Transcript
The Ideas Exchange - Episode 55

Beyond hybrids - Navigating APRA's changes and portfolio alternatives

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Aaron Viscayno (00:00):
Hello and welcome to The Ideas Exchange, ASX's regular podcast where we cover investment trends, market updates, and ideas for your portfolio. My name's Aaron Viscayno, business development associate from the Investment Products team here at ASX, and it is our mission to deliver to you the latest in market updates and ideas through the conversations we have with investment experts.

Speaker 2 (00:23):
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Aaron Viscayno (00:50):
Hi, everyone and welcome back to The Ideas Exchange podcast. My name is Aaron Viscayno, business development associate with the Investment Products team at ASX, and you are listening to the second episode of our three-part series on different investment styles. Well, here we are in a new financial year, and looking back, although the news headlines were dominated by the chaos in the global equity markets relating to tariffs, which continues to roll on, Australian investors should not lose sight of the rolling past on the hybrid market. It was in December 2024 when APRA announced their intention to phase out the use of additional tier one capital instruments with the expectation of banks ceasing new issuance and rolling replacements moving forward. Joining me on the podcast today to talk about APRA's rulings on hybrids, what it means for investors and suitable alternatives to hybrids to supplement your portfolio is the head of ETFs here in Australia for Macquarie Asset Management, good friend of the podcast, Blair Hannon. Welcome, Blair.

Blair Hannon (01:41):
Thank you.

Aaron Viscayno (01:42):
Great to see you again, Blair. Last time we had you on as a guest of the podcast was back in September last year, where you and Jacinta talked on the rise of active ETFs, Macquarie's systematic approach to investing and an overview of some of the ETFs Macquarie have on offer. So, for the listeners looking to hear more about Macquarie, be sure to check that episode out. The title is A Systemic Approach to Active ETFs. So, let's set the scene for the audience. Could you give a brief overview of hybrids as an investment? What are they, and what about them was so attractive to investors?

Blair Hannon (02:13):
Yeah, let's do a hark back and they've been around for I think decades. And it is really the tips in the name, hybrid, with the intention being it had components of equity, and it had components of debt or bonds. I think a lot of investors probably had this concept that the equity component to a certain degree was that it was traded on the ASX and that made it very accessible, and that's true to a certain part. The other part of it was more around the fact that it had a convertibility clause in it that in times of distress, in particular where we're going to dive into this and you mentioned it earlier in APRA, for the banks in times of distress it could convert to equity. That was really the core premise of it. So, look, I think hybrids as a solution for many investors were great.

(02:58):
They certainly served a purpose for those investors who were looking for income and usually getting a higher level of income. Again, we're going to probably centre around the banks here a little bit, but bank hybrids, higher level of income from the banks than you would've got necessarily from their shared dividend and likely from the return deposit or an at-call account. The other kicker that was hugely beneficial for these types of instruments that we know that Australian investors love is franking credits. So, they had the ability, and this is also the hybrid part of it, they had the ability to pay ranking credits. So you had this bond-like structure you gave whoever the bank was in the case, we just send around banks, so we'll generalize around banks, but you gave to the bank $100 for one of their hybrids, the expectation was is that you were going to get this $100 back in however many years, call it eight years, and you got distributions or payments over that period of time and those payments were then franked.

(03:53):
So, you had this really good combination of consistency of income. People love that. You had franking credits, that was that little bit of a kicker at the end of the financial year depending on what the tax situation. Investors love that. And you had this expectation that if the banks were

safe and steady and this is what APRA's job is to do, they're going to pay that money back in the end and you can make a decision around what you want to do then. So, I think you add all that up, and then you go back to that point I made earlier, they were trade on the ASX, they're accessible to everyone. That package was obviously very, very beneficial for certain types of investors, and that's why I think they were certainly well used.

Aaron Viscayno (04:31):
Perfect. And look, just to go back with APRA's decision, as mentioned, it was back in December 2024, the decision came down to phase out hybrids. What was their rationale for doing so?

Blair Hannon (04:43):
Yeah, to be clear, they're phasing out hybrids for banks. So, APRA obviously cover the banks. They also cover insurance companies. They haven't been phased out for that. That may be the case. Not for me to say obviously, but they phased out the banks. And it goes to the core of what the purpose of what hybrids were. So, we just talked about then what the hybrids sold for an investor looking for consistent income from what they believed was a good investment. What did it do for a bank? The bank has got a capital structure that is around making sure that that bank is safe and stable certainly, again, in times of stress. And APRA has set that structure up. And that structure essentially, and we're going to have a reasonably simplified view of this, but senior bonds are going to sit at the top of that.

