Preferred Pairs

James Hymas

That's right, preferred *pairs* not preferred *shares.* The concept of preferred pairs can be profitable for investors. Sometimes a few pennies can be saved by purchasing an equivalent issue a little more cheaply. In many cases an alert investor can swap between equivalent issues at a profitable price spread. In some cases (not generally recommended for tax reasons and due to elements of risk beyond a retail investor's control), it is possible to buy one and sell the other short. Given the potential for profit, it's a good idea to have a working knowledge of preferred pairs and how their prices should move in tandem.

I separate preferred pairs into two classes: strong and weak. A strong pair is exemplified by issues like BCE.PR.Y and BCE.PR.Z. The former is a "ratchet rate" preferred; it pays a proportion of Canada Prime that varies according to the market price of the issue. When the market price, as defined in the prospectus, is less than $24.875, the proportion goes up, to a limit of 100% of prime. When the market price, as defined, is more than $25.125, the proportion goes down, to a limit of 50% of prime. Such issues have been popular with some retail investors due to the implied tendency of the issue to remain near its par value. Unfortunately most such issues now have (or, in the case of BCE, should have) credit ratings that are below investment grade.

The latter element of the pair, BCE.PR.Z, is a "fixed-reset" issue, that is, it pays a fixed rate of dividends (currently 5.319% of its par value), but this rate is reset every five years. The rate after each reset is determined by BCE, with a minimum value defined by the prospectus. For further information and the prospectus, I refer readers to BCE's excellent web page at http://www.bce.ca/en/investors/bondpreferreds/preferredshares/bce/.

The twist in the terms of issue that makes these issues a strong pair is simply that every five years the issues become convertible into each other. There may be a forced conversion if not enough shareholders wish to own one of the issues, but an investor is justified in assuming that, at worst, conversion will be possible.

TABLE 1 - STRONG PAIRS
BAM.PR.E/G
BBD.PR.B/D
BCE.PR.S/T
BCE.PR.Z/Y
BCE.PR.A/B
BCE.PR.E/F
BCE.PR.H/G
FAL.PR.A/B

This conversion feature leads to interesting behaviour; the prices of the two issues should definitely approach each other as the potential exchange date approaches. We may not be sure just what that price might be, but given that we may freely convert from one to the other on a certain date, it is possible to buy one even if we really want the other. I refer to these two issues as a strong pair because price convergence is due to the exchange provision in the prospectus and thus can be forced by an individual investor if the market is oblivious to the event.

Weak pairs, on the other hand, have no such strictly enforced convergence. Rather than "must", they merely "should" be priced relatively close. Consider, for example, TCA.PR.X and TCA.PR.Y. These are both issues of TransCanada Pipelines Limited. They both have a par value of $50.00. They both pay $2.80 dividends annually. Dividends on each issue are cumulative, and for the past few years the ex-dates of the dividends have been identical – but this should be checked at the time a comparison is made! The only difference worthy of note between the two issues is that TCA.PR.X is callable by the company at $50 commencing October 15, 2013 and for TCA.PR.Y the redemption period commences March 5, 2014. This difference of about 5 months will make something of a difference to the expected price of the issue but it should be clear that the market prices of these instruments should be very similar. However, it's only a weak pair since there are no actual contractual commitments in the prospectuses that will ever allow holders to force equality of

TABLE 2 - WEAK PAIRS
BAM.PR.B/C/K
BAM.PR.M/N
BCE.PR.S/Y/B/E/H
BNS.PR.L/M
BPP.PR.G/J/M
NTL.PR.F/G
RY.PR.A/F
RY.PR.D/E/G
SLF.PR.C/D/E
TCA.PR.X/Y
WN.PR.C/D

Note: The first group of RY preferred shares pays $1.1125 per annum; the second group pays $1.125 p.a. Hence, these two groups are very closely related. SLF.PR.C & SLF.PR.D pay $1.1125 p.a.; SLF.PR.E pays $1.125 p.a.

pricing. It's implied by analysis, but is not legally forced.

Expected price differences of weak pairs are relatively easy to analyze. While an investor should be aware of differing redemption schedules, it is fair to assume that the similarity of the issues will lead to similarity of treatment by the issuer. It is possible, for instance, that TCA.PR.Y will be redeemed while TCA.PR.X remains outstanding – but not very likely. In any event, one may expect that if the levels of interest rates are such that TCA.PR.Y is redeemed, then these same factors will be operative on the market price of TCA.PR.X. One may prefer TCA.PR.Y for the potential extra few months of high dividend, but if we can assume that proceeds from a redemption of TCA.PR.X may be invested at the current rate for such issues of about 5.2%, then the difference is 40bp (0.40%) for five months on $50, or $0.20 future value, or about $0.15 present value (discounting the future value by 5% for six years). Note that if rates during that five-month period are higher than 5.6%, we would expect the prices to be identical and should both issues survive until after the period, the expected price difference will be zero.

