BROMPTON FUNDS

Brompton Insights

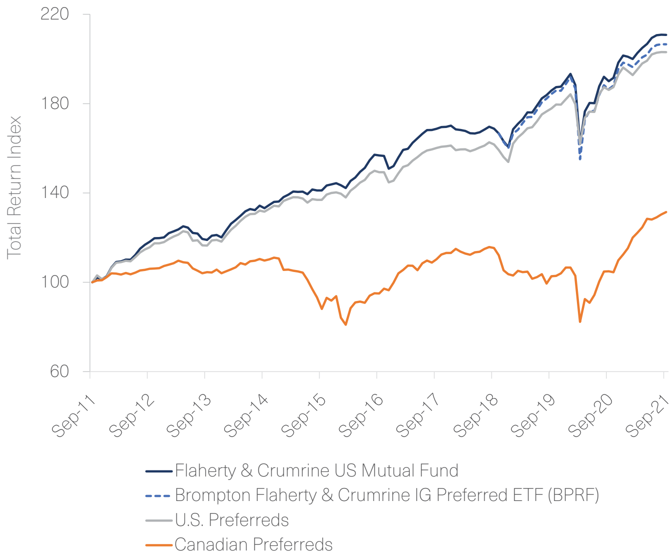
October 2021

US Preferreds Are Well Positioned After the LRCN Rally

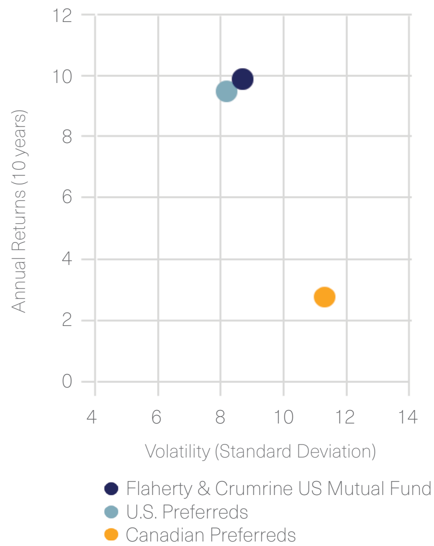
Fund in focus: Brompton Flaherty & Crumrine Investment Grade Preferred ETF (BPRF, BPRF.U)

Canadian Preferreds[1] rallied after the July 15, 2020 capital ruling by the Office of the Superintendent of Financial Institutions approving Limited Recourse Capital Notes ("LRCNs") as acceptable Alternative Tier 1 Capital for Canadian banks. Meanwhile, US Preferreds[2] staged a solid recovery of their own. After recent moves, how do the two markets compare today? Below we compare market metrics for Canadian and US Preferreds, along with Brompton's actively managed US Preferred ETF, BPRF.

US Preferreds: Long-Term Outperformance



Superior 10-yr Risk-Adjusted Returns



Source: Morningstar (September 30, 2021)

Performance: Canadian Preferreds posted a solid recovery following the LRCN announcement with an impressive 1-year total return (to Sept. 30/21) of 25.3%. This provided some relief for Canadian preferred investors who endured dismal total returns of 0.5% per annum for the 9 years prior to Sept. 30/20. 10-year total returns to Sept. 30/21 averaged out to 2.8% per annum.

In comparison, US Preferreds generated an attractive 1-year return of 9.1%, more consistent with the average 10-year return of 7.3% per annum. BPRF's subadvisor Flaherty & Crumrine outperformed US Preferreds over these same periods, with BPRF posting an attractive 1-year performance of 10.8%. As an indication of long-term manager performance, Flaherty & Crumrine's US-domiciled mutual fund[3] (similar to BPRF in investment objective and MER) returned 10.9% over the year ending Sept 30/21, and offered a 10-year total return performance of 7.7% per annum.

Despite the recent rebound for Canadian Preferreds, US Preferreds have provided stronger long-term performance to investors, with Flaherty & Crumrine's active management adding value over and above the US Preferred market returns. Additionally, both Flaherty & Crumrine's preferred mandates and the US Preferred market provided investors with more stability, resulting in strongly improved risk-adjusted returns compared to Canadian Preferreds.

