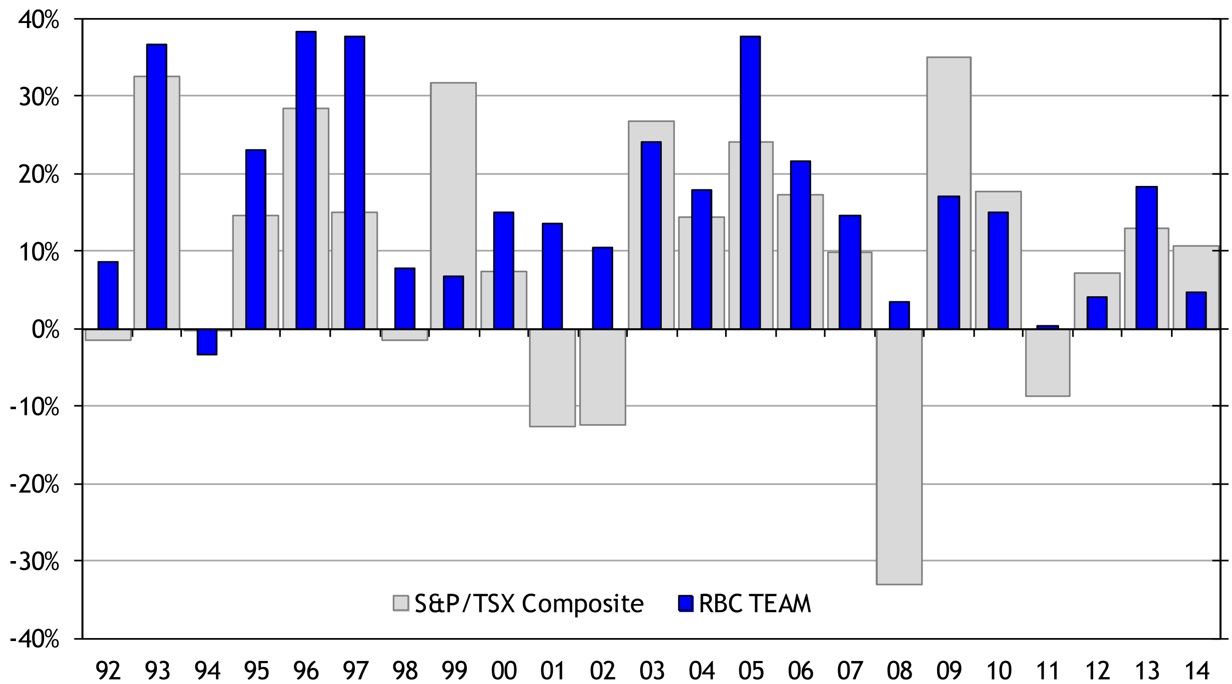
March 2nd 2015

"Won2One" with Nick Foglietta

Tactical Equity Income Model Portfolio Record



Tactical Equity Income Model Present Conditions:

TEAM Model Asset Allocation: **50%** Equities/ **50%** Fixed Income
S&P/TSX 60 Closing Value: 15,245
TSX 200 Day Moving Ave: 14,860
% Above/Below 200 Day Moving Ave: **2.15%**
Levels for change: 100% stocks - **TSX 15,610** and 100% fixed income – **TSX 14,130**

<u>*Weekly Quote*</u>

"10% luck, 20% skill, 15% concentrated power of will, 5% pleasure, 50% pain, and 100% reason to remember the name" – Rap Artist "Fort Minor", 2010

Nick comment: Reminds me of what it was like doing all the trades when I was building the TEAM Model!

Preferred Share Update – This is long overdue!

Canadian preferred shares have had a rough ride the last 9 months. It is rather interesting to think an investment class that has tax advantages, relative safety (when investing in quality names), and reasonable liquidity at the retail level, has been such a weak performer.

Today my goal is to help you understand how we got to this moment in the preferred share market and to see if we should be revisiting this investment idea. But first, we need to take a look at the overall market perceptions during the last 20 years.

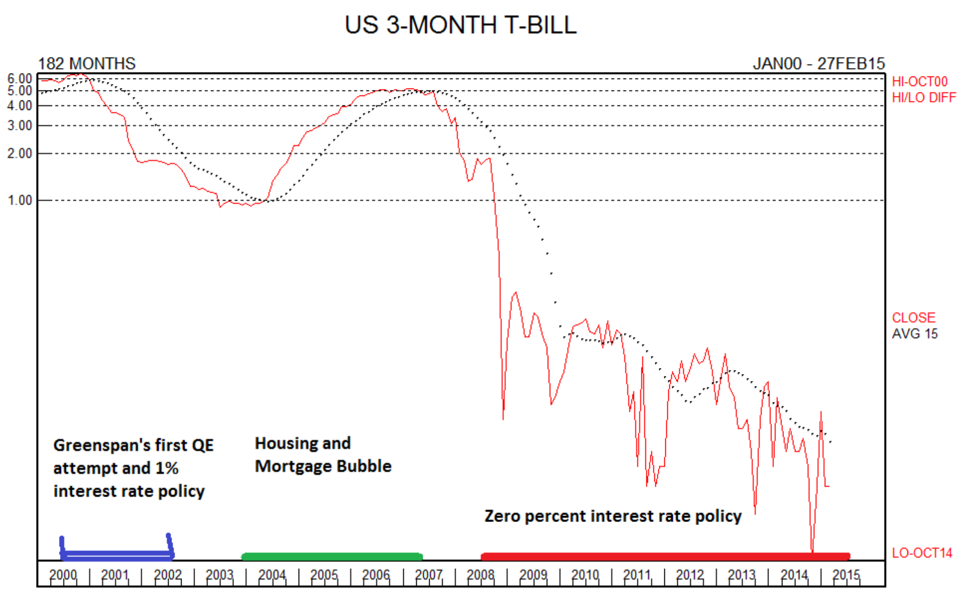
If I was going to build a retirement portfolio in 1995 a typical asset mix might have been:

5% Cash – 5.5% yield
30% bonds and GICs – 6% - 6.75% yield
25% Preferred shares – 5.5% - 7.75% dividend yield
40% Common stocks and equity mutual funds

A $100,000 investment would safely provide about $5500 of income at this time and one could expect approximately 3% growth of the capital while drawing the income off each year. That is all a distant memory today!

In the technology share driven BEAR market of 2000/2001 the portfolio described above did quite nicely. Yes, there were a few names in the equity portion of the portfolio (ahem…Nortel…) that got beat up badly. But the banks and utility stocks made a great come back quickly and the preferred shares were "rock stars".

You see, the 2000/2001 BEAR market was where Alan Greenspan and the US Fed decided to sow the first real destructive seeds of Fed financial engineering by crashing down interest rates to "save the world" from a minor recession!



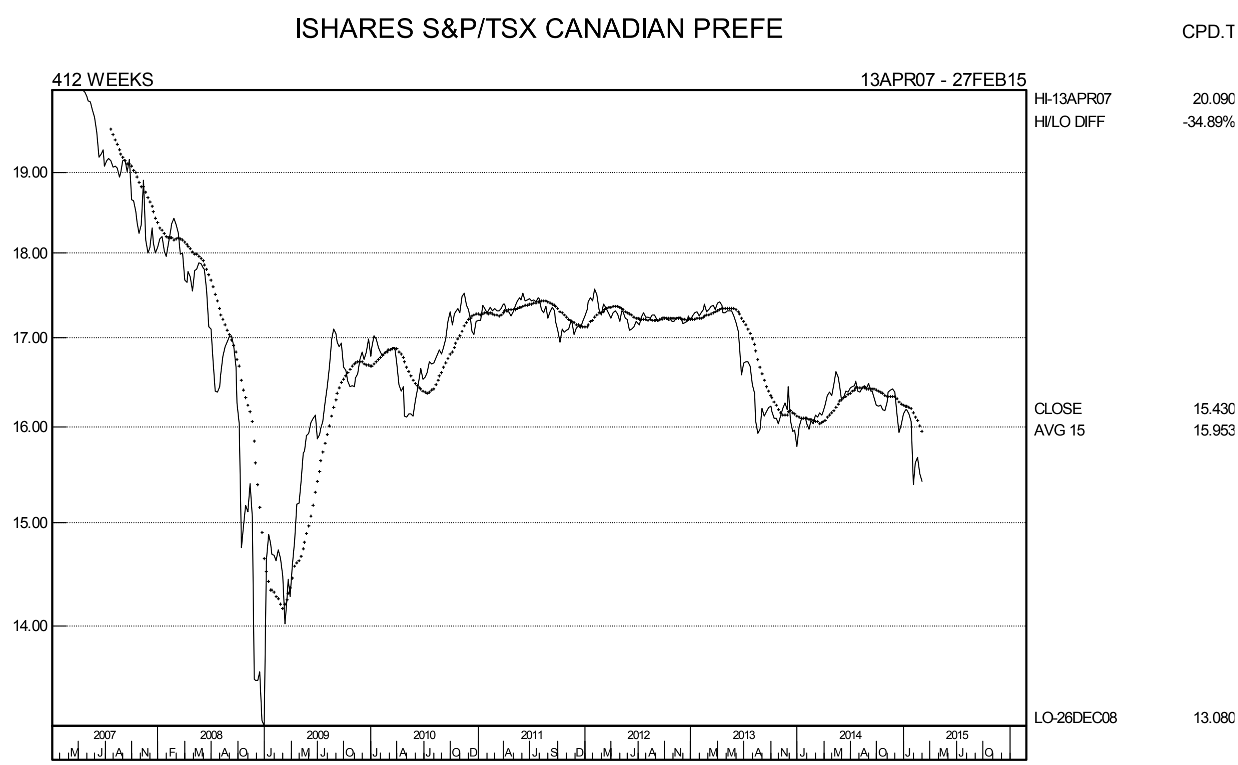
During the recovery phase from the “tech wreck of 2000” the terrorist attacks of September 11th 2001 occurred. This event caused another drop in stock prices, but more importantly, **caused the FED to leave interest rates too low for too long during the subsequent recovery**.

