FixedResets After One Year

James Hymas

A new preferred share structure was introduced last year (see *Canadian MoneySaver,* [*CMS*], May 2008) which I have dubbed "FixedReset". A FixedReset issue has the following characteristics:

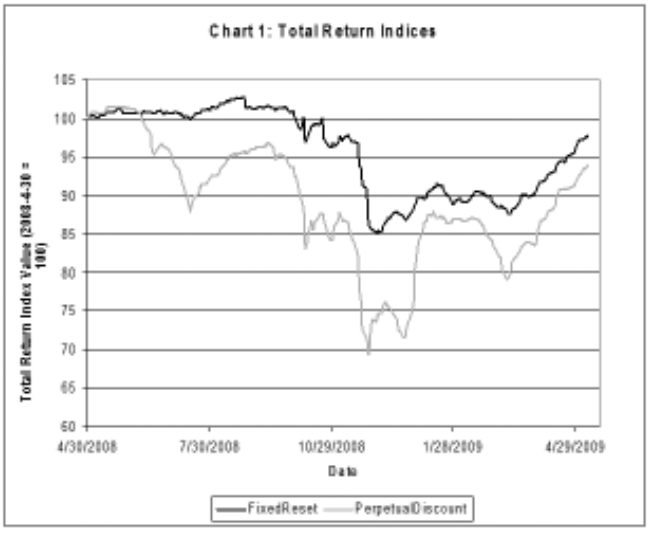
- Dividends are fixed until the first reset date.
- The first reset date occurs about five years after issue; subsequent reset dates are at five-year intervals.
- On every reset date:
  - The FixedReset dividend rate changes to a fixed spread over five-year Government of Canada bonds (5-Yr GoCs).
  - The issue may be exchanged at the holder's option to and from a "FloatingReset" that pays 3-month T-bills plus the same fixed spread, reset quarterly.
  - The issue may be called at par by the issuer.

This structure has proven to be extremely popular with both issuers and the investing public. I am now tracking thirty-six investment grade issues in my preferred share analytical software, HIMIPref™.

Many of the buyers are shell-shocked refugees from the PerpetualDiscount sector. PerpetualDiscounts have precisely the same credit quality as FixedResets, but pay a fixed rate and are redeemable at par any time after a given date. Many of these refugees made the mistake of confusing fixed-income with fixed-price securities and panicked when yields on these instruments rose, depressing their price substantially.

While I am no more capable of forecasting the future than anyone else, I consider it likely that these investors will be equally unhappy in a few years when their issues are called and they have to reinvest their funds at much lower yields. This isn't a prediction – it's just an observation on the way investment fads usually work out.

As may be seen from Chart 1, the market for both PerpetualDiscounts and FixedResets has been extraordinarily volatile over the past year but, critically, the market has risen substantially since a great burst of FixedReset issuance in January. These recent issues are now trading well above their call price, which both increases the chance that they will indeed be called at the first opportunity and limits the potential for further substantial gains. Even after the run-up, PerpetualDiscounts are still well below their call price and, subject to the usual caveats regarding credit quality, may reasonably be expected to continue to pay their agreed annual dividend far into the future.

