Thanks to the SEC’s efforts, investors now understand the perils of parking money in leveraged ETFS. Such products defy market wisdom because they buy high and sell low. When the market rises, the fund’s equity rises faster than the underlying price, so the fund must buy more of the underlying at the increased price to re-establish its leverage. When the market declines, the opposite holds true and the fund sells at a lower price. A highly volatile market results in losses to the investor — often overwhelming any gains that might have been expected from correctly projecting the overall market trend.

Sequence of returns risk
This effect is another example of the sequence-of-returns risk popularized by William Bernstein and Dr. Moshe Milevsky: in the presence of cash flows, it is not sim-ple to calculate the expected yield of the underlying portfolio. The order in which sub-period returns are experienced is also important, as is the volatility of these sub-period returns. Let’s say we have a planning horizon of two years and intend to make cash withdrawals at the end of each year. If these withdrawals are not covered by portfolio income, you’ll have to sell securities to raise cash at the end of the first year. If the market has declined, you’ll have to sell a greater number than anticipated to raise the same amount of cash. Those sold securities will not participate in a market recovery, even if the total return for the underlying portfolio for the two years exactly matches the initial projection. This fits with the observation of volatility effects in leveraged ETFS, when you consider cash flows rather than market prices, to drive the fund’s purchases or sales. And, in the case of these funds, the Sequence of Returns is actually guaranteed to generate the worst possible result for the security holder. These effects of sequence-of-returns risk are intimately related to the credit quality of preferred shares issued by Split Share Corporations (SSCs). Such a corporation is very similar to a mutual fund — in fact, they are legally described as “mutual fund corporations” and are subject to the provisions of National Instrument 81-106, among others.

The difference is, SSCs issue two classes of investment: capital units and preferred units. Potential buyers of the preferred shares are offered preferential dividends and preferential repayment of principal when the company is wound up on a set date; capital unit holders get whatever is left over and have a de facto leveraged investment in the underlying portfolio. In most cases, the corporation’s promised cash dividends are greater than the expected cash income derived from the underlying portfolio. The prospectus for Financial 15 Split Corp. (FTN) states the investment objectives are to distribute $0.525 p.a. to preferred shareholders and $1.20 p.a. to capital unit holders, for a total of $1.725 per whole unit — with the whole units initially sold for $25.

This implies that, even in the absence of fees, the underlying portfolio had to return 6.9% annually to meet the fund objectives, once fees are included, that required return rises to an average of 8.58%. That could be consid-ered aggressive, but not completely unreasonable by the standards of the time. The gigantic CalPERS pension fund was using 8.25% at the time FTN came to market.

But the dividend yield of the underlying portfolio was less than half this figure, implying a cash drag. While the company engages in covered-call writing to generate cash income and reduce this cash drag, neither it nor any other SSC I know has ever published figures demonstrating this strategy works.

In fact, the company’s total return from the commencement of investment operation (November 2003) to the most recent annual financial report date of November 2015 has been only 0.80%. Plus, the NAV has suffered; the total NAV on May 15, 2012 was only $13.60. It should be clear the company’s promise to repay $10 to the preferred shareholders on wind-up is less credible now. DBRS has gradually downgraded the credit rating of the preferreds from Pd-2 to Pd-4(high). What’s a default? However, DBRS, like other rating agencies, considers only the potential for default in assigning a primary credit rating. If the company should find it can only pay $9.99 to preferred shareholders on the scheduled December 2015 termination date, this will be considered a default — but these shareholders, having received only a penny less than promised, will doubtless consider the default a mere pecadillo.

Investors contemplating a pur-chase at the current price of $9.80 given the current NAV of $13.60 will, however, want to understand the risks they face. To this end, I have developed a spreadsheet for the analysis of Split Share preferred credit quality (see www.advisor.ca/hymas-sept12). The spreadsheet models the more common factors differenti-ating SSCs, with the underlying portfolio itself chosen randomly, given an expected average annual return and the expected distribution (volatil-ity) of monthly returns. Each monthly return is com-pounded of relatively constant divi-dends and volatile price changes. The fund’s cash position is adjusted by its distributions and MER, and its NAV on maturity is calculated after a sufficient number of months have passed. This simulation is repeated over 8,000 times to arrive at a distribution of probable end-values, given the specified parameter-ization (see “Parameterization of Split Share Credit” and “Output of Split Share Credit,” this page).

