

How Long is Forever?

Assessing the perpetuals versus retractables decision in today's preferred share market

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Preferred shares are well known as extremely tax-efficient substitutes for bonds in taxable portfolios. Even without the recent proposed changes in the dividend tax credit, most taxable investors can expect an after-tax return on high-quality preferred shares handsomely exceeding that available for similarly rated bonds. The changes, if enacted, will simply make this asset class more attractive to issuer and investor alike. My firm, Hymas Investment Management, forecasts increased issuance in 2006 and beyond.

The covenants attached to preferred shares are similar to those on bonds; one very important exception being that many preferred shares not only have no set maturity date, but there is not even a retraction date available whereby the investor can force the issuer to return the amount invested. Such issues are referred to as "perpetu-als" or "straights," and always have a call provision attached whereby the issuer can redeem the shares at its discretion.

Floating-rate issues, with their tantalizing promise of never being too far wrong on interest rate calls, are also available but are extremely expensive. There is also the problem that the investor is being paid short-term rates for a long-term investment. By default, then, advisors are called upon to examine fixed-rate issues and must decide between "perpetu-als" and "retractables."

Retractable issues are the most bond-like in their risk/reward profile, as the covenants specify that both issuer and investor have the option to force redemption of the shares at the same price or, in the case of "soft retractables," to be exchanged for common stock of the issuer at a price discounted from the market level. This pair of opposing options implies that the issue can be analyzed as having a fixed maturity on the retraction date, as it will be in the best interest of one of the parties to force redemption. Issues with a set maturity date, as is often the case with "split-share" issues, are functionally equivalent to retractables.

A full analysis of the relative merits of preferred shares requires the consideration of many variables – so many, in fact, that fully informed decisions require specialized software to construct the preferred share yield curve and the

relationship of each issue to that curve; multiple scenario analysis, either explicit or implicit, examining the expected behavior of each issue under a wide variety of future interest rates; and an attempt to differentiate between "noise" and "signal" in the day-to-day price movements of each issue analyzed. This article focuses on the perpetual vs. retractable decision, using "yield-to-worst" as the initial differentiating tool.

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Understanding the concept of yield-to-worst is an important first step in preferred share analysis, as it represents an immeasurable improvement over the simpler metric of current yield.

Current yield (reported as simply "yield" in the newspapers) is simply the expected annual dividend divided by the price of the stock. While this measure is very useful in the analysis of common stocks (which represent ownership of an – ideally! – income-generating asset in perpetuity), it loses analytical value when callable assets are being considered. If a preferred share pays an annual dividend of \$2.00 and is currently trading at \$28 (and thus has a current yield of 2/28, or 7.14%), one might be tempted to purchase it rather than a similar issue paying \$1 and also trading at \$28 (with a current yield of 3.57%). If the former issue is called the next day for a redemption price of \$25, however, the imprudent purchaser will lose \$3 immediately. One might think that such a tragedy would be extremely rare, that the market would simply not allow such an issue to trade at such a high price relative to its redemption price – but it happens, time and time again. The universe of preferred shares examined by HIMIPref™, Hymas Investment Management's preferred share analytical software, currently includes 24 issues (out of 159) that have the potential for a negative total return.

Yield-to-worst addresses this concern by considering the shareholders' worst-case scenario of the

terms of the issue. Bankruptcy is excluded, since the yield-to-worst of any instrument would then be -100%, representing a total loss of investment!

The tax rates are presumed to be 23.2% on capital gains and 21% on dividends. It is assumed that the investor has capital gains available against which capital losses may be offset. (Note that all further references to "yield" in this article will reflect after-tax yield).

As an example of an unfavourable redemption privilege, let us consider the case of BNN Split Corp 6.25% Pr, trading as BNA.PR.A on the Toronto Stock Exchange, with a quoted price of \$25.55-85 on Jan. 20, 2006. According to the prospectus, "preferred shares may be redeemed by the company at any time prior to the redemption date at a price (the "preferred share redemption price") which, until Sept. 30, 2002 will equal \$26.20 and which will decline by \$0.20 each year to be equal to \$25.00 after Sept. 30, 2007. All preferred shares outstanding on the redemption date will be redeemed for the preferred share redemption price, equal to the lesser of \$25.00 and net asset value per unit."

