Understanding Preferred Shares

Canadian Preferred Shares

Preferred shares ("preferreds") are hybrid securities with both equity and fixed income characteristics. Similar to an equity security, a preferred share represents an ownership interest, generally does not have a maturity date and is recognized on the equity side of a company's balance sheet. Like a bond, however, a preferred share generally carries no voting rights, has a par value, and tends to pay a fixed distribution rate that is determined at issuance.

In the hierarchy of the issuing company's capital structure, preferred shares are senior to common stock but rank behind debt in a claim for distributions and the right to liquidation proceeds in the event of a bankruptcy of the company. For that reason, preferred shares have less rights than the bonds of a company but carry additional rights above those granted to common equity holders.

Capital Structure Hierarchy
Secured Debt
Unsecured Debt
Unsecured Subordinated Debt
Preferred Shares
Common Shares

Higher

Lower

Why Invest in Preferred Shares?

- **Portfolio diversification:** Preferred shares historically have had a low correlation to both equities and bonds. As a result, preferreds offer significant diversification benefits when added to an investor's portfolio.
- **Greater security than common shares:** Preferred shares are senior to common equities in a company's capital structure, as dividends on preferred shares must be paid before those of common shares. This provides holders of preferred shares with more security than that of common stock investors.
- **Predetermined dividend rate:** Unlike a common share, which could experience a change in its dividend rate, the distributions on a preferred share are determined at issuance. Some preferred shares also have a cumulative provision, where any omitted dividends must also be paid before common shareholders receive their payments. Hence, issuing companies tend to make a concerted effort to not miss a dividend payment.
- **Tax-efficient yield:** Unlike a bond, which has distributions that are taxed as interest income, the distributions of preferred shares are considered dividends, which are taxed more favourably. Consequently, preferred shares can offer a significantly higher after-tax yield than fixed income securities.
- **Lower volatility than equities:** Under normal market conditions, preferred shares tend to trade around their par value given they can be redeemed at that value by the issuer. This makes them more stable than common equities, but more volatile than fixed income securities. As a result, preferred shares offer investors a lower volatility alternative for corporate exposure than common stocks, and a higher yielding option than fixed income.

The Main Types of Preferred Shares in Canada

1) **Perpetuals:** This type of preferred share has no maturity date and pays a fixed dividend for as long as it remains outstanding. Due to its long duration, a perpetual preferred share can be very sensitive to credit spreads and interest rates. This type of preferred share can be redeemed by the issuer, but the holder has no retraction rights, which limits price appreciation.

2) **Floating Rate:** A floating rate preferred share pays a quarterly (sometimes monthly) dividend that “floats” in relation to a reference rate, typically the prime rate. Some issues of these shares have a minimum dividend or “floor”.

3) **Rate Resets:** This kind of preferred share pays a fixed dividend rate until its reset date. Upon its reset date, if the preferred share is not called by the issuer, the holder has two options. A new fixed dividend rate reflecting the current interest rate environment can be locked-in until the next reset date. The reset rate is predetermined and typically a spread above a Government of Canada bond with a similar term. The holder’s other option at reset date is to exchange the issue for a floating rate preferred share.

4) **Retractables:** A retractable preferred share allows the holder to redeem the share at par value on a specified date. For hard retractables, the issuer can only pay cash upon retraction, whereas for soft retractables the issuer can pay either cash or common shares.

Interest Rate Risk	Credit Risk	
Perpetuals	Perpetuals	Higher
Retractables	Floating Rate	
Rate Resets	Rate Resets	
Floating Rate	Retractables	Lower

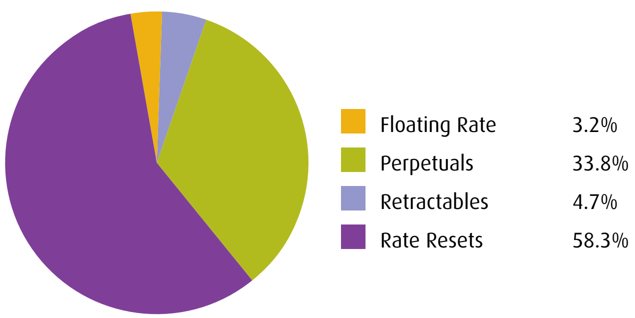
Source: BMO Asset Management Inc.