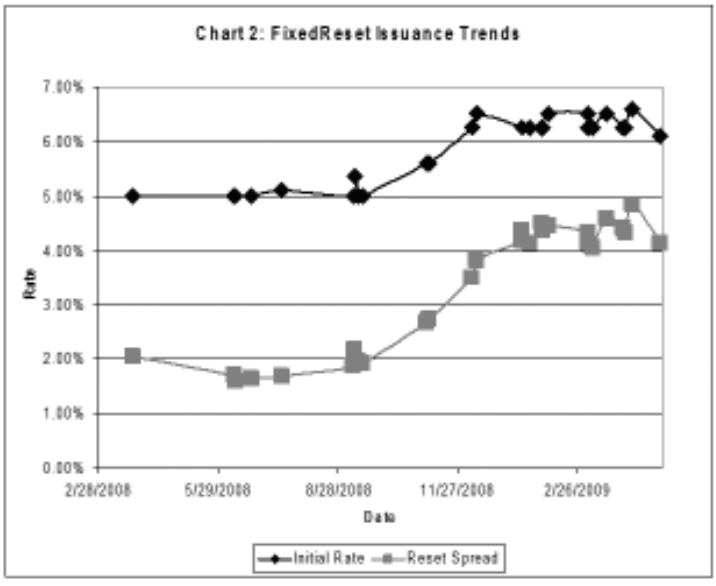


This increase in price, together with the increased heterogeneity of the FixedReset universe (as both the initial fixed rates and the reset spreads have moved up steadily through the year [see Chart 2]), has led to increased confusion amongst investors regarding valuation. Assuming one wishes to invest in the sector, how to choose the best one?

Current Yield

Surprisingly, many FixedReset investors go to great lengths to calculate current yield (current dividend/price) and base investment strategies upon the results, when a lot of effort could be saved simply by setting fire to their money.

Current yield is rarely a good indicator of expected return (see *CMS*, July/August 2006) and there are several factors that make it worse than usual for FixedResets in the current environment. Since most issues are now trading at a premium to their call price, a prudent investor will con-



sider the possibility of a call very seriously.

For example, RY.PR.R was quoted at 26.74-80 on May 5 and currently pays an annual dividend of 1.5625. Thus, the current yield is 1.5625/26.74 = 5.84%. However, the issue is callable at 25.00 on 2014-2-24. If called, an investor will lose more than an entire year's dividend in capital loss on redemption. When this capital loss is factored into the equation, the yield-to-call is 4.61% and experience has shown that the worst-case scenario for an investor is a better predictor of actual returns than current yield (see http://www.himivest.com/media/advisor_0606.pdf).

The other major influence making current yield a thoroughly bogus indicator of value is the reset. It should always be remembered that FixedReset issues are simply another class of Perpetuals (see *CMS*, June 2006) and that if the call is not exercised the dividend rate will be reset to a spread derived from 5-Yr GoCs, which may well be much different than it is today.

For example, TD.PR.S was quoted at 23.76-00 on May 5 and currently pays an annual dividend of 1.25. The current yield is 5.26%. However, the rate resets to a spread of 160bp (1.60%) on 2013-7-31. The yield of 5-Yr GoCs now is 1.85%. If this yield remains constant the rate will reset to 3.45% and the annual dividend will decline to 0.8625.

Yield-to-Worst

The Yield-to-Worst (YTW) of a preferred share, or any other fixed-income instrument, is derived by first listing the possible scenarios of future actions by the company or by the holder that will have an effect on returns (excluding default! Obviously, an instrument that defaults the day after purchase with no recovery will yield -100%, but YTW considers only those actions that are listed in the prospectus as non-defaulting options).

One scenario for RY.PR.R is computed above. If it is called in five years, the realized yield will be 4.61% from the May 5 bid. The other scenario of importance is that the issue resets on the stated date at its stated spread of +450, and the dividend rate becomes 5-Yr GoCs + 4.50% = 6.30% or $1.575, which (according to this scenario) it continues to pay forever. In such a case, the yield on the issue is 5.75%.

The YTW is the worst case of the scenarios examined and is therefore equal to 4.61%.

