Elstree

How do hybrids perform under stress?

- Hybrids currently offer returns of around 3% over risk free rates. That outcome is higher than the broader equity market over the last decade.
- The trade off for the above risk-free rate of return is that the market is occasionally volatile. In 85% of the time over the last decade, the hybrid market as represented by the Elstree Hybrid Index was within 1% of its all-time high. The equivalent figures for the All Maturities and the All Ordinaries Accumulation indices are 79% and 26%.
- We use data captured by the Elstree Hybrid Index to examine the 4 times over the last 15 years (including the GFC) we've seen hybrid market weakness and explain why drawdowns are shallow and short-lived.
- We use our previously unpublished data to explain why the worst performance period (the GFC period) is highly unlikely to occur again.
- If investors can live with a few months of underperformance every few years, and a once in a decade drawdown, hybrids offer a healthy return above other low and medium risk investments.

Equity returns, bond risk

The chart below shows returns over the risk-free rate for a number of asset classes for the decade ending 31/12/2020. The best performing asset class was Listed Property, but with considerable volatility. Hybrids (blue dot) and Unlisted Property (green dot) both produced the best risk adjusted return outcomes (probably because unlisted property is only valued once a year; you never see the volatility). The more interesting aspect was that equities (orange dot) only returned 2% more than bonds with volatility of 14%. Bank equities (yellow dot) were even worse with the popular sector barely beating bond returns.

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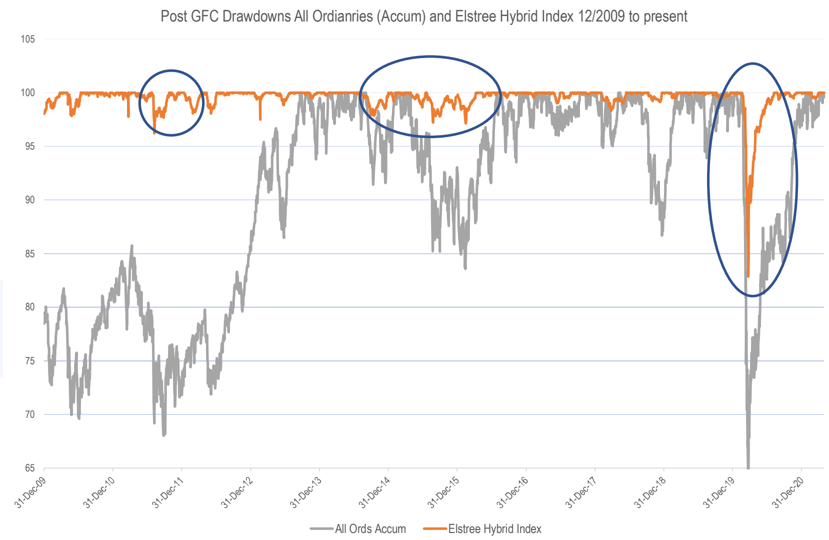
Despite the pain of Covid, it wasn't an atypical decade for investments; there were 3 or 4 medium size crisis and one big one (Covid19). You could go back to the 80s, 90's or 2000's and they all displayed similar patterns.

Post GFC weakness; always short-lived, never as bad as equities

There have only been 3 periods (circled) in the post GFC era where hybrids demonstrated weakness. Two were shallow and of short duration and the other was Covid19 which was deeper, but still short-lived. The chart below shows the drawdown profile of the Elstree Hybrid and the All Ordinaries Accumulation Indices since the GFC (a reading of 100 shows the index is at all-time high while a reading below 100 represents the amount below all-time highs). We have highlighted the weakest hybrid periods.



Covid-19

Covid-19 doesn't need much explanation; it's recent in people's minds, and while it was brutish and nasty it was short lived. Equities fell by 35% at their worst, hybrids had a drawdown of around 16%, but if you take out the worst 2 days, it was around 11%. Hybrids saw a maximum delta of around 30% (i.e.) hybrids had fallen by around 30% of the equity market fall, but over the life of crisis it averaged around 20%. Hybrids had recovered by the end of August 2020 while it took equities until early 2021 to regain pre Covid highs.

Late 2015

Both 2015 and 2011 were variations on the themes of busted Euro/Euro banks and recession risk. In 2015, investors were concerned about Chinese growth (which helped explain a big fall in oil prices) and US bond yields went up in late in the year. Oh, and Greece defaulted on its debt in June 2015. So, there were lots of things going wrong in the world - the All Ordinaries Accumulation Index was a slow-motion car crash – it lost around 15% between April and October 2015, recovered a bit over the next month and then *encored* with another 10% retreat in January 2016. Hybrids' maximum drawdown of 2.7% was in August 2015, soon after a few days where the world equity markets fell by up to 10%.

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Hybrids took a bit longer to recover than usual and were flat for a further 4 months until February 2016, before producing stellar returns since.

Was that painful?

That was like going 12 rounds with Mike Tyson; not so much from the severity, where hybrids lost a few months of income (compared to equities which lost around 4 years of dividends). It was more so from the duration of the hybrid drawdown, which meant investors lost confidence. We can still recall the CBA trying to issue a hybrid at the highest ever issue margin of 5.2% in February and seeing limited market demand, because investors had simply lost confidence. CBA was saved when Unisuper came to the party taking a few hundred $m of the issue. CBA ended up issuing the $1.4b they wanted.

