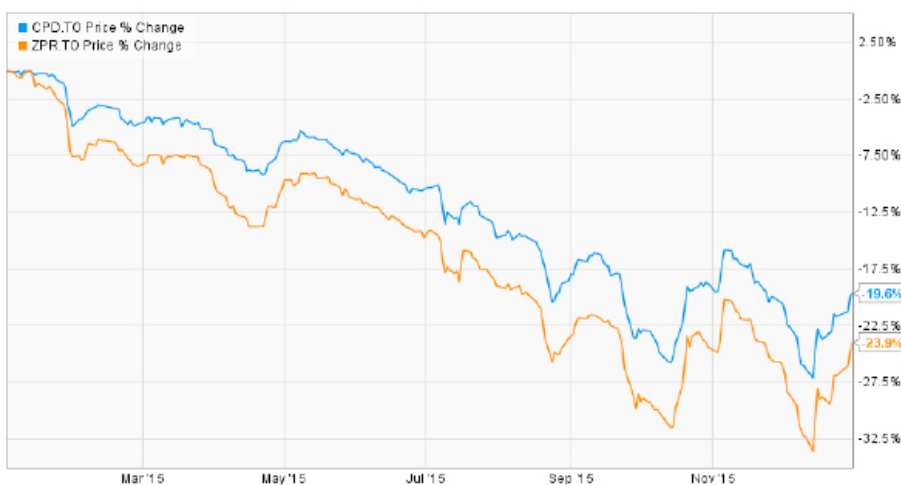


Puzzled Over Preferred Shares?

It goes without saying that 2015 was a rough year for the Canadian preferred share market. The broader preferred market dipped nearly 20 per cent on a price return basis, driven mainly by the perpetual rate-reset segment, which was down nearly 24 per cent for the year. This type of price swing is uncomfortable to say the least, especially for a security held among your normally 'more stable' fixed-income investments.

When things go against you, it is important to review your original investment thesis to ensure that the fundamentals remain attractive. Preferred shares endured special challenges this past year. That being said, we believe preferred shares still represent a favourable return on investment longer term.



Jan 04 2016, 12:55PM EST. Powered by **YCHARTS**

CPD decreased by -19.6% while ZPR—the rate-reset segment decreased by -23.9% in 2015

A Primer on Preferred Shares

Preferred shares can be tough to understand. There are a number of different types of preferred share structures and, much like other fixed-income securities; they can differ dramatically based on yield, term and credit quality. Here's what you need to know about the two categories of preferred shares commonly used within WDS clients' portfolios: perpetual fixed-rate and, a somewhat newer structure, perpetual rate-reset.

Perpetual fixed-rate preferred shares function most like a typical bond; issued at a price (typically \$25 par value) with a *fixed, income payment that does not change over time*. At time of issue, these shares reflect current market yields. As market conditions and yields change, the price of fixed-rate preferred shares goes up and down. The fixed-rate preferred-share price must move to keep its yield in line with that of the comparable market.

Ultra-low interest rates have stubbornly persisted in the after-math of the Great Recession. The longer view, though, is that rates have nowhere to go but up. Like bonds, fixed-rate preferred share prices have an inverse relationship with interest rates. As interest rates eventually do climb, fixed-rate preferred share values will decline. This is commonly known as interest rate risk.

To manage interest rate risk in bonds, a prudent investor may shorten the term to maturity of the bond holdings. Perpetual preferred shares have no maturity date, removing this defensive option. However, there is a category of preferred shares that is structured to provide some protection against rising interest rates; the perpetual rate-reset.

Rate-reset preferred shares pay a *fixed dividend rate for a predetermined period, typically five years*. At every reset date, the dividend automatically resets using a specified formula. Typically the dividend-reset rate is based on a spread above the benchmark Government of Canada (GOC) 5-year bond yield at that time. The rate-reset appeal is simple. The risk of rising interest rates can be mitigated. At given intervals, the dividend rate will be reset at the higher (or lower) prevailing rate. For patient investors, these shares offered a stable, attractive income stream, while managing for interest rate risk.

Of course, there was downside risk involved. Given that the reset feature benefits from a rising interest rate environment, what happened when the Bank of Canada lowered rates?

The risk of rising interest rates can be mitigated. At given intervals, the dividend rate will be reset at the higher (or lower) prevailing rate.

What Just Happened?

In January 2015 the Bank of Canada lowered the overnight rate by one-quarter of one percentage point, taking every respected analyst and forecaster by surprise. In July, although more widely anticipated, another rate cut was announced. Of course the benchmark 5-year GOC bond yield—to which the majority of rate-resets are pegged—followed the central bank in lockstep.

