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## *The Role of Preferred Shares In Your Portfolio*

The risks and rewards of Canadian preferred shares

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This report was written by Raymond Kerzérho, PWL Capital Inc. and Dan Bortolotti, PWL Capital Inc. The ideas, opinions, and recommendations contained in this document are those of the authors and do not necessarily represent the views of PWL Capital Inc.

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Preferred shares are popular with Canadians because of their high yields (compared with bonds and GICs) and favourable tax treatment. While they are often held by large institutions, preferred shares are also a favourite of retail investors and advisors.

While preferred shares can be appropriate in a diversified portfolio, their benefits come at the cost of higher risk, less liquidity and more complexity than traditional fixed income investments. This paper reviews the risks and rewards of preferred shares and offers suggestions for Canadians who are considering adding this asset class to their portfolios.

## ***What are preferred shares?***

Preferred shares (or *preferred stock*) can be issued by any corporation, but in Canada the most popular issuers are banks, insurance companies, utilities and telecoms. Like common stocks—and unlike bonds—preferred shares trade on an exchange. However, the Canadian preferred share market is tiny (\$61 billion) compared to the common stock market (\$1.9 trillion).

Companies issue preferred shares for several reasons. First, it allows them raise capital without issuing new bonds, which would increase the firm's debt-to-equity ratio and perhaps raise red flags with credit analysts. Preferred shares also allow a company to defer dividends in periods of financial distress: doing so has less negative consequences than defaulting on bond payments because it does not force the issuing company into bankruptcy. In addition, preferred shares have the advantage of not diluting the company's earnings: if earnings increase over time, the preferred shareholders will be entitled only to the same fixed dividend, leaving more money on the table for the common shareholders.

Preferred shares are hybrid securities that share some features of corporate bonds and common stocks, so it is helpful to think of them in comparison to these more familiar securities.

- Like bonds, preferred shares typically have a predictable income stream, which is why they are often considered fixed-income investments.
- Unlike bonds, most preferreds do not have a maturity date.
- Preferred shares are typically issued at a price of \$25, which is effectively their par value.
- Preferreds receive standardized ratings from credit analysts like corporate bonds do, which allows investors to assess their level of default risk.
- As with common stocks, the income from preferred shares is considered dividends rather than interest.
- Many preferred shares include a *cumulative dividend* provision. This means that if the company misses a scheduled dividend payment it is obliged to repay it before paying dividends to common shareholders.
- In the event of the company's insolvency, preferred shares rank senior only to common stocks and junior to all classes of fixed income, as illustrated on the next page.

**TABLE 1: PRIORITY RANK OF SECURITIES**

ASSET TYPE	CLASS	SENIORITY
Debt	Secured debt	↓
	Unsecured senior debt	
	Unsecured subordinate debt	
Hybrid	Preferred shares	
Equity	Common shares	

Source: S&P Dow Jones Indices

One of the challenges of investing in this asset class is that corporations can have many preferred share issues outstanding, each with its own characteristics. For example, Royal Bank of Canada has just one class of common stock but 13 different preferred shares, and each one includes a particular set of dividend and option features.

## ***Types of preferred shares***

There are four types of preferred shares, with the first two making up about 90% of the Canadian market.

**Straight perpetuals.** This is the most basic type of preferred share. Straight perpetuals pay a fixed dividend in perpetuity—in other words, there is no specific maturity date. However, most are redeemable at the option of the issuer according to a pre-determined schedule of dates and prices. The redemption features of a typical straight perpetual are outlined in Appendix 1.

The redemption feature limits the upside potential of the preferred share, since the company will only call the issue when it is in its own best interest to do so. This idea is explained in more detail in the discussion of interest rate risk, on page 6.

**Fixed resets.** Fixed reset (or *rate reset*) preferred shares remove much of the interest rate risk of straight perpetuals. Their dividend is fixed for five years: after this period the dividend is adjusted according to the yield on five-year Government of Canada bonds, plus a spread. Investors then have the option to accept this new fixed dividend rate or convert to a new preferred share with a floating rate. Every five years thereafter, shareholders have the choice between the five-year fixed and the floating rate. Fixed resets are attractive to those who believe interest rates are likely to rise in the future.

