

Canadian Preferred Shares Report

Here We Go Again

In the second quarter of 2015, Canadian preferred shares continued to be under pressure with the benchmark index posting a total return of -3.93%. The pref market is now down 8.60% through the first half of the year. Both equity and bond markets were also negative but did fare better in the second quarter posting total returns of -1.63% and -1.72%, respectively.

The second quarter started well for preferred shares but lost steam as the expectation for another cut to the Canadian interest rate policy became more apparent. As the quarter wore on, weak economic data in Canada, along with increased demand for safer assets amid Greece potentially defaulting, pushed yields lower once again. At the time of writing this commentary, the BoC did what was expected by the slightest of margins, cut the overnight rate to 0.50% from 0.75% on July 15. This additional monetary stimulus is to help return the economy to full capacity and inflation to target. The BoC noted that “Global growth faltered in early 2015, principally in the US and China. Recent indicators suggest a rebound in the US economy in the second half of this year, and growth is expected to be solid through the projection. In contrast, China is slowing amid an ongoing process of rebalancing to a more sustainable growth path. This has pulled down prices of certain commodities that are important to Canada’s exports.” The growth projection for this year was also lowered significantly from its April forecast.

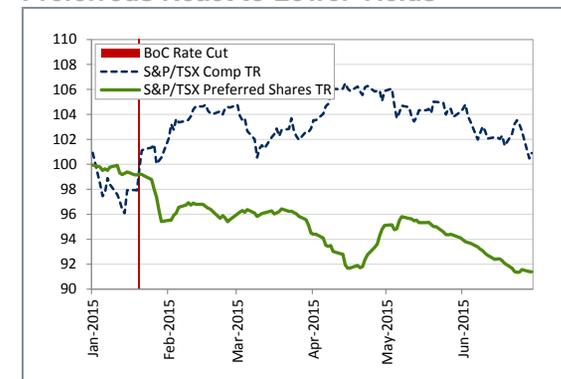
Looking back to the first quarter and what happened after the surprise rate cut on January 21, 2015, we believe that the recent suppression in Canadian sovereign yields have led to another opportunity to pick up some under-valued preferred shares that look to have overreacted to the recent rate cut. Also, with the overnight rate not looking to move higher anytime soon, having a portion of a laddered fixed income portfolio in perpetuals is a prudent way to “get paid to wait” and enhance the portfolio yield while waiting for rates to rise.

Phil Kwon
Fixed Income

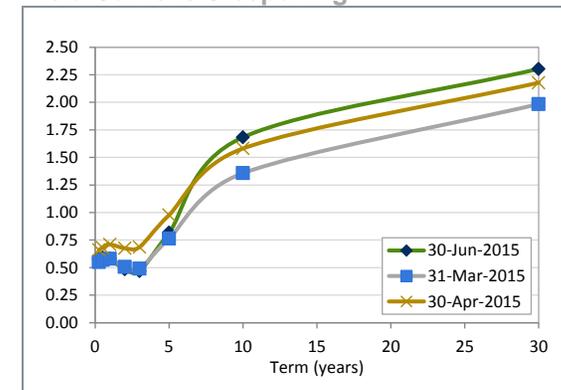
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Preferreds React to Lower Yields



Yield Curve is Steepening



Source: Bloomberg, Raymond James Ltd.

Lessons Learned

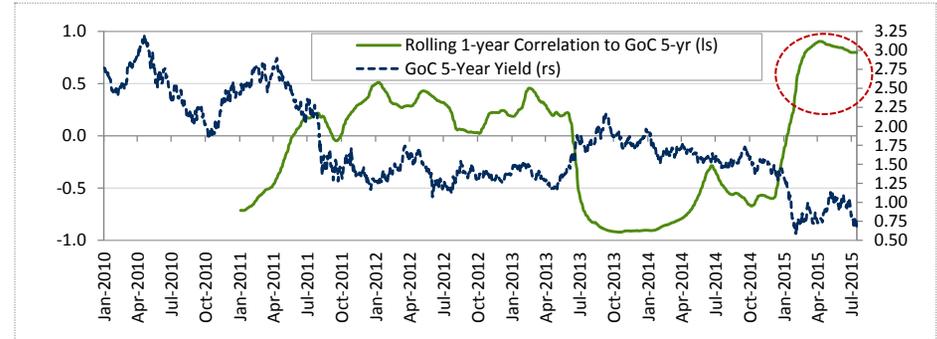
The majority (over 60% by market cap) of the preferred shares market is now made up of fixed-resets. Therefore, the movement of the Canadian Preferred Shares Index is primarily dictated by the action of fixed-resets and not as much by perpetuals (as in the past). As a reminder, below are some of the lessons learned and outlined in the previous quarterly report which showed why fixed-reset prices are positively correlated to Government of Canada (GoC) 5-year yield as opposed to the common misconception that the relationship should be negative.

