# Split Shares

James Hymas

A reader of this column asked for an explanation of split share corporations and their suitability for preferred share investors, so I'll be devoting this column to this particular class of investment.

Suppose that you like bank stocks, for example. For whatever reason, you feel that financial equities are on their way up and you're prepared to back up your beliefs with some money. The most straightforward way to do this is, of course, simply to buy some bank stocks, but we'll assume for now that this is not considered to be a viable option—you, as a small investor, feel at lot more comfortable if you have professional management of your portfolio.

So, given that you are comfortable with your view that financials will go up, but uncomfortable with the notion of direct investing, your options are:

- Buy a mutual fund specializing in financials, or
- Buy an exchange-traded index fund devoted to the "financials" index.

You're very comfortable with the idea that financials are on their way up—so comfortable that you are willing to leverage your bets. Again you have a straightforward option: you can just do whatever you were going to do in your cash account, but more of it in your margin account. This will involve borrowing money from your brokerage firm, however, and a lot of people aren't comfortable with such an arrangement. Why not get the professionals to borrow for you?

The friendly underwriters on Bay Street have anticipated your need and have invented "split share corporations". These corporations are set up so that an investment portfolio can be held by the firm, paid for partly by ownership and partly through borrowing and are thus, in essence, closed-end mutual funds that employ leverage. Many of the corporations will attempt to add a little extra return through such techniques as "covered call writing" and "cash covered put writing", but these embellishments are not our concern at the moment. We're fixed-income investors, not option-strategy fans.

**SOME CREDIT CHARACTERISTICS OF THE SPLIT SHARES EXAMINED**

| Ticker | Date of Annual Report Examined | Common Equity (thousands) $ | Preferred Share Capital (thousands) | Asset Coverage Ratio | Net Normal Income** (thousands) | Preferred Share Dividends (thousands) | Income Coverage Ratio | DBRS Credit Rating (Sept 2006) |
|---|---|---|---|---|---|---|---|---|
| CAC.PR.A | 12/31/2005 | $709,737 | $152,020 | 5.67:1 | 14,185 | $8,209 | 1.73:1 | Pfd-1 |
| CGI.PR.C* | 12/31/2005 | 588,146 | 135,000 | 5.36:1 | 6,728 | 6,728 | 1.00:1 | Pfd-1 |
| DFN.PR.A | 11/30/2005 | 149,347 | 84,000 | 2.78:1 | 3,674 | 4,410 | 0.83:1 | Pfd-2 |
| DIV.PR.A | 3/31/2006 | 135,200 | 125,000 | 2.08:1 | 6,600 | 7,300 | 0.90:1 | Pfd-2 |
| FFN.PR.A | 11/30/2005 | 103,506 | 67,000 | 2.54:1 | 2,510 | 3,518 | 0.71:1 | Pfd-2 |
| FTN.PR.A | 11/30/2005 | 184,021 | 109,000 | 2.69:1 | 4,244 | 5,722 | 0.74:1 | Pfd-2 |
| FTU.PR.A | 11/30/2005 | 64,500 | 48,750 | 2.32:1 | 1,243 | 2,015 | 0.62:1 | Pfd-2 |
| PIC.PR.A | 10/31/2005 | 203,437 | 289,507 | 1.70:1 | 10,264 | 16,788 | 0.61:1 | Pfd-2 |
| TDS.PR.B | 11/15/2005 | 51,097 | 47,770 | 2.07:1 | 2,825 | 1,776 | 1.59:1 | Pfd-2(low) |
| WFS.PR.A | 12/31/2005 | 206,300 | 163,688 | 2.26:1 | 4,690 | 9,471 | 0.50:1 | Pfd-2 |

Note: The annual reports examined are all relatively dated at this time – readers are urged to obtain more recent financial data prior to considering the possibilities for investment.

*Note particularly that there has been a new issue of preferred shares by this issuer subsequent to the annual report examined.

