

Preferred Shares

ScotiaMcLeod Portfolio Advisory Group

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Drop in Preferred Share Pricing Relates to Low Interest Rate Environment Rather than Credit Deterioration of Companies

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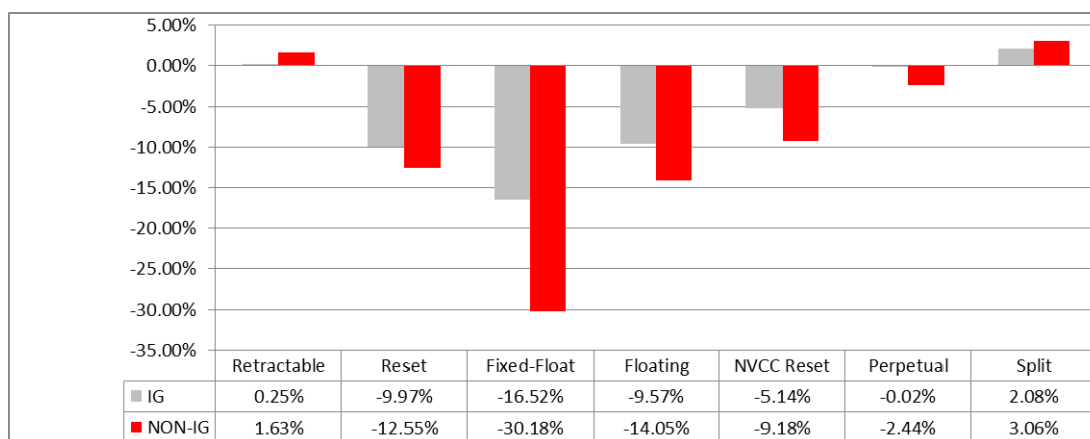
The first half of 2015 has been a challenging environment for preferred share investors as prices have dropped more than anticipated, creating a negative sentiment within the asset class. To put things in perspective the S&P/TSX Preferred Index declined by -10.80% (price return) or -8.60% (total return) while the rate reset market as depicted by the S&P/TSX Preferred Share Laddered Index retreated by -14.50% (price basis) or -12.37% (total return) during the first half of 2015.

	YTD 2015 Total Return
S&P/TSX Preferred Share Index	-8.60%
iShares S&P/TSX Pref Index ETF (CPD)	-8.65%
Horizons Active Preferred Share ETF (HPR)	-7.26%
S&P/TSX Preferred Share Laddered Index	-12.37%
BMO S&P/TSX Laddered Pref Shr Index ETF (ZPR)	-12.42%

The main driver affecting the performance of the rate reset securities, which comprises the majority of the Index, has been the low interest rate environment as the 5-year Government of Canada bond yield acts as a base rate when rate reset securities adjust their dividend rate. Hence, the low rate environment has put price pressure on this type of security. Additionally, there seems to be a misconception that a rising interest rate environment will negatively impact the prices of rate resets, when in reality the opposite is true and higher underlying yields will be beneficial for the price of both rate reset and floating rate preferred shares.

This year can be categorized as volatile as there have often been large daily moves in the bond market corresponding to economic data releases and global events (China, Grexit). As a reference, since the start of 2015 the 5-year Government of Canada bond yield has moved lower by -0.52% while being as high as 1.34% and as low as 0.59%. Breaking down the performance by type of preferred shares it was the perpetual preferred shares, which outperformed the market, while the floating and rate reset sectors saw price depreciation and investment grade credit outperformed non-investment grade credit across the major types of preferred shares. As investors were seeing losses in their accounts on various preferred share positions many panicked and without understanding the factors behind the move in the price, sold preferred shares and often allocated the funds to another asset class.

Total Returns for 2015



Are Preferred Share Dividends in Jeopardy of Not Being Paid?

Based on the magnitude of the price drop seen in many rate reset securities, investors are questioning whether the preferred share dividend is at risk of not being paid and if there are concerns about the credit quality of the underlying company. As a reminder, preferred share dividends cannot be eliminated unless the company has discontinued the dividend paid to common shareholders. For the majority of companies which have preferred shares outstanding, there is little concern that the company will eliminate the dividend on the preferred shares. However, certain types of preferred shares (floating, fixed floating & rate reset) periodically have the level of dividend income adjusted to prevailing interest rate levels. Both short term interest rates (Prime & 90-Day T-Bill) and 5-year yields are lower than at the start of 2015 as Bank of Canada reduced the overnight rate back in January. As the prevailing interest rates are lower, the floating, fixed floating and rate reset preferred shares prices have declined as dividends have been adjusted lower. The opposite effect can occur in a rising interest rate environment and when interest rates move higher, the prices of floating, fixed floating and rate resets should also move higher. Therefore for rate resets that don't reset until 2018, investors will continue to collect the stated dividend until the reset date at which time the security may be redeemed at par (\$25) or the dividend will adjust according to prevailing interest rates.

