



FIXED INCOME

PREFERRED SHARES

Executive Summary

Preferred shares offer investors tax-effective dividend income; as well, these dividends must be paid before any dividends can be paid to common shareholders.

Apart from that, they do not have the potential upside of common shares and most do not have the possibility of growing dividends (floating rate issues aside). In addition, they rank behind debt holders on the balance sheet.

Increasingly, issuers of preferreds have removed most of the “holder-friendly” features that investors used to enjoy such as hard retraction features and cumulative dividends.

This makes preferreds less attractive to most investors.

There are three ways to better approach the preferred market:

1. Seek out hard retraction, cumulative issues
2. Invest in ETFs
3. Invest in Split Corps

The ABCs of Preferred Shares

- What are they?

Lying midway between corporate obligations of bonds and common shares, preferred shares are hybrid securities, possessing neither the seniority of debt obligations nor the upside of ownership.

- Why are they called “preferred?”

This is because they have preferential treatment when it comes to distributing profits as their dividends must be paid before dividends on common shares are paid. In addition, Preferred shareholders rank ahead of common equity holders in case of a bankruptcy.

- What is their appeal?

Their biggest attraction is their yield which is typically higher than the yield on the underlying common shares. Also, since they receive dividend income, their tax treatment makes them attractive to individuals and taxable entities. Bond interest is fully taxable while, with the dividend tax treatment, one dollar of preferred share dividends is worth approximately \$1.40 of interest income (depending on the marginal tax rate of the holder). The combined federal and provincial tax rate on preferreds does not exceed 30%, while interest on bonds is taxed at the highest marginal rate, as high as 48%.

- What are the downsides for preferreds?

- 1) Their dividend rate, in most cases, is fixed, exposing the investor to the inevitable erosion of purchasing power from inflation.
- 2) They are long duration securities and are thus sensitive to changes in interest rates.
- 3) They are corporate securities and thus subject to credit quality concerns (this can also work in your favour).
- 4) They are complex with characteristics varying from one issue to the next, unlike common equity, where all shares have the same characteristics (except for different voting classes sometimes). Caveat emptor!

Types of Preferreds

This is where preferreds begin to lose their appeal and where investors must analyze the features of each issue to protect themselves.

There are several different types of preferreds:

- **Perpetual or Straight** preferred shares have no fixed maturity date and thus pay their stated dividend rate in perpetuity.
- **Retractable or Term** preferreds have a maturity set when issued. Typically, retractable preferreds are issued with a \$ 25 par value. Investors could retract or get their money back in five years for example.
- **“Soft” retractable** preferreds have a retraction value equal to a cash payment or the equivalent in common shares of the issuer, at the option of the issuer.

Typically, the stock price used is 95% of the average price during a specific time period before the retraction date.

- **Fixed Rate** preferreds have a set or fixed dividend rate at issue, normally paid quarterly.
- **Floating Rate** preferreds offer a dividend tied to a market rate; this is usually a percentage of the bank prime rate.
- **Dutch Auction** preferreds have their dividend rate set at a reverse auction.
- **Convertible** preferreds where the preferred shareholder has the option of converting into the underlying common shares at a pre set conversion price. There are not many of these outstanding.

OTHER FEATURES

Dividend Priority

As stated earlier, preferred shareholders have priority in receiving dividends ahead of common shareholders. In actual fact, preferred shareholders have almost no leverage when it comes to a corporate default. It is simple for the board of directors to not make a preferred dividend payment. This is what makes the following features so important:

Cumulative vs Non-Cumulative

Cumulative means that any skipped dividend payments are accumulated until they are repaid in full. With a Non-Cumulative, missed dividends are NOT paid in arrears.

Sadly, the trend in the past 5 years or so is to issue non-cumulative preferred shares leaving the preferred shareholder no recourse if a payment or payments is/are skipped. The bulk of recently issued preferreds are non-cumulative, and issued by large financial institutions. The implication is: “why worry, they will never miss a payment”. That might have been an easy assumption to make before the credit crunch hit but now there are more sober thoughts.

Issuing non-cumulative shares allows these institutions, banks and insurance companies mostly, to treat these preferreds as subordinate capital, ranking after bank deposits.

Combinations

Merging these features produces an array of possibilities:

- Fixed-rate (hard) Retractable
- Soft-Retractable
- Floating rate-Retractable
- Fixed-rate Perpetual
- Floating –rate Perpetual
- Fixed-Floater
- Convertible preferreds

To all of the above, you may add cumulative or non-cumulative to the description. By now, it is clear the preferreds are not simple at all. The trend in recent years has been all in favour of the issuers with a preponderance of soft-retractables or fixed-perpetuals that are non-cumulative.

e.g. *BNS 5.60% Series 17 Perpetuals*. They are callable by BNS beginning 4/26/2013 at \$ 26. There is no retraction feature for the investor and the dividends are **non**-cumulative. The principal reason for BNS to call these shares would be if interest rates fall to the extent that BNS could reissue them at a lower rate.

WHAT IS AN INVESTOR TO DO?

Faced with this array of choices but still interested in the tax advantage of investing in preferreds versus bonds, an investor must first ensure that he knows exactly the features on any preferred share issues that he is considering.

By now, it should be clear that the best choices are the highest quality preferreds that offer a hard call and are cumulative. As one would suspect, there are fewer of these available than other types and they trade at lower yields than the soft calls or perpetuals. At last glance, this spread was approximately 75 basis points. This is a worthwhile tradeoff as it gives the investor an out or “put” should inflation and interest rates both soar, while the holder of a higher yielding perpetual would experience a steady erosion in purchasing power plus a principal loss. If interest rates fall and inflation subside, then the hard retractable holder can elect to not retract.

Here is a shopping list of things to look for:

- Hard or soft retractable
- Yield differentials
- Quality- high quality preferreds are rated P1 and P2 (by DBRS).
- Diversification. This can be accomplished in 3 different ways:
 - 1) Selecting a package of different preferreds in different industries and of different types. There are choices available outside the banks and insurance companies.
 - 2) ETFs. Here is an example of a preferred ETF:
 - The Claymore S&P/TSX CDN Preferred Share ETF, symbol **CPD-T**.
It seeks to replicate the performance of the S&P/TSX Preferred Share Index, net of MER of .48%. This is an excellent way to diversify and thus reduce risks associated with early redemptions and retractions, and risks associated with any one particular security/issuer.
 - 3) Split Corp issues.
There are several dual purpose preferreds where preferred holders give up the right to all capital gains to common shareholders while receiving all the dividends on the common shares. One example of this type of security is:
 - Dividend 15 Split Corp (**DFN.Pr.A**)
It gives all dividends from 15 financial services companies to the preferred holders.
It offers a decent yield, good diversification and a hard call in 2014 and is rated P2.

SUMMARY

The principal purpose of this piece is educational. We receive a lot of enquiries regarding preferreds and we hope that this will answer a lot of those questions and also make the Preferred share report that we send out easier to sift through.

We decry the recent trend to soft call perpetuals or just perpetuals as they offer no advantages to the investor. Lenders have kicked up their heels recently in new corporate bond financings, obtaining poison puts and change of control clauses. There has been no such revolt among preferred investors so an investor is left to use the choices we have listed above. It is one thing to concentrate on nothing but tax treatment and advantages but it is entirely another to give up all rights in an asset class that has no real standing in a corporation, either from an equity point of view or from a debt point of view.

We favour an approach that combines diversification with quality and the appropriate features.

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