Retractible Preferreds and Bonds

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In the June 2006 edition of *Canadian MoneySaver*, we compared perpetual preferred shares with retractibles. It seems appropriate that we now compare the retractibles with bonds for a number of reasons. First, since tax and its effects on investment returns will be on everybody's mind at this time of year and second because, as of the time of writing this article in early January 2007, retractibles are behaving very strangely—very strangely indeed.

All preferred shares have a high degree of similarity with corporate bonds as was discussed in the May 2006 edition, but regular readers of this column will appreciate that there are many different kinds of preferred shares, each with its own characteristics. Of all the various subclasses, retractible preferreds issued by operating companies are the most similar to bonds.

The main reason for this is due to the presence of a definite maturity date for the shares. It may be (and, nowadays, often is) probable that the company will call the shares prior to this date (see the sidebar) but there does exist a date on or before which the investor will definitely have his capital returned (unless the issue defaults).

This maturity date is crucial in maintaining the value of the preferred shares. If interest rates were to double overnight, one might well expect to wake up to scenes of indiscriminate carnage on Bay Street for instance, with all fixed-income investments dropping massively in price as investors sold them to buy new issues at the new rates. Perpetual preferreds would probably not recover without a subsequent decline in yields since the investor cannot force the issuer to buy back the issue, but retractible preferreds and bonds would gradually stagger back to their par value over the next few years as the time approached at which investors received their full issue price back.

Yes, retractibles are certainly safer than perpetuals, at least in terms of recovering the invested capital. To persuade investors to buy perpetuals, issuers have to increase the amount of the annual dividend that is offered until investor greed outweighs investor fear. This month, however, we're not going to look at the question of deciding between retractibles and perpetuals; we'll just look at retractibles and bonds.

In the May 2006 *MoneySaver*, I made the point that, although the pre-tax return on preferred shares has historically been lower than the return on corporate bonds, the after-tax returns have been higher, thanks to our dear friend, the dividend tax Credit (the DTC). While we can't predict either future interest rates or future taxation levels, we can look at the influence of the DTC on current marginal tax rates, which will help determine whether bonds or preferred shares are the way to go.

We'll do this by determining the dividend/interest equivalency factor for a variety of tax regimes and income levels, using the marginal tax rates supplied by Ernst & Young's wonderful online tax calculator at http://

TABLE 1 - DIVIDEND/INTEREST EQUIVALENCY FACTORS FOR VARIOUS PROVINCES AND TAXABLE INCOMES.

Province	$30,000	$75,000	$150,000
BC	1.27	1.44	1.45
AB	1.29	1.35	1.34
SK	1.36	1.42	1.42
MB	1.35	1.42	1.42
ON	1.27	1.40	1.40
PQ	1.31	1.36	1.36
NB	1.26	1.29	1.28
NS	1.37	1.45	1.48
PEI	1.33	1.48	1.48
NL	1.28	1.35	1.35
NWT	1.27	1.44	1.44
YUK	1.29	1.38	1.39
NUN	1.24	1.32	1.31

The figures in the table provide the factor by which to multiply the dividend yield of an investment to determine the interest rate which would provide the same after-tax return.Data are taken from the Ernst & Young website, http://www.ey.com/GLOBAL/content.nsf/Canada/Tax_-_Calculators_-_2006_Personal_Tax, at a time when it "reflects known rates as of December 19, 2006."

www.ey.com/GLOBAL/content.nsf/Canada/Tax_-_Calculators_-_2006_Personal_Tax.

For example, suppose we live in Ontario with an income of $75,000 annually. The calculator tells us that the marginal tax rate on dividends is 20.74%, while the marginal rate on interest and other income is 43.41%. Therefore, if we make $1.00 in dividend income, we will pay $0.2074 tax and be left with $0.7926, whereas $1.00 in interest leaves us with $0.5659. Divide $0.7926 by $0.5659 to get 1.40. We can therefore state that $1 in pre-tax dividends gives us the same after-tax income as $1.40 in interest income. See for yourself!

Calculations have been done for a wide variety of tax situations in Table 1 and it is quite interesting to see the wide range of equivalency factors. Quite clearly, it is possible for two rational investors with the same risk profile to make a different decision regarding bonds or preferreds, depending upon their tax status.

Leaving philosophy to look after itself while we go and make some money, we can now use our equivalency factor to compare preferreds and regular bonds. As was discussed in the July 2006 edition of *Canadian MoneySaver*, the most conservative method of defining yield for a preferred share is its Yield-to-Worst (YTW). In a YTW analysis, we look at all the embedded options defined by the issue's prospectus, examine these scenarios in light of the current date and market price and determine the worst thing that can happen for the investor, in the absence of issuer default.

