PrefBlog

Canadian Preferred Shares - Data and Discussion

Market Timing?

June 21st, 2008

I received the following eMail from a Reader who is not as Assiduous as he should be:

> I haven't been to your blog for a while but I went there today to get your perspective on what was happening with preferred spreads. Sure looks like a buying opportunity at 6%+ as one of your readers commented (RY, SLF , Pow, Pwf . do not hesitate , do not be afraid , do not analyse to much , BUY !!). Others would analyze as don't buy to average down. What's your (long term) perspective on all this? Are you buying (what would be your top 10 list in this market)? Regards,
>
> P.S. Feel free to post on your blog.

The post being referred to is Party Like It's 1999!, in which I made the point that the interest-equivalent PerpetualDiscount spread was pretty close to a ten year high; the comment quoted was by Assiduous Reader *lafontaine*. And as far as a "Top 10 List" is concerned … I offer that service - not precisely 'Top 10′ but the same idea - through my monthly newsletter, PrefLetter.

I don't like market timing and I don't do market timing. Financial Markets are chaotic; things that weren't important a year ago can become the driving force in the blink of an eye; the Law of Unintended Consequences punishes any policy-maker with the temerity to indulge in central planning (and any portfolio manager with the temerity to overlay his own projections on policy changes); and, perhaps most insidiously, there are a lot of players with a vested interest in confusing the issue.

Journalists need something to write about; Dealers want to change your analysis of a situation so you'll trade. Financial advisors find it easier to convince clients that the account is being aggressively and pro-actively managed in their best interest if there are a few actual trades to point at.

And every trade costs money - commissions and spread and sometimes market impact.

My philosopy is to be fully invested at all times. Make yourself an asset allocation based on your personal needs and your long-term view of expected risks and returns. Review it once a year. Always ask yourself: 'What if I'm wrong?'

A disdain for market timing does not mean inactivity. My fund
does an awful lot of trading … but this is never because of a view that the market is going to go up or down. It's simply me telling the cowboys: 'You want to trade? You want to pay the spread? You want to pay the cost of market impact? OK, you can pay that to me. Twist my arm!' I'm not always right when I agree to a trade. Fortunately, I don't have to be right every time to do a good job for my clients. Historically, my assessments of relative value have been accurate enough to outperform the market - although, I must point out, that is no guarantee for the future!

The more similar two instruments, the easier it is to identify the cheap one. Two discounted perps from the same issuer are easy to compare. A PerpetualDiscount and a PerpetualPremium from the same issuer is a little harder. A PerpetualDiscount and cash is … difficult in the extreme.

That being said, I think the recent decline in the market is overdone. It has happened without corresponding declines in the broader credit markets; it has happened without particularly horrible news from the issuers [bank common shareholders may well suffer in the coming months. So? I'm buying their prefs on the basis of them being able to (i) continue paying the dividend, and (ii) avoiding a bankruptcy that would impair my capital. I can't see any but the most infinitesimal changes in the probability of those two outcomes]. Inflation is always a worry, but (a) it appears to be under control, and (b) back on the Central Bankers' agendas and (c) not considered a major problem by the broader credit markets.

I consider that the extra interest-equivalent yield provided by preferreds handsomely compensates for their additional term risk, liquidity risk and credit risk (provided you don't overdo it! *What if I'm wrong?*). As spreads increase without a clear fundamental driver, I suspect that more and more people will eventually agree with me. These people will pile into the market, absorbing spread costs and market impact costs … and I will certainly exert my utmost efforts to put myself in position to say 'Thank you very much! *Ka-Ching!*'

Monday June 23 will be a most interesting day. We can expect BCE issues to skyrocket, as the chances of the deal closing have increased; to the extent that (i) the money that may be received by BCE preferred shareholders will the reinvested in the preferred market and (ii) the market anticipates this tsunami of money; we may well see a good pop in the broader preferred share market. Will I bet on it? Have I bet on it? No and No.

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June 20, 2008

June 20th, 2008

Stop presses! Sit down! Have some smelling salts! The PerpetualDiscount index was actually up today (up almost 42bp, in fact), ending a string of twelve consecutive losses from June 4 to June 19, inclusive. Those twelve consecutive losses took the PerpetualDiscount index down 5.80%.

Average pre-tax bid-YTW for PerpetualDiscounts is now 6.07%, interest-equivalent 8.50%, long corporates .. oh, call it 6.17% and 30-year Canadas at 4.15%.

Work out the spreads and update the graphs yourselves, ya bums! What am I, your maid?

Note that these indices are experimental; the absolute and relative daily values are expected to change in the final version. In this version, index values are based at 1,000.0 on 2006-6-30							
Index	Mean Current Yield (at bid)	Mean YTW	Mean Average Trading Value	Mean Mod Dur (YTW)	Issues	Day's Perf.	Index Value
Ratchet	4.20%	4.22%	51,358	17.00	1	-0.0393%	1,114.6
Fixed-Floater	5.06%	4.85%	62,750	15.82	7	-0.8252%	990.6
Floater	4.04%	4.04%	69,487	17.35	2	-0.4349%	947.8
Op. Retract	4.84%	2.43%	86,636	2.44	15	+0.8648%	1,057.4
Split-Share	5.31%	5.67%	68,606	4.15	15	+0.0429%	1,048.6
Interest Bearing	6.11%	3.77%	48,125	2.01	3	-0.2333%	1,121.5
Perpetual-Premium	5.96%	4.61%	360,772	10.27	13	-0.0252%	1,007.0
Perpetual-Discount	6.00%	6.07%	223,135	13.78	59	+0.4181%	875.6

