Preferred Share Benchmarks and Passive Funds

Forecasting is a tricky thing! Given that financial markets are inevitably more volatile than the real economy[1] and that long-term fluctuations in valuation are readily explainable in hindsight, there is a natural tendency to expect that future fluctuations can be predicted.

Alas, however, the financial world forms a chaotic system, by which is meant a system in which very small differences between measurements at the time of prediction can grow to become decisive differences at the time the prediction is evaluated. In the current Credit Crunch, to take just one example, relatively small differences in the loan-to-value ratio of American mortgages have proved to have had a major effect on the prices of securities based on these mortgages. It is possible, with hindsight, to say that such effects should have been anticipated – but the reasoning behind the explanation, so obvious when examined with the benefit of later knowledge, is somewhat more difficult to adapt to a prediction of what happens next.

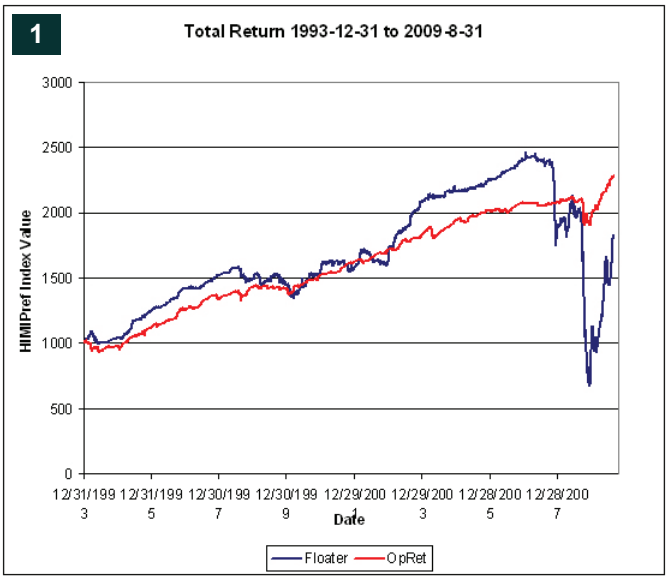
With this in mind, the prudent course for an investor is to maintain an asset allocation in his portfolio that reflects the broad characteristics of each asset class, each class having its own strengths and weaknesses that will be affected in different ways by each potential change in the financial world. Ideally, under any possible economic scenario, underperformance by any particular element of the portfolio will be counterbalanced by outperformance by another element; the classic example of this is a tropical island economy with two industries besides tourism: the manufacture of umbrellas and sun-tan lotion. By investing in both industries, an investor may hope to immunize his exposure to the vagaries of the weather, since the incidence of rain during tourist season will affect the performance of each investment in a different manner.

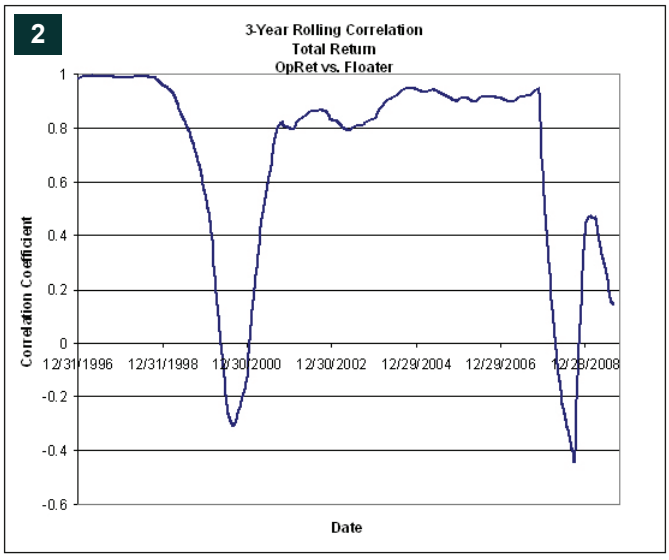
This is, of course, much easier to do in theory than it is in practice! Many American municipalities issued floating rate debt hedged by interest-rate swaps in the past few years, thereby reducing their fixed-rate interest costs provided that the historical relationship between their floating-rate cost of funds and LIBOR was maintained. Alas, the historical relationship became a victim of the Credit Crunch, with shocking consequences[2] and in response the Obama administration has recently introduced legislation that has the intent of restricting the use of OTC derivatives by small municipalities.[3]

In general, however, and while recognizing that historical relationships between economic conditions and asset class performance may not always be as adamantine as one might wish, portfolio management begins with selection of asset classes. Some investors will end their investigation at this step and buy index funds to reflect their choices, while others will seek to outperform within their asset class; reasoning that while it may not be possible to compare, say, resource equity apples to long term bond oranges, it might be possible to compare two more closely related investments with a view to improving relative returns in this manner.