The Canadian Preferred Share Market

Currently, the size of the preferred share market in Canada is approximately $60 billion, almost doubling in size over the last seven years. Given the current low interest rates, there has been an increase in investor demand for less volatile and higher yielding assets such as preferred shares. Also, as preferred shares are typically more cost effective to issue than common shares, companies have used them to raise capital without diluting their common share base. Some companies may also issue preferred shares over debt or debentures because they are more favourable to the company’s debt to equity ratio.

In addition to growing in size, the make-up of the Canadian preferred share market has evolved over the last several years. Where perpetual preferred shares previously made up a majority of the market, rate reset preferred shares have been the most popular type of issue over the last two years, with investors seeking to mitigate the risk of rising interest rates. From an issuer’s perspective, there have also been a growing number of non-financial issuers utilizing the preferred share market as a source of financing, providing the asset class with better sector diversification.

The Canadian Preferred Share Market



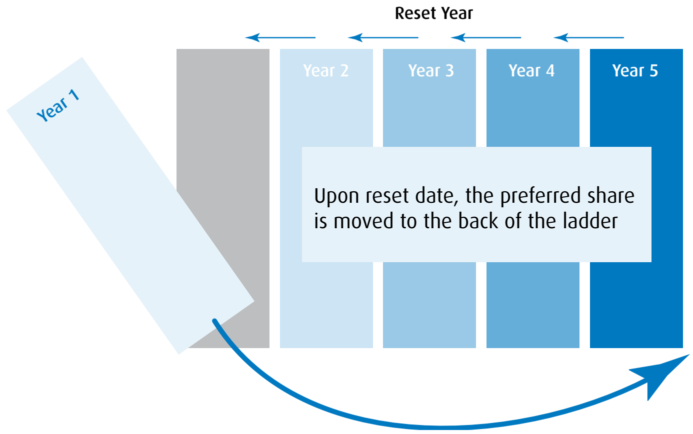
Source: BMO Capital Markets (As of September 30, 2012)

Preferred Share Investing in the Current Market Environment

In recent years, the Bank of Canada (BoC) reduced its overnight rate to a low of 0.25%. Although its key lending rate could remain low for some time, it is likely that the interest rate cycle is near the bottom, especially given that rates have already moved off their lows. When rates continue to rise, this could place pressure on straight perpetual preferred shares, which are interest rate sensitive given their long duration. Rate reset preferred shares, on the other hand, are more adaptable in a rising rate environment since their dividends are reset on a periodic basis, thus adjusting to reflect the current interest rate environment.

Benefits of Laddering

To further diversify a preferred share portfolio against a rising interest rate environment, an investor can structure rate-resets in a staggered manner. This can be done by organizing the portfolio in a ladder, similar to a bond or a guaranteed investment certificate (GIC) ladder. In this structure, the portfolio is evenly divided by calendar years, or term buckets. Within each term bucket, there will be a number of individual rate reset preferred share issues which have a reset date in the same year. Once the particular issue has reset, it will move to the back of the ladder, again grouped with other individual issues with a reset date of the same year. By doing this, each year a portion of the portfolio will be reset to reflect the current interest rate levels.



Should a particular issue of preferred shares be redeemed by its issuer upon its reset date, the capital would have to be reinvested in other securities. Rather than having a large portion of a portfolio called and a disproportionate amount to reinvest, a laddered process spreads the issues evenly across different terms. This reduces the chances that a large portion of the portfolio will be redeemed and have to be reinvested. Redemption risk is further mitigated by holding a number of preferred shares at each reset year.

Conclusion

Asset class diversification has become increasingly important. Preferred shares are an effective portfolio construction tool for investors given their low correlation to both common stocks and fixed income. However, with lending rates looking like they are near a bottom, managing interest rate risk will be very important when investing in preferred shares. By laddering a portfolio of rate reset preferred shares, investors can benefit from the diversification properties and the tax efficient yield of preferred shares, while better positioning their portfolios in a potential rising rate environment.

Please contact your BMO Nesbitt Burns Investment Advisor for more information.

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