Government of Canada Benchmark Bond Yields – 5 Year

Graph Period: 31 December 2014 – 31 December 2015



Looking at the chart, the January rate-cut hit the benchmark rate the hardest. Instantly, fear in the market took hold that the GOC 5-year bond yield may stay lower, for longer. Rate-reset prices began to reflect a potential reduction in the future dividend rate. A sell-off in preferred shares ensued and persists. Also, the prices of some individual preferred shares are down more than the overall market; reflecting corporate factors that impact the issuer to a greater degree than others. Whether it is structural in the market or specific to an individual issuer; short-term fear brings uncertainty and, as you well know, uncertainty breeds volatility.

The “Preferred” Way Forward

When things move against you it is human nature to want to make a change, to react; often the hardest thing to do is nothing at all. Our approach is a middle ground—we stop and actively reflect. Sometimes this reflection leads to action but, other times, the pause allows us to filter out the short-term noise and remain focused on our long-term strategy. So let us share with you the reasoning behind our decision to hold on, and the rewards we see for sticking to the plan.

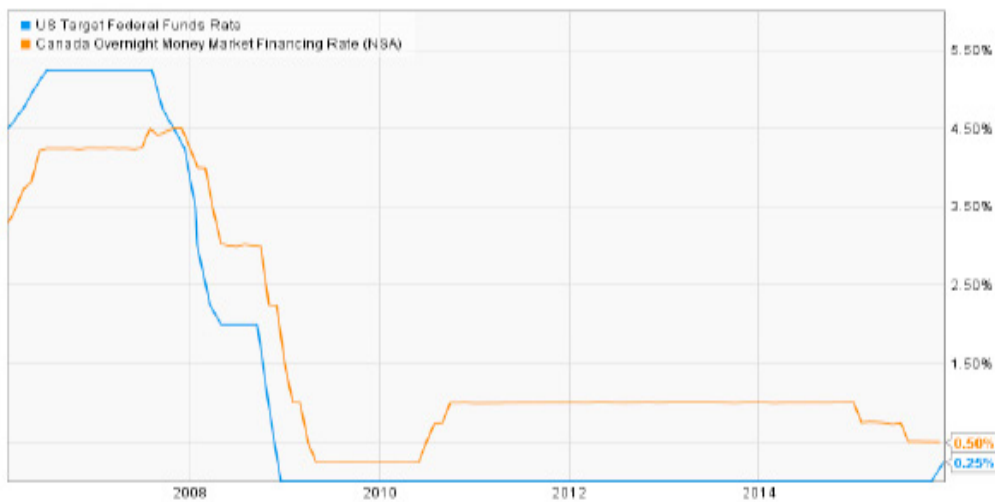
As interest rates increase, though, fixed-rate preferred shares stand to benefit both from higher reset dividend rates and capital appreciation.

A valuable part of your portfolio:

Preferred shares are a valuable part of an investment portfolio for several reasons, not the least of which is the stable, tax-preferred income they provide. Preferred shareholders are paid dividends before common shareholders, adding a layer of safety. Further, the dividend is not impacted by the volatility of the share price. Preferred dividend rates are generally much higher than those of the common shares and corporate bonds. This yield advantage—or spread—is even larger in today's environment. Finally, preferred shares are a portfolio diversification tool, having low correlation to traditional bonds and common stocks.

A value that remains today:

Preferred shares have a place in well-managed portfolios. But what about now is there still value in preferred shares? We think so. Given where interest rates are historically, the most likely scenario is that rates will eventually rise. In the final weeks of 2015, the U.S. Federal Reserve Chairwoman Janet Yellen announced the decision to raise short-term interest rates for the first time since 2006. Exactly when this directional change happens in Canada is difficult to forecast. As interest rates increase, though, fixed-reset preferred shares stand to benefit both from higher reset dividend rates and capital appreciation.

