Interest-Bearing Preferreds

James Hymas

"What?" my interlocutor gasped, "you mean there are preferred shares that pay dividends?"

I assured him that dividend-paying preferred shares were not only extant, but normal. He had been asking about his holding of BAM.PR.T and what should be done about it. An advisor had recommended it to him for his RRSP several years earlier and he had dutifully bought it without much further investigation.

BAM.PR.T is an example of a preferred security, which may be defined as an interest-bearing investment trading without accrued interest on a stock exchange, with at least some attached covenants ranking it ahead of the common stock. Many of these were issued in Canada under the Merrill Lynch trademark, "Canadian Originated Preferred Security" (COPrS), and enjoyed a vogue for a few years since. Provided the terms of issuance were sufficiently favourable, the issuer could treat the financing as equity rather than debt for balance sheet purposes. Such qualifying terms included a very long term to maturity and the ability of the corporation to suspend interest payments without triggering a default. In other words, the holder of the issue might be very angry that he was not receiving payments and be able to ensure the suffering was shared by the common shareholders, but could not petition the corporation into bankruptcy.

These games are over now. As Shaw Communications noted in their press release (http://biz.yahoo.com/iw/060630/0140872.html):

"Effective September 1, 2005 the Company retroactively adopted the amended Canadian Standard, Financial Instruments - Disclosure and Presentation, which classifies the Company's Canadian Originated Preferred Securities ("COPrS") and the Zero Coupon Loan as debt instead of equity."

A few such issues are still trading, but most of the interest-bearing preferreds now trading have been issued by split share corporations with investment portfolios concentrated in the income trust sector of the market. As was noted in the November issue of *Canadian MoneySaver*, split share corporations will, in essence, split the total return on a portfolio into income and capital gains, with the income being earmarked for the preferred shareholders and the capital gains for the capital unit holders. Some of the splits are precise, some are woefully out of balance—but that's the idea, anyway.

Income trusts, as shell-shocked veterans of the Hallowe'en massacre will remember, pay interest income, not dividends, and thus trusts specializing in this market will have only interest income to distribute to their preferred shareholders. We don't know how long this particular investment model will last, but for as long as it does we must understand the instruments designated as "Preferred" by both the Toronto Stock Exchange (who signal their agreement with the designation by listing the issue with a ".PR." insertion into the ticker symbol) and DBRS (who will assign a credit rating on the Preferred Shares, Pfd- scale)—even if the only purpose of understanding them is to avoid them.

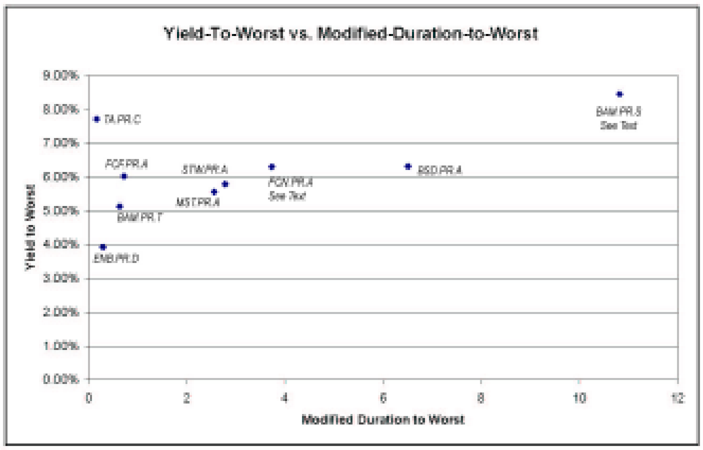
My firm's analytical software, HIMIPref™, tracks a number of interest-bearing preferred issues (usually distinguished from the dividend-paying preferred *shares* by referring to them as preferred *securities*). Interest-bearing issues are, sadly, often too illiquid or too short term for purchase, but some investors with particular requirements may often be rewarded for poking around in the Toronto Stock Exchange's bargain bins.

Chart 1 below shows a graph of Yield-to-Worst vs. Modified Duration for the interest-bearing issues tracked (see July 2006 *Canadian MoneySaver* for an explanation of "Yield-to-Worst") and makes it readily apparent that there are some attractive yields on offer—6% interest income for investment-grade paper might strike some as being an attractive rate, especially now at the height of RRSP season!

