Some Preferreds to Float Your Boat

James Hymas

Floating rate preferreds have had a total return of less than zero over the last fifteen years. Maybe it's time to buy!

Regular readers of this column will recognize that the preferred share asset class is heterogeneous; different types of preferreds will react differently to changes in the investment environment. Each of these investment choices should be understood when constructing a portfolio.

The general heading of "Floating Rate" has many subtypes, but it should be noted that none of these issues has a set maturity date. All fall under the broader heading of "Perpetual" (see *Canadian MoneySaver* [*CMS*], June 2006).

- **Floaters** pay a fixed proportion of Canada prime as dividend. There are four issues with good credit and liquidity, each of which pay 70% of prime on their par value.
- **Ratchets** pay a variable proportion of prime with a minimum proportion of 50% and a maximum of 100%. The value within this range is determined by the market price of the issue. A monthly adjustment increases the proportion if the price is low, or decreases it if the price is high.
- **Fixed Floaters** pay a fixed rate until a predetermined exchange date. Investors then have the alternative of keeping the issue (which will have a new fixed rate set by the company) or swapping them for a ratchet issue (which may be swapped back on the next exchange date).
- **Fixed reset** issues are similar to Fixed Floaters, but
  - Fixed rates are reset every exchange date as a set spread to 5-year Canada issues.
  - The floating rate option pays a fixed spread to Canada 3-month bills.

Only the first three of these types will be discussed here. It should be noted that Fixed Floaters and their corresponding ratchet issues will form "strong pairs", as discussed in the October 2007 edition of *CMS*.

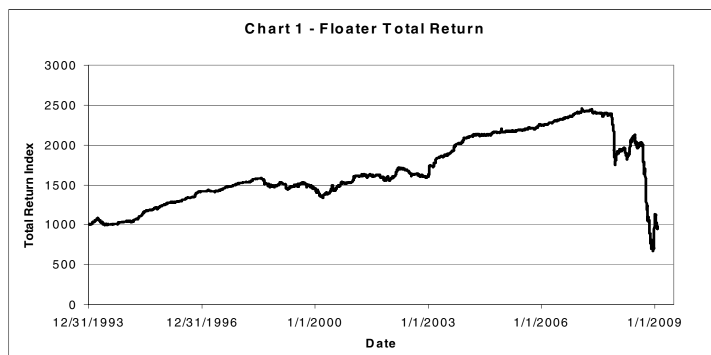
Chart 1 shows the total return of the Floater Sub-Index since 1993. Although plagued by a scanty data set (there have never been more than nine issues qualifying for inclusion and throughout the credit crunch the index has been dominated by Brookfield issues), it is useful in showing overall trends.

There are four periods:

- **December 1993 to July 1998** was a bull market for these issues with an annualized total return (dividends plus capital gains) of 10.59%.
- **August 1998 to January 2003** was a bear market with dividends only slightly outweighing capital losses; annualized total return was 0.72%.
- **January 2003 to March 2007** was another bull market; annualized total return +9.78%.
- **April 2007 to Current** is a vicious bear market with annualized total return to the end of January of -40.16%.

The existence of bull and bear markets for Floaters doesn't make a lot of sense. These issues are typically bought by investors who wish to maintain their capital and are willing to tolerate a lower rate of return in order to get it. One would expect some variation in returns, as prime varies in response to monetary policy, but the expectation is that floating rate investors will be happy to receive a fixed proportion of prime through a credit cycle. Individual issues may rise and fall based on credit considerations, but the existence of major price swings is more of a conundrum.

Credit quality considerations should not be disregarded! Canada prime is a short-term rate, while these issues all have perpetual credit risk. The issue of credit risk has been



brought into sharp relief in the past year, as ratchet issues from Quebecor World (IQW.PR.D) and Nortel (NTL.PR.F and NTL.PR.G) are now in bankruptcy protection and may be considered worthless. Although Floaters have some characteristics of money market instruments (e.g., protection against higher future interest rates), an investor will not necessarily get a return of capital over any given term. If he becomes disenchanted with the credit quality, the only thing to do is sell it on the market rather than let it "run off" to maturity. See *CMS*, October 2006, for more about credit quality and ratings thereof.

