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Bank Hybrids – An Attractive Fixed Interest Alternative in a Rising Rate Environment

KEY POINTS:

- Reserve Bank has strongly signalled need for higher domestic interest rates
- Limited fixed interest investment options for retail investors
- Floating rate hybrids adjust to rate rises and offer a higher yield than comparable fixed interest securities
- Hybrid securities of the major banks have a very low risk of failure by the issuer and a high likelihood of redemption / conversion at maturity / reset

The RBA then went on hold from May 2010 to:

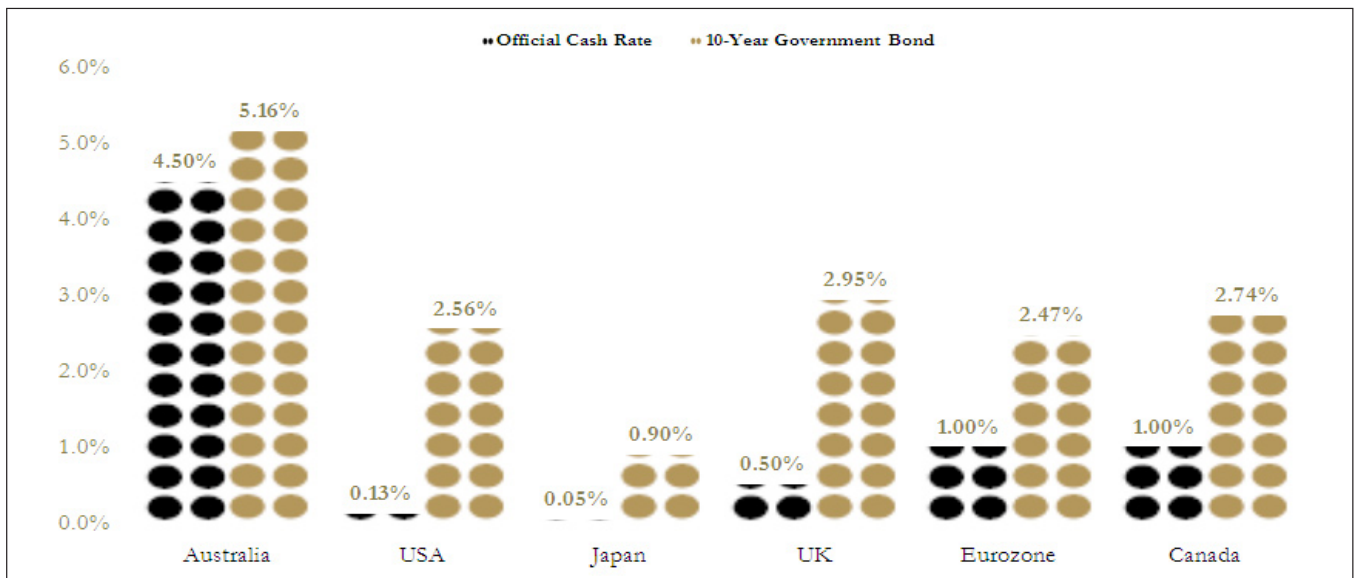
- (1) assess the impact of higher domestic interest rates on the local economy and to
- (2) monitor the potential negative impact of renewed turbulence in international markets (Eurozone sovereign debt issues; China tightening; slowing USA growth).

Over the last month, however, official statements and a raft of speeches from senior RBA managers have emphasized the strength of the local economy, emerging capacity constraints and the strong medium term economic outlook for Australia. Taken together, these conditions suggest that monetary policy will need to be tightened further (read: interest rates have to go higher) “at some point, to ensure that inflation remains consistent with the medium-term target”.

AUSTRALIAN FIXED INTEREST – RBA GIVES CLEAR SIGNALS FOR HIGHER CASH RATES

The Reserve Bank of Australia has been at the forefront of raising official interest rates after the financial crisis. From October 2009 Australia’s central bank lifted the cash rate at 6 consecutive meetings in 7 months (from 3.0% to 4.5%).

CHART 1: OFFICIAL CASH RATES & 10 YEAR GOVERNMENT BOND YIELDS



Sources: IRESS, Central Banks

DEVELOPED ECONOMIES: LOWER CASH RATES AND GOVERNMENT BOND YIELDS

The favourable domestic economic outlook contrasts with a slower than expected economic recovery in other developed economies, particularly the USA and Japan. The central banks of both countries have recently foreshadowed further measures to reduce market interest rates through quantitative easing (essentially buying medium- to longer-term government bonds, but may also include selected high quality private sector debt).

As a consequence of both slower growth and the prospect of central bank intervention, global long-term bond yields have declined to post-GFC lows in all major markets. This has also had an impact in Australia, despite its very different economic position: 10-Year Commonwealth Government Bond yields have declined from a 2010 high of 5.85% in April to a low of 4.75% in early September, before firming slightly to the current yield of 5.16% (as of 22 October).