After checking the DBRS credit ratings (obtainable from www.dbrs.com), as explained in the October issue, and examining financial statements obtained from SEDAR at www.sedar.com, we can prepare a summary such as Table 1. This table reviews the credit characteristics of the issues plotted in Chart 1 and is similar to our review of split shares in the November/December 2006 *MoneySaver*. We should note that:

- TA.PR.C has a credit rating of only Pfd-3. As a general

Chart 1



rule, I do not recommend investing in preferreds (either dividend or interest paying) of this quality. These are the preferred shares' equivalent of "junk". While they might be attractive, they're not only more exposed to unforeseen events but, as a related effect, are less well behaved with respect to interest rates in general than are the better quality issues. As fixed-income specialists, let's stick with what we know best!

- The annual reports are all fairly dated. More information can be obtained from company filings on SEDAR, from the company websites and from the daily newspaper. BSD.PR.A, for instance, is backed by a portfolio of income trusts. Unless we have more precise information, it is prudent to knock 25% off the "asset coverage ratio" to reflect the Hallowe'en massacre. This ratio is better thought of as being 1.78:1, not 2.38:1.

- DBRS lists many of the issues as being under review. Find out why the issues are being reviewed from their website and determine for yourself whether you are comfortable with the idea of investing in the companies. Note that sometimes a review can be favourable!

- DBRS does not list some of the issues as being under review, although their investment characteristics are similar to those being reviewed. Why is that? Frankly, I don't know, and will review all the ratings with a jaundiced eye given the impairment of asset values since the last financial statement.

- I have not shown the calculations relating to the operating companies. Credit analysis of operating companies is much more complex than that required for split share corporations. Additionally, I consider the rating agency pronouncements regarding operating companies to be more reliable than for split shares.

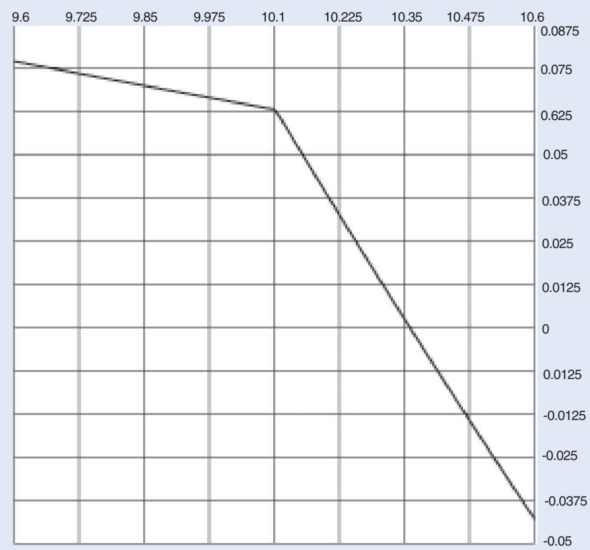
Table 1 shows no hideous surprises, so we can turn to a more detailed examination of Chart 1. BAM.PR.S is plotted as having the highest Modified-Duration-To-Worst of the sample, despite the fact that we know it has been called for redemption (the announcement was made November 16, according to the company website at http://www.brookfield.com/InvestorCentre/835.html). This illustrates one of the perils of relying mechanically on Yield-to-Worst (and hence, on the Yield-to-Worst scenario) as an indicator of investment expectations—it can vary considerably when an issue is trading close to its call price.

To determine the Yield-to-Worst for BAM.PR.S, the HIMIPref™software I used in the preparation of this article selected three scenarios from a plethora of possibilities as being sufficiently likely to be worthy of further examination. These scenarios are specified in Table 2 and, it should be remembered, are prepared without specifying that we know the issue will be called for redemption effective January 2, 2007. We note that the calculated yields seem very high, as the yield of the instrument is "only" 8.35% … but it must be borne in mind that this issue was quoted with a bid of $25.32, despite the fact that a dividend of slightly over $0.52 was to be earned, in its entirety, on the next ex-dividend date of 2006-12-13. Since an entire three-months' worth of interest will be earned in its entirety less than two weeks from the date of the calculation, yield calculations can return surprising results when performed for short holding periods.

A Yield-to-Worst calculation utilizes only the price, maturity date, and cash flows of the issue examined. It does

CHART 2 - FCN.PR.A - PRICE/YIELD-TO-WORST SENSITIVITY

X-Axis - Bid
Y-Axis - Yield-to-Worst (at Bid)



not automatically include common sense, such as the knowledge that Brookfield can borrow money much more cheaply than 8.35% (and may therefore be expected to call at the first possible instant) and the ability to check the company website, DBRS and news reports. Like any other calculation, it is an aid to understanding, not a substitute.

