

A Comparison of Some Preferred Share Funds

The preferred share fund universe has gotten a lot larger since I opened Hymas Investment Management Inc. as a preferred share specialist twelve years ago! At that time there were no public funds available for small investors – and while there may have been private, non-prospectus funds available via some investment managers, I’m not aware of any.

Since then many funds have established themselves, with great success:

FD-2: Assets Under Management		
Fund Name	Fund Ticker	Assets Under Management
iShares S&P/TSX Canadian Preferred Share Index Fund ¹	CPD	\$1,327-million
Diversified Preferred Share Trust ²	DPS.UN	\$144-million ³
Omega Preferred Equity		\$483-million ⁴
Jov Leon Fraser Preferred Equity Fund ⁵		\$45-million ⁶
Manulife Preferred Income Fund ⁷		\$94-million
Horizons AlphaPro Preferred Share ETF ⁸	HPR	\$68-million ⁹
Malachite Aggressive Preferred Fund ¹⁰		\$6-million

There are others, but the above are the ones I track and report regularly for benchmarking purposes.

Extraction of Fund Portfolios

iShares S&P/TSX Canadian Preferred Share Index Fund (CPD)

Data were downloaded from the holdings page¹¹ immediately following August 31. There were several ambiguous descriptions (e.g., “BANK OF MONTREAL NON CUM 5 YR RT RESET CL B PFD” could be any one of several BMO issues), but fortunately the fund holds so many positions (163!) that assignments of these ambiguities to specific securities could be made confidently.

Diversified Preferred Share Trust (DPS.UN)

Data were obtained from the Interim Financial Statements for June 30, 2012.¹² The fund had a position in CU.PR.A, which was redeemed on July 19;¹³ this position has simply been eliminated from the portfolio analyzed (this is the same thing as assuming that redemption proceeds were invested in existing holdings in proportion; or assuming that the funds were utilized to buy back fund units at their NAV).

Omega Preferred Equity

Data were obtained from SEDAR.¹⁴ The list of BCE issues under the heading “Floating-Rate, Redeemable”, includes both “5.00%, Series AJ” and “Series AJ”. I have rather arbitrarily decided that the second of these is actually BCE.PR.B.

¹ http://ca.ishares.com/product_info/fund/overview/CPD.htm

² <http://www.sentry.ca/en/funds/structured-products/dpst.html?seriesId=163>

³ http://www.sentry.ca/assets/docs/17_49_2012_09_12_09_49_06_en.pdf

⁴ <http://www.nbc.ca/bnc/files/bncfunds/en/2/480.pdf>

⁵ <http://www.jovfunds.com/public/ProductsMaterials.aspx>

⁶ http://jovian.transmissionmedia.ca/fundprofile_jov.aspx?f=JOV110

⁷ <http://pricesandperformance.manulifemutualfunds.ca/manulife/profiles/en/72129/fund/html/>

⁸ <http://www.hapetfs.com/pub/en/etfs/?etf=HPR&r=o>

⁹ <http://www.horizonsetfs.com/Pdf/Financials/InterimReports/2012/HPR-EN-IR2012.pdf>

¹⁰ <http://www.himinvest.com/malachite/MAPFMain.php>

¹¹ http://ca.ishares.com/product_info/fund/overview/CPD.htm

¹² http://www.sentry.ca/assets/docs/17_49_2012_09_12_09_49_06_en.pdf

¹³ http://cnrp.marketwire.com/cnrf_files/20120618-n618cu.pdf

¹⁴ <http://www.sedar.com>, Omega Preferred Equity Fund, August 29, 2012, Interim financial statements/report – English

Jov Leon Fraser Preferred Equity Fund

Data were obtained from the 2012 Interim Financial Statements¹⁵ for 2012-6-30; the fund held CU.PR.A and CU.PR.B, both of which have been redeemed and are treated as with DPS.UN.

Manulife Preferred Income Fund

Data were obtained from the Interim report dated June 30, 2012.¹⁶ The fund holds three issues of Innovative Tier 1 Capital (approximately 7.1% of the portfolio) and these were ignored for the purpose of portfolio analysis; a cash-equivalent position of 2.4% of the portfolio was also discarded.