**"Normal Income", as used in this table, refers to income before accounting for realized/unrealized capital gains/losses on both equities and options and performance fees. The inclusion of option premia received in "Normal Income" would increase the calculated "Income Coverage Ratio".

**ISSUES INCLUDED IN THE HIMIPref™ SPLIT SHARE INDEX**

| Ticker | Investment Manager | Base Investment Portfolio | Notes |
|---|---|---|---|
| CAC.PR.A | Natcan Investment Management | Large capitalization Canadian equity | Passive management against custom index |
| CGI.PR.C | Morgan Meighen & Associates | Diversified stock portfolio | Active management of stock portfolio |
| DFN.PR.A | Quadravest | Portfolio of 15 Canadian dividend-paying stocks | May write covered call options; performance fee |
| DIV.PR.A | Independent | Diversified stock portfolio | Active management of stock portfolio |
| FFN.PR.A | Quadravest | Portfolio of 10 Canadian and 5 American financial services stocks | May write covered call options; performance fee |
| FTN.PR.A | Quadravest | Portfolio of 10 Canadian and 5 American financial services stocks | May write covered call options; performance fee |
| FTU.PR.A | Quadravest | 15 American financial services companies | May write covered calls; performance fee |
| PIC.PR.A | Mulvihill | Top 5 Canadian Banks | May write covered calls and cash-covered puts |
| TDS.PR.B | TD Securities Inc. | Toronto-Dominion Bank stock | |
| WFS.PR.A | Mulvihill | Large capitalization financial equities | May write covered calls and cash-covered puts |

The professional money managers who promote and operate the split share corporations have a number of alternatives when deciding how the portfolio is to be funded. They could simply borrow money from a bank, but this is not an optimal strategy. The underlying investment portfolio is going to paying dividends—perhaps a relatively large amount of dividends, if the portfolio is invested in Canadian bank stocks, or perhaps a lesser amount, if the portfolio is roughly matched with the index.

Recall from the May 2006 issue of *Canadian MoneySaver*, that the dividend tax credit and gross-up had the effect of making dividends more valuable than interest—while corporate bonds had a higher pre-tax total return, preferred shares have historically outperformed on an after-tax basis. In fact, with the latest changes to the tax regime in Ontario, an investor in the top tax bracket needs to get $1.40 in interest in order to have the same after-tax income as a similar investor getting $1.00 in dividends. Dividends are good things! They bring with them an enormous tax advantage! Never forget that!

If these corporations borrow money and pay interest on that money, they lose all the tax advantages that would otherwise accrue from the receipt of dividends from their investment portfolio. It would be much better for investors in general (and correspondingly bad for the tax collectors) if the cost of the funds borrowed to leverage the portfolio could be paid in a tax-advantaged way, with the dividends from the investment flowing through to the lender. And this is exactly what happens with most split share corporations: the money used to leverage the capital investment is raised through a preferred share issue and, to a greater or lesser extent depending on the company, dividends from the underlying investment cover the dividends on the issue.

**GT.PR.A : SOME HISTORICAL DATA**

| Date | Asset Coverage | DBRS Rating |
|---|---|---|
| 12/31/1998 | 2.13:1 | Pfd-2 |
| 12/31/1999 | 2.17:1 | Pfd-2 |
| 12/31/2000 | 1.58:1 | Pfd-2 |
| 12/31/2001 | 1.23:1 | Pfd-3 |
| 12/31/2002 | 0.83:1 | D |
| 12/31/2003 | 0.84:1 | D |
| 12/31/2004 | 0.83:1 | D |
| 12/31/2005 | 0.77:1 | D |
| 9/30/2006 | 0.82:1 | D |

Asset coverage calculated from information at www.mulvihill.com.
DBRS rating from information at www.dbrs.com.

