GORDON PAPE INCOME JANAURY 2009

PREFERRED INVESTMENTS

The credit crunch of 2008 resulted in a lot of anomalies as far as investment valuations were concerned. When investors overwhelming desire was to raise cash, the prices they were willing to accept often made no sense at all in relation to either where those investments had traded in the past, or to the income stream that was being generated by them. In some cases, the investors had to sell; they had borrowed money to leverage up their investment portfolio, either by way of margin accounts at their broker or bank, or because of their business model, as in the case of hedge funds. When the margin calls arrived, assets had to be liquidated, regardless of price or valuation, and indeed, in some cases the better quality stocks did worse than lower quality ones, as the latter were impossible to sell and therefore, the good stuff had to be tossed over the side. In fact, some observers have described the second half of 2008 as “the biggest margin call in history” and they are not far wrong.

Looking for bargains amongst the wreckage, there is such a wealth of opportunities that it’s difficult to know where to start, especially for income oriented investors, whose assessment of potential purchases is disciplined by how much income the stock or bond in question provides, and, of course, how sustainable the income distribution proves to be. Therefore, I wanted to look at the more senior securities in a company’s capital structure, where there is greater likelihood of payment, namely bonds and preferred shares, which are effectively bonds with a dividend tax credit attached.

Back in 2005, I recommended a couple of corporate bonds to Income Investor subscribers, which were owned by Guardian’s High Yield Bond Fund, CHC Helicopters 7% and Shaw Communications 7.375%, and which, although they were BB rated (hence below investment grade and hence high yield), were on the cusp of investment status. CHC was redeemed at a premium during its takeover, and we recommended switching the Shaw bonds into the common stock, reflecting the premium it was selling at to its redemption value and the rapid increase in dividends at Shaw. It also reflected the fact that individual corporate bonds are not very liquid, difficult to either buy or sell unless your broker issued them, and even then tend to have a fairly wide difference between the bid and offer prices.

These caveats do not apply to provincial or municipal issues, such as those issued by the Province of Ontario or City of Vancouver. Their issues are usually of reasonable size and any dealer will be willing to trade in them, but even here, the credit crunch has resulted in Ontario bonds due in 2028 trading at over a 1.2% higher yield than equivalent Government of Canada bonds, a truly remarkable phenomenon compared with their usual range of 0.35-0.4%. As far as corporate investment grade bonds are concerned, the DEX universe of A rated bonds yields 3.8% more than Govt. of Canada bonds, and BBB rated bonds 4.2% more, comparable only to the depths of the grim recession of the early 1990s and well above the levels of 3% more hit during the Enron/Worldcom scandals of 2001-02. As for high yield bonds, the spread above US Treasurys reached 20% in November, which implied that over one in five of all issuers would default and that bondholders would receive less than 30 cents on the dollar, compared to the highest ever default rate in the depths of the Great Depression in 1934, when the default rate hit 14.5% Just for some perspective, the GDP of the US and Canada fell by one third between 1930-34 and unemployment topped 25%.

For Income Investor subscribers who are understandably nervous of buying non investment grade bonds, the record high spreads on investment grade bonds means there is no need to be too aggressive about going down the quality scale. Issues from A or BBB+ rated issuers will provide yields of 7.5-8%, effectively giving buyers a similar return to that from equity markets in the form of cash interest payments on a half yearly basis. Opportunities such as this are very rare, and only the panic that broke out in the final quarter of last year could have brought about such results. If investment grade corporate bonds are felt to be too volatile, then provincials paying 4.5-5% are also comparable to other essentially risk free alternatives. After all, if need be, the provinces can always raise your taxes to ensure that the interest gets paid, a solution not available to companies.

However, all of the income from these investments is interest income, taxable at the top marginal rate to investors, apart from the $5,000 p.a. that everyone over 18 can invest in a Tax Free Savings Account. Preferred shares, which are effectively unsecured bonds, pay dividend income, with its appropriate tax efficiency. My colleagues Tom Slee and Gordon have suggested several individual issues in previous editions, but there are several idiosyncracies involved in buying preferreds as Tom has noted. However the raft of new preferred issues, primarily by the Canadian financial sector, has seen over $4.5bn issued in the last six months in resettable fixed/floating rate perpetual shares which cannot be called before the 5 year reset date. This means that the most recent Royal Bank of Canada 6.25% issue, which yields 4.2% more than the equivalent Govt. of Canada 5 year bond, will pay the same 4.2% spread above the Govt. of Canada bond when it resets. If the investor decides to switch from a fixed rate to a floating rate (hence the term fixed/floaters) then it will be at the same 4.2% spread above the 3 month Treasury bill.

Therefore investors have locked in the highest spreads for several decades for at least 5 years, although obviously the issuers are hoping that spreads will be substantially lower in 5 years and will redeem the preferreds. All of the banks and most of the life insurers have issued this type of preferred share, and as a result, the existing fixed/floaters, which were mostly issued by BCE, have performed nearly as badly as the common shares when the takeover was cancelled, as the new bank/lifeco breed of resettable preferreds are more attractive than the older issues, and have contributed to the S&P/TSX Preferred Share Index losing 23% last year, even taking dividends into account. Floating rate prefrreds fell 50%, as interest rates plummeted, perpetuals were off 26% and even retractables, the most defensive type of preferred shares, were down 12%. As a result, yields are extremely attractive, with Brookfield Asset Management preferreds yielding 12% and Thomson prefs 8%, while the older fixed/floaters are also yielding more than 7%. And all of this comes with the benefit of the dividend tax credit. One simple way of accessing good quality preferreds with professional management is the Guardian Group of Funds Monthly Dividend Fund, with tow thirds of its assets in P1-high quality P3 preferreds, which Gordon has recommended before and which, as a mutual fund corporation, pays all of its income in the form of dividends, even including any interest earned.