2011

Hybrids fell 3.8% in August 2011, but recovered within 6 weeks. As with most other instances of hybrid market weakness, there was an extended period of equity market weakness. Equities weakened by 10% between April and August 2011 and a further 10% between August and October. Recessions, concerns surrounding the European banking systems and problems in Europe were again negative influences. There were 2 hybrid specific influences. ANZ announced a new hybrid (ANZPC). This was the first of the Basel 3 compliant hybrids which contained the "non viability" clause that allowed APRA to convert hybrids to ordinary equity. There was a lot of negative commentary about that and how Basle 3 hybrid valuations compared to bank equity. At the same time, spread margins weren't obviously cheap, with margins falling below 2.5% in June. So, there were not unreasonable catalysts for a drawdown, but it was shallow and relatively short-lived.

GFC

One of the major fears of hybrid investors we speak to is a repeat of the GFC. These fears are largely unfounded. The Elstree Hybrid Index is the only comprehensive record of pre 2012 market returns and the previously unpublished data below shows that for bank hybrids the GFC was not that unusual. The chart below shows drawdowns for the Elstree Hybrid Index and the bank/insurer and non-bank sub-categories. As the chart details bank hybrids didn't perform all that badly having a maximum drawdown of almost 20% compared to an equity market which drew down by over 50%. Bank hybrids recovered within 5 months. Non-bank hybrids were however much more badly affected, with most of the losses accruing to the large number of sub investment grade issues.

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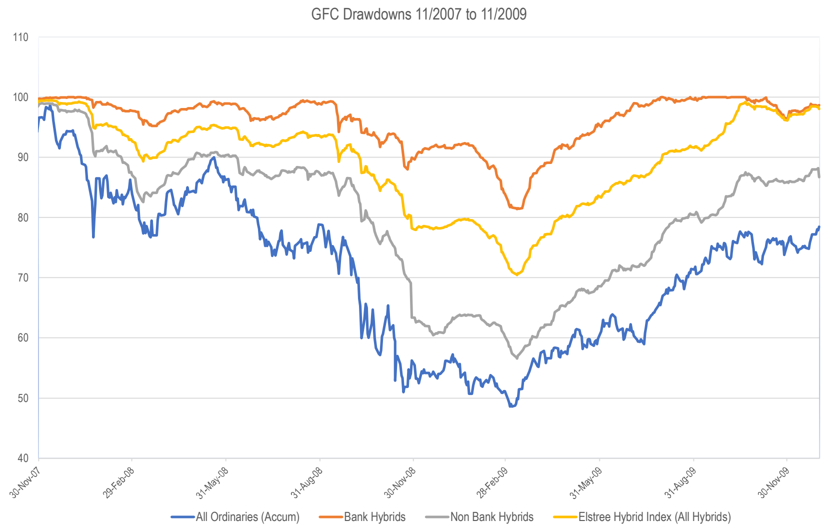

Three non repeatable factors

There were 3 important factors in the pre GFC period that made the experience worse, none of which exist in the post GFC hybrid landscape. The 3 factors are;

1. Spread margins were much narrower. Spread margins on bank hybrids moved from an all time low of just below 1% in 2007 to c5% in early 2009. This resulted in capital losses of c15%, which is the bulk of the bank hybrid drawdown. While post GFC hybrid stress events have also seen margins top out at around 5%, the starting level of c3% results in capital losses of c7%. For bank hybrids to reproduce a GFC type capital loss (i.e 15%), margins would have to increase to around 7% (which we have never seen in the history of the hybrid market).
2. The hybrid market was structured differently in the lead up to the GFC. Bank/Insurer hybrids comprised around 50% of the Elstree Hybrid Index. Of the 50% non bank hybrids, around half were non investment grade with the balance having low investment grade credit ratings. Both these categories are going to be far more volatile in times of stress. Currently around 98% of the Elstree Hybrid Index is comprised of investment grade issuers with 90% being banks/insurers which, in general, have strong investment grade ratings. The path of investment grade hybrids in 2008 was not significantly different to that seen in post GFC stress events.
3. There was an enormous margin lending unwind. The chart below and overleaf, sourced from the RBA, shows the path of margin lending since December 1999.

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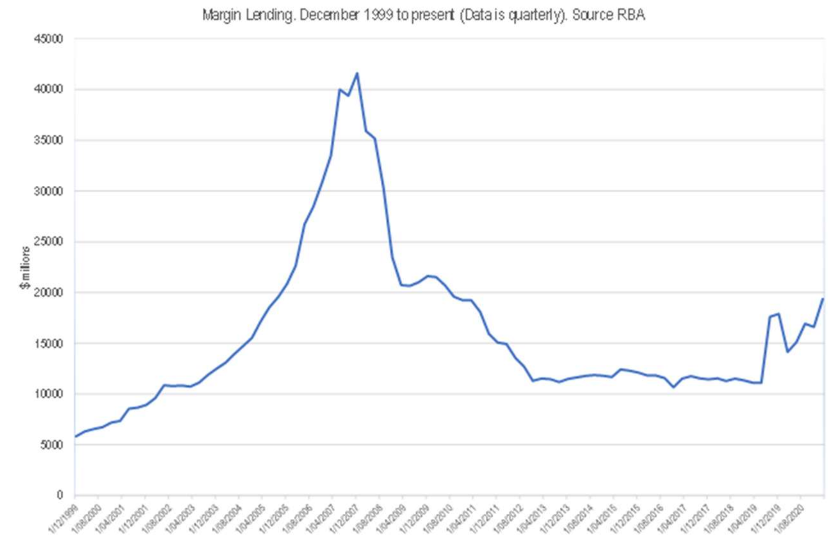

Unwind of margin lending contributed to drawdown

There was enormous growth of margin lending in the run up to the GFC and an even quicker unwind. Hybrids were an easy source of liquidity to meet margin calls (compared to small and mid cap equities) and much of the selling of hybrids can be attributed to that. With margin lending no longer being a material part of market architecture there is less likely to be loose and disruptive selling of hybrid securities.

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