All Risk and No Reward?

August 2019 Commentary

Executive Summary

- Low global yields have pushed investors to search for income wherever they can find it including preferred shares, touted as fixed income-like instruments with higher yields
- Recent experience has shown the opposite – preferred shares have seen a strong sell-off year-to-date (approximately 14%)
- Periods of strong returns with intermittent large drawdowns, show that preferred shares should be an opportunistic allocation rather than a static/passive one

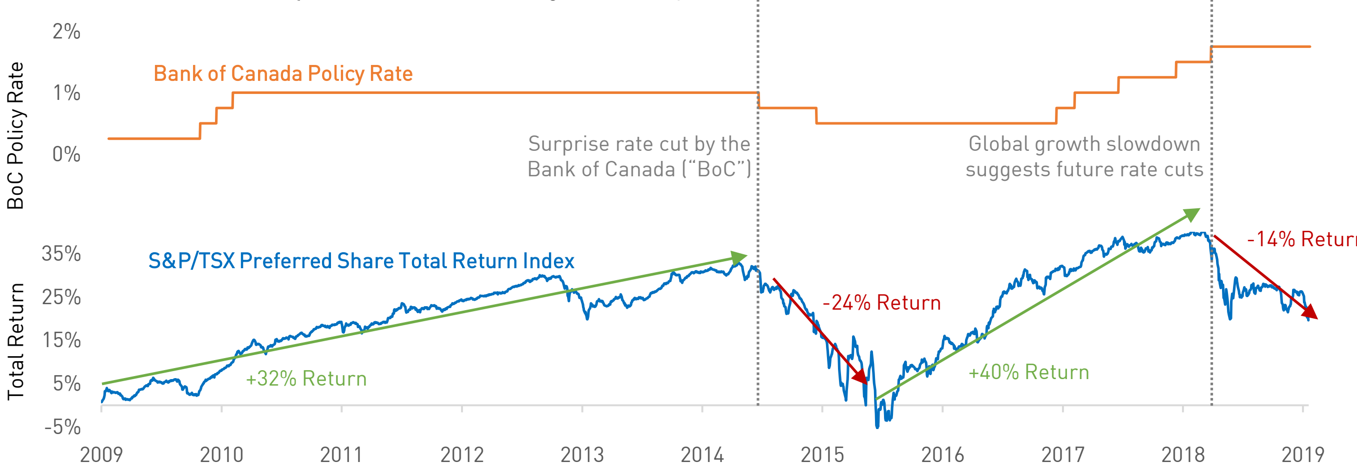
SEARCHING FOR INCOME IN PREFERRED SHARES

Investors have been hungry for any and all sources of income over the last decade thanks to persistently low yields across the globe. One of the areas to which they have turned is preferred shares which have been touted as bond-like instruments that offered a more attractive income than was available in traditional fixed income markets. On this basis, investors allocated capital to this part of the market, both directly and through vehicles such as mutual funds and ETFs.

PERIODS OF STRONG RETURNS BUT ALSO PERIODS OF HIGH RISK

In some respects, investors had uncovered a useful asset class through which to add additional income and return to their portfolios. From August 2009 through December 2014 preferred share markets returned 32%, of which the majority came from income. But these high returns may have masked some underlying, structural risks that can cause preferred shares to act more like highly volatile equities rather than bond replacements. This came to fruition in the latter half of 2018 as participants began to price-in slower global economic growth and central banks began to telegraph future rate cuts rather than the autopilot hikes the market had become accustomed to. This change in direction had significant impacts on preferred shares with the Canadian market selling-off by 14%, more than wiping out the 5% of income investors had collected over the preceding 8 months. This current bout of volatility is not unprecedented. A similar dynamic occurred in 2015 when the Bank of Canada announced a surprise rate cut which led to a 24% sell-off, wiping out the 6% of income investors earned over that same period.

