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Preferred Shares: Stay the Course

A special report by the Portfolio Advisory Group

There's Wealth in Our Approach.™

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For Required Disclosures see page 5.
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Preferred Shares: Stay the Course

We continue to believe the preferred share market will be a key source of portfolio income for individual investors; however, we would caution investors that the turbulence that has defined this market in 2015 could linger into 2016. We encourage long-term investors to stay the course despite recent share price performance, while patient investors with an appetite for risk that are underinvested in this space should consider taking advantage of compelling buying opportunities.

What's Behind Preferred Share Weakness?

2015 has been tough for preferred share investors as the S&P/TSX Preferred Share Index is down 18% YTD and has recently flirted with the lows of 2008. The lackluster performance of the preferred share market has been the result of: (1) lower interest rates that have dragged down the value of rate-reset preferred shares, (2) wider credit spreads, which have affected the prices of both rate-reset and perpetual preferred shares, and (3) fresh issuance of preferred shares on favourable terms that have been a headwind to previously issued securities.

The Government of Canada 5-Year Yield Taketh

Rate-reset preferred shares were first introduced to the market in 2008 and proved to be very popular with investors because of a dividend "reset" feature that serves as a buffer against higher future interest rates.

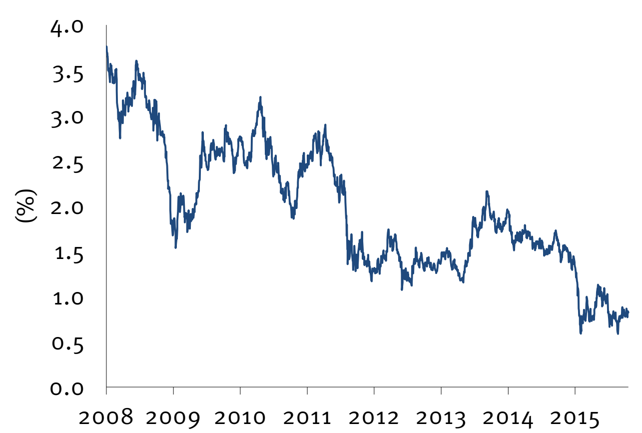
Unlike perpetual preferred shares, which have a constant dividend for the life of the security, dividends of rate-reset preferred shares are periodically adjusted (reset) via a calculation that adds a pre-determined credit spread (unique to each security) to the prevailing yield of the 5-year Government of Canada (GoC) bond at a specified point in time (the reset date). Should the yield of the GoC 5-year bond be higher at the reset date than it was at the time the security was issued, then the future dividend of the security would be adjusted higher.

The flipside is that if the GoC yield at the reset date were actually lower than it was at the time of issue, the dividend on a rate-reset preferred share would be adjusted lower. Rate resets now account for nearly two-thirds of the Canadian preferred share market.

In 2008, when the first rate-reset preferred shares were issued, few investors would have expected interest rates, which were already near generational lows, to be even lower when the first reset dates arrived in 2013. Yet, this scenario has played out with many dividends resetting at significantly lower levels than the dividends on the security at the time of issue. The chart illustrates how the GoC 5-year bond yield has fallen nearly 275 basis points (bps) since 2008, with over 40 bps of that occurring just in 2015.

The value of a preferred share is driven in part by the income stream that it pays out. As a result, the lower resets have had a significant depressive effect on the value of most securities in this market.

5-Year GoC Yield



Source - Bloomberg

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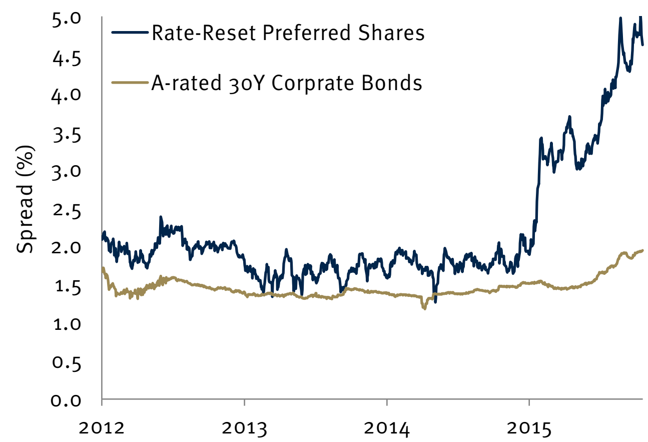
"Wide-Spread" Pressure

The compensation investors require for the risk of owning a preferred share is represented by a credit spread. Risk aversion leads to wider credit spreads, as investors demand more compensation for assuming risk, while greater risk appetite leads to tighter credit spreads. Investors have demanded greater compensation for risk in Canada in 2015 amidst signs of a slowing economy that could remain sluggish for some time to come. In the upper chart we can see how investors in both the preferred share and corporate bond market have required greater compensation through higher credit spreads in response to a weaker Canadian economy.