Whatever one's views, it is important to have a proper benchmark, one that reflects the properties of the asset class under consideration, regardless of whether this benchmark will used to form a passive portfolio, or used to determine the incremental value added by active management. An investor seeking exposure to the broad stock market must ensure that his benchmark does, indeed, reflect the broad stock market; a long-bond index should reflect all long-bonds, not merely government or corporate sub-sectors. It is necessary to look through the marketing obfuscation to see just what comprises a particular benchmark, or portfolio that claims to reflect that benchmark: RBC Canadian T-Bill Fund, for instance, holds 32% of its assets in Provincial Treasury bills and 22% in uninsured bank deposits.[4]

Several benchmarks and passive portfolios are available for the Canadian preferred share market but they are by no means equivalent as they incorporate the various subsectors of the market in differing proportions. The fact that it is necessary to consider the sectoral composition of the differing investments is well illustrated by charts one and two, in which the "Floater" and "OperatingRetractible" HIMIPref™ subindices are compared for a lengthy period of time.





[1] See, for example, Refet S. Gürkaynak, Brian Sack,and Eric Swanson, *The Excess Sensitivity of Long-Term Interest Rates: Evidence and Implications for Macroeconomic Models,* 2003, available on-line at http://www.federalreserve.gov/Pubs/FEDS/2003/200350/200350pap.pdf (accessed 2009-9-11)

[2] E.g., Jefferson County. See Bloomberg, *FBI Probe of JPMorgan Fees Focuses on Swaps Roiling Muni Debt,* October 27, 2008, available on-line at http://www.bloomberg.com/apps/news?pid=20601109&sid=aIL9gsK5wG40&refer=home (accessed 2009-9-11)

[3] US Department of the Treasury, *Press Release TG-261,* August 11, 2009, available on-line at http://www.ustreas.gov/press/releases/tg261.htm (accessed 2009-9-11)

[4] RBC Asset Management, *RBC Canadian T-Bill Fund,* July 20, 2009, available on-line at http://www.rbcam.com/pdf/information/commentary/Qrmfbil.pdf (accessed 2009-9-11)

To review:

- The "Floater" subindex is comprised of issues which pay a fixed proportion of Canada Prime; e.g., BAM.PR.K pays 70% of Canadian Prime on its par value of $25.00
- The "OperatingRetractible" subindex is comprised of issues which are:
  - Issued by operating companies (i.e., this subindex does not include "SplitShare" issues)
  - Retractible for cash or a greater value of common stock at a specified date in the future (e.g., on and after July 31, 2011, holders may convert each share of CM.PR.A into the number of common shares determined by dividing $25.00 by the greater of $2.00 and 95% of the weighted average trading price of the common. It is anticipated that the bank will redeem at par rather than permit this conversion to take effect).

For descriptions of the other subindices, please see http://www.prefletter.com/whatPrefLetter.php.

Chart one shows that there is a huge difference in the volatility of investment returns that have been experienced over the last fifteen years, while chart two shows that these two types of preferred shares behave very similarly – except when they don't.

The differences between the risk and reward characteristics of each type of preferred share is the reason why Hymas Investment Management does not produce an overall preferred share index, restricting itself to the various HIMIPref™ subindices without taking the final step of combining them into one number – it is my view that such an index would obscure more than it illuminated.

There are those who disagree, however; both the BMO-CM "50" Preferred Share Index ("BMO-CM 50") and the S&P/TSX Preferred Share Index ("TXPR") are produced in an attempt to reflect the broad market. The latter index is designed to be "investible" – meaning that institutional investors have the ability to replicate index performance while trading in size – but retail investors may also gain exposure to the latter index, given that the Claymore S&P/TSX CDN Preferred Share ETF seeks to replicate the index composition within reasonable bounds.

