Trading Preferreds

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Right! You've read everything you can find about preferred share analysis, you've made a list of some attractively priced issues and you have cash available to devote to the sector. Having made the theoretical decision, however, you can't just relax – efficiency of trade execution in the fixed income sector can have an even larger effect on relative returns than it has on equity returns. A good bond trader is someone who can lose his temper over a penny's difference in price!

The same rules that apply to buying a car or a house apply to buying preferred shares: The most important rule is to know how much you're prepared to spend before you walk into the showroom. Negotiation is fine, but good preparation will pave the way for good results.

What Yield Do You Want?

In the July 2006 edition of *Canadian MoneySaver* (*CMS*), I described an online preferred share yield calculator – remember that bond calculators must not be used because preferred shares do not trade with accrued interest. When performing your calculations, use a variety of prices, determine for yourself how much difference a nickel makes, for instance. Plug in both the bid price and the ask price. How much yield difference is determined by the bid/ask spread?

Check to see whether there are good alternatives to your ideal result. For instance, many preferred shares come in "Pairs" (*CMS*, October 2007) and the two elements will rarely be quoted identically. Perform the same exercise for your other choices. It may be that market conditions will change in the course of the day.

When is the Next Ex-Dividend Date?

Knowledge of the ex-dividend date ("Dividends and Ex-Dates", *CMS*, September 2006) is required in order to use the online calculator, but the requirement is worth emphasizing. Briefly, if you purchase a share prior to the dividend's ex-date, you will receive that dividend; if you purchase on that date or afterwards, you will not.

The dividend makes quite a difference, as you may tell by toggling the "Include First Dividend?" indicator on the yield calculator. Many companies issue press releases specifically announcing their dividends or include the announcement with their quarterly earnings releases. You may access the press releases by getting an online quote from the Toronto Stock Exchange (TSX, www.tsx.com) and clicking the "News" link. Through the "Company Information" link on that page, you may find the company's website and, if necessary, comb through that for the relevant information.

Some companies do not make dividend details readily available, having notified the TSX and Bloomberg of the particulars, they consider their duty done. In such a case, you may wish to send them an irate e-mail rather than purchasing their preferred shares since guessing is fraught with danger.

What Kind of Order Will You Place?

When trading preferred shares, limit orders are almost always the best choice. Such an order specifies the highest price to be paid for stocks purchased, or the lowest price accepted for issues sold.

Market orders should not be used without very compelling reasons. A market order will be filled by other traders' limit orders at their limit price, and there will usually be relatively few such orders extant when you place your order. It would not be unusual, for instance, for the best offer to be 500 shares at $21.00, with the second best offer to be 200 shares at $21.25. Every now and then, the traded price of preferred share issues will violently change, for instance, 400 shares trade at $21.00, then another 200 shares trade at $21.25, then 400 shares trade at $23.00. The trader in this example should have placed his order for 1,000 shares with a limit of $21.25. He would have been filled for 400 at $21.00 and 200 at $21.25, just as with the market order, but instead of completing his purchase at the awful price of $23.00, he would then be the best bid on the exchange, bidding $21.25 for the 400 shares remaining.

If the security you want to buy is quoted at, say, $22.50-80, there is no need to jump right in with a bid of $22.80 just to guarantee execution (unless you are convinced that $22.80 is a completely anomalous price that will disappear as soon as somebody else notices!). Try bidding 22.65, just to see what happens – maybe a seller will be willing to meet you half way.

Special order types, such as "All or None" (AON), should not be used. These orders are handled on the "Terms" market, a depressingly manual system and it is all too easy for those who place such orders to be appalled at the end result.

Table 1 provides an indication of the average spread (the difference between the best bid and the best offer, according to closing quotations) of issues that are tracked by my company's HIMIPref™ software. These differences each represent over a month's worth of dividends – sometimes much more! This expense, sometimes worthwhile, sometimes not, should be taken into consideration when contemplating a trade.

Keep an Eye on Your Order!

Limit orders should be checked throughout the day, and changes made when necessary. Say, for instance, that you are trading through a full service broker with a minimum commission of $80. You may be happy to pay that much on a 1,000 share trade. You may have good reason to be happy, depending on how hard your broker works for you. But if only 100 shares get filled, that's eighty cents per share – most of a year's dividends!

Check the status of your limit order at about 3:30pm. If your order has been completed, great. Take the rest of the day off! If your order has not been touched, you may wish to cancel it and try again the next day, without risking a 100-share partial fill at the last minute.

