



Credit Stratification

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One of the most important things to keep in mind throughout the investment process is the principle of diversification. Diversification is the practice of creating an investment portfolio by selecting its components with reference to the portfolio's other elements. In the *Canadian MoneySaver (CMS)* of July/August 2007, for instance, I recommended that issues with a lower credit rating be sharply constrained in terms of total weight and of maximum weight per name. I also advised that it was so important that smaller investors, unable to diversify efficiently due to trading costs, should restrict their preferred share investments to the various investment vehicles made available by professional managers and fund sponsors.

At the most basic levels, we diversify our portfolios because we cannot predict the future with a lot of assurance. An investment may look foolproof – high returns, low risk, all that good stuff – and after all the analysis a wise investor will always ask the question: “But, what if I’m wrong?”

The classic example of diversification is to offset an investment in a suntan lotion factory with an investment in an umbrella manufacturer. Rain or shine, the effects of weather will be offset, leaving you with portfolio returns that will better reflect the long-term prospects of the underlying companies.

The most recent widely publicized example of improper diversification has occurred in the Canadian Asset Backed Commercial Paper (ABCP) market, with several investors claiming that their companies are crippled, or their life savings at risk due to overly large investments in this asset class. Those who placed 5-10% of their investment portfolio in this asset class have all my sympathy; the paper looked entirely reasonable to me, too! Those who placed more than 10% in these structured vehicles didn't diversify enough.

It was the collapse of the ABCP market that heralded the onset of the current Credit Crunch, as discussed in the January 2008 edition of *CMS*. As discussed in that article, the Credit Crunch may be blamed in a large part for the widening of spreads between preferred shares in general and their Canada bond benchmarks, but there is another effect

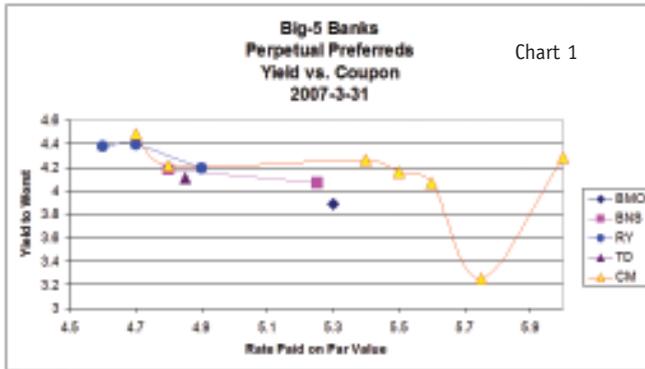
that needs to be examined. It is not just the return and yield of this asset class relative to Canadas that has been affected, but also the returns and yields of the individual components of this class relative to each other that needs to be examined.

Issues with very similar terms from different issuers, even different issuers with the same credit rating, have behaved very differently in recent times and this further illustrates the need for effective diversification, not just by the investment type, but by the issuer – even when investing in fixed income.

Specifically, we will have a look at some “perpetuals”. Perpetuals, as explained in the *CMS* of June 2006 are issues for which there is no way any investor can force the issuer to return the money invested. The issuer has the option to redeem and the issuer has an obligation to pay the stated dividends on the issue, but there is no obligation for the issuer ever to pay back the original capital investment. Investors wishing to get their capital back must sell their holdings on the Exchange or hope, illogically, that some day redemption will be advantageous to the issuer.

Some common misperceptions regarding yield calculations and the potential for profit with perpetuals were discussed in the September 2007 *CMS*. Additionally, calculations of potential risk and reward are more complex than might be expected, as shown in the November 2007 issue. For all that, the homogeneity of the time horizons for perpetuals gives rise to a certain amount of simplification of analysis that can be very useful. It is this degree of simplification (as well as the relatively large number of such issues) that has prompted a focus on such issues to illustrate the application of core fixed-income principles.

The effect of large differences in credit quality were discussed in the October 2006 edition, but the Credit Crunch has had a much larger effect than simply widening the spread between Pfd-1 and Pfd-2 (as defined by DBRS) issues. Investors are now much more nervous, double checking and sometimes second guessing the credit rating agencies, as well as taking a view on the potential for future changes in credit quality, a strategy known as credit anticipation. Some-



times these views are taken on the basis of a thorough look at the financial condition of the company analyzed; sometimes merely on the basis of the latest headline, but each time an investor takes such a view, the market yield of the investments change most microscopically, to be sure, but they do change.

It is not so long ago that investors were indifferent to differences between the banks. “They’re all the same!” was the motto and Chart 1 shows the relationship between the dividend rate (expressed as a percentage of par value) and the yield of the instrument to its presumed call date – all plotted with data from March 31, 2007, near the peak of the market.

Some approximations were necessary in order to present the data in Chart 1. There is no allowance in the graph for the term to expected call; only the expected yield over this period is shown (as the y-axis). There is a limit to how much data may be efficiently communicated, however, and I decided that the most important thing to show (other than the expected yield) was the dividend rate. Those who have studied the “Perpetual Hockey Sticks” of *CMS*, March/April 2007 will recognize that for issues trading at a premium to par a higher dividend rates allows greater confidence when predicting a call date and hence investors will be willing to accept a lower yield on their investment at the time of purchase.

Knowing this, such readers will expect the data in Chart 1 to show a downward slope, with the yield-to-expected-call declining as the dividend rate as a percent of par increases. These expectations are, by and large, correct. So, we can chalk up one point for theory, at any rate!

