INVESTMENT

Why Pensions Prefer Preferreds

BY: **RYAN DOMSY & COLIN RIPSMAN**

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Why Pensions Prefer Preferreds

High and stable income levels are making preferred shares an increasingly attractive fixed income substitute for Canadian institutional investors in the current low and rising interest rate environment.

BY: **RYAN DOMSY & COLIN RIPSMAN**

A preferred share is a form of equity that has a predefined dividend rate. Preferred shares (preferreds) are considered hybrid securities, possessing both equity and fixed income characteristics. Like common equities, a preferred share represents an ownership interest in a company. Preferreds, however, have a predefined dividend rate that must be paid before any dividends can be paid to common shareholders. In some cases, it has a cumulative feature that requires the company to pay any unpaid past preferred dividends before dividends are paid to common shareholders. Like common equities, preferreds normally have no set maturity dates and are recognized on the equity side of a company's balance sheet.

Distribution Rate

Preferreds investment distributions mirror those of bond investments in that they tend to pay a set distribution rate that is determined at the time of issuance. Preferreds share many other features with bonds, including:

- A par value (commonly $25)
- They normally do not attract voting rights
- They are callable at different times
- Their pricing is sensitive to interest rate changes

In the hierarchy of a company's capital structure, preferred shareholders rank ahead of common shareholders, but rank behind bondholders in the event of insolvency. However, it is important to remember that preferred shares are typically issued only by blue chip companies with the strongest balance sheets.

The preferred share market in Canada is comprised of the following three primary types of preferreds:

- Fixed Rate Perpetuals (23 per cent of the S&P/TSX Preferred Share Index)

Fixed dividends are set when the securities are initially issued. The dividends remain constant as long as the security remains outstanding. However, the issuer can call the securities, at or above par, at various points in time. Generally, the market price for these preferreds fluctuates in a similar fashion to the price of a long-term bond.

- Rate Resets (73 per cent of the S&P/TSX Preferred Share Index)

These securities have a fixed or floating dividend for a set period, until the next reset date (normally every five years). At each reset date, the investor can choose to receive either a fixed or a floating rate dividend for the next period, usually determined as a predefined spread over government of Canada bond rates. Rate resets are callable at par by the issuer at each reset date.

- Floating Rate Preferreds (three per cent of the S&P/TSX Preferred Share Index)

These preferred pay a variable dividend that is normally adjusted quarterly, based on prevailing government interest rates. Floaters are callable by the issuer at or above par at various predefined times.