TXPR was created in order to[5] *"serve the investment community's need for an investable benchmark representing the Canadian preferred stock market. The index is comprised of preferred stocks trading on the Toronto Stock Exchange that meet criteria relating to minimum size, liquidity, issuer rating, and exchange listing."*

The purpose of the BMO-CM 50 was originally defined by its predecessor, the "Burns Fry 50 Preferred Share Index", for which I have a note[6] stating *"In early December [1993] Burns Fry introduced the Burns Fry 50 Preferred Share Index designed to track the performance of the preferred share market in Canada. The index is comprised of 50 issues which are selected by screening the entire universe of preferred shares in Canada based on a preset list of criteria. These criteria can be broken down into four broad categories, share volume, dollar volume, credit rating and issue size".*

Besides the Claymore vehicle, another passive fund worthy of mention is Sentry Select's Diversified Preferred Share Trust, which[7] *"consists of an approximately equal dollar amount of dividend or distribution paying preferred shares and preferred securities that (i) are rated Pfd-1, Pfd-2 or Pfd-3 by DBRS, (ii) are listed on the Toronto Stock Exchange (the "TSX"), (iii) have an aggregate redemption value of $100 million or greater, and (iv) meet the other investment criteria referred to herein. The Preferred Portfolio is rebalanced quarterly so that at the time of rebalancing the Portfolio Securities included in the Preferred Portfolio are approximately equally weighted."*

And finally, for those who believe that active management can add value to a portfolio, all the above will be compared to my own Malachite Aggressive Preferred Fund, which seeks[8] *"to achieve a long-term capital growth in addition to a high level of after tax income through investment primarily in preferred shares and preferred securities listed on The Toronto Stock Exchange."* If I had known in 2001 that I was going to have competition, I'd have made the description more precise!

Data Preparation

CPD data (assumed equivalent to TXPR data) were obtained from Claymore as of 2009-8-18 via their website at http://www.claymoreinvestments.ca/etf/fund/cpd/holdings. Ambiguous issue descriptions were resolved through eMail query.

DPS.UN data were obtained from the *Semi-Annual Report* as of 2009-6-30[9]. The number of shares held of each issue was multiplied by that issue's 2009-8-18 closing bid to obtain values for each position (thus, portfolio changes after June 30 have been disregarded). This trust had a bank loan of $9.5-million on June 30, funding 5.2% of the trust's assets. The *Semi-Annual Management Report of Fund Performance* states[10]: *"The Fund does use a limited amount of borrowed money to enhance the yield return available to investors."* The effects of leverage have been ignored in the portfolio analysis.

Both of the above data sets had their raw figures adjusted to reflect the migration of several issues from the PerpetualDiscount to the PerpetualPremium subindex at the end of August.[11]

BMO-CM 50 data were obtained from BMO Capital Markets as of 2009-8-31.

MAPF data were obtained from the August 31 report of Portfolio Composition at http://www.prefblog.com/?p=7782.

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5 Standard & Poors, *S&P/TSX Preferred Share Index,* April 30, 2008, available on-line at http://www2.standardandpoors.com/spf/pdf/index/SP_TSX_Preferred_Share_Index_Factsheet.pdf (accessed 2009-9-11)

6 Burns Fry literature, not available on-line

7 Sentry Select, *Diversified Preferred Share Trust, Prospectus,* January 30, 2006. Available on-line at http://www.sentryselect.com/Theme/SentrySelect/files/pdf/D-F/DPST_prospectus_E_Jan2006.pdf (accessed 2009-9-11)

8 Hymas Investment Management, *Regulation: Malachite Aggressive Preferred Fund,* available on-line at http://www.himivest.com/malachite/MAPFRegulation.pdf (accessed 2009-9-11)

9 Available on-line at http://www.sentryselect.com/Theme/SentrySelect/files/pdf/SemiAnnual2009/DPSU_FS_F_6_30_2009.pdf (accessed 2009-9-11)

10 Sentry Select, *Diversified Preferred Share Trust, 2009 Semi-Annual Management Report of Fund Performance,* available on-line at http://www.sentryselect.com/Theme/SentrySelect/files/pdf/Salesheets/DPSU_MRFP_F_6_30_2009.pdf (accessed 2009-9-11)

