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What's the difference between bonds and hybrids?

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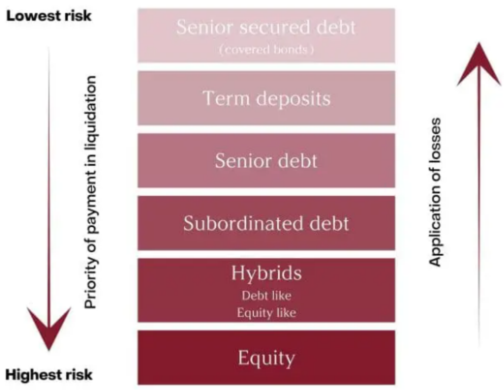
Hybrids are a financial security that combines characteristics from both debt and equity investments into one instrument. Like bonds, hybrids pay investors coupons on a specified date (usually floating rate) until the security is called by the issuer or matures. Investors usually are offered a higher return than bonds as hybrids sit towards the bottom of the capital structure, thus meaning more associated risk if the issuer were to default or collapse (see table below).



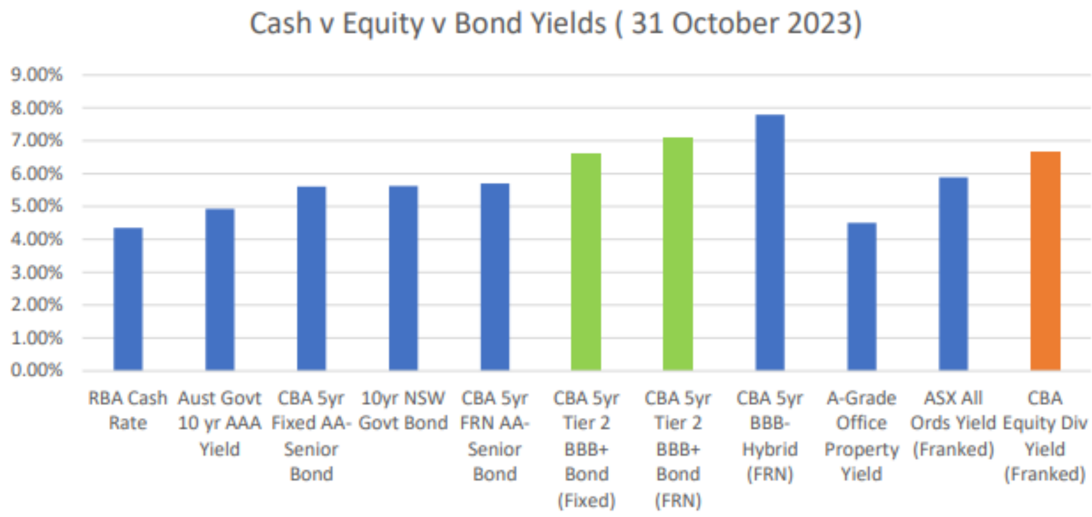
What companies issue Hybrids? And why?

Most Hybrid securities are issued by banks and insurance companies. Under Australian and international regulatory regimes, banks and insurers are required to have certain liquidity at hand in cases of distress. An example of this was the Global Financial Crisis but could also include situations where a certain bank suffers losses to the extent that its common equity falls below certain levels, i.e. a large share price fall.

In cases of stress, Hybrid interest can be stopped and may be done at the discretion of the issuing institution; in these cases, missed interest payments have a non-accumulation clause, and those missed payments are NOT required to be made up for in the future.

In a case like this, most hybrids can, in further distress, be converted into equity, which is why they are known as “loss absorbing instruments”. This is usually not to an investor’s benefit as the shares may be worth less than the initial amount invested. If an investor prefers more certainty and protection, then bonds are safer.

What are the relative risks and returns?



Of course, investors have different risk appetites and different needs in terms of income, and (very importantly) may have very different abilities to replace capital that is lost in adverse market moves. This can be very important, especially right around retirement age. As can be seen above, there is only a 40-50 basis points difference between CBA’s hybrid returns and its safer tier 2 bond returns. Both exceed the dividend yield (including franking credits).
Arguably, the returns of 6.00-7.00% available for major bank bonds (often called tier 2 or subordinated debt) are more appealing than the small incremental yield available in riskier hybrids.

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