Preferred shares:

Higher income with higher risks

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Preferred shares (also known as "preferreds") can provide attractive after-tax income, but they tend to be sensitive to changes in interest rates and the issuing company's ability to pay preferred dividends. As a result, preferreds are typically riskier and more volatile than other fixed-income investments. We include preferred shares with Aggressive Income investments, along with high-yield bonds, due to their higher risk, regular dividends and limited potential for price appreciation. While we believe you don't need to own preferred shares, if you choose to own them, we suggest they represent no more than 10% of your fixed-income investments.

What are preferred shares?

Preferred shares are typically issued with par value of $25 per share and rank between the bonds and common stock of a company. While preferreds share some similarities with bonds, there are also key differences. Unlike bonds, preferreds typically don't have a maturity date, and dividends can be deferred or cancelled without causing a default for the company. Important differences with common shares are that preferred shares don't participate in the potential upside if a company's earnings grow, and they are typically callable at a specific price, which limit the potential for price appreciation.

The most common type of preferred shares in Canada – known as "rate-reset preferreds" - pay dividends based on a rate that is fixed for the first five years, then resets every five years based on an index rate plus an additional fixed rate. A common index rate is the yield on 5-year Government of Canada bonds. Dividends can be either cumulative – meaning dividends missed during any suspensions must be paid before common stock dividends can resume – or non-cumulative.

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Key risks to owning preferred shares include:

- **Interest rate risk –** the value of preferred shares drops when long-term interest rates rise
- **Call / Reinvestment risk –** preferreds typically can be redeemed by the issuing company
- **Credit risk –** dividends can be suspended or cancelled
- **Subordination –** preferred shares rank lower than other investments and claims on a company, except for common stock
- **Conversion risk –** some preferred shares, particularly those issued by banks, can be converted to common stock in certain situations

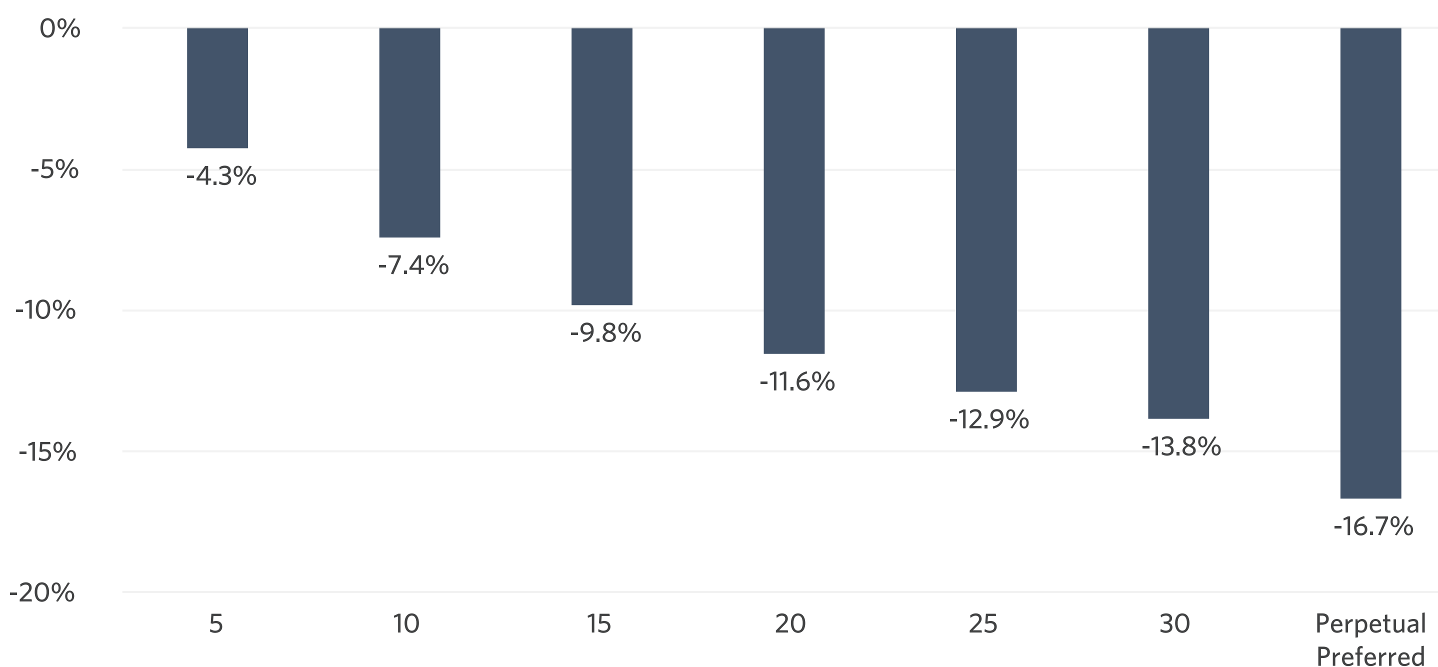
Preferred shares can be sensitive to interest rates

