Preferred Shares

A Brief Introduction to Preferred Shares

Preferred shares can be a fine addition to a fixed income portfolio, providing a higher after-tax yield than bonds and GICs, while addressing many of the inherent weaknesses of an all-GIC portfolio.

The primary problem with most retail investors' fixed income portfolios – and particularly with the very popular "GIC Ladder" – is that the average term to maturity is too short. One source of this problem is the fact that the Canadian Deposit Insurance Corporation (CDIC) will not insure a term deposit with an original term to maturity of greater than five years[1] unlike its US counterpart, which insures all Certificates of Deposit regardless of term.[2] Together with the normal five-year term of a Canadian mortgage, this limitation leads many to believe that five years is the maximum 'safe' term of a fixed income investment and that anything more is 'risky'.

This emphasis on short term investing (in bond market jargon, "short term" is five years or less; "intermediate" is five to ten years" and "long" is over ten years[3]) unnecessarily exposes investors to the ebb and flow of interest rates through the course of a business cycle, which will normally have a term of much longer than five years. In general, some elements of a fixed-income portfolio should be in excess of five years, in order to reduce reinvestment risk.

Reinvestment risk is the risk that the principal invested in a bond or GIC will come due at a time when the relevant interest rates are low. A longer-term investment allows the initially agreed rate to be locked in for a long period of time, allowing greater certainty of future income payments. This does not mean that an entire fixed income portfolio should be invested in long-term investments by any means but, as is the case with many aspects of investing, diversification is the way to increase the predictability of your total portfolio investment returns over a long period.

According to the Bank of Canada[4], the yields offered on five-year GICs had their ten year high in early 2000, when yields were just under 5.75%. Many investors, no doubt, considered this a very fair rate and were more than pleased to invest at this yield; disdaining the yields of 6.0 – 6.5% available on long-term Canada bonds (or the higher yields, taxed at a lower rate, on many preferred shares) on the on the basis of potential inflation, price risk and the relatively small term premium (the term premium is the additional yield received by the investor for increasing the term of his investment). Many will have quite happily invested in the GICs and spent the income, secure in the knowledge that their principal was guaranteed first by their bank with a back-up guarantee from the Canadian Deposit Insurance Corporation … but the story doesn't end there.

Five years later, five year GIC yields were under 3% and investors who were dependent upon the income generated by these instruments saw their income cut nearly in half while buyers of the despised long-term bonds continued to enjoy the same semi-annual payments that they had originally purchased. Holders of the long-term issues had

1 CDIC website, available on-line at http://www.cdic.ca/e/coveredornot/gic-othertermdeposits.html (accessed 2009-8-17)

2 FDIC website, available on-line at http://www.fdic.gov/deposit/deposits/certificate/index.html (accessed 2009-8-17)

3 See, for example, the definitions of the various DEX bond market indices at http://www.canadianbondindices.com/Debt_Market_indices.asp (accessed 2009-8-17)

4 Bank of Canada series V122515: 5-year personal fixed term available on-line at http://www.bankofcanada.ca/en/rates/interest-look.html (accessed 2009-8-13)

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experienced an unrealized capital gain – but this is of only secondary importance, particularly for investors of a buy-and-hold disposition. The important thing is that the income stream derived from their investment did not change after the relatively short span of five years – and isn't it "fixed income" that is of interest?

With their generally longer terms, Canadian preferred shares can help investors address reinvestment risk, while at the same time offering higher after-tax yields. After taking the Dividend Tax Credit into account, yields on investment-grade Canadian preferred shares are well above that available on long-term corporate bonds: on July 31, 2009, the yield on the "PerpetualDiscount" type was an average of 6.06% dividend yield, equivalent (at the normal[5] factor of 1.4x) to 8.48% in taxable interest. Long corporate bonds at that time averaged about 6.3% interest.[6] The Bank of Canada reports that five-year GICs were yielding 1.73%, taxable as interest.[7]

Some investors may be concerned about price volatility but consider this: even after a vicious bear market in preferred stocks from approximately March 2007 to November 2009 – the worst one on record – a diversified index of preferred shares trading on the Toronto Stock Exchange was still able to provide positive returns over the five years to June 30, 2009. Hymas Investment Management's "Malachite Aggressive Preferred Fund" was able to greatly exceed the return on a five year GIC purchased at the beginning of the five year period – particularly when examined on an after-tax basis – through careful selection of its investments and the systematic exploitation of market anomalies.[8] Many investors panicked during the crash of this market during the Credit Crunch – but others simply continued to cash their regular fixed dividend cheques.

For those who prefer to maintain complete control over their investments, but do not have the time to master the intricacies of fixed income investing, my publication "PrefLetter" is published monthly. PrefLetter sorts through all the preferred shares in its universe – over two-hundred issues – and selects potential issues from those of investment grade credit quality.[9] At least one issue is chosen from each class of preferred share[10] so that investors may build a preferred share portfolio customized to their needs, with the knowledge that specific security selection has been meticulously checked by a professional with a long-term track record of success.[11]

Interested? I have written a large number of articles dealing with the Canadian preferred share market[12], including "Preferred Shares and GICs" (available on-line at http://www.himivest.com/media/PrefsAndGICs_090814A.pdf) that looks more closely at the relative merits of the two fixed-income investment classes.

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5 After receiving $1 in dividends and paying tax, a typical investor will have the same amount of money left over as if he had received $1.40 in interest and paid tax on that; hence, the factor is 1.4x.

