

A handy guide to preferred share investing



By Andrew Allentuck
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There are a lot of strange critters in capital markets. Among the oddest are preferred shares, which tend to have higher dividends than common shares from the same company.

The name “preferred” implies superiority. That’s true in the sense that preferred shareholders have to be paid before common shareholders get their dividends, but there the superiority ends, for preferreds are often elaborately constructed, tricky to understand, and risky to buy. They can and do bite investors’ hands if they are bought inappropriately.

Preferreds have been causing investors a good deal of pain recently. The Desjardins Preferred Shares Universe Index, a proprietary benchmark of Desjardins Securities Inc., was down 13.5 per cent for the 12 months ended March 31. In the same period, the S&P/TSX composite index was down just 5.3 per cent. Not surprisingly, financial advisers have become leery of preferreds.

“You have to compare the need for the preferred income to the risk,” says Caroline Nalbantoglu, a registered financial planner with PWL Capital Advisors Inc. in Montreal. “A lot of the investors are elderly people who want the income. I usually tell them to treat preferreds like equity with a high dividend and no recourse if the dividends are not paid. They may promise a lot, but most preferred issues carry a great deal of risk.”

Tax advantages make up for at least some of that risk. Stock dividends of Canadian companies are taxed at various preferential rates according to the investor’s province of residence, but the combined federal and provincial rates do not exceed 30 per cent. Bond interest, in comparison, can be taxed at rates as high as 48 per cent in Quebec, though most provinces are somewhat less.

Preferred share investing comes down to balancing the risk of a loss with after-tax return, explains Michael Cherney, a certified financial planner in Toronto.

“Preferreds are a compromise,” he said. “Their dividends are safer than those of common shares and they usually have a higher yield than bonds. You give up dividend growth most of the time, but in exchange you get more assurance of cash flow than the common shares have and you get the preferential tax rate that goes along with dividends.”

Preferreds can also be confusing because there are so many different kinds.

“Much of the problem is the distinctive set of provisions of each issue,” Mr. Cherney notes. “After all, every share of common stock from a corporation is like every other. There may be voting and non-voting, but that is most of the difference. But with preferreds, there can be some that the company will buy back at a certain date and others that don’t have that money-back guarantee. There are others that have fixed payments and others that have changeable payments. Then there are cumulative preferreds that pay any dividends in arrears and non-cumulative ones that don’t.”

Preferreds may also sound safe, but employees, suppliers, and bond holders have the rights to get paid by the company ahead of all stockholders, including the holders of preferreds. That makes preferreds deeply subordinate to other forms of corporate obligations. Strictly speaking, preferreds do not even rank as obligations.

“Preferreds don’t have the standing of contractual promises that are part of every bond,” Mr. Cherney says. “Even though some preferreds look healthier than some bonds, the issuers of preferreds have no legal obligation to pay dividends. In that sense, they are junkier than junk bonds.”

Defaults do happen. Recently, Quebecor World skipped a preferred dividend, and though dividends in arrears have to be paid before any common share dividends are paid, the fact that the company is in receivership makes any payout unlikely.

Given the lack of protection for preferred shareholders, it is essential to examine the credit standing of the company. Rating agencies like Standard & Poor's and Dominion Bond Rating Service grade preferreds from P-1, which denotes an investment grade issue of superior quality similar to that of a bond rated AA, to P-5, which indicates a highly speculative situation that could result in cessation of dividends, "Use the ratings, but be sure that both agencies rate the preferreds as P-1 or even P-2, which is still satisfactory. Don't go below that rating and don't go with a rating from just one agency." says John Nagel, vice-president of the institutional preferred department at Desjardins Securities Inc. in Toronto. (See www.dbrs.com/intnlweb/jsp/common/infoPage.faces.)

Investors in preferreds also usually get no inflation protection. In most cases, their dividends are fixed at an interest rate (as opposed to floating with interest rates). As long as inflation is tame, the lack of inflation protection is not a problem. But if inflation picks up and interest rates rise, it can be downright ugly for preferreds.

Many preferreds are also long in duration, so they are highly sensitive to interest rate changes. They drop drastically in price if interest rates rise and soar if rates fall.

Is it a good time to buy preferreds?

“A lot of preferreds have come down by 20 to 25 per cent in price in the last 12 months,” said

John Nagel, vice-president of the institutional preferred department at Desjardins Securities Inc. in Toronto. “Central bank rate cuts will eventually improve business conditions. We see gradual price rises ahead for the whole class of preferreds. Moreover, when confidence returns to credit markets, they will become more liquid and that will tend to make what are today lightly traded preferreds more attractive. The hardest hit shares have been perpetuals from banks and those are the ones we would expect to gain the most.”

Here are the types of preferreds.

Cumulative preferreds

These shares pay any dividends in arrears before any dividends on common shares can be resumed. Preferreds from most companies, other than banks, have this feature. Bank preferreds are not cumulative, but that does not mean that they are at great risk of missing dividends. After all, the odds that an issuer like Royal Bank of Canada would stop dividends on its preferred issues are remote. If they did, they would have to stop dividends on common shares, notes Sunil Shah, vice-president and portfolio manager for Sceptre Investment Counsel Ltd. in Toronto. Royal Bank, he adds, has paid dividends without interruption since 1870.

Redeemable preferreds

Can be called and paid by the issuer. Typically, the redemption can occur on or after specified dates. Redemption comes with a sweetener such as a small premium over issue price. For example, a Brookfield Asset Management Series 11 (BAM.Pr.J- TSX) has recently traded \$25.60 for a current yield of 5.4 per cent. and a yield to first redemption March 31, 2015 at \$26 of 5.88 per cent.

Perpetual preferreds

Once issued, these shares exist forever or at least until the shares are redeemed by the issuer. The fixed dividend offers a long-term promise, but the purchasing power of the dividend will decline over time as inflation erodes it. The perpetual feature also means that, if interest rates rise for a sustained time, the holders will not be able to depend on maturity or termination of the issue. They will be victims of the market, at least until interest rates decline to the level at which the preferreds were issued. “If the coupon is 6 per cent or more, there is a good chance that it may be redeemed by the issuer, especially if rates at the time of the first call are in a low range,” Mr. Nagel says. “But if rates are high, redemption is unlikely.”

Retractable preferreds

This version allows the holder to demand repayment of the issue at a stipulated date in the future. This is a valuable feature, for it allows the holder to get out at a known price if the preferreds lose value when interest rates are rising.

Structured preferreds

Often called dual purpose preferreds, these preferreds give all capital gains to the common shares in the structure and all dividends to the preferred holders.

Out of a pool of shares of XYZ corporation, the preferred shareholders get all the dividends of their own class and those of the capital class. The capital class, meanwhile, gets all the gains and losses of their own shares plus those of the preferred shareholders. It's a double your money structure that magnifies dividends for the preferred holders and enhances capital gains or losses for the capital class holders.

For example, the Dividend 15 Split Corp. (DFN.Pr.A-TSX) recently priced at \$10.12 gives all dividends from 15 major financial services companies to the preferred class. It has a decent yield, currently 5.2 per cent – in the dividend class, has a diversified pool of assets, and offers mandatory redemption in 2014.

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