



Yield Ahead

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After all the introductory work of the last two articles, it's time we started looking at preferred share investments with a view to determining whether individual issues are worth buying. We won't get to the end of the investment decision-making process with this column—I only wish it was that easy!—but a framework for our investigations will help us to focus on the important elements of any comparison.

As fixed-income investors, we are interested in yield. We want to lend our money to some organization, somehow, have them pay us rent on our money, somehow, and then get our money back. This can be done with savings accounts at a bank, GICs, bonds—there are any number of potential avenues for achieving this goal, but I'm supposed to be writing a column about preferred shares, so we'll focus on them.

Most people are familiar with yield through GICs or savings accounts, and the banks are very careful to make comparisons as simple as possible. Put in \$100, get paid whatever it is every year, then get the \$100 back. Bonds in the bond market and preferred shares are a bit more complicated:

- The loan may have changed price since the instrument was issued. For example, let's say that last year you bought a 5-year GIC for \$10,000 that yielded 5% or \$500 per year. But now that the bank only pays 4% on new GICs. They call you and offer to give you your money back right now instead of waiting another four years. Naturally, you turn them down. Why would you want to sell back such a good paying investment when you can reinvest only at a lower rate? You want more money for the loan. In fact, ignoring the effects of taxes, you would only give it back to them if they paid you about \$10,350. This is the amount that, reinvested at 4% for four years (reinvesting the interest), will leave the end value of the portfolio unchanged.
- You may not even know when the investment will be paid back. As noted in the June 2006 column, preferred shares can have uncertain end-dates—the issuer may have

a choice of when to pay back the money, or they may even be able to keep the principal forever, as long as they pay you the annual dividend!

These two complications make it much more difficult to compare possible purchases than simply comparing GIC yields at two banks. But in the world of preferred shares, a little work can go a long way!

How shall we determine yields? It won't do us any good to look in the newspaper or to look at the "Dividend Yield" displayed on the Toronto Stock Exchange (TSX) site, www.tsx.com, where we get our market quotes. These so-called yields are the "Current Yield", sometimes referred to as the "Cash-on-Cash" yield, an evil invention of the financial services industry that serves mainly to confuse innocent investors. "Current Yield" is simply the annual dividend divided by the current price—these are the only two things considered.

Most alarmingly, it does not consider the maturity price. If I offered to pay you \$100 per year for a \$1,000 five-year loan, you might consider that a good deal—until you read the fine print of our contract and discovered that I would only pay you back \$500 when the loan came due.

Consider the issue PIC.PR.A, for instance, that trades on the TSX, and let us further assume that we have the opportunity to purchase it at a price of \$16.00. It pays a dividend of \$0.8625 per year, so we might be very happy with the idea of buying it for its current yield of $\frac{0.8625}{16.00} = 5.39\%$ —but then we read the fine print. This issue will mature on November 1, 2010 and the principal paid back to investors on maturity is \$15.00. We don't want to just lose a dollar of our principal for nothing. But on the other hand, maybe the annual dividend is big enough that we don't mind this loss. To determine whether or not this is a good deal, we have to convert these numbers into yield-to-maturity, which will take account of all these numbers.

To calculate yield-to-maturity, we'll visit Keith Betty's website. Keith is a retired chemist and enthusiastic investor who has developed a convenient spreadsheet to perform these calculations. Best of all, he's put it on his website for

free, so we'll use it. You can find Keith's website at <http://www.shakesprimer.com>, and (with a little digging) his "Yield-to-Call" calculator at <http://www.telusplanet.net/public/kbety/ytc.xls>.

There are a number of cells on this spreadsheet we need to fill in. Conveniently, they're all next to each other, so we don't have to look over the entire spreadsheet frantically searching for something we might have forgotten. We'll fill in the cells as follows:

Current Price - We decided above that the price of PIC.PR.A that we're going to consider is \$16.00. So, click on that cell and fill in this price. Remember to include commissions when performing actual comparisons!

Call Price - This is the price we'll get back when the company redeems its shares. Keith calls it "Call Price" rather than "Maturity Price" because this spreadsheet was developed to examine the effect of options for preferred shares. For this particular issue, however, there is only one option: the issuer has to pay back \$15.00 on maturity. Fill in "15.00".

