Fixed term	Usually no fixed -term, though issuer often has option but not obligation to redeem at certain future "call" dates	No fixed-term

Source: BetaShares

In exchange for these particular characteristics, hybrids securities have been able to offer attractive income returns for usually only moderate levels of credit risk or return volatility.

As seen in the table below, for example, the grossed-up (i.e. inclusive of franking credits) running yield on a representative index of hybrid securities was around 5.3% p.a. as at end-October 2017, compared with only 3.0% p.a. for Australia's benchmark fixed-rate corporate bond index. The income return has also been only moderately lower than that for the Australian equity market and financial shares in general, but with considerably less return volatility – especially in the more stable post financial crisis period.

RISK AND RETURN CHARACTERISTICS OF HYBRIDS VS. OTHER INVESTMENTS: 31 OCTOBER 2017

Investment Exposure	Yield	Volatility Since Mar'07	Volatility Since Jun-10	Max Drawdown
Australian Large-Cap Stocks[1]	5.7%	13.9%	11.5%	-16.7%
Australian Major Banks Stocks [1]	8.0%	19.0%	16.6%	-25.8%
Australian Hybrids [2,3]	**5.3%**	**6.0%**	**3.1%**	**-3.8%**
Australian Government & Corporate Fixed-Rate Bonds[4]	2.5%	2.9%	2.8%	-3.6%
Australian Corporate Fixed-Rate Bonds[4]	3.0%	2.1%	1.8%	-1.7%
Australian Bank Floating Rate Bonds[4]	2.4%	0.9%	0.9%	-0.5%
Australian Cash[5,6]	2.0%	0.5%	0.3%	0.0%

Investment Exposure utilises the following indices (in order of appearance): S&P/ASX 200 Index; S&P/ASX 200 Major Banks Index; Spliced index series using Evans & Partners All Bonds & Hybrids ASX Index prior to February 2012 and Solactive Australian Hybrid Securities Index from February 2012; Bloomberg AusBond Australian Composite Bond Index; Bloomberg AusBond Corporate Bond Index; Solactive Australian Bank Senior Floating Rate Bond Index; BetaShares Australian High Interest Cash ETF (ASX Code: AAA).

1.Trailing 12-month gross dividend yield; 2.Running yield (including franking); 3. Spliced index series using Evans & Partners All Bonds & Hybrids ASX Index prior to February 2012 and Solactive Australian Hybrid Securities Index from February 2012 (including franking); 4.Yield to maturity; 5. 12-month distribution yield; 6. Due to limited historical data, volatility of AAA's return proxied by the Bloomberg Bank Bill Index.

Volatility is annualised standard deviation of monthly returns to end-October 2017.
Maximum drawdown (largest peak-to-trough decline) based on daily return series from 14-Feb-2012 to 31-Oct-2017.

Source: Bloomberg. You cannot invest directly in an index. The benefit of franking credits will vary depending on an investor's tax situation – please consult your financial adviser for more information.

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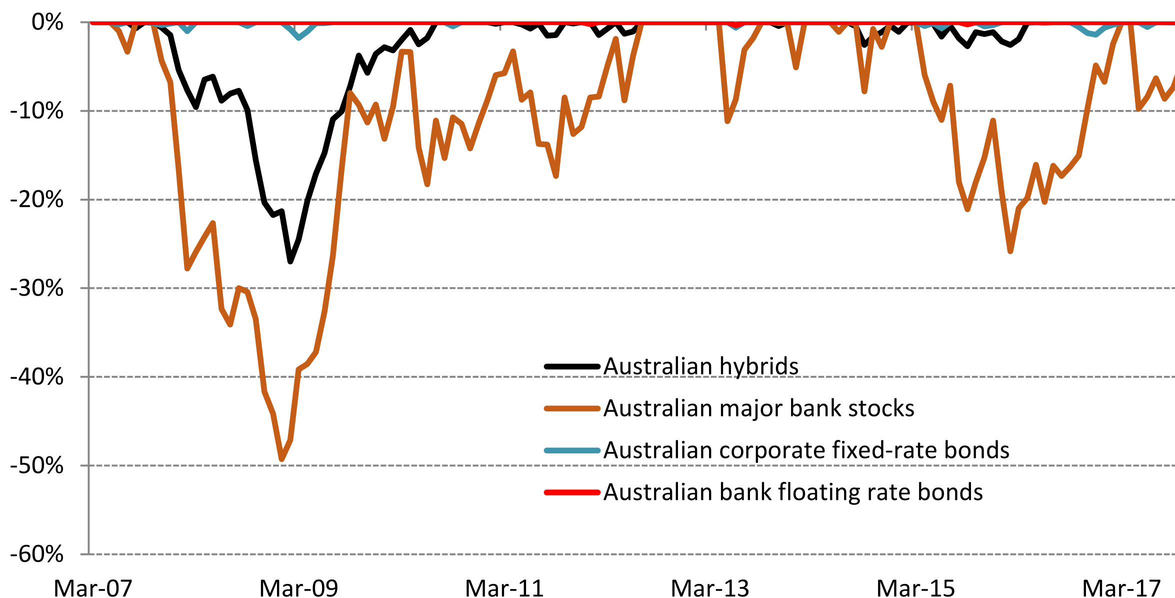
THE CASE FOR HBRD