- **Fixed-Resets Don't Always Mature or Get Called:** Fixed-reset preferred shares are a perpetual fixed income instrument that do not have a set maturity date, but have a call or reset date. These dates may act like a pseudo-maturity date at times, but unlike true maturities, it is not guaranteed. Though the majority of fixed-resets were called last year, we expect redemptions to be less common over the next year. The higher probability of a fixed-reset of being reset and not called are driving prices lower.
- **Fixed-Reset Dividends Can Go Up and Down:** When dividends are lowered, this is normally seen as a negative event. Investors should be reminded that with the majority of fixed-reset preferreds, the dividend being reset lower is not due to the credit quality of the issue, but the structure. A company's goal is to issue at the lowest yield acceptable to investors. When given the choice of resetting to a lower yield compared to the issuing environment the choice is simple. The potential of dividends getting reset lower is driving the prices of fixed-resets lower.

Taking Direction From the GoC 5-Year Yield

The yield of the GoC 5-year bond (the reference rate used to reset a fixed-reset dividend) is nearly back down to a record low once again. This was last seen when the yield breached 0.60% following the surprise BoC rate cut on January 21, 2015. Over the past several months, the preferred shares market, in particular fixed-resets, have been taking direction from the GoC 5-year yield with a correlation of over 80%. Why is this relationship so strong? As the 5-year yield lowers, this increases the likelihood that a fixed-reset will be reset and have its dividend lowered. In turn, selling pressure is added to the preferred, which is especially true when the preferred approaches the reset date. This positive relationship was observed when the 5-year yield shot up from 0.75% to 1.10% at the end of April 2015 - we saw the pref market move in tandem and was up over 4%.

Preferred Shares Correlation to the GoC 5-Year Yield



Source: Bloomberg, Raymond James Ltd.

Preferred Opportunities

Currently, the market is not predicting another rate cut for the BoC, and with the potential for the GoC 5-year yield to rise later this year, we believe that there is an opportunity to pick up some preferred shares (listed below) that are attractively valued.

Issuer	Symbol	DBRS	Price	Div	Reset Date	Call Price	Reset
Altagas Ltd	ALA.PR.E	Pfd-3	\$22.34	\$1.250	31-Dec-2018	\$25	3.17%
Bce Inc	BCE.PR.O	Pfd-3H	\$23.96	\$1.138	31-Mar-2017	\$25	3.09%
Brookfield Asset Man	BAM.PF.A	Pfd-2L	\$22.32	\$1.125	30-Sep-2018	\$25	2.90%
Brookfield Properties	BPO.PR.A	Pfd-3	\$20.05	\$1.188	31-Dec-2019	\$25	3.15%
Brookfield Renew Pow	BRF.PR.C	Pfd-3H	\$20.21	\$1.100	31-Jul-2019	\$25	2.94%
Can Western Bank	CWB.PR.B	Pfd-3	\$22.29	\$1.100	30-Apr-2019	\$25	2.76%
Capital Power Corp	CPX.PR.C	Pfd-3L	\$17.62	\$1.150	31-Dec-2018	\$25	3.23%
Enbridge Inc	ENB.PR.N	Pfd-2L	\$17.84	\$1.000	01-Dec-2018	\$25	2.65%
Fairfax Finl Hldgs Ltd	FFH.PR.K	Pfd-3	\$20.20	\$1.250	31-Mar-2017	\$25	3.51%
Pembina Pipeline	PPL.PR.G	Pfd-3	\$21.00	\$1.125	01-Dec-2019	\$25	2.94%
Riocan REIT	REI.PR.C	Pfd-3H	\$20.00	\$1.175	30-Jun-2017	\$25	3.18%
Veresen Inc	VSN.PR.C	Pfd-3	\$22.13	\$1.250	31-Mar-2019	\$25	3.01%

Source : Bloomberg, Raymond James Ltd. July 17, 2015.

