

LEARNING THE ABC'S OF RATE - RESET PREFERRED SHARES

The preferred share market has had an abundance of new issuance in 2008, and 72% of the new issues came in the form of fixed rate reset preferred shares. Further issuance of this type of preferred share has continued in the start of 2009 and additional issuance is expected going forward. Therefore as an investor it is important to have a strong understanding of this product and the benefits and risks associated with holding a rate-reset preferred share.

Description: This class of preferred share pays a fixed dividend until the reset date, which is typically also the call date. On that date, and every reset date thereafter, if the preferred share is not called, the holder has two options.

1. The investor has the option of locking in a fixed dividend until the next reset date. This rate is at a predetermined spread over an equivalent term Government of Canada bond.
2. The investor has the option of exchanging to a floating rate preferred share. The floating rate is a quarterly dividend based on 3-month Government of Canada Treasury bills, plus the same spread as in option 1.

Investors have the option at each reset date, if the issue is not called of switching back and forth between the two dividend options.

Redemption: These preferred shares are redeemable at the option of the issuer on every reset date at par value (\$25.00). Additionally, if the floating rate option is chosen, the floating rate preferred shares may also be called at the option of the issuer, usually at a premium price. Issues currently outstanding are callable at a price of \$25.50 at any time.

Retraction: Rate-resets are *perpetual in nature* and are not retractable by the holder.

Example: The BNS 5.00% Ser 20 (BNS.PR.Q) is structured to pay an annual dividend of \$1.25 on a quarterly basis until the reset date (Oct 29, 2013). If the preferred share is not called at this time and the yield on The Government of Canada 5-year bond is 4.00%, the dividend will be reset at a rate of 4.00% plus a spread of 1.70% or equal to 5.70% or \$1.425 until the next reset date.

Advantages: In exchange for having no maturity date, investors are rewarded with an attractive dividend rate which is re-set in-line with yields prevailing in the market on a periodic basis. Due to this factor, this structure has less interest rate risk than straight perpetual preferred shares.

Risks: The main risk of investing in fixed-reset rate preferred shares is that they are perpetual and the *issuer will only redeem these structures if it is in their best interest*. In the long term, investors in perpetual securities need to be very concerned about credit quality and the future prospects of the issuer, as there is *no obligation to ever redeem the issue*.

FREQUENTLY ASKED QUESTIONS

What factors are going to negatively impact the price of a rate-reset preferred share?

- **Higher Interest Rates** - the price of a preferred share is inversely related to interest rates. Therefore an upward movement in interest rates will negatively impact the price of a preferred share.
- **Inflation Concerns** - the price of a preferred share is also inversely related to the level of inflation. If inflation is a concern this will increase the yield of a preferred and depress the price.
- **Widening Credit Spreads** (Yield pickup over Government of Canada bonds) – As the yield differential between preferred shares and Government of Canada bonds increases (credit spread widening) – the higher yield will cause a lower price for the preferred share.

- **New Rate-Reset Issuance with higher reset rates** – If an issuer comes to the market with a new rate-reset with a higher reset rate than the issuers outstanding rate-reset preferred shares, outstanding preferred share will decline in price. This is because the shares with the highest reset rates have the highest probability of being called at the call date. The higher reset is then equated with a higher price. New issuance also increases the supply in the market and without increased demand for these products the prices in this space will decline.
- **New Type of Preferred Share** – Down the road there may be a new type of preferred share which offers a more attractive investment than the rate-reset preferred shares. At this time the price of rate-resets may suffer from a decline as investors may sell their rate-reset holdings in order to purchase the new type of preferred share.

What do I look for when deciding which rate-reset to purchase?

- **Yield to Call** – This is the yield an investor will earn given the market price if the issuer redeems the preferred share at the next call date.
- **Current Yield** – Is calculated by dividing the dividend over price. This yield is appropriate to gauge the yield differential between purchasing a straight perpetual and a rate-reset preferred share.
- **Reset Rate** – This is the rate at which the dividend will be reset over the equivalent term Government of Canada bonds if the issue is not called at the first call date. A higher reset rate equates to a higher dividend after the call date and will therefore be more expensive to purchase.

What price is the rate-reset going to trade at as it approaches the call date?

Where the various rate-reset trade over the next 5 years and as they approach the call dates will be determined by factors already mentioned above such as: the interest rate environment, inflation concerns, and credit spreads. The creditworthiness and financial stability of the company will also impact the trading price of this structure of preferred share. It should be noted that just because these structures may be called in 5 years time at par does not mean that the issues will be trading at par as the call date approaches. These structures will only be called if it is in the issuers' best interest to do so.

What is the probability that the rate reset will get called at the reset date?

There is no set probability dictating if these issues will be called at the call date but, it is fair to say that those issues which have a higher reset rate have the highest probability of being called. The higher reset rate makes it very expensive for the issuers to continue dividends past the call date.

For a comparison purpose the spread between the average current yield on a basket of straight perpetuals (BMO.J, BNS.J, CM.P, GWO.F, NA.K, IAG.A, PWF.F, RY.E, TD.O) and the 5 Year Government of Canada bond has been displayed below. From the graph we can see that the yield differential (spread) between straight perpetuals and the 5 year Government of Canada bond has peaked over the last year. The 5 year average indicates that over the last 5 years straight perpetuals traded with a yield approximately 1.24% greater than the 5-year Canada bond.

Based on this information, history provides a strong case suggesting that most of the rate-resets will be called as the reset rates are higher than the 5 year average. However, there is still no guarantee that these issues will be called. Even if these shares are not called at the call date they offer the investor an attractive dividend inline with current interest rates.

