Claymore Preferred Share ETF Analysis

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In late 2003, Diversified Preferred Share Trust (DPS.UN on the Toronto Exchange) commenced operations as a closed-end, passively managed preferred share fund, seeking to reflect the overall behaviour of the market by holding a portfolio of approximately one hundred, more-or-less, equally weighted preferred shares and preferred securities (readers will remember from the January 2007 edition of *Canadian MoneySaver* that a preferred security pays interest income, not dividends).

This product has been hugely successful, with additional issuance bringing the value of the trust to over $300 million and dominating the relatively small universe of funds devoted to this asset class.

No product is perfect, however. As a closed-end fund, there is no direct mechanism whereby the market price of fund units is compelled to be within easy range of the net asset value (NAV). High market demand for this product resulted in the units trading at a premium to NAV that at times was very substantial—over 5% for lengthy periods. In other words, the excess price of the units relative to the holdings represented by those units was often in excess of an entire year's income!

Nature and investment dealers abhor a vacuum, and it was Claymore Investments that stepped up to the plate with "Claymore S&P/TSX CDN Preferred Share ETF", trading on the Toronto Stock Exchange under the symbol CPD.

Its composition has been trumpeted as "investable". Investability is a very important feature, as it indicates that a large amount of money can be benchmarked to such indices without much, if any, tracking error. It also means that, in theory, there exists a large, liquid pool of assets under the control of investors who are indifferent as to whether they hold the sum (CPD) or the parts (the individual constituents).

As an exchange-traded fund (ETF), CPD attempts to ensure that the market price of the units very closely tracks the market value of the underlying securities by allowing the creation and destruction of units by third parties. If CPD trades above its NAV, then it will be profitable for dealers to assemble blocks of the constituent securities, deliver them to the company in exchange for CPD units, and then sell these CPD units on the market, with the reverse process being possible should CPD trade at a discount.

This assurance of minimal tracking error appears to be a popular concept. The premium to NAV that DPS.UN once enjoyed has not just disappeared, it had changed to a discount by early May, presumably due to retail investors swapping DPS.UN for CPD.

Claymore's website, www.claymoreinvestments.ca, provides two yield measures: Weighted Average Yield, which is the Current Yield (annual dividend divided by price) and Weighted Average Coupon (annual dividend divided by par value). Both values are virtually useless for analytical purposes. A much better predictor of future performance is Yield-to-Worst (YTW) as described in the July 2006 edition of *Canadian MoneySaver.*

Table1 shows the main characteristics of the fund with two alternate measures of average YTW. To arrive at the figure of 3.84%, I have simply calculated the YTW for each issue in the portfolio and weighted them by the factors released by Claymore Investments as of April 30. This raw figure includes two contributions from issues with negative YTW: TOC.PR.B was quoted at $25.23 (bid) on April 30, but is callable any time at $25.00, while RY.PR.K was quoted at $25.29 (bid) and is currently callable at $25.25, which will change to $25.00 in August of this year.

TABLE 1 - MAIN CHARACTERISTICS OF CPD (AS OF APRIL 30, 2007)

Management Expense Ratio	0.45%
Mean Yield-to-Worst (raw) of Holdings	3.84%
Mean Yield-to-Worst (negatives zeroed) of Holdings	3.98%
Mean Modified Duration (YTW) of Holdings	6.19
Mean Daily Trading Value of Holdings	$187,000

Therefore, the raw figure is somewhat misleading. If we invest in something that will (or can) lose 1% in one month through redemptions, we might state mathematically that the annualized rate of loss will be 12%. And we'll be right. If we then include this figure of 12% in an average with longer-term instruments, we're overstating the loss. Our loss is limited to 1%, since the investment will not go on losing money forever. In order to avoid such errors, I have computed another measurement of YTW with the negative constituents reset to zero. This results in a much more reliable long-term assessment of mean YTW of 3.98%. Note that this yield is computed before the fees and expenses of 0.45%.