Major Price Changes			
Issue	Index	Change	Notes
BCE.PR.I	FixFloat	-3.7199%	
BCE.PRA	FixFloat	-2.0481%	
POW.PR.A	PerpetualDiscount	-1.6822%	Now with a pre-tax bid-YTW of 6.31% based on a bid of 22.21 and a limitMaturity.
BCE.PR.Z	FixFloat	-1.5625%	Now with a pre-tax bid-YTW of 4.97% based on a bid of 22.05 and a limitMaturity.
POW.PR.D	PerpetualDiscount	-1.4500%	Now with a pre-tax bid-YTW of 6.15% based on a bid of 20.39 and a limitMaturity.
POW.PR.B	PerpetualDiscount	-1.1845%	Now with a pre-tax bid-YTW of 6.18% based on a bid of 21.69 and a limitMaturity.
POW.PR.C	PerpetualDiscount	-1.1059%	Now with a pre-tax bid-YTW of 6.24% based on a bid of 23.25 and a limitMaturity.
PWF.PR.H	PerpetualPremium (for now!)	-1.0962%	Now with a pre-tax bid-YTW of 5.99% based on a bid of 24.36 and a limitMaturity.
PWF.PR.F	PerpetualDiscount	+1.0693%	Now with a pre-tax bid-YTW of 6.15% based on a bid of 21.74 and a limitMaturity.
CM.PR.P	PerpetualDiscount	+1.1364%	Now with a pre-tax bid-YTW of 6.27% based on a bid of 22.25 and a limitMaturity.
HSB.PR.C	PerpetualDiscount	+1.1423%	Now with a pre-tax bid-YTW of 6.03% based on a bid of 21.25 and a limitMaturity.
HSB.PR.D	PerpetualDiscount	+1.1702%	Now with a pre-tax bid-YTW of 6.06% based on a bid of 20.75 and a limitMaturity.
SLF.PR.D	PerpetualDiscount	+1.2168%	Now with a pre-tax bid-YTW of 6.11% based on a bid of 18.30 and a limitMaturity.
BNS.PR.J	PerpetualDiscount	+1.2603%	Now with a pre-tax bid-YTW of 5.68% based on a bid of 23.30 and a limitMaturity.
SLF.PR.E	PerpetualDiscount	+1.3263%	Now with a pre-tax bid-YTW of 5.92% based on a bid of 19.10 and a limitMaturity.
CM.PR.J	PerpetualDiscount	+1.3966%	Now with a pre-tax bid-YTW of 6.31% based on a bid of 18.15 and a limitMaturity.
MFC.PR.B	PerpetualDiscount	+1.4000%	Now with a pre-tax bid-YTW of 5.77% based on a bid of 20.28 and a limitMaturity.
BAM.PR.J	OpRet	+1.4724%	Now with a pre-tax bid-YTW of 5.52% based on a bid of 24.81 and a softMaturity 2018-3-30 at 25.00. Compare with BAM.PR.H (4.07% to 2008-10-30), BAM.PR.I (5.12% to 2013-12-30) and the new issue (5.02% to 2013-6-29).
RY.PR.B	PerpetualDiscount	+1.6427%	Now with a pre-tax bid-YTW of 6.01% based on a bid of 19.80 and a limitMaturity.
GWO.PR.G	PerpetualDiscount	+1.8388%	Now with a pre-tax bid-YTW of 6.04% based on a bid of 21.60 and a limitMaturity.
BNS.PR.N	PerpetualDiscount	+2.2263%	Now with a pre-tax bid-YTW of 5.93% based on a bid of 22.50 and a limitMaturity.
BCE.PR.C	FixFloat	+2.2727%	
BMO.PR.H	PerpetualDiscount	+2.7273%	Now with a pre-tax bid-YTW of 5.90% based on a bid of 22.60 and a limitMaturity.

Volume Highlights			
Issue	Index	Volume	Notes
MFC.PR.B	PerpetualDiscount	273,166	Now with a pre-tax bid-YTW of 5.77% based on a bid of 20.28 and a limitMaturity.
TD.PR.P	PerpetualDiscount	208,374	Now with a pre-tax bid-YTW of 5.82% based on a bid of 22.91 and a limitMaturity.
MFC.PR.C	PerpetualDiscount	207,052	Now with a pre-tax bid-YTW of 5.72% based on a bid of 19.80 and a limitMaturity.
BNS.PR.K	PerpetualDiscount	205,100	Now with a pre-tax bid-YTW of 5.79% based on a bid of 21.10 and a limitMaturity.
GWO.PR.F	PerpetualPremium	100,853	Now with a pre-tax bid-YTW of 5.48% based on a bid of 25.40 and a call 2012-10-30 at 25.00.

There were twenty-two other index-included $25-pv-equivalent issues trading over 10,000 shares today.

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L.PR.A Goes Stale on Shelf

June 20th, 2008

Loblaw's has announced:

> the completion today of the sale of 9.0 million cumulative redeemable convertible Second Preferred Shares, Series A, to yield 5.95% per annum, to a syndicate of underwriters co-led by RBC Dominion Securities Inc. and CIBC World Markets Inc. for distribution to the public. The aggregate gross proceeds of the sale were $225 million. The Preferred Shares, Series A have been listed and posted to trade on the Toronto Stock Exchange under the symbol "L.PR.A".

The announcement of this issue was reported on PrefBlog with the opinion:

> This issue looks expensive.

It would appear the market agrees! The terms of the greenshoe were that the option had to be exercised prior to closing; but the size shown in the current press release indicates that the extra shares have not been issued.

It was a thoroughly pathetic opening day, with 4,448 shares trading in a range of 24.70-90, closing at 24.00-70, 10×52. The underwriters didn't pretend to support the issue; at one point today the bid was 23.00.

More later.

Later, more:At $24.00, it doesn't look so bad … but it's scarcely an inventory blow-out sale!

Bear in mind that Pfd-3 issues (regardless of modifier) are considerably less liquid than they would be if they were higher grade. They will also tend to trade with higher correlation to the company's common than they would otherwise; they are more equity-like than higher grade issues, both in theory and practice. I do not recommend a weighting of more than 10% total Pfd-3 issues in a diversified preferred share portfolio, with no more than 5% in any one name; have more than this if you like, but I will consider your portfolio to be "equity-substitute" rather than "fixed-income".

Loblaw New Issue and Some Comparators				
Ticker	DBRS Rating	Current Quote	Retraction Date	Yield to Retraction (at bid)
L.PR.A	Pfd-3	24.00-70	2015-7-30	6.81%
BPO.PR.K	Pfd-3(high)	22.60-69	2016-12-30	6.72%
YPG.PR.B	Pfd-3(high)	20.30-85	2017-6-29	8.00%
DW.PR.A	Pfd-3	22.00-24	2017-3-12	6.60%

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ALB.PR.A Rating of Pfd-2(low) Confirmed by DBRS

June 20th, 2008

The credit rating of Allbanc Split Corp. II has been confirmed by DBRS:

> DBRS has today confirmed the Preferred Shares issued by Allbanc Split Corp. II (the Company) at Pfd-2 (low) with a Stable trend. The rating has been removed from Under Review with Developing Implications where it was placed on March 19, 2008.
>
> In February 2006, the Company raised gross proceeds of approximately $322 million by issuing 6.73 million Preferred Shares at $25.00 each and 13.46 million Capital Shares at $11.40 each. The net proceeds from the offering were invested in a portfolio of common shares (the Portfolio Shares) of the top six Canadian chartered banks: Bank of Montreal (19%), Bank of Nova Scotia (19%), Canadian Imperial Bank of Commerce (19%), Royal Bank of Canada (19%), The Toronto-Dominion Bank (19%) and National Bank of Canada (5%). The initial split share structure provided downside protection of approximately 45% to the Preferred Shares (after expenses).
>
> The holders of the Preferred Shares receive fixed cumulative quarterly distributions equal to 4.25% per annum. The fixed distributions of dividends on the Preferred Shares are funded from the dividends received on the Portfolio Shares and, if necessary, with proceeds from the sale of Portfolio Shares or from covered call option premium income as determined by the board of directors. The current yield on the Portfolio Shares fully covers the Preferred Shares dividends, providing dividend coverage of approximately 1.6 times. Excess dividends net of all expenses of the Company are paid as dividends on the Capital Shares or re-invested by the Company in additional Portfolio Shares as determined by the board of directors of the Company.
>
> The Company's net asset value has experienced downward pressure over the past year, dropping from $52.86 to $42.87, a decline of about 19%. The current downside protection available to the Preferred Shareholders is approximately 41% (as of June 12, 2008). The confirmation of the Preferred Shares is based on the current level of asset coverage available to cover the Preferred Shares principal, the high dividend coverage ratio and the strong credit quality of the banks included in the Portfolio.

> The redemption date for both classes of shares issued is February 28, 2011.

This would not normally be considered newsworthy, but I am tracking the effects of the DBRS mass review of financial split-shares. On 3/13, the asset coverage ratio was 1.6:1; as of June 19, the coverage is 1.7:1.

ALB.PR.A is tracked by HIMIPref™ and is incorporated in the Split-Share Index.

Posted in Issue Comments | No Comments »

BCE Wins Supreme Court Appeal

June 20th, 2008

From Bloomberg:

> The Supreme Court of Canada, in a unanimous ruling in Ottawa today, overturned a decision of the Quebec Court of Appeal that had derailed BCE's plan for having ignored the interests of the company's bondholders.
>
> The decision removes one hurdle to closing the purchase of Montreal-based BCE, Canada's biggest phone company, by Ontario Teachers' Pension Plan and U.S. private-equity firms. Completion isn't certain, as banks have sought to renegotiate terms of debt in LBOs amid a contraction in credit markets, seeking higher interest rates and tighter loan restrictions, and derailing more than 60 buyout plans since last year.

DBRS has announced:

> its current ratings on BCE Inc. (BCE or the Company) and Bell Canada continue to remain Under Review with Negative Implications following today's unanimous judgment by the Supreme Court of Canada which will allow the planned privatization to proceed.
>
> The ratings were originally placed Under Review with Negative Implications on April 17, 2007. This was maintained after the privatization plan was announced on June 30, 2007. The plan is led by an investor group that includes Teachers' Private Capital, a division of the Ontario Teachers' Pension Plan Board, and includes Providence Equity Partners Inc. and Madison Dearborn Partners, LLC. Subsequently, Merrill Lynch took up an equity commitment. Collectively the sponsors have committed to invest $7.75 billion in equity to fund this transaction.
>
> DBRS will maintain its review while it continues its discussions with BCE and the investor group. As a closing date approaches, DBRS will resolve this status with rating guidance based on the final terms of the transaction and its new Leveraged Finance rating methodology.
>
> DBRS's new methodology uses the default rating and a new Recovery Ratings scale to determine an instrument rating for each piece of new and existing indebtedness. The resulting ratings will likely cover multiple notches, ranging well above and below an Issuer Rating that could be in the lower end of the BB range.

Posted in Miscellaneous News | 1 Comment »

Cumulative Tier 1 Interest?

June 20th, 2008

Hybrid instruments (usually referred to on PrefBlog as "Innovative Tier 1 Capital" due to the Canadian connection; on a global basis, the term "hybrid" includes "non-innovative" hybrids and also such terms as "additional own funds" and "ancillary own funds") achieved recognition in the BIS Sydney Press Release of October 27, 1998, "Instruments Eligible for Inclusion in Tier 1 Capital":

> The Basle Committee on Banking Supervision has taken note that over the past years some banks have issued a range of innovative capital instruments, such as instruments with step-ups, with the aim of generating Tier 1 regulatory capital that is both cost-efficient and can be denominated, if necessary, in non-local currency. The Committee has carefully observed these developments and at its meeting on 21st October 1998 decided to limit acceptance of these instruments for inclusion in Tier 1 capital. Such instruments will be subject to stringent conditions and limited to a maximum of 15% of Tier 1 capital.
> …
> In order to protect the integrity of Tier 1 capital, the Committee has determined that minority interests in equity accounts of consolidated subsidiaries that take the form of SPVs should only be included in Tier 1 capital if the underlying instrument meets the following requirements which must, at a minimum, be fulfilled by all instruments included in Tier 1:
>
> - issued and fully paid;
> - non-cumulative;
> - able to absorb losses within the bank on a going-concern basis;
> - junior to depositors, general creditors, and subordinated debt of the bank;
> - permanent;
> - neither be secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors;
> - and callable at the initiative of the issuer only after a minimum of five years with supervisory approval and under the condition that it will be replaced with capital of same or better quality unless the supervisor determines that the bank has capital that is more than adequate to its risks.

As careful readers of the back pages of the financial press may remember, we are now experiencing a Credit Crunch, that got rolling in a big way in

August 2007, seems to have peaked in March 2008 with the near-death experience of Bear Stearns and … still continues. With this in mind, the Committee of European Banking Supervisors has - after drafting a proposal and obtaining comments from the players, published a Proposal for a common EU definition of Tier 1 hybrids, advice which was solicited from them by the European Commission:

> 29. The main features of the instrument (including whether it is grandfathered), the proportion of Tier 1 capital it accounts for must be periodically and publicly disclosed by the issuer. The main features of the instrument must be easily understood.
>
> 30. Moreover, the three economic characteristics must all be fulfilled at the same time - loss absorbency, permanence and ability of the issuer to cancel payments.
> …
> 34. The instrument helps to prevent insolvency if the following conditions are met :
> • the instrument is permanent;
> • the issuer has the flexibility to cancel coupon/dividend payment;
> • the instrument would not be taken into account for the purposes of determining whether the institution is insolvent; and
> • the holder of the instrument cannot be in a position to petition for insolvency.
> …
> 46. Issuers must be able to waive payments on a non-cumulative basis and for an unlimited period of time whenever necessary.
>
> 47. If the institution is in breach of its minimum capital requirements (or another level defined by the supervisor) then it must waive payments.
>
> 48. In addition, no provision in the terms of the hybrid instrument may prevent the supervisors from requiring institutions to waive payments at their discretion based on the financial situation of the institution.
>
> 49. Dividend pushers are acceptable but must be waived when either of the supervisory events mentioned above occurs between the date the coupon is pushed and the date it is to be paid. Under those circumstances, payment of the coupons will be forfeited and no longer be due and payable by the issuer.
>
> 50. The instrument is not cumulative in kind or in cash: any coupon or distribution not paid by the issuer is forfeited and is no longer due and payable by the issuer.
>
> 51. The issuer must have full access to waived payments.
>
> 52. Alternative Coupon Satisfaction Mechanisms are permitted only in cases where the issuer has full discretion over the payment of the coupons or dividends at all times, and only if the ACSM achieves the same result as a cancellation of coupon (i.e. there is no decrease in capital). To meet this condition, the deferred coupons must be contributed without delay to the capital of the issuer in exchange for newly issued shares having an aggregate fair value equal to the amount of the coupon/dividend. The obligation of the institution is limited to the issue of the shares. Hence, the issuer must have already authorised and unissued shares. The shares may be, afterwards, sold in the market but the institution must not be committed to find investors for these shares. If the sales proceeds are less than the coupon, the issuer must not be obliged to issue further new shares to cover the loss incurred by the hybrid holders.
>
> 53. Distributions can only be paid out of distributable items; where distributions are pre-set they may not be reset based on the credit standing of the issuer.
> …
> 58.
> Under both options, the limit for innovative hybrid instruments would be at all times 15% of total Tier 1 capital after specific Tier 1 deductions (but without taking into account deductions from original and additional own funds). The 15% would be included in the assessment of the limits above.

Further, paragraph 64 of the CEBS paper reports that 89% of Europe's Innovative Instruments are non-cumulative; while:

> 65. The small percentage of cumulative instruments with payment in cash includes grandfathered issues of silent partnerships in Germany and a few non-innovative and innovative grandfathered instruments in Ireland and Denmark. The small percentage of cumulative instruments with payment in kind includes mostly innovative and non-innovative instruments in the United Kingdom.
>
> 66. Direct issues of perpetual non-cumulative preference shares never incorporate cumulative features, be it in cash or in kind.
>
> 67. Coupon payments in kind, often called Alternative Coupon Satisfaction Mechanisms (ACSM) 7, mean that the issuer can satisfy the coupon payment in the form of shares (as opposed to cash).
>
> 68. Instruments with this feature only account for a small part of the total but are, for tax reasons, significant in some jurisdictions, notably in the United Kingdom, Belgium and the Netherlands. A few grandfathered issues have been reported in Ireland and Austria.

A "dividend pusher" is defined in paragraph 83.

CEBS does consider the question of ACSM:

> 91. Therefore ACSM is only acceptable if it achieves the same result as a cancellation of the coupon (i.e. there is no decrease in capital) and when the issuer has full discretion over the payment of the coupons or dividends at all times. To meet this condition, the deferred coupons must be satisfied without delay using newly issued shares that have an aggregate fair value equal to the amount for the coupon/dividend. The obligation of the institution is limited to the issue of shares. The issuer must already have authorised and unissued shares. The shares may be, afterwards, sold in the market but the institution must not be committed to find investors for these shares. If the sales proceeds are less than the coupon, the issuer must not be obliged to issue further new shares to cover the loss incurred by the hybrid holder.

It would appear that the recent OSFI draft advisory
on Tier 1 capital is - grudgingly - in accordance with the results of CEBS discussion, with respect to cumulativity.

It should be noted that "in accordance" does not mean the same thing as "good". It is my understanding that the OSFI advisory is intended to allow the issuance of Innovative Tier 1 Qualifying capital despite the "Hallowe'en Massacre" Income trust legislation that changed all the rules.

Chris Van Loan
of Blakes wrote a paper "The October 31, 2006 Income Trust Proposals and Innovative Tier 1 Instruments" (not available online). In the introduction, he makes the point:

> a trust … would use the proceeds from issuing [Innovative Tier 1 instruments] to either purchase loans and debt obligations from the relevant financial institution (an "Asset-Based Structure") or to make a loan to such financial institution (a "Loan-Based Structure").

For example, the most recent Innovative Tier 1 Instrument was RBC TruCS - Series 2008-1:

> The gross proceeds to the Trust from the Offering of $500,000,000 will be used to fund the acquisition by the Trust of Trust Assets from the Bank.
>
> **…**
>
> The Trust's objective is to acquire and hold the Trust Assets that will generate net income for distribution to holders of Trust Securities. The Trust Assets consist primarily of: (i) Mortgage Co-Ownership Interests (as defined herein) in one or more pools of Residential Mortgages (as defined herein) originated by the Bank or its affiliates; or (ii) Mortgage-Backed Securities (as defined herein).

… whereas, in the case of RBC TruCS — Series 2013:

> The gross proceeds from the Offering of approximately $900,000,000 will be used by the Trust to acquire the Bank Deposit Note from the Bank.

The Loan Based Structure - exemplified by the 2013 TruCS - had a variety of legal kerfuffles described by Mr. Van Loan, but "just as the world seemed safe again for Loan-Based Structures, the SIFT Proposals would seem to have thrown yet another roadblock in the way of these innovative Tier 1 instruments". Under the Hallowe'en Massacre rules:

> A trust that is a SIFT [Specified Investment Flow-Throughs] will not be permitted to deduct certain otherwise deductible amounts distributed to unitholders which distributions will be subject to a special rate of tax meant to approximate the federal-provincial corporate income tax rate.

OK, so is the trust (issuing the TruCS) a SIFT? One of the conditions is that it holds one or more "non-portfolio properties" … and a deposit note from the bank that created and controls the trust is considered to be a "non-portfolio property". Accordingly:

> the SPV would be required to pay the special tax on such non-portfolio earnings and holders of the Capital Trust Securities receiving distributions from the SPV out of such earnings would be taxed as if they had received dividends from taxable Canadian corporations

Not a problem for taxable holders. Big problem for non-taxable holders, such as pension funds. End of Loan-Based Innovative Tier 1 Capital. Thank you, Mr. Flaherty.

