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Preferred Shares: A Primer

Investors who are searching for higher after-tax income with acceptable risk may have been examining the merits of preferred shares. Given today's low interest rate environment, they have become a potential alternative to bonds and other fixed-income vehicles.

Preferred shares are considered as "hybrid" securities because they have both equity and fixed income characteristics. Like equities, preferred shares represent an ownership interest in a corporation and generally do not have a maturity date. Like bonds, preferred shares generally carry no voting rights, have a par value and often pay a fixed distribution rate that is determined at issuance.

Here are some of their advantages:

- **Tax Advantage.** Preferred shares pay dividends which are treated favourably from a tax perspective relative to other forms of income. Dividends enjoy the benefit of the dividend tax credit if the issuing company is a qualifying taxable Canadian corporation. The tax advantage can be significant. As an example, an investor in a tax bracket that has a 46.41% tax on interest income and 29.54% on dividend income would retain $70.46 from $100.00 in dividends, but only $53.59 from interest income. Therefore, that investor would need approximately $1.31 ($70.46/$53.59) of interest income to equal $1.00 of dividend income before taxes are paid.

- **Preferred Ranking.** Preferred shares rank ahead of common shares (but behind bond holders) in the unlikely event that the issuer is liquidated. Preferred share dividends are usually also cumulative, meaning preferred shareholders must be paid any dividends in arrears before common share dividends are paid.

- **Wide Choice.** Many of Canada's most recognized corporations have issued preferred shares. Usually, the shares are also listed on major stock exchanges, meaning buying or selling these securities at any time is a relatively simple matter.

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What about disadvantages?

If interest rates rise, the value of preferreds may decline, just as with bonds. As well, preferred share owners do not usually participate in the growth of a company, which will normally be reflected in the price of the common shares.

Many Kinds of Preferreds

Preferred shares can come with various important features. Some of the major categories are as follows:

- Straight Preferreds usually have no maturity date and are callable by the issuer only after a certain date.
- Redeemable Preferreds can be ‘redeemed’ by the issuing company according to a preset price and time schedule. For example, during periods of lower interest rates, previously issued redeemables may be called, to be replaced in the corporate capital structure by lower cost issues.
- Retractable Preferreds can be ‘retracted’ by the holder according to a predetermined time and price schedule.
- Floating-Rate Preferreds carry dividends that fluctuate, say in reference to the prevailing prime rate. These securities are often popular during periods of interest rate uncertainty.
- Convertible Preferreds are hybrid securities that may offer a fixed dividend rate, but which can be converted to common shares according to a predetermined schedule.
- Rate Reset Preferreds are a newer type of preferred share introduced around 2008 when interest rates were falling (but were expected to rise). Reset preferreds have dividend rates that are fixed for an initial term (usually five years) but are reset to new rates once the term is over. Terms differ depending on the issuer, but usually at the end of a term the holder can convert their holdings to other fixed rate preferred shares or floating rate preferred shares.

What to Watch For

Investors attracted to this asset class need to consider many factors when making a purchase decision. An attractive yield is only the starting point. Indeed, it should be kept in mind that preferreds from the strongest companies will offer lower yields, all other factors being equal. It is important, therefore, to carefully consider the quality of issuer. The work of rating agencies should be consulted in this regard.

The call terms must also be carefully considered. It will do no good to buy an issue at a premium, only to see it called by the company immediately at a lower price.

As part of our service to clients, we maintain in-depth research facilities on preferred shares and can recommend issues that will be suitable to any investor’s requirements.