The analysis of a strong pair is a little more involved, since the coupon rates may be different and are (for all the strong pairs identified in Table 1) dependent upon assumptions regarding the Canada Prime Rate. Let's have a look at the BAM.PR.E / BAM.PR.G pair, summarized in Table 3.

BAM.PR.G pays an annual dividend of 4.35% of its $25 par value quarterly. The most recent ex-date was July 30, 2007 for the September 1 payment. Therefore, if purchased in September, it will pay 17 dividends prior to its possible conversion on October 31, 2011. That amounts to a total of $4.62.

BAM.PR.E paid its most recent monthly dividend at a rate of $0.10286 per share, which is a rate of 4.94% of its par value and is 79% of the current Canada Prime Rate of 6.25%. It will pay fifty dividends prior to possible conversion. We may, therefore, estimate the future dividends until conversion as totaling $5.14, based on 79% of 6.25%. These numbers are important! The figure of $5.14 may be taken as our base case. In this case we are assuming that nothing very special will happen in the next four years. If Canada Prime averages 7%, however, while the proportion remains at 79%, dividends will total $5.75. If Canada Prime averages 5.5% with the proportion unchanged, dividends will total $4.52.

TABLE 3 - COMPARISON OF THE BAM.PR.E/BAM.PR.G "STRONG PAIR"

CHARACTERISTIC	BAM.PR.E	BAM.PR.G
Shares Outstanding	1,805,948	6,194,052
Quotation	24.25-49	24.25-50
Dividend Amounts	Ratchet	Fixed-Reset
Next Exchange Date	2011-11-01	2011-11-01
Dividend Frequency	Monthly	Quarterly
Dividend Payments until Exchange	50	17
Amount of Each Dividend	$0.10286*	$0.271875
Total Dividends until Exchange	$5.14*	$4.62

* base scenario

The Pick of *PrefLetter*

After the close on September 14, my monthly newsletter (www.prefletter.com) recommended NA.PR.L, among others, for long-term, buy-and-hold investors.

Type of Preferred	Perpetual Discount
Quotation (2007-09-14)	$23.11-20
DBRS Rating	Pfd-1 (low)
S&P Rating	P-2 (high)
Annual Dividend	$1.2125
Yield-to-Worst Scenario	Limit Maturity
Yield-To-Worst	5.30%
Modified Duration, YTW	14.96
Pseudo-Convexity, YTW	1.07

NA.PR.L: *Redeemable commencing 2010-5-15 at $26.00, declining by $0.25 annually until 2014-5-15. Redeemable at $25.00 thereafter. Next ex-date 2007-10-10 (declared).* A solid credit with good liquidity and an excellent yield. I will guess that "headline risk" is now more fully appreciated at National Bank after their issues have been hurt by revelations of very high asset backed commercial paper (ABCP) concentrations in their public money market funds. Some governance questions related to this (Are portfolio managers fully independent?) and the transfer of the ABCP to the bank's balance sheet at pre-crisis yields. For all that, I believe that National Bank is still in a position to meet their commitments, and NA.PR.L now yields 43bp more than comparable Royal Bank issues.

An investor may make any assumptions desired about the Canada Prime and the proportion of prime that BAM.PR.E will pay. As always, it is wise to consider a variety of scenarios, at least "best case, base case, worst case", and determine the effect of each scenario on the particular investment and on the total portfolio. An assumption that prime will average 13% may normally be expected to have implications for the performance of your long bond holdings!

The lengthy period before conversion, over four years in this particular case, has three effects:

- Forecasting the average Canada Prime is uncertain and results in a wide range of possible values;
- Forecasting the average proportion of Canada Prime that will be paid by the issuer is also uncertain; and
- This uncertainty is multiplied by a large number of dividend payments.

Another factor that can lead to a legitimate difference in price is liquidity. There are, for instance, more than three times the number of BAM.PR.G shares outstanding.

One thing is clear, however. The uncertainty of the calculation of dividends until the exchange date will decline as the exchange date approaches. And if the prices don't converge, as was the case with BBD.PR.B/BBD.PR.D last summer, investors may simply exercise their conversion right.

Whenever you buy an issue that is paired with another, check the price of each issue!

James Hymas, CFA, Hymas Investment Management, Toronto, ON, (416) 604-4204, jiHymas@himivest.com, http://www.himivest.com/ , http://www.prefshares.com/.