



Fish or Bear Palm

By CK Wong 2006.07.14

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Introduction

There is a Chinese maxim that says it is hard to choose fish and bear palm. When Western reads this phrase, it is really hard to appreciate what is the meaning. The phrase came from the classic literature Man Tze who was student of Confucius. In 2000 years ago, at the inland, fish is hard to come by. Bear palm was also a rare game. The expression vents the frustration to choose from two hard to get delicacy. This is the dilemma for stock picker today. I am going to use the Pengrowth Income Trust as an example to illustrate the danger of speculation in today's market.

Majority Canadian Ownership

Under the Canadian Tax, last year, a income trust must have majority ownership otherwise it will lose all the tax treatment of income trust which avoid any income double taxed at corporate and unit holder levels. Pengrowth was a regular stock. To take advantage of the tax ruling, it created the A and B classes of share where B could only be held by Canadian and A can be anyone. The right and book value of both classes are exactly the same. In fact the B class is more advantage because it gives Canadian investor 5% discount for dividend reinvestment. The A class is also listed on American exchanges. By controlling the ownership of class of shares, there is no dispute on the ownership because the owner has to declare its nationality.

This is fact rather than any stock report. The A class shares had very low volume of trading and had a higher premium. At one point the premium was C\$10. As of today, July 14, 2006, the price still have more than one dollar premium. It is believed that the stock is much sought by the foreign investor and the small volume available from the market enforces the premium. Actually, the A class share has the 49% shares of total outstanding shares. There is no shortage of it.

At the beginning of this year, the income trust under the advisory of legal and financial counseling decided to merge the two classes of shares after it received the Canadian Tax exemption.

Price Movement

The price of merged shares can have 3 possible directions:

1. Moves to the higher price A class because the demand.
2. Moves to the lower price B class because of the abandon supply.
3. Something in between because there is a equilibrium between the demand and supply.

Since the announcement of the merging, the scenario becomes more complicated. Both classes of shares move up. In some day, the A class gain more than B and some day the other way round.

So which one would you buy to take advantage of the situation? If the scenario is 1, buying B class will gain the premium. If the scenario 2, you can short A. If the scenario is 3 and you hold the A, you should short A and buy B.

There is also another dimension of complexity. The trust is a producer of natural gas (about 70%) and oil. With the continuously falling price of natural gas, buying the stock has risk. Would the 30% oil able to cover the fall since the oil price high U\$78 today?

A tough choice to make.

I'll provide an update after the merger.