TABLE 1

BID/ASK SPREADS FOR THE HIMIPREF™ PREFERRED SHARE INDICES

Index	Historical Average	February 8, 2008
Ratchet	44.7	31.5
Fixed-Floater	35.5	39.6
Floating Rate	25.6	23.9
Operating Retractible	13.7	12.6
Split-Share	23.3	26.3
Interest Bearing	17.7	16.3
Perpetual Premium	13.2	12.5
Perpetual Discount	13.9	13.7

Note: For a full explanation of how these indices are constructed, please refer to www.prefletter.com/chatPrefLetter.php The values are all normalized and presented as cents of spread for a notional $25.00 issue.

The Pick of PrefLetter

After the close on February 8, my monthly newsletter, (www.prefletter.com), recommended CM.PR.I, among others, for long-term, buy-and-hold investors.

Type of Preferred	Perpetual Discount
Quotation (2008-2-8)	$20.76-85
DBRS Rating	Pfd-1 [under review – negative]
S&P Rating	P-1(low)
Annual Dividend	$1.175
Yield-to-Worst Scenario	Limit Maturity
Yield-To-Worst	5.71%
Modified Duration, YTW	14.36
Pseudo-Convexity, YTW	1.02

CM.PR.I: Redeemable at $26.00 commencing 2012-1-31; redemption price declines by $0.25 annually until 2016-1-31; redeemable at $25.00 thereafter. Next ex-date 2008-3-24(estimated). The Bank of Commerce has its problems, but the common shareholders can lose an awful lot more money before the preferred shareholders have to worry … and preferred shareholders are being paid significant extra yield to compensate them for the headlines. This issue is quite liquid, with an average trading value (as defined by HIMIPref™) of over $700,000. The low dividend per share is fully reflected in the relatively low price, implying that the yield may be enjoyed for many years to come.

If you have received a partial fill, you have a decision to make based on market conditions and the commission charges you face. For instance, if you are bidding one cent below the current offer, you will probably be well advised to change your order to that higher price. There are too many variables in this calculation for me to provide any general advice; traders have to make their own decisions based on their own circumstances and the state of the market when the decision is made. Just be aware that such a decision might be required and be prepared to make it.

Minimum Guaranteed Fill

Very few retail investors are familiar with the Minimum Guaranteed Fill (MGF) rules.

The TSX, like other exchanges, endeavors to ensure that a reasonable two-sided market exists at all times for the securities it lists. The assurance that at least a small amount of securities may be bought or sold at any time, within some kind of reasonable spread, should contribute to confidence by small investors in the marketplace and hence to these small investors being more willing to participate.

The TSX addresses this issue through the MGF system and is the only exchange that provides guaranteed execution for more than one board lot (for most issues, this is 100 shares). Almost all listed issues have a market maker whose role, described at http://www.tsx.com/en/trading/products_services/market_system.html, "is to augment liquidity, while maintaining the primacy of an order-driven continuous auction market based on price-time priority." Market makers must call a two-sided market, keeping the bid/ask spread within a specified range (on a time-weighted basis), maintain an odd-lot market at the board lot quotation, and service orders meeting the MGF requirements.

A particular MGF is defined for each stock. For example, a preferred share issue might have a MGF of 599 shares. This means that the quoted bid and offer size for this security will always be a minimum of 599 shares, regardless of the size apparently reported. You want to sell 500 shares, but only 100 are bid at the price you want? No problem. Enter your sell order at the bid price for 500 shares and it will all be filled; 100 by the actual bidder and the other 400 automatically by the market maker. Note, however, that if you attempt to sell 600 shares, only the 100 shares actually bid will be filled. Since this order exceeds the MGF, the market maker is not required to step in. You will then be offering 500 shares at your price, and note, that if somebody then comes along with a market order to buy 500 shares, you might only get filled on 300 shares, if the market maker exercises his right to participate in the trade!

There are problems with the market-maker system:

- The market-maker's identity for particular securities is not readily available, although the firm is disclosed on the listing announcement for each issue.
- The TSX does not freely publish a list of MGF sizes. These data are sold to third-party providers such as Bloomberg and Thomson. Very few retail investors will be able to access the information other than awkwardly via their brokerage.
- The desired bid/ask spread for each issue is not publicized.
- Performance measurement of the market makers is not publicized.

I can only suggest that investors call their brokers, or the exchange, when the size of the MGF becomes important to them.

Conclusion

It's not the trades you do that determine whether or not you're a good trader. The trades you walk away from are the ones that matter. Many investment decisions that looked good on paper have run afoul of execution problems and lost any value that they might have otherwise delivered. It is not enough to have done your homework and decided that such-and-such an issue is "attractive at current levels". Investors must ensure for themselves that their trading will be efficient. Nobody else will!

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