I heartily approve of the holding in Innovative Tier 1 Capital, which is functionally equivalent to preferred shares but pays interest income rather than a dividend – as might be expected, the interest income will generally be higher than dividend income due to the taxation effects. Interest revenue for 12H1 was \$172,000, just under 10% of the fund's income, and served to offset almost exactly the fund's expenses for the period – although not, alas, the management fee of \$653,000 (over one-third of fund income). To the extent that pre-tax interest income will be higher than dividend income from comparable securities, it makes sense to include interest-bearing securities in a dividend fund for the purpose of paying expenses; paying these charges with dividend income means the investors are losing the benefit of the dividend gross-up and tax credit.

There was one ambiguous entry on the list of securities held: "TransCanada Pipelines Limited, 5.60%, Preferred" could be either TCA.PR.X or TCA.PR.Y; I have arbitrarily assigned it to the former.

Horizons Preferred Share ETF

Data were obtained from the Interim Report dated June 30, 2012.¹⁷ Several issues were discarded from the portfolio prior to analysis:

- ALA.PR.U (USD)
- ENB.PF.U (USD)
- UNG.PR.C (not tracked by HIMIPref™)
- CPD (an index fund)
- CU.PR.B (redeemed)

The fact that HPR holds a significant position in CPD is interesting. It is certainly not unknown for actively managed portfolios, particularly in sectors where liquidity can be a problem, to hold a position in a very liquid ETF in order that cash can be raised quickly and with little, if any, market impact to meet client cash requirements (in the case of a mutual fund, redemptions) or as a reserve (in the event a buying opportunity is perceived without a simultaneous selling opportunity).

According to the prospectus, HPR is at least somewhat exposed to the need to meet client cash demands: *The Manager, on behalf of each ETF, has entered into and may enter into agreements with registered dealers (each a "Designated Broker" or "Dealer") which, amongst other things, enables such Designated Brokers and Dealers to purchase and redeem Units directly from the ETFs. Holders of Units of an ETF (the "Unitholders") will be able to redeem Units in any number for cash at a redemption price of 95% of the closing price for the Unit on the TSX on the effective day of redemption (the fraction is 100% less a relatively small redemption charge if a minimum number of units is redeemed). Further, An ETF may not deduct interest on borrowed funds that are used to fund redemptions of its Units.*

The practice of holding an ETF as a cash reserve in an actively managed equity portfolio is similar to holding a benchmark, or recently off-the-run government issue in an actively managed bond portfolio. While I agree that arguments exist in favour of the practice, I generally deprecate the approach as this is not what active managers are supposed to do. Limit orders to sell some of the more expensive securities held in the portfolio can be placed to an amount greater than the sum required; as orders are gradually filled, the excess can be gradually adjusted and cancelled.

Assignments to Classes by Funds

iShares S&P/TSX Canadian Preferred Share Index Fund (CPD)

The interim financial report for June 30, 2012,¹⁸ lists securities according to the sector of the issuer rather than by type of preferred, continuing the policy used by Claymore in the year-end financial statements.¹⁹ The fund's "Overview" page on the web provides a breakdown by type, but does not provide any indication of how these types are defined.

- Fixed/Floaters 61.20 %
- Straight/Perpetual 35.94 %
- Convertible 2.86 %

¹⁵ <http://www.jovfunds.com/ProductMaterials/MutualFunds/Jov%20Leon%20Fraser%20Preferred%20Equity%20Fund/Interim%20Financial%20Statements%20-%20JovFunds%20-%20June%202012.pdf>

¹⁶ <http://www.sedar.com>, "Interim financial statements/report – English", August 29, 2012

¹⁷ <http://www.horizonsetfs.com/Pdf/Financials/InterimReports/2012/HPR-EN-IR2012.pdf>

¹⁸ <http://claymoreinvestments.ca/docs/literature/2012-interim-management-report-of-fund-performance-and-semi-annual-financial-statements.pdf>

¹⁹ <http://claymoreinvestments.ca/docs/literature/2011-annual-management-report-of-fund-performance-annual-financial-statements---cpd.pdf>

Diversified Preferred Share Trust (DPS.UN)

The financial statements assign the issues to held to four major classes:

- “Fixed/Floater Preferred Shares” (24.07%) contains a large number of FixedResets, but there are also a number of odd assignments to this class – for instance:
 - BMO.PR.H, HSB.PR.D, MFC.PR.C, RY.PR.D, RY.PR.B, BNS.PR.K, BNS.PR.J, BNS.PR.N, TD.PR.O, TD.PR.R DeemedRetractibles
 - BCE.PR.A, a FixedFloater
 - BAM.PR.N, a PerpetualDiscount.
 - BPO.PR.F, L.PR.A, OperatingRetractibles
- Floating Rate Preferred Shares (12.86%) is largely RatchetRate and Floater preferred shares, but there are others:
 - BCE.PR.F, BCE.PR.R, BCE.PR.C, BCE.PR.I FixedFloaters
- Perpetual Preferred Shares (54.33%) is largely Straight Perpetuals – but not always!
 - ALA.PR.A, BAF.PR.C, BAM.PR.P, CM.PR.M, ENB.PR.B, ENB.PR.D, ENB.PR.F, ENB.PR.H, GWO.PR.N and many other FixedReset
- Retractable Preferred Shares (14.25%) – there are indeed retractable shares in this section, but plenty of others!
 - BMO.PR.O, BMO.PR.P, BMO.PR.Q, BPO.PR.L, FTS.PR.H, TD.PR.C, TD.PR.E, TD.PR.G and TD.PR.K, FixedResets
 - FTS.PR.F, Straight Perpetual
- Leverage ((5.51%))

Omega Preferred Equity

The portfolio data contained in the semi-annual report contained some very puzzling assignments of preferred share issues to the various specified classes:

- “Fixed-Rate, Retractable or Redeemable” is a class that would seem to contain quite a few issues, but in fact only four are listed; three of these are Split Shares from BAM Split Corp (BNA), but the fourth is “Bank of Montreal 5.80%, Class B, Series 15”, which is BMO.PR.L, a DeemedRetractible.
- A much larger class is “Fixed-Rate, Redeemable” (already we have a problem: there would appear to be considerable overlap between this class and the one above) and the first ten entries are AIM.PR.A (FixedReset), BMO.PR.H (DeemedRetractible), BMO.PR.P (FixedReset), BNS.PR.Q (FixedReset), BNS.PR.R (FixedReset), BNS.PR.J (DeemedRetractible), BNS.PR.T (FixedReset), BCE.PR.G (FixedFloater), BCE.PR.I (FixedFloater), BCE.PR.R (FixedFloater) and BPP.PR.M (Floater). I am unable to detect any pattern for inclusion in this group.
- The next group is “Fixed-Rate, Retractable” (again, we have the problem of overlap with the first group), which is comprised of five issues: BPO.PR.J (OperatingRetractible), DC.PR.A (OperatingRetractible), PWF.PR.H (PerpetualPremium), TCA.PR.X (PerpetualPremium) and TCL.PR.D (FixedReset). Again, I am unable to detect any pattern for inclusion in this group.
- The following group “Fixed-Rate, Non Redeemable” is rather staggering in its simple existence, as I am unaware of any Canadian preferred shares that are not redeemable, other than a handful of SplitShares which – a pedant might argue – have maturities, with no interim call. However, this group starts with BMO.PR.K (DeemedRetractible), BMO.PR.M (FixedReset), BMO.PR.N (FixedReset) and BMO.PR.O (FixedReset). You guessed it! I am unable to detect any pattern for inclusion in this group.
- The penultimate group is “Floating-Rate, Redeemable”, which starts the list with five BCE issues, including both “5.00%, Series AJ” and “Series AJ” which is rather perplexing. Three of these are RatchetRate, one is a FixedFloater ... and I don’t know what the second “AJ” refers to! The group also includes such issues as GWO.PR.J (FixedReset), BAM.PR.C (Floater) and several other FixedResets.
- The final group is “FloatingRate, Retractable”, which is comprised solely of GWO.PR.M, which is a DeemedRetractible.

