



Split Shares And Monthly Retractions

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Anybody who has known me for a good period of time knows well that there are certain subjects that I feel should not be discussed in mixed company. Market timing – the belief that an investor may consistently buy low and sell high – is one of those subjects.

It simply doesn't work. It is always comforting to believe that somebody, somewhere, knows what's going on, but the sad fact is that financial markets form a chaotic system, by which I mean that infinitesimal differences between securities at time zero can cause huge differences in subsequent returns. Naturally, the greater the differences between the companies in the beginning, the less certain we can be regarding relative future returns. We can compare apples to apples in an effort to outperform the market, but once our hubris increases to the point that we make pompous comparisons between apples and auto mechanics – we're just guessing. The relative importance of factors influencing the valuation of two elements will change. A previously examined factor, dismissed as unimportant, will become the new valuation paradigm.

And so it is with split share corporations and their monthly retractions.

Regular readers, or those with access to the electronic archives, will be familiar with split share corporations from the articles in *Canadian MoneySaver (CMS)* in November 2006 and July 2008. Briefly and generally, the sponsor purchases a portfolio of equities (or, sometimes, a single equity) funded by the sale of units to the public. Each unit is comprised of a "capital share" and a "preferred share", which trade separately. The preferred shareholders get a fixed dividend and first call on getting their money back when the fund is wound up. The capital shareholders get a leveraged investment in the underlying portfolio and get the full value of the portfolio when it is wound up after paying the preferred shareholders their money. Therefore, the capital shareholders get increased expected return at the expense of safety; the preferred shareholders get increased safety at the expense of expected return.

Mulvihill World Financial Split Corp. (see [http://](http://www.mulvihill.com)

www.mulvihill.com) is a typical split share in many ways, and has the advantage of being a relatively large issue. There are nearly 13 million preferred shares outstanding with a par value of \$10, backed (as of September 30) by a portfolio worth \$15.46 – the asset coverage ratio, as discussed in previous articles, is thus just over 1.5:1. My fund owns it from time to time. It's a nice, liquid issue, although the name no longer has quite the same cachet as it had when the issue was launched.

Like many of its peers, there is a clause in the prospectus that states: "Preferred Shares may be surrendered at any time for retraction by the Company but will be retracted only on a monthly Valuation Date...Shareholders whose Preferred Shares are retracted on a Valuation Date will be entitled to receive a retraction price per share equal to 96% of the lesser of (i) the NAV per Unit determined as of the relevant Valuation Date less the cost to the Company of the purchase of a Class A Share in the market for cancellation; and (ii) \$10.00."

The details of this monthly feature vary, but the intent is more or less the same.

Clearly, there is the potential for this feature to be valuable. But on the other hand, a preferred shareholder who takes advantage of it is, effectively, selling a unit to the company at a discount of 4% to NAV. Four percent! That's more than six months' pay! On an issue with a five-year remaining term to maturity (and a modified duration of slightly less; see *CMS*, May 2007) that's over 80bp in yield! Surely we can count on the financial markets to be efficient enough that, while nice and while appreciated, for analytical purposes we may assume that the market price of WFS.PR.A will exceed the redemption price offered by this option. Anything less would be Armageddon.

Armageddon has arrived. This option, previously dismissed as trivial, has suddenly become very interesting.

On September 30, Mulvihill reported that the value per unit of the underlying portfolio was \$15.46 (NAV). The Capital Units closed at \$4.41 (C) and the preferreds closed at \$8.84. Representing the monthly retraction price (R) as described in the prospectus in terms of an equation, we get:

R = 96% (NAV - C)
 = 96% (15.46 - 4.41)
 = 96% (10) [since the prospectus specifies a maximum of \$10]
 = \$9.60

In other words, some relatively unusual events have occurred:

- The capital units are trading well below their share of the asset value so the \$10 minimum is fairly likely. Therefore, \$9.60 represents a good guess at the monthly retraction price.
- The market price of the preferreds is below the estimated retraction price.
- Both parts of the split unit are sufficiently below their intrinsic values to give us not certainty, but a fair amount of confidence that this will be the case in the near future. There are some complications. So be careful.
- There is generally a provision that shares must be submitted for retraction several days prior to the valuation date – prices may change!
- The preferred share submitter has no control over what price the company actually pays for the capital shares; a discount to NAV may turn into a premium!
- The company may have published its NAV well prior to the date of submission. The submitter will have to estimate how this NAV has changed in the interim.

