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Canadian Preferred Shares - Liquidity and Tax Loss Selling

It's been a rough year for investors in Canadian preferred shares. The S&P/TSX Preferred Share Index has declined by 13.5% on a total return basis for the year ending August 30, 2019. Investors sold off their fixed-rate-reset preferred shares as the coupon-reset reference rate (the Government of Canada 5-year rate) dropped from 2.17% to 1.19% over the period. If factors such as the global trade war contribute to a weakening economy in the future, or if the Bank of Canada announces an interest rate cut, there may be further downward pressure on the 5-yr GOC rate. This could result in more volatility for Canadian fixed-reset preferred shares, which have been trading directionally in-line with the level of the 5-yr GOC yield. Although it isn't out of the realm of possibility, we currently don't see a clear path for beaten-down Canadian rate-reset preferred shares to trade back to par value in the near term.

Several other categories of equity and fixed income investments have had positive returns over the past year, possibly leading to profit-taking and realized capital gains for investors in 2019, which leads us to think about tax-loss selling. We believe that Canadian preferred shares may be a focus as 2019 draws to a close. This raises the question: **could tax-loss selling in 2019 contribute to a further leg down for Canadian preferred shares, due to illiquidity?**

First, we wanted to understand the possible magnitude of losses for investors. We collected daily trading data on 224 constituents[1] within the S&P/TSX Preferred Share Index for 1 year ending August 30, 2019. We looked at price return (excluding dividends) as a proxy for potential capital losses. The simple average 1-yr price return for the group was (-19.2%). 128 Canadian preferred shares, with aggregate market cap of $23.9 bn (43% of the index total), underperformed; this group averaged (-29.9%) price return, ranging from (-19.3%) to (-40.2%), over the period. This confirms in our view that there are a number of opportunities for tax-loss-selling in the Canadian preferred share space.

We next wanted to assess the level of trading liquidity. We define liquidity as a measure of the impact that incremental trading volumes have on the market price of a security; more liquid securities can absorb incremental trade volume without significant impact on market prices. Industry participants that we spoke to generally agreed that liquidity is lacking in the Canadian preferred share market, but we weren't able to find recent data that quantified this. So to answer the question we extended our analysis. For context, we included constituents of the S&P U.S. Preferred stock Index, the S&P/TSX Composite Index, and the S&P 500 Index[1].

As at August 30, 2019	S&P/TSX Preferred Share Index	S&P US Preferred Stock Index	S&P/TSX Composite Index	S&P 500 Index
# constituents with full data set available:	224	216	239	489
% of total index constituents analyzed:	95%	74%	97%	97%
Average Market Cap C$mm	$221	$664	$10,553	$67,672
Average Traded Value C$mm (1-yr)	$49	$410	$6,356	$107,659
Traded Value/Mkt Cap, % (1-yr)	22%	62%	60%	159%
Relative liquidity vs. average S&P/TSX Pref Share Index constituent[1]	**1x**	**11x**	**75x**	**1608x**

The approach we took was to examine 5-day trailing trading data for each security, every day over the 1-yr period ending August 30, 2019. We calculated the average ratio of market price fluctuations (% difference between 5-day high and low price), to trading turnover (5-day trading value as % market capitalization) over the period. We took the average liquidity metric[2] for index constituents with available data and adjusted to account for differences in market cap for each index. This approach gives us a way to compare the market price impact (relative to the Canadian preferred shares analyzed) observed in the past year, for the same dollar amount traded in the average index constituent, across Canadian and U.S. preferred and common shares.

We found that the **US preferred shares included in this study exhibited 11 times greater liquidity than the Canadian preferred share group** over the 1-yr period. This means that for a same-dollar-sized trade, the market price for the average US preferred share in our data set was impacted to only 1/11th of the extent observed for the average Canadian preferred share. This interpretation also applies to Canadian and US common equities, which as expected displayed a much greater ability to absorb incremental trading with minimal price impact relative to the Canadian preferred shares included in this study.

95 of the 224 Canadian preferred shares studied both underperformed the average price return for the group, and exhibited lower liquidity than average for the group (representing $14.4 bn aggregate market cap or 25.7% of the index market cap). This group represents a particular risk due to tax loss selling, with (-42.6%) lower liquidity on average than the overall group of Canadian preferreds studied.

Our conclusion is that the potential for further price declines in Canadian preferred shares due to tax-loss selling through to 2019 year-end is a real risk. Canadian preferred shares in our study that displayed both material negative price performance in the past year (making them tax-loss-selling candidates) and lower-than-average liquidity over the 1-yr period, make up a significant amount of overall market capitalization.

We believe that investors who sell preferred shares in order to crystalize tax losses may be impacted. Unfortunately we also believe that investors who continue to hold Canadian preferred shares either directly or through ETFs or mutual funds, should prepare themselves for the risk of a potential liquidity crunch and the continued volatility that tax-loss-selling season may represent for client portfolios. **Given the relative illiquidity in the Canadian preferred market, it may make sense for clients to carefully begin to liquidate tax-loss-selling candidates, especially the more illiquid names, well ahead of traditional tax loss selling season**.

For clients who could benefit from diversification within the preferred share asset class to protect against some of the unique risks that are apparent in the Canadian market, consider TSX:BPRF, Brompton Flaherty & Crumrine Investment Grade Preferred ETF, as a low correlation addition to Canadian preferred share portfolios.

If you'd like to see our list of 224 S&P/TSX Preferred Share Index constituents ranked by price return and relative liquidity, please contact your Brompton ETFs sales representative.

Best Regards,

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Data Sources: Thomson Reuters EIKON, Datastream, S&P Dow Jones Indices.

(1) Only those index constituents with full data set availability on Datastream over the period analyzed (1-yr to August 30, 2019) were included in this study.

(2) The metric we calculated as a proxy for liquidity is known as the Hui-Heubel Liquidy Ratio ("Lhh"). As a higher Lhh ratio indicates less liquidity, we found it more intuitive to use the inverse of this ratio to compare relative liquidity. See equation 2.3 of the paper "Measuring Liquidity in Financial Markets" (T. Lybek, A. Sarr, December 2002) for an in-depth discussion of this method, among other approaches to quantifying various aspects of liquidity. https://bit.ly/2km8tlw

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