



Hybrids - Risks, Pitfalls & Opportunities

2018 AIA Annual Conference



BetaShares



Important Information

The information contained in this document is general information only and does not constitute personal financial advice. It does not take into account any person's financial objectives, situation or needs. It has been prepared by BetaShares Capital Limited (ABN 78 139 566 868, Australian Financial Services Licence No. 341181) ("BetaShares"). The information is provided for information purposes only and is not a recommendation to make any investment or adopt any investment strategy. Past performance is not indicative of future performance. Investments in BetaShares Funds are subject to investment risk and investors may not get back the full amount originally invested. Any person wishing to invest in BetaShares Funds should obtain a copy of the relevant PDS from www.betashares.com.au and obtain financial and tax advice in light of their individual circumstances.



Today's Presenter

Peter Harper

*Director – Distribution & Head of
Capital Markets, BetaShares*

Formerly with:

- ▶ Macquarie Bank
- ▶ ABN AMRO
- ▶ UBS





Contents



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



The challenges of directly investing into hybrids



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



Contents



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



The challenges of directly investing into hybrids



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



What are hybrids?

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

Capital Structure of an Australian Bank	
Senior secured debt (covered bonds)	Priority of payment in the event of liquidation
Term Deposits	
Corporate Bonds	
Subordinated debt	
Hybrids	
Equity	



Why are hybrids issued?

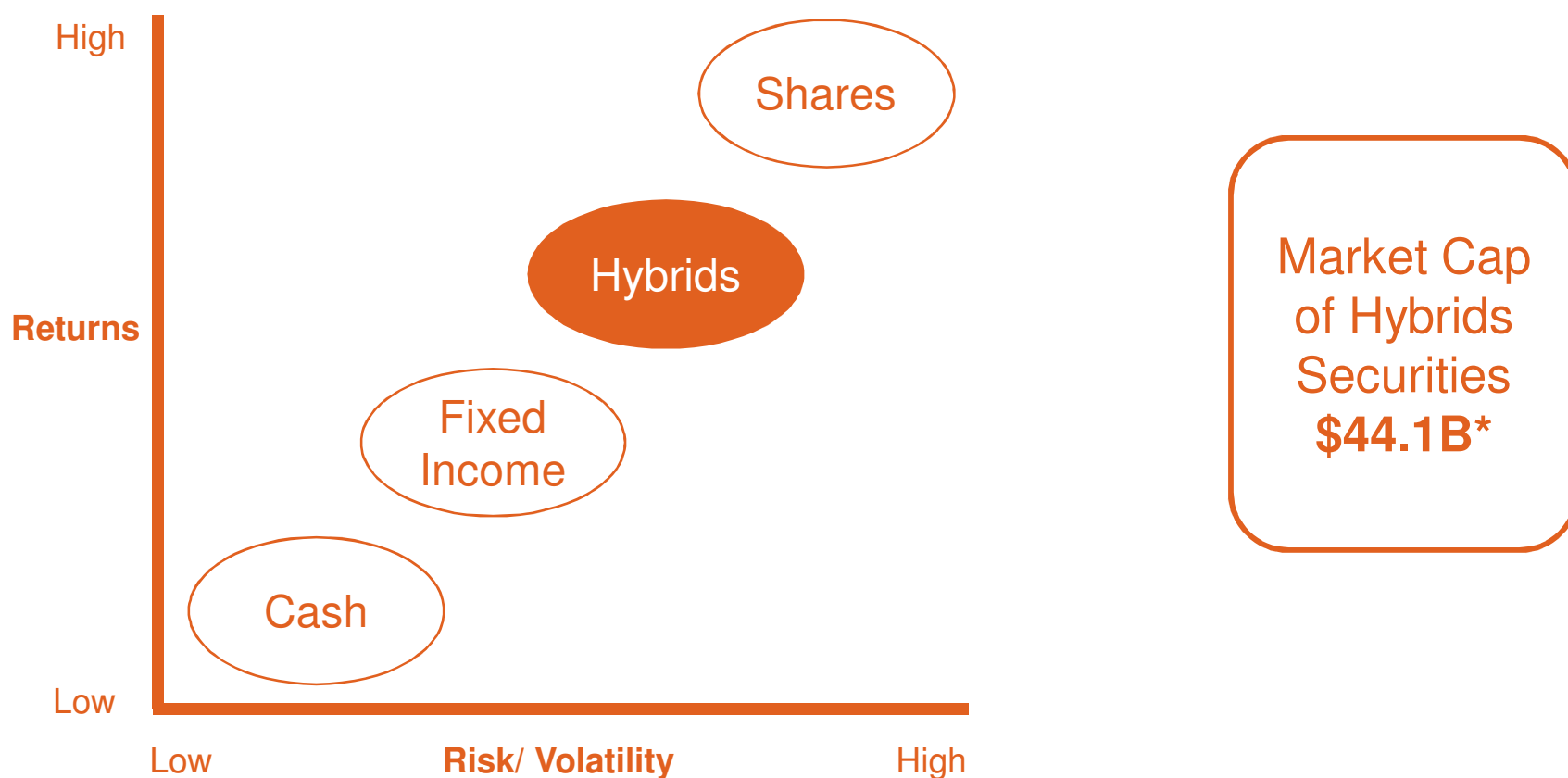
Key drivers of issuance:

- ▶ 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 sit between traditional bonds and equity exposure in the risk & return spectrum

Expected Risk and Return

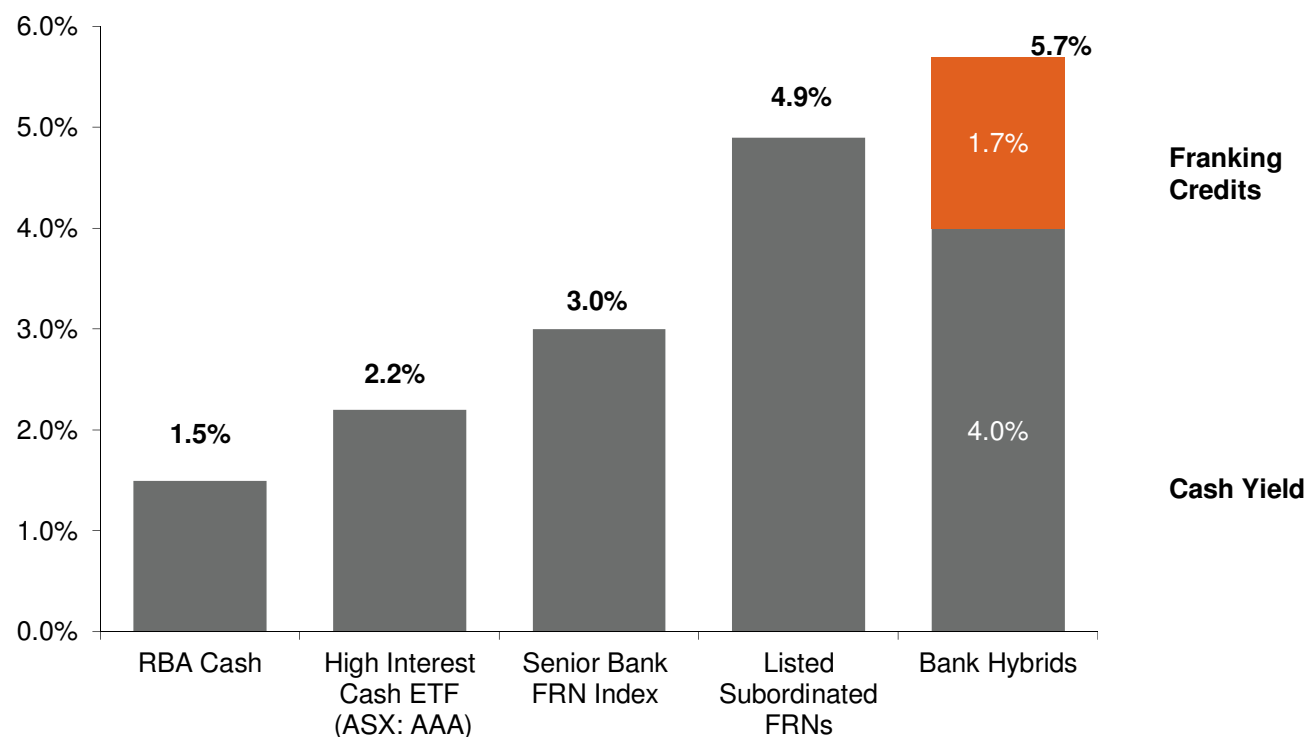


*Source: ASX. As at 30 June 2018.



