

Preferred Securities Have Both Equity and Debt Features

Canadian & US Preferred Securities are “hybrid” securities, meaning they offer a combination of debt and equity features. Like equity, they are subordinate to bonds and other senior obligations, and they typically have no maturity date or are very long-dated. Like debt, Preferreds have a fixed principal value, and offer a coupon payment (a dividend or interest income) as the source of investor returns. US preferred shares are particularly notable as they are among the highest yielding of any US investment grade fixed income asset class.

Not All Preferred Securities are Correlated

The case for US Preferreds is compelling. Not only can US Preferred Securities add meaningful diversification to a Canadian preferred share portfolio (long-term correlation approximately 0.4), they are also higher-yielding than their Canadian counterparts (currently dividends of 5.8% for US preferreds and 5.1% for Canadian preferreds).⁽¹⁾⁽²⁾ Additionally, US Preferreds offer lower volatility and better trading liquidity. In our view, the fixed-rate-reset dividend model so prevalent in Canada is broken, and Canadian investors deserve better.

Comparison: Canada vs U.S.-Preferred Securities Market

	Canada	US
Index Market Capitalization	\$51 Billion ⁽³⁾	\$513 Billion ⁽⁴⁾
# Preferred Share Issues	367 ⁽³⁾	1,118 ⁽⁴⁾
Avg. Issue Market Value	\$225 million ⁽³⁾	\$458 million ⁽⁴⁾
Yield	5.1% ⁽¹⁾	5.8% ⁽¹⁾
After-tax Yield	Approximately equivalent at highest marginal rate	
5 Year Annualized Volatility	10.0% ⁽¹⁾	4.2% ⁽¹⁾
Main Coupon Type	Fixed Rate Reset	Fixed-Floating
Correlation	Low - Approximately 0.4 (10Y) ⁽¹⁾	

Preferred Securities are Mainly Issued by High-Quality Companies

Preferred shares are issued by companies to increase equity capitalization and improve balance sheets. The main reasons companies issue preferred securities are: i) to meet regulatory requirements for strong equity capitalization (banks & insurers), or ii) to target a favorable credit rating so that the company can access low borrowing costs (utilities, telecoms, pipelines, real estate). The average credit rating for preferred shares issued in Canada and in the US is Pfd-2 (low), an investment grade rating.⁽³⁾⁽⁴⁾

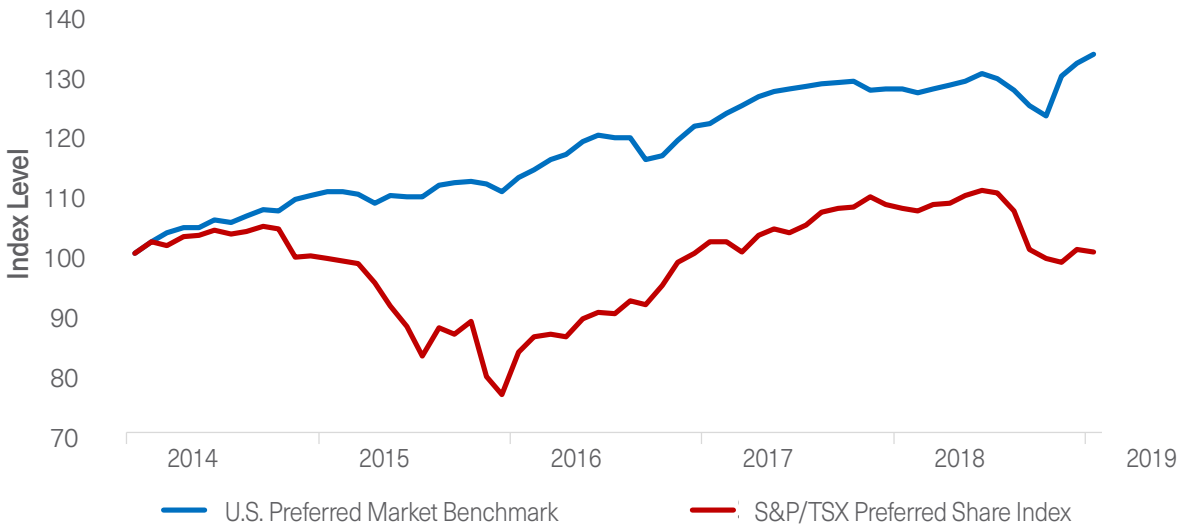
Liquidity & Selection Vary Among Markets

