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# Hybrids – Risks, pitfalls and opportunities

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**BetaShares**



# Important Information

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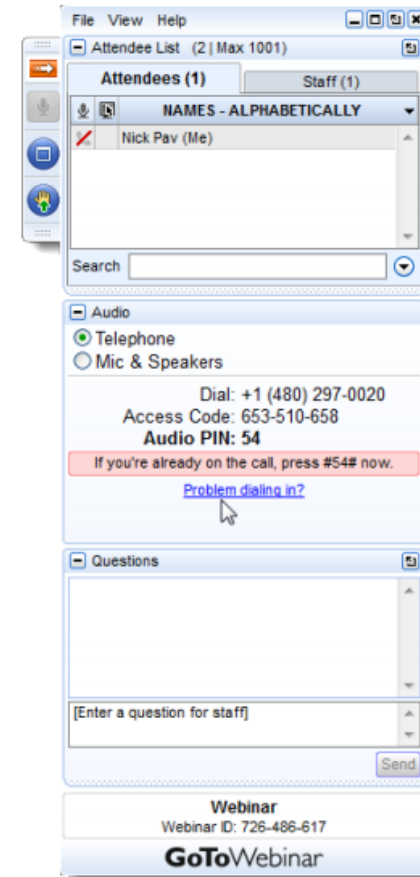
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# Before we start...



A recording of the session  
will be sent to all attendees





# Today's presenters

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## David Bassanese

Chief Economist, BetaShares

Author of *"The Australian ETF Guide"*

### Formerly with:

- ▶ AFR
- ▶ Macquarie Bank
- ▶ OECD
- ▶ Treasury



## Peter Harper

Director – Distribution & Head of  
Capital Markets, BetaShares

### Formerly with:

- ▶ Macquarie Bank
- ▶ ABN AMRO
- ▶ UBS



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**What are hybrids? Where do they sit in the risk-return investment spectrum?**



**The challenges of directly investing into hybrids**



**An introduction into BetaShares Active Australian Hybrids Fund (managed fund)**



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**What are hybrids? Where do they sit in the risk-return investment spectrum?**



The challenges of directly investing into hybrids

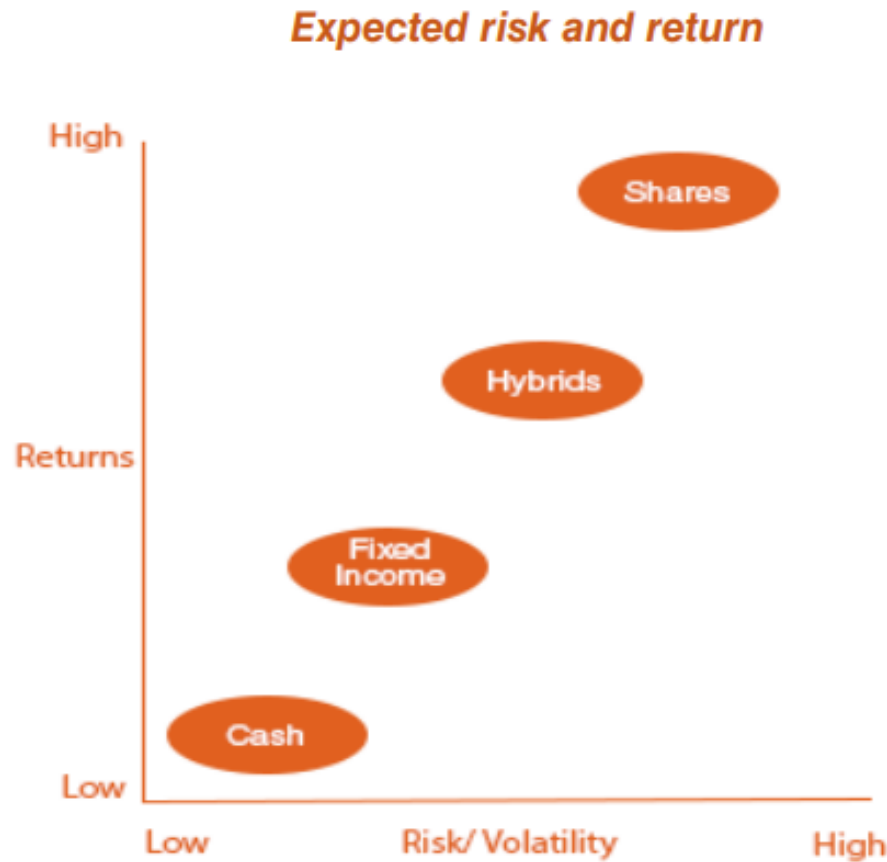


An introduction into BetaShares Active Australian Hybrids Fund (managed fund)



# Hybrids: Sit between traditional bonds and equity exposure in the risk & return spectrum

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# What are hybrids?

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- ▶ Hybrid securities combine debt and equity characteristics

## Debt like characteristics:

- ▶ Rank ahead of equity in capital structure
- ▶ Pay a regular and defined rate of return (usually floating)
- ▶ Fixed date for optional repayment and conversion to shares

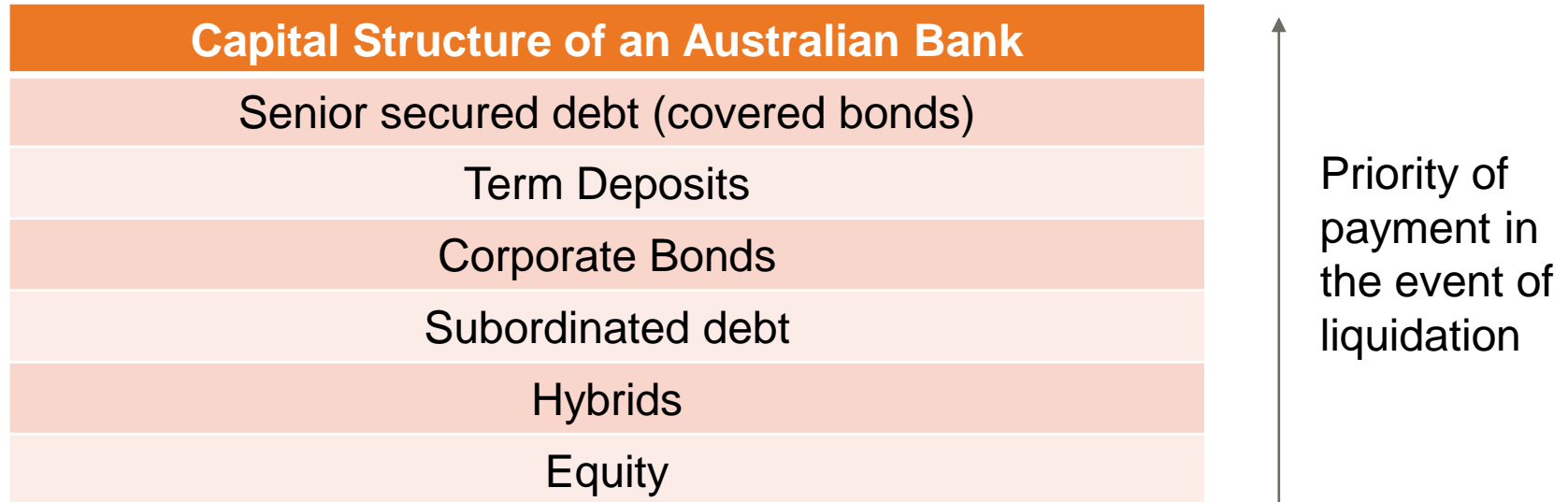
## Equity like characteristics:

- ▶ Perpetual Instruments
- ▶ Issuer may suspend distributions or delay redemption
- ▶ Subordinated on the capital structure
- ▶ May be written off in times of financial distress



# Where do hybrids sit in a typical bank's capital structure?

- ▶ Hybrids rank ahead of equity but below conventional bonds and deposits





# Why are hybrids issued?

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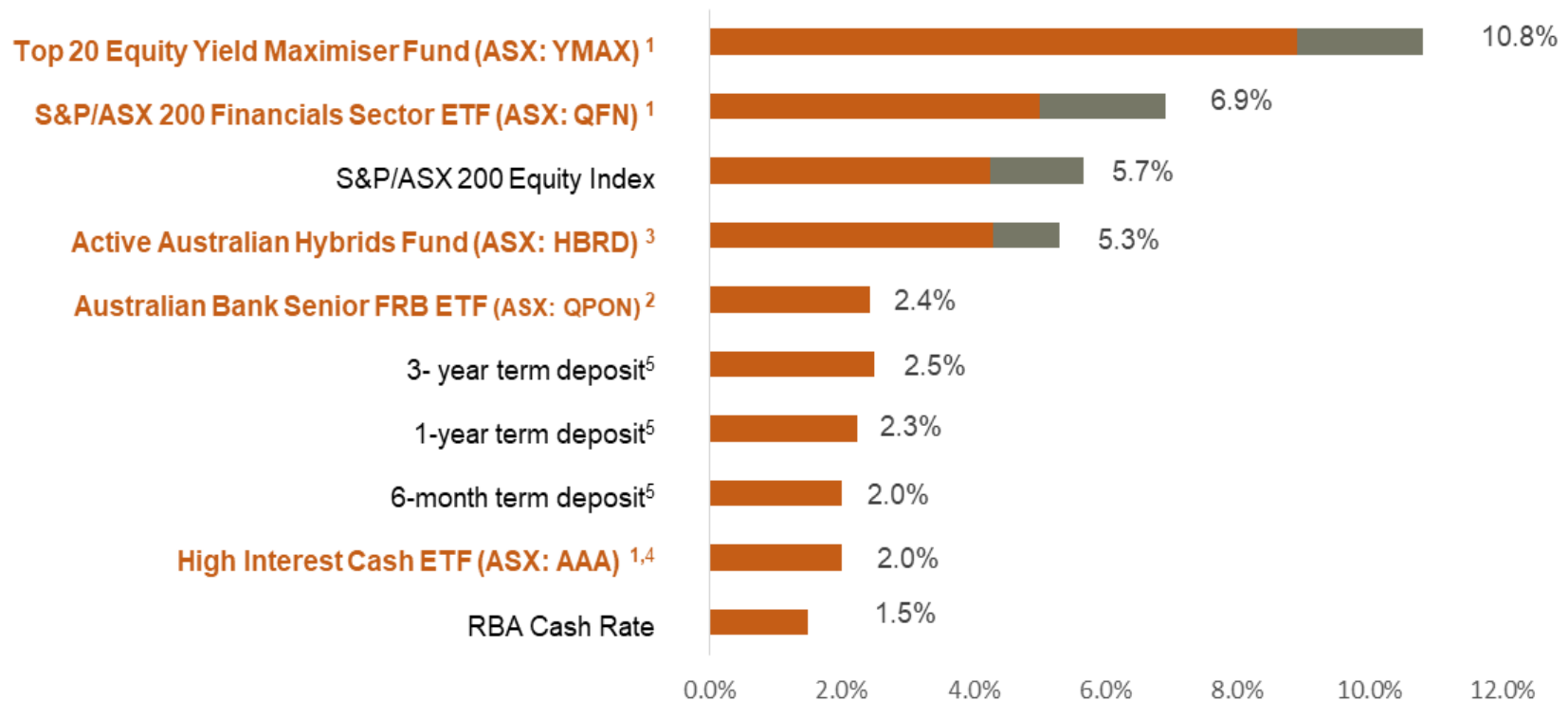
## Key drivers of issuance:

- ▶ Basel III regulations require banks to hold more capital
- ▶ Replacing older hybrids that do not qualify under Basel III
- ▶ Treated as equity capital by credit rating agencies
- ▶ Favourable tax treatment as distribution payments lower taxable income
- ▶ Low interest rates make hybrid yields popular with investors
- ▶ Another means of diversifying funding for issuers