Hybrids offer attractive level of income vs. cash and bonds

Running Yield across Security Types: As at 30 June 2018 (% p.a.)

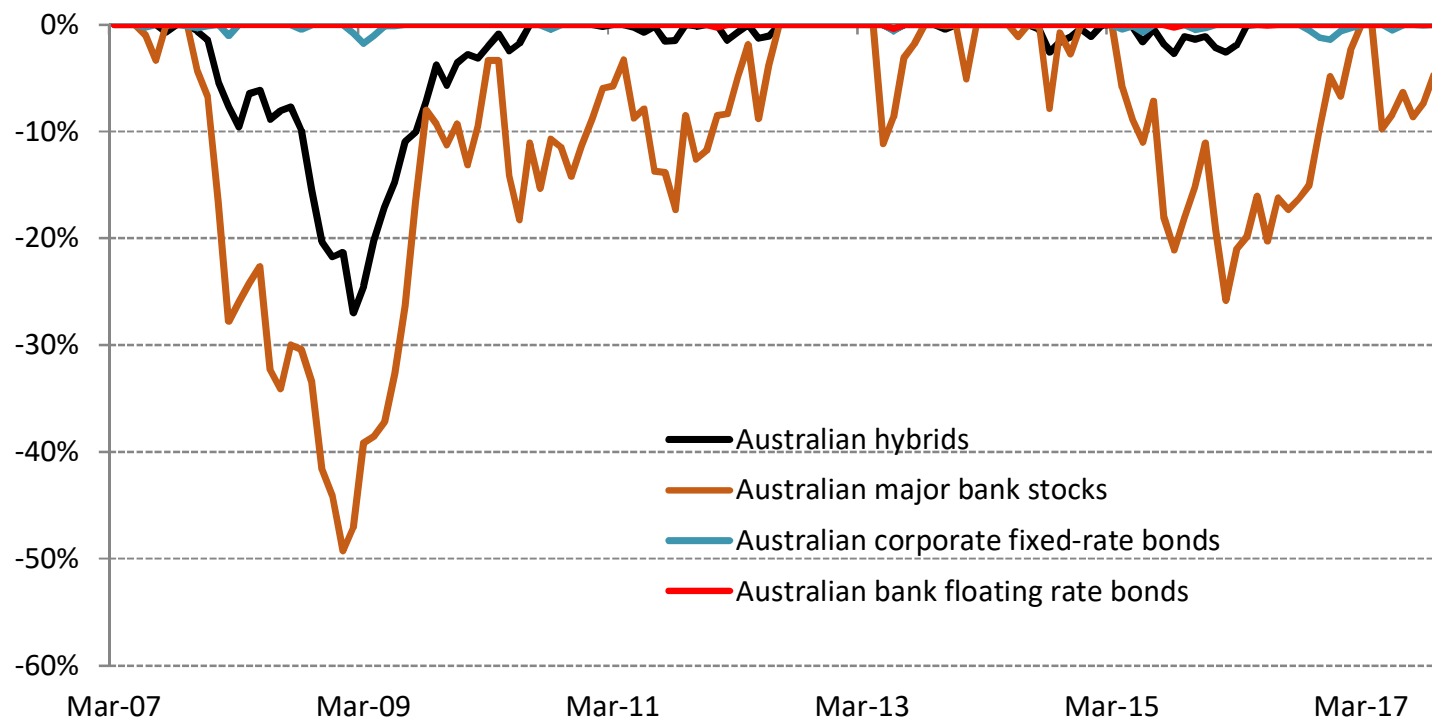


Source: Bloomberg. Yield for AAA is before fees. Senior bank FRNs represented by Solactive Australian Bank Senior Floating Rate Bond Index. Subordinated Bank FRNs represented by ASX listed securities from Solactive Australian Hybrid Securities Index. Bank Hybrids represented by ASX listed AT1 Bank Hybrids from Solactive Australian Hybrid Securities Index. Yields are variable and may be lower at time of investment.

