

Fund in focus: Brompton Flaherty & Crumrine Investment Grade Preferred ETF (TSX: BPRF; BPRF.U)

LRCN refresher: It's been almost a year since Limited Recourse Capital Notes, or LRCNs, were approved by Canadian regulators in July 2020. As a reminder, LRCNs are debt instruments that provide issuers with equity benefits. Banks and Lifecos can deduct interest paid to LRCN holders for tax purposes, like a bond (Preferred dividends are not deductible). However, much like Preferred equity, the Office of the Superintendent of Financial Institutions ("OSFI") has agreed to give a limited degree of Tier-1 Capital credit to LRCNs issued by Banks and Lifecos. Canadian Preferreds are primarily owned by retail investors, while participation in LRCN issuance is restricted to institutional investors.

Banks and Lifecos have been actively issuing LRCNs since the announcement, with over \$9.2B of LRCN capital raised from July 2020 through June 2021.

LRCN Issuance Following OSFI Approval

Issuer	Issuance Date	Maturity	DBRS Rating	Coupon	Amount (\$M)
RBC	Jul-20	Nov-80	A (low)	4.500%	1,750
BMO	Sep-20	Nov-80	BBB (high)	4.300%	1,250
National	Sep-20	Nov-80	BBB	4.300%	500
CIBC	Sep-20	Oct-80	BBB (high)	4.375%	750
CWB	Oct-20	Apr-81	BB (high)	6.000%	175
RBC	Nov-20	Feb-81	A (low)	4.000%	1,250
Empire	Feb-21	Apr-81	BBB (high)	3.625%	200
Manulife	Feb-21	Jun-81	A (low)	3.375%	2,000
Laurentian	May-21	Jun-81	BB (high)	5.300%	125
Scotiabank	Jun-21	Jul-81	BBB (high)	3.700%	1,250
Total					9,250

Source: DBRS, to June 2021

LRCNs sparked a Preferred relief rally, but is it over? At the time of the original announcement in July 2020, speculation was that the proceeds of issuance of low-cost LRCNs would be used to redeem more expensive categories of Preferred shares, especially high-reset-spread Rate-Resets and high-dividend Perpetuals. With the S&P/TSX Preferred Share Index having touched on an all-time low only a few months earlier in March 2020, LRCNs were the best news that Preferred investors had heard in a while.

The Canadian Preferred market rallied in the months that followed and has now made significant progress towards recovery to par value. Rate-Reset Preferreds traded at an average 67% of par value in June 2020, rallying to 92% of par value by May 2021. Overall, Canadian Preferred market prices recovered from 76% (June 2020) to 92% (May 2021) of par value in the same period.

Price recovery has provided some much-needed relief. Canadian Preferred investors have had a good run in the past year, and it's reasonable to ask whether the market is now close to being fully valued. Beyond valuation, Canadian Preferred investors need to consider how LRCN issuance and related Preferred redemptions have negatively impacted the overall quality of the Canadian Preferred market. Below, we compare some of the features of Preferreds redeemed by LRCN issuers with those remaining outstanding in the market.

The Canadian Preferred market is shrinking: LRCN issuers redeemed 17 series of Preferreds with total par value of \$5.6B from July 2020 through to June 2021, the lion's share of the \$7.5B par value of total Preferred net redemptions (redemptions minus new issues) in the period. Net total redemptions (LRCN-related and other) over this time period represent 9.9% of the value of Preferreds remaining as of May 30, 2021. A significant amount of value was removed from an already-small Preferred market by way of redemptions.

Canadian Preferred Redemptions <i>(\$M Par Value, July 2020 - Jun 2021)</i>	Rate-Reset	Perpetual	Floating & Other	Total
LRCN Issuers - Preferreds Redeemed	3,204	2,250	130	5,584
Other Issuers - Preferreds Redeemed (Net of New Issues)	2,049	137	-226	1,959
Total Redemptions, Net	5,253	2,387	-97	7,543
Remaining Canadian Preferred Market	58,598	13,347	4,356	76,301
<i>Redemptions as % Remaining Preferreds</i>	<i>9.0%</i>	<i>17.9%</i>	<i>-2.2%</i>	<i>9.9%</i>

Source: BMO Capital Markets

Fewer choices for liquidity: LRCN issuers redeemed Preferred series that were 44%-51% larger than the Preferred series remaining in the market. Larger total size is often correlated with higher trading liquidity; Preferred investors looking for large, liquid issues have less choice as a result of LRCN issuer Preferred redemptions.

Average Total Par Value of Preferred Series <i>(\$M Par Value, July 2020 - Jun 2021)</i>	Rate-Reset	Perpetual	Floating & Other	Total
Redeemed by LRCN Issuers	400	281	130	328
Remaining Canadian Preferred Market	265	191	90	224
<i>Preferred Series Redeemed by LRCN Issuers, % Remaining</i>	<i>151%</i>	<i>148%</i>	<i>144%</i>	<i>146%</i>

Source: BMO Capital Markets

Redeemed Preferreds were high-quality credits: Preferreds redeemed by LRCN issuers had an average credit rating at or above the category average. Overall the rating of LRCN issuer redeemed Preferreds was Pfd-2(H), a ratings “notch” higher than the average Pfd-2 rating for outstanding Preferreds in May 2021. LRCN issuers are generally high-quality companies, and Preferred redemptions by these issuers negatively impacted availability of high-quality credits in the Canadian Preferred market.

