CBA PERLS are equity dressed up as debt

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Most of the so-called hybrid securities that retail investors have poured billions into over the past few years are equity dressed up as debt. In fact, it is worse than this: hybrids tend to expose you to the risks of shares with none of the upside capital growth.

Today I want to focus on the most high-profile recent hybrid issue: Commonwealth Bank of Australia's PERLS VI, which raised $1.5 billion from punters, and replaced the PERLS IV issue.

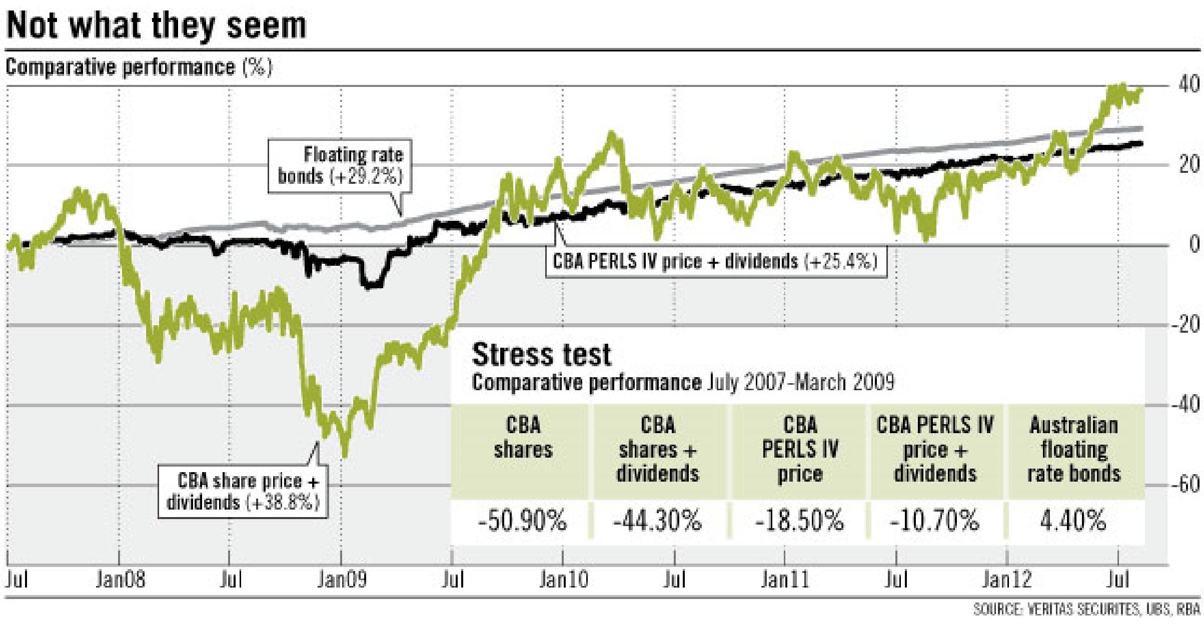
The PERLS have been marketed to mums and dads on the basis of their high interest rate, which involved a 3.8 per cent annual premium over the variable bank bill rate. This underlying benchmark rate is reset quarterly and generally moves in line with the Reserve Bank's cash rate.

The PERLS VI issue offers a total annual yield of about 7.4 per cent subject to movements in the benchmark rate and any changes in the asset's price. Many brokers argued that this was attractive compared to lower returning "cash" rates.

The concern I have is that the PERLS are not remotely like cash.

One can highlight this two ways: first, by examining the economic performance of the PERLS series during times of market stress relative to ordinary shares and cash; and, second, by drilling down into the product's complex terms and conditions, which reveal that you are assuming large equity hazards.

A leading quantitative analyst, Andrew McCauley at Veritas Securities, helped me pull together the analysis for the first exercise. Specifically, we looked at the performance of cash-style assets (namely a portfolio of investment-grade, floating-rate bonds) compared with ordinary CBA shares and the PERLS IV issue. We focused on July 2007 to March 2009, since this includes a downside scenario – the global financial crisis. The results are summarised in the chart and table.



If you bought into PERLS IV in July 2007, you would have lost 18.5 per cent of the value of your investment by March 2009. This is an improvement over CBA's ordinary shares, which were down nearly 51 per cent. If you add back in the dividends and distributions you received, you still lost about 11 per cent on PERLS IV and 44 per cent on the standard shares.

In contrast, if you put your money into a diversified portfolio of investment-grade, Australian floating-rate bonds, which are a cash proxy, you would not have lost anything despite the ructions. In fact, you would have made money, earning more than 4.4 per cent.

Interestingly, the chart shows that notwithstanding the GFC, CBA shares generated the highest total returns if you were happy to persist through the volatility, and years in which your returns were substantially negative.

Most importantly, the analysis shows PERLS behave like they have equity risk, and perform very differently to cash investments. The reason becomes obvious once you absorb their terms and conditions.

Unlike normal bonds that have a fixed maturity date, PERLS VI are "perpetual" investments. That is, you have no certainty of being repaid. To make this unambiguous, CBA has to mandatorily convert PERLS VI into ordinary shares after eight years if it does not redeem them earlier. It has absolutely no obligation to redeem.

A second feature of PERLS VI is that the distributions you get (that is, the 7.4 per cent return) are entirely at the discretion of CBA, just like dividends on shares. So CBA can stop making these payments whenever it wants.

In contrast to conventional debt, this is a not a default event. Further, if CBA stops paying distributions, it has no obligation to make up the cash flows you miss if it ever restarts. CBA is also prevented from paying dividends on ordinary shares (or undertaking buybacks).

PERLS VI have several other hard-wired terms that deliberately embed equity risk to ensure they qualify for “additional tier one” (or first loss) capital under the new global banking regulations known as BASEL III.

The first is that the Australian Prudential Regulation Authority requires that if CBA’s “common equity tier one capital ratio” falls from its current 7.5 per cent level to 5.125 per cent or less, PERLS automatically convert to equity – the capital trigger event. If this happens, you lose your distribution payments and are switched to the riskiest part of CBA’s capital structure at the worst time – when some disaster hits the bank.

A second hazard is that APRA has the right to unilaterally force CBA to convert PERLS VI into equity if it thinks CBA would be non-viable in the absence of this exchange or a taxpayer bailout. This covers situations where CBA suffers steep capital losses or has difficulty raising new finance without government support. Once again, you lose your PERLS investment, which is replaced by pure equity at a time when CBA is in duress.

Under both the capital trigger and non-viability trigger events, the PERLS are also limited to a maximum number of shares they can be exchanged into. At very low share prices, the value of the equity you receive may be less than your original PERLS investment.

Two differences between PERLS and ordinary shares are their legal status and economic rights. The PERLS are junior-ranking notes and you are only paid the distributions outlined. You have no voting rights, although you rank ahead of shares.

Ordinary shares carry voting entitlements and an owner’s claim to CBA’s distributable profits. This means shares afford access to growth potential. If there is a significant change in CBA’s earnings expectations, or the risk associated with those future cash flows, shares may rise in value. The same principles do not immediately apply to PERLS.

Since CBA’s shares now have a dividend yield of about 6.1 per cent, many would be better off retaining the equity upside if they are going to take the downside. Alternatively, consider one of the major banks’ Australian Securities Exchange-listed bonds, which pay about 6.2 per cent with no equity risk at all.