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



Drawdown by asset class



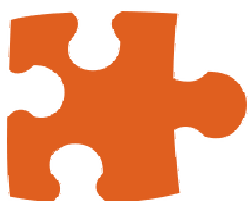
Source: Bloomberg. Investment Exposure: Solactive Australian Hybrid Securities Index, S&P/ASX 200 Banks Index; Bloomberg AusBond Corporate Bond Index; Solactive Australian Bank Senior Floating Rate Bond Index (QPON ETF's Index). Past performance is not an indicator of future performance. You cannot invest 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.



Contents



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



The challenges of directly investing into hybrids



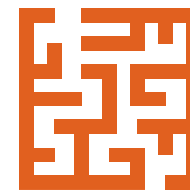
An introduction to BetaShares Active Australian Hybrids Fund (managed fund)



The challenge of direct ownership...

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

- ▶ Complexity
- ▶ Concentration Risk
- ▶ Liquidity
- ▶ Market Risk

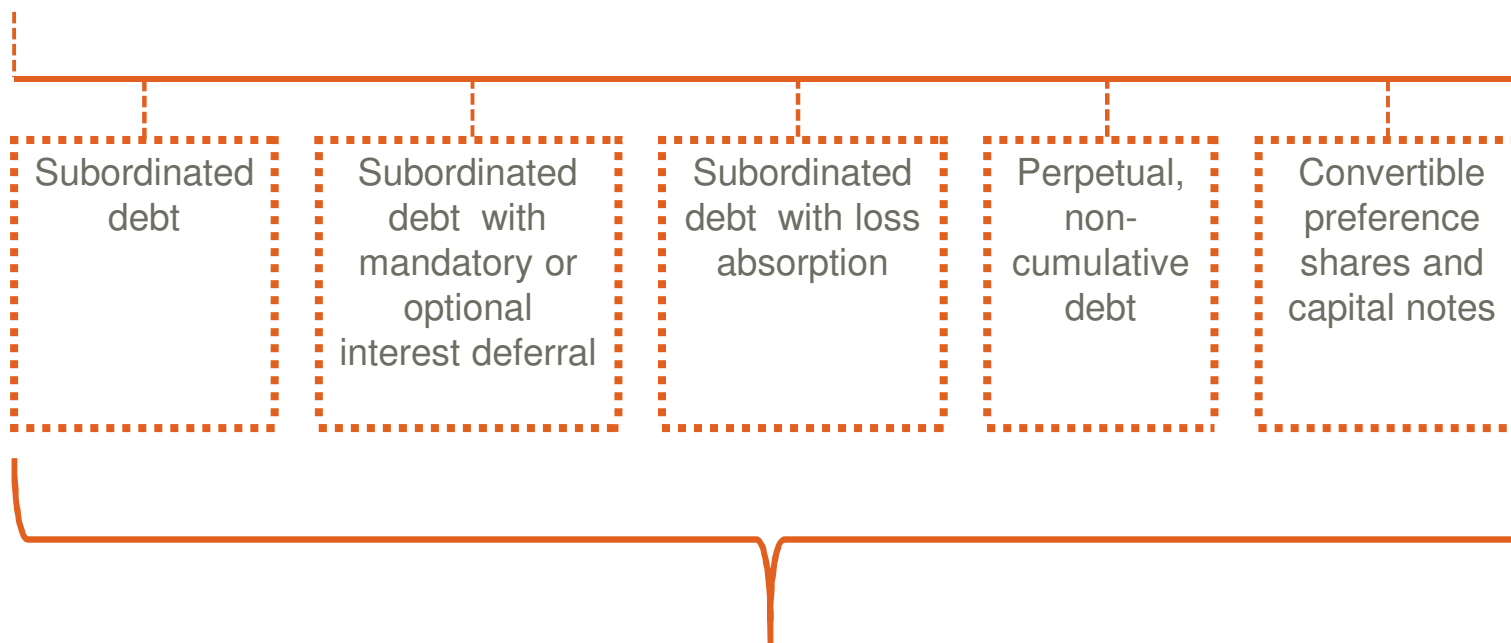




Not all hybrids are created equal...