(05:25):
So, in the case, let's just make a scenario that the bank was to go under, the senior bond holders are going to get their money back first. Then it was subordinated debt, and then it was hybrids, and then it was at the bottom of that sort of, again, reasonably simplified structure, the shares. So, as you can imagine, if the bank is going under and you're a shareholder, you would expect that that share price has fallen significantly, and you're probably going to have nothing left if it's going under. So, what we saw, and this probably accelerated APRA's thinking, I would suspect, I don't know if it's necessarily the catalyst but probably accelerated their thinking was Credit Suisse collapsed and there were hybrids in Credit Suisse. They have a slightly different structure in Europe than they do in Australia, but nevertheless they collapsed, and you saw people have their capital wiped out.

(06:09):
Obviously, Credit Suisse was then purchased by UBS, but it was sort of working with the Government to do that. So, essentially what we saw is that the use case of hybrids because of the users of hybrids who they were traded on the ASX available to everyone, mums and dads, normal everyday investors, me or you. The question I think on APRA's lips was, I'm

not saying they did this, but if they did a survey of those investors, how many knew and understood of those actual risks and understood them properly. So, they reviewed that, I think, from that angle, and they also reviewed it from the lens of the banks. The banks can not necessarily utilize that hybrid structure in that capital structure.

(06:51):
They still have senior debt, they still have subordinated bonds, they still obviously have the shares. And that was deemed to be suitable, so they just moved to a situation where they thought, "Well, we can phase this out." They're going to phase that out obviously over a period of time. What we've seen since the announcement in December is very orderly. Really the banks have no issues with it. They're happy to play on as they have been. Again, the security and safety of those banks is great from an Australian regulation point of view. So, it hasn't necessarily impacted the banks, obviously had a bit more of a full-on impact for investors.

Aaron Viscayno (07:25):
And look, to your point, 20 to 30% of Australian hybrids are held by retail investors at this point in time. What kind of investor would be interested in hybrids, and how are they going to be impacted by this ruling?

Blair Hannon (07:37):
No question if you think about what type of investment solutions you've got, shares are going to give you growth or growth opportunity anyway. If the earnings of the company, earnings of the bank, for example, goes up, the expectation is that, one, either they pay out more dividend or, two, it's going to increase the amount of capital in the bank and essentially the share price is going to go up, so you get growth. Again, pretty simplified, but I think most investors don't understand that organically why they're investing in the share market. When you're investing in hybrid, you're investing for income, you're not going to get that growth. Look, there might've been cases where the banks issued these hybrids at $100 and they might've climbed to 100, 203. We also saw them fall during the GFC during COVID. They recovered obviously, but the growth wasn't what you're looking for.

(08:24):
You're looking for income. So, it really was for investors who sought income, consistent income. Example, my parents, they had some money in hybrids. They were really happy with hybrids because they saw it as an avenue, whether it was one of the banks, and that they could have put the money in the bank or put the money in the hybrid up from the bank. And they saw that consistent income at a higher rate as really attractive. So, no question there's an impact there because what's going to happen is as those hybrids between now and the phase out date, the [inaudible 00:08:55] in 2032, mature because they're a bond-like structure, the

money then goes back into the pocket of an investor, and they need to then make a decision. There's a decision has to be made and that decision is just: am I going to look for another solution that is similar? Am I going to put it back in cash?

(09:12):
Whatever that decision is obviously up to them, but a decision essentially has to be made. If we know that there's a range of hybrids maturing over the next one to two years as we roll out, so there is short-term opportunity. If that investor has one of those hybrids, they can buy a hybrid as a further. I'm sure there's an option there for them to do that. But my point is that they have to make a decision around what they're doing. They can't... What they previously were able to do is sort of roll... what we generally saw is roll into the next one that sort of came along.

Aaron Viscayno (09:41):
So, with income being the main objective of a hybrid, where are the opportunities for investors going to supplement their portfolio with additional income once those hybrids go away?