Mr. Van Loan notes that representations have been made to the Ministry of Finance to fix up the law, but the actions of OFSI indicate - to me - that these representations have been unsuccessful.

But we know - from Royal Bank's issuance of "RBC TruCS - Series 2008-1″ - that the banks can and will issue Asset Backed Innovative Tier 1 Capital. I will confess that I don't know whether such issuance will count against their limit on covered bonds. It might; it might not. But at any rate, the OSFI advisory seems to specifically target the issuance of Loan-backed Innovative Tier 1 Capital.

Now we get to the question that has been puzzling indefatigable Assiduous Readers all along - why should I care? Well … let's have a look at Bank Capital for 2Q08 and drill down to RY Capitalization: 2Q08. Look at that. 15% of their capital is in the form of Innovative Tier 1 Instruments.

Let us assume that RY gets into trouble. Some might consider this to be far-fetched … but as fixed-income investors, this is the basic thing we worry about. How safe is our capital? How likely are the dividends to continue without pause? We don't mind day-to-day market fluctuations so much, and as preferred share investors we're willing to take more risk than exists with, say, sub-debt or deposit notes … but we want to know what our risks are. This is considered prudent.

So RY gets into trouble at a time when … as may eventually be the case given the nature of the OSFI advisory … the maximum 15% of its Tier 1 Capital is comprised of Tier 1 instruments with a cumulative coupon. Dividends on both common and preferreds during this period are lost and gone, but we'll just have to hope the bank works out its difficulties and dividends start up again soon.

15% of tier 1 capital has a cumulative coupon, paid in kind (ACSM) with preferred shares. Let's say the penalty rate on this capital is 6.66%, just to make the numbers easier. Therefore, every year during this period, preferred shares are accumulating at a rate of 1% of Tier 1 capital. RY has 23.3-billion of Tier 1 capital at the moment (in times of stress, presumably, it would have declined due to write-offs), so we can call that $230-million-worth of preferred shares accumulating during the stress period. An entire new issue. Additionally, we consider the fact that preferreds make up only 10% of RY's Tier 1 capital: so one-tenth of the entire outstanding preferred share float will be accumulating every year.

This is a lot of dilution, and it's potential dilution that did not exist prior to the new OSFI advisory. And, just to make sure that preferred shareholders get their faces thoroughly kicked in, it's a pretty good bet that the happy recipients of the cumulated preferred shares will dump them immediately upon receipt - killing a market that should be in the early stages of tremulous recovery at that point.

This is not just a selfish concern about the value of extant investments in the preferred market. In the current Credit Crunch, we've seen a lot of issuance of preferreds, convertible and otherwise, by banks that have been badly hurt. The dilutive effect of the cumulated coupons will make it harder for a wounded bank to take that route and crawl out of its hole - so it's a prudential concern.

So, to review:

- Banks can currently issue Asset Backed Innovative Tier 1 Capital
- The Hallowe'en Massacre eliminated their ability to issue Loan Backed Innovative Tier 1 Capital (LBIT1C)
- The OSFI Advisory restores their ability to issue LBIT1C
- The OSFI Advisory, with respect to cumulativity, is just barely within international standards
- The OSFI Advisory has made the world a slightly scarier place for preferred share investors
- The OSFI Advisory makes it somewhat easier for banks to obtain Tier 1 capital in good times, at the expense of making it harder to obtain such capital in bad times
- There has been no public discussion of the OSFI Advisory

It is thoroughly outrageous
that OSFI feels empowered to make such far-reaching - and unnecessary - changes to bank capitalization rules without discussion.

OSFI does not meet international standards for transparency.

Posted in Regulatory Capital | No Comments »

June 19, 2008

June 19th, 2008

Accrued Interest has posted a good piece about CDS clearing and exposures; I have added the link to my discussion of his prior post on the issue.

OSFI has, essentially, banned "Global Market Disruption" lines of credit, which have been much discussed since non-bank ABCP sponsors found out just how little liquidity they actually provided. Banned? Well, not in so many words. But the credit conversion factor is now the same as a guaranteed line; therefore, the cost to the bank (in terms of capital when the line's undrawn) will be the same; therefore it seems highly unlikely that anybody will ever want one. It's an interesting issue and OSFI has included a fair bit of discussion with the advisory. I'll try to review the rule change … soon!

Practically a return to good times today … PerpetualDiscounts were down only 40bp! Their pre-tax bid-YTW now averages 6.09%; at the standard factor of 1.4x, this is equivalent to 8.53% interest. Those feverishly updating their historical yield spread graphs will note that 30-year Canadas are now at 4.18% and long Corporates at a little over 6.10% … so call Canadas/Corporates at 195bp and preferreds/corporates at 240. This is a thoroughly bizarre market.

Note that these indices are experimental; the absolute and relative daily values are expected to change in the final version. In this version, index values are based at 1,000.0 on 2006-6-30

Index	Mean Current Yield (at bid)	Mean YTW	Mean Average Trading Value	Mean Mod Dur (YTW)	Issues	Day's Perf.	Index Value
Ratchet	4.19%	4.20%	53,460	17.02	1	0.0000%	1,115.0
Fixed-Floater	5.01%	4.80%	61,685	15.90	7	-1.1266%	998.8
Floater	4.02%	4.02%	70,782	17.39	2	+0.7315%	951.9
Op. Retract	4.85%	2.52%	87,648	2.55	15	-0.0097%	1,055.4
Split-Share	5.31%	5.67%	69,455	4.15	15	-0.2410%	1,048.1
Interest Bearing	6.09%	3.56%	48,552	2.02	3	-0.0327%	1,124.1
Perpetual-Premium	5.96%	4.81%	366,149	11.08	13	-0.1660%	1,007.2
Perpetual-Discount	6.02%	6.09%	222,572	13.74	59	-0.3954%	871.9