Vanilla corporate bonds
(‘pure’ debt)

Ordinary shares
(‘pure’ equity)



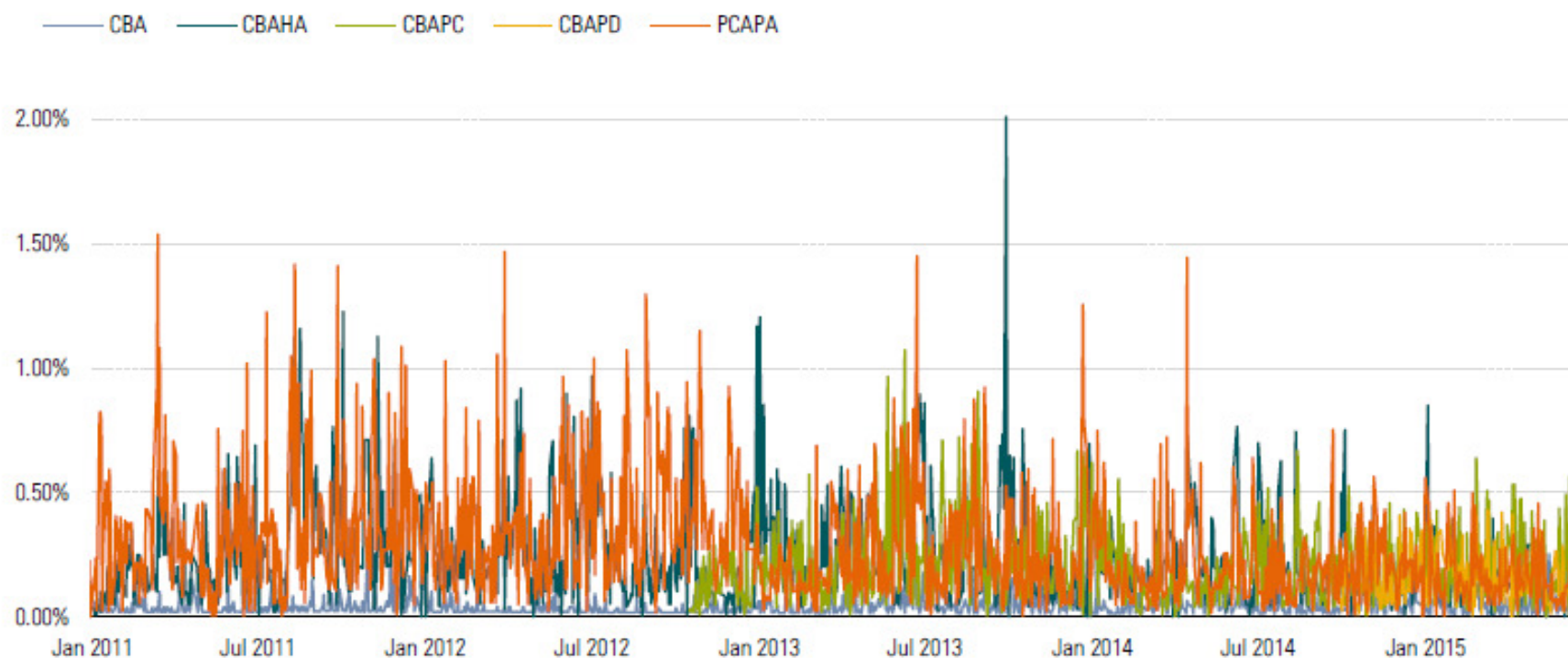
Hybrid Securities

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



Contents



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



The challenges of directly investing into hybrids



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



The potential problems...

- ▶ **No two hybrids are the same** – issuance terms can be complex, requires understanding of the idiosyncrasies of each security
- ▶ **Listed hybrids market relatively inefficient** – some investors may not have the capability to accurately price securities
- ▶ 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**





The potential solution?

