EUREKA report

Build your own hybrids

By Doug Turek
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PORTFOLIO POINT: Investors looking for good, stable returns could consider a mix of shares and cash.

When it comes to constructing a portfolio, many investors seek out hybrid income securities as part of their fixed interest allocation. I tend to avoid hybrids when designing resilient retirement funding portfolios because I consider hybrids to be “half-pregnant”: their price fluctuates like equity but the returns are more like bonds.

Instead of investing in a typical bank-offered hybrid security, I have often thought you would be better off depositing half your money in a savings account with that institution and buying shares in that bank with the other half. Today we show why that may not be such a bad idea.

Most investment portfolios are made from a mix of equity and bond-like investments. The mix you end up choosing is a compromise between many factors, including needing to eat well and being able to sleep at night.

Many financial products offer to help you fill this slot, including at-call bank deposits, fixed-rate term deposits, bank bills, notes, mortgage securities, longer-term fixed rate bonds, floating rate bonds, inflation-linked bonds, funds that hold a diversified portfolio of bonds and exchange traded (hybrid) income securities.

A common type of hybrid security is one that pays an income linked to a benchmark rate and is exchangeable at a future date for equity in the issuing company. Many are an unsecured subordinated note (read: low priority loan) “stapled” to a share of ownership in the borrowing company, often a share that promises to pay dividends or be liquidated in preference to other shareholders if need be.

Which loan to which bank?

Among the banks, the Commonwealth has been the most prolific offeror of income securities. You can currently lend them money by investing in their PERLS (III, IV and recent V issues. The oldest PERLS III, which trades under the ASX code PCAPA, was issued in April 2006 and pays interest quarterly at the rate of 1.05% above the bank bill swap rate, together adjusted by 70%. This discount is because the tax office should later give you a refund or reduction in other tax payable as payments are franked dividends. I frequently wonder whether this is a better deal for the issuer than you or me

For less risk you could buy through a bond broker higher AA-rated, longer-duration rate bonds issued by CBA, such as for instance those currently paying a yield of 6.3% or an inflation linked yield of 4.4% before inflation adjustment.

However, for greatest safety you would deposit your money with the Commonwealth Bank and earn an at-call rate of 4.25% or term deposits rates of 5.1–7% for five months or five years respectively.

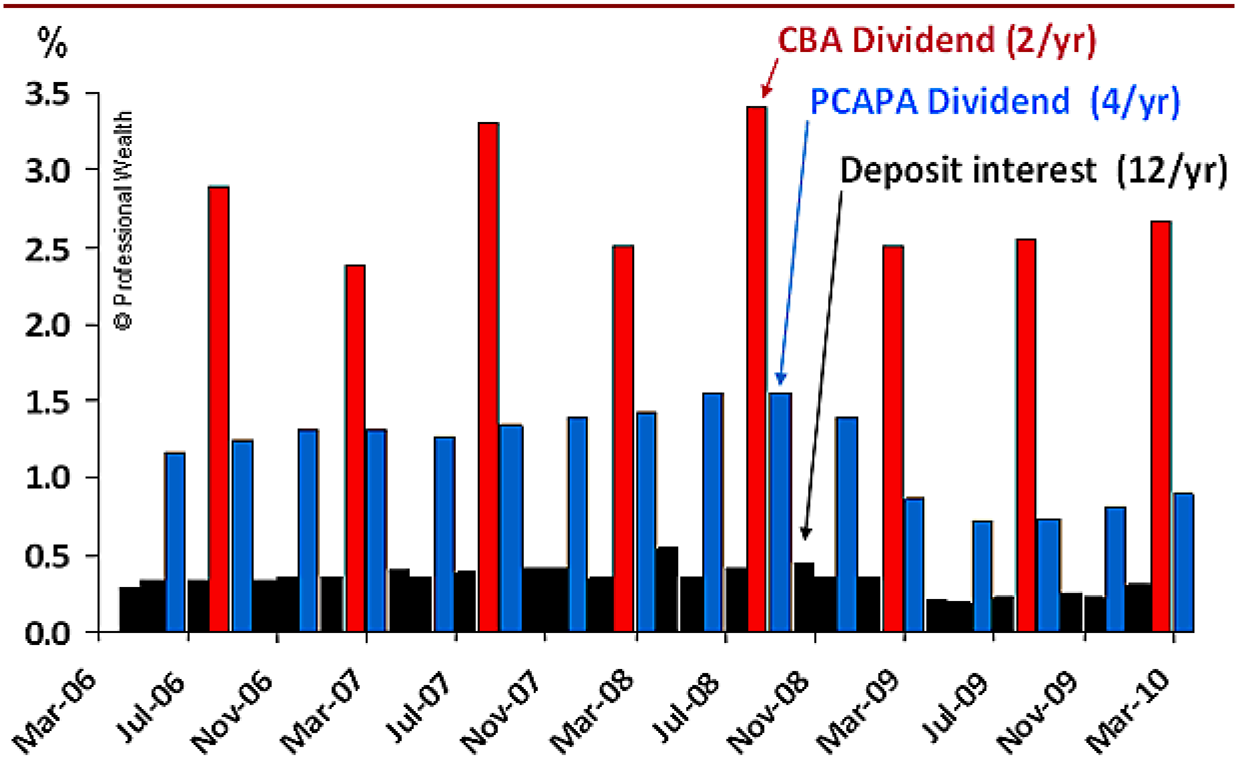
Let’s now look at how investments in this bank income security fared against the alternative of saving with the bank (safest option) while also owning the bank (riskiest option).

