

Closed End Preferred Funds: Effects of Calls

Understanding these investments can yield some solid dividends

BY JAMES HYMAS

Preferred shares are a superb alternative to corporate bonds for taxable portfolios. But the wide variety of covenants have the effect of scaring off many potential investors. It can be an arduous process just to determine what the covenants are, a problem I have attempted to address in my free website www.prefinfo.com, but even once these characteristics are known, the problems of comparing apples to oranges leaves most small investors thoroughly bewildered.

"Forget it!" comes the cry from the crowd. "Just give me a mutual fund, or at least a closed-end fund

of some kind!"

There are no public mutual funds in Canada specializing in preferred shares. There is at least one unit trust (mine) that offers this service, but such unit trusts are only available to accredited investors and usually have geographical restrictions as well. There are a few closed-end funds around, which have proven very popular with investors, sometimes for the wrong reasons.

On one discussion forum, for instance, an investor queried why anybody would bother buying preferred shares directly at all – after

all, he wrote, the yield on DPS.UN was 4.8%, even after deduction of the MER, while new issues were being sold to yield 4.5%. This led to a discussion of sustainability of dividends, an interesting enough topic to explore in detail – particularly in the current environment, which is top-heavy with high-dividend preferreds trading at a high premium.

This article will examine three closed-end funds, each of which passively invests in the Canadian preferred share marketplace. They are:

- Diversified Preferred Share Trust (DPS.UN), total market value about \$317 million, administered by Sentry Select Capital Corp.;
- Charterhouse Preferred Share Index Corp. (PFD.PR.A), about \$53 million, administered by Jovian Capital Corp. via Charterhouse PSI Management Corp.; and,
- Advantaged Preferred Share Trust (PFR.UN), about \$41 million, administered by RBC Dominion Securities Inc.

Portfolios for these three funds were determined from publicly available documents and loaded into HIMIPref™, my firm's commercial preferred share analytical software. PFR.UN is structured as a forward contract based on a notional portfolio of preferred shares, so it was the notional portfolio that was analyzed. Almost all the instruments held are tracked by HIMIPref™, ranging from a high of 95.2% for DPS.UN to a low of 92% for PFR.UN. After determination of major characteristics of these portfolios, floating rate issues were removed from the analyzed portfolios and further characteristics of the portfolios determined (see *Analytical Characteristics*, below).

Floating rate issues were removed since many of them have

UNDERLYING CALCULATIONS

re: DPS.UN holding of FAL.PR.H

$$\begin{aligned} \text{New NAV} &= \text{Old NAV} \times (1 - (\text{FH} \times (1 - \text{CLF}))) \\ &= \text{Old NAV} \times (1 - (0.011074 \times (1 - 0.9506))) \\ &= \text{Old NAV} \times 0.999453 \end{aligned}$$

$$\begin{aligned} \text{New current yield} &= \text{Old current yield} \times (1 - \text{FH} \times (1 - \text{DRF})) \\ &= \text{Old current yield} \times (1 - 0.011074 \times (1 - 0.874)) \\ &= \text{Old current yield} \times 0.99860 \end{aligned}$$

$$\begin{aligned} \text{New dividends} &= \text{New NAV} \times \text{new current yield} \\ &= \text{Old NAV} \times 0.999453 \\ &\quad \times \text{prior current yield} \times 0.99860 \\ &= (\text{Old NAV} \times \text{old current yield}) \times 0.99805 \\ &= \text{Old dividends} \times 0.99805 \end{aligned}$$

large and negative yields-to-worst, which would otherwise have an unwarranted effect on portfolio average values and the rest of the analysis. As has been shown in previous *Advisor's Edge Report* articles (see "A Call, too, Harms," June 2006, and "Are Floating Prefs Money Market Vehicles?" August 2006) floaters exhibit behaviour unlike that of other preferred shares and are not suitable for the analysis shown in this article for this reason.

Having isolated portfolios of relatively normal preferred shares held by these three funds, the analysis proceeded to determine the effects of calls on the NAV and on the projected current yield (which will be the determinant of dividends payable). It was assumed that:

- Issues will be called at the time worst for the holder, determined as of Aug. 31, 2006.
- The funds will use the redemption proceeds to buy replacement shares at par.
- With respect to the above, the "deemed dividend" that results from redemption of shares at a premium to par is considered capital to be reinvested for the purpose of this analysis.
- There will be no preferred share price fluctuations in the future (other than a sudden change from the Aug. 31, 2006 bid price to the call price when the issue is called).
- The funds will pay out exactly 100% of net income (which, for purposes of this analysis, does not include deemed dividends).

To understand the how these effects are calculated, we can look at the issue FAL.PR.H in detail. This issue pays an annual dividend of \$1.625, was quoted on Aug. 31 at a bid price of \$26.30, and is

callable commencing March 31, 2008, at a price of \$25.00. The issue is held by all three funds.