6 PC Bond Analytics, DEX Long-Term Bond Indices, available on-line at http://www.canadianbondindices.com/ltbi.asp (accessed 2009-7-31)

7 Bank of Canada *Series V122515: 5-year personal fixed term* available on-line at http://www.bankofcanada.ca/en/rates/interest-look.html (accessed 2009-8-13)

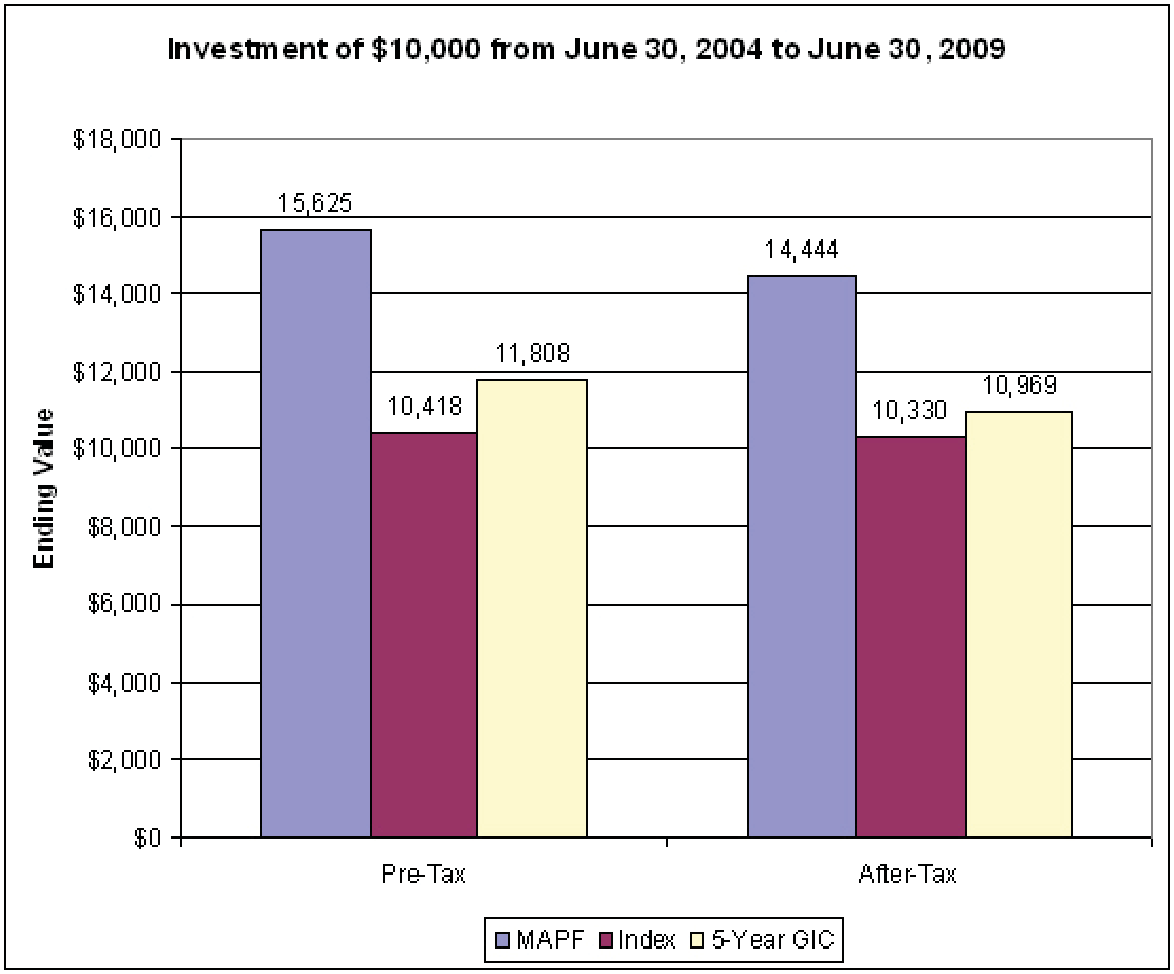
8 Please see "Important Notes Regarding Chart Preparation", below, for details. Past performance is not a guarantee of future returns.

9 "Investment grade" means rated Pfd-2(low) or higher by DBRS. See http://www.dbrs.com/about/ratingScales for an explanation of the meaning of the various grades.

10 See http://www.prefletter.com/whatPrefLetter.php for an explanation of the Hymas Investment Management classification of preferred shares.

11 See http://www.himivest.com/malachite/MAPFMain.php under the heading "Performance" for the complete track record of Hymas Investment Management's flagship "Malachite Aggressive Preferred Fund".

12 See http://www.himivest.com/press.php for a complete list.



Important Notes Regarding Chart Preparation

MAPF is Malachite Aggressive Preferred Fund. Hymas Investment Management Inc. is Trustee and Portfolio Manager for the fund. Further information regarding the fund is available at http://www.himivest.com/malachite/MAPFMain.php. Management fees are charged directly to clients, rather than inside the fund as is normally the case; fund performance has been adjusted by reducing the fund's reported total return by 0.25% every quarter for the period reviewed. Displayed returns reflect reinvestment of distributions. Historical performance is provided for comparison purposes only and may not reflect potential future returns. You can lose money through an investment in Malachite Aggressive Preferred Fund or with any other fund.

The Index is the BMO-CM "50" Preferred Share Index.

Data for the 5-Year GIC assumes compounding of interest, at a yield determined from the Bank of Canada's 'V121773=Guaranteed investment certificates – 5-year' yield data.