Historical security prices and income

The two graphs below chart the price and income from PERLS III, CBA shares and a bank deposit over the four years since PERLS III was listed. The monthly deposit interest rate is that for 90 day term deposits using Reserve Bank monthly figures, an attempted proxy for the return from high-yield at-call deposits (although I suspect you could still do better than the currently RBA quoted 3.3% March 2010 rate).

Investment prices relative movement (%) since March 2006

Investment distributions as a % of March purchase price



These graphs tell an interesting story about price and income stability The CBA share price demonstrated the most extreme volatility – bought at $45, it peaked at $61, fell to $24 and now is back to about $59.

But the price of the PERLS III income security was also far from stable, bringing into question whether it should be considered as a bond-like investment. It issued at $200. The price fell to a low of $130 and it is now back to $170. Holders of PERLS III may need to wait until 2016 to be paid back $200 in capital.

At-call deposits are capital stable investments that are particularly important for profitably rebalancing as I showed earlier (see ***Get ready to rebalance***). This feature is also shared by high quality diversified bond funds, some of which even appreciated when shares went down in value.

Surprisingly, the biggest and most stable income stream came from owning the bank, not lending it money. Dividends from CBA, PERLS III and deposit interest over the four-year period totalled 22%, 19% and 17% respectively when measured against the value of the original investment, or a 5.1%, 4.4% and 3.9% annual return. Grossed up, the CBA and PERLS dividends averaged 7.3% and 6.3% annually (both now are paying a running yield of 6%).