11 Hymas Investment Management, PrefBlog, *HIMIPref™ Index Rebalancing: August 2009,* available on-line at http://www.prefblog.com/?p=7745 (accessed 2009-9-11)

Performance

DPS.UN has greatly outperformed CPD in the year to date, returning 34.2% by market price[12] vs. 23.60% for CPD[13]. There are several factors responsible for this outperformance:

- DPS.UN has made use of leverage
- DPS.UN is much more exposed to the PerpetualDiscount, Ratchet, FixedFloater and Floater sectors, which have outperformed
- DPS.UN is much less exposed to the FixedReset sector, which has underperformed
- DPS.UN has greater exposure to lower quality credits, which have outperformed

The outperformance by DPS.UN is not an artifact of the use of its market price; I have calculated the return by NAV to be 34.0%. The fund had a small margin debit at month-end (facilitating trade execution); tables in this analysis reflect the greater than 100% weight of the securities held.

The BMO-CM 50 has returned +27.58%, while MAPF has returned +63.34% – the latter greatly helped by active trading, as explained in the fund's reporting on PrefBlog[14]. The portfolio turnover of MAPF is routinely in the area of 100% per month, although August was relatively slow with a turnover of slightly less than 60%. It is to be anticipated that as the market heals, new entrants will make rational choices between issues and MAPF turnover will decline from its elevated level, as the increased efficiency will reduce arbitrage possibilities.

Sector Weightings

As discussed in the introduction, the preferred share market may not be perceived as monolithic – each type of preferred share has its own risk/reward profile, something that has been of great importance since the arrival of the Credit Crunch and the subsequent wild gyrations in market yields and perceived risk.

Table 1: Composition of Portfolios by Preferred Share Type, 2008-8-31

HIMIPref™ Subindex	CPD	DPS.UN	BMO-CM 50	MAPF
Ratchet	0%	3.6%	2.8%	0%
FixFloat	4.8%	5.3%	7.5%	0%
Floater	0%	3.0%	2.9%	0%
OpRet	24.9%	21.4%	21.7%	5.4%
SplitShare	0%	0%	0%	10.4%
InterestBearing	0%	0%	0%	0%
PerpPrem	5.4%	5.8%	0%	0.9%
PerpDisc	31.3%	48.6%	51.6%	67.2%
FixedReset	33.9%	12.3%	10.9%	17.4%
Unclassified	0%	0%	2.4%	0%

Data Source: Author's calculations. Please review the section "Data Preparation". Totals may not add to exactly 100% due to rounding.

Credit Quality

One of the great debating points in the Canadian preferred share market is the definition of "Investment Grade". According to DBRS[15] *"Preferred shares rated Pfd-3 are of adequate credit quality. While protection of dividends and principal is still considered acceptable, the issuing entity is more susceptible to adverse changes in financial and economic conditions, and there may be other adverse conditions present which detract from debt protection. Pfd-3 ratings generally correspond with companies whose senior bonds are rated in the higher end of the BBB category."*

It is tempting to conclude that, since even the lower end of the BBB category is considered investment grade for senior bonds, that the preferreds in this category must be investment grade as well. However, this ignores the fact that preferred shares are subordinated to the senior bonds of the issuer. When rating bank preferred shares, DBRS applies[16] a 'base-case' notching that relates the credit rating of the preferreds to senior debt of the same bank of five notches for a bank with senior debt graded at BBB(high): in the absence of adjustments to the base case, the preferred shares of this issuer will be rated BB(low) since there is *"More immediate pressure to raise capital, if needed, but may be more difficult for weaker BBB bank".*

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[12] Sentry Select, *Diversified Preferred Share Trust, Performance* as of August 31, 2009, available on-line at http://www.sentryselect.com/English/Products/ProductDetails/DiversifiedPreferredShareTrust/default.aspx#Performance (accessed 2009-9-11)

[13] Author's calculation

[14] See the various posts in the PrefBlog extract http://www.prefblog.com/?cat=12

[15] Dominion Bond Rating Service, *Rating Scales: Preferred Share,* available on-line at http://www.dbrs.com/about/ratingScales (accessed 2009-9-12)