Average Spread

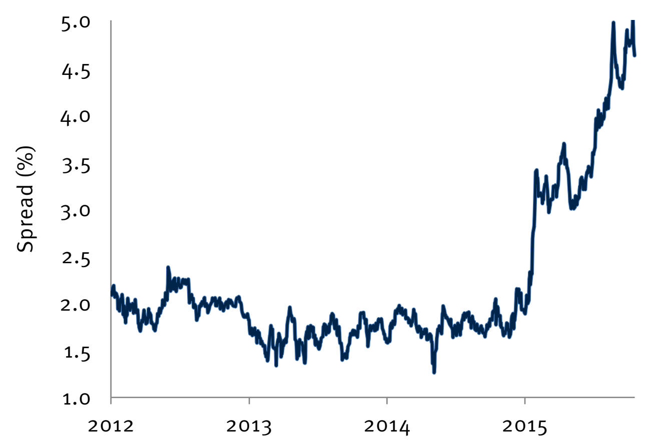


Source - Bloomberg

GDP contraction in each of the first five months of 2015 reflects the impact of lower commodity prices in Canada, and the likelihood that the manufacturing segment of the economy needs more time to fully benefit from lower interest rates and a weaker Canadian dollar.

The lower chart shows how these concerns have manifested themselves in the form of wider credit spreads in the rate-reset segment of the preferred share market. While credit spreads on perpetual preferred shares have widened over 100 bps in 2015, the move in rate-reset preferred shares has been nearly three times higher.

Average Credit Spread on a Basket of Rate Resets



Source - Bloomberg

Fresh "New Issue" Supply

Preferred shares represent an important form of financing for Canadian corporate issuers. As investors have become more risk averse over the course of 2015, issuers have responded with a number of enhancements on newly issued securities in order to make these issues more attractive to investors. The most recent enhancement—the advent of a dividend floor on certain newly issued rate-reset preferred shares—belies the lengths to which issuers have been willing to go in order to drive investor demand.

Dividend floors guarantee that future dividends will never fall below the initial dividend. This feature has understandably proven to be popular with investors that have been affected by falling dividends on previously issued rate-reset shares as it effectively removes the risk that 5-year GoC yields decline.

In addition to dividend floors, issuers have come to market with higher yielding perpetual and rate-reset preferred shares to enhance the attractiveness of new issues.

The net effect of these efforts has likely further weighed on the prices of existing securities, which do not have these enhanced features and/or dividend levels.

Preferred Shares: Stay the Course

Pendulum Has Swung to Extreme Fear – Stay the Course

It is often said that financial markets swing on a pendulum between fear and greed. Using this analogy, we believe there is plenty of evidence to suggest that significant levels of fear have been built into the preferred share market over the past year.

We encourage investors to stay the course with preferred shares despite this having been a very difficult year. Investors with the means and courage to invest in oversold segments of the market should look to add to select securities on an opportune basis.

The largest potential tailwind to rate-reset preferred shares is a reversal of the decline of the GoC 5-year yield. With the GoC 5-year yielding just under 0.85%, we believe the odds are tilted more towards rates rising over time as opposed to falling further. Recent economic data has been encouraging; although we believe that the full benefit of lower interest rates and a weaker Canadian dollar have yet to work their way through the economy.

Both lower rates and a weaker loonie should also be a source of potential inflation in the Canadian economy once their full effect is felt. Since interest rates are a function of growth and inflation, the potential for both growth and inflation to tick higher could spark a modest uptick in yields. This would be a welcome tailwind for rate-reset preferred shares.

A second important tailwind is attractive valuations, which could prompt bargain hunting investors to step into the market. Many issues from quality issuers represent excellent sources of portfolio income at a time when government bond yields remain low and liquidity in parts of the corporate bond market is challenging.

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