Fixed resets now make up well over half of the preferred share market in Canada. Their key features are outlined in Appendix 2.

**Floating rate.** Floating-rate preferred shares reset their dividend monthly or quarterly based on a reference rate: either the Bank of Canada Prime Rate or the three-month Treasury bill yield. Because floating-rate preferreds adapt so quickly to movements in interest rates, their prices are very stable (unless the market becomes concerned with the issue's credit risk). But they may be less attractive to investors because of the unpredictability of their dividend payments. Floating-rate preferreds make up only 5% of the Canadian market.

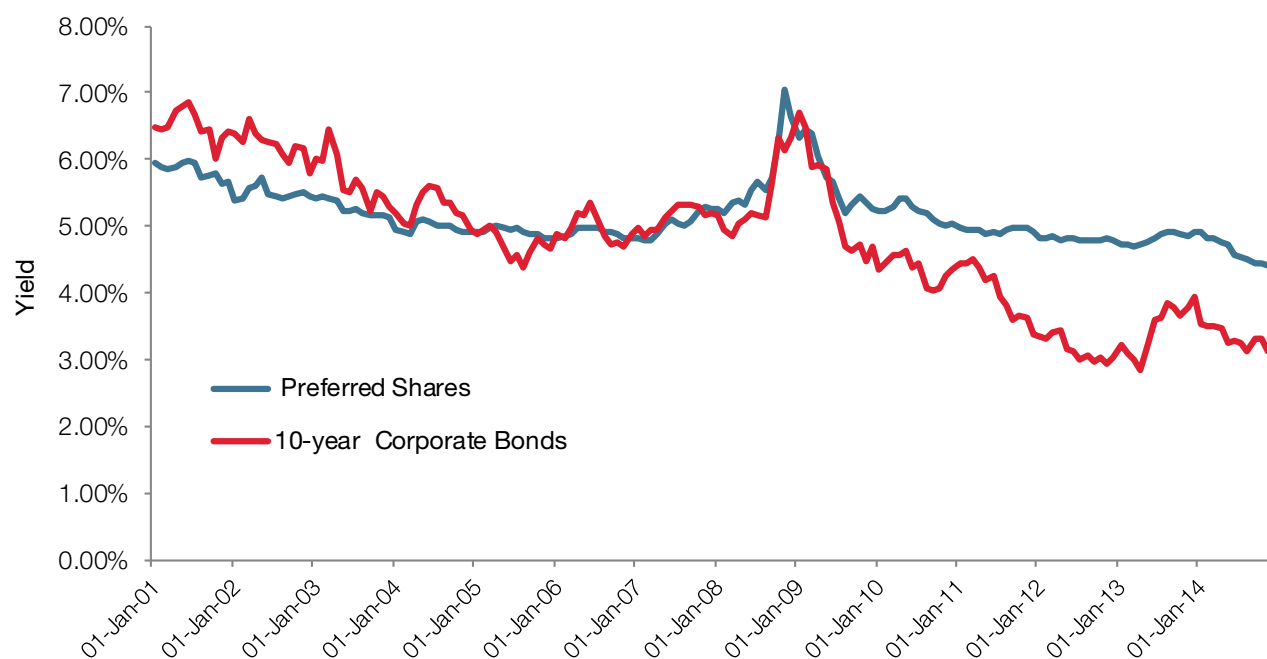
**Retractable.** Like straight perpetuals, this type of preferred share is issued with a fixed dividend in perpetuity and is callable by the issuer. But retractable preferreds put the issuer and the investor on more equal footing by allowing the latter to redeem the shares for their par value on a specific date. As a result, under certain conditions, both the issuer and investor can cancel the contract when it is in their best interest. Retractable preferred shares make up just 3% of the Canadian market.

## Why invest in preferred shares?

There are three main benefits to adding preferred shares to a portfolio: high yield compared with other fixed income investments, favourable tax treatment, and low correlation with other asset classes. We will look at each in detail.

**High yield.** The yields on preferred shares often exceed those of bonds—even bonds issued by the same corporation. The chart below compares the yields of preferred shares and A-rated 10-year corporate bonds for the period 2001 through 2014.

