Bank hybrids are not equities...

Tim Farrelly | farrelly's | 12 December 2016

Another major licensee has reportedly fallen for the hybrid scare campaigns. The group has insisted that bank hybrids securities be treated as equities as far as setting limits on the overall exposure to risky (or growth) assets and to individual company exposures.

The premise that hybrids are equities is hopelessly flawed.

In fact, hybrids are debt securities that can, under certain conditions, be converted into equity. This is a characteristic which they share with all corporate debt securities – under certain conditions, such as insolvency, debt converts to equity. All that differs with hybrids is the likelihood that the conversion occurs. Junk bonds are far more likely to become equity and are therefore far more risky than bank hybrids, even though said licensee is reportedly still happy to describe junk bonds as a defensive asset.

If we take the idea of potential equity conversion to its logical conclusion, only government guaranteed securities could be described as defensive!

It's one of the many problems with using the traditional growth/defensive split to assess risk. A dollar invested in speculative equities is not the same risk as a dollar invested in blue chip stocks. A dollar invested in TDs is not the same risk as a dollar invested in investment grade corporate bonds or junk bonds. The impossible challenge is deciding where to draw the line.

A much better idea is to use a risk weighted approach to setting limits rather than a limit on arbitrarily determined growth or defensive assets.

A risk weighted approach may say that one dollar in equities has a 100% risk weighting. A dollar in direct property may have 65% risk weighting, junk bonds a 50% risk weighting, non-bank hybrids a 50% risk weighting, bank hybrids a 25% risk weighting, bank TDs a 0% risk weighting, and so on.

Yes, it is more complicated. And, while it is nice to dumb things down as far as we can, going too far is, well, dumb.

Just saying....

Tim Farrelly is principal of specialist asset allocation research house, farelly's Investment Strategy, available exclusively through PortfolioConstruction Forum. Tim is a member of PortfolioConstruction Forum's Core Faculty of leading investment professionals.

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