Bank hybrids - equity risk with bond returns?

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We hear this one a lot. And, while overall being incredibly misleading, there is a sliver of truth to it - hybrids do carry some risks in common with equity and do not have unlimited upside. On the other hand, let's test just how accurate this idea really is by looking at the CBA PERLS VII issue.

To do that, we will envisage a worst-case scenario for CBA and compare the returns of the PERLS and the CBA shares. As a worst-case scenario, we'll assume that Australia enters a deep recession and residential housing prices collapse, triggering a string of losses in CBA's lending book. We'll assume that losses of the order of $15 billion on lending will turn a profit of $8 per share into a loss of $20 per share and the bank's Common Equity Tier 1 Capital (CET1) falls from 9.2% to 4.5%, below the capital trigger of 5.125% where the hybrids are converted into equity.

Now, this will come as no great surprise to the market, which will have anticipated much lower earnings and stress on the bank's capital position well before any announcement about a breach of the CET1 ratio. Let's assume that CBA shares fell to $40 on a Friday night, with rumours running wild that the trigger was close to being hit. On Monday morning, APRA declares that CBA has breached it's CET1 trigger point, and all hybrids are to be converted into equity at $40, last week's average price.

The critical issue for hybrid investors is how much further the price falls on the Monday morning. Let's say the price falls another 20% and our hybrid investors sell their newly converted shares at $32, for a 20% loss. Nasty. But how are the equity investors doing? Much worse. They're now down over 65%. To get back to even, they need a gain of 190%. Our hybrid investors need a 25% gain to get back to square.

Things could be worse. If the market was really running scared and the average CBA share price the previous week was say, $10, then under the terms of the issue, the conversion price can be no lower than $15.25. Now our hybrid investors are down around 50%, assuming the price again falls a further 20% to $8 per share on the news of the trigger event. Very nasty. But again, much less so than for the equity investors who are now down 91%, and who now need a 1000% gain to get back to square.

So, the hybrids do carry risk. But to describe them as the same risks faced by equity holders seems an overstatement of gigantic proportions. To describe them as even more risky than equities, as a prominent fixed interest expert did recently, is patently ludicrous.

And what about returns? Australian government bonds are trading at 3.0% per annum. Government-guaranteed TDs offer returns of 3.2% per annum for five years. BBB-rated securities offer around 4.5% per annum for five years. The PERLs offer 3.9% above the cash rate, so around 5.9% per annum over the next five years. In other words, the bank hybrids offer around 1.5% above even BBB-rated securities which, as we know, can and do fail.

In our view, bank hybrids offer better than bond returns with higher than bond risk. They offer lower than equity returns with much lower than equity risk. We like them.

Hybrids give equity risk and bond returns? It's nuts and you can clearly see it's nuts.

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