As if to hammer home my point, BCE preferreds (comprising Fixed Floaters and Ratchets) were downgraded on February 11: from P2 to P2(low) by Standard & Poor's, and from Pfd-2(low) to Pfd-3(high) by DBRS.

Perceived credit risk may explain the market cycles noted above. The first bear market noted above was heralded by the "Russian crisis" of August 1998, while the second is contemporary with the broader credit crisis we are currently experiencing. Chart 2 shows the prime rate and the current yield on Floaters for the past fifteen years, while Chart 3 plots the ratio between these two measures. In the absence of changes in credit, there should be a constant ratio between yields (perhaps occasionally perturbed by changes in dividend taxation).

Thus, based on a grand total of two cycles, one may speculate that investors in Floaters are dominated by fear; in good times, they are concerned about higher future interest rates destroying their capital and therefore buy Floaters, which get dumped during bad times due to fear of default. These are good fears to have and a certain amount of terror is an essential ingredient for successful investing, but one should never place 100% belief in any market scenario, whether of Nirvana or Armageddon.

Table 1 shows the calculation of yield spreads between floating rate issues and fixed-rate perpetuals of the same issuer. It would be very useful to compare the yields of the BCE fixed floaters and ratchets to a BCE straight perpetual, but – and this happens all too often – there is no data. However, given that we may assume that:

TABLE 1 - COMPARISON OF STRAIGHT AND FLOATER YIELDS

Straight Perpetual	Floater Ticker	Straight Dividend	Straight Bid Price	Floater Bid Price	Straight Yield	Floater Yield
BAM.PR.M	BAM.PR.B	1.1875	12.51	7.36	9.87%	7.24%
PWF.PR.K	PWF.PR.A	1.2375	17.37	11.06	7.07%	4.75%

All yields are calculated to perpetuity. Floater yield is calculated assuming a constant Canada prime of 3%. Two credit worthy and liquid Floaters are not reported: BAM.PR.K (duplicate name) and TRI.PR.B (no outstanding straight).

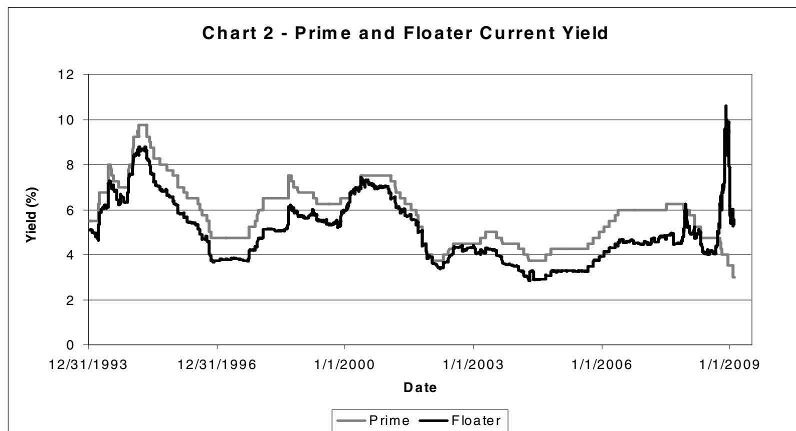
- The Ratchets will pay 100% of prime for the foreseeable future.
- The average bid on the Ratchets is $14.00.