Major Price Changes

Issue	Index	Change	Notes
BCE.PR.C	FixFloat	-3.9721%	
BNA.PR.C	SplitShare	-3.3168%	Asset coverage of just under 3.6:1 as of May 30, according to the company. Now with a pre-tax bid-YTW of 7.44% based on a bid of 19.53 and a hardMaturity 2019-1-10 at 25.00. Compare with BNA.PR.A (6.16% to 2010-9-30) and BNA.PR.B (8.49% to 2016-3-25).
IAG.PR.A	PerpetualDiscount	-2.8243%	Now with a pre-tax bid-YTW of 6.22% based on a bid of 18.58 and a limitMaturity.
PWF.PR.F	PerpetualDiscount	-2.6697%	Now with a pre-tax bid-YTW of 6.21% based on a bid of 21.51 and a limitMaturity.
BCE.PR.A	FixFloat	-2.5597%	
POW.PR.C	PerpetualDiscount	-2.2047%	Now with a pre-tax bid-YTW of 6.17% based on a bid of 23.51 and a limitMaturity.
BNS.PR.N	PerpetualDiscount	-2.1778%	Now with a pre-tax bid-YTW of 6.07% based on a bid of 22.01 and a limitMaturity.
WFS.PR.A	SplitShare	-2.0619%	Asset coverage of just under 1.7:1 as of June 12, according to the company. Now with a pre-tax bid-YTW of 7.11% based on a bid of 9.50 and a hardMaturity 2011-6-30 at 10.00 … 9.95% interest-equivalent for three year money isn't all that bad!

BCE.PR.G	FixFloat	-1.3901%	
BNS.PR.M	PerpetualDiscount	-1.2953%	Now with a pre-tax bid-YTW of 6.01% based on a bid of 19.05 and a limitMaturity.
HSB.PR.C	PerpetualDiscount	-1.1759%	Now with a pre-tax bid-YTW of 6.10% based on a bid of 21.01 and a limitMaturity.
CM.PR.J	PerpetualDiscount	-1.1596%	Now with a pre-tax bid-YTW of 6.40% based on a bid of 17.90 and a limitMaturity.
CM.PR.H	PerpetualDiscount	-1.1329%	Now with a pre-tax bid-YTW of 6.37% based on a bid of 19.20 and a limitMaturity.
PWF.PR.L	PerpetualDiscount	-1.1294%	Now with a pre-tax bid-YTW of 6.18% based on a bid of 21.01 and a limitMaturity.
BNS.PR.J	PerpetualDiscount	-1.0748%	Now with a pre-tax bid-YTW of 5.76% based on a bid of 23.01 and a limitMaturity.
RY.PR.F	PerpetualDiscount	-1.0521%	Now with a pre-tax bid-YTW of 5.99% based on a bid of 18.81 and a limitMaturity.
NA.PR.K	PerpetualDiscount	-1.0309%	Now with a pre-tax bid-YTW of 6.17% based on a bid of 24.00 and a limitMaturity.
BCE.PR.R	FixFloat	-1.0114%	
POW.PR.D	PerpetualDiscount	-1.0048%	Now with a pre-tax bid-YTW of 6.06% based on a bid of 20.69 and a limitMaturity.
ELF.PR.F	PerpetualDiscount	-1.1634%	Now with a pre-tax bid-YTW of 6.77% based on a bid of 20.00 and a limitMaturity.
SLF.PR.B	PerpetualDiscount	+1.2301%	Now with a pre-tax bid-YTW of 6.10% based on a bid of 19.75 and a limitMaturity.
GWO.PR.I	PerpetualDiscount	+1.5541%	Now with a pre-tax bid-YTW of 5.97% based on a bid of 18.95 and a limitMaturity.
W.PR.H	PerpetualDiscount	+2.3661%	Now with a pre-tax bid-YTW of 6.08% based on a bid of 22.93 and a limitMaturity. A fine company. But why is it trading THROUGH the Sunlifes?

Volume Highlights			
Issue	Index	Volume	Notes
BNS.PR.K	PerpetualDiscount	405,200	Nesbitt crossed 400,000 shares in four tranches, all at 21.00. Now with a pre-tax bid-YTW of 5.82% based on a bid of 20.99 and a limitMaturity.
NTL.PR.F	Scraps (would be Ratchet, but there are credit concerns)	132,350	Nesbitt crossed 20,000, Scotia crossed 50,000, Nesbitt repeated for 15,400 shares (and sold 4,600 to Scotia) and CIBC crossed 40,000 - all at 12.10.
BNS.PR.M	PerpetualDiscount	118,940	Now with a pre-tax bid-YTW of 6.01% based on a bid of 19.05 and a limitMaturity.
SLF.PR.A	PerpetualDiscount	68,895	Now with a pre-tax bid-YTW of 6.14% based on a bid of 19.44 and a limitMaturity.
RY.PR.W	PerpetualDiscount	55,955	CIBC crossed 50,000 at 22.20. Now with a pre-tax bid-YTW of 5.58% based on a bid of 22.19 and a limitMaturity.
FBS.PR.B	SplitShare	126,390	CIBC crossed 70,000 at 9.90, then Nesbitt crossed 50,000 at the same price. Asset coverage of just under 1.6:1 as of June 12, according to TD Securities. Now with a pre-tax bid-YTW of 5.25% based on a bid of 9.86 and a hardMaturity 2011-12-15 at 10.00.

There were twenty-seven other index-included $25-pv-equivalent issues trading over 10,000 shares today.

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Corporate Yield Spreads and Bond Liquidity

June 19th, 2008

A paper available on SSRN. I haven't yet done anything but skim it:

> We examine whether liquidity is priced in corporate yield spreads. Using a battery of liquidity measures covering over 4000 corporate bonds and spanning investment grade and speculative grade categories, we find that more illiquid bonds earn higher yield spreads; and that an improvement of liquidity causes a significant reduction in yield spreads. These results hold after controlling for common bond-specific, firm-specific, and macroeconomic variables, and are robust to issuers' fixed effect and potential endogeneity bias. Our finding mitigates the concern in the default risk literature that neither the level nor the dynamic of yield spreads can be fully explained by default risk determinants, and suggests that liquidity plays an important role in corporate bond valuation.

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Yield Curve Pictures - 2008-06-18

June 18th, 2008

Those wishing to wallow in the extreme awfulness of current market conditions may wish to look at the HIMIPref™ graphs of the yield curve for March 31, 2007 (the peak, approximately), November 30, 2007 (the prior trough, approximately) and today (the new trough).

The curves represent spot rates, not yields-to-maturity. A single instrument will use the one-year rate to discount its dividend receivable in one year, the two year rate to discount the dividend receivable in two years, the three year …

When looking at the curve, note that it is computed with tax rates of 21.00% on dividend income; 46.4% on interest income and 23.20% on capital gains. Also note that this represents the core curve (instrument rated Pfd-1, dividend-paying, non-cumulative, operating company, non-retractible, average volume, fixed dividend) … instruments with varying characteristics will find themselves shifted off the curve in accordance with the current best-fit parameters.