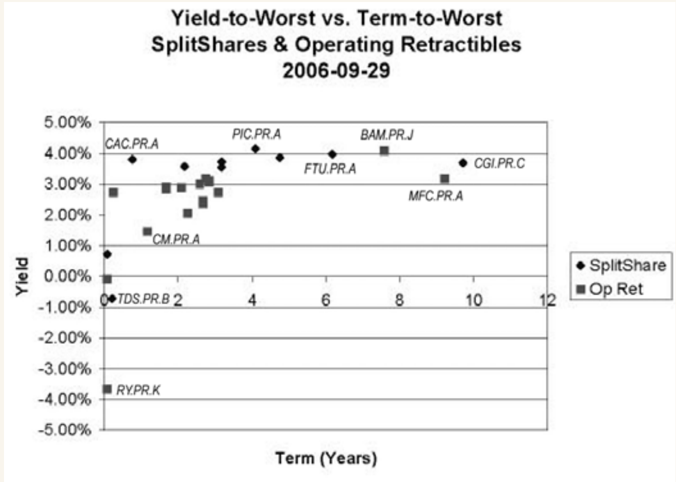
My daily commentary at http://www.prefBlog.com reports on the characteristics and performance of a number of preferred share indices, each index representing a different class of issue. One of these indices reports on split share preferreds that:

- Are included in the universe analyzed by HIMIPref™, my firm's analytical software, and
- Are rated Pfd-2(low) or better by DBRS (see http://www.dbrs.com), and
- Have an average daily trading value of $25,000 or more (the calculation of this value is subject to various constraints and adjustments).

These restrictions reduce the number of qualifying issues to ten, as of the re-balancing at the end of September. The issues are listed in the table "Issues Included in the HIMIPref™ Split Share Index; with more information summarized in the table "Some Credit Characteristics of the Split Shares Examined".

These characteristics include the two ratios that are the backbone of credit analysis: "income coverage" and "asset coverage". The former value has been defined for the purpose of this article as including only "normal" income since capital gains, both realized and unrealized, are too unpredictable to be worthy of notice. In essence, "income coverage" shows the relationship between cash that may be reasonably expected to come in and cash going out … if less than 1.0:1, the company is reliant upon its other income (capital gains, option writing, etc) to pay the preferred share dividend, or may have to dip into capital to meet these payments. "Asset coverage" shows the ratio between what the company owns against what it owes (for example, a 75% mortgage in the absence of any other information, can be viewed as having a 100:75, or 1.33:1 asset coverage ratio). In both cases, higher ratios are better than lower ones.

The major problem with the split shares subclass is the dependence upon financial assets and, in many cases, the narrowness of this asset class. One may hypothesize from the "characteristics" table (and confirm from the actual DBRS report) that TDS.PR.B, with its entire value dependent upon the performance of TD Bank equity, is considered less creditworthy than might otherwise have been the case due to the narrowness of its asset base. As so often with investing, diversification is a means to safety!




Which brings to mind a cautionary tale illustrating the Achilles Heel of split shares: Mulvihill Premium Global Telecom Fund, GT.A / GT.PR.A. The underlying asset for this investment is telecom shares. With the benefit of hindsight we know that this wasn't exactly the best asset class to depend on during the Tech Wreck, but comparing the asset coverage in 1998 to those shown for the current "quality" split shares is a sobering experience. Research using the HIMIPref™database has shown a higher potential for credit downgrades with split shares as opposed to issues of operating companies, so investors must be careful, be alert and be diversified.

Given the sufficient risk of a downgrade of split share corporations' preferred shares, for me to mention it in such a short article, why invest in them at all? Three major points should be considered:

- There is a possibility of credit impairment with any issue, not just with split shares.
- Split shares are always retractible (see "Perpetual and Retractible Preferred Shares" in the June 2006 issue of *Canadian MoneySaver*), a trait desirable for many portfolios, which also means that a limit exists on how long investors must assume credit worthiness of the investment. Note: I consider a set maturity date to be equivalent to retractibility for risk management purposes.
- The yield is generally higher on split share preferreds, as shown by this article's chart.

And so this article ends, with an exhortation that will be familiar to regular readers: there's good yield available but, as with any other investment, check things out for yourself—or ensure that your advisor has done the checking—prior to committing funds.

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