Understanding Preferred Shares

Although most investors are familiar with common shares, publicly traded securities that represent ownership in a company, they may not be as familiar with preferred shares ("preferreds").

A preferred share is a hybrid security that offers both stock and bond-like features; it provides fixed payments (like a bond) in the form of dividends, but has a share price (like a stock) that has the opportunity to rise or fall. This is why a preferred share is often considered or referred to as a "bond without a maturity date."

In a company's capital structure, preferred shares rank above common shares and just behind unsecured debt, which means in the event of an issuer's bankruptcy, preferred shareholders would have a greater claim on assets than common shareholders, but a lesser claim than bond holders. Like other fixed-income securities, preferred shares are also subject to credit risk, with independent credit rating agencies assigning various levels of credit risk to issuers.

Types of Preferred Shares

Preferred shares can be structured in many ways to offer different benefits and features. Below are the four types of preferred shares:

1. Perpetual Preferreds: This type of preferred share has no maturity date and pays a fixed dividend upon issue, usually declared and paid quarterly, as long as it remains outstanding. Shareholders of perpetuals do not have voting rights and the issuers of perpetual preferred stock can typically redeem the shares.

If a perpetual preferred share is retractable, this means that the issuer can retract, or call back, the shares and decide to provide the shareholder with the issue's value at par, payable in cash or the equivalent value in common stock. Par value refers to the predetermined face value for the redemption at the time of the original issue.

2. Floating Rate Preferreds: Sometimes referred to as a "variable rate" preferred share, this type of issue pays dividends quarterly or monthly with a rate that fluctuates, or "floats", with a market interest rate such as a major bank's prime rate. These types of preferreds also set a minimum dividend or "floor." These issues typically have a set term and par value, which is repayable in cash at maturity.

If the floating rate preferred share is retractable, this means the issuer can recall the issue at any time prior to maturity in exchange for cash or equal value of the common stock. Some floating rate preferred shares can also be perpetual with no set term.

3. Convertible Preferreds: Similar to a convertible bond, a convertible preferred gives the investor the option to convert his or her holdings into some other class of shares at a fixed price on a specified date or within a specified period. Normally, the option allows for converting preferreds into the issuer's common shares.

An investor generally pays a premium for this type of option due to the conversion terms influencing a convertible preferred's share price, which is why a convertible preferred share will be typically priced somewhat higher than an equivalent fixed perpetual.

4. Rate-Reset Preferreds: A rate-reset preferred share offers a fixed dividend payment where the rate of that payment is reset upon a specific date, typically every five years. Generally, the rate will be a pre-determined spread above a government bond with a similar term. In Canada this is usually a five-year Government of Canada bond.

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Once a rate-reset issue comes to term, the shareholder will generally have two options — hold for a new five-year fixed rate period or convert the shares to a floating rate security.

Currently, rate-resets are by far the most popular investment structure in the Canadian preferred share market, accounting for more than 60% of all available preferred shares listed in Canada.

Preferred Share Price Fluctuations

A number of factors can influence the future price fluctuations of a preferred share issue —supply and demand, underlying interest rates and the credit quality of the issuer. Since preferred shares can sometimes be treated as a liability on an issuer's balance sheet, interest rates can have the largest influence on rate reset and floating rate issues. Since the payments of rate reset preferred and floating rate preferred are issued based on an underlying benchmark interest rate, it is likely that when the benchmark interest rate declines, so do the dividends offered by these issues.

Conversely, perpetual preferred shares have an inverse-relationship with interest rates, and all other things being equal, will likely see their market value increase during a period of decline and a drop during a rise in interest rates.

When buying a preferred share ETF, it is important to look at the composition of the underlying portfolio to determine what type of preferred structure bias the ETF has. For example, an ETF that is comprised entirely of rate-reset preferred shares would be expected to underperform in a declining interest rate environment, but outperform in a rising interest rate environment versus the larger preferred share market.

Advantages of Preferred Shares

- **Diversification.** Preferred shares have, historically, had a low correlation to equities and bonds, providing important diversification to an investor's portfolio
- **Increased security.** Ahead of common shares in the hierarchy of corporate ownership, preferred shares have a greater claim on assets in the event of an issuer's bankruptcy, just behind unsecured debt holders
- **Fixed or predefined dividend payments.** Due to the terms defined preferred share agreements, companies are less likely to miss a dividend payment compared to that of a common shareholder
- **Greater tax-efficiency.** Preferred shares payout dividend income, which is taxed more favourably than the interest income received from fixed income securities
- **Lower volatility.** Preferred shares tend to trade at their par value during normal market conditions; as a result, they are less volatile than common shares, but provide a more attractive risk/return profile compared to other fixed income securities

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