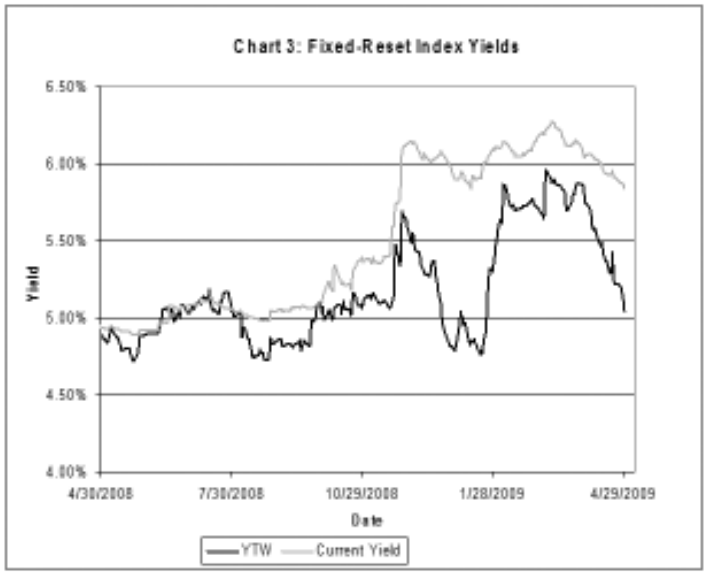
The Difference

I have written many times about the difference between YTW and current yield, but the recent gains in prices have increased this difference in the FixedReset market (see chart 3). There are certainly valid reasons why an investor might wish to buy a relatively low-yielding preferred share trading well above its call price (see *CMS*, March/April 2007), but investors should know these reasons and treasure them at the time of purchase, not react in surprise if an issue should be called at an inopportune time.

An Oddity

The reset feature brings with it a fascinating nuance that does not exist with PerpetualDiscounts.

Determining the YTW scenario for a PerpetualDiscount is fairly simple. If the issue is trading above its call price, then one should normally assume that it will be called. If below, one normally assumes that it will exist in perpetuity. An additional layer of sophistication is the consideration of the next ex-dividend date (see *CMS*, September 2006), but the basics are fairly easy.



FixedResets, though, have variable reset rates. The reset spreads against 5-Yr GoCs are selected so that based on conditions at the time of issue, there will be no change in the dividend paid when the reset becomes effective. One may derive an accurate graph of the market yield on 5-Yr GoCs at the time by plotting the difference between the initial rate and the reset spread shown in Chart 2.

Now that market spreads and overall rates have changed so dramatically, there are four issues that are trading above their call price but which nonetheless have a YTW scenario derived from the presumption that they will not be called. That is, the relatively low reset spread against 5-Yr GoCs implies that a reset to this rate will be worse for holders of the shares than would be a capital loss on the call date.

Two of these issues, IAG.PR.C and NA.PR.N, are trading at relatively low premia: 25.39 and 25.10 respectively. But the other two, GWO.PR.J and PWF.PR.M, are bid at 26.00 but their YTW scenario is a reset, not a call – something that very definitely does not happen with "straight" preferreds (those that pay a dividend fixed at the time of issue for their entire existence).

GWO.PR.J and PWF.PR.M were both issued in late November 2008, with an initial dividend rate of $1.50 or 6.00% p.a. The resets applicable approximately five years after issue are specified as 307bp (basis points) and 320bp, respectively. When we conservatively plug in the current 5-Year GoC rate of 1.85%, we find that the dividend may be predicted to reset to 4.92% and 5.05%, respectively, or $1.23 and $1.2625 in dollar terms. It will be worse for the holder to receive such relatively low dividends in perpetuity than to realize a capital loss of $1 on the reset date!

The Pick of PrefLetter

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

Type of Preferred	SplitShare
Quotation (2009-5-8)	$13.49-04
DBRS Rating	Pfd-2(low)
S&P Rating	Not Rated
Moody's Rating	Not Rated
Annual Dividend	$1.0875
Yield-to-Worst Scenario	HardMaturity 2019-1-10 at 25.00
Yield-To-Worst	13.08%
Modified Duration, YTW	6.81
Pseudo-Convexity, YTW	0.31

BNA.PR.C: Currently redeemable at $26.00 until 2016-1-9. Redemption price then declines by $0.25 annually until maturity of the issue 2019-1-10 at 25.00. Next ex-date: 2009-5-18 (estimated). This issue is backed by Brookfield shares (BAM.A). So despite the difference in ticker symbols it should be considered as exposure to BAM. Asset coverage of 1.8-:1 as of April 30 according to http://www.bamsplit.com/investor/nav.htm. Since then BAM.A has appreciated by 15.1% (to May 11). So current asset coverage may be estimated as 2.1-:1. This issue has a very attractive yield spread over BAM perpetuals, despite the advantage of having a fixed maturity date and deferred taxation on the capital gains component of the yield.

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