

PRIVATE INVESTOR

Preference share funds can boost yields

MY FIRST e-mail of the day must have been written when the newspaper was hot off the press. "Why would you want an active market for preference shares?" the reader asked. "I hold them to give me a regular tax-free income. I don't want to gamble."

The answer is that an active market will improve liquidity and enable investors to buy – and sell – preference shares at prices appropriate to value based on their investment fundamentals.

In particular, as I've already mentioned, a change in the pattern of interest rates does not always alter the market value of an investment in preference shares.

This may not concern investors, such as the reader who has invested for the long run, but it does mean that new investors may be investing cheaply – lucky people – or expensively.

Even long-term investors – or their heirs – have inevitably to cash in their preference shares. They may even, as sometimes happens, be forced to sell them if the issuer buys them back.

An active market also enables investors to make choices based on the inputs from analysis made by both traders and long-term investors.

In any case, if you're confused about which preference share to buy, or can't get it, there are several preference share funds available from asset managers, such as BOE, Coronation, PSG and Grindrod Bank.

If you use the JSE database, you won't find the yields on the market prices. You will have to ask the asset managers to provide



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that information. The principal objective of these funds is to maximise dividend yield and limit loss in capital value.

I asked Gareth Scobie, who manages Grindrod Bank's diversified preference share fund, what the dividend yield was over

the past 12 months. The answer was 9,95%. The current unit price is R104,20. I didn't ask other asset managers for comparative yields.

Scobie also gave more information on the fund, and sent me a copy of an article he wrote earlier this year in Sanlam's Glacier newsletter.

In his article, Scobie graphically shows how over three years, the price of Absa Bank preference shares moved as the prime rate moved when the repo rate was changed.

Lower interest rates drive up capital values of preference shares (linked to prime rate) and vice versa.

In a mature preference share market, I would expect that, because there is an obvious correlation in capital and dividend return, the correlation would be almost exact and not roughly approximate.

As the preference share market is immature, there are opportunities to grab arbitrage profits when, as is often the case, the capital value and dividend return, relative to the prime rate, are skewed.

I have made an approximate internal rate of return on a 12-month investment in Grindrod preference shares over 2009.

Cashing out the investment at the end of the period, after capital gains tax, the internal rate of return – cash in to cash out – was about 16%. On market price to market price, after capital gains tax, the gain was close to 14%, a significant difference.

In a mature market, such as that for bonds, such an attractive arbitrage margin on the capital would have narrowed very quickly.

