**01:**
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# Unlocking the full potential of hybrids

On November 2, the race that stops the nation was run for the 160th time. And, as with each year, with all eyes on Flemington Racecourse, the Reserve Bank of Australia's latest interest rate decision went by largely unnoticed.

This, not only because of the glitz and glamour of the Melbourne Cup, but also because there was no news to come out of the central bank's meeting.

As the old adage goes, no news is good news, right? Well, it depends on who you ask.

The RBA's decision to leave rates on hold at 0.10% was music to the ears of those looking to get their foot in the door – any door – of the property market. However, it's less likely those seeking income from their investments were left jumping for joy.

As the period of historically low interest rates wears on and is expected to continue until 2024, demand from investors for consistent and reliable income investment solutions grows.

In response, Daintree Capital has launched the Daintree Hybrid Opportunities Fund, giving investors exposure to a diversified portfolio of selected Australian and offshore hybrid securities to provide a steady stream of income.

Offering the highest yields for an investment grade credit rating, hybrid securities are a mixture of debt and equity characteristics.

"When you think about it, most hybrids start life as fixed income style instruments, paying regular income and having terms and conditions that very much resemble a fixed income security," Daintree Capital portfolio manager Brad Dunn says.

"They're unique because in those same terms they have very specific conditions where at points in the future they can actually become equity securities, generally of the issuer of the hybrid themselves."

However, there's no such thing as a free lunch, Dunn warns, adding that the higher relative returns come with a catch.

"The terms and conditions are particularly complex, so it does take a lot of work to understand some of the real intricacies of these particular securities because you don't want to be surprised when some of these conditions might be brought to the fore," he says.

But that shouldn't deter investors, as the fund is well diversified. Investing in a global portfolio of 25-125 hybrid bank securities, it also comes with lower risk than investing in equities markets.

The fact that its investable universe is global is also an advantage, Dunn says.

"There are very few active hybrid funds quoted on exchanges. Australia only represents 4% of the global hybrid market, so offering access to global hybrids will help increase access to more diversified and less concentrated hybrid exposures," he says.

And there are several advantages to looking offshore.

Reflecting on some of the research undertaken by Daintree, Dunn says: "There are many banks offshore that have characteristics that are as good as or sometimes even better than the Australian banks, which was really surprising to us in many ways."

"It gave us the opportunity to build a portfolio that is best of breed."

In building the portfolio, Daintree looks around the world and identifies banks that share those characteristics and combines them in a portfolio to provide true diversification.

Some of the portfolio's holding include hybrids from Bank of America, Credit Suisse, Lloyd's Bank and ING Group.

"What that means is that you can have banks in Canada, for example, that have their own different set of operating metrics and it means that if something happens in the Australian banks, the Canadian banks are not necessarily affected by that same thematic, so you've got the benefits of diversification coming through in your portfolio," he says.

"It also doesn't hurt that there are potentially better returns."

The fund is actively managed as well, with Daintree taking an index unaware approach.

"We're not bound to an index, so we don't have to own something that we otherwise don't want to, which we think is one of the downfalls of a passive strategy; you're mimicking an index and you have to own some securities that perhaps don't actually meet your strict criteria," Dunn says.

"We're looking around for opportunities that fit our criteria to achieve our return target with as minimal amount of risk as possible and if we find those opportunities then we include them in the portfolio."

Another aspect of Daintree's strategy involves looking for uncorrelated returns, so part of Daintree Capital's expertise is putting in place a range of strategies that achieve additional returns that are uncorrelated to hybrid security returns.

"That again is one of those things that you love to have when constructing a portfolio; lots of different return sources, moving in different ways at different times because that also provides diversification and a better investment performance over time," Dunn explains.

But there are still risks that investors must consider before taking the plunge with hybrid securities, with Dunn pointing to three key things for investors to keep in mind.

**The quote**

*... We need to be very clear, open and aware of what's happening in the equity market when investing in hybrids.*

The first, as with any investment, is volatility.

"We mean volatility in the credit spread, or the extra spread you need to hold a particular hybrid, because that can move the price around quite considerably and what we know is that credit spread volatility tends to increase when there's equity market volatility," he says.

"So, we need to be very clear, open and aware of what's happening in the equity market when investing in hybrids."

Another risk is that an issuer may choose not to pay a coupon when due. While this is rare, it's still always a possibility. Daintree aims to pay regular distributions of at least 0.6% or 2.4% per annum.

Finally, investments in hybrid securities carry what's referred to as extension risk; a call date or date at which time the terms will change and capital is generally returned, but they can also change and not be implemented by the issuer.

"When it comes to volatility, we'll take a number of measures to manage that. The other two, we can manage those effectively by having true diversification, enough variation in issuer... so we're never dependent on any particular security or call date," Dunn explains.

With that in mind, over the next 12-18 months Dunn says the outlook for hybrid securities is broadly positive.

Banks have managed the risks of COVID-19 very well, largely because they're holding almost double the capital they did during the Global Financial Crisis.

"They're uniquely positioned to be quite positively involved in the recovery. They've got capital and they're able to lend to those borrowers that are willing to step up and have a go. Interest rates are still low and that means that hopefully demand for borrowing will pick up," Dunn says.

"What that means for the hybrid market is a generally positive outlook as well. Credit spreads are quite tight now, but we think they could easily tighten a little further, so we're still broadly positive on the space." FS


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