Settlement Date - Normally you have to pay for a share purchased on the TSX three business days after the trade. For the purposes of this example, we'll assume that this means June 15, 2006 and fill in these boxes. The date appears as it might be written in English to the right of this input, so we can check that there's been no mistake.

Call Date - As noted above, this will be the maturity date of November 1, 2010. We can check that all is well with this input as well.

Quarterly Dividend - We noted from the TSX website that the annual dividend was \$0.8625 and, if we were careful, we confirmed that with the prospectus available at www.sedar.com. (See the June 2006 issue of *MoneySaver* for help on how to do this.) \$0.8625 annually is the same as \$0.215625 quarterly, and we'll fill that in. Just because we have a spreadsheet doesn't mean we can throw away our calculator! The spreadsheet shows the rounded value of \$0.22 in the box, but all the decimal places are shown in the input box at the top of the spreadsheet when we click on the cell.

Cycle - It seems like a minor issue, but it can be important. Remember, we're meticulous and precise fixed-income investors, not sloppy stock jockeys! We know that we're getting quarterly distributions on this issue, but when are they paid? Click "News" on the TSX quotation screen (where we got the price, from www.tsx.com) and find a press release regarding dividends. Sometimes we might have to root around on the issuer's website to find this information—or even contact the

issuer's investor relations department. We learn that dividends are paid in January, April, July and October. So, we input a "1" in the indicated box on Keith's spreadsheet. The spreadsheet then confirms the input to us.

Paydate - From the same press release, we learn that the paydate in April 2006 was the 28th. This is the date that we actually receive the money (or, more likely, the day our brokerage account is credited with the money). We'll fill in this box with "28".

Include First Dividend? - This is a tricky one! When dividends on preferred shares are paid, the entitlements of each shareholder are calculated not on the date the payment is made, but on some date in advance. In order to determine whether we are actually entitled to these entitlements, we have to understand the concept of "ex-date", which does not mean having dinner with an old girlfriend, but rather the date on which the entitlement to the next dividend changes hands from the purchaser of shares to the seller of the shares. This is a tricky topic that will be dealt with at length in a future column. But for now, just take my word for it that if you purchase these shares for a settlement of June 15, you will receive the July dividend. So, we can fill in the box with "1", meaning "Yes, include first dividend".

And we're done! We see in the green boxes on the screen that the "Current Yield" is 5.4%, but we don't care about that—remember? The number that fascinates us is the "Annualized Quarterly Yield to Call" of 4.3%—and before moaning about how little this is, we'll remember that PIC.PR.A pays dividends, not interest. Another column will examine how we can convert this number into bond-equivalent interest.

Play around with the spreadsheet! Make a few changes here and there, just to get a feel for how important the various input specifications are. To prepare for the next column, which will delve more seriously into ex-dates, change the "Include First Dividend?" field from "Yes" to "No". See how important it is to ensure that you get every penny you think you're getting?

You should also check the numbers for "reasonableness". In this case, we know that we're getting dividends of \$0.8625 per year, but we're also incurring a capital loss of \$1.00 over about 4.5 years. Call it a capital loss of \$0.22 per year. Subtracting the yearly capital loss from the dividend gives us \$0.6425 net income per year, for which we're paying \$16.00. Dividing the net income by the cost gives us 4.0%, which is at least close enough to our precise number not to ring any warning bells.

This is a good way to check that the numbers have been entered onto the spreadsheet correctly and that gremlins haven't crept into the spreadsheet. And to be extra safe, you

should also have a look at the calculation areas of the spreadsheet to get an idea of the numbers it's calculating on the way to the final answer. Remember, we're bond investors, so we'll check everything and be careful. If we're sloppy, negligent and slothful, people might mistake us for equity analysts!

In future columns we'll look at the various factors that can affect the yields we receive on preferred shares when they're purchased in the market:

- Credit Rating,
- Term to Maturity or Call Date?
- "Split Shares" or Operating Companies?
- Retractable or Perpetual?
- Cumulative or Non-Cumulative?
- Liquid or Illiquid?

We'll also be looking at tax rates on dividends as compared to tax rates on interest income, so that we may compare preferred shares to regular bonds. In the meantime, get used to the yield calculation spreadsheet and make sure that everything makes sense to you.

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