The current redemption price of

TABLE I

Issue	Premium to worst-case call price	Bid yield-to-worst	Worst-case call date	Worst-case call price
SLF.PR.C	0.00%	3.63%	N/A	N/A
BAM.PR.J	8.88%	3.17%	April 30, 2004	\$26.00
TCA.PR.X	7.70%	3.52%	Nov. 11, 2013	\$50.00

\$25.40 would, if the option were to be exercised, result in an immediate loss to the holder. The probability of such exercise is open to debate, but the fact remains that the company, acting in the best interests of its common shareholders, could exercise this right at any time. More sophisticated yield measures used in HIMIPref™ attempt to account for the possibility that the option will not be exercised, but this article is, very gloomily, focused on worst-case scenarios.

After many years of declining interest rates, today's preferred share market includes many perpetual issues that are trading at a large premium to their call price. To examine how these premia affect the perpetual/retractable decision, let's select three issues meeting the following conditions:

- The issue must be rated Pfd-2(low) or better by the Dominion Bond Rating Service; and,
- The average daily trading value must be at least \$50,000

We wish to select:

- A retractable issue;
- A high-dividend perpetual issue; and,
- A low-dividend perpetual issue.

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We will examine the following

issues:

- Sun Life Fin Ser 3 Pr (SLF.PR.C), a perpetual with a \$1.1125 annual dividend and calls at declining prices commencing in March 2011, quoted at \$24.48-52 on Jan. 20, 2006. The yield-to-worst is equal to the current yield, 3.63%.
- Brookfld Asset Pr 12 (BAM.PR.J), a retractable with a \$1.35 annual dividend and calls at declining prices commencing September 2014, and a put exercisable at \$25.00 (paid in discounted stock) in March 2018, quoted at \$28.31-49. The yield-to-worst is 3.17%, based on a call exercised in 2014 at \$26.00.
- TransCan Pipe Pr U (TCA.PR.X), a perpetual with a \$2.80 annual dividend and call exercisable from October 2013 at \$50.00, quoted at \$53.85-95. The yield-to-worst is 3.52% based on call exercise in 2013 at \$50.00.

It is not by chance or selection bias that the two perpetual issues have a much higher yield-to-worst than the retractable! Regression in the HIMIPref™ universe shows that the two higher-credit-quality classes of preferreds will give up, on average, 65 basis points in

TABLE II

Year	Cash Flow BAM.PR.J (\$28.49)	Cash Flow TCA.PR.X (\$53.95)	Difference per \$100 invested	Discounting factor ⁽²⁾	Present value of difference
2006	\$1.02 ⁽³⁾	\$2.10 ⁽³⁾	3.58 - 3.89 = -0.31	0.992	-0.308
2007	\$1.15 ⁽⁴⁾	\$2.36 ⁽⁴⁾	4.04 - 4.37 = -0.33	0.974	-0.321
2008	\$1.08 ⁽⁵⁾	\$2.21 ⁽⁵⁾	3.79 - 4.10 = -0.31	0.953	-0.295
2009	\$1.08	\$2.21	3.79 - 4.10 = -0.31	0.930	-0.288
2010	\$1.08	\$2.21	3.79 - 4.10 = -0.31	0.907	-0.281
2011	\$1.08	\$2.21	3.79 - 4.10 = -0.31	0.882	-0.273
2012	\$1.08	\$2.21	3.79 - 4.10 = -0.31	0.857	-0.266
2013	\$1.08	\$2.21	3.79 - 4.10 = -0.31	0.832	-0.258
2014	\$1.08	\$2.21	3.79 - 4.10 = -0.31	0.807	-0.250
2015	\$1.08	\$2.21	3.79 - 4.10 = -0.31	0.782	-0.242
2016	\$1.08	\$2.21	3.79 - 4.10 = -0.31	0.758	-0.235
2017	\$1.08	\$2.21	3.79 - 4.10 = -0.31	0.734	-0.228
2018	\$26.02 ⁽¹⁾	\$12.476 + 0.768*X ⁽⁶⁾	91.33 - 23.125 - 1.424X = 68.205 - 1.424X	0.716	48.835 - 1.020X
					Sum: 45.59 - 1.020X

⁽¹⁾ Includes 2019 payment of \$0.14 tax on 2018 dividends and recovery of \$0.77 due to capital loss on redemption at \$25.00

⁽²⁾ Uses July discounting factor applied to BAM.PR.J in each year, except for 2018, when the March 30 ("maturity date") value is used.

