



Using Credit Ratings When Buying Preferreds

James Hymas

Well ... I mentioned them in the July issue and said they were important in the September issue, but I've never explained what they are! How can an investor use them? How should an investor decide how to place his funds?

Credit ratings are a very important part of investing in preferred shares—or any other fixed-income instrument—and they should be thoroughly understood before any investor entrusts his savings to a borrower.

For a fixed-income investor, one of the primary considerations in portfolio construction is safety of principal. Giving up the “equity risk premium” (the amount of extra return which one hopes to gain from stocks as opposed to bonds, in compensation for the extra risk) is a major and potentially costly decision. Before retreating to the shelter of bonds, we need to quantify the level of comfort we have that our loans will be repaid.

We can understand the decision in qualitative terms. Given the choice of investing \$50,000 in a bank account rather than lending it to the proprietors of the nearest convenience store, we know that the bank is safer. The big banks in Canada are enormous and extremely profitable. Not only that, but in the unlikely event that they do experience difficulties, deposits are guaranteed (with certain limits and conditions) by the Canadian Deposit Insurance Corporation (CDIC, www.cdic.ca). On the other hand, the local convenience store could be bankrupted merely by the appearance of a newer and larger one in a slightly superior location, no matter how loyal their clientele or how hardworking the owners (which is one reason why I'm not in the convenience store business). If the borrower goes under, then the investor will feel some pain.

So, you might think, this is an easy decision. The bank will almost definitely pay our investment back with the agreed interest, while the convenience store is a more dubious proposition. Why wouldn't you pick the bank? Well, for the sake of this argument, we'll assume that the bank is offering 3% interest on deposits, while convenience stores are offering 12%. That makes the decision a little harder—greed is now competing with fear! How about if we divide

up our cash? We could lend \$10,000 to the convenience store and \$40,000 to the bank. The latter amount will at least pay for groceries in our retirement if the worst happens to the store, while the store loan will pay as much interest for their loan of \$10,000 as the bank does for our loan to it of \$40,000. And this illustrates two points: that diversification can increase your returns by allowing you to put smaller chunks of money into better yielding investments, and that even fixed-income investors can take small risks every now and then (though rarely as risky as those routinely undertaken in the stock market).

Having made our decision that we're going to put \$10,000 into a convenience store loan, we now need to decide which convenience store it's going to be. How are we going to make this choice? To make a truly informed choice, we need to know as much about each store as the owners do; considering the relatively small size of our investment, the investigation will take more time than the decision is worth. Due diligence can be extremely time consuming and expensive.

And so (finally!) we consider the possibility of using the services of a credit rating agency. As investors, we tell each store owner who wants to borrow our money that we want their credit rated before we loan them our money. No third party credit evaluation, no loan. Take it or leave it. We're not going to do all that work ourselves and we're not going to lend our money unless the work has been done.

Such an agency should do everything that we would do if we had time. We want them to look at the books of the companies, to talk to management, to consider the prospects for competition, to think about what might happen if the factory down the street closes and the store no longer has 500 well-paid workers walking past it each day—everything that a diligent investor would worry about. At the end of the process, they should form a judgment about the probability that the company will be able to meet its obligations (the interest and the principal repayment) when they become due (according to the terms of the loan), and convey that judgment to us and to all the company's other lenders in relatively simple terms.

And this is exactly what actual credit rating agencies do, except of course, they rate enormous companies, rarely anything as trivial as a single convenience store. These ratings are then provided to investors by the agencies; the investors then have available to them a much more thorough analysis of the relative safety of their potential investment than they would typically be able to achieve by themselves.

The agencies are paid by the companies they rate. This may seem at first glance like an impossible conflict of interest to overcome, but what the agencies are selling is the ability of those who use their ratings to make or break the success, and the cost, in terms of the interest rate that will have to be offered for a fixed-income issue. If an agency's analyses are deemed unreliable, investors will no longer care just how that agency rates any particular company; having a rating from such and such an agency will no longer have an influence on the pricing of new issues; issuers will therefore no longer bother to hire the agency; and the agency will go bankrupt through loss of business. It's an indirect system of reward for accuracy, but it works.