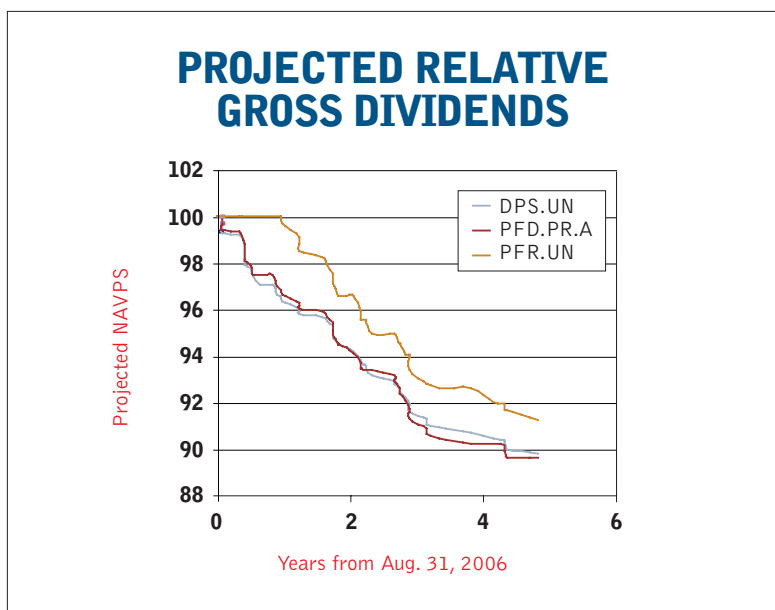
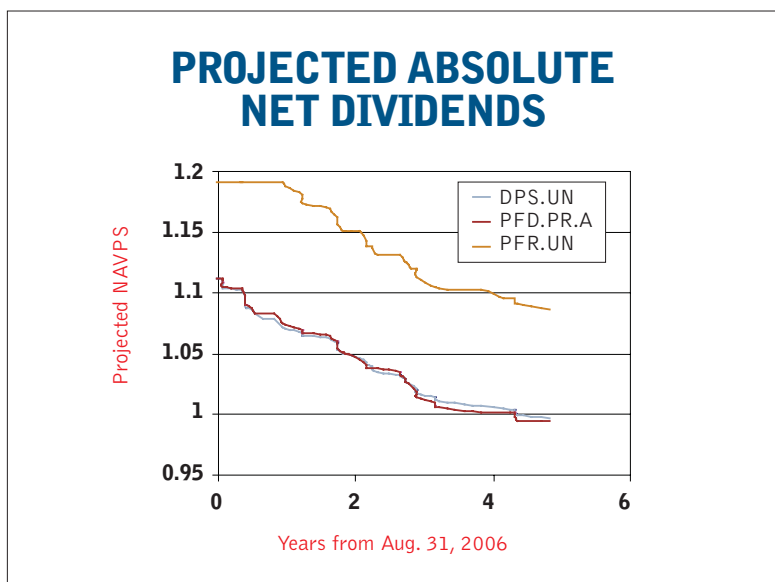
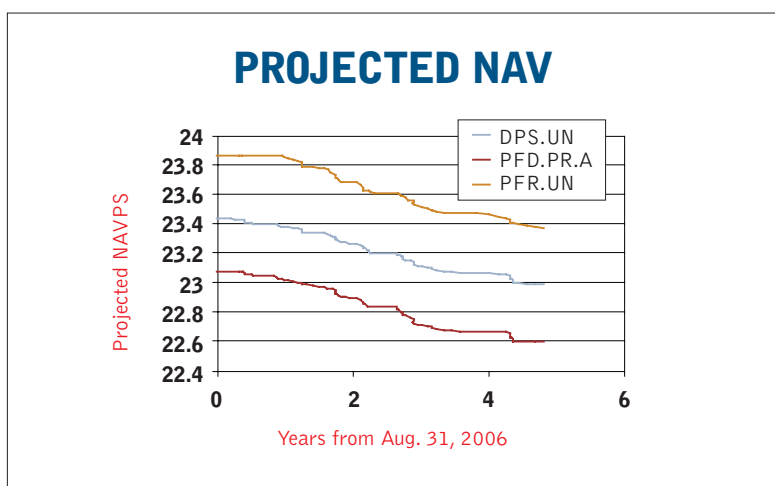
The analysis assumes that this issue will be called, effective on April 30, 2008, at a price of \$25, and be replaced immediately with a share priced at \$25 and an annual dividend of \$1.35. The percentage of the portfolio held in this issue is designated fund holdings (FH). This will result in:

- An immediate decrease in the NAV of the funds holding it, by a capital loss factor (CLF) of $(100\% - 4.94\%) \times \text{FH} = 0.9506 \times \text{FH}$. The figure 4.94% is the drop from \$26.30 to \$25.
- A reduction of the current yield by $(\text{FH} \times \text{dividend reduction factor, or DRF})$ on the portfolio from $(1.625/26.3)$ to $(1.35/25)$, which is from 6.18% to 5.4%, which implies a reduction of relative Current Yield in the fund as a whole of $(\text{FH}/\text{CLF}) \times (1.35/1.625) = \text{FH} \times 0.874$.
- A reduction of total dividends available for distribution equal to the product of these two numbers.

