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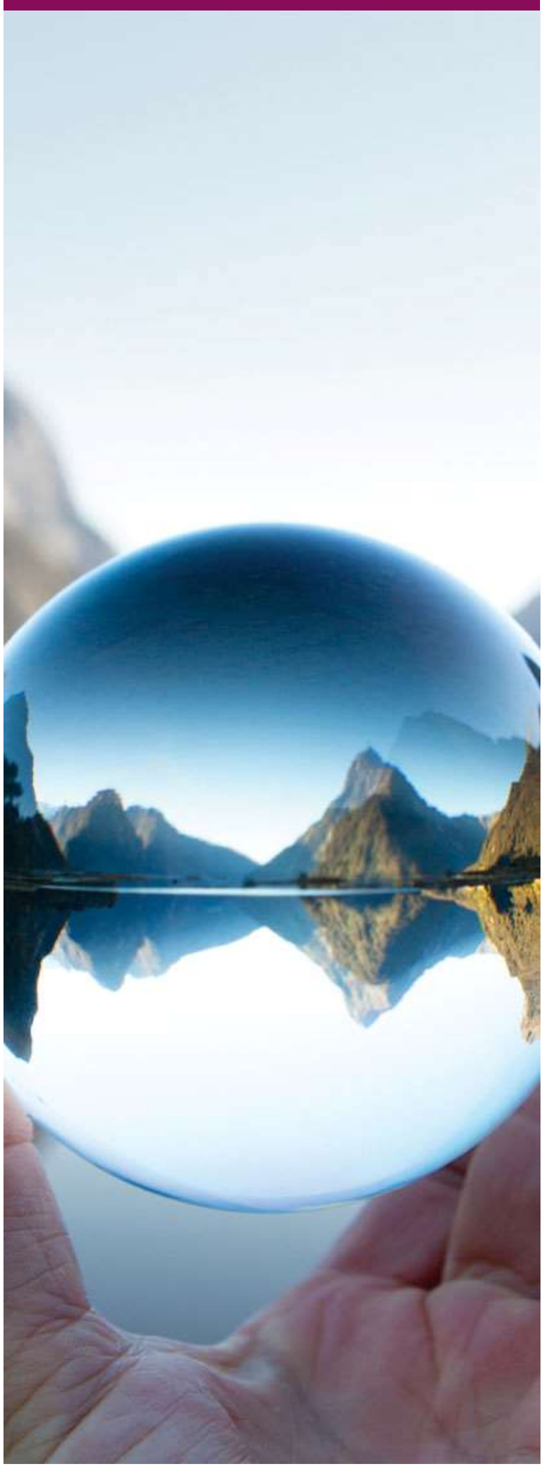
Wealth Management

Special opportunity



On sale!

High quality Canadian Preferred Shares

I have been an investor in the Canadian rate reset preferred shares ("preferred shares") [1] market since starting as a retail advisor at a major Canadian bank. In recent months, the general stock market has been weak, but the preferred share market has been especially hurt. Many high-quality issues are down between 20%-30%+.

To me, this change in price has caused this asset class to go from a small component of a fixed income portfolio to a top idea for all but my most aggressive investors. In a market that I feel is generally fully valued, <u>I think Canadian rate reset preferred shares are cheap and I am currently recommending them for my clients.</u>

Finally, due to some expected tax-loss selling in December they might get even cheaper. This could create one of the best opportunities I've seen in my investing career for long-term investors.

If you're looking for very high yields with the ability for capital appreciation should interest rates start to rise, I encourage you to call me to discuss how preferred shares can lower your risk and increase your after tax returns.

What is a preferred share?

Preferred shares have a higher claim on a company's assets and earnings than common stock. This means that the full dividend must be paid to the preferred share holder before one cent is paid to the common stock holder.

What is a rate reset?

Every five years, the yield of a rate reset preferred share will adjust to the Government of Canada five-year bond plus a fixed spread.

As an example, if a preferred share was first issued five years ago, the five- year government bond was paying 3% and the spread was 2% (200bps), you would get 5% for the first five years (3% + 2%).

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[1] Although there are all sorts of preferred shares, for the purposed of this article Preferred shares refers only to Canadian Rate Reset Preferred Shares

Five years later, when the coupon reset, the government five- year was paying .84% you still get the same 2% spread above the government bond, so your new coupon would be 2.84% (.84% + 2%).

