The Claymore Preferred ETF And Its Index

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Quite a bit has happened to preferred shares since I reviewed the Claymore S&P/TSX CDN Preferred Share ETF (CPD) in the *Canadian MoneySaver* (CMS) of June 2007. The ongoing credit crunch drove the market down (*CMS,* January 2008). A recent spike in yields resulted in a new low (*CMS,* August 2008). An innovative class of preferred shares, fixed resets, was successfully introduced (*CMS,* May 2008).

The index has also changed: in July 2007, split shares (*CMS,* November 2006) were added and the number of issues included increased; in January 2008, the split shares were deleted; and in July 2008, fixed-reset issues were added to the index, with heavy turnover. All this activity requires an update of my previous review!

Tables 1 through 4 repeat the prior analysis and do not require elaboration. Changes over the past fifteen months may be observed (with the help of some digging into detailed fund statements):

- Duration has increased as the fund's holdings of perpetuals were affected by the rise in yields (*CMS*, Nov/Dec 2007).
- Overall credit quality is more or less unchanged. The weight of lower quality issues is above my rule of thumb of 10% weight ranked lower than Pfd-2(low) [*CMS,* July/August 2007], but is well diversified and concentrated in retractible issues.
- CPD has a higher than expected yield in Operating Retractibles ["OpRet", *CMS,* February 2007] due to a heavy weighting in issues of lower credit quality. Overall, one may say that lower-quality OpRet issues have been substituted for split shares.
- CPD is overweighted in fixed-reset issues [*CMS,* May 2008]. At the time of the last rebalancing, the index contained six of the seven issues then outstanding.

The rebalancings are of primary interest. The three semi-annual reviews of the S&P/TSX Preferred Share Index (TXPR) since the inauguration of CPD are summarized in Tables 5, 6 and 7.

Claymore's investor guide claims: "ETFs have relatively low annual expense ratios compared to other investment products. This is because ETFs are index based and do not experience the amount of portfolio turnover and trading costs that other products may have." Their 2007 annual report states (note 11): "The total fees paid to brokers in connection with investment portfolio transactions for the period ended December 31, 2007 were nil."

TABLE 2 - LIQUIDITY CHARACTERISTICS OF CPD PORTFOLIO

Average Daily Trading Value	April 30, 2007	August 29, 2008
$0 - $50,000	8.56%	5.65%
$50,001 - $100,000	22.09%	41.42%*
$100,001 - $200,000	42.65%	23.47%
$200,001 - $300,000	19.23%	13.55%
$300,001+	7.47%	15.96%

*Note: The 13.09% position in fixed-reset issues has been assigned to the second lowest liquidity category based on the long-term trading record of BCE fixed-floaters.

TABLE 1 - MAIN CHARACTERISTICS OF CPD

	April 30, 2007	August 29, 2008
Management Expense Ratio	0.45%	0.45%
Mean Yield-to-Worst (raw) of Holdings	3.84%	5.42%
Mean Yield to Worst (negatives zeroed) of Holdings	3.98%	5.42%
Mean Modified Duration (YTW) of Holdings	6.19	9.84
Mean Daily Trading Value of Holdings	$187,000	$157,000

Portfolio averages have been calculated assuming a 4.90% yield, 5-year duration and $75,000 daily trading value for the "fixed reset" instruments.

TABLE 3- CREDIT QUALITY OF CPD PORTFOLIO

DBRS Rating	CPD - April 2007	CPD - Current
Pfd-1	21.15%	36.53%
Pfd-1(low)	40.40%	28.70%
Pfd-2(high)	7.89%	7.05%
Pfd-2	0	0
Pfd-2(low)	25.74%	13.94%
Pfd-3(high)	4.82%	5.77%
Pfd-3	0	8.06%

TABLE 4 - SECTORAL DISTRIBUTION OF CPD PORTFOLIO COMPARED WITH HIMI UNIVERSE

	CPF				HIMI		
Sector	Weighting April 2007	Weighting Current	YTW*	MD-YTW**	Weighting	YTW*	MD-YTW**
Ratchet	0.87%	0	N/A	N/A	0.90%	4.38%	16.70
FixFloat	6.78%	6.43%	4.31%	16.38	6.22%	4.35%	16.40
Floater	2.96%	1.52%	4.34%	16.66	2.21%	4.09%	17.16
FixReset	0	13.09%	4.90%	5.00	8.07%	4.90%	5.00
Operating Retractible	27.50%	27.32%	4.69%	3.33	14.62%	3.92%	2.80
Split Share	0	0	N/A	N/A	12.04%	5.85%	4.36
Interest Bearing	0	0	N/A	N/A	1.75%	6.38%	5.26
Perpetual Premium	56.78%	1.18%	5.41%	2.25	0.91%	5.41%	2.25
Perpetual Discount	5.11%	50.51%	6.12%	13.76	53.26%	6.10%	13.75
TOTAL	**100.0%**	**100.0%**	**5.42%**	**9.84**	**100.0%**	**5.48%**	**10.32**

Note: The 5.92% "scraps" allocation from CPD in April 2007 has been allocated to specific indices. The HIMI universe is restricted to issues rated Pfd-2(low) or higher by DBRS with an average daily trading value of $25,000 or greater.*YTW is the weighted average Yield-to-Worst. See *CMS*, July 2006.**MD-YTW is the weighted average Modified Duration of the sector, where the Modified Duration of each issue is determined by its Yield-to-Worst scenario. See *CMS*, May 2007.

