Preferred Share ETFs: The Potential Pitfalls of Indexing

"Most preferred shares should continue to provide an attractive mix of tax-efficient income and strong price returns in 2018," according to Nicolas Normandeau, Vice-President and Portfolio Manager, Fixed Income with Fiera Capital Corporation ("Fiera Capital") and the lead manager on the Horizons Active Preferred Share ETF (HPR).

However, this is not currently the case for one sub-set of preferred share ETFs: rate-reset preferred shares, which are presently trading at a premium (i.e. a price higher than the issue price). There is limited value in owning preferred shares that trade at a premium at this point in time, beyond purely speculating on the possibility that they will continue to rise over the short term. Intuitively, investors who actively select preferred shares tend to avoid these issues because they often have a built-in loss, particularly if they have a call feature that would allow the issuer to call them in at a discount to their market value.

The recent rally in rate-reset preferred shares (which was largely ignited by a rise in the five-year government of Canada rates – the baseline yield for rate-reset preferred shares) does not appear to have been fully realized by index strategies such as the BMO Laddered Preferred Share ETF (ZPR). ZPR is 100% invested in rate-reset preferred shares versus approximately 70% for HPR. Given the rally in interest rates, you would expect that ZPR would have outperformed HPR year-to-date for the period ending November 25, 2017.

However, that is not the case.

Despite having a much lower allocation to rate-reset preferred shares, HPR has handily outperformed ZPR year-to-date (see the performance chart below) primarily due to one key advantage – security selection – more specifically, avoiding rate-reset preferred shares that trade at a premium. ZPR is obligated to own these issues based on its reference index, but HPR can avoid them and, as a result, ZPR missed a good portion of the rally in the very product class to which it offers precise exposure. The performance differentiation is even more pronounced with the Horizons Active Floating Rate Preferred Share ETF (HFP) – click here for full fund details – which has more than an 80% allocation to rate-reset preferred shares, but once again, can actively avoid overpriced issues.

Performance of Established Canadian Preferred Share ETFs

	1 Month	3 Months	6 Months	YTD	1 Year	3 Years	5 Years	10 Years	15 Years	Inception Date
Horizons Active Preferred Share ETF (HPR)	1.02%	4.6%	8.49%	15.57%	20.39%	3.12%	3.18%	–	–	22/11/2010
Horizons Active Floating Rate Preferred Share ETF (HFP)	0.93%	4.69%	9.41%	16.76%	22.37%	2.92%	–	–	–	01/10/2013
iShares S&P/TSX Canadian Preferred Share Index ETF (CPD)	0.98%	4.03%	7.47%	13.56%	18.18%	0.69%	1.27%	2.82%	–	10/04/2007
BMO Laddered Preferred Share ETF (ZPR)	0.96%	4.38%	8.78%	14.76%	21.34%	-1.07%	-0.11%	–	–	14/11/2012
S&P/TSX Preferred Share Index (Total Return)	1.06%	4.14%	7.55%	13.81%	18.55%	1.04%	1.66%	3.33%	3.35%	12/06/2007

Source: Morningstar Direct, as at November 25, 2017.

The indicated rates of return are the historical annual compounded total returns including changes in per unit value and reinvestment of all dividends or distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any securityholder that would have reduced returns. The rates of return shown in the table are not intended to reflect future values of the ETF or returns on investment in the ETF. The index is not directly investable.

According to Nicolas Normandeau, there are other significant reasons to consider HPR over ZPR for preferred share exposure.

1. **Active Management/Credit Analysis:** ZPR does not undertake any independent credit analysis or interest rate outlook. ZPR is just mandated to replicate, to the extent possible, the performance of the Solactive Laddered Canadian Preferred Share Index, net of expenses. Conversely, HPR is not tied to an index. Fiera Capital undertakes independent credit analysis on all issues. The team at Fiera Capital is a corporate credit team, and manages tens of billions in corporate credit alongside their preferred share holdings. As a result, HPR is not forced to buy weaker credit issuers.

2. **Security Selection:** HPR currently has a bigger allocation into the discounted[1] rate-reset and floating preferred vs. ZPR (46.0% vs. 43.8%)[2]. Accordingly, we believe HPR should continue to outperform ZPR in a higher-rate and strong credit tone environment.

3. **Interest Rate Outlook:** If Fiera Capital thinks rates could continue to increase, they will add discounted fixed reset or floating issues to the portfolio. On the flipside, if they think rates could decrease, they will buy a fixed rate perpetual. HPR can hold up to 10% of cash or up to 20% in investment-grade bonds. HPR can also buy foreign preferred shares (up to a 20% allocation) for diversification. This flexibility allows HPR to pivot if the market dramatically changes, as it did in 2015.

4. **Rebalancing:** HPR is not tied to fixed date rebalancing like ZPR. The Canadian preferred share market remains relatively shallow in terms of liquidity. When a huge asset pool like ZPR has to rebalance its exposure, it gets grinded by the secondary market. HPR is not forced to buy or sell any issues on a fixed date and in some cases it can also take advantage of the price dislocation that occurs when index ETFs rebalance.

5. **Similar Fees:** ZPR has a management fee of 0.45% (plus applicable taxes); compared to HPR's management fee of 0.55% (plus applicable taxes). It's actually very surprising that HPR is average 10 bps more than ZPR. For 10 bps, you're getting all the added benefit of active management in the preferred share space with HPR.

6. **New Year (Mandatory) Rebalance Risk:** Just like last year, in its next big annual rebalancing season (January), ZPR can be expected to add exposure to securities that trade at a premium (mainly most recent issues) and sell or reduce its exposure to 2018 reset issues, most of which still trade at a discount to par. In Fiera Capital's opinion, if you think rates will continue to increase, this next ZPR rebalance will reduce the effectiveness of ZPR in a rising rate environment.

[1]A discounted issue for Fiera Capital is an issue that trades at $24 or lower.
[2]Source: Fiera Capital, as at November 24, 2017.

If you want to optimize your preferred share exposure in 2018, we believe that Fiera Capital's management approach through HPR and HFP is the best way to accomplish that objective.

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General Investment Objectives

HPR: Seeks to provide dividend income while preserving capital by investing primarily in preferred shares of Canadian companies. The ETF may also invest in preferred shares of companies located in the United States, fixed income securities of Canadian and U.S. issuers, including other income generating securities, as well as Canadian equity securities and exchange traded funds that issue index participation units.

HFP: Seeks to generate income consistent with prevailing short-term preferred share yields while stabilizing the market value of the ETF from the effects of interest rate fluctuations. HFP invests primarily in preferred shares of Canadian companies and may also invest in preferred shares of companies located in the United States, fixed-income securities of Canadian and U.S. issuers, including other income generating securities and listed funds. Horizons HFP will generally maintain a portfolio duration of less than two years. HFP may use derivatives, including interest rate swaps and futures contracts, to contribute to the ability of the ETF to seek to deliver a floating rate of income.

CPD: Seeks to replicate the S&P/TSX Preferred Share Index, net of expenses.

ZPR: Seeks to replicate, to the extent possible, the performance of the Solactive Laddered Canadian Preferred Share Index, net of expenses. The Fund invests in and holds the Constituent Securities of the Index in the same proportion as they are reflected in the Index.

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