The Fortnighter

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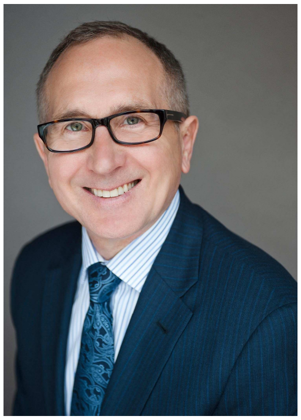

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One of the "fundamental truths" of the investment world is that a properly diversified portfolio will always contain something that stinks.

Given the recent markets, "stinkers" are not in short supply. Energy shares and REITs, for example, have landed firmly in this category. But for an investment that has done poorly for the past decade, we need go no further than **preferred shares**. Performance of these securities has been extremely disappointing.

The "preferred" name comes from where these securities rank in a company's capital structure. Preferred shares pay dividends and those dividends rank ahead of payment of the common shares dividends, hence the "preferred" name. In the event of "trouble", a company would have to eliminate all of its common share dividends before its preferred share dividends could be cut.

Preferred shares basically come in two types – fixed and variable. They are perpetual securities with no fixed maturity date, although they can be redeemed or "called in" in certain circumstances. In the old days, most preferred shares were of the fixed-dividend type. Investors bought them for a solid, tax-efficient income stream for life – a "widows and orphans" type of investment.

As economies began recovering from the 08/09 financial crisis, concerns started to appear about rising inflation and interest rates. A "new" type of pref share became popular - the "Rate Reset". As the name suggests, this type of preferred comes with a reset feature – with the dividend adjusted every 5 years based on the Gov't of Canada 5-year bond rate.

Unfortunately, as economies recovered, things never really "heated up" and neither did inflation and interest rates. In fact, central bank stimulus continued to be needed to keep the party going. In places like Europe, bond yields actually went negative. While this never happened in Canada, that 5-year bond yield got pretty darn close – in fact, it's now less than 0.5%. That made the reset feature on Rate Reset preferred shares a liability, not an asset.

On the flip side, that "cheap money" drove an 11-year bull market for the broader equity market – especially in the U.S. In other words, the conditions that caused one investment to do horribly caused another to do really well. Portfolios that were diversified, again, held up just fine.

I know there are some investors who will never own another "Rate Reset" and that's fine. But with 5-year Canada Bonds at 0.4%, cash at 0.25% and GICs about 2%, a tax-efficient 5%+ yield looks quite compelling. "Post pandemic", I believe rates will creep higher and that preferred share values should do the same. A final thought: What if rates go MUCH higher due to the massive amount of government borrowing going on? Owning an asset with a rate reset feature might make even more sense.