Some investors supplement (or even replace) the work of credit rating agencies with their own work. The banks, for instance, have developed an impressive body of expertise to determining the risk involved in loaning money, for obvious reasons, and this expertise is often put to use for the benefit of bank-employed portfolio managers who invest in the public debt markets on their clients' behalf.

Other portfolio managers and interested parties also develop proprietary systems to evaluate credit risk. The Bank of Canada, for instance, recently published some of the results of its research (Working Paper 2006-28 "Estimation of the Default Risk of Publicly Traded Canadian Companies", online at <http://www.bankofcanada.ca/en/res/wp/2006/wp06-28.html>). Moody's "RiskCalc" is a well known commercially available system. And Altman's "Z-Score" is discussed and calculated all over the Internet (start with <http://www.defaultrisk.com/>!).

This level of sophistication is all very well and good for institutional investors, for whom a basis point ("bp", one-one-hundredth of a percentage point) can be worth millions, but individual investors are well served using the public agency ratings. These are most conveniently available online from the Dominion Bond Rating Service (DBRS) at <http://www.dbrs.com>. DBRS is a leading and widely used agency, with a convenient website; retail investors may also register at www.standardandpoors.com to learn the Standard & Poors (S&P) ratings on any particular issue.

At the DBRS website we can click on the "Rating Scale" tab, then "Preferred Share" to get an explanation of the various levels of credit quality into which DBRS categorizes each issue they rate. In the preferred share market, the term "Investment Grade" is generally taken as meaning from Pfd-1(high) to Pfd-2(low), inclusive. In my research with the quantitative HIMIPref™ software, I have found that issues rated lower than Pfd-2(low) do not trade in nearly as well defined a manner with respect to the yield curve as do those of "Investment Grade". The lower the rating, the more fixed-income instruments behave like equities!

Retail investors, unable to diversify their risk efficiently by holding a large number of issues, should stick to issues rated Pfd-1 and Pfd-2. If you're only going to hold one or two issues, I recommend sticking just to the Pfd-1 issues, which usually means the banks. You may be giving up a little bit of yield, but the great objective in fixed-income investing is to sleep well; eating well is a secondary consideration. Investors should also monitor their portfolio's credit ratings on a regular basis—the world can change, business conditions can change and companies can change. Anybody who got ten cents on the dollar for their Air Canada bonds can attest to that.

How much yield will you have to give up for a restriction to Pfd-1 issues? The answer depends upon the type of preferred share chosen for investment (retractable vs. perpetual, as discussed in the June 2006 issue, is just where the questions about "type" start), the expected term of the instruments compared ... many factors that come into play, but you can gain an idea of the spreads involved by inspection of Chart 1, "Yield-to-Worst vs. Term-to-Worst".

In this chart, "Yield-to-Worst" (YTW) has been calculated as explained in "Yield Ahead" (in the July/August 2006 issue). "Term-to-Worst" is simply the time in years from