[16] DBRS, *Methodology: Rating Bank Preferred Shares and Equivalent Hybrids,* June 2009, available on-line at http://www.dbrs.com/research/229438/rating-bank-preferred-shares-and-equivalent-hybrids.pdf (accessed 2009-9-12)

The performance of the lower grade preferred shares (that is, those rated Pfd-3(high) or lower) is much more company-dependent that the higher grade shares. There is certainly stratification of yields in the higher grades[17], but changes in yields of lower-quality instruments are much more headline- and financial-statement dependent – a bare assertion on my part, I admit, but one that I hope to quantify in future publications.

Table 2: Composition of Portfolios by DBRS Credit Rating, 2008-8-31

DBRS Credit Rating	CPD	DPS.UN	BMO-CM 50	MAPF
Pfd-1(low)	59.4%	47.4%	64.6%	80.6%
Pfd-2(high)	10.5%	10.7%	5.6%	3.8%
Pfd-2	3.7%	1.8%	2.9%	1.3%
Pfd-2(low)	7.6%	14.8%	9.1%	10.1%
Pfd-3(high)	13.4%	18.1%	13.4%	5.2%
Pfd-3	5.4%	4.6%	4.4%	0
Pfd-3(low)	0	2.6%	0	0

Data Source: Author's calculations. Please review the section "Data Preparation". Totals may not add to 100% due to rounding and cash effects.

The greater stratification and volatility for lower quality credits makes sense, because preferred shares represent a point on the seniority spectrum between stocks and bonds. Lower quality issues, being more dependent upon less certain prospects for the company to operate as a going concern, will be more equity-like than similar issues from higher rated corporations.

In any event, without getting into endless hair-splitting about the definition of "Investment Grade", Hymas Investment Management recommends that the proportion of issues in a preferred share portfolio that are rated Pfd-3(high) or lower should not exceed 10%, with no more than 5% in any single name. This should not be considered an iron rule, to be followed blindly regardless of circumstance. One good rationale for violating this general principle would be in the case of SplitShares: to take an extreme example, a split share issue trading at $5 with a par value of $10, but backed by a portfolio worth only $9 might be considered very likely to default; but it is also very likely that recovery on default will exceed the market price.

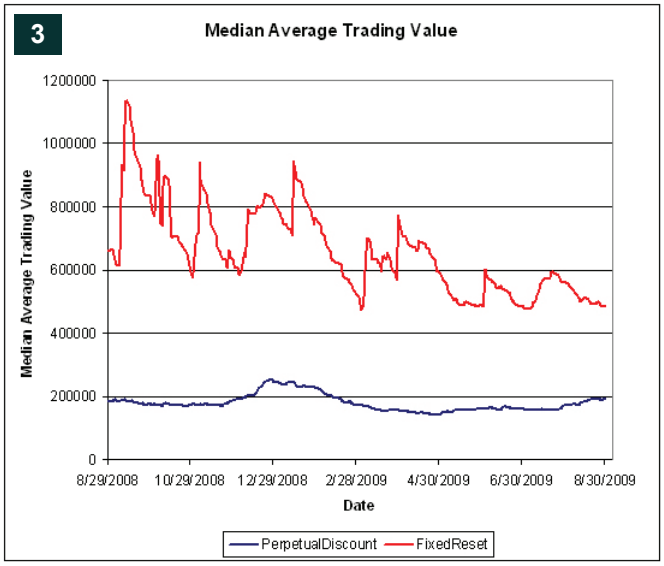
It is interesting to note that all three of the potential preferred share benchmarks examined in this essay violate the overall rule; although their exposure to individual names is limited.

Liquidity

Liquidity calculations are skewed by FixedReset issues, which as a class may be thought of as still being in their distribution phase: not only are the issues relatively unseasoned ("seasoning" is the process whereby the tendency of buy-and-hold investors to refrain from selling their holdings results in their holding an increasing proportion of any individual issue, resulting in declining liquidity over the life of a bond), but the stream of new issues (which appears to be slowly dwindling) gives all investors reason to engage in swaps between them.