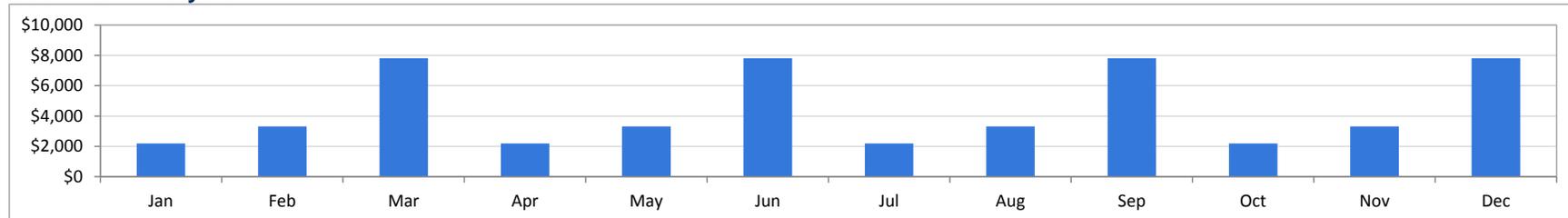
* Reset Spread is 5-Year Government of Canada Yield + rate indicated

Highlights: Sample Portfolio

Issuer	General Information		Rating	Pricing			Dividend		Possible Calls			Shares	Value	Weight
	Series	Symbol	DBRS	Par	Last	Current Yield	Annual	MMMM-DD	Date	Price	YTC			
Fixed Reset														
BROOKFIELD ASSET MAN INC	32	BAM.PF.A	Pfd-2L	\$25.00	\$22.84	4.93%	\$1.13	MJSD-30	30-Sep-2018	\$25.00	7.47	4,500	\$102,780	9.9%
BROOKFIELD PROPERTIES CO	AA	BPO.PR.A	Pfd-3	\$25.00	\$20.36	5.83%	\$1.19	MJSD-31	31-Dec-2019	\$25.00	9.79	4,500	\$91,620	8.8%
FAIRFAX FINL HLDGS LTD	K	FFH.PR.K	Pfd-3	\$25.00	\$19.90	6.28%	\$1.25	MJSD-31	31-Mar-2017	\$25.00	19.41	4,000	\$79,600	7.7%
MANULIFE FINANCIAL CORP	9	MFC.PR.I	Pfd-2H	\$25.00	\$25.10	4.38%	\$1.10	MJSD-19	19-Sep-2017	\$25.00	4.35	4,500	\$112,950	10.9%
POWER FINANCIAL CORP	T	PWF.PR.T	Pfd-1L	\$25.00	\$24.50	4.29%	\$1.05	JAJO-31	31-Jan-2019	\$25.00	4.93	4,500	\$110,250	10.6%
RIOCAN REAL ESTATE INVST	C	REI.PR.C	Pfd-3H	\$25.00	\$21.17	5.55%	\$1.18	MJSD-30	30-Jun-2017	\$25.00	13.37	4,000	\$84,680	8.2%
TORONTO-DOMINION BANK	7	TD.PF.D	Pfd-2	\$25.00	\$24.31	3.70%	\$0.90	JAJO-31	31-Jul-2020	\$25.00	4.04	4,500	\$109,395	10.6%
Perpetuals														
BANK OF MONTREAL	15	BMO.PR.L	Pfd-2H	\$25.00	\$25.87	5.60%	\$1.45	FMAN-25	25-May-2017	\$25.00	4.35	4,500	\$116,415	11.2%
NATIONAL BANK OF CANADA	20	NA.PR.M	Pfd-2	\$25.00	\$25.52	5.88%	\$1.50	FMAN-15	15-May-2017	\$25.00	28.13	4,500	\$114,840	11.1%
POWER FINANCIAL CORP	R	PWF.PR.R	Pfd-1L	\$25.00	\$25.33	5.43%	\$1.38	MJSD-1	30-Apr-2021	\$25.00	5.11	4,500	\$113,985	11.0%
TOTAL												\$1,036,515		