Why we believe you need an **experienced professional active manager** for your hybrids allocation:

- ▶ **Access to valuation models** allowing them to detect and potentially profit from mispricing
- ▶ Potentially have a greater ability to **detect overvalued securities** and mitigate risks to capital
- ▶ Likely to have a **greater understanding of the complexities** of individual securities to potentially identify and mitigate risks
- ▶ Likely to hold a **more diversified portfolio** of hybrid securities (~20-50 in the case of HBRD) and may therefore reduce concentration risk

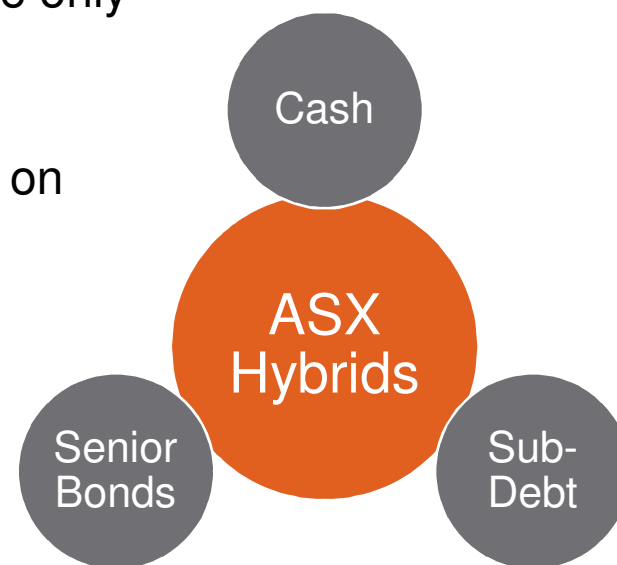




Professional Management of Hybrids (I)

HBRD targets:

- ▶ Returns after fees that are greater than Australian Hybrids Index⁽¹⁾
- ▶ Post-fee returns > RBA cash rate + 2.5% pa over medium term
- ▶ Post-fee, franked running yield generally similar to Australian Hybrids Index⁽¹⁾
- ▶ 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



⁽¹⁾ Solactive Australian Hybrid Securities Index



Professional Management of Hybrids (II)

- ▶ 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)

