

[Looking at a dividend yield of 11% \(III\)](#)

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I have [posted before](#) on the Dividend 15 Split Corp. as an investment for income investors to consider. This post reprints a more complete report I recently did on the corporation for a subscription investment advisory; it contains additional material and provides a fuller analysis. (Disclosure: I don't own any shares in Dividend 15 Split Corp. at the present time but am considering adding them to my holdings).

Looking for income yield?

It's hard to find income investments with good yields these days. But there is one overlooked corner of the stock market where you might find what you are looking for: split shares (if you are unfamiliar with them, see Appendix I).

By way of illustration, let's consider Dividend 15 Split Corp. At current prices, its Class A shares (DFN) pay a dividend of over 11 per cent and its Preferred shares (DFN.PR.A) pay a dividend of more than 5 per cent.

Dividend 15 holds a portfolio of 15 dividend-yielding, high-quality Canadian companies (see list in Appendix II below). The weights for the 15 stocks are expected to vary between 4 and 8 per cent, but may go outside this range from time to time.

Let's roll up the sleeves and take a look under the hood. How are the dividends paid? Are they secure? As it turns out, the preferreds are well secured according to a preferred-share expert. The Class A shares don't look too bad either if you can live with a bit of risk.

How the dividends are paid

The Preferred shares pay fixed monthly dividends of \$0.04375 each. They are funded from the dividends distributed by the 15 companies in the portfolio. The preferreds do not participate in the growth of the 15-stock portfolio.

Class A shares participate in the growth of the 15-stock portfolio. They also receive monthly cash dividends of \$0.10 each.

The Class A dividends are "predominately funded by the additional income earned from the covered call writing program," notes a company publication. That is, income is collected from selling call options on the 15 stocks, and is supplemented with capital gains realized in the event the call options are exercised. Another source of income is the excess in dividends not required to fund the preferred shares dividend.

Preferred-share expert likes the preferreds

I asked preferred-share expert James Hymas of Hymas Investment Management for his opinion on the Dividend 15 Preferred shares. His comments were favorable. To quote:

“The preferred shares are well secured, with each \$10 preferred share backed by about \$19.5 in stock of mostly blue-chip Canadian corporations (although heavy on the financials). Income coverage in the first half of 2009 was a very healthy 1.4 to 1.

Investors should not be overly concerned about the credit rating of only Pfd-3(high) from DBRS. The latter considers only the potential for default and makes no allowance for recovery after default, which may be expected to be much higher for split share corporations than for ordinary corporations.”

Note: The preferred dividends are preferential (paid before Class A) and cumulative (make up for any skipped payments). They are also non-callable (company can't ask for them back whenever it wants).

What about the Class A shares?

The monthly payments to Class A shares are a target (not fixed). “They can be missed if the portfolio declines ...,” says company literature. Nevertheless, the targeted monthly dividend has been met since the corporation was set up in early 2004. In addition, there were special dividends in three years.

Moreover, the payout would be missed only if the net asset value of the fund went below \$15 for a certain period of time, says a company spokesperson. During the recent bear market — one of the severest in decades — this threshold was not breached (although it was close). Currently, net asset value stands at \$19.50. Special dividends are paid out when net asset value reaches \$25.

The price of the Class A shares have run up by more than 50 per cent since the March trough. They typically trade close to their intrinsic value (the net asset value of the portfolio less the \$10 par value of the preferred share). At times, though, they may trade at a discount or premium to the intrinsic value. Right now, there is a premium of about 7 per cent.

Annual fees

Owning shares in Dividend 15 is effectively the same as owning units in a mutual fund. The annual management expense ratio is 1.3 per cent presently, according to a company spokesperson. These fees are not charged directly; they are taken out of the dividends received from the 15 companies, and the covered call program.

Termination date

Like most split-share corporations, Dividend 15 has a termination date (which may be extended). It is December 1, 2014. If the wind-up proceeds, the preferred shareholders are entitled to receive the original issue price of the preferred shares. They have first claim to the underlying assets. The Class A shareholders will receive the balance of the net asset value. If the stocks held in the fund have increased in value, they should receive more than the issue price.

Wrap-up

With plenty of slack in the economy and policy makers eager to produce an economic recovery, there may be scope for an extended period of non-inflationary growth in the economy. That would seem to be supportive (within a 12- to 18-month time frame, at least) of the 15-stock portfolio underlying Dividend 15 – and, in turn, capital gains on the Class A and dividends on the Class A and Preferred shares.

Still, the Class A would only be for risk-tolerant investors. Areas for further research include the covered-call program and how it is managed. Conservative investors might be content with the preferred shares of Dividend 15 Split Corp.

Appendix I: How split shares work

Let's say the common shares of ABC Corp. trade on the exchange at \$35 and pay a \$1.50 dividend to yield 4.3 per cent. A sponsor sets up a company through a public offering to buy the shares and then split them into preferred shares priced at \$25 and capital shares at \$10. The ABC Preferred Split share gets the dividend, while the ABC Capital Split share gets the capital gains (or losses) and perhaps a special dividends or other income other than the regular dividends.

Now assume the underlying ABC common shares rise over three years from \$35 to \$50 for a 43-per-cent capital gain. The ABC Preferred shares get an annual dividend yield of 6 per cent ($\$1.50/\25), while holders of the ABC Capital shares earn a capital gain of 150 per cent because their \$10 shares are now worth \$25 ($\$10+\15).

Appendix II: Portfolio of Dividend 15 Split Corp.

(sorted by weight, as of Nov. 30)

Bell Canada Inc.
Canadian Imperial Bank of Commerce
TransCanada Corp.
Manulife Financial
CI Fund Management
TransAlta
AGF
TMX Group
Enbridge
Telus
Bank of Montreal
Toronto Dominion Bank
Royal Bank
Sun Life Financial
National Bank