Issuer	General Information		Quarterly	Annual	Notes
	Series	Symbol	Income	Income	
Fixed Reset					
BROOKFIELD ASSET MAN INC	32	BAM.PF.A	\$1,266	\$5,063	Reset to GoC 5-Year Yield + 2.37%. Next reset date is September 30, 2018.
BROOKFIELD PROPERTIES CO	AA	BPO.PR.A	\$1,336	\$5,344	Reset to GoC 5-Year Yield + 2.79%. Next reset date is December 17, 2019.
FAIRFAX FINL HLDGS LTD	K	FFH.PR.K	\$1,250	\$5,000	Reset to GoC 5-Year Yield + 2.86%. Next reset date is March 31, 2017.
MANULIFE FINANCIAL CORP	9	MFC.PR.I	\$1,238	\$4,950	Reset to GoC 5-Year Yield + 2.90%. Next reset date is September 19, 2017.
POWER FINANCIAL CORP	T	PWF.PR.T	\$1,181	\$4,725	Reset to GoC 5-Year Yield + 2.66%. Next reset date is January 31, 2019.
RIOCAN REAL ESTATE INVST	C	REI.PR.C	\$1,175	\$4,700	Reset to GoC 5-Year Yield + 3.15%. Next reset date is June 30, 2017.
TORONTO-DOMINION BANK	7	TD.PF.D	\$1,013	\$4,050	Reset to GoC 5-Year Yield + 3.51%. Next reset date is July 31, 2020.
Perpetuals					
BANK OF MONTREAL	15	BMO.PR.L	\$1,631	\$6,525	Next par call date is May 25, 2017 at \$25.
NATIONAL BANK OF CANADA	20	NA.PR.M	\$1,688	\$6,750	Next par call date is May 15, 2017 at \$25.
POWER FINANCIAL CORP	R	PWF.PR.R	\$1,547	\$6,188	Next par call date is April 30, 2021 at \$25.
TOTAL			\$13,323	\$53,294	

Cash Flow Analysis



Source: Bloomberg, Raymond James Ltd., Prices as at July 20, 2015. Settlement date July 23, 2015.

Most Actively Traded

Trading volume data as at July 17, 2015. 30-Day = Average volume over past 30 days. 5-Day = Average volume over past 5 days

Floating-Rate

Issuer	Series	Symbol	30-Day	5-Day
BOMBARDIER INC	B	BBD.PR.B	13,550	32,499
BCE INC	AJ	BCE.PR.J	12,131	2,537
BANK OF MONTREAL	17	BMO.PR.R	11,777	482
BANK OF NOVA SCOTIA	21	BNS.PR.B	11,681	17,952
BANK OF NOVA SCOTIA	23	BNS.PR.C	9,600	44,668
BANK OF NOVA SCOTIA	19	BNS.PR.A	9,462	2,094
TORONTO-DOMINION BANK	T	TD.PR.T	8,806	5,061
BCE INC	AD	BCE.PR.D	8,683	5,083
BCE INC	AE	BCE.PR.E	7,930	5,950
BROOKFIELD ASSET MAN INC	2	BAM.PR.B	7,903	7,899

Retractable

Issuer	Series	Symbol	30-Day	5-Day
LOBLAW COS LTD	A	L.PR.A	9,554	1,167
BROOKFIELD OFFICE PROP	J	BPO.PR.J	8,003	13,560
DUNDEE CORP	4	DC.PR.C	6,179	4,202
BROOKFIELD OFFICE PROP	H	BPO.PR.H	5,243	20,230
NOVA SCOTIA POWER INC	D	NSI.PR.D	4,548	771
BIRCHCLIFF ENERGY LTD	C	BIR.PR.C	2,882	554
BROOKFIELD OFFICE PROP	K	BPO.PR.K	1,683	957
CANADIAN GENL INVESTMENT	4	CGI.PR.D	836	625
FORTIS INC	E	FTS.PR.E	778	365
BROOKFIELD INVESTMENTS	A	BRN.PR.A	497	100
CANADIAN GENL INVESTMENT	3	CGI.PR.C	437	130

Perpetual

Issuer	Series	Symbol	30-Day	5-Day
BANK OF NOVA SCOTIA	15	BNS.PR.M	23,120	24,464
BANK OF NOVA SCOTIA	14	BNS.PR.L	18,273	4,923
GREAT-WEST LIFECO INC	F	GWO.PR.F	16,824	864
ROYAL BANK OF CANADA	AA	RY.PR.A	16,676	18,273
POWER FINANCIAL CORP	L	PWF.PR.L	14,182	12,418
BROOKFIELD ASSET MAN INC	36	BAM.PF.C	10,353	17,192
MANULIFE FINANCIAL	2	MFC.PR.B	10,034	14,444
BANK OF MONTREAL	15	BMO.PR.L	9,936	4,079
ROYAL BANK OF CANADA	AB	RY.PR.B	8,613	6,846
CANADIAN UTILITIES LTD	CC	CU.PR.F	8,382	5,085

