Why Invest in Preferred Shares?

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The question of asset class is an important one to all investors. The basic considerations involved in making this decision are liquidity, expected returns, risks – and it should be noted that risk should be examined across the entire portfolio, not just in isolation. Various option strategies, for instance, may be considered risky if executed "naked", but reduce risk in a portfolio if executed on a "covered" basis.

Preferred shares and securities can be considered for inclusion in almost any Canadian portfolio subject to tax; and, to a lesser extent, for any non-taxable portfolio such as a RRSP or pension fund. This class of investment has many desirable characteristics – offset to some extent, of course, by a unique spectrum of risk – and a historical level of after-tax return that can be most attractive to investors.

Characteristics of Preferred Shares

Preferred shares come with a bewildering array of features, which makes security selection quite difficult but extremely rewarding. As very little thorough, quantitative analysis is done with respect to this asset class the market is inefficient compared to the more intensively studied bond market; mispricing abounds and aggressive trading strategies can flourish.

Some of the features considered in the Hymas Investment Management Inc. analytical process are:

- **Redemption:** This refers to the ability of the company to "call" the issue, i.e. to force the investor to return the shares to the company for cash, or for an equivalent amount of common stock (in which case the conversion ratio is determined by the market value of the common). Redemption usually becomes possible 5-10 years after issue of the preferred and sometimes is made possible on a sliding schedule – e.g. $26.00 in the 5th year after issuance at $25.00, $25.75 in the 6th year, down to $25.00 if redeemed after a certain date.
- **Retraction:** This is the ability of the investor to "put" the issue, i.e. to force the company to accept the shares and pay cash or (in the case of a "soft" retraction) an equivalent amount of common stock priced according to its market value. When shares include a redemption feature, the ability to exercise this right will almost always commence subsequent to the issuer's rights of redemption
- **Floating Rate:** This attribute refers to the fact that some issues do not pay a fixed dividend, but instead the dividends are determined as some fraction of an external rate, such as Canadian Prime. Issues of this type are further subdivided into two classes – those which pay a fixed percentage of the benchmark rate and

those for which the fraction varies inversely with the market price of the issue ("ratcheted" in Hymas Investment Management terminology).

- **Cumulative Dividends:** Preferred shares will include some provision for the steps that will be taken in the event that the issuer finds itself unable to pay the regular dividend. A very strong form of protection for the investor in such a situation is cumulative dividends – that is to say that the payment is not considered to have been skipped, but that it has merely been delayed. It is, however, more important to have some degree of assurance that this event will not occur at all; the chance of this happening is estimated by the issuers Credit Rating.
- **Credit Rating:** The rating agencies, such as Dominion Bond Rating Service and Standard & Poor's, are retained by the issuing companies to provide independent and standardized assessments of the issuer's ability to meet its obligations (with respect to the preferred shares) as they become due. The inherent conflict of interest in the rating agencies' roles has not been a major issue in the industry, largely due to the fact that it is almost impossible to bring an issue to market without having arranged for credit ratings – and a cancellation of the service by the issuer would make future issues extremely difficult to sell.
- **Split Share Corporations:** Some issuers are not in business directly, but simply hold shares in other listed corporations. The capital structure of these issuers attempts to "split" the return on the portfolio into a predictable dividend stream and a relatively leveraged opportunity for capital gains. While preferred shares issued by such corporations can be quite attractive, much depends on the details of the capitalization – just how safe is the dividend stream and the principal?
- **Duration:** Duration is a measure of the expected average term of the cash-flows inherent in a financial instrument, including both dividends and repayment of principal. Calculation of duration, and hence the degree of sensitivity to overall changes in the yield curve, is a trivial operation for normal bonds with fixed interest payments and a fixed term to maturity. It is much more complex and reliant upon analytical assumptions for preferred shares and other instruments which have embedded options or other sources of analytical uncertainty, but the effort expended in this analysis is well worth-while in terms of providing a quantitative measure of portfolio risk.
- **Convexity:** Convexity is a measure of the sensitivity of duration to changes in price. A normal bond will have a positive convexity, which is to say that as the price increases, the duration will increase. Strict belief in the theory of convexity will lead one to favour higher convexity over lower, but as the theory does not allow for differing shapes of the yield curve, non-parallel shifts thereof, or indicate any price one should be willing to pay for convexity, it is not a particularly useful indicator for normal fixed-income instruments. Preferred shares are not "normal", however, nor is a high degree of precision required in order for the concept to be useful. Embedded options (usually redemptions and retractions) can have the effect of making convexity large and negative – an analysis with minimal assumptions can quantify this effect and make convexity a useful, if rather blunt, tool in the analysis of preferred shares.
- **Uncertainty:** In dealing with issues with embedded options, the uncertainty in estimating the probable effects of these options on received cash flow makes a

comparison of two issues more difficult than is the case with normal bonds. Overall interest rates may change between the time of calculation and the date the option becomes exercisable; so may the issuer's financial situation. Hymas Investment Management Inc. calculates an estimated degree of uncertainty in the analysis and applies this source of risk to the trade determination process.