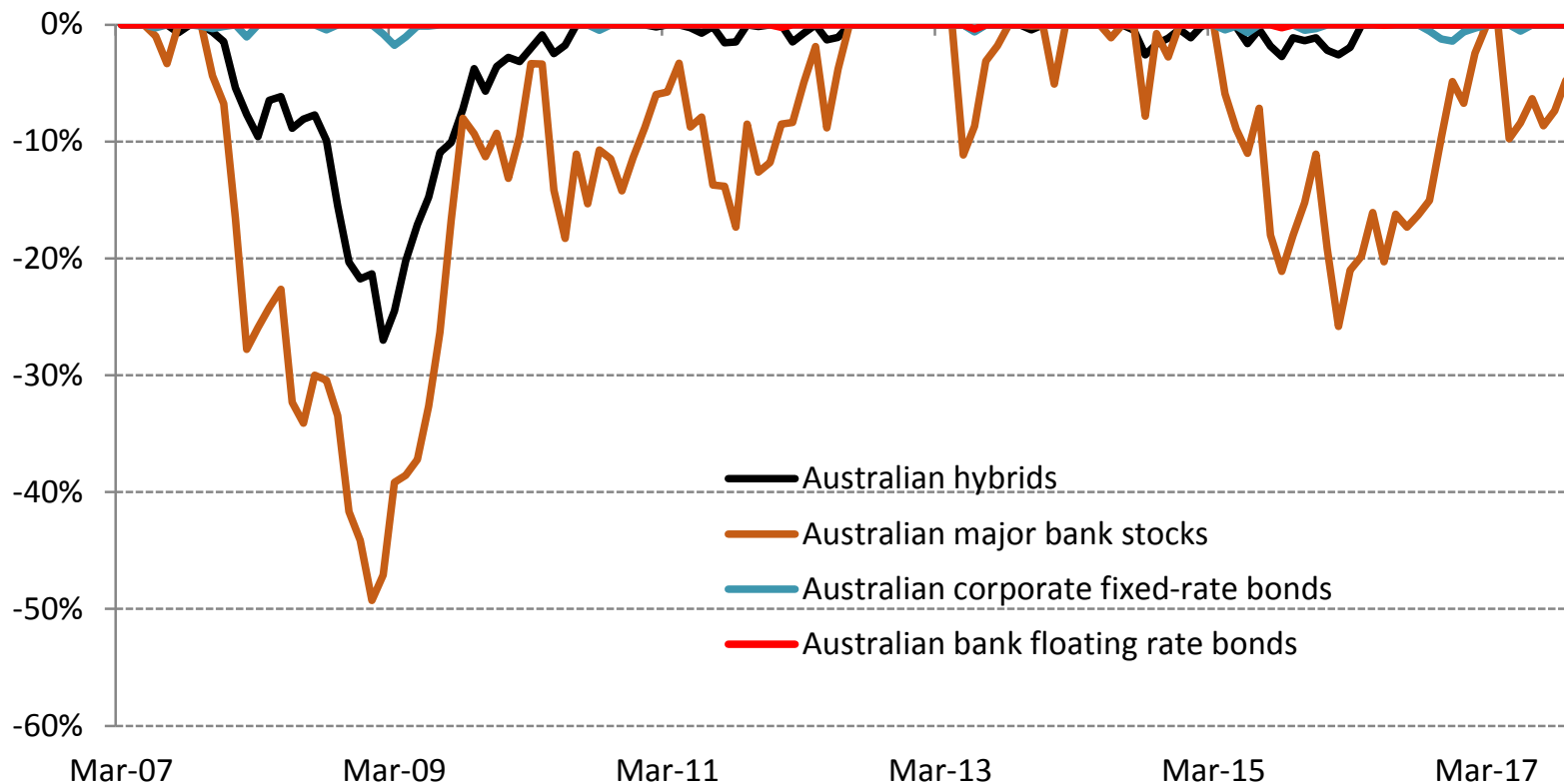
# Hybrids offer attractive income

## Yield comparisons along the risk spectrum: as at 31 October 2017



1. 12-month distribution yield 2. Yield-to-maturity 3. Running yield (including franking) as at 31 October 2017 4. After fees 5. Average of the major banks per RBA. Past performance not an indicator of future performance.

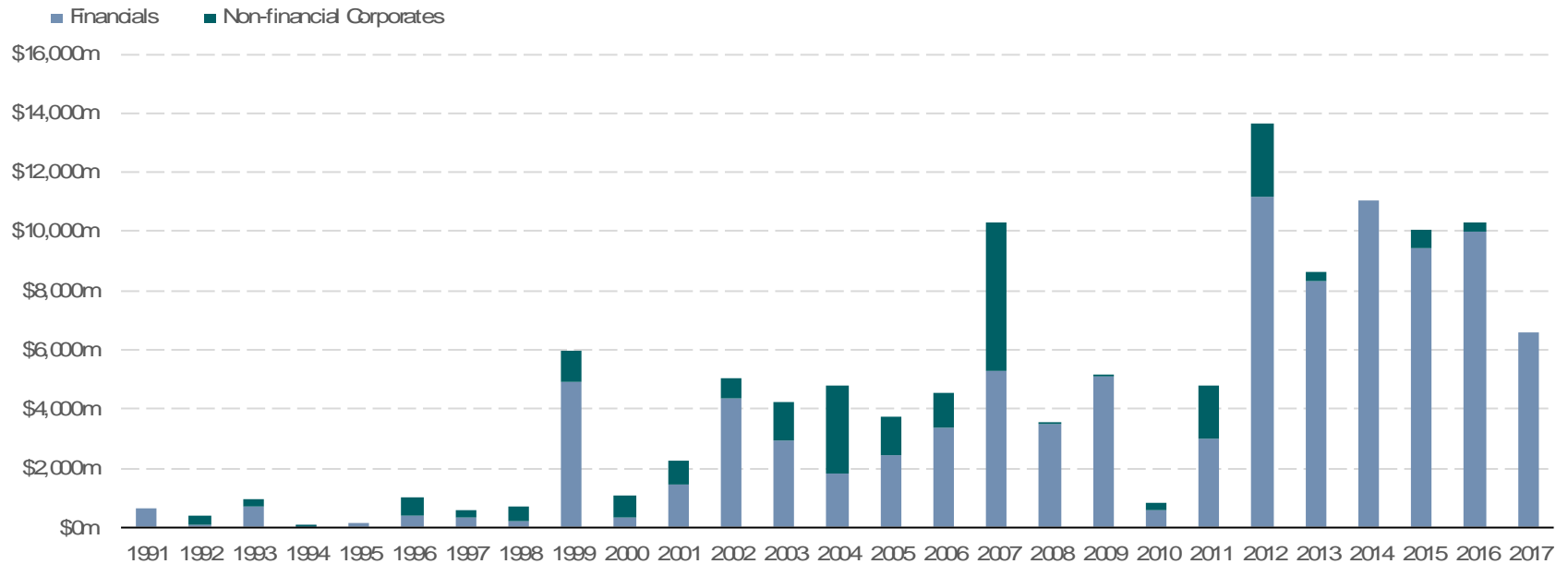
# Hybrids volatility sits between cash and bonds, but can experience declines in risk-on events



Source: Bloomberg. Investment Exposure: Solactive Australian Hybrid Securities Index, S&P/ASX 200 Banks Index; Bloomberg AusBond Corporate Bond Index; Solactive Australian Bank Senior Floating Rate Bond Index (QPON ETF's Index). 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.



# Financials dominate the issuance of hybrids



Source: Morningstar, Thomson Reuters

# Current valuations for hybrids appear reasonable



## HBRD's mandate keeps valuations front and centre



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



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What are hybrids? Where do they sit in the risk-return investment spectrum?



