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Are Floating Prefs Money Market Vehicles?

Closer analysis points to major differences with easy-to cash, stable, no-lose paper

BY JAMES HYMAS

Preferred shares can be a very attractive alternative to corporate bonds for taxable portfolios – this much is well known. But if an investor is to go out and buy a portfolio of preferreds, how should he choose between the major types: Perpetual, retractable and floating rate?

Some investors view floating rate preferreds as conservative, safe investments since the dividend income that they pay is tied to prime. An informal survey of active independent investors yielded the following rationales for investing in floaters:

- Bank account substitute
- An expectation of stable value and increasing dividends in the face of interest rate increases (perhaps as a hedge for other investments)
- Unwillingness to pay a premium for straights, given a primary decision to place money in tax-advantaged preferreds
- Potential for capital gains when floaters are at a deep discount

The first three motivations indicate that the investing public, taken as a group, has a strong feeling that floating rate preferreds are money market instruments. Is this truly the case or is the idea a snare and delusion?

To answer this question, we must first define what we mean by "money market instrument." We all know that a three-month treasury bill is "money market," but why is it money market?

Money market investors accept relatively small returns in exchange for lower "risk," however risk might be defined. It might be "chance of loss of capital over any time period," it might be "standard deviation of monthly returns," . . . you can define risk any way you like and the archetypal money market investor will ask for the smallest amount. Money market investments share the following characteristics:

- The investment will definitely turn into a known amount of cash on a well-defined date in the future.
- The investment can be turned into cash at any time at a fairly well defined price known at the time of the investment.
- There is negligible chance of disastrous loss of investment.

These characteristics are all interrelated, of course, but emphasize different attributes of such investments.

The First Test: The investment will definitely turn into a known amount of cash on a well-defined date in the future

To the best of my knowledge, floating rate preferreds have always been perpetuals and therefore the only way in which these issues can turn into a known amount of cash is if they are called. As I noted in "A Call, Too, Harms," published in the June edition of *Advisor's Edge Report*, "[t]here appears to be some odd behaviour of floating rate issues, which needs to be investigated further."

To examine how well floating rate issues meet the first test, we shall examine the universe of preferred shares currently trading, as approximated by the HIMIPref™ database. The results of this comparison (*see "Currently Trading Issues" below*) show that floaters are in fact the type of issue with the longest average lifetime of any major type – the average life of the 31 floating rate issues currently trading is 9.5 years, almost double the next longest-lived class of preferred shares (retractables, at 5.0 years).

We can confirm the impression we have of the expected lifespan of floating rate issues (*see "Called Issues" below*).

In the 13-odd years covered by the HIMIPref™ database, a total of 93 issues in the database have been called (or have matured). Eleven of these have been floating rate issues and such issues have been the longest-lived of any of the five classes examined with an average term from issuance to call date of 10.7 years, more than double the shortest term group (split shares, 5.0 years) and slightly longer than the so-called perpetual shares.

To make matters worse, there is also the evidence that the call price of floaters is usually, and sometimes substantially, above the price of the issue 12 months prior (*see "Gain or Loss on Called Issues" bottom, left*), a pattern not seen with any other class of preferred share. These data are consistent with the idea that FR issues are called more as the result of structural corporate requirements than the market value considerations that would apply if the called issue were refinanced. To the extent that this is the case, floaters must be considered more "equity-like" than "bond-like," another failure of the money market hypothesis.

Thus, data regarding floating rate issues, regardless of whether the data is historical or current, indicates that such issues should be expected to exist for a long time once issued – longer than their fixed-rate peers. So floaters fail our first test for money market characteristics: They will not, in and of themselves, turn into cash at a well-defined date in the future.

The Second Test: The investment can be turned into cash at any time at a fairly well defined price – known at the time of the investment.

The failure of the first test need not be damning, in and of itself. If we can find reasonable assurance that we will be able to sell our floaters on the market for a well-defined price at any time during its lifespan, we may still be able to consider ourselves money market investors to the extent that we invest in this class of instrument.

The requirement for a well-defined price implies that the market price of the instruments be stable; the return on the investment should accrue and be paid regularly and predictably; and should we ever decide to sell our position then the total return on our investment for our entire holding period should be fairly close to what we may have predicted in advance. In order to test for this condition, we'll examine the table "Monthly Returns" (*bottom, right*), which looks at the "normal" floating rate issues from Dec. 31, 1993 to Feb. 28, 2006. By "normal" we mean that:

- The issues are not "ratchet rate" floaters that are intended to pay a varying percentage of prime depending upon the trading price of the security. We only wish to examine issues that pay a fixed percentage of prime;
- The issues are not "fixed floaters" that pay first a fixed and then (usually five years after issuance) a floating rate dividend;
- The issues are rated Pfd-2(low) or better by DBRS;
- The issues had an average dollar volume greater than $25,000.

If floating rate issues were to meet our second test of money market characteristics, we would

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CURRENTLY TRADING ISSUES

Type	Count	Average life (Years)	Average dollar volume
Float	31	9.5	$59,000
Interest bearing	10	3.1	$60,000
Perpetual	58	4.0	$202,000
Retractable	30	5.0	$79,000
Split-Share	34	4.4	$45,000

There has been some prioritization necessary in the specification of the "type" of each issue. An issue that is both "floating rate" and "perpetual" is listed in the former category only; an issue that is both "retractable" and "split-share" is considered to be of the latter category. "Interest bearing" takes precedence over all other descriptive types.

