

Schroders

Exceptional opportunities in hybrids

by Mihkel Kase, Portfolio Manager, Hybrid Securities

We are about 16 months into the credit crisis and continuing to face difficult market conditions. The pain experienced by investors has intensified and everyone is concerned about the severe sell off in equities we've seen. Hybrids have been caught up in this by virtue of having both debt and equity characteristics. They've been hurt by the sell off in credit markets as well as the impact of being listed.

Despite this we still think there are quite a lot of opportunities for investors who are prepared to take a medium term view.

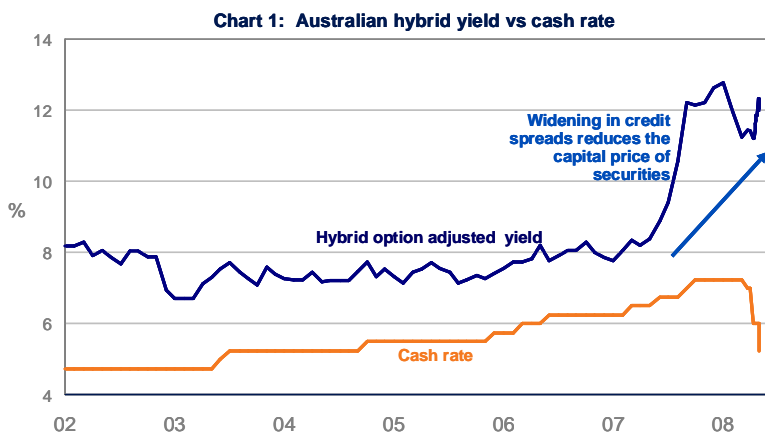
In the context of broader markets Hybrids haven't performed as badly. Growth assets such as Australian equities and property trusts have experienced an extreme sell off with equity markets falling nearly 40% while property trusts have taken a battering of around 55%. Government Bonds, on the other hand have delivered double digit returns.

The dispersion of returns evident across asset classes is also evident across Hybrid funds on offer in the market. Some funds are closed for redemptions and others have experienced strongly negative returns which are not unlike those of equity funds. However, the Schroder Hybrid Securities Fund (the Fund) is open for business as usual despite market turbulence and looking to capture the opportunities that market volatility is presenting.

The Fund has been insulated by high levels of cash and, of course, minimal exposure to defaulting securities. Schroders is in fact looking to take advantage of opportunities that we see in the hybrid space at the moment. The Fund currently has no exposure to companies in voluntary administration including ABC Learning and MFS, amongst others.

Exceptional opportunities

Hybrids currently offer outstanding yields. Average yields of hybrids are around 12% compared with a cash rate of 4.25%. From 2002 through most of 2007 we experienced a long period of very benign credit markets. However, as a result of the very aggressive re-pricing of risk credit spreads (or the risk premium on credit) have widened.

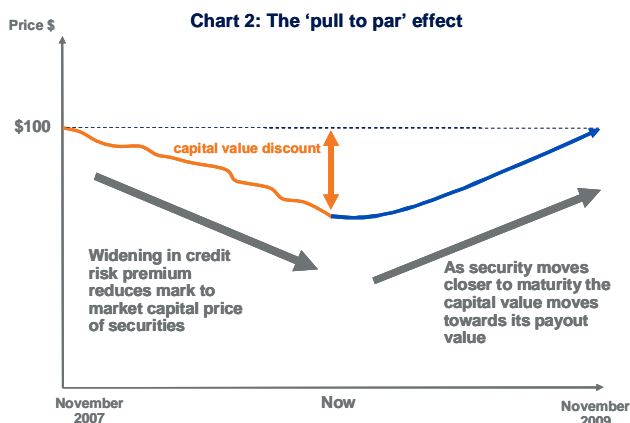


One of the things to note is the difference between the yields on cash and hybrids. Hybrids are paying a margin of around 8% over the cash rate. Arguably, as cash rates continue to drop those investors tempted to move out of hybrids into cash are setting themselves up to lock in losses and even lower yields. Selling out of hybrids now you would be effectively giving up a yield to maturity of 12% while we could quite easily see cash drop to a 3%, Government guarantee or not.

