Pat Keene, (416) 359-4284
Vince Sansalone, CFA (416) 359-8289

April 15, 2009

Preferred Shares

Fixed-Reset Preferred Shares — An Explanation

"Fixed-reset" is a type of preferred share that has a dividend rate ("coupon") that is reset every five years. The shares are also redeemable at the issuer's option every five years at par value. As redemption is not mandatory, fixed-reset preferred shares have no maturity date and are considered "perpetual" securities.

Fixed-reset preferred shares appeal to income-oriented investors. The reset feature is considered defensive, as it helps bring the coupon rate into line with prevailing interest rates. This, in turn, helps support the shares' market price even during periods of rising interest rates. Historically, high quality fixed-reset preferred shares have traded in the secondary market at a price that is close to par value.

Recent issues of fixed-reset preferred shares offer an innovative feature. Rather than simply state that the coupon rate *will* be reset, issuers are telling investors *how* the coupon will be reset.

How Is a Coupon Reset?

Recent fixed-reset issues state the "spread" (or "premium") over Government of Canada bond yields at which the coupon must be reset. The reset spread is fixed at the time the issue is priced and reflects credit market conditions at that time.

The example below illustrates how a coupon would hypothetically be reset. (Note: a coupon rate is applied to the par value, which is usually $25; dividends are paid quarterly).

Example:

For illustration purposes we use **Bank of Montreal 6.50% Fixed-Reset Preferred Share Series 21**. The coupon rate is fixed at 6.50% ($1.625 per annum) for five years. Effective May 25, 2014, and every five years thereafter, the coupon rate will be equal to the 5-year Government of Canada bond yield plus 4.58%.

Let's assume that the 5-year Government of Canada bond yield is 3.00% on the first reset date. The new coupon rate would be 7.58% (=3.00% + 4.58%). The new dividend would be $1.895 per annum. The coupon rate would be reset in this manner every five years as long as the shares remained outstanding.

Exchange Feature

In addition to a five-year reset feature, most fixed-reset preferred shares offer holders the privilege to exchange their shares into a new preferred share series with a “floating-rate” dividend. In our example, the quarterly dividend on the new series would be equal to the 90-day Canada T-bill yield plus 4.58%. As the T-bill yield changes, so will the quarterly dividend, hence the term “floating-rate.” The example below illustrates how the dividend on the floating-rate series would hypothetically be calculated.

Example:

Let’s assume that for the first floating dividend payable on August 25, 2014, the T-bill yield is 1.00%. The initial dividend would be based on 5.58% of par value (=1.00% + 4.58%). The dividend would be $0.35 ($25 x 5.58% / 4).

For the second dividend, the T-bill yield is 1.10%. The dividend would be based on 5.68% of par value (=1.10% + 4.58%). The dividend would be $0.36 ($25 x 5.68% / 4).

For the next dividend, the T-bill yield is 0.85%. The dividend would be based on 5.43% of par value (=0.85% + 4.58%). The dividend would be $0.34 ($25 x 5.43% / 4).

The coupon rate would be reset in this manner every quarter as long as the shares remained outstanding.

Automatic Exchange

As long as the issue remains outstanding, investors will have two options. Every five years, they can exchange a fixed series for a floating series or vice versa. However, if on any reset date there would be fewer than one million shares of either series outstanding, the issuer will not issue that series due to a lack of trading liquidity.

Why Do Companies Issue Fixed-Reset Preferred Shares?

An issuer wishing to raise capital must consider what will appeal to potential investors. As investors enjoy the defensive characteristics of the fixed-reset structure, this type of preferred share is an ideal choice to bring to market. In addition, the issuer enjoys the flexibility of being able to either reset the coupon rate if that suits their needs, or retire the issue by exercising their redemption privilege.

Recently, Canadian financial institutions have been the largest issuers of preferred shares, and fixed-reset preferred shares in particular. The fixed-reset structure suits the banks’ desire to raise Tier 1 capital, which includes common equity and perpetual non-cumulative preferred shares. Approximately $9 billion in new fixed-reset preferred shares were issued between March 2008 and April 2009. As of March 31, 2009, fixed-reset preferred shares represented almost 30% of the conventional Canadian preferred share universe.

Call for Redemption or Reset?

The decision to call a preferred share for redemption or leave it outstanding will depend on the issuer’s financing needs, the options available to them and credit market conditions.

Over time, the yield that a particular company must pay to raise capital compared to the yield on government debt (i.e., its credit spread) will vary. If an issuer’s credit spread narrows substantially, they will be more likely to exercise their redemption privilege in order to refinance at a more favourable level. The higher the likelihood of a redemption call, the closer a preferred share will trade to its par value. (The reverse is true if credit spreads widen). If a fixed-reset issue is called for redemption, yields in the preferred share market will likely have fallen and investors would have to reinvest the redemption proceeds at a lower yield.

Risk Factors to Consider

Key risks that preferred share investors face include: (a) price volatility in the secondary market; and (b) safety of income. Factors that will negatively impact share price performance and/or a company's ability to sustain dividend payments include: (1) weakening company fundamentals; (2) rising interest rates; (3) widening credit spreads; and/or (4) low trading liquidity. Generally speaking, preferred share issues that are rated "P1" or "P2" by a major Canadian rating agency and have a market capitalization of $250 million or more are considered to offer better long-term return potential than issues with a lower credit rating (i.e., "P3" or lower) or smaller market capitalization. As mentioned earlier in this publication, the reset feature on a fixed-reset preferred share should, all else equal, help support the shares' market price during periods of rising interest rates.

Investment Conclusion

Fixed-reset shares are a significant and growing part of the Canadian preferred share landscape. Investors enjoy exposure to high quality issuers, a relatively high tax-efficient dividend yield and a defensive coupon reset feature. These qualities make fixed-reset preferred shares an attractive complement to a diversified income portfolio. For more information, contact your BMO Nesbitt Burns Investment Advisor.

RT10123_PK (04/15/09)

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