

The Great Bank Hybrid Con:

How conflicted advice has cost investors

Bank hybrids have an unparalleled brand as a go-to income generator across many Australian high net worth investors

For over two decades listed bank hybrid securities have been a go-to high income investment that advisers and brokers have recommended to their high-net-worth (HNW) clients. These hybrid securities have been marketed aggressively, and hugely successfully, with approximately \$43Bn outstanding currently. The 1.25% fees paid on new issues acted as a powerful incentive for advisers to recommend these products over other, potentially better, alternatives.

Genius one: Arbitrate the investor vs regulator

The brilliance in bank hybrids began with their design. Complex instruments with intricate structuring to achieve an arbitrage where they are treated as debt by accounting standards and investors while being treated as equity by APRA (the bank regulator) and the ATO. This master stroke achieved two things: 1) Investors priced the instrument like senior debt despite it actually ranking fairly low in the capital stack; and 2) allowed hybrids to pay fully franked distributions, something a normal debt instrument can't do. This was a boon for the banks because it cheapened their cost of capital significantly.

Genius two: $7 + 3 = 14.3$

Misconceptions - Many investors think the franking credit is on top of the quoted yield

One troubling aspect of the promotion of bank hybrid securities is the way their returns are upsold. The returns and yields are quoted including the grossed-up value for the franking credit, making them appear more attractive. In contrast, all other securities paying a franked yield have their dividend yield quoted unfranked. This practice can mislead investors into believing that hybrids offer superior returns, when in fact, a straightforward comparison may reveal otherwise. The result is investors thinking the income is 43% higher than it actually is. Incredibly, we often come across advisers who also think this is the case!!! ... sounds crazy I know.... I wish I was joking.



There are numerous managed fund alternatives that have generated higher and more stable returns than hybrids

A raft of hybrid replacement offerings are coming to market currently. It's worth asking whether they are the best solution for your portfolio

But hybrids have still been the best solution.... right?

Many individual factors determine the suitability of an investment – and beauty is in the eye of the beholder. However, **on simple return and risk metrics the reality is that there have been a number of better alternatives than hybrids.** There are a number of income funds available in the market that are invested in high grade credit and have generated superior returns to hybrids (on average ~1% better income per annum). Interestingly these particular funds have also displayed lower risk characteristics (e.g. their value fell by significantly less than hybrids during COVID). Higher return and lower risk is about as compelling as it gets!

New hybrid issue fees of ~1.25% paid to brokers and advisers (usually 0.5% to the corporate broker plus 0.75% to the adviser) have acted as enough incentive that many advisers have ignored whether there are other options with a better investment case. With \$5bn or more being issued each year the annual fees being paid equates to greater than \$60m.

Watch out for the look-a-like

There has been a recent regulatory move to phase out bank hybrid securities. Fund managers have seen an opportunity to pick up some of the \$43Bn invested in hybrids and have begun launching hybrid replacement products. So far these replacements don't look any better than hybrids to us, but they are paying issuance fees which seems to be making them popular amongst some advisers.

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