

Preferred Securities Have Both Equity and Debt Features

Canadian and US Preferred Securities are “hybrid” securities, meaning they offer a combination of debt and equity features. Like equity, they are subordinate to bonds and other senior obligations, and they typically have no maturity date or are very long-dated. Like debt, Preferreds have a fixed principal value, and offer a coupon payment (a dividend or interest income) as the source of investor returns. US Preferred Securities are particularly notable as they are among the highest yielding of any US investment grade fixed income asset class.

Why Consider US Preferred Securities?

The case for US Preferreds is compelling. Not only can US Preferred Securities add meaningful diversification to a Canadian Preferred Share portfolio (long-term correlation approximately 0.45), they are also higher yielding than their Canadian counterparts (currently dividends of 5.0% for US Preferreds and 4.5% for Canadian Preferreds).⁽¹⁾⁽²⁾ Additionally, US Preferreds offer lower volatility and better trading liquidity.

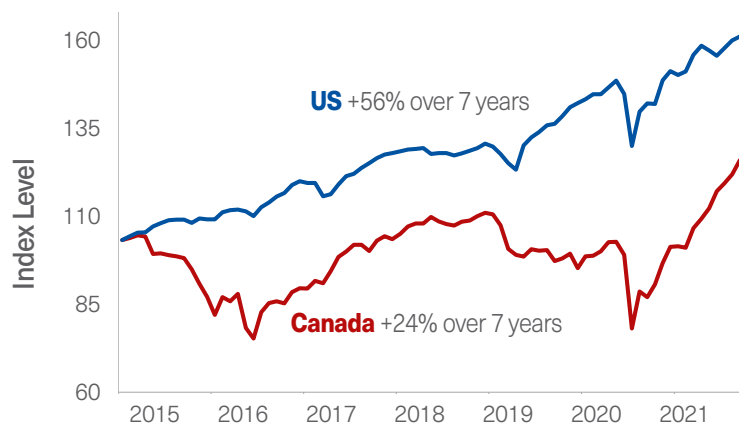
Comparison: Canada vs U.S. - Preferred Securities Market

	Canada	US
Index Market Capitalization	C\$69bn / US\$55bn ⁽³⁾	US\$602bn ⁽⁴⁾
# Preferred Share Issues	325 ⁽³⁾	1,223 ⁽⁴⁾
Avg. Issue Market Value	US\$168m ⁽³⁾	US\$492m ⁽⁴⁾
Yield	4.5% ⁽²⁾	5.0% ⁽²⁾
After-tax Yield	Competitive at highest marginal rate	
10 Year Annualized Volatility	11.4% ⁽²⁾	6.0% ⁽²⁾
Main Coupon Type	Fixed Rate Reset	Fixed-Floating
Correlation	Low - Approximately 0.45 (15Y) ⁽¹⁾	

Liquidity & Selection Varies Among Markets

The US Preferred Securities market is a large, liquid market approximately US\$602bn in size, making it approximately ten times larger than the US\$55bn/C\$69bn Canadian Preferred Share market.⁽³⁾⁽⁴⁾ There are over 1,200 securities and approximately 450 issuers in the US, whereas Canada has 325 securities and only 58 issuers.⁽³⁾⁽⁴⁾ In Canada, Preferred Shares are listed for trading on a stock exchange (making them available to the “Retail” market) and generally have a \$25 par value. The US has a similar “Retail” Preferred Securities market (exchange-listed, \$25 par value) which represents 30% of the total US Preferred market.⁽⁴⁾ The remaining 70% is the “Institutional” market. Institutional Preferred Shares trade “over-the-counter” (not listed on an exchange) like bonds, in larger denominations (generally \$1,000 par value), and may have more attractive yield or other features when compared to Retail Preferred Securities.⁽⁴⁾

U.S. & Canadian Preferred Indices - 7-Year History²



Preferred Securities are Mainly Issued by High-Quality Companies

Preferred Shares are issued by companies to increase equity capitalization and improve balance sheets. The main reasons companies issue Preferred Securities are: i) to meet regulatory requirements for strong equity capitalization (banks & insurers), or ii) to target a favorable credit rating so that the company can access low borrowing costs (utilities, telecoms, pipelines, real estate). The average credit rating for Preferred Shares issued in Canada and in the US is Pfd-2 (low), an investment grade rating.⁽³⁾⁽⁴⁾

Fixed Coupons Were Standard in the Past; Adjustable Coupons are Dominant Today

Prior to 2008, most US and Canadian Preferreds were issued with a “perpetual fixed-rate” coupon: a set dividend rate for the life of the investment. Today, adjustable rate dividends - which may benefit investors during rising rate periods - are predominant. The Canadian Preferred Share market is currently 76% weighted to “fixed-rate-reset” dividends, which means coupon rates are fixed for a 5 year term, and then are “reset” for each following 5 year term at the then-current 5-year Government of Canada (“GOC”) bond interest rate plus a predetermined fixed premium.⁽³⁾ Similarly, US Preferred Securities are now 68% “fixed-to-floating” dividends, whereby a fixed dividend rate is paid for an initial period, followed by the dividend being reset, typically each quarter at LIBOR or another reference interest rate, plus a predetermined fixed premium for the remainder of the Preferred’s life.⁽⁴⁾ An additional 7% by market weight offers floating-rate coupons, for a total of 75% adjustable dividend issues in the US Preferred market.

The Canadian Preferred Market Has Been Challenged

The Canadian Preferred Share Index has experienced high volatility and declines of more than 10% on 3 occasions in the last decade. In our view this is due to low liquidity: Canadian Preferred investors are almost entirely Retail investors, with deep-pocketed Institutional investors nowhere in sight. Over the past decade, Retail investors became frustrated with perceived low levels of dividends at the reset date, many became frustrated and sold their Preferreds, causing high market volatility. The advent of LRCNs, a new financing vehicle widely expected to replace many Preferred Share issues, is good for issuers but comes at a cost for Preferred investors. LRCN financing proceeds are being used to redeem and retire higher-yielding issues, leaving behind more volatile, lower yielding Preferreds, and causing overall Canadian Preferred market capitalization to shrink and become even less liquid.

US Preferred Securities Have Been More Resilient

US Preferred prices have experienced approximately half the level of volatility as have Canadian Preferreds. The greater breadth of US market participants – Domestic & International, Retail and Institutional – compared to the Canadian Preferred market, has resulted in greater liquidity and a better overall experience for investors. Given the stability and low correlation with Canadian Preferreds, we recommend that Canadian preferred investors diversify with US Preferreds.

⁽¹⁾Source: Morningstar Direct, as at 2021-09-30, US preferreds are represented by the ICE BofAML 8% Constrained Core West Preferred & Jr Subordinated Securities Index. Canadian Preferreds are represented by the S&P/TSX Preferred Share Index.⁽²⁾Source: ICE Bank of America Merrill Lynch, S&P Dow Jones Indices, as at 2021-09-30, US Preferreds are represented by the ICE BofAML 8% Constrained Core West Preferred & Jr Subordinated Securities Index. Canadian Preferreds are represented by the S&P/TSX Preferred Share Index. ⁽³⁾Source: BMO Capital Markets, Brompton, as at 2021-09-30. ⁽⁴⁾Source: Bloomberg, Flaherty & Crumrine, as at 2021-09-30.

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