Although the Average Trading Value as defined by the HIMIPref™ software (essentially an adjusted exponential moving average) for the FixedReset issues is declining, it is still very high; it is therefore very difficult to take a view on the relative expected liquidity of the various portfolios when taking, say, a one year view.

Chart 3 shows the calculated median Average Trading Value for the two main HIMIPref™ subindices, while Table 3 shows the breakdown of the various portfolios according to liquidity of the constituent issues.



[17] That is, yields of similar instruments with an identical credit rating will be persistently different. See my essay Credit Stratification, via http://www.prefblog.com/?p=2340 (accessed 2009-9-12)

Table 3: Composition of Portfolios by Average Trading Value				
Average Trading Value	CPD	DPS.UN	BMO-CM 50	MAPF
<50M	0.9%	10.3%	8.2%	0.3%
50M – 100M	2.1%	24.0%	5.4%	14.9%
100M – 200M	35.3%	28.8%	28.1%	2.5%
200M – 300M	18.3%	16.3%	29.5%	37.7%
>300M	43.4%	20.6%	26.2%	45.6%
Unclassified	0%	0%	2.4%	0%
Data Source: HIMIPref™, author's calculations. Please review the section "Data Preparation". Note that "Average Trading Value" is, essentially, an exponential moving average, is presented in units of dollars of trading daily, and that "M" means "thousand".				

Yield Measures

It is the yield measures that are most interesting when considering the passive funds. When investing in common stocks, or in individual preferred share issues, investors have come to expect a constant payout; while dividend cuts are certainly not unknown, they are sufficiently rare as to be considered a source of grievance. Dividend cuts have been routine in the past few years in the "Ratchet", "FixedFloater" and "Floater" subindices due to declining government and administered rates; in most cases, of course, a dividend cut on a preferred constitutes an effective default.

In October, 2006, Advisor's Edge Report published my essay *Closed End Preferred Funds: Effect of Calls*[18] in which I warned that the very high proportion of issues held by closed end funds that were trading above their call price led to the conclusion that their dividend pay-outs were unsustainable – as these issues with their high coupons were called, the principal would have to be reinvested in lower-coupon issues and the distributions from the fund would necessarily suffer.

Of the issues held by DPS.UN at the time of that essay, no less than 57.1% were trading at levels that indicated a probable call within five years. As it turns out, the forecast was gloomy in some respects – a YTW calculation assumes a constant market environment and the precipitous decline in market prices since that time has taken most of those issues below their call price. Holders might be forgiven for considering this a rather small blessing!

None-the-less, the passive funds still hold very large positions in OperatingRetractible and FixedReset issues; the former having it in their nature to disappear, while the latter are all trading well above their call price. With this in mind, we can compare the Current Yields to the Yields-to-Worst to gain some understanding of the prospects for future income distributions, as shown in Table 4.

Table 4: Yield Measures for the Portfolios Examined				
Yield Measure	CPD	DPS.UN	BMO-CM 50	MAPF
Current Yield	5.44%	5.50%	5.24%	5.80%
Yield-to-Worst	4.31%	4.90%	4.29%	5.85%
Data Source: HIMIPref™, author's calculations. Please review the section "Data Preparation", and see text for notes on treatment of issues with negative YTW.				

In order to prepare this chart, some liberties have been taken with the calculation of the average yield-to-worst. It is not uncommon – particularly in the OperatingRetractible subindex – for an issue to be trading above its current call price. This is not necessarily an indication of the obtuseness of preferred share investors; in many cases it reflects an analysis of the company's options in the current credit environment.

Consider, for example, CM.PR.R, which closed with a bid of 26.01 on 2009-6-30. It is currently callable at 25.60; the redemption price declines by $0.15 annually every April 30 until 2013-4-30 and is redeemable at $25.00 thereafter. The worst case scenario for a holder of the issue – barring default – is an immediate call which, after thirty days' notice, may be presumed to be effective July 30.

Such a call would result in a loss of 1.53% of principal (-18.58% annualized), but how likely is it? The issue pays $1.238 annually – from the company's perspective, they would be having to refinance the redemption price of 25.60 in order to save $1.238 in dividend payments per share. However, the redemption price is declining by $0.15 annually, so the effective cost of the funds is only $1.088. Thus, they are ahead only if they can borrow $25.60 at an annual cost of less than $1.088 – a yield of 4.25%.