Another way of considering risk is to examine peak-to-trough declines in total returns or "drawdowns". As seen in the chart below, while hybrid valuations did experience a decline during the GFC-induced panic regarding bank solvency, these declines were still much less than that for bank shares and losses were recovered relatively more quickly.

What's more, hybrid values were hardly affected during the most recent periods of share price weakness in 2011 and 2016, i.e. since the financial crisis. This suggests that during normal periods of share market volatility – when the ultimate solvency of major hybrid issuers such as banks is not seriously in question – the volatility of hybrids returns might be expected to be relatively low, even approaching that of traditional bonds higher up the capital structure.

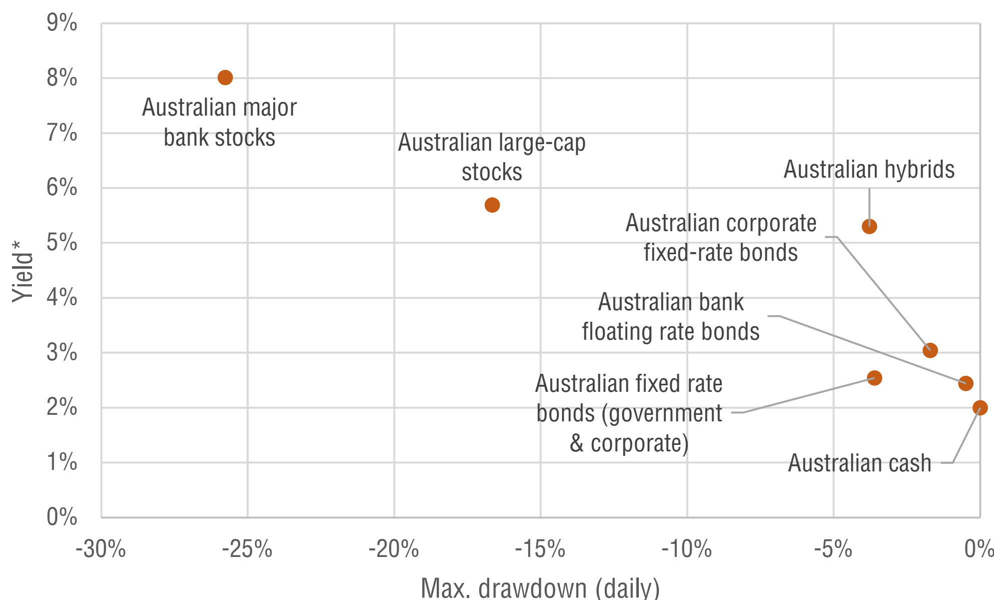
PEAK TO TROUGH TOTAL RETURN DRAWDOWN: MARCH 2007 TO OCTOBER 2017



Source: Bloomberg. For definitions of each series, see footnotes to table above. Past performance is not an indicator of future performance. You cannot invest directly in an index. * For Australian Hybrids data, a spliced index series used incorporating Evans & Partners All Bonds & Hybrids ASX Index prior to February 2012, Solactive Australian Hybrid Securities Index from February 2012.

Given this relatively modest drawdown in the recent post-financial crisis period, the chart below highlights how hybrids have in recent years provided relatively good income returns for only relatively moderate levels of return drawdown (or downside risk). In this sense, hybrids can be considered to offer relatively good risk-adjusted returns.

