The Preferred Share Market and the New Rookie in Town: **Limited Recourse Capital Notes (LRCNs)**

The preferred share segment of the market has often attracted individual investors seeking yield. In recent years, this demand has been further reinforced by a low interest rate environment, which has created challenges for investors looking to generate income within their portfolio. Although demand remains healthy, the preferred share market has struggled to produce solid returns for investors over the last few years. In Canada, the preferred share market returned -7.9% and 3.5% in 2018 and 2019 respectively; not exactly numbers worth bragging about. However, 2020 started to show a little more promise, with the segment up 6.2%. So, what in the world is going on in the preferred share market and what does it mean for the asset class's outlook?

Revisiting Preferred Share Fundamentals

Before we take a closer look, let us briefly revisit what exactly a preferred share is. A properly constructed investment portfolio will have multiple asset classes involved, all working together. One could consider the stock side of the portfolio to be the offense and the bond side the defense, although that might not be the full team. If we imagine the stocks to be in the attack zone and the bonds as the goaltender, then preferred shares would lie somewhere in between, playing defense on the blue line. From a risk perspective, the preferred share market sits between common shares (public company stocks) and corporate fixed income (public company debt). In an extreme scenario, if a company goes bankrupt, debt holders would be repaid first, preferred share holders second and the remainder would be paid to common share holders. The position of each security within the repayment process is what we refer to as "capital structure" and is the foundation of each asset class's risk. Generally speaking, the higher on the capital structure, the less volatile the security will be and the lower on the structure, the more volatile. From a return perspective, preferred shares also lie somewhere between common shares and corporate debt. The level of income produced by preferred shares is quite healthy, usually between 3% and 6% for relatively good credit quality preferred shares. Given there is credit risk in the instrument, preferred shares can get beaten up if risk sentiment turns negative, as was the experience through 2018. Finally, although there is healthy demand for preferred shares from individual or retail investors, because the institutional world does not purchase preferred shares for the most part, it remains a smaller and less liquid segment of the market. In comparison, the Canadian preferred share market is valued at approximately $90 billion CAD vs $3 trillion CAD for the Canadian common share stock market.

The Introduction of LRCNs (Limited Recourse Capital Notes)

The outlook for preferred shares may have shifted over the last twelve months, and here is why. On July 21st of last year, RBC issued $1.75 billion of a new instrument called Limited Recourse Capital Notes (LRCN): "the new rookie in town". The security sounds complicated, as they often do. For simplicity's sake, a LRCN is like a preferred share in that it is in the same position within the issuer's capital structure (similar risk – on the blue line) and pays a healthy stream of income. Here is how it is different. First off, LRCNs are traded in values of $1,000 and require a minimum purchase of $200,000. For this reason, they are better suited to institutional investors rather than individuals. Secondly, the tax treatment of the LRCNs differs from that of preferred shares, as the coupon or interest income is paid out of the issuer's (bank or corporation) pre-tax income. This is beneficial for the issuer as it results in a lower cost of capital. On the other hand, dividends paid by the issuer on preferred shares are sourced from after-tax income, resulting in a tax credit which is more attractive for the investor.

What Does This Mean Going Forward?

Let us start with the preferred share market outlook, in the absence of the LRCN introduction. The outlook for preferred shares is driven by a couple of primary factors. First, preferred shares do well during an economic expansion, when riskier asset prices (like stocks) are stable. From this perspective, we believe we are in the early stages of the next economic expansion, which should provide a good runway for preferred shares to remain relatively stable. Secondly, the majority (approximately 70%) of the preferred share market is dedicated to rate-reset preferred shares. This type of preferred share resets its coupon every five years based on the Canadian 5-year interest rate, plus a spread. So, if interest rates rise, this means the coupon or dividend of the preferred share will be reset higher, producing healthier income for the investor. With these factors in mind, the outlook for the preferred share market looks solid.

The introduction of LRCNs, however, will have an impact on this outlook. First off, with LRCNs being more attractive from the issuer's perspective, banks, financial institutions, and other corporations are likely to issue more LRCNs than preferred shares going forward, to help lower their cost of capital. Ultimately, this means a lower supply and lower liquidity for preferred shares in the future. Furthermore, it means some institutions may be redeeming preferred shares sooner rather than later if the structure allows them to. This could create an opportunity for preferred shares while the market segment goes through this transitionary period.

What does this mean for the Matco Fixed Income Fund?

With the outlook for preferred shares looking more solid than in recent years, we are selectively incorporating a ladder (staggered terms) of fixed rate reset preferred shares within our fixed income portfolio. These preferred shares will be taking the place of corporate bonds that have performed well, but now offer much lower yield than their preferred share counterparts. We use the word selectively, as we will be focusing our investment on the highest of quality preferred shares, companies with strong fundamentals, that are trading at a discount. This will ensure that if the fixed rate reset preferred shares within our Matco Fixed Income Fund are called/redeemed by the issuer, it will translate to positive performance contribution within the fund.

In Summary

This is a very interesting time in the preferred share market segment, which is one that has been far from exciting for a long time. The market is likely to go through a transition period, where LRCNs will begin to replace a portion of the preferred share market. Drawing on our earlier analogy, if preferred shares serve as the defensemen, there might be a new rookie joining them on the blue line with one heck of a slapshot. Will preferred shares go away? Only time will tell how much capital the LRCN market will attract. However, given LRCNs are ideal for institutional investors while preferred shares are more tailored to individual investors, the “veteran preferred shares” are likely to stick around, allowing them to co-exist in the future with “the new rookie LRCNs” . As with all market developments, we at Matco will continue to monitor this one closely, ensuring we are allocating your investment capital as optimally and as efficiently as possible.

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