Rightly or wrongly, the market is making the judgment that redemption is unlikely to be a winning proposition for the bank and that therefore the issue will not be called. If the issue does, in fact, survive until its SoftMaturity 2013-4-29 at 25.00, it will have yielded 3.85% from its purchase price of 26.01 and it is trading on this basis.

[18] Available on-line at http://www.himivest.com/media/advisor_0610.pdf (accessed 2009-9-12)

This is a very common analytical nuance with the OperatingRetractible sector[19], but does not mean that YTW as an analytical tool has been discredited – YTW has been shown to be a more accurate predictor of future returns than current yield[20].

One way or another, the inclusion of calculated YTWs that are both large and negative would skew the calculation of the overall portfolio YTW to the point of uselessness; although the annualized figures are large, the absolute figures are much less. Given the very short term until presumed call, incorporating the values into the mean would give them equal weight with instruments of much longer duration. Therefore, when calculating the portfolio average YTW for Table 4, all negative values were replaced with zero.

One puzzle that arises from examination of Table 4 is the relatively large difference between the calculated YTWs of DPS.UN and BMO-CM 50; the other metrics used in the comparison of the two portfolios do not make the difference easily explicable.

More detail about the composition of these two portfolios and the impact of this composition on the average YTW is provided in Table 5. Clearly, it is the OperatingRetractible sector that bears most of the blame for the difference – in this sort of analysis, it seems that it is always the OperatingRetractible sector that fouls up the arithmetic! – so the sector is further analyzed in Table 6.

Table 5: YTW Analysis by Sector for DPS.UN and BMO-CM 50

Sector	DPS.UN Weight	DPS.UN YTW	BMO-CM 50 Weight	BMO-CM 50 YTW
FixedReset	12.3%	4.06%	10.9%	4.07%
FixedFloater	5.3%	3.84%	7.5%	3.85%
Floater	3.0%	2.93%	2.9%	2.94%
OpRet	21.4%	3.85%	21.7%	1.45%
PerpDisc	51.1%	5.86%	51.6%	5.69%
PerpPrem	3.3%	3.88%	0%	0%
Ratchet	3.6%	4.16%	2.8%	4.14%
Unclassified	0%	0%	2.4%	N/A

Data Source: HIMIPref™, author's calculations. Please review the section "Data Preparation", and see text for notes on treatment of issues with negative YTW.

Table 6: Analysis of Credit Quality of OperatingRetractible Issues Only in DPS.UN and BMO-CM 50

Credit Rating (DBRS)	DPS.UN	BMO-CM 50
Pfd-1(low)	32.3%	63.0%
Pfd-2(high)	3.7%	13.8%
Pfd-2(low)	20.0%	9.2%
Pfd-3(high)	34.7%	14.0%
Pfd-3	4.7%	0.0%
Pfd-3(low)	4.6%	0.0%

Data Source: Author's calculations.

The fact that the average YTW in DPS.UN for the sector is much higher than in BMO-CM 50 is readily explained by reference to the average credit quality – in fact, it could hardly be otherwise, particularly given that four of the five issues representing BMO-CM 50's exposure to Pfd-1(low) OperatingRetractibles have a negative YTW.

DPS.UN does have exposure to some OperatingRetractibles with a negative YTW, however, which deserves some investigation. These issues are listed in Table 7.

The DPS.UN Prospectus states: *"The Preferred Portfolio consists of preferred shares and preferred securities that: … (f) have a yield to worst greater than 0%"* and *"The Trust rebalances the Preferred Portfolio quarterly to adjust for changes in the market value of the Portfolio Securities, to add any preferred shares or preferred securities which at the time of rebalancing newly qualify for inclusion and to remove any Portfolio Securities having an aggregate redemption value of less than $90 million and those that otherwise no longer meet the selection criteria."*

[19] See my essay *Retractible Preferreds and Bonds,* Canadian Moneysaver, February 2007, available on-line at http://www.prefblog.com/?p=659 (accessed 2009-9-12)

[20] See my essay *A Call, too, Harms* from the Advisors' Edge Report of June 2006, available on-line at http://www.himivest.com/media/advisor_0606.pdf (accessed 2009-9-12)