For the formula used when fitting the curve, see the glossary entries on the yield curve.

Posted in HIMIPref News | No Comments »

June 18, 2008

June 18th, 2008

Another thoroughly appalling day for the preferred share market. The dividend yield on PerpetualDiscounts is now 6.07%, equivalent to interest of 8.50%. Long Corporates are now at about 6.15%, so the PerpetualDiscount Interest Equivalent spread to long corporates is now at a stunning 235bp, while the 30-year Canada is now at 4.15%. See Party Like It's 1999! for an illustration of why the PDIE spread is "stunning".

Note that these indices are experimental; the absolute and relative daily values are expected to change in the final version. In this version, index values are based at 1,000.0 on 2006-6-30							
Index	Mean Current Yield (at bid)	Mean YTW	Mean Average Trading Value	Mean Mod Dur (YTW)	Issues	Day's Perf.	Index Value
Ratchet	4.18%	4.19%	51,627	17.00	1	-0.0393%	1,115.0
Fixed-Floater	4.96%	4.72%	61,452	15.98	7	-0.3252%	1,010.2
Floater	4.05%	4.05%	71,224	17.33	2	+0.5677%	945.0
Op. Retract	4.85%	2.52%	87,437	2.56	15	-0.0942%	1,055.5
Split-Share	5.30%	5.61%	69,131	4.16	15	+0.0665%	1,050.7
Interest Bearing	6.09%	3.98%	48,952	2.03	3	+0.1004%	1,124.5
Perpetual-Premium	5.95%	4.82%	369,839	11.11	13	-0.3102%	1,008.9
Perpetual-Discount	6.00%	6.07%	222,203	13.78	59	-1.1154%	875.4

Major Price Changes			
Issue	Index	Change	Notes
SLF.PR.D	PerpetualDiscount	-4.2246%	Now with a pre-tax bid-YTW of 6.24% based on a bid of 17.91 and a limitMaturity.
POW.PR.A	PerpetualDiscount	-4.0732%	Now with a pre-tax bid-YTW of 6.16% based on a bid of 22.73 and a limitMaturity.
PWF.PR.E	PerpetualDiscount	-3.5000%	Now with a pre-tax bid-YTW of 6.00% based on a bid of 23.16 and a limitMaturity.
GWO.PR.I	PerpetualDiscount	-3.0649%	Now with a pre-tax bid-YTW of 6.06% based on a bid of 18.66 and a limitMaturity.
W.PR.H	PerpetualDiscount	-2.6510%	Now with a pre-tax bid-YTW of 6.24% based on a bid of 22.40 and a limitMaturity.
TD.PR.O	PerpetualDiscount	-2.4988%	Now with a pre-tax bid-YTW of 5.85% based on a bid of 21.07 and a limitMaturity.
RY.PR.D	PerpetualDiscount	-2.2108%	Now with a pre-tax bid-YTW of 5.99% based on a bid of 19.02 and a limitMaturity.
W.PR.J	PerpetualDiscount	-2.1730%	Now with a pre-tax bid-YTW of 6.34% based on a bid of 22.51 and a limitMaturity.
TD.PR.P	PerpetualDiscount	-2.1450%	Now with a pre-tax bid-YTW of 5.84% based on a bid of 22.81 and a limitMaturity.
ELF.PR.G	PerpetualDiscount	-2.0533%	Now with a pre-tax bid-YTW of 6.88% based on a bid of 17.65 and a limitMaturity.
RY.PR.A	PerpetualDiscount	-2.0103%	Now with a pre-tax bid-YTW of 5.92% based on a bid of 19.01 and a limitMaturity.
CM.PR.P	PerpetualDiscount	-1.9512%	Now with a pre-tax bid-YTW of 6.31% based on a bid of 22.11 and a limitMaturity.
RY.PR.E	PerpetualDiscount	-1.8528%	Now with a pre-tax bid-YTW of 5.97% based on a bid of 19.07 and a limitMaturity.
IAG.PR.A	PerpetualDiscount	-1.8480%	Now with a pre-tax bid-YTW of 6.05% based on a bid of 19.12 and a limitMaturity.
BNS.PR.L	PerpetualDiscount	-1.7312%	Now with a pre-tax bid-YTW of 5.93% based on a bid of 19.30 and a limitMaturity.
BNS.PR.M	PerpetualDiscount	-1.6811%	Now with a pre-tax bid-YTW of 5.93% based on a bid of 19.30 and a limitMaturity.
BAM.PR.N	PerpetualDiscount	-1.6451%	Now with a pre-tax bid-YTW of 7.14% based on a bid of 16.74 and a limitMaturity.
RY.PR.C	PerpetualDiscount	-1.5768%	Now with a pre-tax bid-YTW of 6.02% based on a bid of 19.35 and a limitMaturity.
ELF.PR.F	PerpetualDiscount	-1.3965%	Now with a pre-tax bid-YTW of 6.85% based on a bid of 19.77 and a limitMaturity.
RY.PR.F	PerpetualDiscount	-1.3492%	Now with a pre-tax bid-YTW of 5.92% based on a bid of 19.01 and a limitMaturity.
BMO.PR.J	PerpetualDiscount	-1.3326%	Now with a pre-tax bid-YTW of 5.91% based on a bid of 19.25 and a limitMaturity.
BCE.PR.A	FixFloat	-1.2848%	
BNS.PR.J	PerpetualDiscount	-1.2314%	Now with a pre-tax bid-YTW of 5.69% based on a bid of 23.26 and a limitMaturity.
MFC.PR.B	PerpetualDiscount	-1.2225%	Now with a pre-tax bid-YTW of 5.79% based on a bid of 20.20 and a limitMaturity.
SLF.PR.B	PerpetualDiscount	-1.2152%	Now with a pre-tax bid-YTW of 6.18% based on a bid of 19.51 and a limitMaturity.
RY.PR.B	PerpetualDiscount	-1.2066%	Now with a pre-tax bid-YTW of 6.05% based on a bid of 19.65 and a limitMaturity.
RY.PR.G	PerpetualDiscount	-1.1942%	Now with a pre-tax bid-YTW of 5.99% based on a bid of 19.03 and a limitMaturity.

