Claymore S&P/TSX CDN Pref ETF Common CPD

Morningstar Rating	Last Price	Net Asset Value	Expense Ratio	12 Month Yield	Assets Under Management	Volume	Category
★★★	17.38	17.40	—	5%	858	66,065	Canadian Dividend and Income Equity

Per share prices in CAD

This ETF offers a high yield and seniority to common stocks, but it is not without risk.

by Morningstar Analyst

Pricing data through January 10, 2012
Rating updated December 31, 2011

Thesis 12-22-11 | John Gabriel
Suitability

Claymore S&P/TSX CDN Preferred Shares is not very diversified in terms of sector exposure, but it could be an appropriate satellite holding for income investors who are looking for a little extra yield and are willing to take on the risks imbedded in moving down the capital structure to do so. This fund is concentrated; more than 80% of its holdings are in the financials sector, and just 27 companies are represented (many issuers have several classes of preferred stock). As such, we strongly urge investors to consider their existing allocation to the financial sector. Remember, CPD will be highly correlated to financial stocks and would thereby offer minimal diversification benefits to a portfolio already overweight in the sector.

We view adding preferred equity securities to a portfolio as being analogous to adding midgrade corporate fixed income. They offer high and consistent yields and are safer than common stock but are still more volatile than bonds. In fact, should a default occur, preferred shares are subordinate to bonds in the priority of claims on assets. In exchange for taking the riskiest position at the bottom of the capital structure, common stock investors retain all of the voting rights and enjoy all of the upside should the firm do well. Preferred shares have no voting rights and little potential for capital gains.

Like all preferred stock securities, this ETF benefits from having dividends taxed like common stock dividends. Distributions are taxed more favourably as dividend income, as opposed to interest income, which bolsters the after-tax return relative to what might be earned in traditional fixed-income securities. This preferential tax treatment could also make this ETF a good choice for taxable accounts.

Fundamental View

The fund currently offers a 4.9% yield, which is between the yields offered on investment-grade and junk bonds. Although Morningstar analysts do not rate preferred stock, this fund is highly concentrated in financial issuers, and our analysts currently see Canadian financial stocks trading at fair value. However, as investors in preferred shares, we're more concerned with balance sheet strength and the overall health of the underlying businesses. On this front, the portfolio looks more attractive, as our analysts see Canadian banks as having lower uncertainty with wider economic moats than the broader market.

That doesn't mean an investment here is without risk; CDP's portfolio includes more than just the fortress-like Canadian banks. In fact, about 19% of the current portfolio is rated P-3, which qualifies as "junk" status, or non-investment grade on the global ratings scale. Investors should keep in mind that the fund's current high yields are reflective of this risk.

Because of their hybrid debt and equity characteristics, preferred shares are treated as Tier 1 capital under bank regulatory capital requirements. This is why we saw increased issuance of preferred stock in the United States during the financial crisis as U.S. banks tried to strengthen their balance sheets. Fortunately, the banking system in Canada didn't experience the same balance sheet stress as its U.S. counterpart. By maintaining more prudent lending standards and keeping roughly three-fourths of loans on their books (rather than securitizing and selling them off) the Canadian financial companies avoided many of the questionable practices that led to the global credit crisis.

The reasonable leverage ratios of most Canadian financial institutions (relative to their U.S. counterparts) are a big positive for preferred investors, as balance sheets are less sensitive to asset price swings. Finally, keep in mind that although increases in bank capital dilutes the capital of common stockholders, they also strengthen the banks' ability to meet preferred dividend payments.

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Portfolio Constructions

This fund tracks the S&P/TSX Preferred Share Index, whichcontains preferred issuances that are meant to track Canadian preferred stocks that trade on the Toronto Stock Exchange. The types of preferred securities include floating- and fixed-rate preferreds, cumulative and non-cumulative preferreds, preferred stocks with a callable or conversion feature, and trust preferreds. The index uses a modified cap weighting and screens constituents for minimum size, liquidity and issuer ratings. The benchmark is rebalanced quarterly, and currently contains 149 securities from 27 unique issuers.

Fees

With an MER of just 0.50% (including HST adjustments), CPD makes owning a basket of preferred stocks very cheap and simple. An advisor version is offered under the ticker , which includes a 0.50% trailer fee has a total MER of 1.06%.

