Preferred Shares- How About We Do A Reset

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If you have never heard of or know very little about preferred shares you may be excited to read this article. Why wouldn't you want to own something that is preferred? Why would you want to own "Common shares" when you can own "Preferred shares"? We will go through the details and you can draw your own conclusions. Then we can see what the current environment is and if there are any good opportunities available.

Preferred shares have been around since the 1800s and were initially issued by railroads. So, they do have a history which means they pass the first test, longevity. They have been around almost 200 years, so the concept has proved durable.

What they are is a hybrid of debt and equity. They generally rank above common equity stocks but below the bonds of a company. They are a fairly large asset class with over $60 billion dollars worth of preferred shares issued in Canada.

Preferred shares pay dividends which is advantageous to holders since dividends are taxed at a much lower rate than interest. For example, if you are in the top tax bracket, $100 dollars in interest results in $53 dollars in taxes, whereas $100 dollars in dividends results in $39 dollars in taxes. These dividends are usually paid quarterly. Meaning holders receive cash payments every three months.

There are many different types of preferred shares. The most common are Perpetuals, Resets, Retractable, Synthetic and Floating rate.

Perpetual Preferreds pay a fixed rate of dividend every year, hopefully forever. Usually though, there is some sort of call feature by the company if they are willing to a pay a premium to redeem the shares.

Floating rates means that the amount paid to the investor will vary according to some pre-determined interest rate benchmark. Usually it's matched to the prime rate or 3-month government T-Bill rates.

The preferred shares that are most popular in Canada, are the Reset Preferreds and this will the primary focus of the rest of this post.

Resets pay a fixed rate of income to holders for 5 years. Once the 5-year term is up the issuing company can renew them for another 5 years or call them in. If they renew them the rate paid for the next 5 years will be a predetermined rate above what a 5-year government of Canada bond is paying at that time. The lowest reset I think is about 1.28% above the bond yield and the higher ones are over 5% above the government bond. For example, today the 5-year government of Canada bond yield is 0.60%. A Reset Preferred resetting today with the predetermined reset at 2% would pay holders 2.6% yield per year for the coming 5 years. Which is a decent yield considering government bonds are 0.6% and GICs are under 1% per year as offered by most of the larger financial institutions. In addition to that, you receive the dividend tax credit so that 2.6% may be like receiving 3.8% in a taxable account.

So, relatively high yields and tax advantages, what could go wrong? Volatility is the main problem. Reset Preferreds like stable or rising interest rates. And that is not what we have had for the last decade.

This latest drop in interest rates during the pandemic caused some of these Resets to drop 70% below their issue price or par value. Not exactly what an investor wants in their fixed income portion of their portfolio. This drop in value is irrelevant if you want to just collect your annual income and are comfortable that the company you own is of good quality. However, this amount of fluctuation has caused many investors to swear off ever owning them again. Which may be an unfortunate decision since there are a couple of developments that may turn things around. Actually, they already have started.

In July of last year, the Office of the Superintendent of Financial Institutions (OSFI -an independent agency of the government of Canada), allowed Limited Recourse Notes. In a nutshell, this means that there is now a cheaper way for Canadian banks and some other financial institutions to raise Tier 1 Capital by issuing preferred shares. This means that many preferreds may get called in over the next few years. Less supply can make the still existing ones, more in demand.

Secondly, interest rates have started to creep up. Remember that 5-year government bond I mentioned above yielding 0.60%? Well, just a month or so ago it was at 0.40 percent. This may not make you run to the bank to lock in your mortgage, but these Resets like rising rates.

As I have stated before, I don't think interest rates are going to go up a lot, but they should go above 0.60% once the recovery fully kicks in.

Preferred shares may not be a hedge against a falling stock market and they do fluctuate in value, but they do have some unique features that can be used to an investor's benefit if some time and research is done.

Talk to you soon.