Fixed-Reset

Issuer	Series	Symbol	30-Day	5-Day
BCE INC	AI	BCE.PR.I	33,453	7,600
ENBRIDGE INC	D	ENB.PR.D	29,495	19,446
SHAW COMMUNICATIONS INC	A	SJR.PR.A	26,772	12,132
BCE INC	AK	BCE.PR.K	26,223	42,685
BANK OF NOVA SCOTIA	32	BNS.PR.Z	25,375	31,266
ENBRIDGE INC	R	ENB.PR.T	25,295	11,795
ENBRIDGE INC	F	ENB.PR.F	24,463	17,551
BANK OF MONTREAL	27	BMO.PR.S	23,708	19,975
ENBRIDGE INC	11	ENB.PF.C	23,381	13,627
ENBRIDGE INC	B	ENB.PR.B	22,886	58,948

Credit Rating Changes

DBRS Ratings Changes

Company Name	Date	Rating Type	Curr Rtg	Last Rtg
Emera Inc	11-Mar-2015	Preferred Stock	Pfd-3H	Pfd-3H *
Brompton Oil Split Corp	24-Feb-2015	Preferred Stock	Pfd-3H	
Big Bank Big Oil Split Corp	06-Feb-2015	Preferred Stock	Pfd-2L *-	Pfd-2L

Source: Bloomberg, WR = Withdrawn Rating, NR = No rating has been requested.

New Issues

AIMIA, Series 2

- **Symbol:** AIM.PR.B
- **Type:** Floating, Cumulative
- **Issue:** \$25.00 | 2.9 million shares | March 31, 2015
- **Rating:** Pfd-3L (DBRS)
- **Dividend:** MJSD-31
- **Notes:** Coupon resets every quarter @+3.75% over 3-Month Government of Canada bond yield.

Bank of Montreal, Series 33

- **Symbol:** BMO.PR.Y
- **Type:** Fixed-Reset, Non-Cumulative
- **Issue:** \$25.00 | 8.0 million shares | June 5, 2015
- **Rating:** Pfd-2 (DBRS)
- **Dividend:** \$0.95 | FMAN-24
- **Notes:** Coupon is 3.80% until Aug 25, 2020, thereafter resets every 5 years @+2.71% over 5-year Government of Canada bond yield.

Bank of Nova Scotia, Series 31

- **Symbol:** BNS.PR.D
- **Type:** Floating, Non-Cumulative
- **Issue:** \$25.00 | 4.5 million shares | April 26, 2015
- **Rating:** NR (DBRS)
- **Dividend:** JAJ0-26
- **Notes:** Coupon resets every quarter @+1.00% over 3-Month Government of Canada bond yield.

Brookfield Renewable Power, Series 2

- **Symbol:** BRF.PR.B
- **Type:** Floating, Cumulative
- **Issue:** \$25.00 | 4.5 million shares | May 1, 2015
- **Rating:** Pfd-3H (DBRS)
- **Dividend:** JAJ0-31
- **Notes:** Coupon resets every quarter @+2.62% over 3-Month Government of Canada bond yield.

Element Financial, Series G

- **Symbol:** EFN.PR.G
- **Type:** Fixed-Reset, Cumulative
- **Issue:** \$25.00 | 6.9 million shares | May 29, 2015
- **Rating:** NR (DBRS)
- **Dividend:** \$1.63 | MJSD-31
- **Notes:** Coupon is 6.50% until Sept 30, 2020, thereafter resets every 5 years @+5.34% over 5-year Government of Canada bond yield.

Fairfax Financial Holdings, Series F

- **Symbol:** FFH.PR.F
- **Type:** Floating, Cumulative
- **Issue:** \$25.00 | 3.5 million shares | March 31, 2015
- **Rating:** Pfd-3 (DBRS)
- **Dividend:** MJSD-31
- **Notes:** Coupon resets every quarter @+3.15% over 3-Month Government of Canada bond yield.

Fortis, Series I

- **Symbol:** FTS.PR.I
- **Type:** Floating, Cumulative
- **Issue:** \$25.00 | 3.0 million shares | June 2, 2015
- **Rating:** Pfd-2L (DBRS)
- **Dividend:** MJSD-1
- **Notes:** Coupon resets every quarter @+1.45% over 3-Month Government of Canada bond yield.

Husky Energy, Series 7

- **Symbol:** HSE.PR.G
- **Type:** Fixed-Reset, Cumulative
- **Issue:** \$25.00 | 6.0 million shares | June 17, 2015
- **Rating:** Pfd-2L (DBRS)
- **Dividend:** \$1.15 | MJSD-31
- **Notes:** Coupon is 4.60% until June 30, 2020, thereafter resets every 5 years @+3.52% over 5-year Government of Canada bond yield.