For example, if the issue is trading at $26.00, the worst-case scenario might be a call the next day at $25.00 (if the issuer has that right) and this would almost certainly be the "YTW Scenario". If the issue is trading at $24.00, then the investor would probably be very pleased if the issuer exercised such a privilege—the YTW Scenario will probably be something else.

TABLE 2 - WHAT THE MARKET SHOULD EXAMINE – YIELD-TO-WORST FOR SOME RETRACTIBLE ISSUES.

Issue	Bid Price	Annual Dividend	Annual Call Premium Reduction	Yield-to-Worst*	"Worst" Redemption Date	Bond-Equivalent Yield**
BMO.PR.G	25.52	1.20	0.25	-3.14%	2007-01-28	N/A
RY.PR.K	25.56	1.175	0.25	-4.76%	2007-01-28	N/A
BMO.PR.I	26.05	1.1875	0.25	-26.38%	2007-01-28	N/A
CM.PR.A	26.25	1.325	0.25	2.55%	2007-11-30	3.57%
WN.PR.B	26.28	1.45	0.00	3.02%	2009-06-30	4.23%
CM.PR.R	26.40	1.238	0.15	2.71%	2008-05-30	3.79%
GWO.PR.E	26.85	1.175	0.25	2.29%	2009-04-30	3.21%
PWF.PR.J	26.92	1.175	0.25	2.50%	2008-05-30	3.50%
MFC.PR.A	26.99	1.025	0.25	3.08%	2011-07-19	4.31%
BAM.PR.I	27.05	1.375	0.25	3.30%	2009-07-30	4.62%
BAM.PR.H	27.20	1.4375	0.25	2.42%	2008-10-30	3.39%
TD.PR.N	27.27	1.15	0.25	2.65%	2009-05-30	3.71%
GWO.PR.X	27.50	1.20	0.33	2.51%	2009-10-30	3.51%
TD.PR.M	27.62	1.175	0.25	2.18%	2009-05-30	3.05%
IGM.PR.A	27.90	1.4375	0.33	2.59%	2009-07-30	3.63%
BAM.PR.J	28.30	1.35	0.25	3.82%	2014-04-30	5.35%
ACO.PR.A	28.80	1.4375	0.50	0.35%	2008-12-31	0.49%

*The Yield-to-Worst (YTW) is reported as shown by HIMIPref™ analytical software. This software does not directly search for YTW; instead, a host of scenarios are examined, those with a sufficiently high probability of occurring are isolated and the YTW determined from this selection. Hence, an assiduous reader might be able to identify possibilities resulting in a slightly worse yield for the shareholder; I do not believe that such differences will be significant.

**The Bond-Equivalent Yield has been determined by multiplying the YTW by 1.4, the equivalency factor for Ontario residents in the higher tax brackets. Other readers may determine the factor applicable to them from Table 1. This calculation shows the coupon rate on a bond priced at par that gives the same after-tax income as a preferred share priced at par with an annual dividend equal to the YTW; a more precise calculation would treat the capital gain and dividend components of the pre-tax YTW separately.

When we compare the YTWs for some retractible issues (shown in Table 2) to contemporary bond yields (Table 4), our reaction is stunned disbelief. Mine is, anyway. Most

TABLE 3 - IS THE MARKET HOPING FOR THESE RESULTS?
YIELDS-TO-RETRACTION FOR SOME RETRACTIBLE ISSUES

Issue	Yield-to-Retraction (Pre-Tax)	Retraction Date	Bond-Equivalent Yield*
BMO.PR.G	3.59%	2008-05-24	5.03%
RY.PR.K	3.60%	2008-08-23	5.04%
BMO.PR.I	2.72%	2008-11-24	3.81%
CM.PR.A	4.02%	2011-07-30	5.63%
WN.PR.B	3.02%	2009-06-30	4.23%
CM.PR.R	3.98%	2013-04-29	5.57%
GWO.PR.E	3.56%	2014-03-30	4.98%
PWF.PR.J	3.53%	2013-07-30	4.94%
MFC.PR.A	3.11%	2015-12-18	4.35%
BAM.PR.I	4.16%	2013-12-30	5.82%
BAM.PR.H	3.90%	2012-03-30	5.46%
TD.PR.N	3.29%	2014-01-30	4.61%
GWO.PR.X	3.16%	2013-09-29	4.42%
TD.PR.M	3.13%	2013-10-30	4.38%
IGM.PR.A	3.74%	2013-06-29	5.24%
BAM.PR.J	3.96%	2018-03-30	5.54%
ACO.PR.A	2.56%	2011-11-30	3.58%

**See the second note to Table 2.*

Embedded Options

An embedded option is an option that is inherent in the security being discussed. For instance, a retractible preferred share will normally include a "put" and one or more "calls", which are defined by the issue's prospectus. Such options are referred to as "embedded" because they cannot be separated from the issue and traded separately—everything comes in one bundle. See the June 2006 issue of *Canadian MoneySaver* for some examples of how a prospectus might specify these options.