The 2003 – 2007 BULL market had its underpinnings in a global real estate and mortgage debt bubble. As you note in the chart above, the FED was trying to get ahead of the twin bubbles but was, once again, too slow on the draw and let the bubbles get out of hand.

By 2007/2008 US 90 day T-bills were back at 5%. So were 5 year GICs. The subprime mortgage bubble burst taking with it the quality mortgage markets and the real estate markets…and finally the stock markets cracked in August of 2008.

During the entire 2000 – 2008 time period preferred shares continued to provide a steady rate of return for retired investors and maintained small capital gains in portfolios for clients most of the time.

By September 2008 the preferred share market had “cracked”. Investors were nervous the banking system was going to implode and this made top quality preferred shares issued by banks and utilities a perceived risk.



But as the Quantitative Easing policies of early 2009 took hold, banks were again considered lower risk and the preferred shares staged a nice come back!

Now we get to the present situation in the preferred share markets. It is important to see that through the past 20 years there have been two times when preferred shares were hated for very different reasons…and then they returned to favour at a later time. We are now living through the third episode of this cycle.

The key to understanding preferred shares in 2015 is to catch a glimpse of the psychology of what investors thought was going to happen to interest rates in the last 7 years.

Once again, the US Fed crashed down interest rates in 2008/2009 to save the banks. When low rates weren't enough, the Fed began its insane policy of Quantitative Easing which was the equivalent of printing money to give to the banks for free! The "temporary" measure of QE has been administered by the global central banking community ever since…the total amount now surpassing $30 trillion US.

Intuitively, QE should be supportive of preferred share valuations. Why? **Because low interest rates on T-bills and bonds should make the higher dividends of preferred shares desirable.**

But that has gone wrong for two important reasons:

1. Low interest rates are no longer considered "**temporary**".
2. The stock market bubble started drawing money out of fixed income investments and into the stock market. Preferred share supply/demand got out of balance.

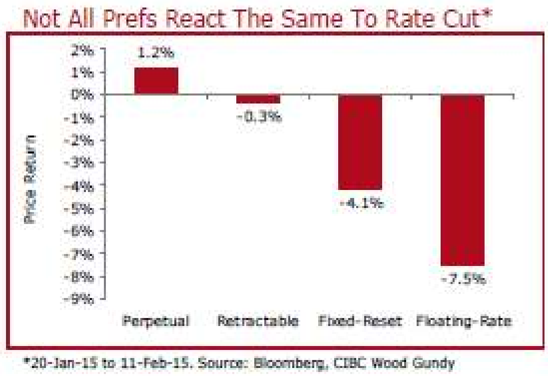
The main part of the preferred share weakness story actually comes from the interest rate perceptions of the past 7 years.

Again, back in 2009, the low interest rates and QE were supposed to be "temporary". When this was believed to be true investors did not want to be caught holding long dated (perpetual) preferred shares that would not reset their interest rates to the coming much higher interest rates in the future.

So companies began issuing RATE RESET preferred shares. The idea was to give investors a good rate of return for a five year period and then give them the option at the end of the five years to either buy another FIXED rate preferred share set at a rate that was a predetermined amount above the 5 year Canada bond interest rate at the time…or a FLOATING rate preferred share that would go up in rate if interest rates were still increasing when the option date came along.

Read that paragraph again if you own preferred shares that have gone down in value. If you think back, that concept made absolute sense in 2011 – 2013.

Now look at the chart below and see what happened to the "fixed/floating" rate preferred shares compared to the fixed (perpetual) preferred shares when the Bank of Canada cut its interest rate last month.



It really makes me laugh and cry at the same time. Back in 2011/2012, owning fixed/floating preferred shares made sense because EVERYBODY "knew" that interest rates could not stay at zero forever! Now EVERYBODY "knows" that interest rates will never go up again…right?

Hmmm?

What if they are wrong? What if they are just as wrong as they were in 2011 – 2012?

I'm not saying they are…I'm just saying…

The worst case scenario with quality issued preferred shares as long as the underlying company does not go under is you will get a dividend yield for the next 5 years based off of the 5 year Government of Canada bond rate. Each preferred share has its own set of rate reset conditions. If interest rates stay low…that is as bad as it gets. So you "only" get 2.5% based off the original $25.00 price. (For you who already own these shares that are down in value…that is the deal you get…I can think of worse!)

Something tells me that when EVERYBODY thinks something is going to happen in financial markets…it never does! Old timers in the markets (like me now!) use the expression that **financial markets like to exert "price pain" on investors when too many people agree on what the future holds in store.** Another old expression is **"financial markets always do what they supposed to do but rarely when they are supposed to do it!"**

Maybe these neglected preferred share ideas are coming to an end in their "pain" cycle and maybe…just maybe are worth a second look!

About the author: Nick Foglietta is a Vice President, Investment Advisor at RBC Wealth Management in Nanaimo, B.C., Canada. He has been managing money since 1988.