Loblaw Cos, Series B

- **Symbol:** L.PR.B
- **Type:** Perpetual, Cumulative
- **Issue:** \$25.00 | 9.0 million shares | June 9, 2015
- **Rating:** Pfd-3 (DBRS)
- **Dividend:** \$1.33 | MJSD-31
- **Notes:** Coupon is 5.00%. Par call on June 30, 2024 at \$25.

Pembina Pipeline, Series 9

- **Symbol:** PPL.PR.I
- **Type:** Fixed-Reset, Cumulative
- **Issue:** \$25.00 | 9.0 million shares | April 10, 2015
- **Rating:** Pfd-3 (DBRS)
- **Dividend:** \$1.19 | MJSD-1
- **Notes:** Coupon is 4.60% until Dec 1, 2020, thereafter resets every 5 years @+3.91% over 5-year Government of Canada bond yield.

Royal Bank of Canada, Series BH

- **Symbol:** RY.PR.N
- **Type:** Perpetual, Non-Cumulative
- **Issue:** \$25.00 | 6.0 million shares | June 5, 2015
- **Rating:** Pfd-2 (DBRS)
- **Dividend:** \$1.23 | FMAN-24
- **Notes:** Coupon is 4.90%. Par call on Nov 24, 2024 at \$25.

Sun Life Financial, Series J

- **Symbol:** SLF.PR.J
- **Type:** Floating, Non-Cumulative
- **Issue:** \$25.00 | 6.0 million shares | June 30, 2015
- **Rating:** Pfd-2H (DBRS)
- **Dividend:** MJSD-31
- **Notes:** Coupon resets every quarter @+1.41% over 3-Month Government of Canada bond yield.

TD Bank, Series 9

- **Symbol:** TD.PF.E
- **Type:** Fixed-Reset, Non-Cumulative
- **Issue:** \$25.00 | 8.0 million shares | April 25, 2015
- **Rating:** Pfd-2 (DBRS)
- **Dividend:** \$0.93 | JAJ0-31
- **Notes:** Coupon is 3.70% until Oct 31, 2020, thereafter resets every 5 years @+2.87% over 5-year Government of Canada bond yield.

TransCanada, Series H

- **Symbol:** TRP.PR.H
- **Type:** Floating, Cumulative
- **Issue:** \$25.00 | 5.5 million shares | June 30, 2015
- **Rating:** NR (DBRS)
- **Dividend:** MJSD-1
- **Notes:** Coupon resets every quarter @+1.28% over 3-Month Government of Canada bond yield.

Veresen, Series 9

- **Symbol:** VSN.PR.E
- **Type:** Fixed-Reset, Cumulative
- **Issue:** \$25.00 | 8.0 million shares | April 1, 2015
- **Rating:** Pfd-3 (DBRS)
- **Dividend:** \$1.25 | JAJ0-31
- **Notes:** Coupon is 5.00% until June 30, 2020, thereafter resets every 5 years @+4.27% over 5-year Government of Canada bond yield.

Appendix A: Yield Tables

Yields tables are included as a separate report/attachment, and are also available on a daily basis from the Fixed Income Group of Raymond James Ltd.

Appendix B: Credit Ratings Comparisons

DBRS	S&P	S&P Global	Description
Pfd-1 (high)	P-1 (high)	AA	Superior: High quality with minimal credit risk. Such a rating is back by strong earnings and balance sheet.
Pfd-1	P-1	AA-	
Pfd-1	P-1	A+	
Pfd-1 (low)	P-1 (low)	A	
Pfd-1 (low)	P-1 (low)	A-	
Pfd-2 (high)	P-2 (high)	BBB+	Satisfactory: Upper-medium grade and comes with moderate credit risk. There is substantial protection of dividend and principal.
Pfd-2	P-2	BBB	
Pfd-2 (low)	P-2 (low)	BBB-	
Investment Grade Cut-Off			
Pfd-3 (high)	P-3 (high)	BB+	Adequate: Medium grade and comes with moderate credit risk. There may be speculative characteristics.
Pfd-3	P-3	BB	
Pfd-3 (low)	P-3 (low)	BB-	
Pfd-4 (high)	P-4 (high)	B+	Speculative: substantial credit risk, and are speculative in nature. The protection of dividend and principal is uncertain, but especially so during times of economic adversity.
Pfd-4	P-4	B	
Pfd-4 (low)	P-4 (low)	B-	
Pfd-5 (high)	P-5 (high)	CCC+	Highly Speculative: Very high credit risk due to chance of default. The protection of dividend and principal is uncertain.
Pfd-5	P-5	CCC	
Pfd-5 (low)	P-5 (low)	CCC-	
Pfd-5 (low)	CC	CC	
Pfd-5 (low)	C	C+	
Pfd-5 (low)	C	C	
Pfd-5 (low)	C	C-	
D	D	D	In Arrears: The lowest rated class. Low prospect for recovery of principal and interest.

