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THE CASE FOR PREFERRED SHARES

"I expect that it will be appropriate at some point later this year [2015] to take the first step to raise the federal funds rate."
- US Federal Reserve Chairwoman Janet Yellen

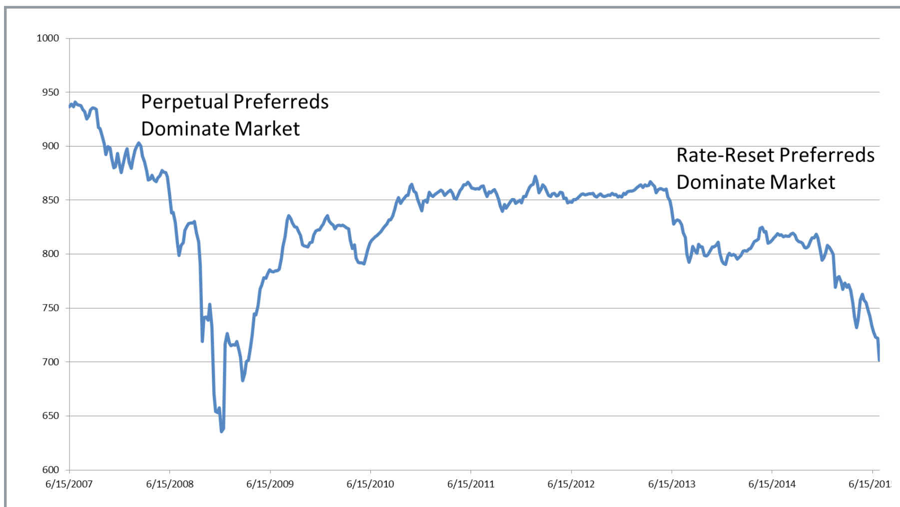
"Know what you own, and know why you own it."
- Legendary Investor Peter Lynch

FIRST, WHY THE DECLINE?

Preferred shares are supposed to be a steady asset class, rarely declining dramatically and providing investors with a consistent return. Unfortunately, this has not been the case in 2015 with the S&P/TSX Preferred Share Index falling by a gut-wrenching 14%. So what has changed? Why has this traditionally defensive asset class behaved with so much volatility?

First, let's begin with some history. Prior to the credit crisis of 2008–09 Canadian preferred shares were mostly of the perpetual variety. Perpetual preferreds have a fixed, usually very attractive, dividend, but they can also be redeemed by the issuer—the issuer can, at their option, "call" them back from investors at par in exchange for cash. The attractive dividend usually prevents major price declines and the call feature usually prevents major upside price moves. Hence, perpetuals historically had predictable price movements rarely straying far from their redemption, or par, values. However, perpetuals also have one key weakness: no fixed maturity date. This weakness became apparent during the credit crisis when investors fled from perpetuals because there was nothing *compelling* issuers to ultimately pay investors a set price for their shares. As confidence in markets eroded, particularly in the financial sector, which is a major issuer of preferred shares, investors, who had no maturity feature to protect against the downside, watched their perpetuals plunge in value.

S&P/TSX Preferred Share Index - Longer Term



Source: Bloomberg

In the aftermath of the credit crisis, investors were stuck in a world of rock-bottom interest rates and depressed bond yields. They'd also had enough of perpetual preferreds. They wanted a product that at least offered a quasi-maturity feature and some protection against rising interest rates, as the accepted wisdom following the credit crisis was that interest rates had only one way to go: up. Thus rate-reset preferreds were born. Rate-resets could still be called by the issuer, but they offered investors the opportunity to "reset" their dividend, typically every five years, at a yield equal to the Government of Canada (GoC) 5-year bond plus a pre-determined premium spread. So, for example, if in five years' time GoC 5-year bond yields moved to 3% and the premium spread on a rate-reset preferred was 200 basis points (2 percentage points), investors had the option to reset the dividend to the equivalent of a 5.0% yield. Investors loved these new products because they ostensibly offered protection against rising interest rates (if bond yields moved higher, investors stood to receive a higher dividend down the road) and, in theory, provided the maturity feature investors desired because the reset spread would incentivize issuers to simply redeem, or call, their preferred shares at par rather than support the new reset yield, which might be above current market rates.