⁽³⁾ Three dividend payments, no tax yet payable

⁽⁴⁾ Four dividend payments, tax on three payments from 2006

⁽⁵⁾ Four dividend payments, tax on four payments from prior year - from 2008-17, inclusive

⁽⁶⁾ One dividend of \$0.70, less tax on prior year's dividends of \$0.59, less \$0.15 tax payable in 2019 on 2018 dividend, + X (sale price) + (53.95 - X) * 0.232 (tax recoverable on capital loss in 2019)

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yield-to-worst for the retraction privilege; interestingly, there is no effect for lower quality (Pfd-3 by DBRS) preferreds. The simple question of retractability accounts for slightly over one-third of the variation in yield-to-worst observed in the three most creditworthy classes of preferred shares.

An examination of the data in **Table I** allows us to conclude that TCA.PR.X is clearly superior (according to these metrics) to BAM.PR.J, as long as the price remains in the range in which the October 2013 call may be considered a certainty. After all, the yield is significantly higher, while the term to the worst-case call date is lower.

But what if the “fair” market price of TCA.PR.X does fall below the \$50 call price at the time the call becomes exercisable?

We note that the put/call combination on the retractable BAM.PR.J allows us to count on the instrument effectively maturing in March 2018 at par, if it is not called prior to this date. Since we are now assuming that TCA.PR.X has fallen below its call price in October 2013, it seems fair to assume that this will also be the case for BAM.PR.J. With this in mind, we prepare **Table II**, which examines the cash flows inherent in the two issues (these calculations are not explicitly performed by HIMIPref™, which performs comparisons in a more abstract manner, but the following methodology will illustrate the issues).

In the manner beloved by fixed income analysts, we sum the present values of the differences and set them equal to zero. We find that the value of X, which is the price at which TCA.PR.X must be sold in March 2018 in order to break even with the straight investment in BAM.PR.J is \$44.70. This implies a pre-tax yield-to-worst on the TCA.PR.X in 2018 equal to its pre-tax current yield at that time (since it will be trading below its call price), which is 6.26%

It should be noted that with the tax rates used throughout this article of 21% on dividends and 46.4% on income, a dividend rate of 6.26% provides the same after-tax income as an interest rate of 9.23%.

We may therefore summarize the current investment situation, in which perpetual issues are trading at a large premium to their call prices, as applied to a decision as to whether to invest in BAM.PR.J or TCA.PR.X as:

(i) If perpetual preferred share pre-tax current yields remain significantly below 5.6% (they are

currently about 4.7% for comparably rated new issues) then TCA.PR.X is the better investment, since we may expect it to be called, while providing a yield superior to BAM.PR.J in the interim. Dividends of 5.6% are equivalent to interest of 8.25%.

(ii) If perpetual preferred share pre-tax current yields remain below 6.26% (the “break-even current yield”), then TCA.PR.X is the better investment, since we may expect to sell it at the time the BAM.PR.J is called at a price which will provide a superior total after-tax return.

(iii) BAM.PR.J is a superior investment only in those cases in

which perpetual preferred share issues yield in excess of 6.26%.

After a similar calculation for SLF.PR.C, we find that the break-even current yield is 5.01% (as opposed to 6.26% for the TCA.PR.X). It should be noted that at the calculation price of \$24.48 for SLF.PR.C, the current yield is 4.54%.

This example illustrates how the current environment in the preferred share market has changed the old rules of thumb. In a “typical” environment, represented by the SLF.PR.C, the retraction privilege becomes useful with an increase in yields on the order of half a percentage point – approximately the

amount of yield given up when purchasing retractables. But in the current environment, in which many high-dividend perpetuals are available, the increase in market yields must be much higher for the privilege to have any value and such perpetuals are now much more attractive, relative to retractables, than they have been in higher-yield environments. Advisors should be aware of this change and perform their calculations accordingly. **AER**

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