Appendix C: Education and Glossary

What are Preferred Shares?

Preferred shares are equity securities that provide investors a fixed dividend which must be paid out before common share dividends are paid. Preferred shares have characteristics of both equity and debt instruments. The fixed dividend is stated by a coupon rate and is commonly paid out quarterly. In the event of a dissolution or liquidation of the issuer, preferred shareholders' claims on assets are senior to common shareholders but behind debt holders.

Preferred vs Common

- Like most common shares, these are equity instruments which pay dividends
- Potential for price appreciation but price is less volatile than common shares
- Not able to participate in the upside profits from ownership of the company and usually have no voting rights unlike common shares

Preferreds vs Debt Securities

- React similarly to interest rates as bond instruments
- Many preferred shares are issued at a fixed par value
- Rated by the major credit rating agencies
- Redeemable for a set amount at the end of a fixed term
- Typically pay a fixed dividend

What are the Benefits?

- **Favourable tax treatment:** Better after-tax return for preferred share distributions from Canadian corporations; preferred dividends are less heavily taxed due to the dividend tax credit compared to interest which is fully taxable as income under Canadian federal and provincial legislation.
- **Higher yield than other fixed income products:** Preferreds tend to have higher yields than other fixed income products such as bonds since distributions are less assured. Yields are not guaranteed but many major public companies will meet preferred share obligations even in times of losses. However, some issuers have the right to defer (or suspend) payment of dividends upon financial hardship.
- **Price stability compared to common shares:** Less volatility in price of preferreds.

- **Addresses reinvestment risk:** available in longer terms unlike money market products such as GICs

What are the Drawbacks?

- **Interest Rate Risk:** Many preferreds pay a fixed rate distribution similar to fixed income securities; there is an inverse relationship between changes in interest rates and the price of the preferred shares. Price sensitivity of the preferreds is greater for longer terms and for lower coupon rates. Preferreds are less price sensitive to interest rate fluctuations than bonds.
- **Call Risk:** Callable preferreds tend to have higher yield to maturities given the call risk. However, the call risk is a disadvantage to the investor for the following reasons: future dividend income stream is uncertain, reinvestment risk for the investor since the issuer often exercises the call provision when interest rates have fallen in order to refinance at lower rates. Callable issues are unlikely to appreciate in price when interest rates fall and possibly decline below the call price given a significant rise in rates.
- **Credit Risk:** Independent agencies such as the Dominion Bond Rating Service (DBRS), and Standard & Poor's (S&P), assess an issuer's ability to fulfill its obligations and assign a credit rating. A decline in credit quality can negatively impact the price of preferreds and the dividend policy of the issuer.
- **Liquidity Risk:** Preferreds often have light trading volumes, i.e. "thin" markets. This lack of liquidity can cause exaggerated swings in price when buy or sell volumes pick up from normal levels.

What to Look for in Buying Preferreds?

- **Credit Quality:** Higher quality preferreds provide higher assurance of a dependable income stream. The price of preferred shares is likely to erode much more upon the issuer facing financial difficulty than from a shift in rates. High credit quality preferreds are rated P1 and P2 by DBRS.
- **Yield to Call/Redemption:** This is the yield shown to a call date or reset date.
- **Liquidity:** - Certain issuers are more easily purchased or sold on the market due to higher liquidity. The size of the initial preferred offering can influence liquidity. In general, the larger the issuance size, the better the liquidity.
- **Diversification:** Selecting preferreds in different industries and with different features can help provide balance and flexibility to an investor.

Types of Preferred Shares

Preferreds can be structured in a variety of ways based on a combination of features related to the 1) term or maturity (fixed or no maturity date), 2) payment provision (fixed or floating rate), 3) dividend policy (cumulative or non-cumulative), and 4) other unique qualities. It is easy to see that there can be a number of different combinations of the different features for preferred shares which give the holder/issuer different rights. Therefore, prior to investing in preferred shares, it is important to understand the specific features of the particular preferred share issuance. The following is a description of the different types of preferred shares.