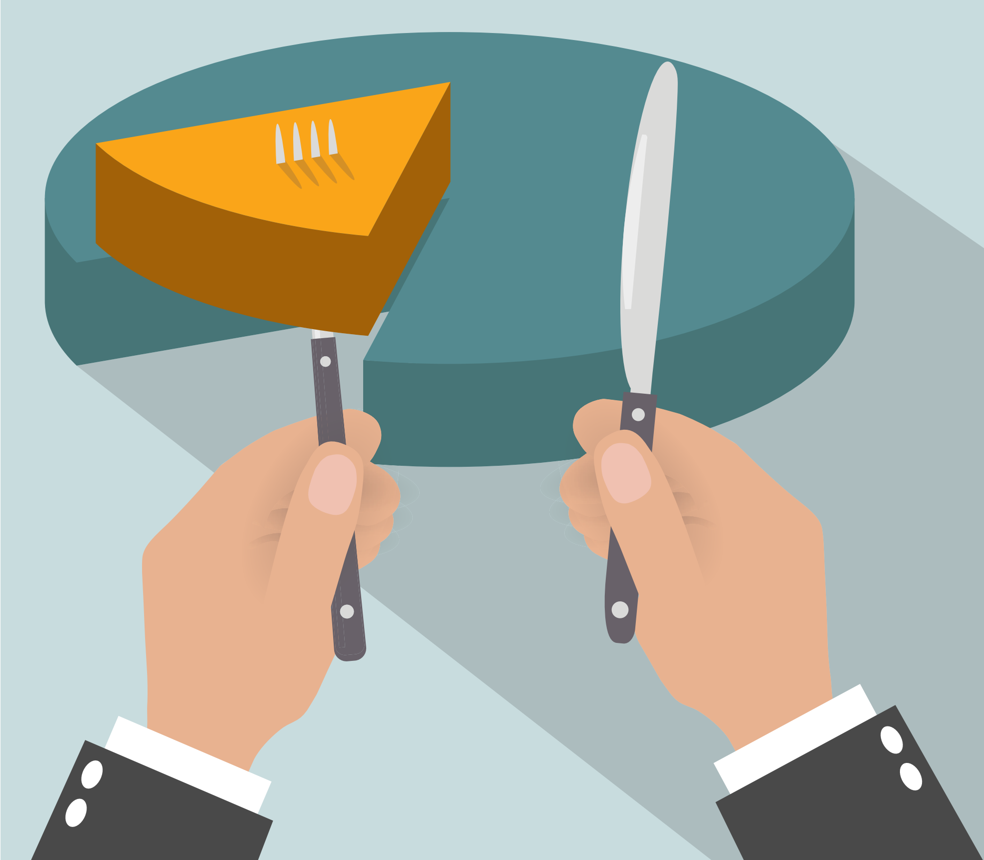
Chart 1 illustrates sector breakdown of the index. In general, the preferred market is comprised of large blue chip companies and are dominated by large banks and insurance companies.

Benefits Of Preferreds

There are many benefits to institutional investors of including an allocation to preferreds in their portfolios, including:

- Higher Yields

Preferreds offer a significant yield advantage over bond yields (often referred to as the spread). *Chart 2* compares the yields spread offered by preferreds over traditional bonds over the last five years. Historically, this spread has ranged from a low of two per cent to a high of approximately 3.5 per cent.



In a low yield environment, this represents a huge income enhancement, with little incremental risk, due to the high credit quality of the issuers and priority over common shareholders.

This higher yield level is appealing not only to pension funds looking to enhance the low yield of their bond portfolio, but is also appealing to not-for-profit investors who must achieve a minimum income level to meet Canada Revenue Agency payout requirements.

For insurance companies which build significant fixed income allocations in their portfolios to match liability streams, an allocation to preferreds offers an opportunity to enhance portfolio yields, without impacting their regulatory capital structure.

♦ Shorter Duration

The five-year dividend reset feature embedded in most preferreds acts to reduce their sensitivity to interest rates (or lower duration). The duration of a preferred portfolio is much shorter than the FTSE/TMX Canada Universe Bond Index and more consistent with a mortgage portfolio which has a similar five-year reset feature. This shorter duration will help preferreds potentially further outperform traditional bond portfolios when the Canadian economy begins to improve and interest rates inevitably rise.

At the same time, preferreds offer an attractive spread over other shorter duration investment options, like shorter duration bonds and mortgages. *Chart 3* shows the yield spread offered by preferreds over mortgages for the last five years. Historically, this spread has ranged from a low of 0.9 per cent to a high of 2.2 per cent.

The current yield on preferreds is consistent with that offered by Canadian high yield bonds, but with much lower credit and default risk. Preferreds are issued by high quality issuers in Canada. This is in stark contrast to the below investment-grade ratings of the issuers in the high yield bond market.

♦ Low correlations with stocks and bonds

As illustrated in *Chart 4*, preferred share returns have exhibited a low correlation with Canadian stocks and a slightly negative correlation with Canadian bonds, over the last five years.

Accordingly, an allocation to preferreds can enhance the diversification level within the portfolio and act to improve the volatility of the overall portfolio. This makes preferreds an attractive alternative asset class that can enhance portfolio return and yield, while at the same time lowering portfolio risk.

