When Will Preferreds Recover?

James Hymas

Two thousand seven was not a good year for preferred shares and I have received many inquiries asking me to unveil my crystal ball, sacrifice a few chickens and make predictions as to when the pain will stop. Before addressing these requests, let's have a look at what the preferred share market has done this year, in the hopes that this will provide some insight as to what it might do.

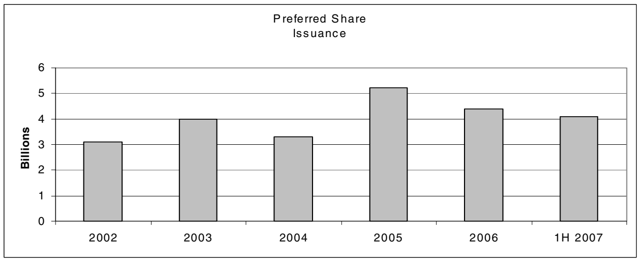
Many unforeseeable factors buffetted the preferred share market this year:

- Heavy issuance of preferred shares in the first half of the year,
- The BCE announcement of plans to restructure,
- Increasing long-term bond yields from early March until mid-June,
- The credit crunch,
- The effect of bank capital requirements, and
- A large retraction at a closed-end fund.

Heavy Issuance

The Investment Industry Association of Canada (IIAC) reports on its website at www.iaac.ca that preferred share issuance in the first half of 2007 was $4.1-billion, over double the figure for the first half of 2006. See Chart 1 for a comparison of issuance in the first six months of 2007 with each of the past five years. As with all booms, it ended in tears. Issues that were late to the party, such as BAM.PR.N and CCS.PR.A, were extremely difficult to sell and remained on the dealers' books for quite some time, all the while declining in price. It is noteworthy that BMO revealed a charge of "$160 million in respect of trading and structured-credit related positions and preferred shares" – surely one of the few times that preferred share trading has been mentioned as a significant element of a Canadian bank's profitability!

Chart 1

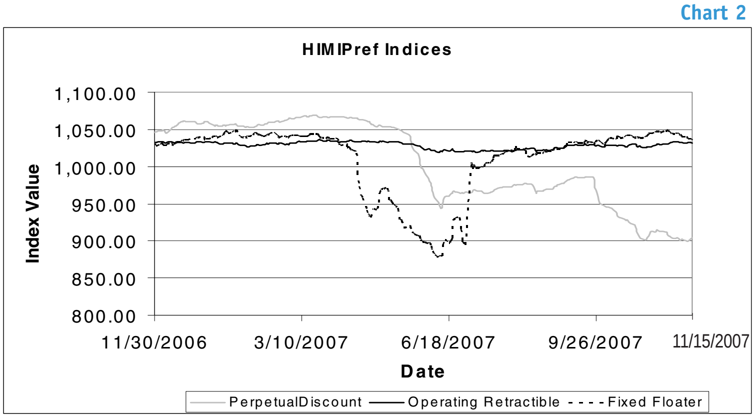


Worries over BCE

BCE announced on April 17 that it was "reviewing its strategic alternatives" which was interpreted to mean a shareholder friendly, creditor unfriendly, recapitalization of the company. Concerns over the credit quality of this name grew rapidly.

Chart 2 shows the performance of three of the HIMIPref™ Preferred Share Indices (which are reported daily at http://www.prefblog.com). The "Fixed Floater" index may be used as an indicator of the performance of BCE issues, as it was and still is, heavily dominated by this name. This index declined substantially until *deus ex machina* intervened in the form of an announcement that the preferred shares would be purchased and cancelled as part of a takeover by Teachers' Pension Plan.

Chart 2

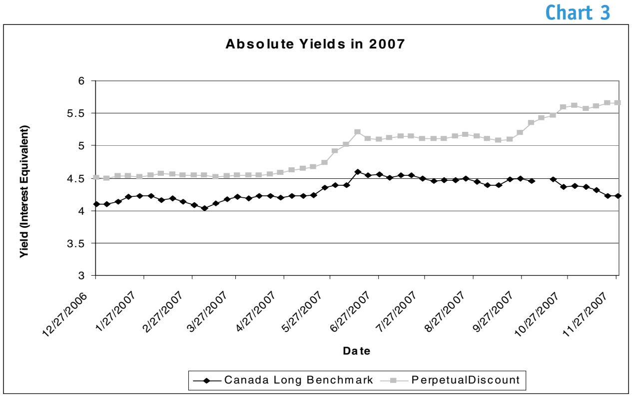


While this episode was, strictly speaking, relevant to only a single name in the preferred share universe, the renewed focus on credit risk did not improve the performance of the overall market.

