

Investment advisors know that taxes can have a major impact on investment returns and look for ways to reduce taxes for clients. We find more and more retail clients are also making better use of the tools available to Canadian investors to minimize taxes, including earning investment income in a tax-efficient manner by allocating investments with income taxed at higher rates (e.g. bonds) to registered accounts, and income taxed at lower rates (e.g. eligible dividends, capital gains or ROC) in non-registered or taxable accounts.

When we talk about the Brompton Flaherty & Crumrine Investment Grade Preferred ETF (TSX:BPRF), clients and advisors often ask if the fund pays eligible Canadian dividends. Only Canadian corporations can pay eligible Canadian dividends, and since this ETF invests in U.S. preferred shares, it does not. Sometimes the investor response is: “why would I want to own a preferred fund if it doesn’t pay eligible dividends?” The answer is that U.S. preferred shares offer high after-tax income which is often comparable to Canadian preferreds and the U.S. preferred share market offers superior diversification benefits.

Investors often use the search for “eligible dividends” as a proxy for finding the highest after-tax income and, at least in the case of U.S. preferreds, they are not getting it exactly right. If U.S. preferred shares offered the same current yield as Canadian preferred shares, screening for eligible dividends would be the right approach. However, U.S. preferreds often pay higher current yields, and in many cases offer other tax credits that often improve the tax efficiency of the income received. Currently, this means that **the after-tax income from U.S. preferreds is comparable to the after-tax income from Canadian preferreds.**

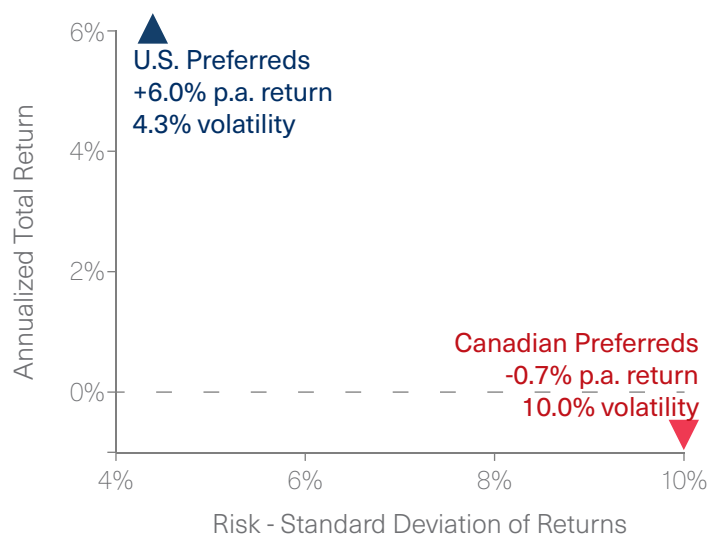
After-tax equivalency – U.S. vs Canada Preferred Shares Indices

	U.S. Preferreds	Cdn Preferreds
<b>Index Current Yield (net of Withholding Taxes)<sup>1,2</sup></b>	<b>5.3%</b>	<b>5.1%</b>
Tax Character of Current Yield	Foreign Source Income	Eligible Dividends
Canadian Income Taxes Due (on Foreign Source Income/Grossed-Up Eligible Dividend) <sup>2</sup>	3.1%	3.8%
Income Tax Credits Available (Withholding Tax Credit/Dividend Tax Credit) <sup>2</sup>	0.5%	1.8%
Income Taxes Due Net of Tax Credits	2.6%	2.0%
<b>After-Tax Current Yield</b>	<b>2.7%</b>	<b>3.1%</b>

Due to the sharp decline in Canadian preferred share prices in late 2018, continuing into 2019, the Canadian Preferred Share Index currently has a slight after-tax yield advantage compared to U.S. Preferreds. However, when total returns for the Canadian Preferred Share Index are considered that advantage disappears. Tax efficiency of yield is important, but even more important is the fact that the U.S. Preferred Share Index has produced superior overall performance, with much lower volatility, than the Canadian Preferred Share Index over the past five years. In an RRSP or TFSA, the result is even better – U.S. preferreds have higher pre-tax current yields, making them a more attractive yield investment than Canadian Preferreds.

Brompton Flaherty & Crumrine Investment Grade Preferred ETF (TSX:BPRF) is an actively managed solution, that invests primarily in U.S. dollar denominated corporate preferred securities, with a CAD-hedged and an unhedged U.S. dollar option.

Risk and reward in the preferred market (5-yrs)<sup>3</sup>



(1) As at June 30, 2019, Indicative Current Yield (dividend rate divided by market price). U.S. Preferred Index is composed of ICE BofAML 8% Constrained Core West Preferred (62%) & Jr Subordinated Securities Index (38%) and Canadian Preferred Index is represented by S&P/TSX Preferred Share Index. Current yields are gross of all fees and assume 15% withholding tax on US dividends. (Sources: ICE BofA ML, Standard & Poor's, TSX, Bloomberg, Flaherty & Crumrine Inc.)

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(2) Based on combined Federal & Provincial (Ontario) highest marginal tax rates / tax credits and US withholding tax levels (Source: KPMG Tax Facts 2018-2019).

(3) Source: Bank of America Merrill Lynch, Thomson Reuters Datastream, as at June 30, 2019. U.S. Preferred Market is represented by an equally-weighted average of the performance of the ICE BofAML Hybrid Preferred Securities 8% Constrained Index and the ICE BofAML US Capital Securities 8% Constrained Index through June 2015 and by the BofAML 8% Constrained Core West Preferred & Jr Subordinated Securities Index from July 2015 through the present. Canadian Preferred Market is represented by S&P/TSX Preferred Share Index.

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