- **Tax Effects:** Tax issues have a major effect on the return that will actually be received by investors. There are not only differing tax rates for capital gains, interest income and dividends, but these rates can differ according to the overall income level and capital gain status of the individual investor. When a potential trade is analyzed, the book value of the issue to be sold is also a major factor. These differing rates are accounted for in the analysis of different issues and therefore differing issues may be selected for differing portfolios to maximize the expected after-tax return for the investor.

Comparision of Preferred Shares with Corporate Bonds

Preferred shares share many characteristics with corporate bonds; enough, in fact, that this paper argues that they may be substituted for a large portion of the corporate bonds that would otherwise be held in clients' taxable portfolios. Major similarities are:

- **Predictability of Income:** Preferred shares are generally issued with a fixed dividend (although, as noted above, there are many issues offering a floating rate).
- **Predictability of Principal Repayment:** Many Preferred issues are retractable, as noted above, while some others (primarily those issued by Split Share Corporations) have a fixed maturity date. In the latter case the Split Share Corporation is wound up and preferred shareholders paid in full before any distribution is made to the holders of the 'capital gains shares'. Note, however, that "Maturity Date" is also a major difference between bonds and preferreds!
- **Availability of Standardized Credit Reports:** Virtually all preferred shares and corporate bonds are assigned a credit rating by a major rating agency, as discussed above. In sharp contrast to equity research published by brokerage houses, these reports are useful, independent, re-examined after the fact to determine their statistical usefulness as a predictor of financial difficulty and have a legitimate business purpose as a "profit centre" for the rating agency. While there are no guarantees any issue will avoid default, the agencies do a very good job of ranking the relative risks inherent in investment in the various issues.
- **Priority over Common Equity in the Event of Default:** Both preferreds and corporate bonds rank senior to common equity in the event of default by the corporation. In recent years, this has best been illustrated by Split Share Corporations, which have on occasion arrived at their wind-up date with the 'capital gains shares' owners virtually or entirely wiped out while the preferred share-holders have had all or virtually all of the companies' obligations to them met. Note, however, that corporate bonds are senior to preferreds, as noted in the section summarizing differences.

Major areas of difference between preferreds and corporate bonds are:

- **Exchange Trading:** While trading conditions for retail investors in corporate bonds has greatly improved in the past few years, bonds (traded directly by the brokerage firms) are not so transparently traded as preferreds, which are almost always listed on a recognized stock exchange. The exchange listing allows investors to track the best bid and offer available in the marketplace and to place orders, secure in the knowledge that no lower bid or higher offer will be executed before the order is filled.
- **Priority in the Event of Default:** In the event of default, bond-holders will always be ranked higher than preferred share-holders. It should be noted, however, that preferred share-holders are rewarded quite handsomely for this assumption of higher risk.
- **Maturity Date:** All but a few very special bond issues will have a fixed maturity date, whereas preferred shares will not necessarily offer such certainty for repayment of principal.
- **Taxation of Income:** This is the major advantage of holding preferred shares. They pay dividends rather than the interest paid by bonds, which has major consequences for after-tax returns, as discussed below.

Historical Index Returns

Two indices have been selected in order to compare the returns achieved by Preferred Shares as a class with those of Corporate Bonds: The "BMO Nesbitt Burns 50 Total Return Index" and the "Scotia Capital Corporate Bond Total Return Index". Further analysis has been done in order to compare the approximate returns realized by an investor taxable at Ontario's highest marginal tax rate:

Calendar Year	Bonds, pre-tax	Preferreds, pre-tax	Bonds, after tax	Preferreds, after tax
1994	-3.19%	+2.45%	-2.89%	+1.80%
1995	+19.68%	+13.79%	+11.29%	+9.01%
1996	+10.55%	+10.78%	+5.79%	+7.08%
1997	+9.51%	+5.03%	+5.26%	+3.41%
1998	+7.06%	+5.53%	+3.74%	+3.74%
1999	-2.72%	-2.98%	-2.42%	-1.67%
2000	+5.67%	+9.50%	+2.61%	+6.67%
2001	+8.52%	+3.98%	+5.27%	+2.58%
2002	+4.52%	+4.39%	+2.27%	+2.92%
2003	+8.50%	+7.57%	+5.32%	+5.38%
Cumulative	+89.97%	+77.56%	+41.73%	+48.76%
Annualized	+6.63%	+5.91%	+3.55%	+4.05%