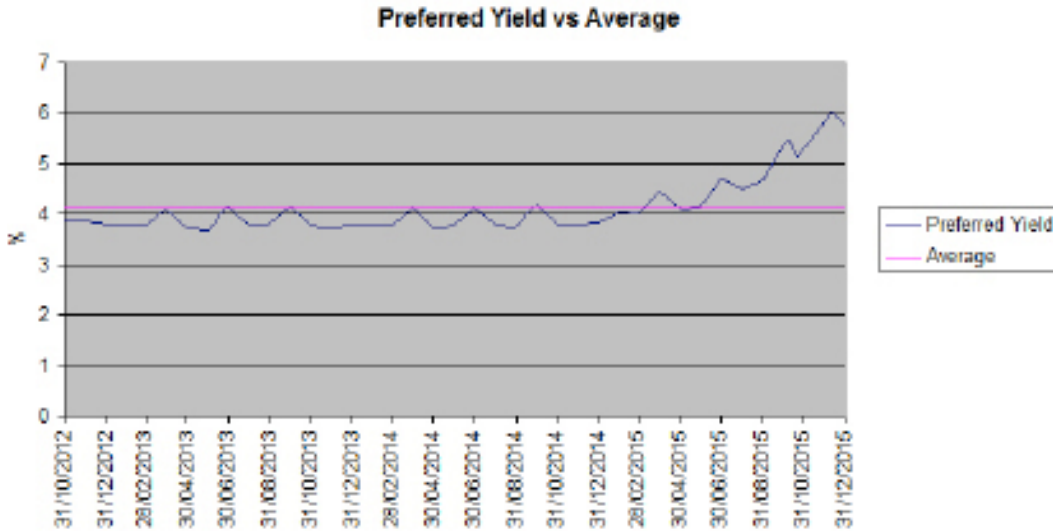


Sources: Federal Reserve, Bank of Canada

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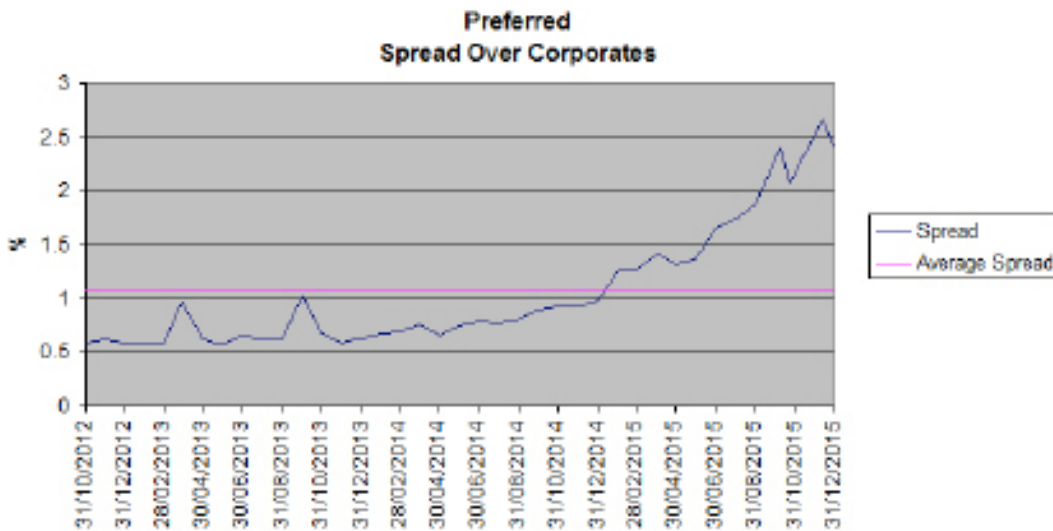
The evidence of an oversold market:

We believe that the preferred share market has been unfairly penalized, the sell-off too extreme, and the market is oversold. The yields on preferred shares are well-above their average (see below), indicating that investors are currently demanding a higher risk premium than normal for holding this asset class.



The yields on preferred shares are 1.6% higher than their average.

Given that preferred shares have similar characteristics to corporate bonds; it is often helpful to compare the spread between the yields of both of these asset classes. Again, the comparison in the chart below shows just how far this spread has diverged from the average. Both these points of reference suggest that preferred shares are being priced at the low end of the spectrum. This affords plenty of upside price movement as preferred yields move back towards an historical norm.



The preferred spread over corporates also widened dramatically.

How is WDS managing risk?

We do have conviction that rates will rise and value restored to the preferred shares. Without knowledge of when this will happen, though, we manage risk by including rate-reset preferred shares with varying reset dates into the future. The dividend rates—when reset at regular intervals—hedge the risk of changing interest rates. This is a similar concept to laddering bond-maturity dates over several years.

Preferred shares offer important diversification to a portfolio. Equally important is appropriate diversification within the preferred share component of a portfolio. We ensure holdings are spread across different issuers, leaving no holding over-concentrated.

Often investors view price volatility as a warning sign over dividend sustainability. The declining prices on rate-resets have been mostly related to their structure, not credit quality. Even so, an important part of our research process is monitoring the issuers of preferred shares to maintain our view on the safety of the dividend—which is paramount.

Keeping On Track...

We understand it's hard to stomach drastic price movements. We hope you take some level of comfort knowing that preferred shares continue to pay attractive dividends, despite last year's price decline. This income collection will continue, while prices firm-up and recover. This is a patient investors' reward. In this environment of compressed interest rates, we believe preferred shares still offer value.

The dividend rates—when reset at regular intervals—hedge the risk of changing interest rates.

We are here to listen and provide solutions. Always share your views with us.