Update on Various Types of Preferred Shares

Floating Rate Preferred Shares: This type of preferred share pays a monthly/quarterly dividend based on short-term interest rates (Prime or 90-Day T-Bills). In January, the Prime rate was lowered to 2.85% from 3.00% and 90-Day T-bills ended the first half of 2015 at 0.57% down from 0.93% at the start of the year. With short-term interest rates lower, the dividends on floating rate preferred were also lowered and the prices dropped accordingly. Additionally, as concerns on another rate cut surfaced demand for floating rate product waned putting further pressure on prices.

Top 10 Best Floating Performers YTD					Top 10 Worst Floating Performers YTD				
Name	Ticker	Type	IG/NON-IG	% Change YTD	Name	Ticker	Type	IG/NON-IG	% Change YTD
Atlantic Power	AZP.PR.C	Floating	NON	5.58%	Bombardier	BBD.PR.B	Floating	NON	-33.60%
Fortis Inc	FTS.PR.I	Floating	IG	2.47%	Dundee Corp	DC.PR.D	Floating	NON	-24.58%
Brookfield Asset Mgmt	BAM.PR.L	Floating	IG	1.14%	Brookfield Asset Mgmt	BAM.PR.E	Floating	IG	-17.79%
TransCanada Corp	TRP.PR.H	Floating	IG	-1.46%	Brookfield Renewable Energy	BRF.PR.B	Floating	NON	-17.24%
Aimia	AIM.PR.B	Floating	NON	-1.98%	BCE Inc	BCE.PR.Y	Floating	IG	-17.05%
Bank of Nova Scotia	BNS.PR.A	Floating	IG	-2.76%	BCE Inc	BCE.PR.B	Floating	IG	-16.95%
Toronto-Dominion	TD.PR.T	Floating	IG	-3.92%	BCE Inc	BCE.PR.J	Floating	IG	-16.37%
Bank of Nova Scotia	BNS.PR.C	Floating	IG	-4.03%	BCE Inc	BCE.PR.D	Floating	IG	-16.27%
Royal Bank	RY.PR.K	Floating	IG	-4.25%	Brookfield Property Partners	BPO.PR.X	Floating	NON	-16.06%
Bank of Nova Scotia	BNS.PR.B	Floating	IG	-4.27%	TransCanada Corp	TRP.PR.F	Floating	IG	-16.04%

Banks floaters are among the best performers, albeit still with negative returns, as these securities are expected to be redeemed prior to 2022 as per Basel III regulations.

Straight Perpetual Preferred Shares: This type of preferred share pays a fixed quarterly dividend to holders indefinitely. With no maturity date, the price of this type of security moves inversely with moves in 30-year bond yields. The 30-year bond yields moved down to 1.98% during the first quarter but then reversed course and are now relatively unchanged from the start of the year corresponding to flat performance from the sector overall.

Top 10 Best Perpetual Performers YTD					Top 10 Worst Perpetual Performers YTD				
Name	Ticker	Type	IG/NON-IG	% Change YTD	Name	Ticker	Type	IG/NON-IG	% Change YTD
Atlantic Power	AZP.PR.A	Perpetual	NON	14.71%	Bombardier	BBD.PR.C	Perpetual	NON	-21.74%
GreatWest Life	GWO.PR.S	Perpetual	IG	3.66%	Innergex Renewable Energy	INE.PR.C	Perpetual	NON	-6.96%
HSBC	HSB.PR.C	Perpetual	IG	2.69%	Manulife Financial	MFC.PR.B	Perpetual	IG	-5.18%
Power Financial Corp	PWF.PR.E	Perpetual	IG	2.66%	Industrial Alliance	IAG.PR.A	Perpetual	IG	-4.49%
Power Corp of Canada	POW.PR.B	Perpetual	IG	2.15%	Sun Life Financial Inc	SLF.PR.D	Perpetual	IG	-3.66%
Power Corp of Canada	POW.PR.A	Perpetual	IG	2.12%	Manulife Financial	MFC.PR.C	Perpetual	IG	-3.61%
Power Corp of Canada	POW.PR.C	Perpetual	IG	2.06%	Brookfield Renewable Energy	BRF.PR.F	Perpetual	NON	-3.44%
Power Financial Corp	PWF.PR.R	Perpetual	IG	1.93%	Sun Life Financial Inc	SLF.PR.C	Perpetual	IG	-3.36%
HSBC	HSB.PR.D	Perpetual	IG	1.91%	Sun Life Financial Inc	SLF.PR.A	Perpetual	IG	-3.19%
Power Financial Corp	PWF.PR.H	Perpetual	IG	1.91%	Fortis Inc	FTS.PR.F	Perpetual	IG	-3.15%

