portfolio construction forum

# ASIC on hybrids

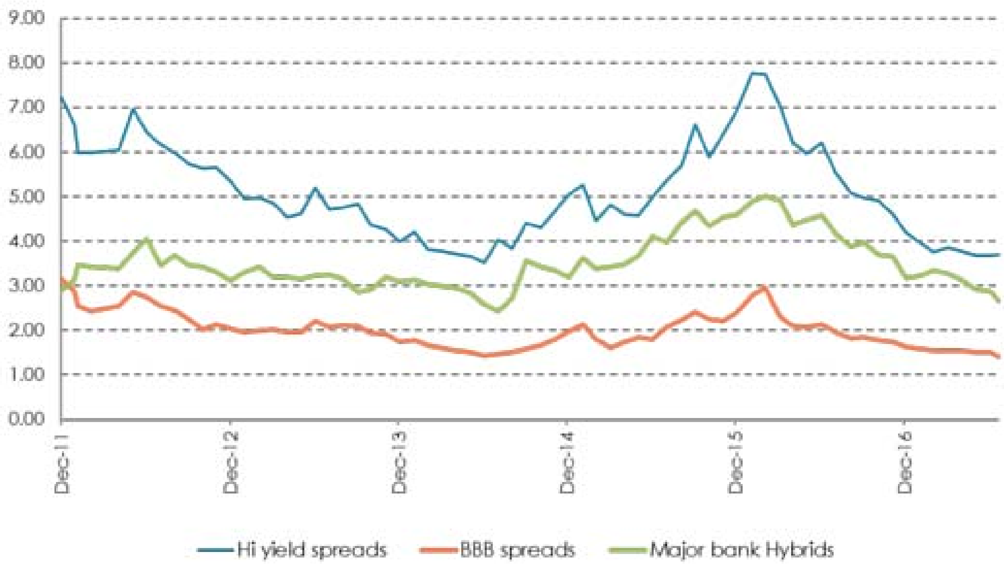
Tim Farrelly | farrelly's | 25 July 2017

The head of ASIC says that hybrids are a ridiculous investment for retail investors. Are they?

Yes and no. Yes, they are ridiculous, if investors think of hybrids as a listed version of a term deposit. No, they are not ridiculous, if investors have a fair understanding of the risks involved.

The fact is that the yields offered on these securities lie between those offered by BBB corporate bonds and junk bonds as shown in Figure 1.

Figure 1: Spreads: BBB and Hi yield securities




Source: US Federal Reserve, Evans and Partners.

That seems pretty attractive to me. I find it really hard to think of the circumstances in which the regulator, APRA, would stand idly by and let losses at one of the major banks mount without ordering an equity capital raising. As a result, I find it hard to think of major bank hybrids as riskier than a BBB corporate bond.

And that's all an investor really needs to understand – that the return more than compensates the low risk involved but that the risk, while low, is real.

That allows the investor to contemplate what would happen in the unlikely event that a major bank did get into trouble. How much can they afford to lose – including any exposure to the bank's equities? That thought process lets any investor, with the help of their adviser, decide how much they want to invest in these securities. Not IF they invest, but how much.

Investors just need to know the basics rather than all the ins and outs of these admittedly complicated securities - just as they don't need a highly detailed knowledge of the inner workings of a bank's P&L in order to own bank shares.

So why the alarming remarks from ASIC chief Greg Medcraft?

I suspect the primary motive was to ensure that hybrid investors never get to claim that they didn't realise that their investment isn't covered by the government guarantee of TDs. He is just protecting the Treasury.

Secondly, he was probably also hoping to encourage investors to at least contemplate the possibility of a failure and to set their exposures accordingly.

Both are sensible objectives. Even if the message itself is not.

*Tim Farrelly is principal of specialist asset allocation research house, farrelly's Investment Strategy, available exclusively through PortfolioConstruction Forum. Tim is a member of PortfolioConstruction Forum's core faculty of leading investment professionals.*