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Two high-yielding blue chips in the preferred-share bargain bin

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Rate-reset preferred shares were built for the kind of world we were living in until this fall.

The sudden reversal of investor expectations for interest-rate increases has pushed rate-reset preferreds into a tailspin that is a bit reminiscent of the harrowing plunge of 2015. Rate-resets turned out to be a great buy back then. Can the same be true of the most recent setback?

Portfolio manager Dustin Van Der Hout of Richardson GMP believes there are some bargains to be had in the rate-reset preferred market. As examples, he highlights a pair of issues from Brookfield Asset Management Inc. – BAM.PR.R and BAM.PF.B.

Rate-resets thrive when there are expectations of rising rates ahead. Until fall 2018, that was exactly the outlook. Now, investors are worrying that economic growth has peaked and rates many not rise much further. Rate-resets offer a yield that is set every five years using a spread over the five-year Government of Canada bond. Rising rates offer the opportunity to get a higher yield from a rate-reset, while falling rates mean you could get less.

As a proxy for the rate-reset preferred market, let’s use the BMO Laddered Preferred Share Index ETF (ZPR-T). It’s down 7.3 per cent for the year through Nov. 30 on a total-return basis, which means dividends are included.

Mr. Van Der Hout said he's buying certain rate-reset preferred-share issues at current prices. "I'm building a core position now at these prices," he said. "I'm saying to clients, 'Hey, get ready because if this sells off more, we're going to stock up again like we did in 2015.'"

The rate-reset market is divided by Mr. Van Der Hout into two parts – the old generation of rate-resets, which tend to offer smaller spreads over the five-year Canada bond, and a newer generation that offered juicier spreads to spark investor interest in this type of preferred share.

The newer rate-resets have done well lately. Mr. Van Der Hout said some have basically sidestepped the recent decline and are trading near or even above their $25 issue price. The older rate-resets are the ones that are suffering and it's there that Mr. Van Der Hout sees some value.

He said BAM.PR.R resets in June, 2021, with a spread of 2.3 per cent over the five-year Canada bond yield, which has recently been around 2.06 per cent. That works out to a yield of 4.36 per cent, which in turn suggests an annualized dividend of $1.09 based on the $25 issue price. With BAM.PR.R closing at $16.35 on Monday, that $1.09 dividend would produce a yield of 6.67 per cent. The current yield is 4.6 per cent

BAM.PF.B has a current yield of 5.5 per cent and comes up for reset in March, 2019. Based on the closing price Monday of $19, he calculates a yield of about 6.2 per cent after reset.

"For Brookfield, which I feel is one of the highest-quality companies in Canada, that is amazing," Mr. Van Der Hout said.

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