Key Statistics: Canadian & US Preferreds

	Canada	US	BPRF
Current Yield	4.6%	5.0%	4.8%
Weighted Average Reset Spread	297	371	409
Yield to Worst	1.2%	2.7%	3.2%
Investment Grade Securities	78%	85%	75%

Sources: Bloomberg, Flaherty & Crumrine (September 30, 2021)

Current yield represents the annualized cash distributions available to investors and is expressed as a percent of market price. Current yields have compressed significantly for both Canadian Preferreds and US Preferreds due to recent higher trading prices. Canadian Preferreds now offer a 4.6% current yield to investors, lower than US Preferreds' 5.0% and BPRF is slightly higher at 4.8%. For preferred shares with adjustable-rate coupons (rate-reset, fixed-floating or floating coupons), the "reset spread" gives an indicator of future yields. Adjustable rate Canadian Preferreds have an average reset spread of 297 bps, compared to the robust levels seen in the US, with 371 bps average reset spreads for adjustable-rate US Preferreds and 409 bps for adjustable-rate preferreds in BPRF's portfolio.

Yield to Worst ("YTW") assumes that preferred share issuers will act in their own financial best interest by taking the lowest-cost funding route. This could mean calling a preferred share for redemption and refinancing in the case where the issue is trading above call price (ie. at a premium to par). This route may result in a capital loss for investors who have preferred shares called away for less than market price. Alternatively, it may be less costly for issuers to leave preferred shares outstanding and pay the current yield. It's not uncommon for certain preferred shares with a high current yield to have a low or negative YTW, and there is no guarantee a low or negative YTW for a preferred issue will be realized. While there is some YTW dispersion across portfolios and markets, this metric is a better measure of preferred share portfolio value than simply looking at current yield. Canadian Preferreds offer on average a rather low effective YTW of 1.2%, while broad US Preferreds offer a more robust 2.7%. Through active portfolio management, BPRF's portfolio has the added benefit of a high YTW of 3.2%.

Liquidity refers to how easily a given preferred share can be traded in volume, without the trade driving the market price higher or lower. We carried out an extensive study on Canadian and US preferred market liquidity in a past Brompton Insights note, suggesting that US Preferreds may be over 10 times more liquid than Canadian Preferreds. Since the time of that publication on September 10, 2019, Canadian preferred share issuance has been minimal and redemption activity has been high due to LRCN refinancing, resulting in a shrinking Canadian preferred market with lower liquidity. In contrast, new issuance in the U.S. has been robust, supporting even higher relative liquidity for US Preferreds. Since the introduction of LRCNs, the US has seen an issuance of C$162.5B versus a meagre C$1.5B in Canada.

Credit quality is strong in Canada and the US. Canadian Preferreds are 78% Investment Grade, while the US market has a larger portion of high-quality preferred shares to select from at 85% Investment Grade. BPRF maintains a portfolio minimum of 75% Investment Grade securities.

Brompton's Approach

Following the recent price recovery in Canadian Preferreds, a re-examination of Canadian preferred share holdings is in order, with an eye to re-allocating some income investments to the US market. US Preferreds are liquid, have high credit quality on average, 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.

	Annual Compound Returns[4]			
	1-YR	3-YR	5-YR	10-YR
Brompton Flaherty & Crumrine Investment Grade Preferred ETF	9.0%	7.4%	-	-
Brompton Flaherty & Crumrine Investment Grade Preferred ETF (USD)	9.7%	-	-	-
Flaherty & Crumrine US Mutual Fund	9.4%	8.1%	6.1%	7.7%
U.S. Preferred Securities	9.1%	7.9%	6.3%	7.3%
iShares S&P/TSX Canadian Preferred Share Index ETF	24.4%	4.9%	6.6%	2.8%

[1] "Canadian Preferreds" is represented by the S&P/TSX Preferred Share Index. Select statistics derived from index tracker iShares S&P/TSX Canadian Preferred Share Index ETF.

[2] "US Preferreds" is represented by an equally weighted average of the performance of the ICE BofA Hybrid Preferred Securities 8% Constrained Index and the ICE BofA US Capital Securities 8% Constrained Index through June 2015 and by the BofA 8% Constrained Core West Preferred & Jr Subordinated Securities Index from July 2015 through the present. Select statistics provided by Flaherty & Crumrine/Bloomberg.

[3] "Flaherty & Crumrine's US-domiciled mutual fund" is represented by Destra Flaherty & Crumrine Preferred and Income Fund, Series I (DPIIX), a US-domiciled mutual fund (available only to US investors), with substantially similar investment objective and fees compared to BPRF.

[4] Morningstar as of October 18, 2021. BPRF Inception date October 15, 2018. BPRF.U Inception date August 8, 2019. © 2021 Morningstar. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results.

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