

A Preferred Share Primer

Foyston, Gordon and Payne (FGP) has invested its clients' assets in preferred shares for decades. Late last year, FGP launched the FGP Preferred Share Pooled Fund.

We thought it would be a good idea to answer some questions you may have about preferred shares.

What is a preferred share?

A preferred share is a security that represents ownership in a company. Like common equities, preferred shares normally have no set maturity dates. Overall, however, preferred shares have more in common with fixed income investments than with common equities.

Preferred shares ...

- have a par value.
- normally do not have voting rights in company matters.
- pay dividends according to terms outlined at issuance.
- are callable at various points in time.
- have a superior ranking to common shares in a company's capital structure.

Why Invest In Preferred Shares?

Diversification – Traditionally, preferred shares have had a low correlation with both equities and bonds. This can dramatically reduce overall portfolio volatility.

Correlation of returns of the S&P/TSX Preferred Share Index*	
vs. the S&P/TSX Composite Index	vs. the FTSE TMX Universe Bond Index
0.29	-0.10

* Five years to September 30, 2017
Source: Bloomberg, FGP

Dividends – Preferred shares pay dividends based on predetermined terms. Dividends are great for income-oriented investors, and the yield on preferred shares is generally much higher than on comparable bonds.

Tax-Efficiency – Preferred share dividends from Canadian corporations currently receive much more favourable tax treatment compared with interest income from bonds.

Volatility – Despite recent history, preferred shares have traditionally exhibited low volatility relative to equities.

Security – Preferred shares have a more senior ranking than common shares in a firm's capital structure, thus providing a more beneficial claim on assets.

higher
↑
↓
lower

General Hierarchy of Claims
Secured debt*
Senior unsecured debt
Subordinate unsecured debt
Preferred Shares
Common Shares

*Secured debt has a claim on specific assets but does not necessarily have a general claim (senior or subordinate) on all company assets.

What are the different types of preferred shares?

Fixed Rate Perpetuals

- Fixed dividends are set when the securities are initially issued.
- Dividends are constant as long as the security remains outstanding.
- The issuer can call the securities at or above par at various points in time.
- The market price usually fluctuates the same way as a long-term bond's price.

Rate Resets

- These securities have a fixed or floating dividend for a set period until the next reset date (normally every five years).
- At each reset date, the investor can choose to receive either a fixed or a floating rate dividend for the next period.
- The rate of the fixed dividend is usually determined as a set spread over the prevailing five-year Government of Canada bond yield.
- The floating dividend rate is usually determined as a set spread over the prevailing three-month Government of Canada T-Bill rate.
- Rate resets are callable at par by the issuer only at each reset date.

Floater

- The dividend rate normally resets quarterly and is either based off the prevailing prime rate or a spread over the 3-month Government of Canada T-Bill rate.
- Floaters are callable by the issuer at or above par at various points in time.

What is a “cumulative” dividend?

Most preferred share dividends are cumulative. This means that if the dividend is not paid in cash, the missed dividend accrues and is still owed to the preferred shareholder. For non-cumulative preferred shares, an unpaid dividend does not accumulate. Usually the only securities with non-cumulative dividends are those issued by regulated financial institutions such as banks and insurance companies. Non-cumulative dividends improve the preferred share's effectiveness as a capital instrument.

Are preferred shares convertible to common shares?

Certain preferred shares are convertible to common equity through one of two mechanisms. The first mechanism is through a regulatory conversion. For example, the capital securities of all Canadian banks are required to be convertible into common equity in extreme circumstances to enhance the stability of the financial system. The second mechanism is at the option of the company, which is a rare feature.

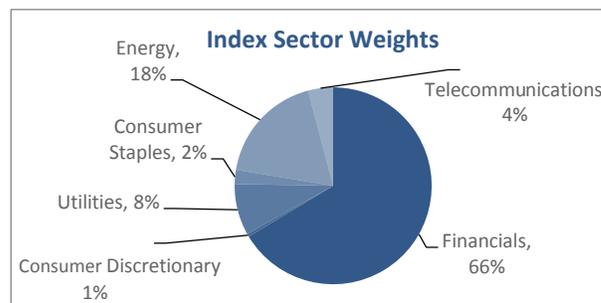
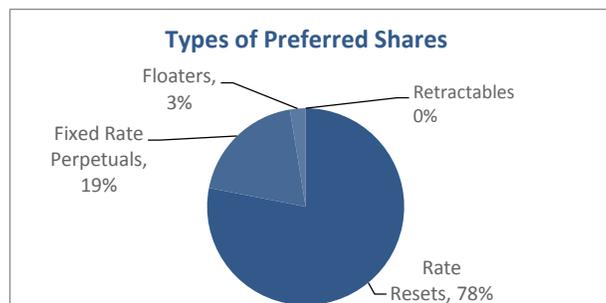
How has the Canadian preferred share market changed in the last decade?

The Canadian preferred share market has seen a dramatic shift over the last ten years. The market used to be dominated by Fixed Rate Perpetuals but is now predominantly made up of Rate Reset securities. This change has coincided with an increased use of preferred shares by Canadian banks as a form of regulatory capital. The composition of the market is now currently heavily weighted towards both Rate Resets and financial institutions.

Preferred shares have also increased in popularity among more corporate issuers as these securities provide access to equity capital without diluting common shares. Preferred shares also receive favourable debt treatment from rating agencies which improves certain credit metrics.

The increased use by both banks and other issuers has led to significant overall growth in the marketplace. Preferred shares totalled roughly \$71 billion by par value and \$55.7 billion by market value on June 30, 2016. Between 2014 and 2015, the market value of most preferred shares experienced declines mainly attributable to the persistence of extremely low interest rates. As a result, preferred shares now offer a quite favourable value proposition versus bonds and versus alternative asset classes such as mortgages and REITs.

S&P/TSX Preferred Share Index*



* As at September 30, 2017
Source: S&P/TSX

The opinions expressed in this document are those of Foyston, Gordon & Payne Inc. ("FGP") and may change at any time without notice based on market conditions or other relevant factors. FGP expressly disclaims liability for any loss suffered based on reliance on the information herein.