Blair Hannon (09:51):
Look, I think most of your listeners would fully be aware of the kind of options they've got available to them, but obviously they can stay in cash and turn deposits. That's an income-based structure. You're not going to get growth out of that. And look, this sort of... Rising even above that, it is thinking about this at the broader portfolio level. I think I would always advocate for portfolio thinking because I think thinking about whether it was a hybrid or whatever it is you're investing in fits into your broader portfolio and then what income it's then providing is a really important part. Now, that's not something that you're necessarily thinking about. That's why where obviously advice is very helpful. And, again, I would say go out and seek an advisor. They can think about the broader portfolio and what it's doing and how it overlaps and how the correlations work and then what your income sources are. Depending on the situation, certainly a worthwhile venture.

(10:41):
Cash, we know chairs paid dividends. Again, the franking credit part of that is beneficial to some investors in Australia. Something to look at. If that's what you are looking for in income, you obviously can sort the shares based on dividend. There is risk to that. Obviously, companies can cut dividends, and their share price can fluctuate. And then naturally for a hybrid investor, if we're sort of bucketing those type of people, "I've got a hybrid, I had a hybrid, I want to look at something new," the more obvious replacement is like a bond because that's what hybrids were. But the issue with bonds really comes down to accessibility. So, we mentioned

earlier like hybrids were accessible and that was a big draw card for many people.

(11:25):
There is some bonds available in the ASX. I think it's... Look, they're trying, and some certain businesses and other parts are trying to grow that space, but it's not overly easy. So, for some certain types of investors, bonds are accessible, but obviously that comes with concentration risk a little bit. And then obviously ETFs are helpful because you get, again, diversification. And we can dive into that later if you'd like, but diversification of a range of bonds. And there is a lot of choice in fixed income, if we're talking about bonds, fixed income or bond ETFs now available on the ASX as well.

Aaron Viscayno (11:55):
Sure. And just to kind of push that forward, with fixed income ETFs on the market as well, they are looking to be a viable option for investors to flock to for income. How do these products differ from a traditional hybrid vehicle?

Blair Hannon (12:10):
The obvious one, and I've just sort of touched on it, is diversification. In an ETF, one of the big benefits of ETFs is instant diversification. The likelihood, and I'm going to generalize a lot through this podcast, but the likelihood is that the ETF you're buying, especially it's fixed income, are going to have a huge range of bonds from a range of companies or of governments or whatever it might be. So, you get diversification, and we all know the benefits of diversification. It spreads the risk across more than just one company. So, if you had one hybrid and you had one bank, I would assume in generalizing that you probably had those shares as well, so your concentration risk is reasonably high. What's your CBA? You had a CBA. You owned CBA shares. You owned one of the pearls and there's still a range of them out there and your money in CBA.

(13:00):
The point is the concentration. It's not negative. I'm not saying it's a negative, but there is risk around that. So, great, jump in an ETF, you get exposure to CBA, we'll use that as an example, plus potentially Westpac, plus potentially NAB, plus potentially ANZ and a range of other options. And that then... that diversification is going to, from a risk point of view, help you. No question. I think the issue that you're going to find, and if we're just thinking about as a direct replacement of hybrids, is the franking part of that really can't be replaced. So, your really only avenue to access franking now is going to be through shares. So, if that was your key driver of what the investment was, well, then you need to look at shares and need to understand the risk differences that are involved in having a

hybrid or having a bond and buying shares. It's a vastly different asset class and there's different risks than that.

(13:51):
Again, it's obviously on the investor's behalf, but understanding that's important. So, just I think knowing those things. But the other part of it, so we just talked about in general diversification, so buy an ETF, you get diversification. I think the other part of it is, and this just goes back to that point in the portfolio I mentioned earlier, diversification of income sources is also important. And I think most investors inherently get that. So, even if you're an older investor, you still have some income coming in through work. Having an investment property, that's another source of income. Having some money in certain types of shares, that's a source of income. Having some money in some ETFs, fixed income or equity ones, that's a source of income. So, that diversification of income is obviously going to be helpful.

(14:32):
So, you're diversifying your portfolio and diversifying your source of income because they're inherently going to fluctuate over time. So, again, if that's something that you're not overly aware or comfortable, that's where, again, advice is going to be very beneficial for you to seek that out. And an advisor's job is really to help you understand what risk metrics you're thinking that your profile, how much risk do you want to take on, and then helping you diversify and understand what you're investing in. So, again, I would always... For those who sort of listening to this, looking to educate, great, but that's where advice is going to play a huge role.