**The challenges of directly investing into hybrids**



An introduction into BetaShares Active Australian Hybrids Fund (managed fund)



# Navigating Hybrids: The challenge of direct ownership...

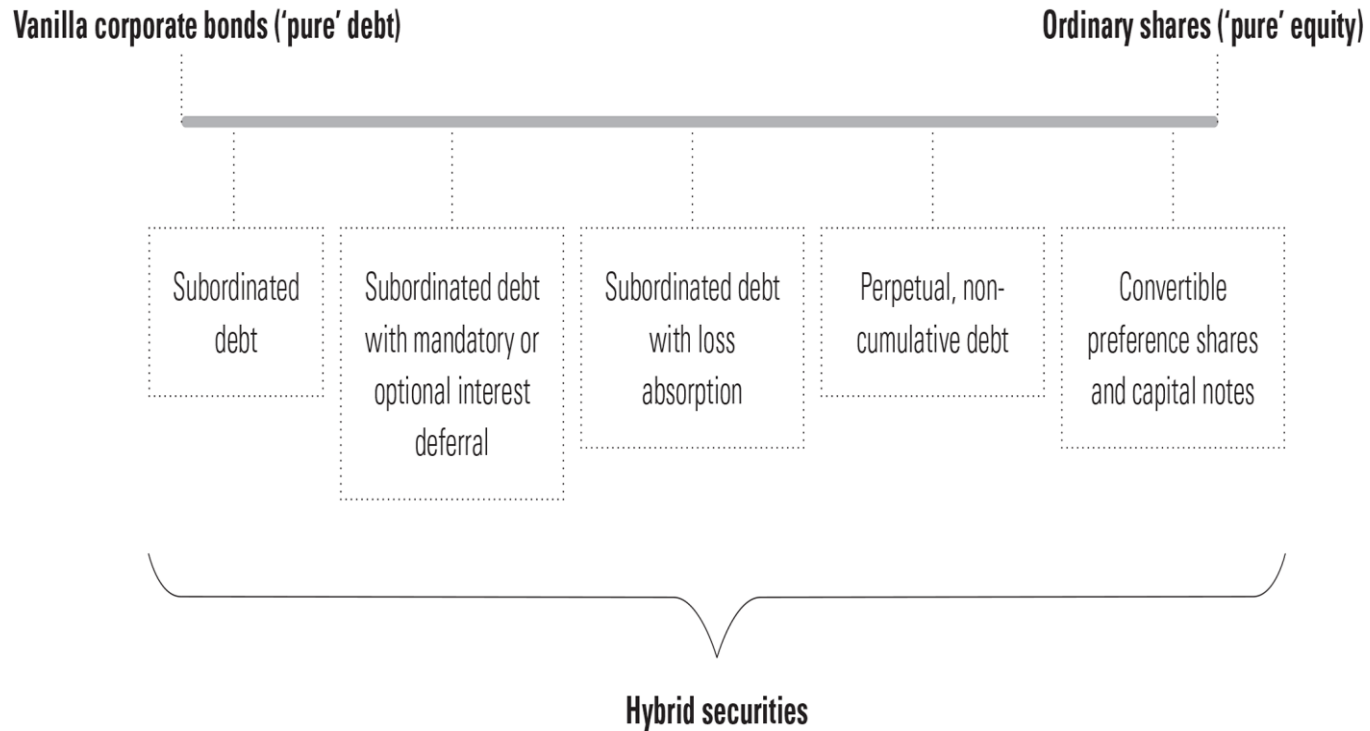
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**Whilst hybrids can offer attractive risk adjusted returns to portfolios, for many investors and their advisers they present some difficulties, such as:**

- ▶ **Complexity:** While the offered yield on individual hybrids is relatively transparent, the risks associated with each can be difficult to fully understand without expert knowledge and time commitment - as the terms and conditions of individual hybrids can vary widely. This means investors risk taking on more risk than anticipated and/or are not as well compensated as they should be for the risk assumed.
- ▶ **Concentration risk:** Risks are accentuated by the fact holdings of hybrids in portfolios tend to be relatively concentrated (often 3-5 individual securities) creating potential for security and issuer risk.
- ▶ **Liquidity:** Due to low turnover, bid-offer spreads – especially those faced by retail investors – tend to be wider than in the equities market, adding to investor costs. It may be especially costly to sell relatively large holdings when desired, especially in times of market volatility.
- ▶ **Market risk:** The risk faced by hybrids as a whole can also change over time depending on market developments – which could expose unwary passive investors to added risks.