Like long-term bonds, preferred shares tend to be sensitive to interest rates, with their prices declining when interest rates rise, and vice versa. Preferreds with fixed dividend rates – which now represent a relatively small portion of the market – are generally the most sensitive to interest rates. As bonds approach maturity, their prices move toward par value, but preferred stocks do not because they have no maturity date.

Consider the following example: If interest rates rise by 1%, the price of a 20-year bond with a 5% coupon would decline about 11.6%. The price of a 5% fixed-rate perpetual preferred share would decline approximately 16.7% according to Edward Jones calculations. The lack of a specified maturity for the repayment of principal makes preferred shares more sensitive to changes in interest rates.

Price decline for a 1% rise in interest rates for a 5% coupon bond or preferred stock

Maturity (years)



Source: Edward Jones calculations. This example is for illustration only and does not represent any currently available investments.

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Rate-reset preferreds may be less sensitive to interest rates because their dividends would increase if the index rate rises, which would partially offset higher interest rates. Nevertheless, market prices of rate-reset preferreds can still fluctuate substantially, especially if long-term rates rise more than intermediate-term rates, referred to as a steepening yield curve. However, if long-term rates fall more than intermediate-term rates, the potential for price appreciation is generally be limited to the call price.

Preferred shares are typically callable
Most preferreds can be redeemed by the company, typically five years after issuance at a specific price known as the call price. This effectively caps the value near the call price, which is typically at or slightly above par value. It is generally beneficial for companies to redeem preferreds when rates decline, so investors may have to reinvest at lower rates, known as reinvestment risk.

Preferred dividends can be suspended or cancelled
Preferred dividends can be suspended or cancelled by the issuing company. Although this can typically happen only if common stock dividends are also suspended. If the preferred dividend is cancelled, the preferred share could drop in value significantly since it would pay no income and have no maturity. Even if the perceived risk that the dividend could be suspended – known as "credit risk" – increases, the additional yield to compensate for this risk – referred to as "credit spread" – will typically also rise. This would, in turn, increase the yield required for investors to buy or hold the preferred, likely pushing the price down. Preferreds tend to be more sensitive than bonds to an increase in a company's credit risk since preferred dividends can be suspended or cancelled at management's discretion, while failure to pay interest and principal on bonds typically results in bankruptcy. As a result, preferred share dividends could be interrupted while bond interest payment would continue to be paid.

Preferred shares are deeply subordinated
Subordination refers to the order of priorities in claims on a company. Preferred shares rank lower than bonds and most other claims on a company, such as pensions, leases and bank deposits. As a result, preferred-share holders could receive a very low recovery in bankruptcy.

Some preferred shares can be converted to common stock
Most preferred shares issued by banks, known as non-viability contingent capital ("NVCC")

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or contingent convertibles (“CoCos”), can be converted to common stock. This can be done in certain circumstances, such as the bank being deemed by the regulator as no longer viable or the bank receiving capital from the government to avoid becoming non-viable. In this scenario, the value of the common shares received could be much lower than the par value of the preferred shares converted.