Aaron Viscayno (15:03):
Great, thank you. And, look, just keeping on the topic of fixed income ETFs, one thing that investors may not be aware of is obviously on the passive side with shares, that's probably the most prevalent product that you've got, not so much on the fixed income side. Are you able to speak on the importance of active management in fixed income ETFs?

Blair Hannon (15:24):
Yeah, just to qualify, yes, I work for an active management business, but I have in the past, throughout my career worked for passive. So, I'm not an active acolyte. So, just to sort of quantify my situation for your listeners, and I think I might've said that in the last podcast as well. I think when it comes to the active verse passive debate, I think it gets a little bit hated, depending on what side you're on. And really when it comes down from an investor's viewpoints, not from the fund manager, from the investor's, there is benefits in both, and you can use both in wonderful ways, spread out a portfolio. I certainly think that there's no right or wrong, there's no everyone should be all passive, or everyone should be all active. There is a place for both, no question. I think the differences though, just to sort of

tease out your question around, in particular, fixed income, [inaudible 00:16:14] bonds and equities, we need to be clear that they're very, very different markets.

(16:19):
And when you think about equities or shares... And we'll keep using CBA as an example. I've sort of started that and we'll keep on going. If you and I buy CBA, we're buying the same thing. It's you go on the ASX, you type in the code CBA, whatever platform you buy shares through, you buy it. We own the same thing. The problem with bonds is, one, the accessibility. So, it's inherently an institutional style product because the minimums to buy one bond are much, much higher. What's the minimum for a share? $500. Great. Anyone can do that, essentially. The minimum in many cases for bonds can be $500. So, it's an institutional style investment. The second part of it is because they have... the structure of them is that they're essentially the debt, right, they're a loan, they have a fixed timeframe.

(17:11):
So, then you start to add in maturities. Now, you're adding in a maturity, then you're also adding in different currencies. Then you're adding in, we talked about it earlier, the levels of seniority of that debt in the business. So, you're just adding in high levels of layers of complexity. So, we both might want to buy a CBA bond, but again, our risk profile might be different. I might want to buy the three-year subordinated debt bond from CBA, but you have a different risk profile, so you're buying the five-year senior bond. The point isn't to articulate all this and go into... The point is there's a much higher level of complexity when it comes to fixed income and equities. And you add to that that there's new bonds being issued all the time. Again, CBA has only been floated once. Has done capital raisings in the past. Been a long time, but generally it's you're getting a bond consistently all the time, so you need to then review that particular bond. Is it right for you, wrong for you?

(18:09):
So, again, layers of complexity. You add to that another whole layer, which is the difference between not just the markets, the asset class, how the construction of indexes are made. So, when it comes to equities, we think about how the core of what an equity index is, it's market cap weighted. So, a market cap essentially how big the company is, but we know what is driving that: units on issue and the share price. So, if the unit's on issue, if again they're not raising any more money, the share price goes up, the company gets bigger, great. But that's a bit of a cycle, where, as we've seen in Australia, as we're seeing more and more in the US, is the concentration of those indices with market cap, the biggest company has the highest weighting. And that that's perpetuating seeing these indices as equity indices, the share indices do really well because,

as CBA goes up and has it gone up significantly, that's driving the whole index up.

(19:13):
As in the US, the Mag Seven or it's getting smaller, that. The magnificent style of those companies, that's dragging the whole index up. So, equities, what you are seeing generally is... If a company's doing really well, we talked about the difference between growth and income a little bit, that's very beneficial for the investor, it helps them. The problem with fixed income indices is the highest weighting in those indices is the companies have the most debt. So, fundamentally it's a bit flawed because you're not getting the growth benefit from bonds. There is potentially in capital growth there, but it's not the driver of what you're trying to do. You're trying to get income in comparison to equities, but what you're essentially saying if you're on index is, "We need to have the largest most indebted company as our highest weighting."

(19:58):
And I assume most of your investors would know that in times of stress, those with most debt are probably going to be under the most pressure. So, we look at that and go, again, hop back to my earlier point, "There is certainly value and reason that passive is going to play a huge role in investors' portfolios." But sort of understanding the dynamics around the differences of how index works, which I assume most investors probably wouldn't go and do a deep dive into that, is worthwhile. And the fixed income in particular, looking at it from that angle can be reasonably flawed.

Aaron Viscayno (20:33):
Great. Thank you, Blair. And look, last question here. How does Macquarie approach the management of the fixed income strategies in your ETF portfolio?