Source: Schroders

'Pull to par' effect

One of the reasons we think hybrids offer such good opportunities is the "pull to par" effect, another way of saying if you hold the hybrid to maturity you get the full face value of \$100 back, assuming it doesn't default.



This effect is unique to debt securities and often overlooked by investors. What most don't realise is that when debt securities are experiencing a negative mark to market effect (as they are currently) it's not a realised loss. By holding on you typically recover the capital loss while also collecting the coupon. Buying in when hybrids are underpriced means you can collect capital appreciation as well as the coupon.

Some examples of hybrids will assist this explanation (refer Charts 2 and 3 below). There are many good examples and Woolworths and Ramsay Health Care are just two. Looking at Chart 3 you can see Woolworths is currently trading at around 94c and is expected to mature in 2011. It currently offers a yield of around 8.5% or close to 4% over cash.

Woolworths captures over 40% of Australia's grocery sales, is a very well run and successful company, however, its hybrid security is trading at a discount of 6%. The pull to par effect in this example will mean that in 2011 I expect to get my money back. If I invest today I'll get an 8.5% per annum coupon for the next 2 years plus the 6% capital appreciation. This does assume Woolworths isn't going to default which I'm fairly confident it won't.

Ramsay Health Care is the other example. It's been even further sold down to 83cents in the dollar. Ramsay are very good operators of a large number of private hospitals around Australia. It's a solid company with strong cash flows. The 17% discount on the capital value of Ramsay's hybrid is very attractive at the moment. The list goes on with other attractive hybrids including IAG, one of Australia's largest insurers trading at 77c and Orica, the explosive and handyman products company is trading at 81c.

Chart 3: Woolworths

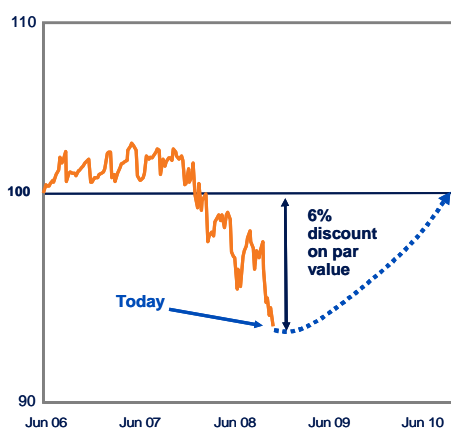
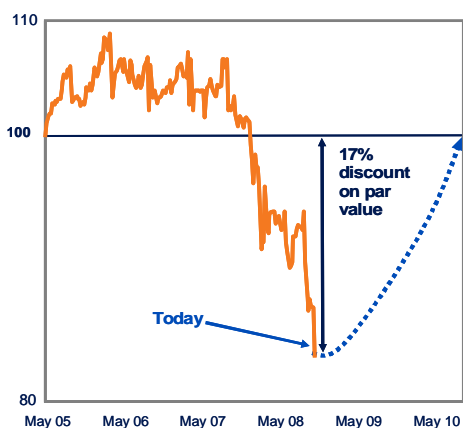


Chart 4: Ramsay Health Care



Looking forward

Looking forward we believe that the Schroder Hybrid Securities Fund is very well positioned to take advantage of the opportunities available. Obviously there have been concerns with some of the mortgage funds closing or freezing redemptions but for Schroders its business as usual. With in excess of 14% cash we are well placed to meet any redemptions and take advantage of the pull to par effect on many securities.

Australian hybrid securities currently account for 71% of the portfolio in the Schroder Hybrid Securities Fund. Hybrids are complemented by a 10% weighting to Global High Yield and a 5% weighting in Asian Bonds both of which are providing attractive yields as well as diversification.

Overall we believe hybrids have been oversold and remain a very attractive asset class. Existing investors while understandably anxious are setting themselves up for strong yields going forward.

Charts 2,3 and 4. Source: Schroders. Stocks presented to illustrative purposes only.

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