Eventually, the majority of the Canadian preferred share market moved to a rate-reset structure and perpetuals fell out of favour. Currently, the market is roughly two-thirds rate-resets. Unfortunately, of course, interest rates did not move higher, they stayed low and the reset spreads, which were initially modest (100–150 basis points) made redemptions improbable—"resets" were likely to be at yields lower than prevailing market rates, so there was no advantage for issuers to call. In other words, the wave of redemptions (or "maturities") that investors were hoping for seemed unlikely to occur. The Bank of Canada unexpectedly cutting interest rates in January 2015 and then again in July 2015 has only compounded the problem. Interest rates and bond yields have plunged and preferred share values have fallen almost in lock-step (see chart below). Compounding the problem even more is that preferred shares tend to be widely held by retail investors who, unfortunately, often sell out of fear without fully understanding market conditions. The final difficulty is that the preferred share market is illiquid, which can magnify downward price action, particularly when retail investors are running for the exits.

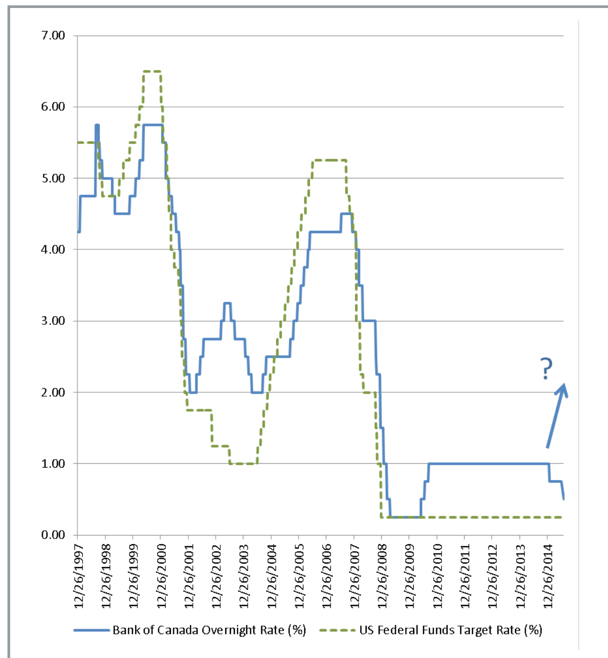
WHY INVESTORS SHOULD NOT SELL

So, it sounds pretty grim for the preferred share market and maybe investors should just throw in the towel? We completely disagree. We believe that the preferred share market is oversold and that it would be a mistake to sell into current weakness. Several factors inform our opinion:

- Interest rates are likely to move higher. Consider the quote we cited at the outset from Janet Yellen. Central bankers rarely use language so transparent and we are quite confident that interest rates will be moving higher in the US shortly and indeed bond yields have already been moving higher south of the border since February. So why should Canadian investors care? Because, recent rate cuts aside, the Bank of Canada almost always adopts an identical interest rate policy to the US (see chart below). If the US raises rates, eventually Canada does as well. The cost of following an opposing interest rate policy, we believe, will ultimately be too great.

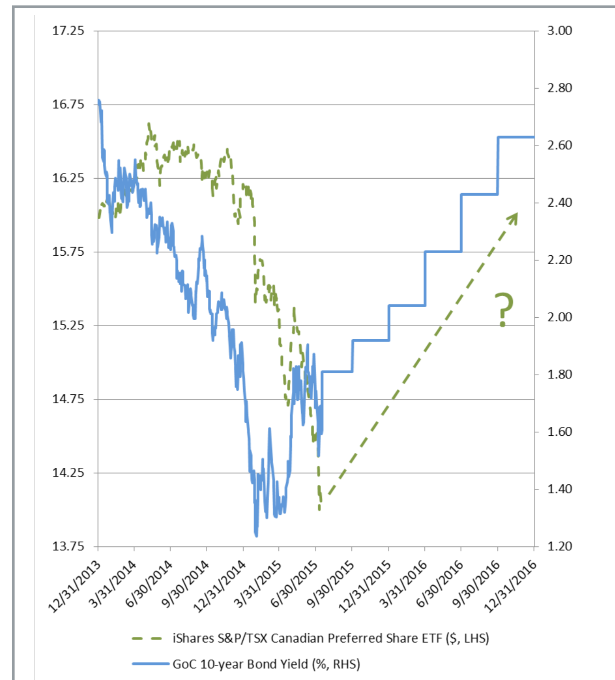
  Opposing the US can be particularly devastating to the Canadian dollar, for instance, which can bring all kinds of economic problems including higher inflation. Also of note, the correlation between US 5-year Treasury and GoC 5-year bond yields is nearly 93% over the past 25 years! In other words, if US bond yields move higher, Canadian bond yields will almost certainly move higher as well. Remember: higher bond yields are positive for rate-reset preferred prices because their dividends are indirectly pegged to the GoC 5-year bond yield.