Why did prices drop so much?

When preferred shares were issued in 2010 and 2011, the five-year Government of Canada rates were around 3% and most investors couldn't imagine them going lower. Everyone thought when the shares reset in five years (happening now) rates would be higher. To investors' surprise, rates are *lower* now than they were five years ago with the five- year Government of Canada bond yielding around 0.84%. Investors are getting 2.16% (3% rate five years ago less 0.84% current rate) less than what they initially received and certainly less than what they expected under the assumption that rates would have risen by the first reset date.

As these 2010 issues first started to reset, investors realized the extent of the lower rate of returns they would now be getting and started selling them, ignoring the current interest rate environment. Many investors tend to only care about what yield they receive without considering what other fixed income alternatives are yielding in this new low interest rate environment. This selling snowballed because preferred shares are one of the most illiquid markets around. This means it's difficult to buy or sell without moving the price significantly. Small amounts of selling had big impacts on prices in the market.

As prices dropped, more and more retail investors insisted on selling, pushing the price down even more. In my opinion they were selling because they had lost money from their first purchase price and not because the shares didn't offer value at current prices. It was a case of Mr. Market being irrational in the short term. Most great investors agree that the market is irrational in the short term but a very good indicator of value in the long term.

Adding insult to injury, preferred shares were and continue to be marketed like bonds. They were sold to very conservative investors that didn't want to lose money. Expecting a very secure investment, and seeing drops in price of 20%+, retail investors are willing to get out at any price. I believe this is a major shortfall of retail investors. They invest only based on what has done well in the past, versus objectively analyzing what should do well in the future. My belief is that what has done the best in the past is the most due for a correction while what has done poorly is most likely to appreciate with a reversion to the mean.

Why is this attractive now?

Understanding the call feature

All Canadian preferred shares are issued at $25. The company has the option to call them at set dates in the future at or slightly above this $25 price. What this means is new issues that are coming out now are at $25, but in the future if the terms of these issues became more attractive than what the company could issue at that future date, the company will call them. Because we have the ability to buy existing preferred shares in the market in the $15-$18 range, the company is very unlikely to call these issues at $25+. And even if they chose to it would result in a gain for us of about 40%-66% on top of any yield we collected while we wait. It's important to remember that a call feature is a negative feature for investors – it means that the companies can call your investments away when they are doing well. Buying at a discount to the issue price of $25 significantly reduces the risk of call.

Tax

The income from most preferred shares is considered dividends and is taxed very favorably versus the income from a bond which is fully taxed. So, if you had a preferred share paying 5%, you would need to find a bond paying 6.55% to end up with the same after tax yield. *Assuming you are in the highest tax bracket and a taxable account

Discount to Issue Price

As explained above, all pref shares are issued at $25 with a set spread. This spread sets the coupon which is based on a $25 shares price. A 4% coupon means a dividend of $1.00. When that share is priced at $25, your yield is 4%. When that same share is priced at $21, your yield increases to 4.8%. Lower share prices make higher yields. With some pref shares trading in the $15 range this means the same security is yielding 6.6% or 65% more than for an investor who had originally bought it at $25.

After tax return

Issue	Yield	Yield Type	Capital upside potential
Canada 2.25% 01-Jun-2025	1.44%	interest	nil if held to maturity
Ontario 2.60% 2-June-2025	2.47%	interest	nil if held to maturity
Fairfax 4.95% 03-Mar-2025	4.34%	interest	nil if held to maturity
FFH.PR.M 4.75% 31-Mar-2020 +398 reset	5.78% to 2025 *	dividend	potential for up to 25%
Brookfield Ast Mgmt 4.54% 31-Mar-2023	3.41%	interest	nil if held to maturity
BAM.PF.A 4.50% 30Sep-2018 +290 reset	5.39% to 2023 *	dividend	potential for up to 35%
iShares US High Yield ETF (XHY)	6.08%	mostly interest	market

Source: Bloomberg

This table shows the yield you would get on similarly dated fixed income securities. On a 2025 Government of Canada bond you are going to receive 1.44% or 2.47% for an Ontario Provincial Bond. If you're willing to increase your risk and buy the corporate credit of Fairfax Financial you would receive 4.34%. To take the additional risk of moving down one level in the capital structure and buying the preferred share of the same company, you would receive 5.78% over the same time period (using current rates). On a pre-tax equivalent yield (the bond price you would need to receive to achieve the same after-tax rate of return) you would need to find a Fairfax bond paying 7.55% assuming you are in the highest tax bracket.