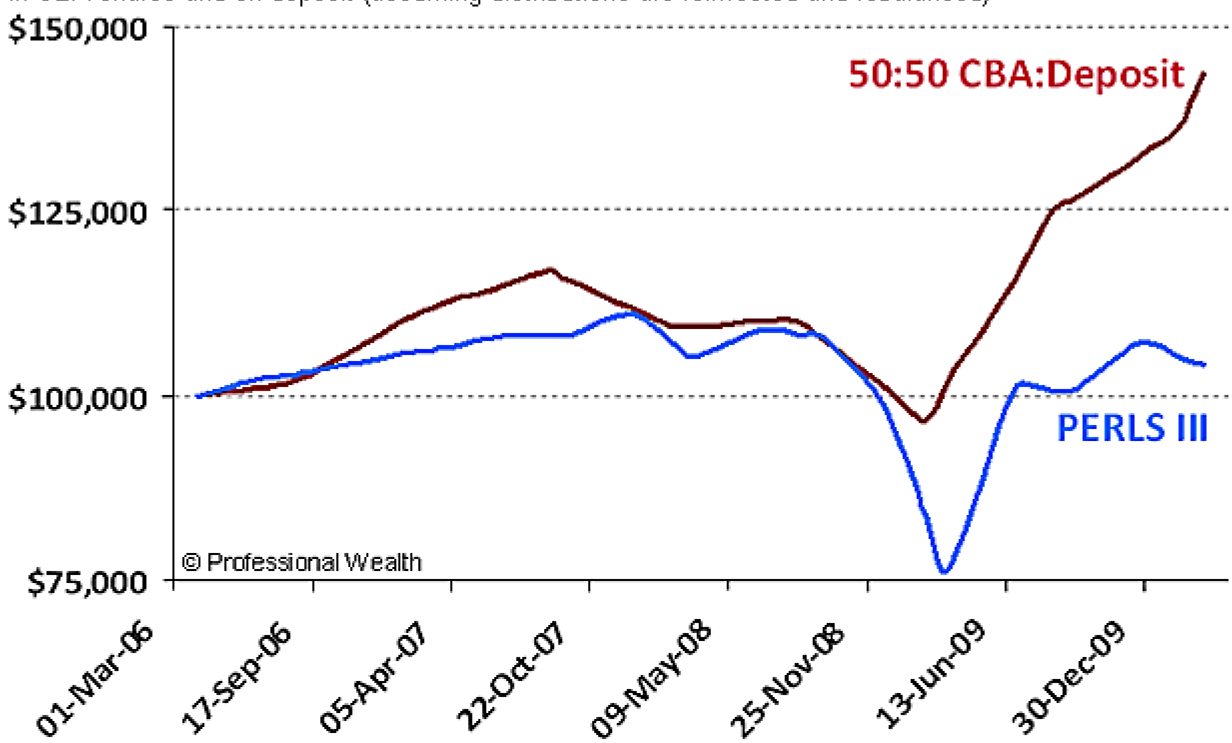
The amount of distributions paid by the bank fell only 15% at its worst, compared to 40% for PERLS III and deposit interest. This is because the latter are tied to benchmark rates, which swung wildly through the GFC while the former is tied simply to profits which kept being earned despite crisis conditions.

Equity versus income security investing

Now let's compare how an investment in the income security performed versus a portfolio made equally of bank shares and deposits. The below figure shows the total return from a $100,000 investment made in March 2006. In this calculation distributions from the income security were each time reinvested and after each half-yearly bank share dividend was paid the portfolio was rebalanced back to a 50:50 mix.

PERLS III vs investments in Commonwealth Bank shares and on deposit

Value of $100,000 invested in March 2006 into a PERLS III income security compared with $50,000 each in CBA shares and on deposit (assuming distributions are reinvested and rebalanced)



At least over the past four years simultaneously owning and depositing with the bank delivered a superior result than investing in the income security. Not only is the end result better ($143,000 versus $104,000), but the decline in portfolio value was less than that from the income security. Note that without rebalancing the portfolio would have grown to a lesser, but still better, $138,000.

In the current situation good credit quality income securities are yielding 6–7% when at call bank deposit returns range from 4–5%. Rather than chase the higher return offered by income securities and its associated capital instability and credit risk, consider instead allocating one-quarter more of that intended investment into diversified equities, keeping the balance in safer bond alternatives or bank deposits. There is a good chance you'll get the same or better outcome.

Reinforcing the role of bonds in portfolio construction

I don't mean to be overly negative about this class of investment, and indeed there are worse-performing income securities to have used as an example. From time to time income securities become mispriced and offer good buying opportunities. During "normal" periods they can boost portfolio returns. However, I don't see them playing the critically important defensive role in resilient portfolios.

During this recent crisis if your bond portfolio was made up only of income securities you would have been reluctant to sell them down to even fund living expenses. Whatever extra income you earned earlier from this or any other low credit quality investment would have been given up by your inability to use them to rebalance other securities or lost until their capital value recovers at redemption (assuming they don't default before then).

Your core bond portfolio should include a mixture of only high credit quality investments – some which resiliently earn a locked-in rate, attractive during the last rate fall, some which benefit as interest rates rise and some which earn a return linked to inflation, in case costs don't track interest rates.

At-call and term deposits can be used to get some of this exposure, but be careful only being a depositor. Otherwise you'll concentrate your money in just one institution or institutions that, at least in the recent global context, can still get into problems. A good bond fund works by spreading your investments across, say, 50 different investments so the failure of one equals a maximum loss of 2% of your capital.

The GFC had its origins in too-clever product manufacturers satisfying perhaps too-greedy, but certainly misled, bond investors. The lesson is to be careful chasing extra yield from income-style investments. Sometimes the returns from more boring, lower yielding investments contribute more to a portfolio.

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