Preferred Shares – Where Are We Now?

James Hymas

Last year at this time I posed the question, "When will preferred shares recover?", making the bold prediction that 2008 would bring more unforeseeable factors. The uncanny accuracy of this prediction leaves me awed – but humble. I will endeavor to do as well in my forecast for 2009.

Highlights of 2008 included:

- Introduction and heavy issuance of "Fixed-Reset" preferreds,
- Collapse of the market in the third quarter,
- Strange behaviour of split-share preferreds in the third quarter, and
- Cancellation of the BCE takeover.

Fixed-Reset Preferreds

This new class of preferred shares was introduced in an issue by the Bank of Nova Scotia in March. I discussed the analysis of this class in the *Canadian Moneysaver* (*CMS*) of May 2008. Essentially, these issues offer a fixed rate for five years, at which time there are three possibilities:

- The shareholder may retain the shares with the rate reset for another five years at a spread to 5-year Canadas determined at the time of issue.
- The shareholder may elect to exchange the shares to a new series, which pay a dividend of 3-month Canada T-bills plus the same pre-determined spread, reset quarterly.
- The issuer may elect to call the issue at par.

To my astonishment, these issues have proved to be exceptionally easy to sell. Purchasers seem to be concentrating on inflation risk and minimizing both deflation risk and credit risk, taking the view that a Canadian bank could no more run into difficulties than a man could have a baby. My preferred share analytical programme, HIMIPref™, is now tracking 18 of these issues with an aggregate value of $4.3-billion.

My deprecation of these issues has, so far, left me with egg all over my face, as the asset class has greatly outperformed the perpetuals that don't pretend to be five-year investments! There has been weakness lately, however, that has clarified analytical models somewhat:

- The issues are currently trading as perpetuals. When one determines the yield-to-five-year-call (YT5) and yield-to-perpetuity (YTP) for each issue, the most consistent set of yields determined by averaging these yields is obtained by assigning the YTP a weight of 90-95%, with a YT5 weight of 5-10%.
- Expensive perpetuals! Table 1 shows the calculation of the yield difference between the "blended yield" of fixed resets and the average of fixed-dividend perpetuals between the same issuer. Investors will take their own views on how much yield give-up is appropriate for the reset feature – but I say it's too much!

TABLE 1 - SPREADS BETWEEN "FIXED-RESET" AND "STRAIGHT" PREFERRED SHARE CLASSES

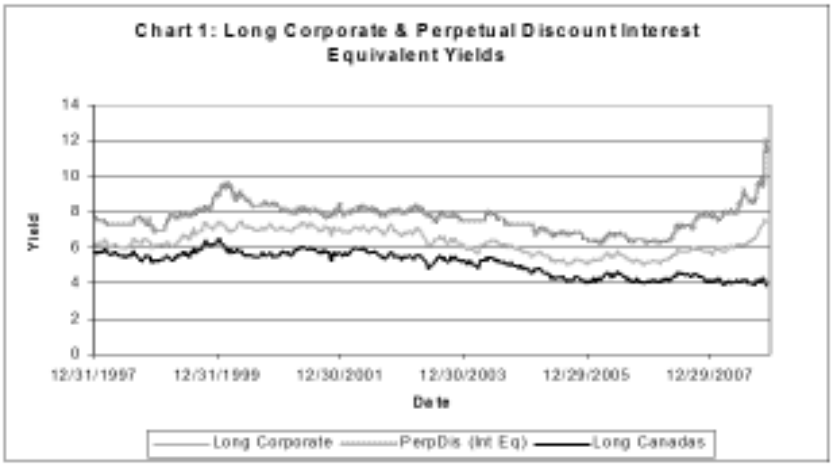
Issuer	"Fixed Reset" Blended Yield	"Straight" Yield	Spread
BMO	5.31%	7.76%	245bp
BNS	5.70%	7.53%	183bp
CM	5.85%	8.02%	217bp
RY	5.62%	7.19%	169bp
TD	5.30%	7.40%	210bp

"Blended Yields" are a mean average of the yields of all Fixed-Reset issues from the issuer with the individual issue yield calculated by assigning a 10% weight to YT5 and 90% to YTP."Straight Yield" is a mean average of all the YTW of all Perpetual Discount issues from the issuer.All calculations have been performed with market prices as of December 10, assuming a constant yield on 5-year Canadas of 2.18%.

Collapse of the Market in the Third Quarter

Two thousand eight will be remembered by preferred share investors for a long time, as the market set several records for dismal performance (see Charts 1 & 2). It is quite true that there weren't many places to hide from an awful year in capital markets of all descriptions, but the preferred share market stands out.

If we look at the BMO Capital Markets "50" index of preferred shares, we find that the worst single month since December 31, 1992 was November 2008 with a loss of 10.70%. The second worst month was October 2008 with



a loss of 8.16%. It is not until we look at the third worst month that we find a non-current entry: August 1998 (the Russian Crisis and the demise of Long Term Capital Management) with a picayune loss of only 4.51%. Of the twelve worst months in the sixteen-year span examined, six of them were in 2008 – two more were in 2007.

As recently as the September issue of *CMS* I was expressing surprise at the enormous interest-equivalent spread of Perpetual Discount issues to long corporates, when it peaked at 300bp. Too soon! The spread "went vertical" in November, climbing more than 150bp in a single week to peak at over 450bp on November 26. I can only attribute this spike to a confluence of frightened buyers refusing to bid and tax-loss sellers seeking simply to get out at any price.