Alternatives

iShares S&P/TSX North American Preferred Stock Index (CAD-Hedged) and PowerShares Canadian Preferred Share Index , which both charge MERs of 0.45%, are the only other ETFs in Canada that provides exposure exclusively to the preferred equity market. Unlike CPD and PPS, which only hold Canadian securities, the iShares ETF has 50% exposure to Canadian preferreds with the bulk of the remainder allocated to the U.S. Investors looking for safety of capital and high yields should also look at fixed-income ETFs such as BMO Long Corporate Bond Index (), which charges an MER of 0.30%. ZLC, which holds investment-grade bonds from corporate issuers, has a weighted average yield of 5.2%. Other alternatives to consider include iShares DEX All Corporate Bond Index (), iShares DEX Long Term Bond Index () and Claymore 1-5 Yr Laddered Corp Bond (), which all sport yields above 5% and charge MERs of 0.40%, 0.35% and 0.25%, respectively.

Investors looking for preferred stock alternatives that trade on U.S. exchanges should look at iShares U.S. Preferred Stock (roughly half of iShares' XPF), which charges an expense ratio of 0.48% and offers a yield of about 7.2%. PFF, which holds about 32% of its assets in non-investment grade (junk) issuers, contains 249 securities from more than 100 issuers. There's also PowerShares Preferred Portfolio , which charges an expense ratio of 0.50% and has a yield of 7%. Although 80% of this fund is in the financials sector, it offers better diversification than PFF with 58 strictly investment-grade issues. There's also PowerShares Financial Preferred , which has an 7.5% yield and a 0.60% expense ratio. Focused on global financials, this fund holds preferreds from 21 issuers with 53% of assets in just four issuers. SPDR Wells Fargo Preferred Stock carries an expense ratio of 0.45% and with 67 issues, about 74% of the assets are in financials. However, as one of the newer preferred ETFs, it has not yet attracted significant assets or volume.

Bulls Case

- Preferred securities are higher up in the capital structure pecking order, making them relatively safer than common stock.
- Preferred securities generally pay out consistent dividends like bonds but are taxed like common stock dividends.

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- While expected volatility and returns of preferred securities fall between those of common stocks and bonds, their yields are typically higher than both.
- Although increases in bank capital dilute banks' common stockholders, they strengthen theability of the banks to meet preferred dividend payments.

Bears Case

- Preferred stocks are exposed to interest-rate risk like most other fixed income. A rise in interest rates will cause the price of these securities to drop.
- Although higher in the capital structure than common stock, preferreds are still subordinate to debt and can lose substantial sums. They also give up voting rights and capital gains to common stock.
- Many of the preferred issues in this fund are noncumulative in nature. That means the company will not pay preferred dividends in arrears if it suspends its dividend.

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Morningstar's Approach to Evaluating ETFs

Our Key Investing Concepts

- Company Quality
- Consider Buying/Consider Selling
- Coverage Rate
- Expected Return
- Fair Value
- Hurdle Rate
- Margin of Safety
- Valuation

Our approach to evaluating ETFs is multi-faceted, reflecting the various ways ETFs can be used.

For instance, given their diversification and low cost, ETFs are good candidates to anchor a portfolio. Alternatively, narrowly focused ETFs like region- or sector-specific funds can be used to plug holes in a portfolio. ETFs can also be worthwhile alternatives to positions in individual securities. Instead of buying a healthcare stock, for example, an investor might opt for a healthcare ETF that owned an assortment of firms.

This versatility informs the way we analyze ETFs. for investors using ETFs to build more efficient portfolios ("Portfolio-Builders"), our analysis coalesces around a fund's role and utility in a portfolio. For those investing opportunistically in certain areas that they think are poised to beat the market ("Market-Beaters"), we focus on the fundamental attractiveness of the securities that an ETF owns.

Portfolio-Builders

Investors trying to construct a low-cost, well-diversified portfolio are likely to focus on a few key attributes when selecting ETFs.

Cost: An ETF's stated expense ratio is crucial in that costs drag on a portfolio's returns. For that reason, we generally recommend investing in ETFs that levy the lowest expense ratios.

Portfolio Construction: There are innumerable ways to build a portfolio using ETFs. Ultimately, the "right" ETF is the one that's best suited to an investor's needs. Therefore, we typically consider an index's breadth (the variety of securities it holds) and depth (the weight of those securities in the portfolio) in evaluating an ETF's usefulness.

Tax Efficiency: ETFs should be more tax-efficient than comparable open-end mutual funds. With that in mind, we typically monitor whether an ETF has kept a lid on taxable capital gains distributions.