Increasing Long Bond Yields

Chart 3 shows the yield on the Canada Long Bond Benchmark (data courtesy of the Bank of Canada, http://www.bankofcanada.ca). As may be seen, conditions were perfect for issuers for the first part of the year. The benchmark remained in a fairly tight range of 4.00-4.25% until mid-May. At that point, however, the preferred share market got another piece of bad news when inflation concerns took the long bond up above 4.5%.

Chart 3



Inflation is, as always, the enemy of fixed-income investors and this was simply the last straw for the market. Perpetual issues underperformed bonds under the combined weight of heavy issuance, credit worries and rising yields. There were still a few optimists, however. After all, what else could possibly go wrong?

The Credit Crunch

The inability of Canadian asset-backed commercial paper conduits to secure funding made, and continues to make, headlines across Canada as a home-grown example that good times in the securitization and credit business have ended. This did not have an immediately harmful effect on the preferred share market as a whole, although Brookfield issues performed extremely poorly, but the news did nothing to stop the slow increase in spreads to Canadas! The credit crunch set the stage for...

Bank Capital Requirements

In times of financial stress, banks' balance sheets tend to balloon and with these increased assets and liabilities comes the need for more capital to safeguard depositors.

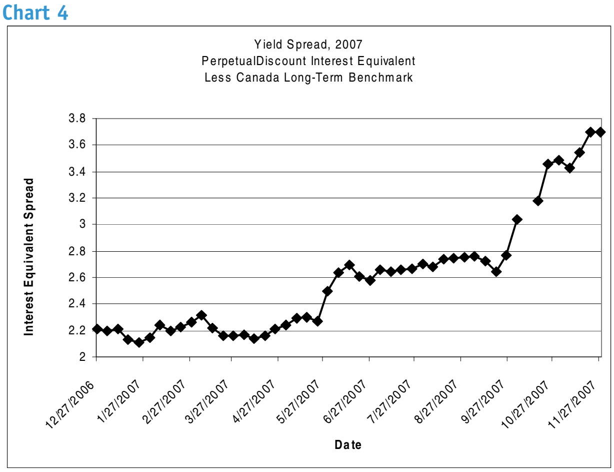
Royal Bank and CIBC had already issued their maximum allowable amount of qualifying preferred shares, but at the end of September BNS, BMO and TD came to market in rapid succession for a total issuance of $800 million. An attractive dividend rate of 5.25% was offered on these issues but the fragile market could not bear the strain. As may be seen in Chart 3, preferred share yields rapidly increased to well over 5.25% and the market suffered accordingly. But there was one more kick in the teeth awaiting the market.

DPS.UN Retraction Pressure

Diversified Preferred Share Trust (fully described at www.sentryselect.com) is a closed-end preferred share fund trading on the Toronto Stock Exchange. In October, many of its shareholders decided that they'd had enough bad news for one year, thank you very much, and exercised their retraction rights over one-sixth of the portfolio holdings. And therefore, preferred shares worth $40-million hit the market on a "must-sell" basis.

I may be over-emphasizing this factor in preferred shares' *annus horribilis*. After all, the amount is only 5% of the new issue size! New issues, however, have the advantage of an army of well-paid salesmen flogging the product, while opportunities in the secondary market do not attract anywhere near the same amount of attention. And DPS.UN was in a "must-sell" position. Chart 4 indicates the change in spreads after mid-October. I believe this selling had a disproportionately large influence on prices.

Chart 4



How Bad Was It?

Pretty bad! I have examined the last 14 years history of the BMO-CM 50 Preferred Share Index (since December 31, 1993) and the peak-to-trough performance of this index, from the peak at March 30, 2007 to November 30, 2007, is the worst on record. This period's loss of 7.4% is unmatched by any other decline.