GAIN OR LOSS ON CALLED ISSUES

Gain (loss) (%)	Floaters	Interest-bearing	Perpetual	Retractable	Split
> +4.00	6	0	4	0	0
0.00 to +3.99	4	0	4	5	0
-4.00 to -0.01	1	4	6	31	6
-8.00 to -4.01	0	3	5	13	0
< -8.01	0	0	0	1	0

The gain or loss is calculated for the twelve-month period immediately preceding the call.

DBRS DOWNGRADES

Float	Operating retractable	Perpetual	Split-share	Interest-bearing
AIT.PR.A	IPS.PR.A	BT.PR.E	CGQ.E	TA.PR.A
BBD.PR.B	LB.PR.B	BBD.PR.C	SPL.A	TA.PR.B
BBD.PR.B	LB.PR.C	LB.PR.D	STR.E	TA.PR.C
CCS.PR.A		GT.PR.A		
NTL.PR.F		STQ.E		
NTL.PR.G		SXT.PR.A		

CALLED ISSUES

Type	Count	Average life (years)
Float	11	10.7
Interest bearing	7	5.2
Perpetual	19	10.2
Operating retractable	50	7.9
Split-Share	6	5.0

MONTHLY RETURNS

Monthly return (%)	Frequency
<= -5.00	2
-4.00 to -4.99	1
-3.00 to -3.99	1
-2.00 to -2.99	4
-1.00 to -1.99	10
0 to -0.99	22
0.01 to 0.99	56
1.00 to 1.99	25
2.00 to 2.99	10
3.00 to 3.99	8
4.00 to 4.99	4
>= 5.00	3

Average : +0.66% Standard deviation : 1.93%

All tables are generated using data from *HIMIPref™ Database, 1993-2006*

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expect to see that all, or nearly all, of the returns would be in the range of 0.01 to 0.99% monthly, given that the maximum prime rate in the period was 9.75% (from early March to early May, 1995). It is with some consternation, therefore, that we see such a wide spread of monthly returns (*see "Monthly Returns," on previous page*), with an average monthly return of +0.66% and a standard deviation of nearly triple this amount, 1.93%.

It should also be noted that, as many pseudo-quantitative modellers have found to their chagrin, the "market price of the instruments" can be very dependent upon the size of the trade contemplated. The average dollar volume of floaters is not particularly high (*see "Currently trading issues," on previous page*); whether entering or exiting a position, all but the smallest investors will need to exercise patience when accumulating a stake or arranging for a block trade.

The second test, therefore, has been failed.

The Third Test: There is negligible chance of disastrous loss of investment.

Financially strong companies are able to issue paper that is universally recognized as "money market." The most obvious example of such corporations are the banks: If one of the big-five banks offers to repay a certain amount of money (or to guarantee that it will be repaid, as is the case with bankers acceptances) on a certain date in the future then, particularly if this date is not too far in the future, we can place a very high degree of confidence that this promise will be kept.

The crucial condition is, however, "if this date is not too far in the future." We have seen above that floating rate preferred shares may, as a general rule, be expected to be around for a long time. This not only influences our first and second tests, but nasty surprises can happen when they have a long window of opportunity, as shown in the table "DBRS Downgrades" (*on previous page*), which looks at preferred shares rated Pfd-2(low) or better to Pfd-3(high) or worse.

The credit quality tripwire has been set between Pfd-2(low) and Pfd-3(high) for two reasons: Firstly, that it is a rule of thumb commonly used in the industry to delineate between "investment grade" and "speculative grade" preferred share issues; secondly, that research into the Canadian preferred share marketplace conducted with the HIMIPref™ database and software has shown that the lower-rated issues are not well behaved when analyzed according strictly to their projected cash flows, even when the lower credit rating is taken into account. They are sufficiently equity-like that straightforward fixed-income analysis, while retaining some value, is not entirely sufficient for investment and analytical purposes.

Floating rate issues are over-represented in the list of downgrades, with six issues being affected by this tragedy (*see "DBRS Downgrades," on previous page*). We note as well that four of these issues were issued by two names: Bombardier and Nortel, big household-name companies that found their floaters severely punished when they fell from grace.

The retail buyers who are so influential on the preferred share market, particularly the floaters, do not take kindly to their icons' revelations of feet of clay! NTL.PR.G (as it was then) was quoted at the "imminent bankruptcy" price of $2.81 to $2.99 on Oct. 9, 2002, while BBD.PR.D fell to a closing quotation of $11.75 to $12.00 on Sept. 24, 2002 (on volume of 419,955 shares, by the way, which indicates that one mustn't focus solely on the panic-stricken nature of retail!).

The third test, therefore, has been failed: There is a significant risk of loss of capital.

The Verdict: Floating rate preferreds cannot be thought of as money market equivalent investments – they're simply too risky in terms of standard tests for "money marketness." They are more perpetual than the ordinary perpetuals; their monthly returns show a disconcerting volatility; and disastrous loss of investment is more likely than with other preferreds as their long effective term increases the chance of a credit downgrade over the life of the investment.

If they're not money market investments, what are they then? This question will be addressed in a future article. AER

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