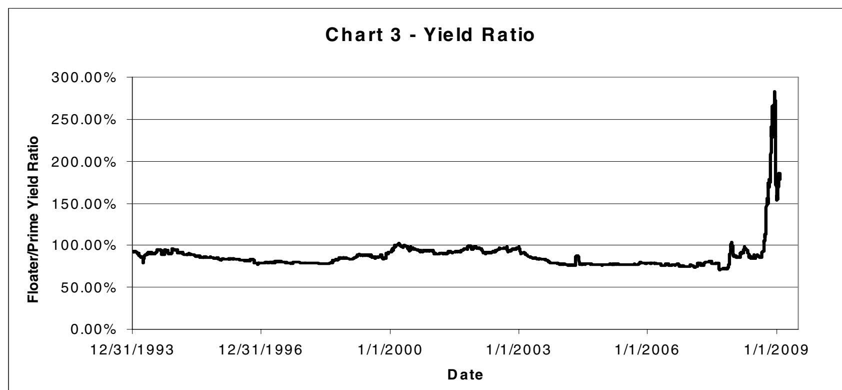
We may conclude that Ratchets are paying about 180% of prime relative to their market value, which is comparable to the relationship shown for Floaters in Chart 1.

The spreads shown in Table 1 are well above the range of the past fifteen years. The yield spread of Straights less Floaters over this period has an average of 35bp and a standard deviation of 117bp. The distribution is well-behaved with 80% of all observations being recorded in the interval from -100bp to +200bp.

We have now accumulated some data and may now attempt a hypothesis that will be tested over the next few years as, we hope, the world emerges from the current credit crisis:

- In bad times, monetary policy relaxes with yields on government bonds and administered rates (such as the Central Bank overnight rate and, therefore, prime) declining.
- However, bad times bring with them increased fear of corporate bankruptcy, increasing spreads of corporates to governments. The current crisis is remark-





able only to the extent that this normal response has been amplified.

- The yield on floating rate issues has two anchors:
  - ➛ Canada prime, on which the dividends are based, and
  - ➛ Straight Perpetuals, which are credit equivalent.
- The current crisis has taken these two anchors so far apart that normal links have snapped.
- The market price of Floaters is thus being hit with a double-whammy: dividends are decreasing with prime, while yields are increasing with Straights.
- An unwinding of the credit crisis, assumed to bring increasing prime and decreasing credit spreads, will prove extremely profitable for investors in Floaters. Contrary to situation with most Fixed Resets, the issues have significant room for capital gains before investors must fear a call.

Is this reasoning rational? The next few years will tell! I will point out, however, that many investors are purchasing Perpetual Discounts as an explicit market-timing call on a return of credit spreads to normal levels. This, however, provides only one source of excess returns: a decline in credit spreads. An investment in Floaters may well provide two sources of excess return, by realizing additional profit from increases in prime.

But all such investors are urged to diversify – I might be wrong!

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The Pick of PrefLetter

After the close on February 13, my monthly newsletter (www.prefletter.com) recommended IAG.PR.C among others for long-term buy-and-hold investors.

Type of Preferred	Fixed Reset
Quotation (2009-1-13)	$21.96-00
DBRS Rating	Pfd-2(high)
S&P Rating	P-1(low)
Moody's Rating	Not Rated
Annual Dividend	$1.55 Until 2013-12-31, then resets to 5-Year GOC +338bp
Yield-to-Worst Scenario	Limit Maturity
Yield-To-Worst	6.51% (Based on reset to 5.30% = $1.325)
Modified Duration, YTW	12.72
Pseudo-Convexity, YTW	1.84

IAG.PR.C **-** Redeemable every exchange date at 25.00. Rate resets to 5-Year Canadas + 338bp every exchange date, at which time it may be exchanged for Floaters. Exchange dates are 2013-12-31 and every five years thereafter. Next ex-date 2009-2-25 (declared). Fourth quarter results were poor due to equity market exposure and a decision to increase reserves against potential future declines. The MCCSR (Minimum Continuing Capital and Surplus Requirements) of the firm was approximately 200% on 2008-12-31 with a further drop in equities of 37% required before new capital is needed. The company is more exposed to segregated funds as a percentage of equity than ELF (E-L Financial), but less than SLF (Sun Life Financial). The excess provisioning for equity exposure helps mitigate this exposure. This issue had a disastrous underwriting (http://www.prefblog.com/?p=4159) and an even more disastrous repricing (http://www.prefblog.com/?p=4893). There may be a fair bit still left on the underwriters' books.