Jov Leon Fraser Preferred Equity Fund

The fund’s financial statements²⁰ avoid the pitfalls of classification by structure through the expedient of reporting by sector:

- Financials (53.3%)
- Utilities (18.8%)
- Energy (13.1%)
- Telecommunication Services (5.3%)
- Consumer Staples (5.2%)
- Consumer Discretionary (2.0%)

²⁰ <http://www.jovfunds.com/ProductMaterials/MutualFunds/Jov%20Leon%20Fraser%20Preferred%20Equity%20Fund/Interim%20Financial%20Statements%20-%20JovFunds%20-%20June%202012.pdf> 24

Manulife Preferred Income Fund

This fund also follows the safe course of emphasizing issuer sectors and avoiding structural reporting:

- Energy (15.4%)
- Industrials (2.5%): a bit odd – the sole holding in this sector is VSN.PR.A, which would generally be classed as “Energy”
- Consumer Discretionary (7.4%)
- Consumer Staples (3.1%)
- Health Care (1.3%): another oddity – the sole holding is POW.PR.G, which most would class as a financial.
- Financials (33.2%)
- Telecommunication Services (8.5%)
- Utilities (18.0%)

Horizons Preferred Share ETF

The fund’s financial statements also follow the safe course of avoiding structural reporting by emphasizing issuer sectors:

- Financials (73.7%)
- Energy (7.4%)
- Preferred Indices (5.2%)
- Telecommunication Services (5.0%)
 - All but one issue is BCE ... the exception is BAF.PR.C
- Utilities (4.5%)
- Consumer Staples (2.1%)
- Information Technology (0.6%)
 - Allocation comprised entirely of BAF.PR.A
- Consumer Discretionary (0.0%)

Fund Facts

iShares S&P/TSX Canadian Preferred Share Index Fund (CPD)

The Fund Facts for June 30, 2012,²¹ repeats the information provided in the financial statements and the fund’s web page regarding sector composition of the fund.

The only mention of expenses comes with the disclosure that the Management Fee is 0.45%. There is no disclosure of other expenses or taxes applied to the Management fee. The fund’s ‘Overview’ web page²² discloses that while Management Fees are 0.45%, the Management Expense Ratio as of 12/31/11 was 0.50%.

“Risk” is not categorized in the Fund Facts; it appears that the fund is covering this requirement by quoting the Average Annual Return (4.21%) and Annualized Standard Deviation (7.08%) of the base TXPR index from 2002-12-31 to 2012-6-30 and claiming that the source of their data is TSX Datalinx. Oddly, when I attempt to recover index data from DataLinx for the period 2002-12-31 to 2007-6-30, all I get is the single 2007-6-30 value. The S&P Fact Sheet for the index²³ states “The inception date for the S&P/TSX Preferred Share Index was April 3, 2007 at the market close. All information presented prior to the index inception date is backtested. The back-test calculations are based on the same methodology that was in effect when the index was officially launched.” The S&P Methodology²⁴ for the index states “The indices base dates are July 19, 2002. The base value, for the price return and total return series, on that date is 975.14 and 975.01, respectively. Historical daily returns are available beginning on July 19, 2002.”

The question of the propriety of using backtested index data as a risk measure may be decided by the reader; I will note that the inclusion of the backtested data might be expected to reduce the standard deviation of monthly returns compared to that following 2007-6-30. The standard deviation of the monthly returns of the TXPR Total Return Index for the 60 months ended 2012-6-30 was 2.72%, which is annualized by multiplication by the square root of twelve to 9.42%; considerably greater than the 7.08% claimed for the longer period by the fund company.

²¹ http://ca.ishares.com/content/stream.jsp?url=/content/en_ca/repository/resource/fact_sheet/cpd_en.pdf

²² http://ca.ishares.com/product_info/fund/overview/CPD.htm

²³ <http://ca.spindices.com/documents/factsheets/fs-sp-tsx-preferred-share-index-ltr.pdf>

²⁴ <http://ca.spindices.com/documents/methodologies/methodology-sp-tsx-preferred-share-index.pdf>

Additionally, alert readers will have noted that the fund company reports the “Average Annual Return”, which will not be as much as the Annualized Return due to the volatility. The average monthly return for the 60 months ending in June, 2012, was 0.33%; when multiplied by 12 to get an average annual value, we obtain 3.99%. Alternatively, the five individual years in that period reported returns (in chronological order) of -6.25%, 0.15%, 9.70%, 11.47% and 3.98% with an arithmetic average of 3.81%. Both of these ‘Average Annual’ values may be compared with the five-year annualized return of 3.61%. The differences are significant!

It must be remembered that none of the three methods of calculation described above may be described as “wrong”. They merely use different conventions and the very significant differences between the figures simply illustrate that investors should verify that numbers that appear comparable have in fact been calculated in a comparable manner.

Diversified Preferred Share Trust (DPS.UN)

There is no “Fund Facts” document available.