1. Term to Maturity

- Perpetual/straight preferreds have no fixed maturity date, the stated dividend rate is paid in perpetuity. Although the issuer does have redemption rights.
- (Hard) Retractable/term preferreds have a set maturity date at the time of issue, the investor would get back his capital investment at the end of the specified period.
- Soft Retractable preferreds pay out the retraction amount either as cash or an equivalent amount in common shares of the issuer, at the option of the issuer. Typically, the stock price used to calculate the number of common shares is 95% of the average price of the common shares in a time period before the retraction occurs.

2. Payment Provision

- Fixed Rate preferreds have a fixed dividend at issue date, can be a fixed dollar value of a stated percentage of par value, normally paid quarterly
- Floating Rate preferreds offer a floating dividend tied to a benchmark, typically as a percentage of the bank prime rate
- Resettables pay a fixed dividend rate for a specified period, usually for five years after their date of issue. On and after that date and on every fifth anniversary, if the issue is not redeemed by the issuer, the holder has the option to either receive a floating-rate dividend, or exchange the series for a further series of a fixed-rate preferred.

3. Dividend Policy

- Cumulative means any missed dividends are accumulated and paid in full before common dividends are paid or preferred shares are redeemed.
- Non-cumulative means dividends are paid only when declared and to do not accumulate if missed. The trend in the marketplace has been issuances with non-cumulative preferred shares.

4. Other Features

- Convertible preferreds allow the holder to convert the preferreds into common shares based on a specified conversion formula, there are not many of these in the market nowadays.
- Redeemable or Callable features allow the issuer to reserve the right to redeem or “buy back” shares at a predetermined price after a specific date. A small premium above the par value per share is often paid as compensation to the investor when the shares are called. Non-callables, which are rare, cannot be called or redeemed as long as the issuing company is in existence.

There are a couple of other types of preferred shares which have characteristics which are quite different from conventional preferred shares and are described below.

- Deferred Preferred Shares are non-dividend-paying preferred shares, similar to strip bonds, the shares are redeemed at a set par value on a set date in the future. However, unlike strip bonds, the accrued dividends (the dividend premium) on a deferred preferred share are not subject to yearly tax. When the holder is an individual, such dividends do not qualify for the gross-up and dividend tax credit rules normally applicable to dividends received by individuals from taxable Canadian corporations. If the preferred is held to redemption, the accrued dividends are fully taxable as interest income.
- Synthetic Preferreds (Split Shares, Structured, Equity Dividend Shares) are preferreds where holders give up the right to all capital gains to common shareholders while receiving all the dividends on the common shares. The maturity values of such structured shares are dependent upon the value of the underlying common. Another feature of many Split Shares is a possible early redemption date.

Tax Consequences

For tax purposes, there is usually a disposition when preferred shares are redeemed or called. Here is a list of tax related terminology related to such an event.

- **Deemed Dividend:** The difference between the redemption price and the shares' paid up capital
- **Deemed Proceeds of Disposition:** The deemed dividend deducted from the redemption price
- **Adjusted Cost Base (ACB):** This is generally the purchase price plus sales commissions
- **Capital Gain/Loss on the Disposition:** The amount the deemed proceeds of disposition exceeds (or is less than) the adjusted cost base

The table below provides a few illustrative examples of the tax consequences upon redemption of preferred shares.

Tax Consequences

Redemption	Tax Consequence
Redemption Price Equals Paid-up Capital	<ul style="list-style-type: none"> ▪ No deemed dividend ▪ Deemed proceeds of disposition is the paid-up capital
Redemption When Paid-Up Capital Is Less Than Par	<ul style="list-style-type: none"> ▪ Can result in a significant deemed dividend ▪ Deemed proceeds of disposition well below par resulting in the realization of a significant capital loss on the redemption
Purchase price above par value & Redemption at Par	<ul style="list-style-type: none"> ▪ Capital loss, can offset any capital gains realized in calendar year of redemption or carry back 3 yrs or carried forward indefinitely
Redemption Price Above Par	<ul style="list-style-type: none"> ▪ Paid-up capital rarely greater than par, thus, this results in deemed dividend ▪ Deemed proceeds of disposition is the paid-up capital

Please note that the tax implications in the examples are for illustrative purposes only, and should not be considered an interpretation of the Income Tax Act; nor do they purport to constitute specific tax advice. Clients should seek independent advice on tax-related matters from qualified professionals licensed to practice in that area.

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