However, it is the clustering of data points I want to illustrate. If we look at the left hand side of the graph in the area that shows perpetuals paying a coupon of 4.7%-4.9% of par, we see that the yields-to-worst are, for all intents and purposes, independent of the issuer. From these data, we can (tentatively) conclude that as of March 31, 2007, investors did not consider differences between the banks to be important. When buying a bank perpetual, the only thing that mattered was the annual dividend rate.

There is one caveat to this conclusion, however. Of ne-

cessity, the data has been selected from perpetual shares trading at a premium and therefore expected to be redeemed at some point within the following few years. It would be more precise to say that the data show that the marketplace did not differentiate much between bank perpetuals expected to be called in the near future, but I believe this to be an artifact of the data. If there had been low-dividend bank perpetuals at this time trading at discounts to par, I think that they all would have traded with very similar yields.

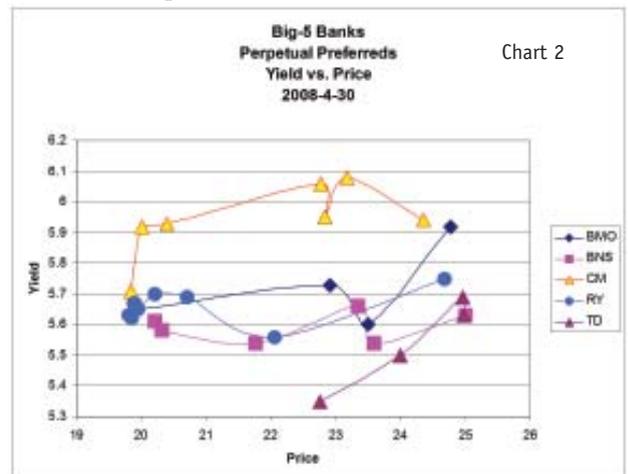
This is the problem with conducting research regarding the Canadian preferred share marketplace – there’s never enough data to draw firm conclusions!

As a result of heavy bank issuance since early 2007, as well as a large increase in market rates for perpetuals, there are considerably more data points available for discounted perpetuals as of April 30 (Chart 2). It is very clear that considerable stratification has occurred in the market.

Issues from the Canadian Imperial Bank of Commerce (CM) are trading to yield more than their peers, while it seems equally clear that Toronto Dominion Bank issues are trading to yield much less. The spread between the two is well in excess of 50bp – a very substantial difference. The other three banks are more comparably priced between the two extremes, although it is possible to make a case that BNS issues are trading to yield less than RY and BMO issues.

These issues are all rated Pfd-1 by DBRS. Why should the market be trading these issues over such a broad range of yields?

The first point to remember is that credit ratings, at best, represent a range. There are gradations within the generic categories that the agencies make no attempt to quantify, but nevertheless have an influence. There will be very little dispute, for instance, that TD is a “better” credit than CIBC. All else being equal, CIBC issues should not trade to yield less than TD. The question of how much more they should yield is open for debate, but they should not yield less. This, by itself, places a boundary on normal fluctuations in



price due to supply and demand.

Secondly, there is the question of supply and demand itself. CIBC has significantly more preferred shares outstanding than does TD, in terms of both number and value. Some investors may be very happy with the CIBC name, but have reached their comfort limits with exposure to the name in order to ensure diversification of their own portfolios. They have enough, and won't buy more no matter how cheap they get!

Thirdly, not all the CRA's information is revealed by the "headline" rating. DBRS rates both issuers as Pfd-1, to be sure, but CIBC has a "negative trend". There may be some investors who think of "negative trend" and "perpetual" at the same time and draw drastic conclusions!

And finally, some players may be ignoring the credit rating altogether. Why not? It's advice – take it, leave it, your choice. In times of stress (like now!) and after a period of poor returns (like now!), some investors abandon analysis and simply do not want to hold a name attracting unfavourable comment in the press.

There are many mechanisms that can cause credit stratification in the marketplace. Investors should understand them and be prepared to take a view as to whether such spreads are appropriate or if these spreads are not where they should be, presenting a differential between price and value that may be exploited. And all the while, investors should be asking: "But what if I'm wrong?" and remain diversified to the extent that an unexpected change in the degree or the nature of credit stratification will not compromise their entire investment strategy.

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The Pick of PrefLetter

After the close on May 9, my monthly newsletter (www.prefletter.com) recommended FFN.PR.A, among others, for long-term, buy-and-hold investors.

Type of Preferred	Split Share
Quotation (2008-5-9)	\$10.03-24
DBRS Rating	Pfd-2(low)
S&P Rating	Not Rated
Annual Dividend	\$0.525
Yield-to-Worst Scenario	Hard Maturity 2014-12-1 at 10.00
Yield-To-Worst	5.25%
Modified Duration, YTW	5.54
Pseudo-Convexity, YTW	0.18

FFN.PR.A: matures 2014-12-1 at 10.00. Next ex-date: 2008-5-28 (estimated monthly dividends); Financial 15 Split II Corp. is a split share corporation (see CMS, November 2006) based on fifteen financial corporations in Canada and the U.S. asset coverage of 1.9+:1 as of April 15 (according to <http://www.financial15.com/valuations.html>). A DBRS review of split shares based on financials (see <http://www.prefblog.com/?p=1936>) has resulted in a one-notch downgrade to its current rating of Pfd-2(low). See <http://www.prefblog.com/?p=2090>.