Omega Preferred Equity

The Fund Facts dated August 28, 2012²⁵ does not reflect the classification scheme of the financial statements, reporting (as of July 31):

- Fixed Rate 37.3%
- Fixed-Reset 47.5%
- Retractable 12.4%
- Floating Rate 0.5%
- Floating – Reset 2.3%

The risk is described as “Low to Medium”.

The Advisor Series MER is 1.46% and the TER 0.28%, for a total of 1.74%.

The “O Series” MER is 0.02% and the TER 0.28% for a total of 0.30%. However, “For the O Series, the management fees are negotiated with National Bank Securities Inc. and paid directly by investors (maximum of 1.25%).”

The “F Series” MER is 0.60% and TER of 0.28% for a total of 0.88%, but “The F Series is only offered to investors who have entered into an agreement to pay fees directly to their dealer. These investors pay their dealer annual compensation based on the asset value of their account.”

In sharp distinction to CPD, the fact sheet for CPD makes the method of its return calculation explicit: *A person who invested \$1,000 in the series of the fund since its inception now has \$1,266. This works out to an annual compound return of 5.15%.*

Jov Leon Fraser Preferred Equity Fund

The Fund Facts for Series A²⁶ repeats the classification of preferred shares according to the industrial classification of the issuer that is reported in the financials.

The risk is described as “medium”.

Performance is shown by calendar year returns and as an annualized compound figure from inception January 26, 2009 to April 30, 2012.

The MER is reported as:

- Series A: 1.93% + 0.03% TER
- Series F²⁷: 1.18% + 0.03% TER
- Series I²⁸: 0.39% + 0.03% TER
- Series T²⁹: 1.84% + 0.03% TER

²⁵ <http://www.sedar.com>, Omega Preferred Equity Fund, September 6, 2012, “Amended and restated final fund facts – English”

²⁶ <http://www.jovfunds.com/ProductMaterials/MutualFunds/new%20fund%20fact%20sheets/english/FFS%20-%20Jov%20LF%20Pref%20Equity%20-%20Ser%20A.pdf>

²⁷ <http://www.jovfunds.com/ProductMaterials/MutualFunds/new%20fund%20fact%20sheets/english/FFS%20-%20Jov%20LF%20Pref%20Equity%20-%20Ser%20F.pdf>

²⁸ <http://www.jovfunds.com/ProductMaterials/MutualFunds/new%20fund%20fact%20sheets/english/FFS%20-%20Jov%20LF%20Pref%20Equity%20-%20Ser%20I.pdf>

²⁹ <http://www.jovfunds.com/ProductMaterials/MutualFunds/new%20fund%20fact%20sheets/english/FFS%20-%20Jov%20LF%20Pref%20Equity%20-%20Ser%20T.pdf>

Manulife Preferred Income Fund

SEDAR returns a document³⁰ 1,883 pages long, which appears to be the “Fund Facts” for every class of every mutual fund offered by Manulife.

Holdings are classified by industrial sector, as in the financial statements.

Performance is shown by calendar year returns and as an annualized compound figure from inception April 20, 2009, to July 5, 2012.

Risk is described as “Low”.

Expenses are disclosed as:

- Series A: 2.25% MER + 0.05% TER
- Series F: 1.29% MER + 0.05% TER
- Series FT6: New class; 1.00% management fee
- Series I: 0.15% MER + 0.05% TER
- Series IT: New class; negotiable management fee
- Series T6: New class; 2.00% management fee

Horizons Preferred Share ETF

There is no “Fund Facts” document available.

Investment Conclusions

It's too early for conclusions, I've only just finished describing the data!

It is clear, however, that the funds report to unitholders in an inconsistent manner, sometimes (as is often the case with reporting the structural breakdown of the fund) not even internally consistent. While this is clearly an indication of a certain level of sloppiness, it should not necessarily be taken as a reflection of the portfolio manager's skill, as the portfolio manager will typically be involved in the audit and preparation of financial statements in a very minor way, if at all.

However, it does show that there can be no such thing as a casual investment in a preferred share vehicle, as (unlike bond funds) funds and their strategies cannot be compared directly via summaries prepared by the fund companies with any confidence whatsoever.

A future appendix to this newsletter will show the structural breakdown for all of the funds listed above in a consistent manner.

³⁰ <http://www.sedar.com> “Final fund facts – English”, August 1, 2012