# Not all hybrids are created equal...

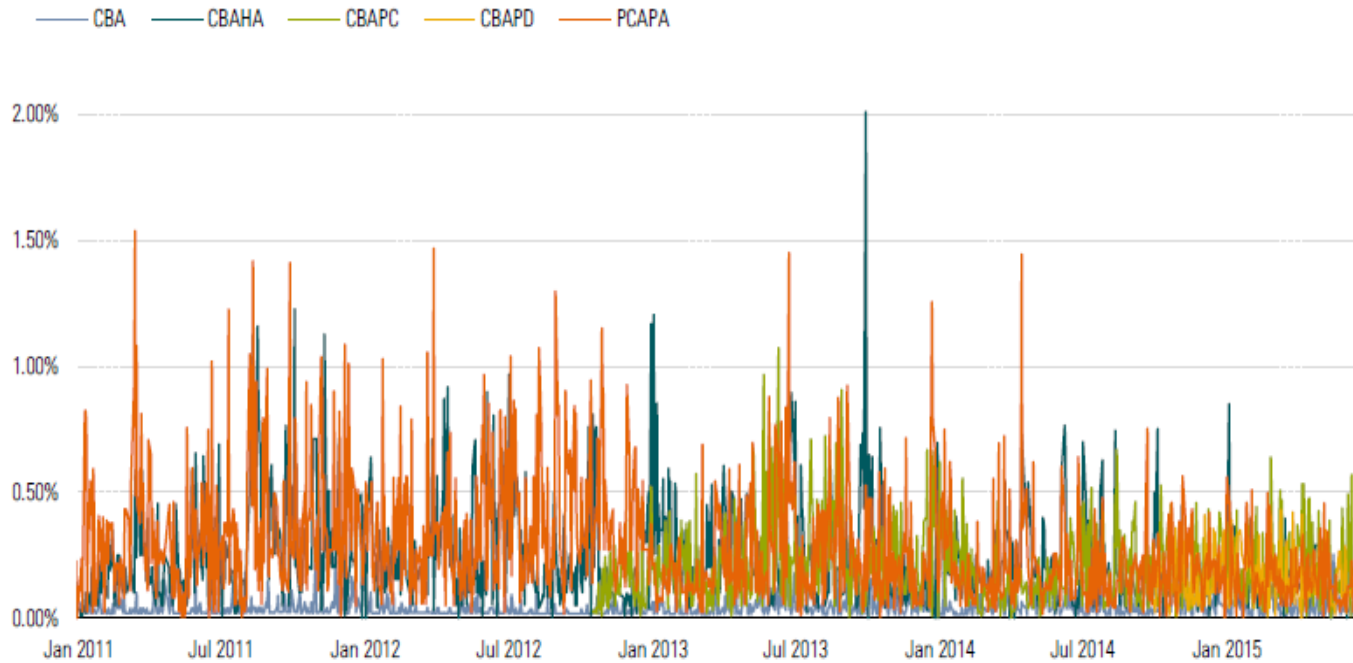


Source: Morningstar



# Hybrids market is relatively illiquid – professional investors have an advantage

## Bid-Offer Spread of Commonwealth Bank Equity and Hybrids

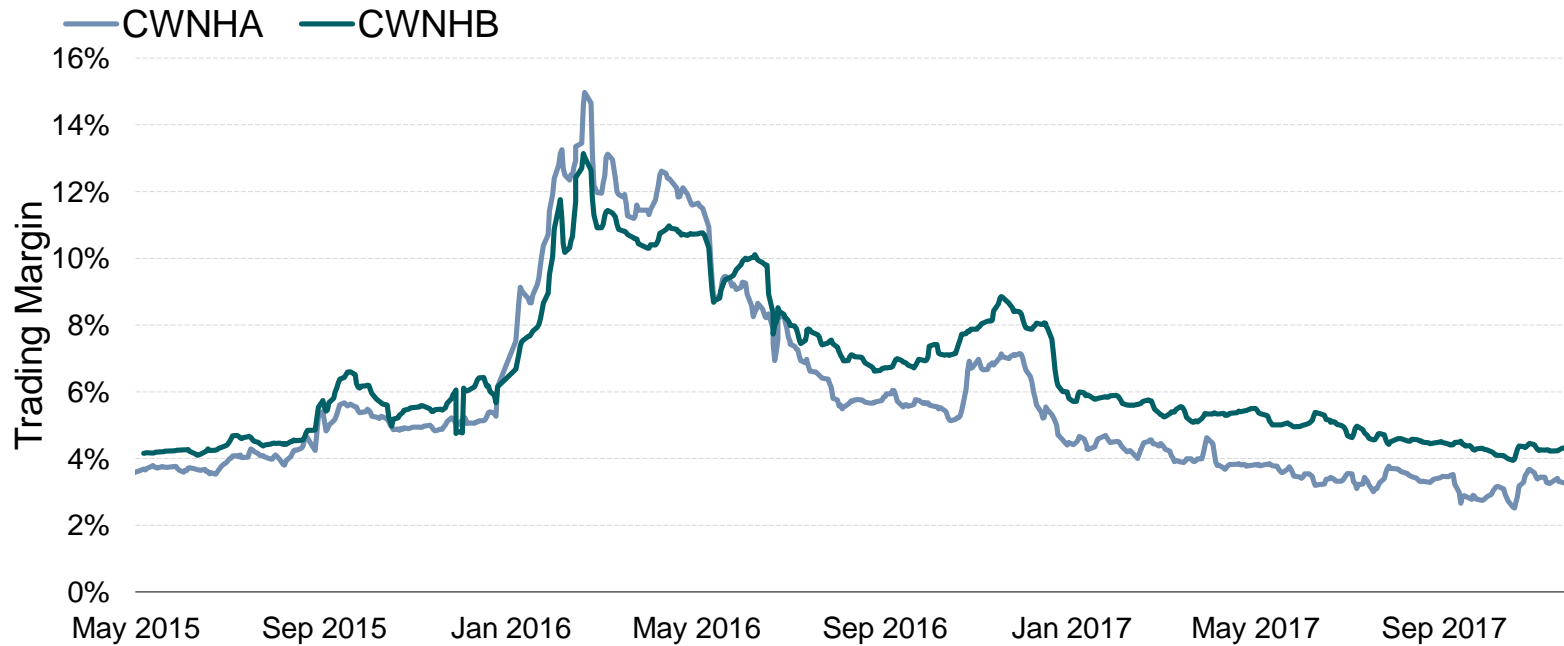


Source: Morningstar



# Hybrids – can't just set and forget...

## Trading Margins – Crown Subordinated Notes: May 2015-November 2017



Source: Morningstar



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# The potential problems...

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- ▶ The hybrids market is relatively inefficient and thus prone to regular over and under valuation – some investors may not have the ability to accurately price these securities
- ▶ Most investors' hybrid holdings tend to be relatively passive creating the potential for risks to capital if securities become overvalued or during "risk-on" events
- ▶ The issuance terms of hybrid securities are complex and can differ greatly from security to security which, along with the relatively low ranking of hybrids in the capital structure, makes understanding the idiosyncrasies of each security all the more important
- ▶ Holdings of hybrids in portfolios tend to be relatively concentrated (often 3-5 individual securities) creating potential for security and issuer risk
- ▶ The passive nature of many investors' hybrid holdings has led to a relatively illiquid listed market in hybrid securities



# A potential solution?

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**We believe many of the complexities of holding hybrids can be largely addressed via the use of an actively managed hybrids exposure run by an experienced professional manager:**

- ▶ A professional manager may have valuation models allowing them to detect and potentially profit from mispricing in the relatively inefficient and retail focussed hybrid market
- ▶ A professional manager may potentially have a greater ability to detect overvalued securities and mitigate risks to capital than an investor without sophisticated valuation models
- ▶ A professional manager may have a greater understanding of the issuance terms and complexities of individual securities to potentially identify and mitigate risks
- ▶ A professional manager will likely hold a broader and more diversified portfolio of hybrid securities (~20-50 in the case of HBRD) and may therefore reduce concentration risk for many investors
- ▶ A professional manager may have access to deeper liquidity
- ▶ Using a professional manager may assist in alpha generation, risk mitigation, improving diversification and building scalability in portfolios

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





# Investment Strategy for HBRD (I)

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## HBRD will target:

- Returns after fees that are greater than Australian Hybrids Index<sup>(1)</sup>
- Post-fee returns > RBA cash rate + 2.5% pa over medium term
- Post-fee, franked running yield generally similar to Australian Hybrids Index<sup>(1)</sup>
- Post-fee volatility of 3-4% p.a.
- Minimal interest rate duration – floating rate exposure only
  
- **Ability to go 100% cash/bonds if hybrids materially overvalued**
- **Ability to invest up/down capital structure depending on relative value**
- Ability to hold following securities:
  - Cash
  - Bonds
  - Subordinated debt
  - Australian Hybrids

<sup>(1)</sup> Solactive Australian Hybrid Securities Index



# BetaShares Active Australian Hybrids Fund

<b>Product Name:</b>	BetaShares Active Australian Hybrids Fund (managed fund)
<b>Investment Objective</b>	The Fund provides investors with a convenient way to access attractive income returns, including franking credits, from an actively managed, diversified portfolio of hybrid securities. As the Fund is overseen by a professional investment manager it actively seeks to reduce the volatility and downside risk that may otherwise be experienced by direct holders of hybrids.