Performance: An ETF's returns and risk are important, but not a divining rod. We consider an ETF's past performance in gleaning insights into the fund's tendencies--does it lag in rallies and hold its ground during downturns? This can shed light not only on how the fund is likely to perform in the future, but also how it might complement other portfolio holdings.
All told, we favor low-cost, tax-efficient ETFs which are founded on prudent strategies that lend themselves to portfolio construction.

Market-Beaters

Our approach to opportunistic investing with ETFs starts from a central premise: An investment in a stock ETF isn't a wager on the value the market places on a piece of paper; it's a stake in the dozens of businesses the fund owns.

Thus, we think investors seeking to beat the market using ETFs should focus on the intrinsic worth of the businesses concerned. When the market is fairly valuing those firms, then an investor is getting her money's worth. But when the market significantly undervalues those businesses, then an investor stands to reap a market-beating return.

Of course, estimating the value of hundreds of businesses is no mean feat. To that end, Morningstar's equity analysts cover 2,000-plus stocks spanning numerous industries and geographic locales. To estimate a firm's fair value, our analysts conduct extensive fundamental research, examining its competitive profile, the durability of any advantages it might boast, and the economics of the markets in which it operates.

By aggregating these fair value estimates, we can also estimate a stock ETF's intrinsic worth. We can begin to evaluate an ETF's attractiveness by comparing its market price with our fair value estimate.

This process culminates in our ETF "valuation ratings", which denote the attractiveness of a stock ETF based on the valuation of its underlying holdings. For instance, if an ETF is trading meaningfully below our fair value estimate, then we'll assign it an "undervalued" rating. By contrast, if

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it's trading at a substantial premium to our fair value estimate, we'll give it an "overvalued" rating.

Following is a guide to some of the important themes in our ETF research.

Company Quality: High-quality firms boast intractable competitive advantages, or "economic moats", that confer economic benefits to shareholders for years and years. Scale in an industry where cost leadership is paramount (ExxonMobil, Wal-Mart), intellectual property protection (Merck, 3M), and brand equity (Coca Cola, Procter & Gamble) are examples. The wider a firm's moat, the more defensible its advantages and, thus, the higher its quality. Since higher-quality firms are worth more, an ETF that's chock full of wide-moat businesses is more valuable than a fund that invests in lower-quality firms in an intensely competitive industry.

Consider Buying/Consider Selling: The "consider buying" price is the market price at which we would recommend investing in an ETF (i.e., when it receives an "undervalued" rating). The "consider buying" price will vary depending on an ETF's risk. Generally speaking, the riskier the ETF, the lower the "consider buying" price relative to the fair value estimate. The opposite is true for less-risky ETFs. The "consider selling" price is the counterpart to the "consider buying" price, marking the price at which we would recommend selling an ETF.

Coverage Rate: This is the percentage of an ETF portfolio's assets that our analysts cover. Generally speaking, we only estimate an ETF's fair value when we cover stocks representing 70% or more of the fund's assets.

Expected Return: An ETF's expected return measures the pre-tax, pre-fee annualized return an investor would stand to realize if the ETF's price converged to our time-adjusted fair value estimate over a three-year time horizon.

Fair Value: A stock ETF's fair value estimate is our estimate of what the portfolio is worth in aggregate. We derive an ETF's fair value estimate by aggregating the fair value estimates that our analysts place on the fund's constituent stock holdings. The more valuable an ETF's holdings, the higher those stocks' fair value estimates and, in turn, the higher the ETF's aggregate fair value estimate.

Hurdle Rate: An ETF's hurdle rate is the sum of its portfolio's weighted-average cost of equity (COE), its annual expense ratio and, in certain cases, an incremental risk premium. The COE expresses a firm's intrinsic risk as a percentage (e.g., 10%). It represents the minimum return an investor would accept in exchange for purchasing the stock.

Margin of Safety: The gap between the "consider buying" price and the fair value estimate, the margin of safety affords protection should our fair value estimate end up being off the mark. It's a margin of error that varies depending on an ETF's risk; the riskier the ETF concerned, the wider the margin of safety we'd demand, and vice versa.

Valuation: An ETF's valuation rating can take three forms--"undervalued", "fairly valued", and "overvalued". ETFs trading at a meaningful discount to our fair value estimate receive an "undervalued" rating while those trading at a substantial premium get an "overvalued" rating. ETFs hovering near our fair value estimate are rated "fairly valued".

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