Jan 9 2017 at 11:00 PM
Updated Jan 9 2017 at 11:00 PM

Bank hybrids deliver double-digit returns for bargain hunters

by Jonathan Shapiro

Investors who piled into bank hybrid securities in 2016 at record high margins were well rewarded with near double-digit returns for the year.

The broader ASX market of listed securities returned 9.2 per cent over the year but for those who bought hybrids issued by the banks, and claimed extra tax credits, returns topped 11.8 per cent for the year.

That matched the 2016 gain in the S&P/ASX 200 Index, and beat the 2.9 per cent of the S&P/ASX Fixed Income Index. The strong returns make up for a weak 2015 when a glut of supply by banks flooded the listed debt market, forcing down prices, and returns.

An improvement in risk appetite and reduced sales of new securities helped investors to strong gains in 2016.

"The performance of the market was largely driven by confidence in the first half of the year but technical factors such as net issuance – new issues less redemptions – reducing by $1.6 billion in the second half also helped the overall returns," said Nick Yaxley of credit research firm BondAdviser.

Among the best performing securities were major bank hybrids, which had fallen out of favour after investors lost money backing new deals sold in 2015.

Evans & Partners numbers put the return on Basel III hybrid securities sold by major and regional banks to meet their capital requirements at 9.9 per cent for the year. Dividend imputation, or franking, added an additional 1.9 per cent, to push the total return to 11.8 per cent.

Over five years, however, listed senior bonds delivered a stronger return of 10.8 per cent, versus the grossed-up returns of 10.3 per cent for investing in hybrid securities. Investing in a combination of hybrids and bonds returned around 8.9 per cent.

According to BondAdviser numbers, the average spread of bank hybrids declined from 5.3 per cent over the bank rate, in February 2016 to 3.2 per cent in December 2016.

The major banks are the largest issuers in the hybrid market and investors track the margin these securities are paying above the risk-free rate as a gauge of value. The higher the margin, the cheaper the price of the security, and the more attractive the yield.

Bank hybrids pay a set margin above the three-month bank bill swap rate, which is now about 1.8 per cent. This means the average bank hybrid pays an annual interest rate of about 5 per cent, compared with about 7.5 per cent in February.

While the majority of hybrids sold in 2015 traded below their listing prices, investors who subscribed to new offers in 2016 fared far better.

The controversial CBA Perls VIII deal, which some investors and commentators pointed out was sold at a margin below that available in the secondary market at the time, is currently trading 7.4 per cent above its listing price. However CBA Perls VII securities which were sold at the top of the hybrid market in August 2014 at a margin of 2.80 percentage points over the bank rate, still trades at a 4 per cent discount to face value.

The gain in prices, and fall in margins, has made the sector less attractive. But reduced spreads may encourage more bank and corporate borrowers to raise funds through ASX listed debt securities.

"Pockets of value still remain in the listed market but we expect issuers to respond to these valuations with increased issuance in the first quarter," Mr Yaxley said.

Some investors took advantage of record high spreads at the start of the year. Melbourne based credit fund Realm Investments moved almost a quarter of its credit portfolio into bank hybrids at the start of the year but has since reduced its exposure to less than 10 per cent of its portfolio.

Realm portfolio manager Andrew Papageorgiou said it was highly unlikely hybrids would be able to repeat the capital gains of 2016 because hybrid security margins would converge with safer senior unsecured bonds if that happened.

"The market was pricing in a stress level around these assets that didn't reconcile with the asset quality," he said. At current margins, bank hybrids were "fair to moderately expensive".

"They went from being cheap to extremely cheap but now the market is applying a more normal long-term level of risk," Mr Papageorgiou said.

Without a margin of safety that was evident at the start of the year, bank hybrids could be affected to a greater degree if global markets become more volatile.

"It's too simplistic to say that a margin of about 4 per cent [above the bank rate] is fair because bad things happen once in every 25 years. There are lot of things going on overseas that could impact us," he said.

Bank hybrid securities count as tier one regulatory capital and while they resemble fixed income securities they do carry some equity-like risk as regulators can demand that they be converted to shares or written off if the bank runs into trouble.

However, most Australian bank capital has been sold to mum and dad investors, which would complicate a potential "bail-in" of hybrid holders.

The steps taken to protect retail investors of troubled Italian bank Banca Monte dei Paschi di Siena, Mr Papageorgiou said, showed that policymakers had little appetite for enforce losses on non-institutional investors.