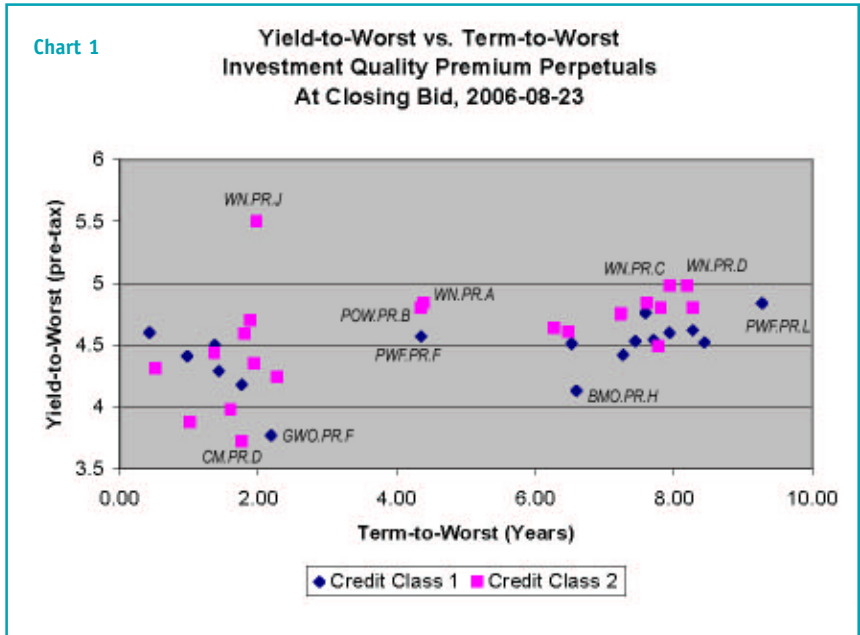
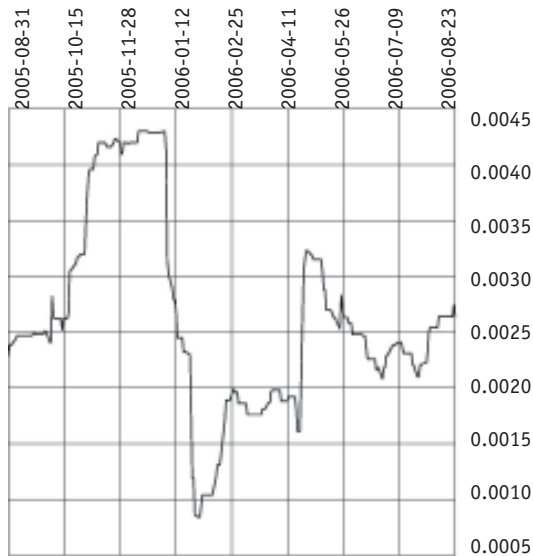


Chart 2

Yield Curve Data: Period (inclusive) from 2005-08-31 to 2006-08-23

X-Axis: Date

Y-Axis: Yield (premium) as fraction



Historical Market Data Source: TSX 1993-2006
The Toronto Stock Exchange. All Rights Reserved.

To which I have to shake my head sadly and advise that I'm a portfolio manager, not a magician. I don't know. Credit spreads will be determined by a host of factors, including economic conditions (during good times, companies of all sorts are generally less likely to default, which can be expected to result in a narrowing of spreads) and supply and demand (what if somebody starts a bank-only preferred share investment trust and needs to buy \$100-million Pfd-1 bank issues? What if a lot of Pfd-2 issuers should become enamoured with the market and swamp the market with issuance of that level?). To get an idea of the range of values that can exist over one year (of good times for the economy, remember!) look at Chart 2: Pfd-1 / Pfd-2 Historical Credit Spread—a value of 26bp is about in the middle of its one-year range.

Use the credit ratings! Buy only issues that have credit profiles that make sense for your own portfolio and when you condescend to lend your hard-earned capital to lower rated companies, make sure you get paid well for it and understand the risks that are involved.

*James Hymas, CFA, Hymas Investment Management,
129 Humbercrest Blvd, Toronto, ON, M6S 4L4 (416)
604-4204, jjHymas@himinvest.com. James specializes in
preferred share analysis.*

the day of measurement, August 23, 2006, until the call date of the redemption scenario, which defines the YTW. In order to make the data more directly comparable than might otherwise be the case, the issues plotted on this chart are all perpetual issues which were quoted (using the closing bid) at a premium to their ultimate call price. So, in other words, our first approximation in our analysis is an expectation that the issues will, in fact, be called.

A fair amount of scatter in this graph is to be expected. Most obviously, the chart makes no allowance for the “high” and “low” modifiers that DBRS places on the primary measure of credit quality. Additional possible features of analysis are also lost in this first-order chart: a higher dividend, for example, will normally mean a higher premium for issues of comparable term; one may then assign a higher probability to the redemption scenario than might otherwise be the case. A complete analysis of the preferred share yield curve, using all instruments in the HIMIPref™ universe and a “non-taxable” tax regime, results in the estimate that the Pfd-1/Pfd-2 credit spread (the amount of yield difference due solely to this difference between issues) is 0.26%, which certainly looks consistent with a quick look at the chart.

“Okay”, you say, “Okay! So, an investor on 2006-08-23 could have expected a 26 bp difference in YTW between the bid-side quotations of Pfd-1 and Pfd-2 issues! So what? I'm an investor, not an historian. What's it going to be tomorrow?”