It's a similar story for Brookfield Asset Management. The bond is paying 3.41% in interest and the preferred share is paying 5.39% over the same period. You would need to find a bond paying 7% to have the same after-tax yield as the preferred shares.

High yield bonds in the U.S. are yielding about 1%-1.5% less on an after-tax basis than these preferred shares of companies who have a dramatically higher credit quality than the high yield index.

Capital appreciation

When looking at the after-tax return of the previous preferred shares, it's my belief that they are mispriced. Over time, I think the market will realize this and start to pay more for the preferred shares, increasing the price and creating a capital gain for holders. Although I don't think the preferred shares will trade back to their par issue price of $25, I think a 10%-25% increase over the next three years is quite possible.

Catalyst for capital appreciation

The short-term catalyst for the prices of these preferred shares to increase is simply the market doing the risk/return analysis I showed you and the selling pressure on the shares to stop and buying to start again.

I also think low interest rates set by the government have made investors reach for return into more high-risk assets like stocks. The current sell off in stocks will remind people that the stock market is not a smooth ride and revisit more conservative investments.

Longer term, I'm a strong believer interest rates will rise. If this will be in 1, 3, 5 or 10 years I'm not sure. Admittedly, I didn't think interest rates would have stayed this low this long. In the US, I believe a rise in interest rates is almost here. The rise in interest rates in Canada could take longer. At its core, I think the US has a very strong economy while Canada, who significantly relies more on energy and resources is really struggling which should keep rates lower at home longer. When interest rates do rise, these preferred shares will become much more attractive as many will carry a 4% spread to the five- year Government of Canada rate. Long term I don't think it's unreasonable to think rates will return to 3% or 4% on a five-year government bond. This would create a yield in the 6%-7% range for some very high-quality companies. Issues being sold now at $25 would likely be called if their yields reached this range.

Risks

I never want to imply any trade is without risk and this one is no different. The recent sell in the market should make it extremely clear how volatile this market can be. Just because I think it's cheap now, doesn't mean it can't get cheaper. There are all sorts of risks. I just want to touch on a few major ones.

Tax loss selling

I'm quite concerned about year-end tax selling. Investors are going to be seeing huge losses on these shares starting now and increasing through the end of the year. They'll want to sell at any price to crystalize the loss. Strong retail selling into a very illiquid market could be very scary in the short term.

Lack of liquidity and institutional buyers

Some top institutional money I know is very excited about this space. I've confirmed that several of the most respected institutional fixed income and equity funds are buyers into this asset class where they don't normally play. With the limited liquidity of the market, I think it will keep many from getting as involved as they would be if it were more liquid. Without the full backstop of smart money getting involved, drawdowns could be more significant.

New issues

Recently a few new issues have come out such as Brookfield and Royal Bank. The Brookfield had a beneficial new provision that actually guarantees a minimum yield if rates continue to drop addressing the retail community's largest problem with previous issues. When new issues come out, the existing issues trade (in this case down) to match the terms of the most recent issues. As preferred shares are in the bad books of many retail investors, new issues are offering attractive terms to entice new investors. This has been and could continue to drive price of existing issues lower. Longer term I believe it will be beneficial to own the older preferred shares trading at a discount to its issue price because the company will be much less likely to call them.

Summary

Part of the selloff in the preferred share market is justified. These shares yield a lot less than they did in the past and new shares coming out are offering more attractive terms.

Although prices could continue to be volatile in the near term, for a long-term investor I see incredible value. If interest rates stay very low, holders will be receiving a tax efficient yield of about 5-6%+. This is very attractive in a super low interest rate environment. If interest rates rise, investors will receive substantially more than this and will also benefit from capital appreciation.

I'm currently a buyer and will use any further price drops, particularly year-end tax loss selling as an opportunity to increase my position. If you have interest in purchasing some preferred shares, I'd be happy to talk to you about the individual shares that I find most attractive. You can contact me at 416-512-5698.

Contact

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