GROSS YIELD (AS AT END-OCTOBER 2017) VS. MAXIMUM RETURN DRAWDOWN: 12-FEBRUARY-2012 TO 31-OCTOBER-2017



Source: Bloomberg. For definitions of each series and for yield measures, see footnotes to table above. Past performance is not an indicator of future performance. You cannot invest directly in an index.

Indeed, one feature of hybrids that should help mitigate return volatility over time – especially compared to traditional fixed-rate government and corporate bonds – is that their interest rates tend to be floating, or adjust to the general level of interest rates over time. Due to this feature, the price or capital value of hybrids tends to be much less sensitive over time to changes in the general level of interest rates than is the case for fixed-rate bonds. This is particularly noteworthy in the present climate (at the time of writing), given interest rates globally remain quite low but are generally expected to start rising over the next year or so.

What's more, as seen in the chart below, hybrid valuations – as measured by the average yield margin above short-term interest rates that major bank (Tier-1) hybrids are trading at – are currently reasonably fair by historic standards. As at late-September 2013, the average yield margin was around 3%, or only little below the average of 3.2% in the post-financial crisis period since end-2009. Valuations were more expensive (the yield margin lower) in 2011 and mid-2014, and somewhat cheaper (yield margin wider) in mid-2012 and early 2016.

AVERAGE MAJOR BANK AT1 TRADING MARGIN (>1 YEAR)

Source: BondAdvisor. Past performance is not an indicator of future performance.

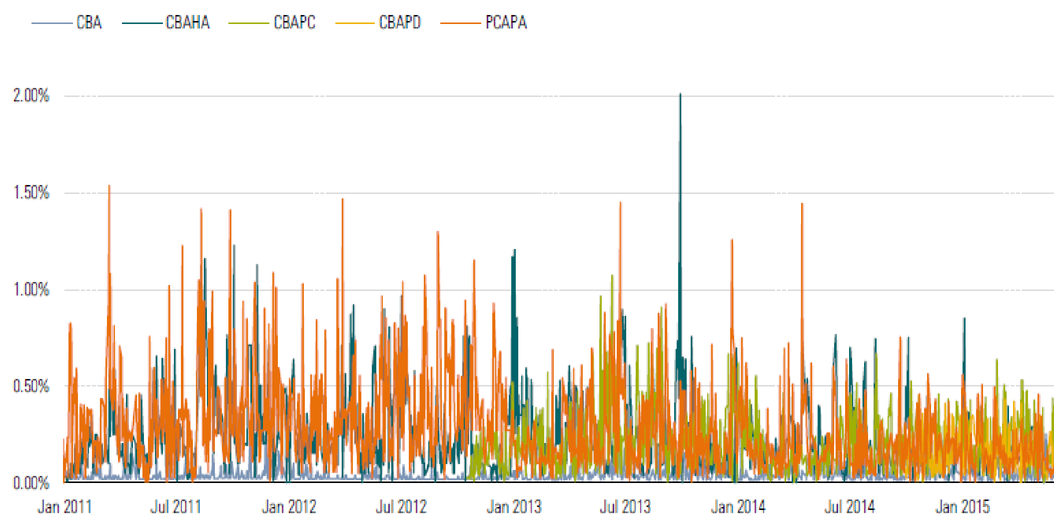
But hybrids are complex and may be better left to experts

Although they offer the potential for attractive income returns, hybrids are complex securities which can differ greatly in terms of their bond and equity characteristics - and hence their ultimate risk to investors. Failure to properly understand each hybrid security's specific terms and conditions can result in some investors taking on unintended risks, or at least potentially forgoing better returns available on other hybrids with similar risk.

In addition, the relative inefficiency and make-up of the hybrids market allows experts to potentially take regular advantage of mispricing. Of the hybrids available on the ASX, the vast bulk have been directly purchased and are owned by retail investors – many of whom might not have the expert knowledge to pick and choose the best hybrids available.

What's more, compared to the share market, the hybrids market is relatively illiquid. As seen in the chart below, for example, the bid-offer spreads (i.e. the difference between the market price at which hybrids are able to be bought and sold) for Commonwealth Bank hybrid securities tend to be notably higher than that for its shares. What's more, these spreads can vary greatly on a day-to-day basis – suggesting they can be highly influenced by the number of buyers and sellers on any given day. While it's possible for retail investors to get into and out of hybrids securities on the exchange, it can often come at a cost!