The reductions for DPS.UN, with 1.1074% of its analyzed portfolio invested in this issue (see Underlying Calculations, above) don't seem like very much, do they? But this analysis is repeated many, many times in order to come up with a five-year projection for each of the three funds, and the final numbers (see *Cumulative Effect of Projected Calls*, page 28) will be shocking to those small investors who assume the dividends they are currently receiving on their investment are secure.

No less than 52 issues of the 95

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ANALYTICAL CHARACTERISTICS

ATTRIBUTE	DPS.UN	PFD.PR.A	PFR.UN
Weighted mean current yield	5.29%	5.26%	5.03%
Weighted mean yield-to-worst	3.81%	3.97%	4.11%
Weighted mean modified-duration-to-worst	3.39	3.44	5.66
Sustainable dividend rate [Equal to NAV x (yield-to-worst minus MER)]	\$0.76	\$0.81	\$0.91
Indicated Dividend Rate	\$1.23*	\$1.0088*	\$1.20†

*per www.tsx.com †per prospectus

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included in the three analyzed portfolios are assumed to be called in the five years following Aug. 13, 2006, representing a low of 46.2% of the analyzed portfolio value to a high of 60.3%.

The effect of capital losses as the issues are redeemed at their call price instead of being valued at their Aug. 31 bid price is illustrated in the chart Projected NAV (see

previous page). It should be noted that the values shown are dependent upon the preferred share market remaining unchanged in terms of overall price levels over the next five years; the chart isolates the effect of calls projected from the Aug. 31 prices.

Additionally, even with this caveat, the projected NAVs are an upper bound: There is no allowance for a gradual amortization of the

current premia to call prices. The issue FAL.PR.H analyzed earlier, for instance, is assumed for purposes of this illustration to maintain its bid price of \$26.30 all the way until April 29, 2008. On the following day, bang! The value of the position as analyzed drops to the call price of \$25.

The charts of Projected Absolute Net Dividends and Projected Relative Gross

Dividends (both on previous page) are prepared from the same analysis, while the table Cumulative Effect of Projected Calls (below) gives the total reduction of NAV and dividend receipts after five years in tabular form.

There will be more to come, even after these effects. Careful readers will have noticed the listing of sustainable dividend rate in the table Analytical Characteristics (see bottom of previous page) ... this value is obtained for each analyzed portfolio by:

- Calculating the yield-to-worst of every issue;
- Computing the average yield-to-worst;

The same effects will be observed in any fixed income fund in a declining rate environment.

- Subtracting the current MER from this figure to obtain a Net yield-to-worst after fees; and,
- Multiplying the current NAV by the net yield-to-worst after fees to calculate the sustainable yield for each portfolio.

As may be seen, the carnage to be expected over the next five years is not expected to end the pain to be experienced by those who believe their dividend receipts to be inviolable. It should be noted, however, that this figure represents a lower bound to the sustainable fund yield, as not every issue will be called at the time that is currently worst for investors.

After all the above, there may be some readers who are convinced that I think these three funds are the worst thing on the financial markets. Decline in NAV, decline in dividend receipts, surely I will sum up by labeling the funds "Avoid!"

This is not the case. The same effects will be observed in any fixed income fund in a declining rate environment; the expected behaviour of these funds simply reflects the market, which is their explicit purpose.

However, investors should definitely understand what they are buying prior to making the purchase decision – and they are most definitely not buying investments which can be expected to maintain their current levels of net asset value and dividends forever in the absence of substantial market movement.

As always with this type of investment, investors should:

- Determine the premium or discount of market price to net asset value (including brokerage charges);
- Determine the MER that will be paid on the investment; and,
- Determine whether, in sum, the benefits of the investment outweigh its costs. **AER**

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FIVE-YEAR CUMULATIVE EFFECT OF PROJECTED CALLS

EFFECT	DPS.UN	PFD.PR.A	PFR.UN
Percentage of holdings presumed called	57.1%	60.3%	46.2%
Market value reduction as a fraction of NAV	-1.9%	-2.1%	-2.1%
Dividend receipt reduction as percentage of current receipts	-10.3%	-10.4%	-8.8%