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Bombardier Inc. preferred fell more than others as its credit profile deteriorated as S&P lowered the credit rating to P-5H and the company also discontinued its dividend payment to its common shareholders.

Rate Reset Preferred Shares: This type of preferred share has its dividend reset every 5-years based on a predetermined spread above the 5-year Government of Canada bond yield. So far during 2015, the 5-year Government of Canada bond yield has moved down to 0.70% from 1.34% where it started the year. This move in 5-year yields influenced the rate reset market and prices declined.

Top 10 Best Investment Grade Rate Reset Performers YTD				Top 10 Worst Investment Grade Rate Reset Performers YTD			
Name	Ticker	IG	% Change YTD	Name	Ticker	IG	% Change YTD
TransCanada Corp	TRP.PR.G	IG	0.92%	Husky Energy	HSE.PR.A	IG	-23.84%
Manulife Financial	MFC.PR.H	IG	0.90%	Sun Life Financial	SLF.PR.G	IG	-22.90%
Bank of Nova Scotia	BNS.PR.R	IG	0.69%	Enbridge	ENB.PR.D	IG	-22.73%
Bank of Nova Scotia	BNS.PR.Q	IG	0.63%	Enbridge	ENB.PR.B	IG	-22.62%
Bank of Montreal	BMO.PR.M	IG	0.48%	TransCanada Corp	TRP.PR.C	IG	-21.50%
Toronto-Dominion	TD.PF.E	IG	0.16%	Enbridge	ENB.PR.F	IG	-21.21%
Canadian Imperial Bank of Canada	CM.PR.Q	IG	0.13%	BCE Inc	BCE.PR.M	IG	-20.36%
Royal Bank	RY.PR.J	IG	0.12%	Brookfield Asset Mgmt	BAM.PR.R	IG	-20.10%
Toronto-Dominion	TD.PR.Y	IG	-0.14%	Manulife Financial	MFC.PR.F	IG	-20.00%
Manulife Financial	MFC.PR.I	IG	-0.15%	Enbridge	ENB.PR.P	IG	-19.64%

Top 10 Best Non-Investment Grade Rate Reset Performers YTD				Top 10 Worst Non-Investment Grade Rate Reset Performers YTD			
Name	Ticker	NON	% Change YTD	Name	Ticker	NON	% Change YTD
Atlantic Power	AZP.PR.B	NON	12.72%	AltaGas	ALA.PR.A	NON	-24.79%
Talisman Energy Inc	TLM.PR.A	NON	5.52%	Brookfield Renewable Energy	BRF.PR.A	NON	-24.36%
Veresen	VSN.PR.E	NON	0.83%	GMP Capital Inc	GMP.PR.B	NON	-23.73%
Laurentian Bank	LB.PR.F	NON	0.43%	Canaccord Financial	CF.PR.A	NON	-23.04%
Birchcliff Energy	BIR.PR.A	NON	-0.71%	Shaw Communications	SJR.PR.A	NON	-22.96%
Pembina Pipeline	PPL.PR.I	NON	-1.20%	Pembina Pipeline	PPL.PR.A	NON	-22.00%
Equitable Bank	EQB.PR.C	NON	-1.49%	Capital Power Corp	CPX.PR.A	NON	-21.81%
Element Financial	EFN.PR.C	NON	-1.96%	Capstone Infrastructure	CSE.PR.A	NON	-21.54%
Element Financial	EFN.PR.E	NON	-2.05%	Brookfield Property Partners	BPO.PR.P	NON	-20.88%
Element Financial	EFN.PR.A	NON	-2.61%	Brookfield Property Partners	BPO.PR.N	NON	-20.79%

Among the worst performers are those securities which have already reset in 2015 and the dividend has been adjusted or those securities which have an upcoming reset date in the next year. The low interest rate environment has affected near-term rate resets to a greater extent as there is less time available for the base rate (5-year Canada bond yields) to improve from its current level leading to adjusted dividends being lower than the current dividend level.