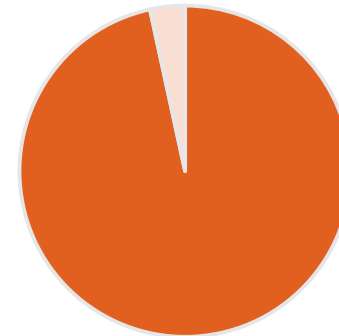
## Key Information

## Top 10 Constituents As at 13 November 2017

## Sector Allocation (%) As at 13 November 2017

<b>ASX Code</b>	HBRD
<b>Bloomberg Code</b>	HBRD AU
<b>IRESS Code</b>	HBRD.AXW
<b>Asset backing</b>	Australian Hybrids, Bonds & Cash
<b>Management Fee</b>	0.45% p.a.
<b>Expense recoveries</b>	Capped at 0.10% p.a.
<b>Performance Fee</b>	15.5% of performance above Solactive Australian Hybrid Securities Index
<b>Inception Date</b>	13 November 2017

<b>ASX Code</b>
ANZPG
ANZPH
BENPF
CBAPD
CBAPE
CBAPF
NABPB
NABPC
NABPD
WBCPG



■ Bank Hybrids    ■ Subordinated Bonds

# ASX: HBRD



# Investment Strategy for HBRD (II)

## Fund will adopt a hub-spoke strategy

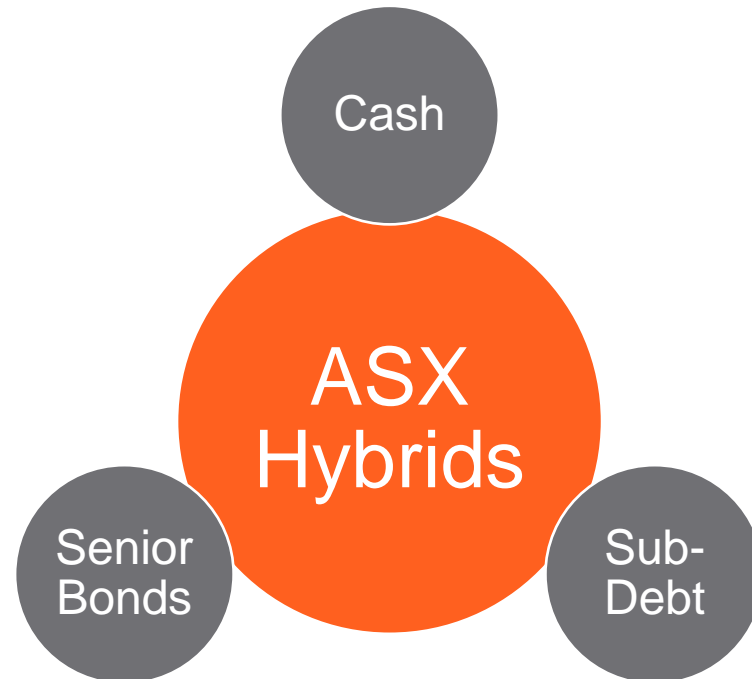
Core holdings will be ASX hybrids during normal conditions to meet post-fee yield targets

Augmented by cash, bonds and sub-debt

Expecting to hold 20-50 positions across cash, bonds, hybrids

Actual portfolio weights will depend on:

- Relative value opportunities
- Bottom-up analysis on outright valuation fundamentals
- Risk-aversion





# About HBRD's Investment Manager - CCI

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**HBRD is actively managed by Coolabah Capital Institutional Investments (“CCI”), a leading independent Australian active-fixed income specialist**

**CCI is a specialist “active credit” investor with ~\$2bn in FUM, and one Australia’s largest fixed-income boutiques**

- Established 2011, 75% owned by investment team, 25% owned by large Australian family office

**CCI has a strong record of alpha generation**

- As at November 2017, best performing Australian cash plus/short-term fixed interest portfolios past ~6yrs (Source: Morningstar)
- Seeks to deliver “true alpha” not 1/ duration beta, 2/ credit beta, or 3/ illiquidity beta
- Seeks to identify asset mispricings using rigorous quantitative valuation capabilities
- Investment Approach: when mispricings converge with fair value, realise capital gains + income

**Leading credit research & quant fixed-income capability**

- More than 12x different quant valuation models
- Investment team comprises 8x portfolio managers/analysts
- 2x senior portfolio managers
- 2x junior portfolio managers/quant analysts,
- 3x credit analysts,
- 1x quant analyst
- Chaired by Melda Donnelly (ex CEO QIC) with Independent Director Bob Henricks (ex Chair Energy Super)



# Investment Strategy for HBRD (III)

Deliberate flexibility to range up/down corporate capital structure depending on assessed opportunities

Cannot hold ordinary shares/equities

Approach assists in preserving capital when core hybrid holdings become overvalued

Risk/return targets motivate alpha generation/excess returns subject to not increasing volatility beyond ASX hybrid market



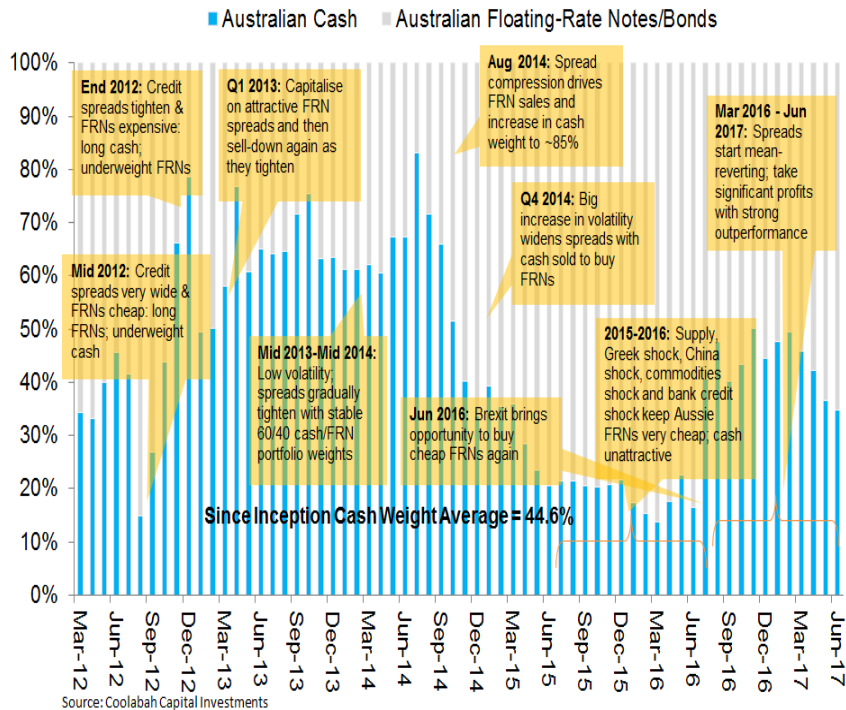
- Senior secured covered bonds (Debt)
- Cash deposits (Debt)
- Senior unsecured bonds (Debt)
- Subordinated bonds
- Hybrids