The parameters of the model listed in Table 1 can be adjusted to chart many interesting relationships. What if, for instance, we vary the current NAV of the SSC? How should changes in NAV influence the price we are willing to pay for the preferred share? (For these variations in relationship see www.advisor.ca/hymas-sept12). As may be seen from the data, the expected maturity price — and therefore the fair value of FTN.PRA, if it is to be expected to yield 5.45% until maturity — is currently relatively insensitive to changes in NAV at the current NAV of $13.60. The fair value of FTN.PRA has been plotted with a constant desired yield of 5.45%, equal to its current yield to the expected maturity price. However, as the chart shows, the sensitivity of the expected maturity price to changes in NAV (or, to put it another way, the exposure of the preferred share to the performance of the underlying portfolio) increases as the NAV rises.
INVESTMENTS

FINDING THE RIGHT FIT

Allocation of capital
Look for managers who act like owners. They won’t lose sight of their prime objective — to increase shareholder value. The most important act of management is the allocation of capital. This is where rationality and good judgment come into play.

Volatility has influence
In the presence of portfolio cash flows, the volatility of the underlying portfolio has a significant influence, which is simply another instance where we see sequence-of-returns risk.

Volatility has influence
So it’s not sufficient to project the expected total return of the underlying portfolio of an SSC when making an assessment of credit quality.

In the presence of portfolio cash flows, the volatility of the underlying portfolio has a significant influence, which is simply another instance where we see sequence-of-returns risk.

This sensitivity to sequence-of-returns risk increases sharply as the NAV of the underlying portfolio declines. The SSC quality model allows for the quantification of these effects, which may be used by investors to gauge fair values for the preferred shares based on their own assessments of these prospects for the underlying security.

3 WAYS TO SPOT GOOD MANAGEMENT
1. They go beyond minimum reporting requirements
2. They have a long-term vision with a strong and consistent operating history
3. They only reinvest earnings if they can produce returns above the average cost of capital

A return above the average cost of capital. In fact, it would make sense to retain and reinvest all of the company’s earnings if this were the case. Berkshire Hathaway has earned high returns, retaining all its earnings and never paying dividends. The test is whether Buffett can produce incremental earnings above those available to investors, because if a dividend were paid, it will be up to shareholders to find reinvestment opportunities.

We often see management destroy shareholder value by retaining earnings to produce sub-par returns, or using earnings to chase growth with overvalued business acquisitions. In those cases, investors are better served with the issuance of dividends or the repurchase of shares, but only when they’re trading below their intrinsic worth. Managers who have a record of poor capital allocation decisions and careless corporate expansions should be avoided.

Assessing management is a subjective process, because numbers don’t tell the whole story. Choosing strong management is also linked to the advisor-client relationship. A client is diligent in choosing whom to entrust his dollars with, so his advisors and managers should also pay careful attention to whom they invest with on their client’s behalf. After all, they’re the ones doing the heavy lifting.

SURYA ABBONDIA is an equity partner with Cetera First Financial Group.

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IT’S ALL ABOUT SEQUENCE

Allocation of capital
Look for managers who act like owners. They won’t lose sight of their prime objective — to increase shareholder value. The most important act of management is the allocation of capital. This is where rationality and good judgment come into play.

Good economic performance is a process, not a number. Investors are better served with a wealth of information, including corporate details, industry issues and business conditions. Look to weak accounting standards, such as the non-expensing of stock options, the use of pro-forma financial statements and unintelligible accounting footnotes.

Volatility has influence
In the presence of portfolio cash flows, the volatility of the underlying portfolio has a significant influence, which is simply another instance where we see sequence-of-returns risk.

This sensitivity to sequence-of-returns risk increases sharply as the NAV of the underlying portfolio declines. The SSC quality model allows for the quantification of these effects, which may be used by investors to gauge fair values for the preferred shares based on their own assessments of these prospects for the underlying security.

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