Preferred Shares, An Investing Solution to Rising Rates

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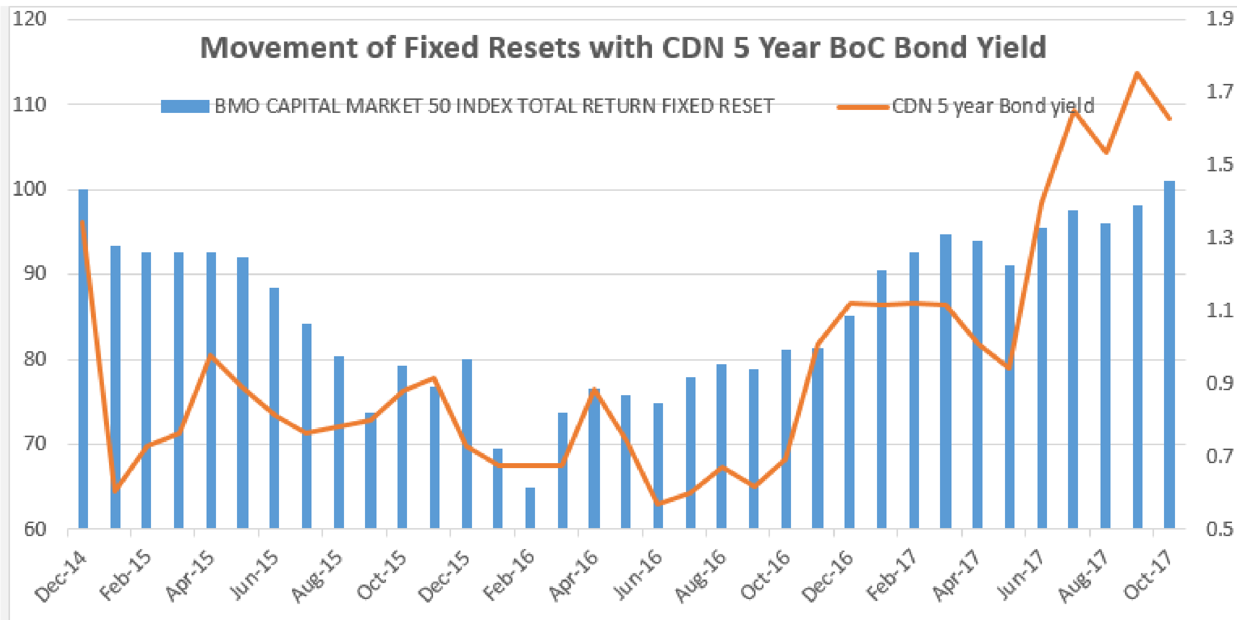
When interest rates rise, fixed income duration risk is real and with the recent upward movement of bond yields, the impact on fixed income portfolios has begun to manifest itself. Investors are beginning to recognize their recent muted returns. To combat higher interest-rates we feel considering a sleeve of a well-managed Preferred Share product (committed to owning discounted fixed reset Preferred Shares), could be advantageous for any taxable Canadian income account.

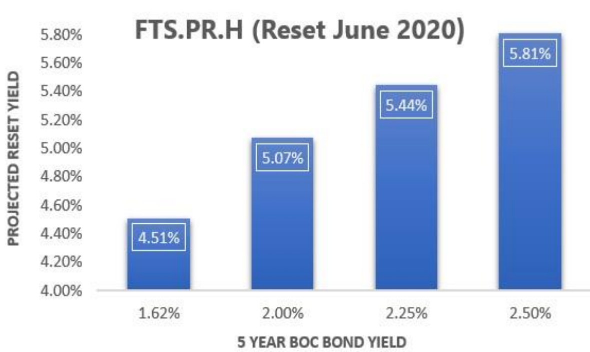
To truly appreciate the “silver lining” of rising rates, it is important to explain what occurred in the Preferred Share market in 2015. That year the Canadian Preferred Share Index was down 15.3%, caused mostly by the decline in fixed reset Preferred Shares, which make up over two-thirds of the Canadian market. Fixed resets were introduced to investors as a Preferred Share that offered a measure of protection over the long-term against rising interest rates. Specifically, issuers offer investors a fixed 5-year coupon, and each subsequent 5-year term they receive a ‘reset’ coupon (as determined by a set spread over the 5-year GoC bond yield). By offering reset spreads over 400 bps, this structure gained traction in 2008 and 2009 during the financial crisis, as some investors saw these Preferred Shares as attractive 5 year investments. Consequently, the Canadian banks were able to issue over $15 billion worth of such securities in short order.

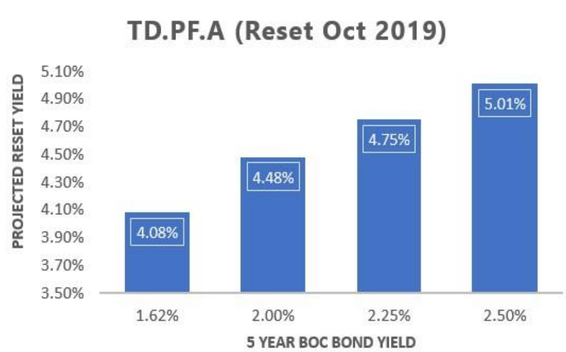
However, as the economy recovered from the financial crisis, two key developments occurred. First, as reset issuance continued, the resets spreads decreased significantly, and became as low as 141 bps. Second, the 5-year GoC bond yield also declined considerably (from 3.0% in 2010, to 1.5% in 2013, and then to 0.60% in January 2015). The combination of these developments severely reduced the coupon value of resets. For example, the Fortis Inc. Series H (FTS.PR.H), which was issued in 2010 with a coupon of 4.25%, reset (June 2015) with a coupon of 2.50%, a 40% reduction and consequently a drop in value from $25.00 to $14.95. To varying degrees, this phenomenon affected the entire fixed reset sub-sector of the Preferred Share market.

Today, the running yield of high quality fixed reset Preferred Shares is wide (ranging from 3.25% to 4.75%). However, many of the discounted issues (trading below par) could benefit from the recent upward move in the 5-year GoC bond yield (which has moved from 0.48% in Feb 10, 2016 to current level of 1.62%), and even more so if rates continued to rise. In essence, a reversal of what occurred in

2016. This is illustrated in both the FTS.PR.H and TD.PF.A bar charts below. For example, if the 5-year GoC bond yield returned to the level in 2013 of 2.50% (a 87 bps move from current levels), the Preferred Share running yields of each would increase 5.81% and 5.01% respectively. Such an unfolding could also result in these issues returning to parity. Chart 1 below overlays the recent performance of fixed reset Preferred Shares over the recent month to month value of the 5-year GoC bond yield – as you can see both are trending higher.







*Projected yields based on current trading price as of October 31, 2017
FTS.PR.H $17.00
TD.PF.A $23.65

A rise in interest rates is usually a substantial headwind for fixed income vehicles. However, as discussed above, a portfolio of fixed reset Preferred Shares, may benefit from higher rates. To go a step further, we would argue that investing in an asset class that performs well in the event of higher interest rates is a rare opportunity for portfolio managers.