CHART 1: YIELD HISTORY – PREFERRED SHARES VS. CORPORATE BONDS



Sources: BMO, Bloomberg

**Preferential tax treatment.** Whereas bond interest is taxed at an investor's full marginal rate, preferred shares provide income in the form of eligible Canadian dividends, which are taxed far more favourably. This makes them a tax-efficient alternative to corporate bonds in non-registered accounts.

The table below outlines these estimated tax savings by comparing the tax liability of \$1,000 in interest with the same amount in eligible Canadian dividends.

TABLE 2: TAX SAVINGS ON \$1,000 OF DIVIDENDS VS. INTEREST INCOME

TAXABLE INCOME	ONTARIO	QUEBEC	BC	ALBERTA
\$50,000	\$227	\$192	\$232	\$224
\$100,000	\$180	\$157	\$191	\$209
\$150,000	\$157	\$148	\$171	\$197

Estimated from 2014 tax rates. Source: KPMG



**Low correlation.** Investors achieve the greatest diversification benefit when the asset classes in their portfolios move independently of one another. The *correlation coefficients* in the table below describe the degree to which preferred shares move in lockstep with other asset classes. The lower the figure, the lower the correlation and the greater the diversification benefit.

Preferred shares display low to moderate correlation with most asset classes, with coefficients generally below 0.50. Perhaps surprisingly, they are least correlated with bonds.

**TABLE 3: CORRELATIONS OF PREFERRED SHARES WITH OTHER ASSET CLASSES 2005-14**

ASSET CLASS	INDEX	CORRELATION
Canadian bonds	FTSE TMX Canada Universe Bond	0.16
Real estate	S&P/TSX Capped REIT	0.62
Canadian equities	S&P/TSX Composite	0.44
US equities	S&P 500 in CAD	0.29
International equities	MSCI EAFE in CAD	0.38
Emerging market equities	MSCI Emerging Markets in CAD	0.43

Source: Morningstar Direct

## ***Risks of preferred shares***

Like any asset class, preferred shares are subject to a number of characteristic risks. The most important are interest rate risk, credit risk and market risk.

**Interest rate risk.** One of the features shared by preferred shares and corporate bonds is sensitivity to interest rates. When rates increase, the prices of both preferred shares and bonds decline, and vice-versa.

Straight perpetuals have no maturity date, so they tend to act like very long-term bonds, which are the most sensitive to interest rate moves. In theory, interest rate risk can be beneficial if dividend yields go down (propelling prices upwards), but straight perpetuals do not behave like traditional bonds. Because the issuer has the option to redeem the shares if their price goes too high, straight perpetuals have more downside risk than upside potential.

