



Corporate Bonds...or Preferred Shares?

James Hymas

The question of asset class is an important one to all investors. The basic considerations involved in making this decision are liquidity, expected returns and risks—while noting that risk should be examined across the entire portfolio relative to the portfolio's purpose, not just in isolation.

In most instances, a well-balanced individual portfolio will include a fixed-income component—many investors will have a need for a reliable income stream, others may want a component of their portfolios that can be sold at any time with a certainty of price not provided by equities, while still others may regard fixed-income securities as a means to reduce the short-term volatility of their total portfolio. Regardless of the rationale for the inclusion of this asset class, most investors will devote some proportion of their capital to fixed income.

Having made that initial decision, the question remains: Which fixed income? Typical choices are Guaranteed Investment Certificates (GICs), government bonds, corporate bonds and preferred shares. Mutual funds are also an option—but these normally have expenses and fees, collectively referred to as the Management Expense Ratio (MER), and will normally hold government and corporate bonds almost exclusively. In this article, we'll attempt to eliminate "the middle man" and focus on the underlying investment.

Each type of fixed-income investment has its own characteristics and there is no magic formula to assist in making the choice. Investors should have some degree of familiarity with the various alternatives, if for no other reason than to ensure advisors are asked the right questions. This article will focus on the choice between corporate bonds and preferred shares, as an introduction to the field of preferred share investing.

As noted in Table 1 discussing the differences between corporate bonds and preferred shares, taxation of income received is a major difference between the two types of investment. Preferred shares pay dividends, while bonds pay interest. There is a very great tax advantage for investors for the former payment method because of the dividend tax credit.

We all know that nothing in life is free—so all readers will now know there is some kind of catch to this wonderful tax treatment.

The catch is that preferred shares will generally pay a lower rate of pre-tax income than bonds, which, in turn, means:

- When deciding between corporate bonds and preferred shares, compare the after-tax rate of return.
- Never hold preferred shares in a registered account (such as an RRSP or RRIF). This would throw away the comparative tax advantage.

All right then. We know something of the similarities and differences between corporate bonds and preferred shares (in many cases issued by the same

SIMILARITIES

➤ **Predictability of Income:** Preferred shares and corporate bonds are generally issued with a fixed rate of income payments (although there are many issues offering a floating rate).

➤ **Priority over Common Equity in the Event of Default:** Both preferreds and corporate bonds rank senior to common equity in the event of default by the corporation. In recent years, this has best been illustrated by Split Share Corporations, which have on occasion arrived at their wind-up date with the "capital gains shares" owners virtually or entirely wiped out while the preferred shareholders have had all or virtually all of the companies' obligations to them met. Note, however, that corporate bonds are senior to preferreds.

➤ **Predictability of Principal Repayment:** Many preferred issues are retractable (allowing the shareholder to sell the shares back to the company at a specified price and time), while some others (primarily those issued by Split Share Corporations) have a fixed maturity date. Note, however, that some preferreds are "perpetual" as noted in the outline of the differences.

➤ **Availability of Standardized Credit Reports:** Virtually all preferred shares and corporate bonds are assigned a credit rating by a major rating agency such as DBRS (at www.dbrs.com). In contrast to equity research published by brokerage houses, these reports are useful, independent, re-examined after the fact to determine their statistical usefulness as a predictor of financial difficulty and have a legitimate business purpose as a "profit centre" for the rating agency. While there are no guarantees any issue will avoid default, the agencies do a very good job of ranking the relative risks inherent in investment in the various issues.

➤ **Generally Less Liquid Than Government Bond Issues:** There are nine Government of Canada bond issues with an issue

corporations—perhaps even to fund the same projects!) but what's the bottom line? When the lower pre-tax income stream is offset by the lower rate of tax, how does one type of investment compare in terms of cash in the investor's pocket?

In order to come to a reasonable conclusion, we'll look at some indices. There are a lot of indices in the financial world—some say there are far too many! Most readers will be familiar with the S&P/TSX Composite index, which provides a measure of how well the Toronto stock market is doing; the Dow Jones Industrial Average measures thirty of America's largest public corporations; the S&P500 examines the performance of the stock in 500 of America's largest corporations.

In order to determine how well corporate bonds do, we'll use the Scotia Capital Universe Corporate Bond Index and for preferred shares, the BMO-Nesbitt Burns '50' is the most appropriate measure. We want to capture both good periods and bad, so we'll look back at the history of these markets from December 31, 1993 in order to capture the spring of 1994 (certainly the worst period for fixed income in recent memory—a time when the U.S. Federal Reserve stopped keeping short-term interest rates artificially low to prop up a sickly banking sector and commenced increasing interest rates considerably to fend off incipient inflation).

And we'll look at whole years only, so that readers who don't happen to be professional fixed-income portfolio managers can see the results in familiar terms of annual percentage returns.