Nonetheless, the sudden attraction of monthly retraction privilege is applicable to a great many split share corporations, as shown in Table 1. There is not just the potential for arbitrage, but there is also the potential for holders of these preferred shares to use the long-deprecated monthly retraction option rather than selling into a very, very sick market. As always, check the precise language in the prospectus for yourself, carefully review the details of submitting the shares for retraction with your broker well before the submission date, and estimate the fund's NAV as well as possible immediately before submitting the shares. The effort may be handsomely repaid.

Pick of PrefLetter

There will be no "Pick of PrefLetter" this month. I regret this, but the month's edition of *PrefLetter* was prepared as of the close on October 10, which was certainly the wildest day I remember for preferred shares with the S&P/TSX Preferred Share Index down 4.78%.

Bids just disappeared and bid/offer spreads widened to a ridiculous extent, and perfectly good, solid preferred shares issued by blue chip corporations were trading in a range of 2%. It is my concern that any recommendation that I make at the time of the *Canadian MoneySaver* deadline will have

become hopeless and perhaps misleading by the time members receive their issue.

In the meantime, there are certainly many bargains out there, and enormous potential for investors to swap issues with very similar risk at a substantial yield pickup.

Recommendations will resume next time, barring continued chaos. Daily updates on the preferred share market are available on my blog at www.prefblog.com.

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TABLE 1 - SOME SPLIT SHARE MONTHLY RETRACTION PROPERTIES

Ticker	Monthly Retraction	Annual Retraction	NAV Date	Capital Units Close	Preferred Close	NAV	Estimate Pfd Ret	Diff
ALB.PR.A	95%NAV - 2C - \$1	February	10/2/2008	8.5	23.75	40.52	20.49	-3.26
ASC.PR.A	96%* (NAV - C)	May	10/3/2008	4.6	7.4	13.6	8.64	1.24
BMT.PR.A	95%NAV - 2C - \$1	August	10/2/2008	8.02	27.04	44.23	24.98	-2.06
BNA.PR.A	\$25 - 5%NAV - \$1	-	8/31/2008	NA	25	80.27	19.99	-5.01
BNA.PR.B	\$25 - 5%NAV - \$1	-	8/31/2008	NA	19.71	80.27	19.99	0.28
BNA.PR.C	-	-	-	-	-	-	-	-
CBW.PR.A	95%NAV - C - 0.95	November	10/3/2008	2	5.85	10.81	7.32	1.47
CIR.PR.A	95%NAV - C - 0.95	June	10/3/2008	2	5.95	10.69	7.2	1.25
DF.PR.A	96%NAV - C	August	9/30/2008	9.3	9.5	18.09	7.88	-1.62
DFN.PR.A	96%NAV - C	August	9/30/2008	12.99	9.3	21.6	7.74	-1.56
FBS.PR.B	95%NAV - C - 0.40	December	10/2/2008	5.51	9.25	15.07	8.41	-0.84
FFN.PR.A	96%NAV - C	October	9/30/2008	8.23	8.86	18.07	9.11	0.25
FTN.PR.A	96%NAV - C	October	9/30/2008	10.72	9	22.06	10	1.00
FTU.PR.A	96%NAV - C	February	9/30/2008	3.24	6.59	10.78	7.1	0.51
GBA.PR.A	95%NAV - C	November	10/3/2008	1.74	7.21	10.42	8.15	0.94
LBS.PR.A	96% (NAV - C)	November	10/2/2008	9.77	9.35	19.5	9.34	-0.01
LFE.PR.A	96%NAV - C	March	9/30/2008	10.28	9.16	21.98	10	0.84
NBF.PR.A	95%NAV - 2C -0.40	December	10/2/2008	9.01	30.92	51.66	30.65	-0.27
PIC.PR.A	96%(NAV - C)	October	9/30/2008	5.75	14.44	21.12	14.4	-0.04
RBS.PR.A	95%NAV - 2C - 1	May	10/2/2008	9.45	28.65	48.9	26.55	-2.10
SBC.PR.A	96%(NAV - C)	December	10/2/2008	9.01	9.85	19.37	9.6	-0.25
SBN.PR.A	95%(NAV - C) - 1.20	June	9/30/2008	8.8	9.54	21.35	8.3	-1.24
TXT.PR.A	-	Monthly	-	-	-	-	-	-
WFS.PR.A	96%(NAV - C)	June	9/30/2008	4.41	8.84	15.46	9.6	0.76