There are also various Enbridge Inc. (ENB) rate resets listed among the worst performers and rather than only interest rate risk the credit profile of these preferred shares has deteriorated following the dropdown of assets to one of its subsidiaries. S&P has downgraded the preferred shares to P-2L from P-2 and revised the outlook to Stable. DBRS maintained the rating on the preferred shares (Pfd-2L) yet put the securities Under Review with Negative Implications. DBRS also mentioned it “expects a downgrade of all ENB ratings by 1 notch, and a Stable trend, upon completion of the transaction.” The one notch downgrade will put the preferred shares at Pfd-3H (non-investment grade) which has already been partially reflected in the price as the ENB preferred shares are trading inline with other Pfd-3 peers (VSN & PPL). Enbridge Inc. preferred shares will likely continue to be volatile and will also be influenced by peer companies (Veresen Inc. & Pembina Pipelines) coming to the market with new rate reset securities at wider spreads. At this time, it is very likely that Enbridge Inc. will continue to stay a going concern with the ability to pay both its common share and preferred share dividends on a go forward basis.

Outlook for Remainder of 2015

During the summer months, volatility is likely to continue as liquidity dries up and negative sentiment is continued to be felt by forced selling with limited bids. Going forward, any rhetoric from the Bank of Canada with respect to the outlook for the overnight rate will be watched closely and has the potential to impact markets. Although, it is not fully anticipated that the Bank of Canada will reduce the overnight rate in the near term, the upcoming data will continue to provide clarity as to the strength of the Canadian

economy. Should the overnight rate get reduced in Canada, the preferred share market has the potential to fall further, based on the price moves seen in January.

Although there is the potential for price swings to continue in the preferred share market over the near term, having a longer term view is important as longer dated (+2018) rate resets still provide investors with good dividend income and allow time for the underlying base rate (5-year yields) to move higher before the dividend reset date.

With a longer term outlook, it is our expectation that rate reset prices will eventually move higher once we see a rise in underlying benchmark yields and a tightening in credit spreads. If investors see some price appreciation on their preferred share holdings, positive sentiment should return to this asset class as dividend yields are attractive while also offering investors the potential for capital gains. While the recovery may be slow as underlying benchmark yields may remain low the income provided remains attractive.

It is important to understand the features associated with preferred shares and the reasons behind the price moves. Preferred shares are often incorporated into portfolios to provide dividend income, which despite the price drop, these securities are posed to continue to pay investors the dividend income. Contact your ScotiaMcLeod Advisor to discuss the preferred share opportunities and recommendations for your portfolio.

Preferred Shares

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*The supervisors of the Portfolio Advisory Group own securities of the following companies.
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Our risk ranking system provides transparency as to the underlying financial and operational risk of each stock covered. Historical financial results, share price volatility, liquidity of the shares, credit ratings, and analyst forecasts are evaluated in this process. The final ranking also incorporates judgmental, as well as statistical, criteria. Consistency and predictability of earnings, EPS growth, dividends, cash flow from operations, and strength of balance sheet are key factors considered. Scotiabank GBM has a committee responsible for assigning risk rankings for each stock covered.

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Ratings	Risk Rankings
Focus Stock (FS) The stock represents an analyst's best idea(s); stocks in this category are expected to significantly outperform the average 12-month total return of the analyst's coverage universe or an index identified by the analyst that includes, but is not limited to, stocks covered by the analyst.	Low Low financial and operational risk, high predictability of financial results, low stock volatility.
Sector Outperform (SO) The stock is expected to outperform the average 12-month total return of the analyst's coverage universe or an index identified by the analyst that includes, but is not limited to, stocks covered by the analyst.	Medium Moderate financial and operational risk, moderate predictability of financial results, moderate stock volatility.
Sector Perform (SP) The stock is expected to perform approximately in line with the average 12-month total return of the analyst's coverage universe or an index identified by the analyst that includes, but is not limited to, stocks covered by the analyst.	High High financial and/or operational risk, low predictability of financial results, high stock volatility.
Sector Underperform (SU) The stock is expected to underperform the average 12-month total return of the analyst's coverage universe or an index identified by the analyst that includes, but is not limited to, stocks covered by the analyst.	Speculative Exceptionally high financial and/or operational risk, exceptionally low predictability of financial results, exceptionally high stock volatility. For risk-tolerant investors only.
Other Ratings	
Tender – Investors are guided to tender to the terms of the takeover offer.	
Under Review – The rating has been temporarily placed under review, until sufficient information has been received and assessed by the analyst.	