Table 7: DPS.UN Holdings of OperatingRetractible Issues with a Negative YTW on both 2009-6-30 and 2009-8-18

Ticker	Closing Bid, 2009-6-30	Relevant Option	YTW Scenario 2009-6-30	YTW 2009-6-30
ACO.PR.A	26.25	Currently callable at 26.00	Call 2009-7-30 at 26.00	-0.82%
CM.PR.A	25.86	Currently callable at 25.50	Call 2009-7-30 at 25.50	-16.52%
CM.PR.R	26.01	Currently callable at 25.60	Call 2009-7-30 at 25.60	-18.58%
GWO.PR.E	25.75	Currently callable at 25.50	Call 2009-7-30 at 25.50	-7.15%
IGM.PR.A	26.17	Currently callable at 26.00	Call 2009-7-30 at 26.00	-2.40%
PWF.PR.D	26.30	Currently callable at 25.80	Call 2009-7-30 at 25.80	-8.02%
PWF.PR.J	26.12	Currently callable at 25.75	Call 2009-7-30 at 25.75	-3.58%

Yield to worst is a defined term – and quite properly defined – in the DPS.UN prospectus:

- "yield to call" means the yield that would be realized on a callable security, in the event the security was redeemed by the issuer on the next available call date
- "yield to maturity" means the yield that would be realized on a security if the security was held until the maturity date
- "yield to worst" means the lowest of all yield to calls or the yield to maturity

I will emphasize that I have not examined DPS.UN's portfolio on 2009-8-18; throughout this essay I have taken the portfolio as it existed on 2009-6-30 and assumed it was held constant until the August 18 date on which the calculations are based. However, it will be a worthwhile exercise to determine whether or not these issues have been sold – and if not, why not.

With respect to the sustainability of dividends, it is again DPS.UN that presents special problems. On August 19, the day after the effective date of these calculations, the NAVPU of DPS.UN was $20.29[21] and the indicated annual dividend was $1.20 p.a.[22], a rate of 5.91%. The Management Expense Ratio (excluding issue costs and interest) was 0.44% in 2008[23], so in order to maintain a stable NAVPU the fund must earn about 6.35% p.a. on its investments.

The current yield on the portfolio is 5.50%, while the YTW is 4.90%: the unit value is not sustainable given the current dividend. This is borne out by the fund's characterization of its distribution for tax purposes[24]: over one-third of the distribution is return of capital. While this attribute of the fund is largely irrelevant to the determination of its attractiveness as an investment, I have little doubt but that there will be many investors who find themselves unpleasantly surprised as the fund copes with either the constant drag on NAV or a dividend cut.

Conclusion

After this analysis, readers might be forgiven for asking for a clear recommendation of one of the passive vehicles over another – to the undoubted surprise of some cynics, I will restrain my natural inclination to recommend my Malachite Aggressive Preferred Fund.

Sadly, a simple choice is not possible. Some investors, having particular portfolio objectives, will choose one; other investors with differing objectives will choose the other. The important thing to realize is that not all passive vehicles are identical; as noted earlier, the preferred share market in Canada is too heterogeneous to be treated with such simplicity and it is necessary to look inside each vehicle and determine its holdings.

[21] Sentry Select, *Diversified Preferred Share Trust – Historical NAVs,* on-line at http://www.sentryselect.com/English/Products/ProductDetails/DiversifiedPreferredShareTrust/HistoricalNAVs/default.aspx (accessed 2009-9-12)

[22] Sentry Select, *Diversified Preferred Share Trust – Distribution History,* on-line at http://www.sentryselect.com/English/Products/ProductDetails/DiversifiedPreferredShareTrust/Distributionhistory/default.aspx (accessed 2009-9-12)

[23] Sentry Select, *2008 Annual Management Report of Fund Performance,* on-line at http://www.sentryselect.com/Theme/SentrySelect/files/pdf/AnnualMRFP2008/DPST_MRFP_12_31_2008.pdf (accessed 2009-9-12)

[24] Sentry Select, *Diversified Preferred Share Trust: Distributions,* on-line at http://www.sentryselect.com/English/Products/ProductDetails/DiversifiedPreferredShareTrust/default.aspx#Distributions (accessed 2009-9-12)