As a matter of fact, the previous worst peak-to-trough performance is that realized from March 30 to October 31 of this year. November's poor returns were merely icing on the cake. The worst period previously, from the peak of January 1999 to the trough of February 29, 2000, experienced a loss of a mere 6.1%.

So, those who have held preferred shares this year are justified in feeling a little aggrieved! And they may also be excused for feeling a little nervousness about the future. After all, if the period ended November 30, 2007 was so bad...

What About the Future?

I have been asked throughout this horrible year, "When will this end?" And all I can do is refer my questioners to somebody with greater access to the supernatural than I have.

The world is a chaotic place. Even assuming that it is possible to analyze financial markets perfectly, using every scrap of available information, the world will change. Things that looked like adjustments at the time of analysis will suddenly be found to determine the entire trend of the market.

Remember U.S. housing prices last year? They had virtually doubled since 2000, mortgage debt was very high, it was looking as if a certain plateau had been reached and many commentators felt that growth might slow a little bit, without the fuel of increased mortgage borrowing. I knew that. We all knew that. Great! Economic slowdowns are good for fixed income, right?

Wrong. I don't remember many predictions that the survival – never mind the mere health – of the world financial's system was to be called into question. I'm sure there were some, e.g. Prof. Nouriel Roubini (who blogs at http://www.rgemonitor.com/blog/roubini/) has a better claim than most to prescience, but there are always some. Whenever a machine breaks down due to a faulty wing-nut, you'll always be able to find some wing-nut who predicted it. Chances of repetition are slim.

Nobody can time the market with any significant degree of reproducibility. All you can do is arrange your portfolio so that it will weather the storms of unpredictability and meet your objectives better than most alternatives under most circumstances.

I can, however, point to one critical point that should have some bearing on the performance of Canadian preferreds in 2008, i.e. the purchase and cancellation of the BCE issues as part of the Plan of Arrangement with Teachers' Pension Plan. Should the deal close according to plan, we should see a jump in the price of preferreds in general and a flood of issuance (probably of relatively low quality) as extant holders reinvest their capital. Should the deal fail, I believe the BCE issues will drop like a stone, as confidence in their credit ratings will be impaired for quite some time.

Investors should maintain an insouciant attitude to the vagaries of the market place and leave market timing to speculators. Preferred shares, with their unique risk/reward profile, are suitable for inclusion, to a greater or lesser extent, in a majority of taxable fixed-income accounts. Check to see whether your taxable fixed-income portfolio is among the majority and don't put all your eggs in one basket.

In the meantime, my prediction for 2008 is...more unforeseeable factors!

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The Pick of PrefLetter

After the close on December 14, my monthly newsletter (www.prefletter.com) recommended **BNA.PR.C**, among others, for long-term, buy-and-hold investors.

Type of Preferred	SplitShare
Quotation (2007-12-14)	$19.20-47
DBRS Rating	Pfd-2(low)
S&P Rating	Not Rated
Annual Dividend	$1.0875
Yield-to-Worst Scenario	Hard Maturity, 2019-1-10 at $25.00
Yield-To-Worst	7.53%
Modified Duration, YTW	8.29
Pseudo-Convexity, YTW	0.26

BNA.PR.C - *Currently redeemable at $26.00 until 2016-01-09; redemption price then declines by $0.25 annually until maturity of the issue on 2019-01-10 at $25.00. Next ex-date: 2008-02-20 (estimated).*This issue is backed by Brookfield shares (BAM.A). So, despite the difference in ticker symbols, it should be considered as exposure to BAM. Asset coverage of just over 3.7:1 as of November 30 (according to http://www.bnnsplit.com/investor_nav.htm) implies that the rating is constrained not by the structure or leverage of the split share corporation itself, but rather due to the nature of the BAM.A underlying security. Despite my continued recommendations, the issue performed poorly in the past month and now yields substantially more than BAM perpetuals, despite the advantage of having a fixed maturity date. I am at somewhat of a loss to understand why this issue has underperformed to the point where its interest-equivalent yield (using a factor of 1.4) exceeds 10%. I can only suppose that the issue was sold in January 2007 to retail investors who did not fully understand what they were buying and that the momentum and fear of holding a *structured* investment in an *investment bank* in the current environment is doing its wicked work. Additionally, I know there is at least one brokerage house that incorrectly lists these shares as perpetuals, which creates major confusion regarding valuation!