Question
SERVING WHISTLER AND PEMBERTON

YOUR MONEY

FEBRUARY 19, 2009

Kim Inglis, BCom

A Closer Look at Preferred Shares

The preferred share is the Duck Billed Platypus of investing – sharing characteristics of two entities without being either. As most of our big banks have been releasing new preferred share issues, a closer look might be timely.

When you purchase a company's *common share* you have ownership in the company and you *may* receive dividends, depending what the company declares. You usually have voting rights. If the company flourishes and is evaluated higher, you will experience increased wealth with increased share value.

When you purchase a company's *bond* you don't have ownership but you *will* receive interest or coupon payments, no matter what the company declares. That is where your rights end. You're loaning money to the company and the bond is an IOU with the company paying interest.

A preferred share is a hybrid of both. It resembles a common share because it is traded and has other equity characteristics. You may have limited voting rights. The share will not increase in value as a result of the company flourishing (unless it is a participating preferred share such as a convertible).

The preferred share also resembles a bond because it pays a fixed yield. As well, there is interest rate risk meaning that if interest rates go up, share value goes down and vice versa. The risk increases with a longer time to maturity.

One advantage of preferred shares is preference over common shares regarding dividend payments or distribution of liquidation assets. However the most important benefit of preferred shares may be that the income is taxed at a much lower rate than bonds or other fixed income securities.

This also dictates where the preferred share should fit into your portfolio. It is not for your RRSP or your RESP as the tax rate advantage would be lost in a registered plan. These shares belong in a non-registered portfolio.

There is a wide range of preferred share offerings with a mind-numbing array of options so you must do your homework. Here are a few things to watch for:

Preferred shares are rated by credit agencies with Pfd-1 the safest and Pfd-5 the riskiest. Since you are subjected to the credit risk of the issuer, their credit quality is important to you. Be wary if a preferred share offers a high dividend but the credit rating is low.

Cumulative or non-cumulative? If you purchase a non-cumulative preferred share and the company board suspends dividends for a year, you won't get your dividend and the company has no obligation to pay it later. With a cumulative share, unpaid dividends are carried over and paid in arrears.

Is there a fixed maturity date? Issuers have been moving away from term preferred shares with finite maturity dates to perpetual preferred shares without maturity dates. With these a company could choose not to pay back the money you loaned them, instead keeping it forever, only paying dividends according to the first agreed issue.

A redemption clause allows the issuer to buy back your shares at their option with prices and redemption periods defined in the prospectus. While there will be a minimum period to prevent exploitation, the clause is something you have to be comfortable with.

I have only touched the surface on preferred shares. There are many complicated aspects to them and, if you think they may have a place in the fixed income part of your portfolio, it is a good idea to talk to your advisor.

Kim Inglis, BCom, CIM is an Investment Advisor. The views in this column are solely those of the author. www.kiminglis.ca