TD Waterhouse

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Preferred Shares

Preferred shares are equity investments that can play a key role in many income portfolios. When constructing a portfolio to provide income and security, it is crucial to consider not only how much money you can earn but how much money you keep after taxes. Preferred shares can help maximize a stable stream of after-tax income.

What are preferred shares?

Dividend paying preferred shares can be considered a "hybrid" investment, sharing attributes with both bonds and stocks. Preferred shares are a class of equity carrying additional rights above and beyond those of common stocks. These preferred shares are called "preferred" because their dividend must be paid before the common stock dividend (if any) is paid. Preferred shares do not participate in the profits of a company and under normal circumstances have no voting rights. The payment of dividends is not a legal obligation like that of interest on bonds. In addition to being a form of equity capital, preferred shares trade on a stock exchange similar to common shares. Preferred shares are similar to bonds in that they pay a fixed distribution (dividends), have a set par value (generally $25) and their pricing is impacted by the same factors affecting bonds – interest rates and corporate credit spreads. Preferred shares have a claim on liquidation proceeds, equivalent to par or liquidation value. This claim is senior to the claims of common stocks, which have only a residual claim but is junior to traditional debt.

What are the advantages of investing in preferred shares?

Preferred shares often offer yields that are higher than those on bonds, money market instruments and common stock. The tax treatment of preferred dividends makes them attractive to individuals and other taxable entities. While bond interest is fully taxable, with the dividend tax credit, one dollar of preferred share dividends is worth approximately $1.30 of interest income (depending on the marginal tax rate of the holder). Preferred stock returns have low correlations with common stock returns, making them good diversifiers. They typically exhibit expected volatility and returns between those of common stocks and bonds. This makes them a good complement to a bond portfolio.

Dividends

Most preferred shares pay a quarterly dividend. The dividend is usually expressed on an annual basis as a percentage of par value. For example, a preferred share paying 5.00% would pay an annual dividend of $1.25 (0.05 x $25.00), which would be paid out $0.3125/quarter. Preferred share dividends will either be "cumulative" or "non-cumulative." In the event that a preferred share's dividend is suspended, a cumulative dividend would accrue and would have to be paid in full before any common dividends could be reinstated. A non-cumulative dividend, if suspended, would not accumulate. Generally, most financial preferred shares are non-cumulative, while non-financial issues tend to be cumulative.

Preferred Share Classes and Characteristics

Retractable
Retractable preferred shares pay a fixed dividend. In addition, these issues grant investors the option to retract (put) the shares on or after the retraction date at par value. This feature makes them resemble a bond more than any other class of preferred share as it provides investors with some certainty with respect to the time horizon and future value of the investment.

Rate-Reset
The most common form of preferred share issuance in Canada is the rate-reset preferred share. Rate-reset preferred shares typically pay a fixed dividend for the first five years after issue, after which they are either redeemed or reset. On the redemption date the preferred shares will either be: 1) redeemed at the issuer's discretion; or 2) left outstanding. If left outstanding, the investor can elect to receive either: 1) a new fixed rate for five years at the reset spread + the 5-year GoC bond yield; or 2) convert into a floating rate share which pays the same set spread + short-term 90-day T-bill rate, reset quarterly for the next five years. The reset provision provides investor with some protection against rising interest rates. Despite the protection against rising interest rates, rate-resets are perpetual assets with long-term credit risk.

Perpetual
Perpetual preferred shares are the traditional form of preferred share. The investor receives a fixed dividend either in perpetuity or until redeemed by the issuer. Perpetuals often provide the highest yield amongst all types of preferred shares. Perpetuals can be used to provide a relatively high, steady stream of income. Perpetuals are the most sensitive to changes in the level of prevailing interest rates, because of their long duration.

Floating Rate
Floating rate preferred shares pay a dividend that is set as a percentage of the prime rate. As is the case with most other preferred shares, only the issuer has the option to redeem. Floating rate dividends are usually reset and paid monthly, although some issues do so quarterly. As interest rates rise, so does the dividend. Floating Rate preferred shares can provide fixed income investors with protection in a rising interest rate environment but, despite exposure to short-term interest rates, the credit risk associated with these securities is still perpetual in nature.

Conclusion

The preferred share market can offer opportunities for yield seeking investors. Individual and institutional investors alike are attracted to the quality, high yield and tax efficiency that preferred shares offer. Depending on investor income requirements and risk tolerances, it may be advantageous to selectively include preferred shares in income portfolios consisting of bonds and debentures, as a means to enhance returns without the addition of undue risk.

<For more information on Preferred Shares, visit tdwaterhouse.ca, call 1-800-465-5463 or speak to your investment representative. TTY 1-866-966-6061>

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