Preferred Average Credit Ratings <i>(Par-Weighted)</i>	Rate-Reset	Perpetual	Floating & Other	Total
Redeemed by LRCN issuers	Pfd-2	Pfd-2(H)	Pfd-2(H)	Pfd-2(H)
Remaining Canadian Preferred Market	Pfd-2(L)	Pfd-2(H)	Pfd-2(L)	Pfd-2

Source: BMO Capital Markets; last Preferred issue rating prior to redemption, or issue rating as at May 31, 2021.

Attractive Rate-Reset spreads and competitive coupon rates removed from the market: Rate-Reset Preferreds redeemed by LRCN issuers offered an average reset spread of 446 bps, 47% higher than the 304 bps average reset spread for Rate-Reset Preferreds that remained outstanding in May 2021. Rate-resets were the most significant category of LRCN-issuer Preferred redemptions, with over \$3.2bn redeemed, so this was a meaningful development. The next biggest category was Perpetuals. Although the par-value coupon rate for LRCN issuer-redeemed Perpetuals was 0.2% lower than average for the category, this is still very competitive and the amount redeemed by LRCN issuers was large at \$2.3B par value, leaving investors with less choice among higher-yielding fixed-rate Preferreds. Only one Floating series of Preferreds was redeemed, a Scotiabank issue with a yield on par value of 1.5% (0.7% p.a lower than the category average), but since the redeemed amount was small compared to Rate-Reset or Perpetual LRCN issuer redemptions, it had little impact.

Yield (% Par Value) or Rate-Reset Spread (bps) <i>(May 31 2021)</i>	Rate-Reset	Perpetual	Floating & Other
LRCN Issuers - Redeemed Preferreds	446 bps	4.9%	1.5%
Remaining Canadian Preferred Market	304 bps	5.1%	2.2%

Source: BMO Capital Markets.

Time to consider options: LRCNs have been a boon to Banks and Lifeco issuers in terms of access to cheaper capital, diversification of investor base (away from retail investors/Preferreds, towards institutions/LRCNs), and has supported a relief rally in Canadian Preferred shares. Now the Canadian Preferred market has returned to within striking-distance of par-value trading. LRCN issuance has led to redemptions of Preferreds with better than average terms, and this represents a meaningful loss for the Canadian Preferred market and for retail investors. The result is a smaller Preferred market offering fewer choices to investors searching for liquidity, high credit quality, and high yields. We believe that Canadian Preferred investors should consider looking for opportunities to reduce exposure to Canadian Preferreds and seeking other options.

We suggest US Preferreds as an attractive alternative for Canadian Preferred investors. US Preferreds are liquid, have high credit quality on average, have modest duration and offer yields that are higher than Canadian Preferreds and more than double the yields on US Investment Grade bonds. [Brompton Flaherty & Crumrine Investment Grade Preferred ETF \(TSX - BPRF, BPRF.U\)](#) offers a way to invest in the US Preferred share market with the benefit of active management by the longest-tenured US preferred share specialist, Flaherty & Crumrine Incorporated.

This document is for information purposes only and does not constitute an offer to sell or a solicitation to buy the securities referred to herein. The opinions contained in this report are solely those of Brompton Funds Limited ("BFL") and are subject to change without notice. BFL makes every effort to ensure that the information has been derived from sources believed to be reliable and accurate. However, BFL assumes no responsibility for any losses or damages, whether direct or indirect which arise from the use of this information. BFL is under no obligation to update the information contained herein. The information should not be regarded as a substitute for the exercise of your own judgment. Please read the prospectus before investing.

Commissions, trailing commissions, management fees and expenses all may be associated with exchange-traded fund investments. Please read the prospectus before investing. The indicated rates of return are the historical annual compounded total returns including changes in unit value and reinvestment of all distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any securityholder that would have reduced returns. Exchange-traded funds are not guaranteed, their values change frequently and past performance may not be repeated.

Certain statements contained in this document constitute forward-looking information within the meaning of Canadian securities laws. Forward-looking information may relate to matters disclosed in this document and to other matters identified in public filings relating to the ETF, to the future outlook of the ETF and anticipated events or results and may include statements regarding the future financial performance of the ETF. In some cases, forward-looking information can be identified by terms such as "may", "will", "should", "expect", "plan", "anticipate", "believe", "intend", "estimate", "predict", "potential", "continue" or other similar expressions concerning matters that are not historical facts. Actual results may vary from such forward-looking information. Investors should not place undue reliance on forward-looking statements. These forward-looking statements are made as of the date hereof and we assume no obligation to update or revise them to reflect new events or circumstances.



VALUE
INTEGRITY
PERFORMANCE
THE FOUNDATION FOR EXCELLENCE

Investor Relations

PHONE 416.642.6000
TOLL FREE 1.866.642.6001
FAX 416.642.6001
EMAIL info@bromptongroup.com

Website

www.bromptongroup.com

Address

Bay Wellington Tower,
Brookfield Place
181 Bay Street
Suite 2930, Box 793
Toronto, Ontario M5J 2T3