# Portfolio Construction

James Hymas

In the past year I have written many articles regarding the nuts and bolts of security selection but have largely ignored the question of portfolio construction. This omission has not been accidental: an investor seeking a taylor-made portfolio has many decisions to make and even should two investors come up with precisely the same portfolio objectives, the final portfolios may well be very different due to the vagaries of the marketplace.

Many investors will not wish to agonize over security selection and contend with the marketplace for fills on their orders. The financial services industry is well aware of this and provides a variety of products for those who wish to have exposure to preferred shares with a minimum of fuss. There are no public mutual funds available that specialize in the asset class of which I am aware, but there are several vehicles trading on the Toronto Stock Exchange (TSX) that will provide this benefit: Diversified Preferred Share Trust (DPS.UN), Advantaged Preferred Share Trust (PFR.UN), Charterhouse Preferred Share Index Corporation (PFD.PR.A) and most recently Claymore S&P/TSX CDN Preferred Share ETF (CPD & CPD.PR.A), which was discussed in the June 2007 edition of *Canadian MoneySaver*. And there is my own actively managed Malachite Aggressive Preferred Fund, directed towards high net-worth investors.

Each of these products has its strengths and weaknesses. Their holdings will vary, the fees and expenses will vary and (for the TSX listed issues) their premium or discount of market price to Net Asset Value may vary considerably.

I urge small investors, those who will be investing less than $25,000 into the preferred share sector, to avoid individual issues and to place the funds in one of the TSX-listed index funds named above. There are several reasons for this:

- Diversification is difficult in small portfolios: there is simply not enough money available to buy a well-diversified portfolio with individual components of good size.
- If a diversified portfolio is built anyway, trading will be very expensive. One could, for instance, diversify a $25,000 portfolio by buying one hundred shares of each of ten issues. However, even at a discount brokerage, this will probably cost $0.30 per share just in commission, which is about three months' income. This is very expensive. Reinvesting dividends will be a nightmare.
- The effort expended will not be commensurated with returns. Let us assume that such an investor makes an enormous effort and not only covers trading costs, but winds up beating the index by 0.50% per annum, thus outperforming the listed fund of his choice by about 1.00%. That's superb performance—and it puts $250 per year in his pocket. I suggest that he would have done better taking a part-time job flipping hamburgers.

It is up to each investor to determine the asset value cutoff for direct investment. Some investors crave the challenge of pitting their wits against the markets. Some are philosophically averse to investing in anything but the most basic building blocks—the atoms—of an investment portfolio. Others will have special needs for the preferred share portion of their portfolios that make direct investment the only option. There are lots of rationales for avoiding pay-

**RISK & RETURN?**

Risk & Return: Indicators of Risk and Return from HIMIPref™ Indices, as of close June 8/07.

| Index | Mean Average Yield-to-Worst | Mean Average Modified Duration |
|---|---|---|
| Operating Retractible | 3.87% | 3.18 |
| Split Share | 4.79% | 4.19 |
| Interest-Bearing | 6.77% (as interest) | 6.12 |
| Perpetual Premium | 5.22% | 8.23 |
| Perpetual Discount | 5.13% | 15.28 |

As a very rough indicator of the differing risk/return profiles of each of the various types of preferred shares discussed, the "Risk & Return" table may be examined. It should be noted that the figures presented are mean averages of the constituents of the indices, weighted by market value of an original purchase of $100,000 per issue; the averages can conceal a lot of very profitable detail! Modified duration may be taken as a rough estimate of the interest-rate sensitivity of each index; but it should be noted that credit quality is not quantified in the table!

ment of management fees! I would suggest, however, that most people putting less than six figures into preferred shares will ultimately be better off buying a managed product of some sort. The rest of this article is devoted to the atom scientists.

The most important thing that needs to be decided prior to executing portfolio trades is to determine the purpose of the portfolio. If you have decided that the purpose of your portfolio is "to make money" then do yourself a favour and stick to managed products. Portfolio management is much more complicated than that and to focus on the "return" side without specifying the "risk" side is ultimately a losing game.

**PORTFOLIO OBJECTIVE: SAFETY OF PRINCIPAL**

| Credit Rating (DBRS) | Increasing Risk, Increasing Return | Class of Preferred |
|---|---|---|
| Pfd-1(high) | ↓ | Operating Retractible |
| Pfd-1 | | |
| Pfd-1(low) | | |
| Pfd-2(high) | | |
| Pfd-2 | | |
| Pfd-2(low) | | Split Share |
| Pfd-3(high) | | Perpetuals: Premium |
| Pfd-3 | | Perpetuals: Near Par |
| Pfd-3(low) | | Perpetuals: Discount |

Note that the columns "Credit Rating" and "Class of Preferred" are independent; I do not mean to imply that a Perpetual Discount is as risky as a Pfd-3(low) issue.

The single most important factor when considering safety of principal is the credit rating of the instrument as discussed in the *Canadian MoneySaver* of October 2006. This factor deals with the likelihood that the issuer will be able to meet the commitments that were made in the prospectus. It should be well understood that this has nothing to do with whether the holder will actually like the way the issuer meets the term of the prospectus!

The ordering of the classes of preferred shares reflects this risk in terms of the expected timeframe of the investment—the shorter the period until the capital is repaid, the more confidence one may have in projections of the company's financial situation on repayment date.

