

One answer for Canada's treacherous preferred share market is to buy American

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The bulk of Canada's preferred-share market was built for a world that never materialized – one where interest rates returned to normal from their financial-crisis lows.

Ten years after the crisis, rates are low and trending lower. That's why the rate-reset preferred shares that make up about 70 per cent of this country's preferred-share market have performed so dismally in the past 12 months. Looking for a preferred-share investment with less drama? Consider U.S. preferred shares.

“The U.S. has a bigger and more liquid preferred-share market than we have in Canada,” said Chris Cullen, senior vice-president and head of ETFs at Brompton Group, which runs the Brompton Flaherty & Crumrine Investment Grade Preferred Share ETF (BPRF-TSX). Like the Canadian preferred-share market, U.S. preferreds have many nuances to trip up retail investors. But Mr. Cullen said the typical U.S. preferred-share issue works along these lines: a fixed dividend for seven to 10 years and then an adjustable dividend that is reset quarterly using a benchmark rate, often the London interbank offered rate, or Libor.

BPRF was launched in mid-October, 2018, about the time that the Canadian preferred-share market tanked. This ETF has managed a small gain since then, while funds holding Canadian preferred shares are down 20 per cent or more.

The obvious knock on U.S. preferred shares is that investors can't use the dividend tax credit to reduce tax on their dividends. Mr. Cullen said mildly higher yields in the U.S. preferred-share market can help offset this disadvantage. However, the better performance of U.S. preferreds in the past year means BPRF has a yield of 4.8 per cent based on its recent share price and targeted annual distributions. Beaten-down Canadian preferred share ETFs have yields above 5 per cent.

U.S. preferred- and common-share dividends received in a taxable account would be subject to a 15-per-cent withholding tax, but Mr. Cullen said Canadian investors can claim a credit for this amount when filing their income taxes. He added that some U.S. preferred shares pay income that is considered interest and thus is not subject to withholding tax.

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