Blair Hannon (20:42):
Look, that's a wonderful question to finish off. I think, look, for Macquarie's angle, we're the largest fixed income manager in Australia, which I would assume, again, most of your listeners probably aren't necessarily aware of. If you're thinking about who Macquarie is, it's Macquarie Bank, which is great if they are thinking of us that way. That's fantastic. I think from the asset management side of things, we certainly... The really large infrastructure and green investments, again, fantastic people think of us that way, but from the fixed income lens might look in and go, "I might not have known Macquarie does fixed income, or I might not be fully aware." Being the largest for many investors out there, the odds on, I'm not saying it's everyone, but the odds on through their super fund, they probably had some exposure to

Macquarie Fixed Income and Macquarie's Fixed Income team, so that's great.

(21:31):
Look, we're obviously a large global team, and the importance is... I've just talked about active, we're an active business. We see the value in providing active management, in particular, in fixed income. And the example I would use is this: our expectation is we want to research, understand and quantify if us buying a bond for a company is worthwhile for our investors. We take that very, very seriously. On the flip side, let's say, Aaron, you went to a bank and you want to get a loan, a home loan, would you just expect them to go, "Aaron, you're..." I don't know how old you are. You're probably younger than you look, but let's call you 35, Aaron. Okay? "Yeah, Aaron's 35. He works in finance. Good. We're lending that much money." With no thinking about who you are in particular. They're going to ask you a huge range of details.

(22:22):
They're going to go, "What's your income? How much do you spend? You got any kids? How much are you spending on that?" All these things. You'd have to expect the same from a fixed income manager. And this is going back to that point on passive verse active. You would expect some view on the company to say, "When you're buying a bond, you're essentially lending the money, they're paying you that money back over time. I want to have a view on that." So, that's really the core of what we do. And we take that very seriously, and we've done that for a long time. So, we thought about how we build investment... especially when it comes to ETFs now, investment solutions that hopefully solve investors' problems around whether it's wanting to buy potentially a bond fund that provides more defence and a balance in their portfolio when times are tough.

(23:07):
Obviously, that's a solution we've got. If you’re looking for just more consistent income that is there to pay you monthly, that's a solution we've got. If you're looking at more... We talked about subordinate debts in terms of it's a hybrid, potential hybrid placement. That's a solution we've got. So, it depends on what you're looking for as a solution. I think it's always important for... And we sort of bring it all way back to the top, a hybrid investor who's now going, "I need to change." Okay, we'll make an assumption. Macquarie looks good. What I would say to those investors is, "You need to hold us as any investor holds a fund manager account. What we say we're going to do, we're going to do." So, if you're looking at one of the ETFs that we've got, there is a level of research and due diligence you need to do on that.

(23:53):
This is not just Macquarie, any ETF manager should be really willing to help, and whether that's just your website or help you make your investment decision easy, whether that's buy or not buy it. But we know that if you bought a hybrid and you knew who CBA was and you're comfortable with that, that's maybe an easy decision. If you're buying an ETF that has a lot more holdings underneath the hood, there is more work for you to do. So, obviously reach out, we can help. Reach out to any of your ETF providers, make sure they all help you do that.

(24:22):
And I think as long as the ETF business is moving forward, and, again, that's whether that's active or passive, and from Macquarie's lens, we're all about thinking about: how can we make an advisor, an investor, whoever's going to be out buying some of these ETFs that we have on offer, life easier and more confident in what we're doing for them? So, I think if I redo the whole sort of conversation we just had, I think it's really all about, if you're an income investor, thinking about what's best for you, from a portfolio point of view, looking at your options. We've talked about the options. And then also doing a DD on who those options are, especially if it's an ETF.

Aaron Viscayno (25:00):
There you have it, folks. That wraps up our quick rundown, Into the Transition to a New Hybrid-Less World. If you currently hold hybrids, we hope you're able to take away some ideas on how you can supplement your portfolio. Blair, always a pleasure.

Blair Hannon (25:13):
Thank you, Aaron.

Aaron Viscayno (25:14):
For more information on any of the Macquarie funds you've heard of today, head on over to etf.macquarie.com or of course the ASX website. Thanks for tuning in. Catch you on the next one.

Speaker 2 (25:23):
Are you keen to learn more? Why not visit the ASX Blog, asx.com.au/blog, for a wide range of articles, videos and insights from ASX experts, listed companies and investment professionals?