Canadian preferred shares are worth a closer look

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A unique feature of Canadian markets is the plethora of preferred shares that offer generous dividend yields. Preferreds are higher-ranked in safety terms than common shares, many pay a good dividend, but most have suffered enormous losses this year. The sell-off is so steep that one has to think there is something wrong. What is going on that triggered this and what is a "rate-reset" preferred share?

In a September 29th article for The Globe and Mail, John Heinzl opines that the slump in preferred shares makes values attractive, for those investors who can stomach the volatility.

Here is the one-year chart of the Horizons Active Preferred Share ETF, a fund that holds many different Canadian preferred shares. The annualized yield is 4.5%, not bad when five year Govt. of Canada (GOC) bonds yield about 0.8%. It's easy to see that 2015 hasn't been kind to preferred share investors.

Chart courtesy of Y Charts

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So what is going on? One reason for the sell-off involves the characteristics of rate-reset preferred shares. Most preferreds are issued at a par value of $25 and an initial dividend rate (coupon) fixed for 5 years from the issue date. After five years the coupon is reset to a new yield based on a spread above the benchmark yield of the GOC five year bond. Here is an example from research by James Price, Richardson GMP's Director of Capital Markets:

Pembina Pipeline Perpetual Rate Reset Preferred PPL.PR.A
Par Value $25 Initial Coupon $1.06 Initial Yield 4.25% in 2013
Current trading price as of September 30, 2015 = $15.85 to yield 6.6%
Capital loss in 2015 to end of September ~ 37%
Coupon reset December 1 2018. Spread over 5 year GOC bond interest = 2.47%

If bond yields remain at the current 0.80%, the new coupon on this preferred will be trading at such a large discount. Nobody wants to go to a coupon rate of 3.27%, even if the reset date is still three years out.

But the reset coupon is still uncertain as we don't know what will happen to interest rates. There is one way that this investment becomes a big winner. What if the rate rises on the five year GOC bond before 2018? After all, 0.80% is very low in historical terms.

The US Federal Reserve intends to move rates higher so the Fed Funds rate could go to 1.5% or even higher by the end of 2016. Once the Fed starts raising rates they usually continue for many years, based on past experience.

Can Canadian rates stay below US rates? This is unlikely. If Canadian rates stayed at current levels while the US rates rose, the Canadian dollar would lose value, dropping below 70 cents. This decline would push inflation higher which would force the Bank of Canada to act, if they wanted to maintain credibility as their mandate is to control inflation.

Most market participants don't believe in rising rates but one possible scenario goes like this: US rates rise, Canadian rates move higher and the 2018 reset coupon on preferred shares like Pembina Pipeline gets pegged at a higher rate. For example, if the GOC benchmark bond yield rises to 3%, then the new coupon would be 5.47%. For the purchaser buying today at $15.85 on the example above the yield would be a staggering 8.7%! And that's before we add the dividend tax credit which boosts the after-tax yield for many investors.

Investors should not rely on this discussion or this example to make investments. There are many different types of preferred shares with different features. Please consult an investment advisor who knows your circumstances and preferred shares before investing your money.