The Preferred Share Experience in Canada – High Sensitivity to Interest Rate Cuts



Source: Bloomberg

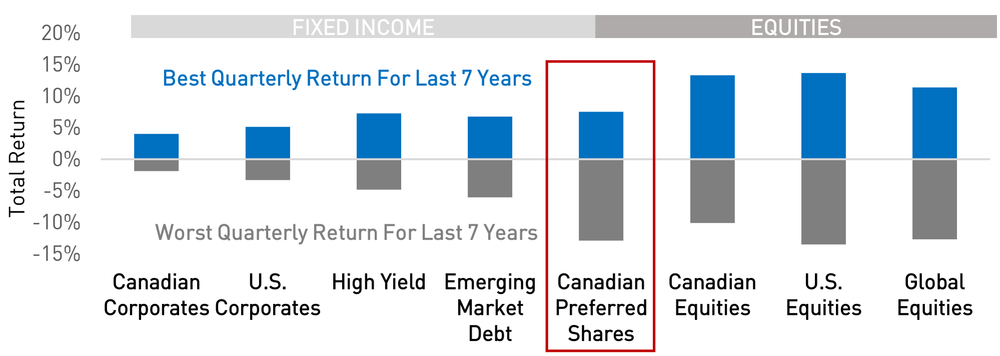
WHY PREFERRED SHARES DO NOT ACT LIKE BONDS IN CERTAIN MARKETS

Why did lower interest rate expectations have such a negative impact on preferred shares? This is because the market is now dominated by a certain type of preferred share known as “rate resets” which represent over 70% of the total market. Rate reset prices are largely driven by future expectations for interest rates. This is because the future dividends paid by rate reset preferreds are based off the level of interest rates in the future. When future interest rates are expected to be stable or increasing, investors buy preferred shares to earn the potential income they offer via higher future dividend payouts. This is what happened in the 2010 to 2015 period where prices rose on the expectation of higher-and-higher future interest rates, stoking demand from investors looking to increase their portfolio’s income production. However, just as the expectation for rising interest rates boosted the returns of preferred shares, the expectation for lower interest rates has now led investors to price-in lower future income from these investments. With the expectation for lower future dividends, preferred shares are no longer offering as high a yield as previous periods, pushing investors to sell their holdings and putting pressure on the market.

PASSIVE APPROACH CAN MAKE FOR AN UNATTRACTIVE RISK-RETURN PROFILE

Preferred shares have an important role in investors portfolios and, as seen in periods outside of 2015 and the current drawdown, they can be attractive sources of income and total returns. However, investors should not let the “good times” mask the underlying risks found in these instruments and choose to approach the asset class simply from as passive perspective. As shown with rate-resets, preferred share instruments (and their inherent risks) can vary greatly depending on the type of structure through which they are issued, putting a premium on security selection versus other, more homogenous asset classes. Therefor, a passive approach can expose investors to unattractive risk-reward profiles such as those that offer a fixed income-like return but with equity-like risk.

Passive Approaches to Preferred Shares Can Expose Investors to Fixed Income Like Returns but Equity Like Risks



A passive exposure to Canadian preferred shares has been suboptimal, providing fixed income-like returns but equity-like risk

Source: Bloomberg, FTSE Russell
Please see disclaimer for definitions

TAKING AN OPPORTUNISTIC APPROACH TO INVESTING IN PREFERRED SHARES

It is our opinion that preferred shares are best utilized as an opportunistic allocation amongst a diversified portfolio of fixed income instruments. This is the case for RPIA’s solutions which will tactically add and remove exposure to preferred shares based on their relative value at any given point in time. In fact, we believe that the current market volatility presents an interesting entry point to purchase certain preferreds which now offer attractive income at extremely low prices.

For investors able to put capital to work after a large drawdown the rewards have been enticing. We believe the current sell-off could presage returns not unlike those seen after 2015 where attractive income and extremely discounted prices skewed the risk-reward relationship in oinvestor’s favour. Note that those who could put capital work after the 2015 experience went on to see a nearly 40% total return over the following two years.

These rebounds show that a nimble, active manager can exploit periods of dislocation in preferred shares by being highly opportunistic – avoiding periods where preferred shares offer more risk than reward and taking advantage of extremely cheap pricing when other investors just want to "get out" and are willing to sell any and all positions despite the differences in fundamental and structures across instruments. By applying an opportunistic approach to preferred share investing we believe we can help our clients capture the benefits of the market but also avoid some of its pitfalls, striking a better balance between risk and reward.

Important Information

'Preferred Shares are Hybrid in Nature Offering Strong Total Returns but Also Downside Risk' chart based on best and worst quarterly return period for the 7 years ending July 31, 2019. Indices are as follows:
Canadian Corporates = FTSE Canada All Corporate Bond Index
US Corporates = Bloomberg Barclays US Corporate Bond Index
High Yield = Bloomberg Barclays US High Yield Bond Index
Emerging Market Debt = JPM EMBI Global Bond Index
Canadian Equities = S&P TSX Composite Index
US Equities = S&P 500 Composite Index
World Equities = MSCI World (Ex. US) Equity Index