For an investor who insists on holding preferred shares directly, while only having the funds available to buy two or three names, I very strongly recommend that each of these names be Pfd-1(low) or higher. Examples of companies with such a rating are Sun Life Financial (SLF), Canadian Imperial Bank of Commerce (CM) and Power Financial Corporation (PWF). While one can never be sure of anything in this uncertain world, the continued ability of these companies to meet their obligations as they come due is better than most!

Investors with enough funds to construct an efficient portfolio with more names can purchase worse credits (although still investment grade), protecting themselves against total loss through diversification. However, issues rated Pfd-3(high) or lower are of insufficient quality to be recommended for fixed-income portfolios in any but the most minimal amounts. I suggest a good limit for any investor is 10% total in such issues, with no more than 5% for a single name.

**PORTFOLIO OBJECTIVE: INCOME**

| Type of Preferred | Increasing Risk, Increasing Return |
|---|---|
| Operating Retractible | ↓ |
| Split Share: Dividend & Interest Bearing | |
| Perpetuals: Premium | |
| Perpetuals: Discount | |

Having made some decisions about the level of credit risk we are going to take, we now turn to the "reward" side of the equation and define "risk" as the chance that real income will be reduced through prolonged inflation. Readers will be familiar with operating retractibles from the February 2007 edition of *Canadian MoneySaver* as well as the June 2006 edition; split shares were discussed in November 2006; interest bearing issues in January 2007; and the usual, but not uniform, relationship between perpetual issues with differing dividend rates in the March/April 2007 edition.

I greatly regret my inability to place floating rate preferreds in this table. I agonized over their placement, but I consider them high-risk, low-return investments. I may return to this topic in a future article, but briefly, these investments require one to accept short-term interest rates while assuming long-term credit risk, an unhealthy combination—as holders of BCE issues have cause to know very well in light of recent events.

For much the same reason, perpetual issues trading at or near par have no place in the table. As readers of the March/April 2007 issue will remember, high-dividend issues will generally have a lower yield, but will suffer less from rising interest rates than low-dividend issues. All else being equal, perpetual preferreds priced near par will experience the worst of both worlds: exposure to losses from rising rates, with limited gains in the case of falling rates.

It should also be noted that operating retractibles are often so expensive that, even on an after-tax basis, they're no better than bonds, and sometimes worse! Similarly, while premium perpetuals can provide an attractive yield with significant protection from increasing interest rates, it does not follow that they can be purchased irrespective of price! In all cases, investors should perform their own yield calculation, as outlined in the July 2006 edition of *Canadian MoneySaver*—generalities must always defer to particulars.

## Portfolio Objective: Growth

I have not produced an ordered chart for this portfolio objective. I'm afraid it would just look too silly! Growth is not a common rationale for investing in preferred shares, but there are some possibilities, especially given the huge change in the marketplace recently with recent declines, particularly in the perpetual-discount sector.

There are limited ways by which growth can be achieved in a preferred share portfolio. The first is frequent trading and exploitation of inefficiencies in the marketplace. This can be a rewarding practice, but requires a far greater understanding of the market and a lot more data collection than is appropriate to discuss here. The second is interest rate speculation. If one believes that interest rates will decline, deeply discounted perpetuals can be a very good investment.

For example, an instrument issued to yield 4.5% with a par value of $25.00 may trade at $22.50 to yield 5%. At the time of writing there are numerous such issues. If yields decline by 0.50% in the future, one may expect the issue to resume trading at its par value, resulting in a capital gain of 11.1% that (as readers of the May 2007 *MoneySaver* will realize) implies a modified duration in excess of 20 years. It is very difficult to get that kind of interest-rate leverage with any other instrument, let alone one that will pay such a nice income while the investor waits—and hopes—for his prediction to come to pass.

For premium perpetuals, of course, such leverage does not exist: a decline in rates will only increase the probability of the issue being called. Gains will be limited to those implied by a modified duration of much less, probably 3-5 years.

## The Pick of PrefLetter

With the declines in the preferred share market since the BCE meltdown which commenced in April and the Bank of Canada tough talk on rates at the end of May, many investors will be emphasizing safety when they put their cash to work, perhaps even over-emphasizing it, so don't be more timid than you need to be! With that in mind, this month I will highlight MFC.PR.A, a retractible preferred share issued by Manulife Financial Corporation.

This issue is retractible (*Canadian MoneySaver* [*CMS*], June 2006) and has a rating of Pfd-1(low) from Dominion Bond Rating Service (www.dbrs.com) and P-1 from Standard & Poors (www.standardandpoors.com) (*CMS*, October 2006). It is redeemable commencing 2010-6-19 at $26.25, with the redemption price declining by $0.25 annually until 2015-6-19; redeemable at $25.00 thereafter. It is retractible for shares of MFC commencing 2015-12-19, which is presumed to trigger a call immediately prior to this date. This issue is guaranteed by MFC, but ranks behind bonds of this company in the event of bankruptcy or liquidation.

In sharp contrast to the recent over-pricing of retractibles (*CMS*, February 2007), it now sports a Yield-to-Worst (CMS, July 2006) of 4.16%, based on its June 8 closing bid of $24.90 and a modified duration (*CMS*, May 2007) of 7.17 years. For a resident of Ontario subject to the highest marginal tax rate, the yield on this issue is equivalent on an after-tax basis to a pre-tax interest rate of 5.82%. It has been quite some time since investors have been offered such a rate from such a well regarded company for an 8-year bond.

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 article 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.

*James Hymas, CFA, Hymas Investment Management, 129 Humbercrest Blvd, Toronto, ON, M6S 4L4 (416) 604-4204, jiHymas@himivest.com. http://www.himivest.com.*