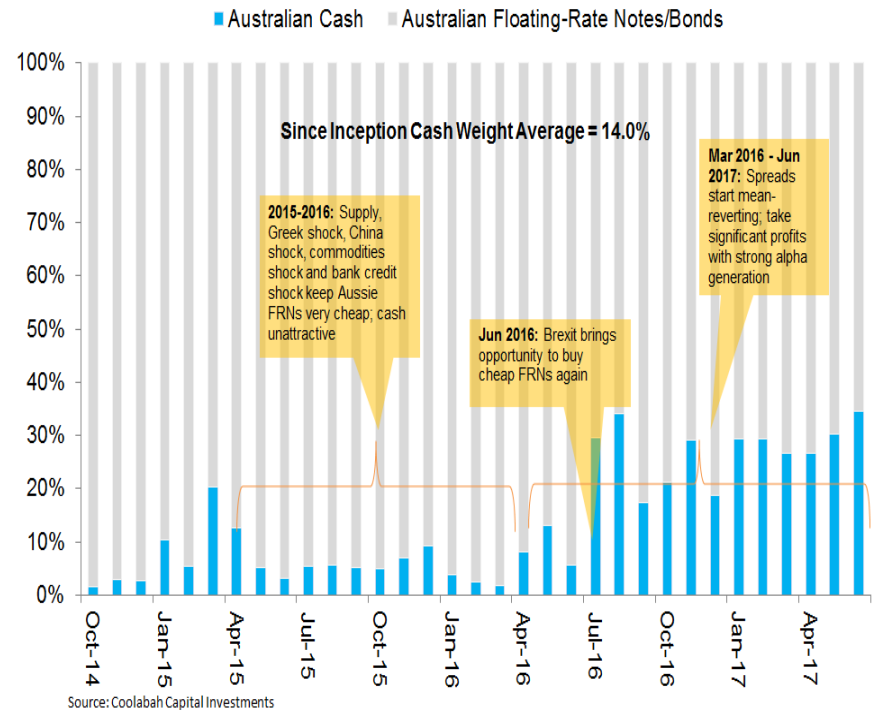
# Active Asset-Allocation Across Cash/FRNs/Hybrids

## Cycles Portfolio Weight to Cash from <20% to >80% as Function of Active Asset Opportunity Set

SMAC Portfolio Weights: Cash vs. FRNs (End of Month)



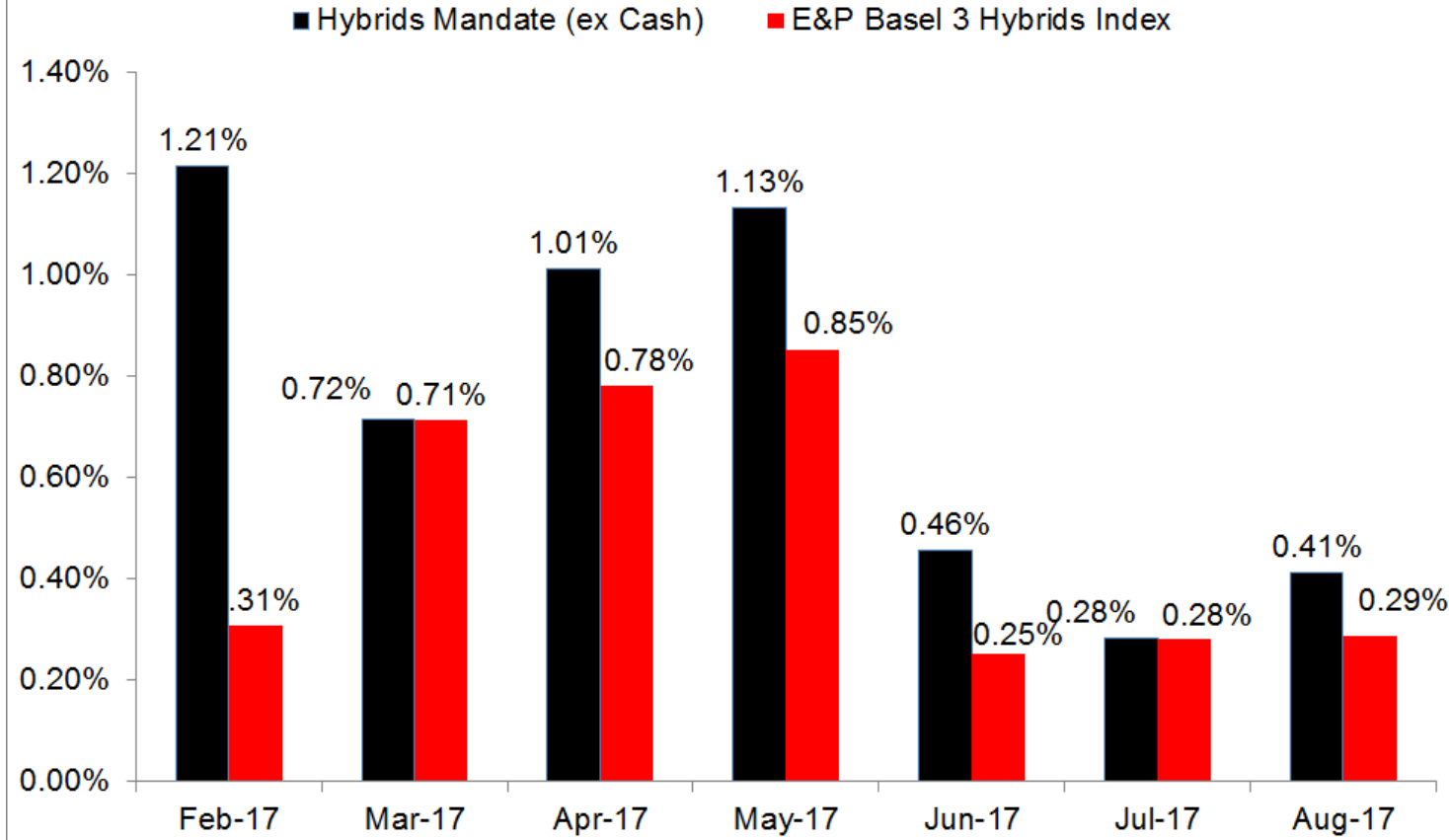
SMHI Portfolio Weights: Cash vs. FRNs (End of Month)