We also note that the weighted average daily trading value of the constituents of the fund is $187,000. The universe of preferred shares analyzed by my firm's software, HIMIPref™ has an average trading value of about $100,000, so we can give S&P full marks for choosing issues with liquidity well above average. Table 2 shows the distribution of these trading values—a few of the constituents are very illiquid. These are ACO.PR.A (1.19% of the fund, trades about $31,000 per day), ELF.PR.F (0.76%, $37,000), FAL.PR.A (0.87%, $24,000), FTS.PR.E (1.55%, $15,000), TOC.PR.B (1.1%, $19,000), W.PR.J (1.09%, $38,000) and WN.PR.B (2.00%, $47,000). This last issue, WN.PR.B, has experienced an uptick in trading lately due to its recent downgrade in credit ratings by S&P (see the October 2006 edition of *Canadian MoneySaver* for a discussion of credit ratings), but that's hardly a reason for celebration!

TABLE 2 - DISTRIBUTION OF AVERAGE TRADING VALUE OF CPD CONSTITUENTS, APRIL 30, 2007

$0 - $50,000	8.56%
$50,001 - $100,000	22.09%
$100,001 - $200,000	42.65%
$200,001 - $300,000	19.23%
$300,001+	7.47%

In any event, these individual issues will bear watching. The inefficiency of arbitrage with respect to the less liquid issues implies that a larger than normal variance of NAV to market price will be required before larger players take action to narrow the gap.

The main measure of safety in preferred shares—or fixed-income of any sort—is the credit rating. Credit, credit, credit! The single most important decision to be made in fixed-income investment is credit rating, and here CPD scores well, as shown in Table 3. Readers may be surprised to learn that CPD has no issues rated exactly Pfd-2 by the Dominion Bond Rating Service (DBRS, www.dbrs.com), but that is due largely to the nature of the DBRS' rating policies: every single one of the issues tracked by my firm's HIMIPref™software that is rated Pfd-2 is a split share corporation. Split share corporations are not currently included in the S&P/TSX Preferred share index, although S&P has indicated that they are eligible.

TABLE 3 - DISTRIBUTION OF DBRS CREDIT RATINGS IN HOLDINGS OF CPD, APRIL 30, 2007

Pfd-1	21.15%
Pfd-1(low)	40.40%
Pfd-2(high)	7.89%
Pfd-2	0.00%
Pfd-2(low)	25.74%
Pfd-3(high)	4.82%

That being said, the credit quality of the CPD portfolio is entirely acceptable. There are a few Pfd-3(high) issues, and while I do not recommend Pfd-3(high) issues as major holdings (which rules them out of most retail accounts), a combined weight of 5% or so in a large, well diversified portfolio is entirely acceptable. Over half of this weight is represented by Fortis preferreds (FTS.PR.E and FTS.PR.F) which are not only rated by S&P as P-2(low) but have recently been placed on credit-watch positive by that firm. We can hardly blame S&P for paying more attention to their own ratings when designing their index! The FAL.PR.A issue rated by DBRS as Pfd-3(high) is also considered P-2(low) by S&P. Only one of the four issues in this lowest rating category, BPO.PR.J, is also given an inferior rating by S&P (P-3[high], negative outlook). Note, however, that CPD holds two issues of Weston (WN.PR.B and WN.PR.D) totaling 3.46% of the portfolio that have been downgraded to P-3(high) by S&P subsequent to the analysis date, with DBRS still undecided regarding a downgrade at the time of writing.

We may now look at the sectoral distribution of the CPD holdings as determined by the type of preferred, which is summarized in Table 4. This shows that the weighted average YTW of CPD is significantly less than that which would be implied by the HIMI indices, and that there are two basic reasons for this:

- CPD is much higher weighted in Operating Retractibles than are the HIMI indices, at the expense of the similar but smaller-sized and higher-yielding split share corporations.
- Within the Operating Retractible index, CPD achieves a significantly lower YTW than implied by the HIMI indices.

Some digging into the source of the second point reveals that of the sixteen issues included in the HIMI Operating Retractible Index, CPD owns ten—but none of the four highest yielding issues in this collection (BMO.PR.I, BMO.PR.G, CM.PR.R and BAM.PR.J).