Market risk is often exacerbated by the potential for an early call—see the references to redemption in the June 2006, *MoneySaver*. Many issues have a call price of par, exercisable by the company once per year, every year. Such schedules are not in the best interest of the preferred shareholders. It means the price of the issue can never rise too high, since it is anchored by the possibility of such a call in the near term—the yield will drop very quickly as the price rises. While we are not necessarily looking for capital gains when we purchase preferred issues, we won't necessarily turn them down, either! And a premium to our purchase price will, if the issue is called, help compensate for the time and trouble we have to take in order to find a new investment, as well as making it somewhat less likely that the capital unit holders will retract their holdings in the first place.

For a graphic depiction of how quickly yield can go negative when the price rises, see Chart 2, in which yield is plotted against price for FCN.PR.A, one of the issues examined in this article. It is clearly the height of lunacy to pay more than about $10.20 for this issue (including commission!), but the TSX reports a 52-week high of $10.70. Note that FCN.PR.A may shortly be merged by the manager into a larger trust—see my blog at http://www.prefblog.com/?p=377 for details. Issues discussed in this article with a call premium that declines over time, which is the ideal we should look for when examining any issue, are BSD.PR.A, MST.PR.A and STW.PR.A. The first mentioned of that triumvirate recently had an annual retraction. No preferreds were called because the company was able to purchase enough in the marketplace at prices well below the call price, which is exactly the way it should be. Interested readers may read my blog, at http://www.prefblog.com/?p=372 for more details and commentary.

TABLE 2 - BAM.PR.S : SCENARIOS EXAMINED FOR YIELD-TO-WORST ANALYSIS

Maturity Date	Maturity Price	Yield to Maturity
2007-1-30	$25.00	9.05%
2007-6-29	$25.00	8.62%
2036-11-30	$25.14*	8.45%

*This is a "limit maturity" - a 30-year term used for analytical purposes by HIMIPref™. In such a case, the maturity price reflects the current price, with a separate computation of the final income payment.

So there you have it! Preferred securities pay interest and can be a rewarding addition to your list of potential investments, particularly for RRSPs. But you must:

- check the credit quality;
- check the Yield-to-Worst;
- check the potential for an early call; and
- don't pay too much!

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TABLE 1 - CREDIT CHARACTERISTICS OF SOME PREFERRED SECURITIES

Ticker	Type of Company	Date of Annual Report Examined	Common Equity^	Preferred Share Capital^	Asset Coverage Ratio	Net Normal Income, before Preferred Dividends^	Preferred Share Dividents^	Income Coverage Ratio	DBRS Credit Rating
BAM.PR.S*	Operating	—	—	—	—	—	—	—	Pfd-2(low)
BAM.PR.T	Operating	—	—	—	—	—	—	—	Pfd-2(low)
BSD.PR.A	Split	2005-12-31	94,364	68,423	2.38:1	7,057	3,665	1.92:1	Pfd-2
ENB.PR.D	Operating	—	—	—	—	—	—	—	Pfd-2
FCF.PR.A**	Split	2005-12-31	56,500	47,538	2.19:1	6,478	3,385	1.91:1	Pfd-2 (Under Review)
FCI.PR.A**	Split	2005-12-31	39,231	18,665	3.1:1	4,244	5,722	0.74:1	Pfd-2 (Under Review)
FCN.PR.A**	Split	2005-12-31	169,297	123,000	2.4:1	14,468	7,688	1.88:1	Pfd-2 (Under Review)
MST.PR.A	Split	2005-12-31	70,400	53,166	2.3:1	5,927	4,446	1.33:1	Pfd-2(low)
STW.PR.A	Split	2005-12-31	113,629	72,363	2.6:1	15,195	5,092	2.98:1	Pfd-2(low) (Under Review)
TA.PR.C*	Operating	—	—	—	—	—	—	—	Pfd-3

^ Thousands. *By the time of publication, both BAM.PR.S and TA.PR.C will have been called. They have been included in this review of the situation as of November 30 for completeness. ** There is an outstanding proposal to merge FCF.PR.A, FCI.PR.A and FCN.PR.A.