LIMITED FIXED INTEREST ALTERNATIVES FOR RETAIL INVESTORS

Australian fixed interest markets are dominated by wholesale investors. There is no actively traded market for retail investors in commonwealth and state government bonds. Efforts to develop a retail corporate bond market are still in its infancy. The main access to fixed interest investments for retail investors is therefore through managed funds or via bank term deposits. This lack of alternatives has contributed to the development of a market for listed hybrid securities.

MAIN FEATURES OF HYBRID SECURITIES

Hybrid securities combine characteristics of both debt and equities, i.e. they are a cross between a loan and a share.

Hybrids rank before ordinary shareholders in the capital structure of the firm, but behind all secured and unsecured creditors. Technically, most Australian hybrids are structured as preference shares or as stapled securities including a preference share component. Hybrids can be converted into ordinary shares, either at a fixed date (mandatory

conversion) or at the option of the issuer on specified dates or specified events.

A decline in the fundamentals of the issuer's business can affect hybrid prices, if there is a risk that future dividends will not be paid or that the equity of the issuer will not be worth as much as the face value of the outstanding hybrid securities at conversion time (equity risk). On the other hand, the conversion terms usually provide no upside in equity prices for the hybrid holder.

Hybrids are similar to debt securities in that they have a face value (usually \$100/unit) and pay a specified quarterly or semi-annual dividend which is either at a fixed rate or – in most cases – a specified margin over bank bills. These dividend payments (grossed up for any attached franking credits) are the main basis for the pricing of hybrid securities (together with the time until conversion / buy-back / remarketing at which point the face value of the hybrid security can be realised). Like debt securities, the capital value of hybrids is therefore affected by changes in market interest rates (interest rate risk). However, interest rate risk is minimal for hybrids with quarterly or semi-annual dividend resets tied to bank bill rates.

SELECTED BANK HYBRIDS ATTRACTIVE AS ALTERNATIVES TO FIXED INTEREST SECURITIES

The financial crisis has led to a significant change in the pricing of hybrids: Hybrid prices were more volatile than expected. The greater awareness of equity risk has subsequently led to a greater differentiation among listed hybrids and investors demanded a greater risk premium for holding hybrids. New hybrid securities have therefore been issued at a much higher margin over bank bill rates than before the GFC. Bank hybrids e.g. were issued at a margin of 1%-1.2% over bank bill rates before the financial crises, while recent issues offered distributions that are 3.2-3.8% higher than comparable bank bills.

The rapid rise of official cash rates from October 2009 to May 2010 and the recent hawkish statements from the RBA has also put a lot more focus on interest rate risk.

With a likely tightening of monetary policy in Australia in mind, we have identified 6 hybrid securities that have both very low equity risk and minimal interest rate risk:

Table 1:

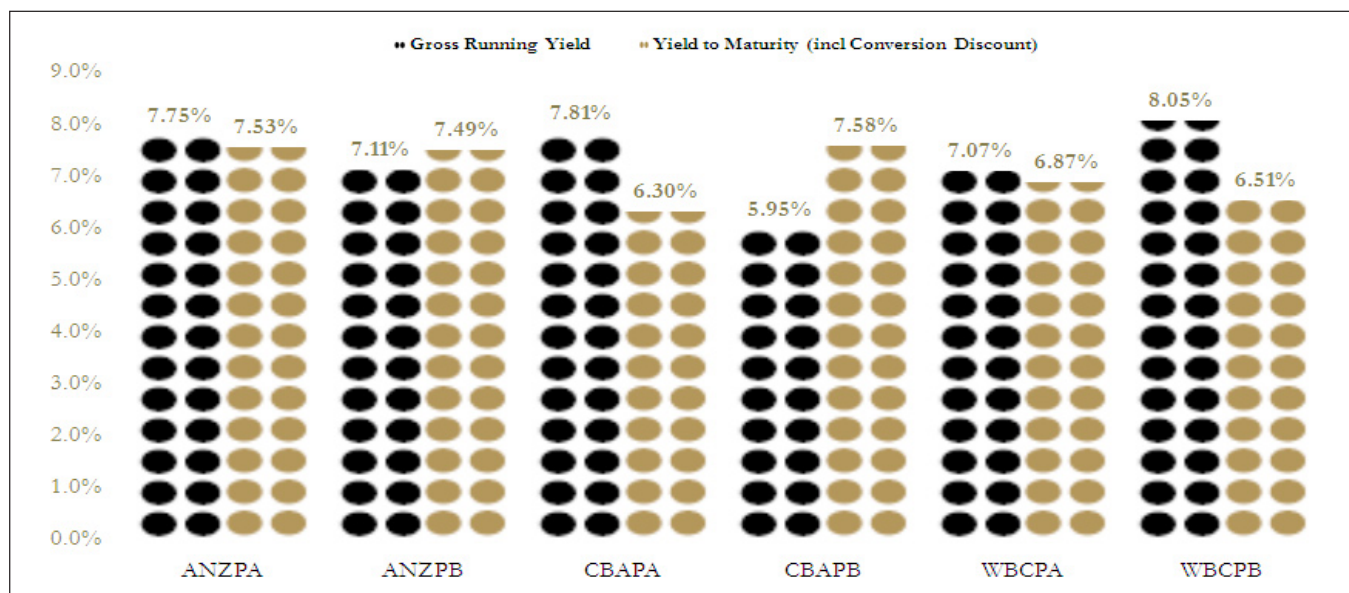
Hybrid Name	ASX Code	Recent Price (22/10/10)	Margin over Bank Bills	Running Yield (Gross)	Yield to Maturity*	Maturity Date
ANZ CPS 2	ANZPA	\$104.50	3.20%	7.82%	7.53%	15/12/2016
ANZ CPS 1	ANZPB	\$102.90	2.50%	7.20%	7.50%	16/06/2014
CBA PERLS V	CBAPA	\$210.50	3.40%	7.88%	6.31%	01/09/2014
CBA PERLS IV	CBAPB	\$196.00	1.05%	6.03%	7.59%	31/10/2012
WBC SPS 1	WBCPA	\$102.60	2.40%	7.16%	6.88%	26/09/2013
WBC SPS 2	WBCPB	\$107.32	3.80%	8.11%	6.52%	30/09/2014