BID-OFFER SPREAD OF COMMONWEALTH BANK EQUITY AND HYBRIDS



Source: Morningstar.

While retail investors are reliant on making trades through the exchange, moreover, professional fund managers can additionally source other hybrids opportunities - and often deeper liquidity - through direct trades with other financial institutions in over-the-counter ("OTC") transactions.

All up, given the complexity of hybrid securities, the relative inefficiency of the hybrids market and associated opportunity to take advantage of mispricing, and generally lower levels of exchange liquidity, we believe there are advantages in gaining exposure to these investments through a professionally run managed fund.

First and foremost, a fund provides diversification across the range of hybrid securities via a single investment. What's more, the fund's buying power – both on-and-off exchange – also means it should be able to achieve better trading terms (i.e. tighter bid-offer spreads) than available to the typical retail investor. Last, but not least, a fund manager with sufficient expertise should over time be able to take advantage of the often significant degree of security mispricing that can occur in what remains a relatively inefficient market.

Partnering with an experienced fund manager

With this in mind, BetaShares has decided to bring the convenience and diversification benefits of a hybrids fund to the market – along with the potential to add alpha from market mispricing, as well as manage risk - by engaging one of Australia's leading managers of hybrid securities, Coolabah Capital Institutional Investments (CCI). CCI has a six-year track record in actively managing hybrid securities.

BETASHARES
THE CASE FOR HBRD

CCI is an active manager, seeking to achieve "alpha" returns over time through use of a rigorous quantitative valuation methodology that aims to regularly identify and exploit mispricing in securities. Indeed, CCI already has strong purchasing power in the hybrids market, and is regularly a cornerstone investor in new hybrid issues.

As well as identifying mispriced securities within the hybrids markets, moreover, CCI will also have flexibility within the BetaShares Active Australian Hybrids Fund (managed fund) (ASX Code: HBRD) to move to cash or senior bonds should overall hybrid valuations be deemed too expensive compared to their risks (e.g. during episodes of bank stress or when hybrids credit spreads get too narrow).

Conclusion

Hybrid securities are popular with Australian investors for good reason: they offer attractive franked income returns for usually only moderate levels of return volatility, and many carry the creditworthiness of being some of the most profitable and prudentially sound banks in the world. They have a valid place along the market place's risk-return spectrum, and offer a useful source of diversified income in many investor portfolios.

That said, hybrids can be subject to complex terms and conditions, such that professional expertise can help ensure investors are being adequately compensated for the risks assumed. Hybrids also tend to be relatively illiquid, meaning it can be costly for the typical retail investor to buy and sell them over time. Given the nature of the hybrids markets, in our view it would make sense for many retail investors to gain access though a professionally run, actively managed fund.

It's for these reasons that BetaShares has decided to provide exposure to this appealing investment class by engaging one of Australia's leading active fund managers in this field. The BetaShares Active Australian Hybrids Fund (ASX Code: HBRD) continues the BetaShares tradition of offering Australian investors innovative and intelligent investment solutions to help them meet their financial objectives.

Trading Information

BetaShares Funds can be bought or sold during the trading day on the ASX, and trade like shares.

EXCHANGE	ASX
ASX CODE	HBRD
CURRENCY	AUD
TRADING HOURS	10:00-16:00 (AEST)
BLOOMBERG CODE	HBRD AU
IRESS CODE	HBRD.AXW
IRESS INAV CODE	HBRDINAV.ETF

Fund Information

DISTRIBUTIONS	MONTHLY
MANAGEMENT FEE	0.45% P.A
EXPENSES	ESTIMATED AT 0.10% P.A
PERFORMANCE FEE	15.5% OF PERFORMANCE ABOVE THE BENCHMARK
BENCHMARK	SOLACTIVE AUSTRALIAN HYBRID SECURITIES INDEX
FUND INCEPTION	13 NOVEMBER 2017
INVESTMENT MANAGER	COOLABAH CAPITAL INSTITUTIONAL INVESTMENTS PTY LTD

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There are risks associated with an investment in the Fund, including interest rate risk, credit risk, hybrids complexity risk and sector concentration risk. For more information on risks and other features of the Fund please see the Product Disclosure Statement

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