

April 2, 2009

Economic Indicators

Canada

	Dec. 2007	Feb. 2009	
GDP ⁽¹⁾	2.7	-2.4 ⁽²⁾	↘
CPI ⁽¹⁾	2.4	1.4	↘
Unemployment	5.9	7.7	↗

United States

	Dec. 2007	Feb. 2009	
GDP ⁽¹⁾	2.0	1.1 ⁽³⁾	↘
CPI ⁽¹⁾	4.1	0.2	↘
Unemployment	5.0	8.1	↗

⁽¹⁾ Year-over-year % variation

⁽²⁾ January 2009 ⁽³⁾ December 2008

Sources: Statistics Canada, U.S. Dept. of Commerce, U.S. Dept. of Labor Statistics.

Equity Indices

% Change	2009 in local currency	2009 in C\$	
S&P/TSX	-0.5	-0.5	↘
S&P 500	-10.2	-7.0	↘
Russell 2000	-14.1	-11.0	↘
Nikkei	-5.7	-10.1	↘
S&P 350 Europe	-10.7	-12.3	↘

CAPITAL TRUST NOTES: AN OVERVIEW

In recent weeks, securities known as “Capital Trust Notes” (CTNs) have received a certain amount of attention. These securities, which are issued by Canadian banking and life-insurance conglomerates, seem to offer a high interest rate and the seeming safety of a familiar issuer.

How high are the interest rates on these instruments? Here is an example: on December 15, 2008, BMO Capital Trust II, an affiliate of the Bank of Montreal, launched a Capital Trust Note callable at their full face value in 2018 with an eye-popping 10.22% coupon. On the same day, Bank of Montreal Deposit Notes maturing in 2018 were yielding 5.94%. Why such a difference? Was this a bargain?

Probably not. Capital Trust Notes carry a higher interest rate than Deposit Notes because they are riskier. One reason for this is the relative ranking of CTNs within the institution’s priority of liabilities, as shown in the following list of BMO Financial Group liabilities (as of October 31, 2008), ordered by priority of claim:

Deposit Notes are here →	Deposits	\$257.7 billion
	Other liabilities	\$134.7 billion
	Subordinated debt	\$4.3 billion
CTNs are here →	Capital trust securities	\$1.1 billion
	Preferred share liability	\$250.0 million
	Shareholder equity	\$17.9 billion

Total liabilities and shareholder equity: \$416 billion

A few other characteristics of CTNs make them relatively risky. First, they typically have a 99-year original maturity. Nevertheless, the market tends to value them based on their *interest-reset date* (typically 10 years after the time of issue) because the interest-reset mechanism makes CTNs very likely to be called by the issuer—very likely, but not certain. In addition, just like dividends on preferred shares, the issuer is allowed to stop paying cash interest on these notes without being declared insolvent. And last but not least, CTNs are issued by a subsidiary of a bank (or life insurer), not by the bank itself, which makes them a lot less valuable in the unlikely event of financial distress.

How risky are Capital Trust Notes? Although they are part of major bond indices, we consider them as fixed-income securities with a relatively high yield and an equity-like risk level. Therefore, an investor wanting to add CTNs to his or her portfolio should apply the same rules of caution and diversification that are recommended for equities.

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