BNA.PR.B	SplitShare	-1.1846%	Asset coverage of just under 3.6:1 as of May 30, according to the company. Now with a pre-tax bid-YTW of 8.60% based on a bid of 20.02 and a hardMaturity 2016-3-25 at 25.00. Compare with BNA.PR.A (6.18% to 2010-9-30) and BNA.PR.C (7.01% to 2019-1-10).
SLF.PR.A	PerpetualDiscount	-1.1771%	Now with a pre-tax bid-YTW of 6.18% based on a bid of 19.31 and a limitMaturity.
GWO.PR.H	PerpetualDiscount	-1.1707%	Now with a pre-tax bid-YTW of 6.01% based on a bid of 20.26 and a limitMaturity.
NA.PR.L	PerpetualDiscount	-1.1581%	Now with a pre-tax bid-YTW of 6.27% based on a bid of 19.63 and a limitMaturity.
SLF.PR.E	PerpetualDiscount	-1.1506%	Now with a pre-tax bid-YTW of 5.98% based on a bid of 18.90 and a limitMaturity.
BCE.PR.R	FixFloat	-1.1304%	
HSB.PR.D	PerpetualDiscount	-1.1111%	Now with a pre-tax bid-YTW of 6.14% based on a bid of 20.47 and a limitMaturity.
POW.PR.B	PerpetualDiscount	-1.0825%	Now with a pre-tax bid-YTW of 6.06% based on a bid of 22.11 and a limitMaturity.
CM.PR.H	PerpetualDiscount	-1.0698%	Now with a pre-tax bid-YTW of 6.29% based on a bid of 19.42 and a limitMaturity.
MFC.PR.C	PerpetualDiscount	-1.0495%	Now with a pre-tax bid-YTW of 5.72% based on a bid of 19.80 and a limitMaturity.
TD.PR.Q	PerpetualDiscount	-1.0183%	Now with a pre-tax bid-YTW of 5.85% based on a bid of 24.30 and a limitMaturity.
WFS.PR.A	SplitShare	+1.0417%	Asset coverage of just under 1.7:1 as of June 12 according to the company. Now with a pre-tax bid-YTW of 6.34% based on a bid of 9.70 and a hardMaturity 2011-6-30 at 10.00.
POW.PR.C	PerpetualDiscount	+1.0455%	Now with a pre-tax bid-YTW of 6.03% based on a bid of 24.04 and a limitMaturity.
BAM.PR.B	Floater	+1.1702%	
BMO.PR.H	PerpetualDiscount	+2.1296%	Now with a pre-tax bid-YTW of 6.06% based on a bid of 22.06 and a limitMaturity.

Volume Highlights			
Issue	Index	Volume	Notes
BMO.PR.I	OpRet	162,000	Anonymous bought 122,000 from Nesbitt in six tranches at 25.20 … not necessarily the same "anonymous" for each tranche. Now with a pre-tax bid-YTW of -0.37% based on a bid of 25.18 and a call 2008-7-18 at 25.00.
RY.PR.W	PerpetualDiscount	149,975	Now with a pre-tax bid-YTW of 5.58% based on a bid of 22.20 and a limitMaturity.
BNS.PR.K	PerpetualDiscount	101,200	Desjardins crossed 90,800 at 21.20. Now with a pre-tax bid-YTW of 5.77% based on a bid of 21.15 and a limitMaturity.
SLF.PR.A	PerpetualDiscount	57,270	Anonymous bought 10,000 from Scotia at 19.45. Now with a pre-tax bid-YTW of 6.18% based on a bid of 19.31 and a limitMaturity.
TD.PR.O	PerpetualDiscount	45,700	Now with a pre-tax bid-YTW of 5.85% based on a bid of 21.07 and a limitMaturity.

There were twenty-eight other index-included $25-pv-equivalent issues trading over 10,000 shares today.

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- February 2007
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- November 2006
- October 2006
- September 2006
- August 2006
- July 2006

Categories

- Administration (5)
- Better Communication, Please! (25)
- HIMI Preferred Indices (158)
- HIMIPref News (112)
  - Data Changes (80)
  - Documentation (6)
  - Programme Changes (7)
- Index Construction / Reporting (71)
- Interesting External Papers (44)
- Issue Comments (364)
- MAPF (45)
- Market Action (500)
- Miscellaneous News (72)
- New Issues (56)
- PrefLetter (37)
- Primers (12)
- Publications (22)
- Reader Initiated Comments (26)
- Regulation (33)
- Regulatory Capital (31)
- Spreads to Bonds (5)
- Sub-Prime! (39)
- Taxation (11)

Canadian Fixed Income Data

- Canada Yield Curve
- Canadian Bond Indices
- Canadian Bond Prices
- Canadian Money Market Data
- Canadian T-Bill Rates
- IIAC Yield Conventions
- S&P/TSX Preferred Share Index
- Yield Calculation Convention

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- Economist's View
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  - MarketWatch
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  A Call, too, Harms
  Advisor's Edge Report
  June 2006
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  Yield Ahead
  Canadian Moneysaver
  July, 2006
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  September 2006
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  Advisors' Edge Report
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- **Research**
  Using Credit Ratings When Buying Preferreds
  Canadian Moneysaver
  October, 2006
- **Research**
  Closed-End Preferred Funds: Effects of Calls
  Advisors' Edge Report
  October, 2006
- **Research**
  Split Shares
  Canadian Moneysaver
  November 2006
- **Research**
  Interest-Bearing Preferreds
  Canadian Moneysaver
  January 2007

- Research
  Retractible Preferreds and Bonds
  Canadian Moneysaver
  February 2007
- Hymas Investment
  PrefLetter
  Monthly recommendations of Canadian Preferred Shares
- Research
  Perpetual Hockey Sticks
  Canadian Moneysaver
  March/April 2007
- Research
  Modified Duration
  Canadian Moneysaver
  May 2007
- Research
  Claymore Preferred Share ETF Analysis
  Canadian Moneysaver
  June, 2007
- Research
  Portfolio Construction
  Canadian Moneysaver
  July/August 2007
- Research
  Perpetual Misperceptions
  Canadian Moneysaver
  September, 2007
- Research
  Preferred Pairs
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  October, 2007
- Research
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  November 2007
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  A Collateral Proposal
  Advisor's Edge Report
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Online Resources

- BBA LIBOR Report
- Gummy Stuff
- OSFI Canadian Bank Data
- S&P/TSX Preferred Share Index
- Tax Calculator
- Yield Calculator (Excel Spreadsheet)

Research from Brokers

- CIBC Asset Management
- TD Securities

US Fixed Income Data

- Fed Funds Data
- Federal Reserve Economic data
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