Well, it's always very pleasant to have "nil" transaction costs. It makes the Trading Expense Ratio (TER) so beloved of regulators and investor advocates 0.00%! As investors, however, we must remember that the TER represents only part of the total cost of investing – not even a particularly big part. Full implementation costs include:

- **Explicit costs** - commission and settlement fees.
- **Spread costs** - the cost of buying at the offering price, while only obtaining the bid price for securities sold.
- **Market impact costs** - the cost due to the trade itself moving the market, as all available liquidity is soaked up by the need to transact.

Many readers will recognize that the latter two "costs" represent revenue for those individuals and firms that take the other side of the trades. The fund managed by my firm makes something of a fetish of "selling liquidity" to the market!

Explicit costs, those that are included in the TER, are minimal. Three cents a share commission is routine; many readers will trade for even less. In the preferred share sector, where the bid/ask spread is often twenty-five cents, trading technique (see *CMS,* March 2008) is much more important than explicit costs.

Transaction details regarding CPD's rebalancings is not available so spread costs and market impact costs cannot be readily estimated. However, Tables 5 through 7 calculate the return (from bid price to bid price, dividends reinvested at the bid on the ex-date) for periods of about three months

The Pick of PrefLetter

After the close on September 12, my monthly newsletter (www.prefletter.com) recommended BAM.PR.O among others, for long-term, buy-and-hold investors.

Type of Preferred	Operating Retractible
Quotation (2008-9-12)	$22.45-50
DBRS Rating	Pfd-2(low)
S&P Rating	P-2
Annual Dividend	$1.25
Yield-to-Worst Scenario	Option Certainty, 2013-6-30 at $25.00
Yield-To-Worst	7.56%
Modified Duration, YTW	4.19
Pseudo-Convexity, YTW	0.19

BAM.PR.O - Redeemable and retractible (for discounted shares) commencing 2013-6-30, which is presumed to (at worst) trigger a call at 25.00. Next ex-date 2008-12-11 (estimated). This issue had the misfortune of being sold to the public just as the "Swoon in June" got under way and the underwriters have been struggling to get the issue off the books ever since. A recent uptick in volume may indicate that they have finally found a level – at a yield that is very attractive not only when compared with other short-term issues in general, but even with other issues of similar term from the same issuer (BAM.PR.H & BAM.PR.I).

TABLE 5 - JULY 2007 REBALANCING – APPROXIMATE WEIGHT 30% (ADD SPLIT SHARES)

	Pre-Rebalancing Return (2007-5-31 to 2007-7-20)	Post-Rebalancing Return (2007-7-20 to 2007-8-31)
Adds	+1.26%	-1.32%
Deletes	-0.84%	+0.53%
CPD	-2.11%	+0.05%

Note: The trade weight was estimated from the 2007 yearend weights of the issues added. One of the deleted issues was redeemed during the "post-rebalancing" period. Its return has been set equal to CPD.

TABLE 6 - JANUARY 2008 REBALANCING – APPROXIMATE WEIGHT 10% (DELETE SPLIT SHARES)

	Pre-Rebalancing Return (2007-12-3 to 2008-1-18)	Post-Rebalancing Return (2008-1-18 to 2008-2-29)
Adds	N/A	N/A
Deletes	-0.84%	+0.94%
CPD	+0.63%	+2.17%

Note: The trade weight was estimated from the yearend weights of the issues deleted. No issues were added.

TABLE 7- JULY 2008 REBALANCING – APPROXIMATE WEIGHT 29% (ADD FIXED RESETS)

	Pre-Rebalancing Return (2008-5-30 to 2008-7-18)	Post-Rebalancing Return (2008-7-18 to 2008-8-29)
Adds	-4.47%	+3.06%
Deletes	-7.42%	+6.14%
CPD	-7.75%	+4.25%

Note: The trade weight is estimated from the 8/29 weight of the issues added. Four of the sixteen issues (4.22% of total portfolio) added were issued during the "pre-rebalancing" period. Their returns have been assumed to be equal to the CPD return.

spanning each rebalancing. The calculations shown will, at best, reflect market impact costs, as index-dependent investors (not just CPD) slavishly reposition their portfolios to reflect the changes and thereby move the market.

The calculations show that index investors would have been far better off had the index remained unchanged – an important analytical insight not captured by the TER. It is possible that the poor performance of indexed (relative to constant) portfolios has nothing to do with market impact. It might simply be the result of bad or unlucky market timing when changing the index composition. Additionally, CPD's implementation costs may be different from the cost implied by index analysis and will comprise part of its tracking error.

Indexing has its place, benchmarking has its place and exchange-traded funds have their place. But investors considering CPD as a suitable vehicle for preferred share exposure should recognize that changes to the index have, so far, cost them money.

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