# HBRD's investment manager has shown evidence of alpha generation in the hybrids market



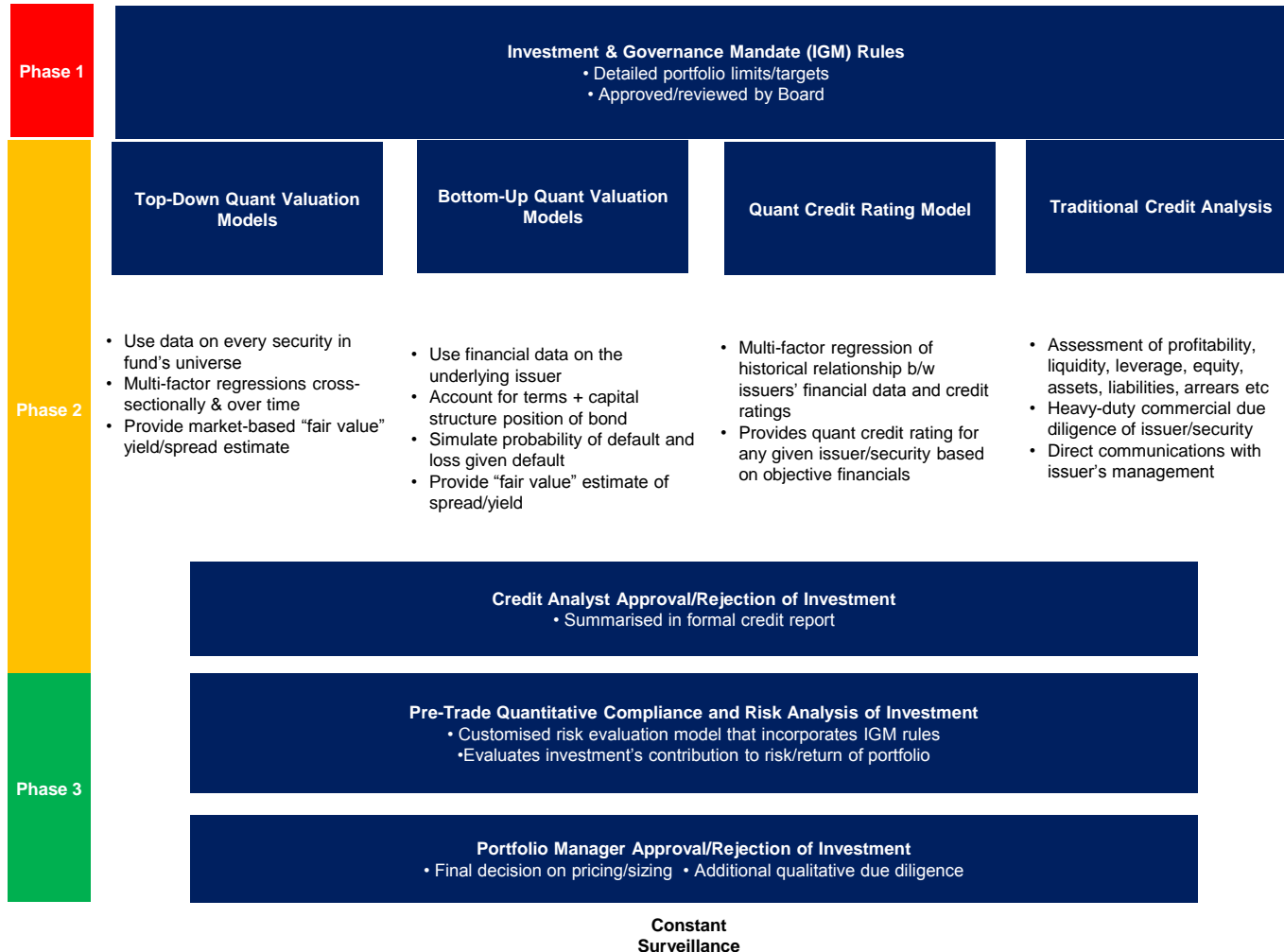
## Hybrids Mandate vs Index



Source: CCI. Past performance is not an indicator of future performance. Mandate shown differs from the HBRD investment strategy. Illustrative only.



# Quant. and Qual. Asset-Selection Process: 12+ Models





# Re-cap: Why HBRD

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We believe the hybrids market is well suited to active management for the following reasons:

1. **Potential for alpha generation in a relatively inefficient market**
2. **Potential to mitigate :**
  - ▶ Risks to capital arising from exposure to overvalued securities
  - ▶ Risks to capital as a result of issuance term complexity
  - ▶ Risks to capital from default thanks to detailed modelling
  - ▶ Risks to capital from concentrated holdings by adding significant diversification
3. **Potential to access a broader liquidity base than many investors may see in ASX listed turnover**



# Things to keep in mind

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- ▶ Investment risk: Investment returns are uncertain and will be influenced by the performance of the markets as a whole and other risks.
- ▶ Income payments are variable. If interest rates fall, HBRD's income payments can be expected to fall.
- ▶ Hybrids are, by their nature, predominately issued by banks, creating sector concentration risk.
- ▶ HBRD is exposed to the credit risk of issuers. Hybrids rank behind all-debt and deposit holders in the event of issuer default.
- ▶ The issuance terms of hybrid securities are complex and can differ greatly from security to security
- ▶ Investors should seek professional financial advice before investing.
- ▶ See PDS for more information about risks.





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The screenshot shows the BetaShares website homepage. At the top, there is a navigation bar with the BetaShares logo and a 'SUBSCRIBE TO OUR NEWSLETTER' button. Below the navigation bar, there are social media icons for Twitter, LinkedIn, and Facebook. The main content area features a large banner for the 'BETASHARES/ INVESTMENT TRENDS ETF REPORT' with a hand holding a large orange arrow. Below the banner, there is a section for 'I WANT TO...' with a 'Go' button and a dropdown menu for 'select a goal'. The 'LATEST NEWS' section includes three articles: 'BetaShares launches Strong Australian Dollar Fund and Strong US Dollar Fund', '3 predictions for the Australian ETF industry in...', and 'BetaShares Australian ETF Review - year end 2016...'. A 'Most Viewed Funds' table is also visible.

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Global Sustainable Leaders ETF	ETL	International Shares
Asia Pacific Growth Leaders Fund	AGL	Equity Income
Global Yield Investment Fund	GYI	Equity Income

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