♦ More liquid than other alternatives

While less liquid than traditional bonds, preferred shares are significantly more liquid than other alternatives. For example, real estate, infrastructure, and mortgage funds will normally greatly restrict withdrawals. Since these asset classes have very limited liquidity, open ended funds will normally be limited to quarterly withdrawals, but they may be completely suspended in certain market conditions. Closed-end real estate and infrastructure funds do not permit withdrawals. In contrast, preferred share funds trade daily and fund withdrawals can normally be accommodated within a week.

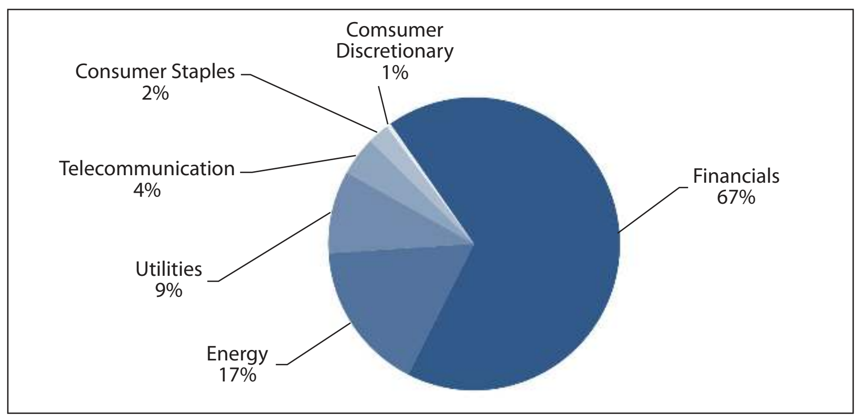
♦ Lower fees than other alternatives

The fee on preferred share portfolios

Chart 1

INDUSTRY ALLOCATION OF THE INDEX

S&P/TSX Preferred Share Index. Sector Allocation – June 30, 2016

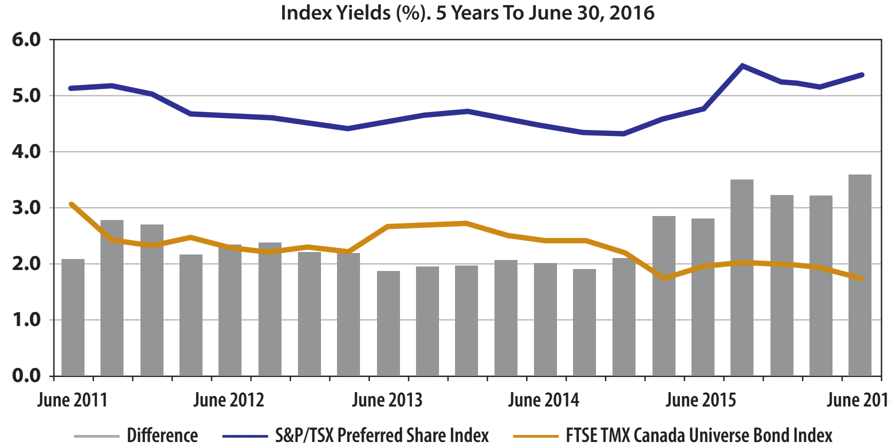


Source: S&P/TSX

Chart 2

PREFERRED VS. FTSE TMX CANADA UNIVERSE BOND INDEX

Index Yields (%). 5 Years To June 30, 2016



Source: FTSE TMX Canada

are significantly lower than other alternative investments. For example, the fee levels on real estate and infrastructure funds will often exceed one per cent and also incorporate extra performance-based fees. In contrast, the fees charged for a preferred portfolio will normally be less than half the levels of other alternatives and will not attract any performance based fee.