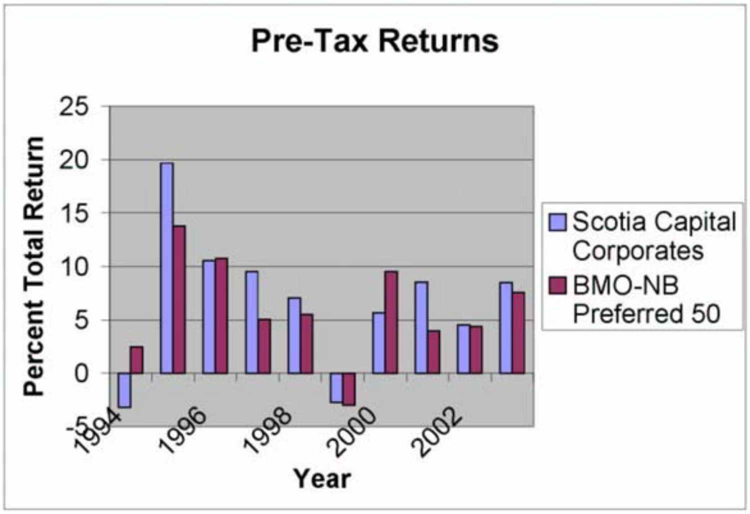
Certain assumptions were required to derive this table. For both "bonds" and "preferreds", the total return was analyzed into "income" and "capital gains" components by estimating the income received for the year and finding the deemed capital gain by difference. For bonds, the income was deemed to be the index yield (as reported by Scotia Capital) at the end of the preceding year. For preferreds, a sample (minimum 29 issues) of the BMONB-50 was taken (excluding USD issues, participating *preferreds and other unusual instruments) and determining the index-weight weighted average Current Yield on the resultant portfolio at the end of the preceding year.*

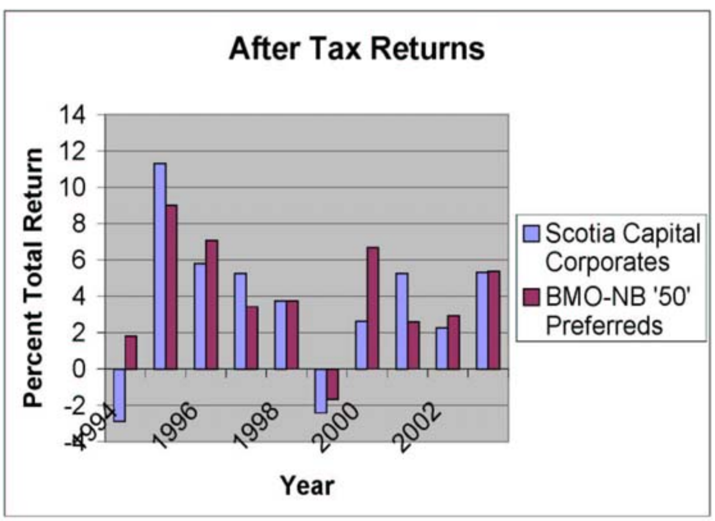
Tax rates for an investor in Ontario's highest marginal tax bracket were then applied. When a capital loss was indicated, a tax recovery was included in the net result.

Thus, the analysis applies to an investor subject to Ontario's highest marginal tax rate, purchasing the index at the beginning of each year and selling it at the end, who had capital gains outside his index holdings against which possible capital losses could be applied.

It is clear from the ten years of returns shown that Preferred Shares have performed very well versus corporate bonds, when compared on an after-tax basis for individuals in the highest marginal tax bracket.

Hymas Investment Management considers the Preferred Share market to be extremely inefficient compared with the bond market – allowing superior returns to those who are able to capitalize on those inefficiencies.


Pre-Tax Returns
25
20
15
10
5
0
-5
Percent Total Return
1994
1996
1998
2000
2002
Year
Scotia Capital Corporates
BMO-NB Preferred 50


After Tax Returns
14
12
10
8
6
4
2
0
-2
-4
Percent Total Return
1994
1996
1998
2000
2002
Year
Scotia Capital Corporates
BMO-NB '50' Preferreds