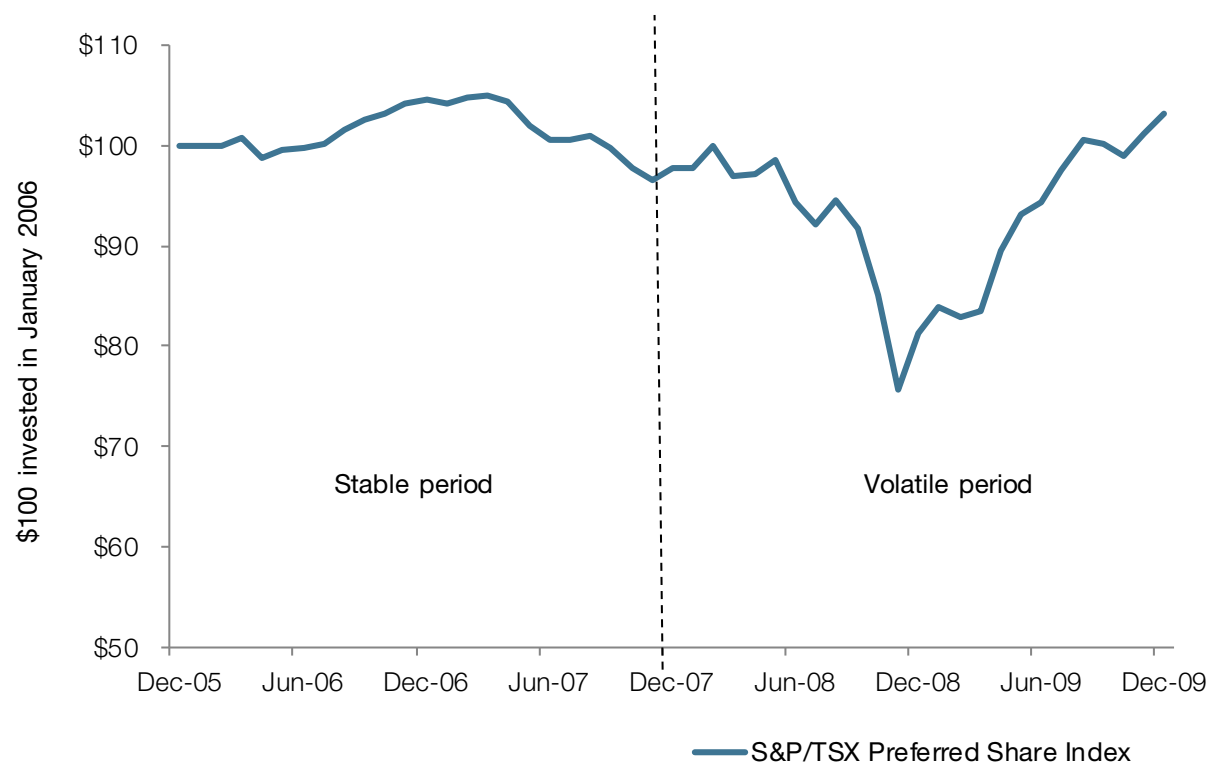
Fixed reset, floating rate and retractable preferreds are far less exposed to interest rate risk than straight perpetuals, either because their dividend is adjusted regularly according to current rates, or because investors can convert them into floating-rate preferreds if they are not happy with the dividend yield. This conversion right is described in more detail in Appendix 2.

**Credit risk.** There are two components to credit risk: the first is *default risk*, or the chance that the issuer will stop paying the dividend. This is rare: companies usually cannot stop paying dividends on their preferred shares unless they first cut dividends on their common shares, so default will only occur when the issuer is having serious problems. However, companies can stop paying preferred dividends while continuing to pay interest on their bonds. As a result, the default risk of preferred shares is always greater than that of the bonds from the same issuer.

The second component is *recovery risk*, which is the uncertainty around how much of the par value would be recovered if the issuer defaults on its obligations. While recovery rates for bonds vary widely, most can be sold for between 20% and 60% of their par value following a default (assuming the seller is a large institution). If the company defaulting on its preferred dividend is in real distress (rather than having temporary problems), our best guess is that the recovery rate for its preferred shares will likely be close to zero.

**Market risk.** Although market risk is related to credit risk, the two are not identical. The price of preferred shares can turn sour during severe equity declines, even if the issuers do not cut dividends or face imminent bankruptcy. These price declines can happen without warning: preferreds can enjoy long periods of stability, leaving the false impression that they carry little risk, only to see sudden and steep price drops. This cycle is illustrated by the chart below:

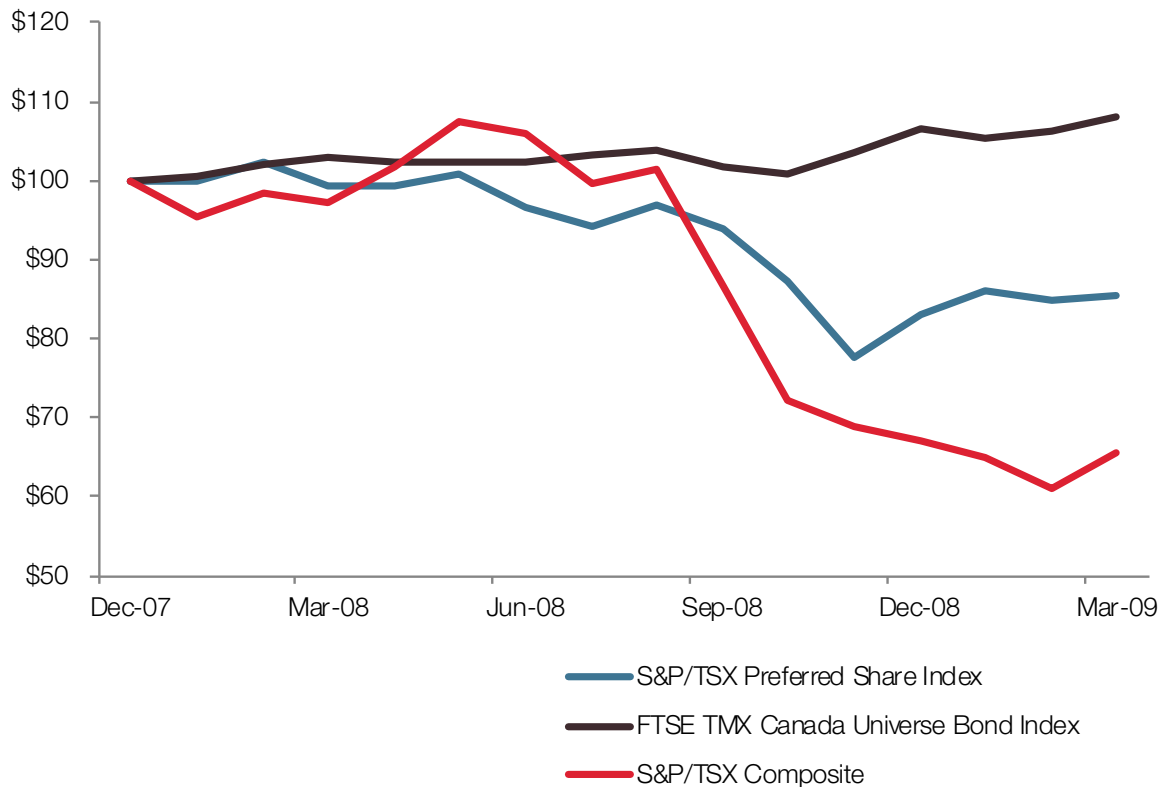
**CHART 2: \$100 INVESTED IN PREFERRED SHARES 2006–09**



Source: Morningstar Direct

Another way to look at the market risk inherent in preferred shares is to compare it to that of other asset classes. As seen in the chart on the next page, during the latest period of extreme stress (January 2008 to March 2009), preferred shares were far less stable than bonds, but also far less volatile than stocks.

**CHART 3: \$100 INVESTED IN PREFERRED SHARES, STOCKS AND BONDS,  
JANUARY 2008 TO MARCH 2009**



Source: Morningstar Direct

### ***Preferred shares as part of an investment portfolio***

As we have seen, preferred shares have a unique risk/reward profile. We will now consider how these characteristics affect the performance of this asset class on its own and in the context of a diversified portfolio.

Table 4, on the next page, displays the returns and risk (as measured by volatility) of major asset classes over the 10-year period ending December 2014. Preferred shares delivered relatively low pre-tax returns, with moderate risk. The preferred share index underperformed both the corporate and broad-market bond indexes over most periods, with much higher risk.



**TABLE 4: 10-YEAR RETURN AND RISK COMPARISON OF PREFERRED SHARES AND OTHER ASSET CLASSES, 2005–14**

NAME	RETURN				RISK STANDARD DEVIATION
	1 YEAR	3 YEAR	5 YEAR	10 YEAR	
<b>S&amp;P/TSX Preferred Share</b>	<b>6.82</b>	<b>3.14</b>	<b>4.57</b>	<b>2.91</b>	<b>7.26</b>
FTSE TMX Canada All Corp Bond	7.58	4.84	6.01	5.80	3.36
FTSE TMX Canada Short Term Bond	3.06	2.27	3.00	3.84	1.85
FTSE TMX Canada Universe Bond	8.79	3.65	5.45	5.32	3.58
S&P/TSX Capped REIT	10.36	6.84	12.71	9.90	16.93
S&P/TSX Composite	10.55	10.22	7.53	7.60	15.29
S&P 500 in CAD	23.93	25.70	17.78	7.31	12.23
MSCI EAFE in CAD	4.12	16.46	7.94	4.56	14.22
MSCI Emerging Markets in CAD	7.03	8.99	4.17	8.41	19.97

Source: Morningstar Direct

Now we will consider the effect on returns and risk when preferred shares are added to a balanced portfolio. In the table below, the first portfolio is made up of 60% equities and 40% bonds. The second portfolio includes 10% preferred shares and just 30% bonds. Note that the model with preferred shares had a slightly lower return over all periods, as well as slightly more risk in the form of higher volatility. (All returns are pre-tax.)