Canada's Interest Rate Policy Moves in Lock-Step with the US



Source: Bloomberg

If Bonds Yields Move Higher, So Should Preferred Share Prices



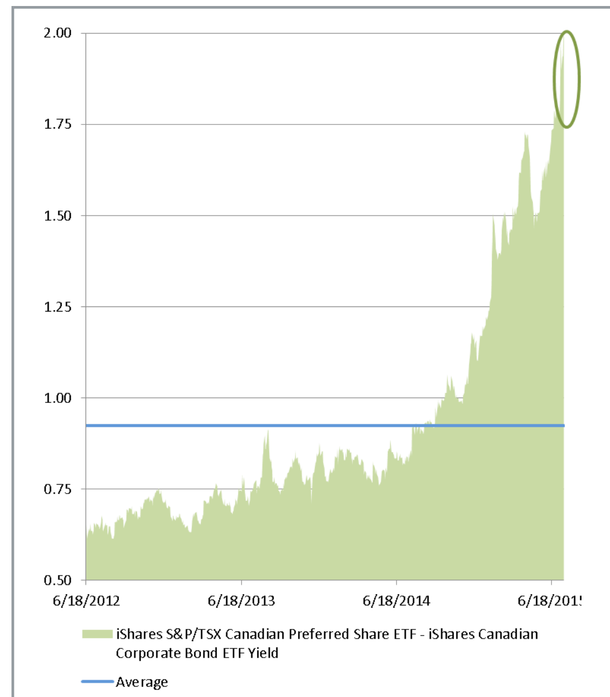
Source: Bloomberg. Rate-reset preferreds are pegged to GoC 5-year bond yields, but forecasts are only available for the 10-year yield. The overall relationship is similar however. The bond yields beyond mid-2015 represent the consensus forecast of 20 leading economists.

- Preferred share yields are compelling. While there is a valid argument that many rate-reset preferred dividends will get reset at lower values because of the prevailing low bond yields, hence the overall yield of the preferred share market may fall, we believe this correction in yield will be minor and that the sell-off in preferreds has become excessive. For instance, of the roughly 165 rate-resets in the market, only 8 (or about 5% of the market) face resets over the remainder of 2015. So even if these preferreds are reset with lower dividends, the impact on yields overall will be minimal. Also, investors often evaluate the preferred share market against corporate bonds because both are bought for additional yield and frequently have similar risk characteristics. Currently, the yield spread between preferred shares and Canadian corporate bonds is incredibly wide (see charts below). In other words, the preferred share market is very likely to start attracting buying interest from income-oriented investors. Additionally, rate-resets issued in recent years have much higher reset spreads making it more likely that these preferreds will, in fact, get redeemed by their issuers in the coming years thus providing the market with the desired "maturities" that it has sought all along.

Yields on Preferreds Compelling vs. Corporate Bonds

Source: Bloomberg

The Yield Spread is Significantly Above the Longer-Term Average



Source: Bloomberg

- Professional investors are licking their lips. Our clients need to resist making the mistake that most other retail investors are making. Institutional investors love to feast on retail investor fear and the preferred-share portfolio managers and analysts whom we speak with on a regular basis repeatedly

mention the compelling value that they're seeing in the preferred share market. Professional investors are more than happy to buy on retail investor panic and a few years from now, we believe, it will be the pros who are reaping the rewards.

STAY THE COURSE WITH PREFERREDS

We know it's been a painful year thus far for preferreds, but take some solace in the fact that you have been paid attractive dividends during the downturn and that you will continue to be paid these dividends as the preferred share market, we anticipate, steadily recovers. We expect that interest rates will move higher later this year—first in the US and possibly in early 2016 in Canada—which means bond yields will likely continue to drift higher in both countries. The preferred shares in our client portfolios, usually between a 14–18% weighting, represent one of the best asset classes for protecting against rising interest rates. If interest rates and bond yields move higher, preferred shares are very likely to benefit. You own preferred shares in your portfolio and now you know why. Peter Lynch would be proud.

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