Current Market Environment

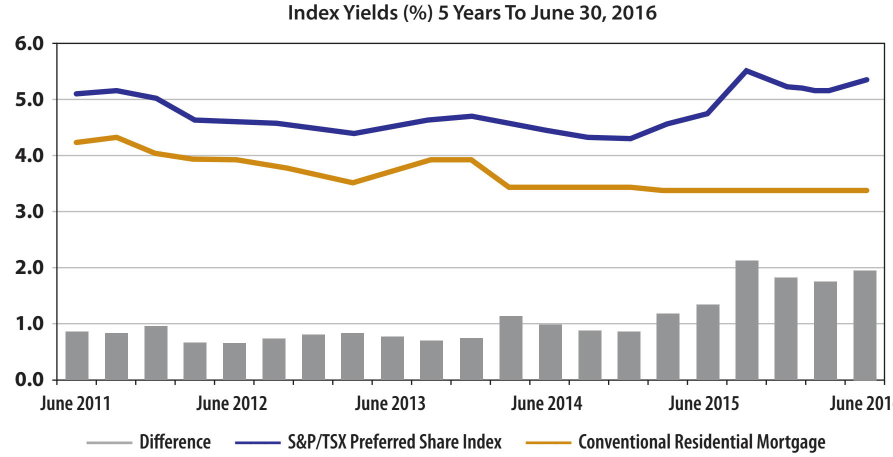
Historically, the preferred share market was dominated by retail investors who were attracted by the high and stable income levels. Taxable retail investors also benefited from the tax advantage granted to preferred shares which have their income taxable at preferential dividend rates. In contrast, income from traditional bonds is fully taxable.

We have seen a significant shift in this market starting in the second half of 2015. At that time, many rate reset preferreds experienced their first rate reset. Because interest rates continued their decline, the preferreds reset at a lower interest rate. Concern and confusion among retail investors, who did not have a good understanding of these complex investments, caused many to liquidate their positions. The severity of this response caused yields and yield spreads to increase to levels well in excess of those of bonds and equities of those same companies.

At the same time, the composition of the investor base has shifted. As retail investors exited the market, they were replaced by institutional investors who were alerted to the short-term capital gain opportunity resulting from the overly strong price correction in the market. Now that institutional investors are beginning to familiarize themselves with the asset class, they remain attracted to the appealing long-term risk/return characteristics of the asset classes.

Chart 3

PREFERRED VS. MORTGAGES



Source: FTSE TMX Canada

The early institutional adopters will benefit from the asset class in two ways:

- Over the short-run, they will benefit from the short-term capital gain as preferred pricing reverts to a more normal (higher) level with a more typical spread over other asset classes.
- Over the long run, they will benefit from the attractive long-term stable yield spread relative to bonds and even mortgages as well as risk reduction offered through shorter duration and low correlations to traditional asset classes. These long-term benefits will ensure that the asset class remains attractive for institutional portfolios over the long run.

It is also important to note that the shift in the investor base to institutional investors, with long-term time horizons, has also increased the stability and resilience of the asset class.

One word of caution. Preferreds are a complex asset class, with fewer issuers and lower trading volumes than traditional asset classes. Successful management of a preferred portfolio requires expertise in evaluating and trading preferred shares and in building and managing a prudent and well-diversified preferred share portfolio.

Preferreds are an emerging class that should be evaluated and carefully considered by institutional investors looking to better position their portfolios for the low and rising interest rate environment that faces Canadians for the foreseeable future. Whether treated as an allocation to an alternative asset class due to its low correlation to traditional asset classes or as an attractive substitute for shorter duration fixed income – such as short-term bonds, mortgages or high yield bonds – preferreds are destined to remain an important tool for institutional investors. **BPM**

Chart 4

CORRELATION OF RETURNS OF THE S&P/TSX PREFERRED SHARE INDEX*

Vs. The S&P/TSX Composite Index	Vs. The FTSE TMX Canada Universe Bond Index
0.27	-0.06

* Five years to June 30, 2016

Source: Bloomberg, FGP

Ryan Domsy *is senior credit analyst and portfolio manager, fixed income, at Foyston, Gordon & Payne Inc.*

rdomsy@foyston.com

Colin Ripsman *is vice-president and portfolio manager, institutional client services, at Foyston, Gordon & Payne Inc.*

cripsman@foyston.com