* includes discount on conversion into ordinary shares at maturity

The issues listed in Table 1 share a number of common characteristics:

- The hybrids have all been issued by major banks which are highly profitable; are supervised by APRA; and can rely on liquidity support from the RBA – the risk of failure / non-payment of hybrid dividends is therefore very low over the 2-6 year remaining life of the selected hybrids;
- The terms of the issue require a mandatory conversion within 2-6 years (subject only to meeting minimum share price conditions for the underlying bank shares). –This feature provides a certain date for the realisation of the face value of the hybrid securities, unlike e.g. the NABHA perpetual notes (no set conversion, redemption or remarketing date) or the PCAPA and WCTPA notes which give the issuer (CBA and WBC respectively) the option not to redeem or convert the issue by paying a higher margin over bank bills);
- Quarterly dividend reset: The dividends are paid quarterly and are adjusted at that time to the latest bank bill yields. – The frequent adjustment to changes in market interest rates means that changes in interest rates have only minimal impact on hybrid prices.

CHART 2: GROSS RUNNING YIELD AND YIELD-TO-MATURITY FOR SELECTED HYBRID SECURITIES OF MAJOR BANKS



Source: ANZ, CBA, WBC, IRESS, Entrust

The comparison of running yields and yield-to-maturity in Chart 2 highlights that investors looking for higher cash distributions (= higher running yield) from their hybrid securities will generally have to accept a lower total return (= yield-to-maturity), e.g. WBCPA – running yield: 8.05%, but yield-to-maturity: 6.51%; CBAPB – running yield: 5.95%, but yield-to-maturity: 7.51%.

CONCLUSION

The above selection of hybrid securities has deliberately focused on minimising both equity risk and interest rate risk to make the selected hybrid securities as comparable as possible to popular fixed income products such as term deposits and bank bills. We believe this demonstrates that the hybrids of the major banks can offer a higher yielding, yet low-risk investment option for the fixed income needs of retail investors.

There are a number of other hybrid securities that offer slightly higher running yields and/or yield-to-maturity in return for a modest increase in equity risk and/or income risk that may also serve as viable fixed interest alternatives. Listed in Table 2 are hybrids of the two largest domestic insurance companies, Suncorp and Insurance Australia. Both are APRA-regulated and supervised and therefore have a low risk of failure. Their issues – namely Suncorp Reset Convertible Preferreds (SUNPA); Suncorp Convertible Preferreds (SUNPB); IAG Finance Perpetual Reset Exchangeable Notes (IANG); Insurance Australia Reset Convertible Preferreds (IAGPA) – are examples of other hybrids that could be included in a well-structured portfolio.

Table 2:

<i>Hybrid Name</i>	<i>ASX Code</i>	<i>Recent Price (22/10/10)</i>	<i>Margin over Bank Bills</i>	<i>Running Yield (Gross)</i>	<i>Yield to Maturity*</i>	<i>Maturity Date</i>
Insurance Australia CPS	IAGPA	\$102.55	Fixed Rate	8.09%	10.38%	15/06/2012
IAG Finance ExchgbL Notes	IANG	\$103.25	4.00%	8.63%	8.74%	01/12/2020
Suncorp Reset CPS	SUNPA	\$100.65	Fixed Rate	7.25%	10.67%	14/09/2011
Suncorp CPS	SUNPB	\$101.98	3.20%	8.00%	8.05%	31/10/2012

* includes discount on conversion into ordinary shares at maturity

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