Income from Preferred Shares – What You Should Know

Publicly-traded preferred shares of high-quality Canadian companies can be a source of tax-efficient income, if chosen correctly. In our experience, many investors do not adequately understand the features of preferred shares, which can lead to some unpleasant surprises, as each share can have different features.

As an example, consider the Series J preferred shares of Great-West Lifeco Inc. An investor seeking a price quote on these preferred shares could look them up on the Toronto Stock Exchange's website (tmx.com) under the stock symbol "GWO. PR.J". She would learn that the shares pay a quarterly dividend of $0.375 ($1.50 annually) and see a quoted annual yield of 5.906 percent (at their June 12 closing price of $25.35). Knowing the yield is crucial, as the primary purpose of investing in these shares is to generate income. (They are not a growth investment, even if Great-West's business performs well, as they have no right to share in the earnings of the company beyond their fixed dividend.) However, there is more to the yield than the price quote suggests.

First of all, Great-West has a right to "call" (repurchase) all of the shares from investors at $25 per share on Dec. 31, 2013. An investor who paid $25.35 would take a capital loss of $0.35 per share if the shares are called, offsetting some of the dividends received. She should therefore know the yield to the Dec. 31 call date, not just the quoted yield. In this case, the yield to the call date, which includes both the capital loss and the dividends, is less than three per cent annualized. Second, these shares are "fixed-reset" preferred shares, meaning that the yield will reset after the call date if Great-West does not call them away. If Great-West decides not to call the shares, they will pay a new fixed dividend rate for the five years after Dec. 31, which will equal to the five-year Canadian government bond rate plus a premium of 3.07 per cent.

Based on current five-year government bond yields, the investor should expect a sizable cut to the future dividend. Alternatively, if the shares are not called, the investor has a right to convert the shares into another series of Great-West preferred shares that pay a floating rate (fluctuating) dividend. This scenario would also result in a sizable near-term dividend cut. Terms like these are fairly widespread among preferred shares and could cause some investors to miscalculate how much income they will receive.

Investors should also understand the concept of interest equivalent yield. As dividends paid to Canadian investors from Canadian preferred shares are taxed at a lower rate than bond interest, an investor cannot simply compare a bond yield to a dividend yield when deciding between investments. An investor in a high tax bracket may need 30 per cent more interest income from bonds to equal an amount of dividend income from preferred shares on an after-tax basis.

Another detail investors should understand is dividend timing. If an investor buys the Great-West Series J preferred shares on June 12 hoping to receive the June 30 dividend, she will be disappointed, as the shares began trading ex-dividend (without rights to the next dividend) on May 29. Finally, investors should not get fixated on yield. Preferred shares lack the upside potential of common shares, but can still be volatile due to interest rate changes, company-specific factors, or even just general market skittishness. Preferred share investors should be realistic about their expectations for share price stability and should ensure they understand all of their features.

Michael H.F. Armstrong *BA, CIM, FCSI*
Portfolio Manager

Andrey Schmidt *BA, LLB*
Investment Advisor

This article was first published in Sounding Board, the official monthly publication of The Vancouver Board of Trade. Michael Armstrong and Andrey Schmidt are Investment Advisors with CIBC Wood Gundy in Vancouver. Their clients may own securities mentioned in this column. The views of Michael Armstrong and Andrey Schmidt do not necessarily reflect those of CIBC World Markets Inc. CIBC Wood Gundy is a division of CIBC World Markets Inc., a subsidiary of CIBC and a Member of the Canadian Investor Protection Fund and Investment Industry Regulatory Organization of Canada. This information, including any opinion, is based on various sources believed to be reliable, but its accuracy cannot be guaranteed and is subject to change. CIBC and CIBC World Markets Inc., their affiliates, directors, officers and employees may buy, sell, or hold a position in securities of a company mentioned herein, its affiliates or subsidiaries, and may also perform financial advisory services, investment banking or other services for, or have lending or other credit relationships with the same. CIBC World Markets Inc. and its representatives will receive sales commissions and/or a spread between bid and ask prices if you purchase, sell or hold the securities referred to above. © CIBC World Markets Inc. 2015.