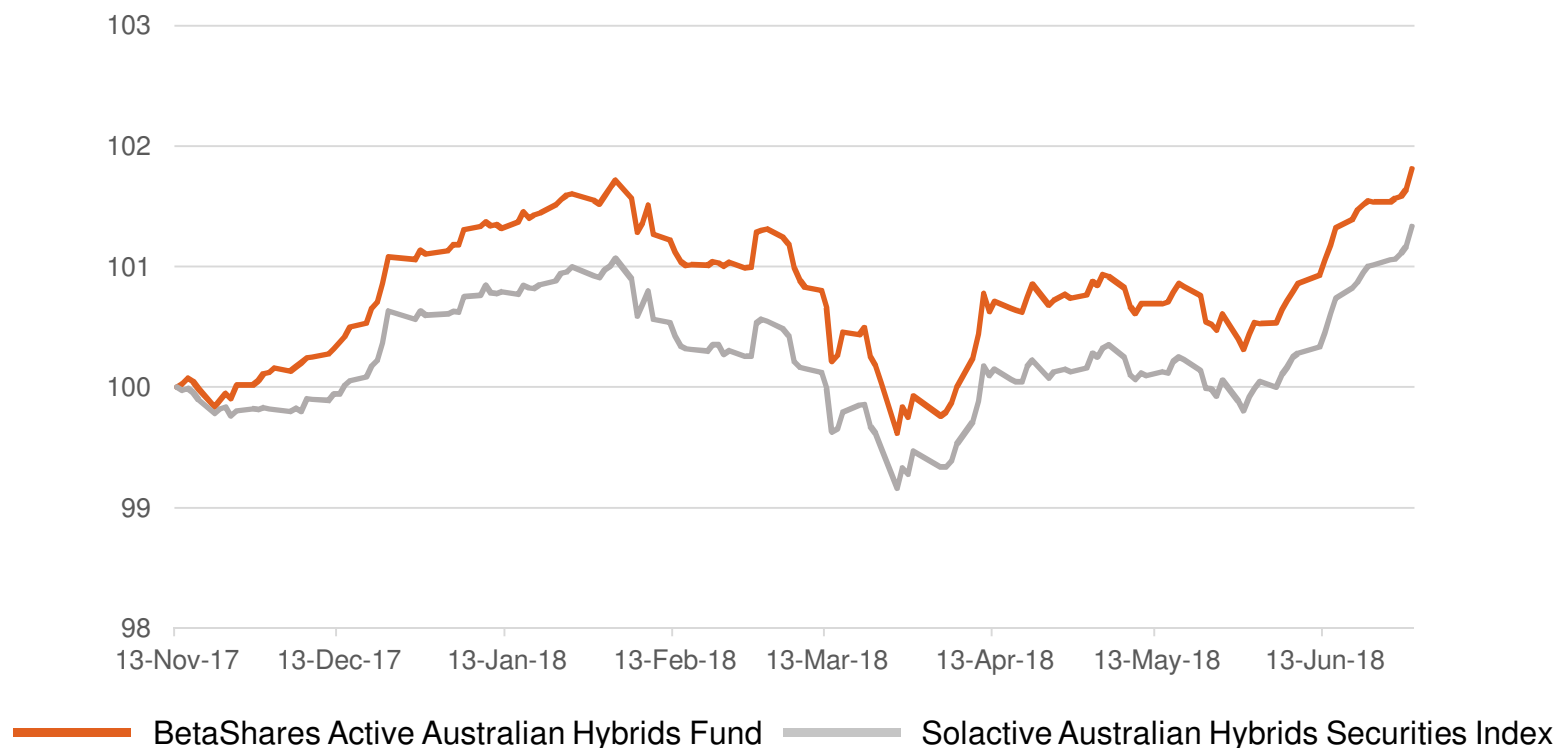
📌 Subordinated bonds

📌 Hybrids



The Professional Management Advantage

Performance of HBRD v Benchmark since inception to 30 June 2018



Past performance is not an indicator of future performance. Returns are calculated in Australian dollars using net asset value per unit at the start and end of the specified period and do not reflect brokerage or the bid ask spread that investors incur when buying and selling units on the ASX. Returns are after fund management costs, assume reinvestment of any distributions and do not take into account tax paid as an investor in the Fund. Returns for periods longer than one year are annualised. Current performance may be higher or lower than the performance shown.



Re-cap: Hybrids & Professional Management

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



Things to keep in mind

- ▶ 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, income payments from hybrids can be expected to fall.
- ▶ Hybrids are, by their nature, predominately issued by banks, creating sector concentration risk.
- ▶ Investors in hybrids are 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.





Stay informed

Visit our website

The screenshot shows the BetaShares website with a navigation bar including links for ABOUT US, OUR FUNDS, EDUCATION, INSIGHTS, ADVISERS & INSTITUTIONS, YOUR HOLDINGS, and CONTACT. The main content area features a large banner for the **BETASHARES AUSTRALIA 200 ETF (ASX: A200)**, described as 'The world's lowest cost Australian shares ETF'. Below this, there are sections for 'LATEST NEWS' and 'INSIGHT'. The 'LATEST NEWS' section includes an article titled 'Proposed modifications to Fund constitutions regarding AMIT tax regime'. The 'INSIGHT' section includes an article titled 'Australian House Price Valuation Update: What's cheap, what's...'. A 'Most Viewed Funds' table is also visible.

NAME	CODE	CATEGORY
NASDAQ 100 ETF	NDAQ	International Shares
Global Sustainability Leaders ETF	ETHI	International Shares
Equity Yield Maximiser Fund	YMAX	Equity Income

Sign up for regular insight

The screenshot shows the 'Bassanese Bites' newsletter sign-up page. It features a header with the name 'Bassanese Bites' and a photo of a man. Below the header, there are three article teasers: 'Trump throws markets a bone', 'Wall Street at Record Highs', and 'A Focus on Trump Trades'.

Follow us on Social Media