The US Preferred Securities market is a large, liquid market approximately US\$513bn/C\$694bn in size, making it approximately ten times larger than the US\$51bn/C\$69bn Canadian Preferred Share market.⁽³⁾⁽⁴⁾ There are over 1,000 securities and 433 issuers in the US, whereas Canada has 367 securities and only 61 issuers⁽³⁾⁽⁴⁾. In Canada, Preferred Shares are listed for trading on a stock exchange (making them available to the “Retail” market) and generally have a \$25 par value. The US has a similar “Retail” Preferred Securities market (exchange-listed, \$25 par value) which represents 36% of the total US Preferred market.⁽⁴⁾ The remaining 64% is the “Institutional” market. Institutional preferred shares trade “over-the-counter” (not listed on an exchange) like bonds, in larger denominations (generally \$1,000 par value), and may have more attractive yield or other features when compared to Retail Preferred Securities.⁽⁴⁾

US Preferred Securities Have Been More Resilient

US Preferred Securities came under pressure in the fourth quarter of 2018, but by the end of the first quarter of 2019 the index entirely recovered. Canadian Preferred prices have continued to languish alongside 5-yr GOC interest rates. The fixed-to-floating dividend model common in the US, with more frequent and more digestible incremental dividend rate adjustments compared to the Canadian fixed-rate-reset model, has resulted in greater visibility and a better overall experience for investors.

U.S. & Canadian Preferred Indices - 5-Year History²



Fixed Coupons Were Standard in the Past but Adjustable Coupons are Dominant Today

Up until approximately 2008, most US and Canadian Preferreds were issued with a “perpetual fixed-rate” coupon: a set dividend rate for the life of the investment. Today, adjustable rate dividends - which may benefit investors during rising rate periods - are predominant. The Canadian Preferred Share market is currently 74% weighted to “fixed-rate-reset” dividends, which means coupon rates are fixed for a 5 year term, and then are “reset” for each following 5 year term at the then current 5-year Government of Canada (“GOC”) bond interest rate plus a predetermined fixed premium.⁽³⁾ Similarly, US Preferred Securities are now 62% “fixed-to-floating” dividends, whereby a fixed dividend rate is paid for an initial period, followed by the dividend being reset, typically each quarter at LIBOR or another reference interest rate, plus a predetermined fixed premium for the remainder of the Preferred’s life.⁽⁴⁾

The Canadian Preferred Fixed-Rate-Reset Dividend Model is Challenged

The Canadian Preferred Share Index has experienced two drawdowns (i.e. declines) in excess of 10% in recent years (2015 & 2018), and volatility is relatively high. 5-year annualized volatility for the US Preferred market is 4.3%, less than half the 10.0% 5-year average volatility of the Canadian market.⁽¹⁾ In our view, current market conditions for Canadian Preferreds are an unintended consequence of the fixed-rate reset approach. Falling GOC 5-yr interest rates in 2014 and again in 2018 caused investors to expect that upcoming dividend resets would result in an unacceptably low dividend rate for the next 5 year term, which disappointed and triggered a sell-off of fixed-rate-reset preferred shares. Canadian preferred share prices now seem to be moving up and down in lockstep with movements in the volatile 5-yr GOC rate.

⁽¹⁾ Source: Morningstar Direct, as at March 31, 2019. US preferreds are represented by the ICE BofAML 8% Constrained Core West Preferred & Jr Subordinated Securities Index. Canadian Preferreds are represented by the S&P/TSX Preferred Share Index.

⁽²⁾ Source: ICE Bank of America Merrill Lynch, S&P Dow Jones Indices, as at March 31, 2019. US preferreds are represented by the ICE BofAML 8% Constrained Core West Preferred & Jr Subordinated Securities Index. Canadian Preferreds are represented by the S&P/TSX Preferred Share Index.

⁽³⁾ Source: BMO Capital Markets, Brompton, as at March 31, 2019.

⁽⁴⁾ Source: Bloomberg, Flaherty & Crumrine, as at March 31, 2019.

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