Operating retractibles, their similarity to bonds and their optimistic pricing were discussed in the February 2007 edition of *Canadian MoneySaver*, while split shares were the subject of the November 2006 edition. Due to the weighting of CPD, understanding these two classes of preferreds and their relative yields, is crucial to the decision as to whether CPD will adorn or disfigure your portfolio.

The other issue that must be considered prior to an investment is the weighting of CPD in the floating-rate sector. Most investors will know of the very bad things that have happened to BCE issues in the past month, but some may not be aware that the carnage is spreading. With the mergers involving Thomson Corp. (TOC) as a possible acquirer and Alcan (AL) as a possible target, virtually the entire floating rate sector comes with very significant event risk attached.

TABLE 4 - SECTORAL ANALYSIS OF CPD HOLDINGS (WITH COMPARISON TO HIMIPREF™ INDICES), APRIL 30, 2007

	CPD Holdings, April 30, 2007			HIMIPref™ Indices		
Sector	**Weighting**	**YTW**	**Modified Duration (YTW)**	**Weighting**	**YTW**	**Modified Duration (YTW)**
Ratchet	0	N/A	N/A	1.65%	4.61%	16.4
FixFloat	6.78%	4.22%	17.01	4.84%	4.52%	16.47
Floater	1.86%	4.25%	16.84	2.72%	2.50%	5.55
Operating Retractible	24.47%	2.71%	2.24	16.05%	3.18%	2.59
Split Share	0	N/A	N/A	10.10%	4.28%	4.04
Interest Bearing	0	N/A	N/A	4.52%	4.87%	2.25
Perpetual Premium	55.86%	4.49%	5.24	44.35%	4.52%	4.97
Perpetual Discount	5.11%	4.63%	16.14	15.77%	4.63%	16.16
"Scraps"	5.92%	3.56%	7.10	N/A	N/A	N/A
Total	**100%**	**3.98%**	**6.19**	**100%**	**4.26%**	**6.90**

Some, particularly very small investors, will choose CPD for the instant diversification and "name-brand indexing" it provides. Others will compare the market price to the NAV for this passively managed issue and its passively managed competitors (i.e., DPS.UN, PFD.PR.A and PFR.UN) and seek to purchase a more-or-less reasonable approximation of the index at the greatest possible discount. Still others will look for more active management—usually, but not necessarily always, disdaining Operating Retractibles for higher-yielding alternatives—either by themselves or with professional assistance.

As always look before you leap!

The Pick of *PrefLetter*

This month I'm going to highlight BNS.PR.J: Bank of Nova Scotia Preferred Series 12. This issue is perpetual (*Canadian MoneySaver* [*CMS*],June 2006), but has very good interest rate protection (*CMS*, March/April 2007) due to its relatively high dividend of 5.25% of par value. At its May 11 price of 26.17-22, it sports a pre-tax bid Yield-to-Worst (*CMS*, July 2006) of 4.49% and a Modified Duration (of the YTW scenario, *CMS,* May 2007) of 5.54 years.

These are excellent characteristics for a preferred share with a credit rating (*CMS,* October 2006) of Pfd-1 from DBRS (www.dbrs.com) and P-1(low) from S&P (www.standardandpoors.com). Note that for a resident of Ontario subject to the highest marginal tax rate, the dividend yield of 4.49% provides as much after-tax income as an interest rate of 6.28% (*CMS,* February 2007).

Note that these preferred shares are direct obligations of the bank, but are not government guaranteed and rank behind bonds in the event of dissolution of the company. A risk of loss exists in such investments, primarily due to (but not limited to) increases in interest rates during the life of the investment. The publisher of PrefLetter.com is Hymas Investment Management Inc. (HIMI). The firm, its clients and/or its officers may have or enter into long or short positions in these shares at any time, without notice and this notice does not constitute specific investment advice by HIMI. HIMI will not necessarily update this notice should its view of the investment's quality change. Readers should consult their own financial advisors before investing.

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