The enormity of this spread may be illustrated by two thirty-year bonds, one with a yield of 7.5% (call this one "Corporates"), the other with a yield of 12% (representing the interest-equivalent of the dividend on Perpetual Discounts at the peak – call it "Preferreds"). When we discount the cash flows of the Corporates at 7.5% p.a., we are not terribly surprised to learn that the sum of these values is $100 – the present value of the bond. We might be a bit more surprised to find that the present value of the principal payment expected in 30 years for this bond is less than $12 – more than seven-eighths of the entire value of this bond is represented by its annual coupon.

When we discount the $12 annual payments and maturity value of the "Preferreds" at the 7.50% base rate, we learn two things:

- The present value of these payments is $153.
- The sum of the present values of the coupons alone for the first fourteen years is nearly $102. In other words, the "Preferreds" could default completely after fourteen years, and it would still have been a better investment than the non-defaulting 30-year "Corporates".

While it is clear that Perpetual Preferred shares should yield somewhat more than long corporate bonds, I'll venture that a few of November's sellers will be a little surprised to consider the implications of their views!

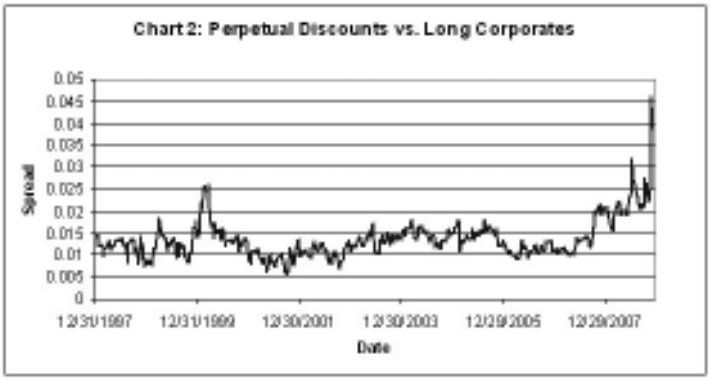
Strange Behaviour of Split Shares

Split-share preferreds (see *CMS*, November 2006) also performed abysmally in 2008's penultimate month, down more than twelve percent over the month – almost as bad as perpetuals! This is highly surprising, because with a modified duration of 3.7 (see *CMS*, May 2007), split shares should only be about one-third as sensitive to changes in interest rates as Perpetual Discounts – in the absence of changes in credit quality.

The fact that they came so close to matching the disastrous loss of the Perpetual Discounts implies that credit quality – or, at least, perceptions thereto – markedly deteriorated. And, in fact, this was the case as the value of the underlying portfolios of most split-share preferreds were badly hit by the crashing equity markets.

The poor performance does not appear to be well correlated with any standard fixed-income metric. I have tried and failed to correlate yields with either term to maturity or asset coverage. It's more interesting than that! When, for example, I examine a sample of 23 split-share preferreds rated Pfd-3(high) or better, I find that the average yield to maturity is 13.43% with a standard deviation of 5.60% – an enormous variance.

If I examine only the current yield (simply the annual dividend divided by the price, ignoring capital gains or losses on maturity; see *CMS*, July/August 2006) of these issues, I find an average of 6.64%, with a standard deviation of 1.58% – a much tighter range than yield to maturity, contrary to all expectations. In other words, split shares, with their average term of less than four years, were trading more as perpetuals than as bonds (see also *CMS,* February 2007). And this is happening despite the fact that the monthly retraction feature for these issues (see *CMS*,



November/December 2008) is highly supportive.

Cancellation of the BCE Deal

BCE preferreds had quite a ride in 2008 as the spread between intrinsic value and takeover value got wider and wider. These issues peaked in early September 2008 and in early December are down about 37% from those levels.

Yes, Yes, But What About the Future?

There are patterns in the price of any market-traded object that become perfectly clear in retrospect, and once the patterns have become clear, it is the easiest thing in the world to select from the plethora of data available to explain how the patterns could have been predicted.

Unfortunately, market timing – the practice of predicting future trends in prices – remains a refuge for fools and charlatans. While it seems clear to me that a 400bp interest equivalent spread of Perpetual Discounts vs. Long Corporates is too wide and non-sustainable, it could resolve itself in a number of ways: bond yields could rise, preferred yields could fall, I could change my views in the face of changing facts, or, and this is the most important precept for any portfolio manager, *I could be wrong*.

The pooled fund managed by my firm has had an excellent year relative to the competition, derived not from market timing, but by weighing baskets of cash flows and adjusting portfolio composition accordingly. Preferred shares will make a lot of sense for many taxable fixed-income investors. This column attempts to assist such investors to maximize their returns given a fixed allocation.

I predict in 2009 that the market will be inefficient.

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

The Pick of PrefLetter

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

Type of Preferred	Perpetual Discount
Quotation (2008-12-12)	$17.77-20
DBRS Rating	Pfd-1-(low)
S&P Rating	P-1(low)
Annual Dividend	$1.4375
Yield-to-Worst Scenario	Limit Maturity
Yield-To-Worst	8.25%
Modified Duration, YTW	11.07
Pseudo-Convexity, YTW	1.04

PWF.PR.H - Currently redeemable at $25.75; redemption price declines by $0.25 every December 9 until 2011; redeemable at $25.00 on and after 2011-12-10. Next ex-date 2009-1-7 (Declared). This issue continues to suffer from a flight from insurers. However, earnings remained strong, while its subsidiary GWO ended the third quarter with 2.03x required capital, so the decline looks more like blind flight from insurance-related businesses than sober analysis. Any other PWF perpetual may be substituted depending on market conditions: PWF.PR.E pays 1.3125, PWF.PR.F pays 1.3125, PWF.PR.G pays 1.4750, PWF.PR.I pays $1.5000, PWF.PR.K pays 1.2375, and PWF.PR.L pays 1.2750. The higher-paying issues should yield more due to the slightly reduced opportunity for capital gain, if yields should decline (see *CMS*, November 2007).