**TABLE 5: REWARD AND RISK OF PREFERRED SHARES IN A BALANCED PORTFOLIO, 2005–14**

	RETURN				RISK STANDARD DEVIATION
	1 YEAR	3 YEAR	5 YEAR	10 YEAR	
Portfolio <i>without</i> preferreds	10.66	10.39	8.81	6.81	7.30
Portfolio <i>with</i> preferreds	10.46	10.33	8.71	6.56	7.70

Source: Morningstar Direct. Portfolios are comprised of 15% Canadian equity, 15% U.S. equity, 15% international equity, 5% emerging markets equity, 10% REITs and 30% or 40% broad-market bonds.

## ***Should you add preferred shares to your portfolio?***

Now that we have described the risks and potential rewards of Canadian preferred shares, it's time to consider whether it is worth adding this asset class to a portfolio. And if so, what is the best way to access the preferred share market? We make the following recommendations.

**Only use preferreds in non-registered accounts.** While preferred shares may offer a diversification benefit in any portfolio, their largest benefit is their tax-advantaged dividend income. We therefore believe investors should only invest in this asset class if they need to hold investments in non-registered accounts. In this case, preferreds can be a good alternative to corporate bonds, which are often very tax-inefficient.

We do *not* believe preferred shares are appropriate for tax-sheltered accounts such as RRSPs or TFSAs. Once you remove their tax advantage, preferred shares do not offer sufficient returns to justify their additional risks compared with high-quality bonds.

**Limit this asset class to between 5% and 15% of your portfolio.** There is no perfect rule to determine the maximum weight that should be allocated to preferred shares. But given the additional risks and limited rewards compared with corporate bonds, we believe most investors should limit their exposure to about 5% or 10% of their overall portfolio. This limit can be pushed to 15% for investors who have a large allocation to fixed income (70% or more) in taxable accounts.

**Diversify broadly.** If you use preferred shares in your portfolio, diversification is paramount. To illustrate this point, imagine an investor who holds a portfolio of 10 equally weighted common stocks. Each has tremendous downside, but also a lot of upside potential. So if one of these 10 companies were to go bankrupt, the investor would lose 10% of his capital but the rest of his holdings have the potential to make up for the loss. With a similar preferred-share portfolio, however, there is little or no opportunity to recover from the default of one issue, since preferred shares deliver their value gradually over time, piling up small gains in the form of dividends. Credit losses are rare, but they are devastating in this asset class, so it is crucial to diversify across many issues.

**Do not invest in individual preferreds.** Many investors attempt to diversify their preferred share holdings by selecting a number of individual issues. But we believe investors should avoid individual preferred shares for at least three reasons.

First, it is difficult to get sufficient diversification with individual preferred shares. Holding 10 or 20 issues does not provide enough protection, and assembling a portfolio with a larger number of holdings is impractical for most investors.

Second, the complexity of preferred shares makes it extremely difficult to select individual securities. While it is tempting to look only at yield and credit quality, investors also need to have a complete understanding of the embedded options and other features in each issue. This complexity makes selecting preferred shares challenging for retail investors, and even advisors.

Finally, individual preferred shares are notoriously illiquid. They frequently trade with wide bid-ask spreads, making them expensive and difficult for investors to buy and sell.

We believe the best way to invest in preferred shares is through a low-cost ETF or index fund. We present a list of both actively and passively managed preferred share ETFs and mutual funds in Appendix 4. At the time of writing, the fund we are most comfortable with is the [BMO S&P/TSX Laddered Preferred Share Index ETF \(ZPR\)](#), for the following reasons:

- it has a relatively low management expense ratio
- it uses an indexed (rather than active) approach
- it focuses on less risky fixed-reset preferred shares
- it holds only Canadian preferreds, which are eligible for the dividend tax credit

## Appendix 1: Structure of a straight perpetual preferred share (example)

<b>Issuer</b>	Canadian Utilities Ltd.	
<b>Year of issue</b>	2013	
<b>Issue price / par value</b>	\$25.00	
<b>Dividend</b>	4.50%	
<b>Type of dividend</b>	Cumulative	
<b>Redemption right (at the issuer's option)</b>	On and after September 2018	\$26.00
	On and after September 2019	\$25.75
	On and after September 2020	\$25.50
	On and after September 2021	\$25.25
	On and after September 2022	\$25.00