These returns are compared in Table 1. It can be seen that while the pre-tax returns on corporate bonds have been much greater than the pre-tax returns on preferred shares (by 0.89% yearly), the tax effect has reversed the order. Preferred shares have returned an average of 0.31% yearly, after-tax, more than corporate bonds over this time.

Bond holders have lost 3.0% from their return on investment to the taxman; preferred share holders have lost only 1.8%. This is the critical point to understand when comparing returns from interest-paying forms of fixed income with preferreds.

A number of assumptions have been necessary in order to estimate the after-tax return on the indices since after-tax figures are not calculated by the dealers. Please feel free to e-mail me and ask for the spreadsheet used to calculate them. The most important assumption is that the holder of the index investment is taxable at the top marginal rate in Ontario.

TABLE 1 - RATES OF RETURN, IN PERCENTAGES, FOR CORPORATE BOND AND PREFERRED SHARE INDICES

Year	Corporate Bonds		Preferred Shares	
	Pre-Tax	After-Tax	Pre-Tax	After-Tax
1994	-3.19	-2.89	2.45	1.80
1995	19.68	11.29	13.79	9.01
1996	10.55	5.79	10.78	7.08
1997	9.51	5.27	5.03	3.42
1998	7.06	3.74	5.53	3.74
1999	-2.72	-2.42	-2.98	-1.67
2000	5.67	2.61	9.50	6.67
2001	8.52	5.27	3.98	2.58
2002	4.52	2.27	4.39	2.92
2003	8.50	5.32	7.57	5.38
2004	7.29	4.43	6.02	4.21
2005	6.01	3.61	3.83	2.54
Total*	116	53	95	59
Average	6.63	3.63	5.74	3.94

* Total percentage gain over 12-year period.

Thirty-one basis points (a basis point, or bp, is a hundredth of a percentage point) may not sound like much—but in the fixed-income world, this is a huge gain. It is very difficult to outperform a bond index. To be one of the best bond portfolio managers in Canada, for instance, all you have to do is outperform your index consistently by twenty-

size of over \$10 billion (according to the Bank of Canada at www.bankofcanada.ca), while \$300 million is a healthy size for corporate issue of bonds or preferreds. The size of these issues and the frequency with which they are traded means that an institutional bond manager can easily trade \$50 million of a particular issue of government bonds—virtually impossible in the corporate market.

DIFFERENCES

➤ **Exchange Trading:** While trading conditions for retail investors in corporate bonds has greatly improved in the past few years, bonds (traded directly by the brokerage firms) are not so transparently traded as preferreds, which are almost always listed on a recognized stock exchange. The exchange listing allows investors to track the best bid and offer available in the marketplace and to place orders, secure in the knowledge that no lower bid or higher offer will be executed before the order is filled.

➤ **Market Efficiency:** Given the above difference it might come as a surprise to some that the corporate bond market is much more efficient than the preferred share market. The relative inefficiency of the preferred share market can lead to profitable trades for those willing to learn to tell the difference between an expensive preferred share and a cheap one.

➤ **Priority in the Event of Default:** In the event of default, bond holders will always be ranked higher than preferred shareholders. It should be noted, however, that preferred shareholders are rewarded quite handsomely for this assumption of higher risk.

➤ **Maturity Date:** All but a few very special bond issues will have a fixed maturity date, whereas preferred shares will not necessarily offer such certainty for repayment of principal. Some may be "perpetual" and, unless redeemed by the issuer, can only be disposed of by sale on the stock exchange.

➤ **Taxation of Income:** This is the major advantage of holding preferred shares. They pay dividends rather than the interest paid by bonds, which has major consequences for after-tax returns, as discussed.

CAREFUL! ARE YOU ACTUALLY BUYING A PREFERRED SHARE?

Some issues that trade on the exchange and look like preferred shares are actually preferred securities and pay interest income. An example of such an issue is listed on the Toronto Exchange as BAM.PR.S - Brookfield's 8.35% Preferred Securities. Before buying, check the prospectus at www.sedar.com or confirm the details with your advisor or other reliable source.

five basis points—pre-tax. When it is considered that this increase has been made with no appreciable increase in credit risk (both indices focus on high-quality issuers unlikely to default) and, most importantly, is after-tax, this outperformance is even more impressive.

So, we can conclude that investing in preferred shares can make a lot of sense, for investors who hold fixed income in a taxable portfolio. The favourable tax treatment this class of investment receives makes an enormous difference in the amount of after-tax income that eventually makes it into the investor's pocket.

In future columns the various types of preferred shares will be examined—there is enough variety available in the class to allow a portfolio to be adapted to the needs of virtually any taxable investor.

James Hymas, CFA, Hymas Investment Management, 129 Humbercrest Blvd, Toronto, ON, M6S 4L4 (416) 604-4204, jiHymas@himinvest.com. James specializes in preferred share analysis.