Calls - The call embedded in most preferred share issues gives the issuer the right, but not the obligation, to return the investor's capital at a time of its choosing, subject to the terms of the prospectus. There may be a series of such calls embedded in the issue, often with a declining premium; perpetual preferred shares are often issued at a price of $25; the issue might be callable at $26.00 five years from issue, at $25.75 four years from issue; and so on until the $25.00 original price is applicable from a certain date and forever afterward. A "call" is often referred to as a "redemption".

Puts - The put embedded in retractible issues gives the investor the right, but not the obligation, to force the company to buy back his shares at the price (or for some other consideration) specified in the prospectus. The put may be exercisable only on certain dates, for a certain period, or at any time following a specific date. The investor will not necessarily receive cash when he exercises his put; in some cases the company is required to exchange the preferred share for a certain value of its common stock. For the purpose of such an exchange, the common stock is usually valued at 95% of its market price, which should give the investor some comfort that the original capital invested will be recovered, even after transaction costs. A "put" is often referred to as a "retraction".

operating retractibles are now trading at such high prices that the YTW is well below that of bonds issued by companies of equivalent (or better) credit quality—even after we take account of an equivalency factor of 1.4. One would normally expect to get paid a little extra money for accepting the slightly lower credit quality of preferred shares.

We can guess at the reason for the discrepancy by examining Table 3, which shows the Yield-to-Retraction for the preferred shares—and I must apologize to you for introducing so many measures of yield! You didn't think that investing would involve so much memorization of definitions, did you?

TABLE 4 - BOND MARKET COMPARABLES – SOME REPRESENTATIVE BANK BONDS

Type of Investment	Description*	Due Date	Pre-Tax Yield**
Bond	BNS 3.47%	2008-09-02	4.25%
Bond	BMO 4.3%	2009-09-04	4.22%
Bond	BNS 3.93%	2010-02-18	4.24%
Bond	CM 4.35%	2011-11-01	4.30%
Bond	CM 4.95%	2014-01-23	4.43%
Bond	CM 4.75%	2014-12-22	4.48%
Bond	RY 4.71%	2014-12-22	4.47%
Bond	BMO 4.55%	2017-08-01	4.58%

*The description is given as a symbol of the issuing bank and the coupon rate. The price of these issues will not be par.
**There will be a component of capital gain or loss inherent in holding these bonds to maturity which may increase or decrease the yield compared to the coupon rate. "Pre-Tax Yield" includes the effects of the capital gain or loss.

Yield-to-Retraction is calculated by assuming that no matter what is happening in the market, issuers will not call their shares until the last possible day prior to the investor being able to exercise his retraction privilege (see sidebar). This is popular as a comparative measure, but is not as conservative as YTW, since there's always a chance that issuers will exercise their rights to investors' detriment.

As conservative fixed-income investors we should pay a lot of attention to YTW. At current market yields, issuers may well call their shares as early as possible, even if they have to pay extra for the privilege, so that they can refinance their operations at lower rates.

The possibility that the issuer will choose to redeem before the last minute should not be ignored. At least two of the issues listed in Tables 2 and 3 are currently the subject of an issuer bid for a substantial part of the outstanding shares (GWO.PR.E and GWO.PR.X). If the issuer is willing to pay market price now, it seems reasonable to fear a call as soon as possible at a prospectus-defined price that is lower than the current market price.

One may sometimes make a reasonable argument that YTW is not the most appropriate method of calculating yields. Say, for instance, that a company has the ability to issue preferreds that pay $1.25 p.a. and has an issue outstanding that pays $1.40 and is currently callable at $26.00, with this price declining by $0.25 annually for the next four years. If the issue is trading above $26.00, the YTW scenario will almost certainly be an immediate call. However, since the company can save $0.25 by delaying redemption, the net cost to the company of leaving the shares outstanding for another year is the dividend less the saving, or $1.15 (during the declining call-price period). Since this is less than the rate it would pay on a new issue, the company may well prefer to wait.

The question of what to believe is a complex question—complex enough, in fact, that I am currently devoting a great deal of time to researching the matter. Most investors will be well advised to rely on YTW.

You may calculate YTWs themselves, using market prices that are applicable at the time of calculation. The procedure for this was explained in the July/August edition of *Canadian MoneySaver*; data regarding the embedded options for a wide variety of issues is summarized at http://www.prefinfo.com .

Since a significant part of achieving good portfolio returns consists simply of avoiding losses, investors should generally use YTW as their primary test of value, not the

Yield-to-Retraction that appears to be the market's current dream and certainly not yet a peculiar measure of yield that I am now developing to account for declining call premia. Sometimes the issuer will not choose the sequence of options that is the worst for us. Enjoy that luck—don't count on it.

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