Source: Bloomberg

## Appendix 2: Structure of a fixed-reset preferred share (example)

<b>Issuer</b>	Royal Bank of Canada
<b>Year of issue</b>	2014
<b>Issue price / par value</b>	\$25.00
<b>Dividend</b>	4.00%
<b>Type of dividend</b>	Non-cumulative
<b>Reset conditions</b>	In May 2019 and every five years thereafter. New dividend yield based on 5 year Government of Canada bond yield + 2.21%
<b>Conversion right (at the shareholder's option)</b>	Convertible into a floating-rate preferred share in May 2019 and every five years thereafter. New dividend yield based on 3 month Government of Canada Treasury bills + 2.21%
<b>Redemption right (at the issuer's option)</b>	Redeemable at \$25 in May 2019 and every five years thereafter

Source: Bloomberg

## ***Appendix 3: Measuring the yield of preferred shares***

When comparing the yield of various preferred shares, it is not enough to simply divide the dividend amount by the current price. Because preferreds have many provisions, analysts use several other yield measures to get a more complete picture.

**Current yield:** The last four quarterly dividends divided by the stock price. This measure is simple, but it doesn't account for the potential capital gain or loss in the event the shares are redeemed.

**Yield to call:** This measure is similar to the yield to maturity on a bond, assuming the shares will be redeemed at the first call date. Unlike current yield, this measure takes account of the potential gain or loss from a redemption.

**Yield to next reset:** Fixed-reset preferreds have a known dividend only until the next reset date. The yield to reset calculates the yield to maturity of the shares assuming they will be priced at par at the next reset date. As with yield to call, this measure considers the potential gain or loss from a redemption at the time of reset.

**Yield to worst:** As illustrated in Appendix 1, straight perpetual preferreds have a schedule of potential call dates. This measure considers the yield to call for each of these dates, well as the current yield. The lowest among these figures is the "yield to worst," and it represents the most prudent measure of yield.

**Interest equivalent yield:** Some investors want to compare the yield of their preferred shares with those of bonds. The interest equivalent yield adjusts for the preferential tax treatment of Canadian dividends: it adjusts the preferred share yield upwards to make it comparable to bond yields on an equivalent basis.

## Appendix 4: Preferred share ETFs and mutual funds with MERs less than 1%

ETFs	TICKER	MER
iShares S&P/TSX North American Preferred Stock (CAD-Hedged)	XPF	0.47
iShares S&P/TSX Canadian Preferred Share	CPD	0.49
BMO S&P/TSX Laddered Preferred Share	ZPR	0.51
PowerShares Canadian Preferred Share	PPS	0.51
Horizons Active Floating Rate Preferred Share	HFP	0.62
Horizons Active Preferred Share	HPR	0.64

MUTUAL FUNDS (F-SERIES)	FUND CODE	MER
PowerShares Canadian Preferred Share Index	AIM56207	0.62
National Bank Preferred Equity Income	NBC780	0.63
NexGen Canadian Preferred Share Registered Fund	NXG5207	0.74
Dynamic Preferred Yield	DYN2903	0.78
BMO Preferred Share	GGF95730	0.90

Source: Morningstar Direct

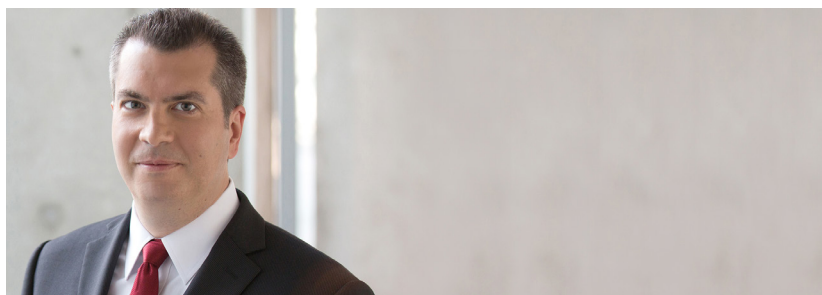




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