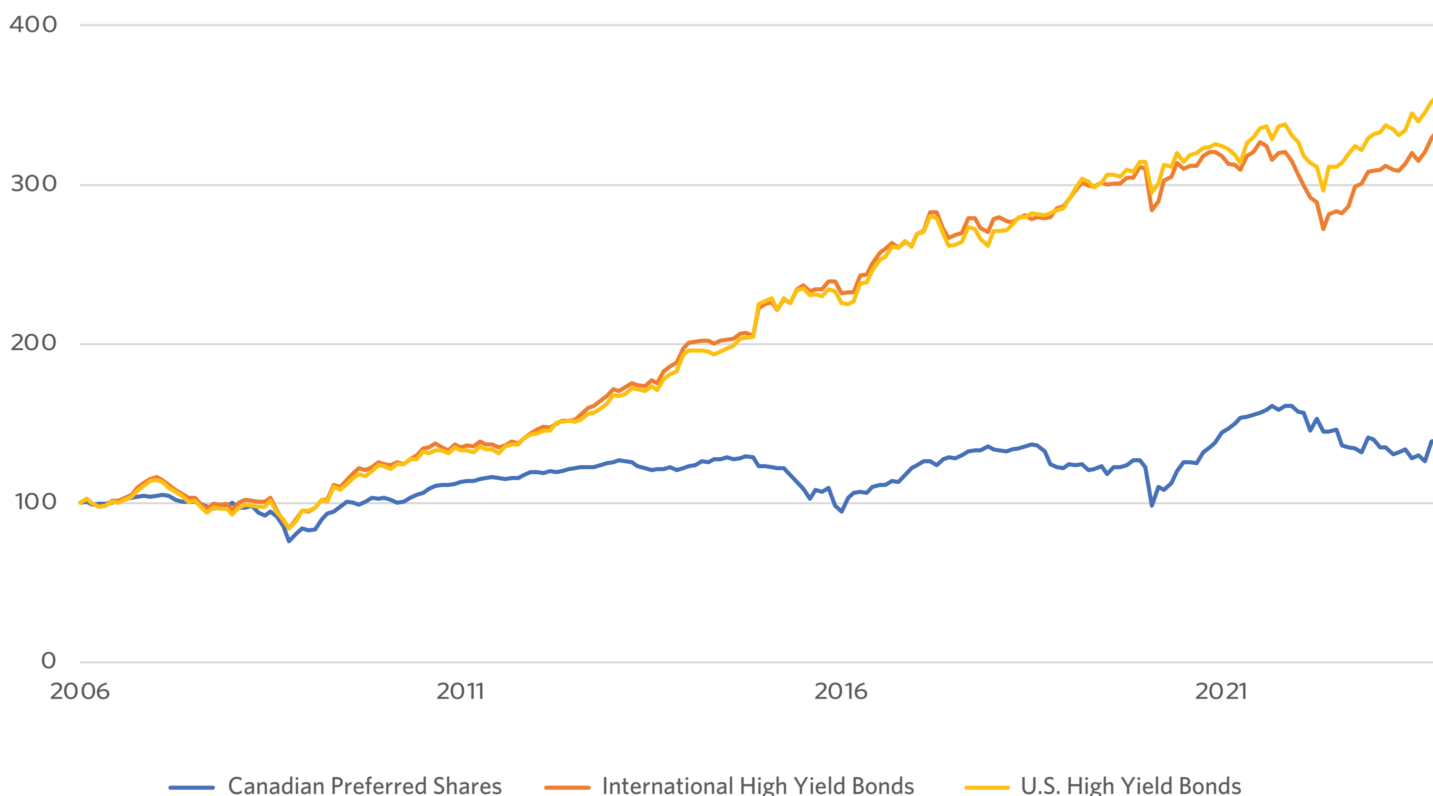
Taxes on preferred dividends may be lower

Dividends on preferred shares (and common shares) of large Canadian corporations that pay income taxes are generally considered “eligible” for tax purposes. This means holders may be able to receive federal and provincial dividend tax credits, which reduce the total tax owed. If held in taxable accounts, this may be a benefit over interest income on bonds, which are generally taxed at the investor’s income tax rate. Please see a tax professional for specific tax considerations for preferred shares.

Performance has lagged high-yield bonds but with higher risk

Preferred shares have delivered lower investment returns than high-yield bonds over time, as shown in the chart below. While the performance of any particular issue will vary, preferred shares have generally underperformed high-yield bonds. Volatility of preferred-share returns – a common measure of investment risk based on how much returns fluctuate – has also been higher than that of high-yield bonds, indicating higher risk. Additionally, preferred shares tend to move in the same direction as Canadian common stocks – known as “correlation” – more than high-yield bonds do. This suggests that preferred shares provide less diversification to common stocks than high-yield bonds do. For these reasons, we recommend that investors who seek higher income and can tolerate higher risk should consider high-yield bond mutual funds or exchange-traded funds rather than preferred shares.

Canadian Preferred Shares vs High Yield Bonds - Cumulative Total Returns



* Source: Bloomberg Index Services Limited, S&P Dow Jones Indices. Canadian preferred shares represented by S&P/TSX Preferred Share Index.

International High Yield Bonds represented by Bloomberg Global High Yield Index. U.S. High Yield Bonds represented by Bloomberg U.S. High Yield 2% Issuer Cap Index. Past performance does not guarantee future results.

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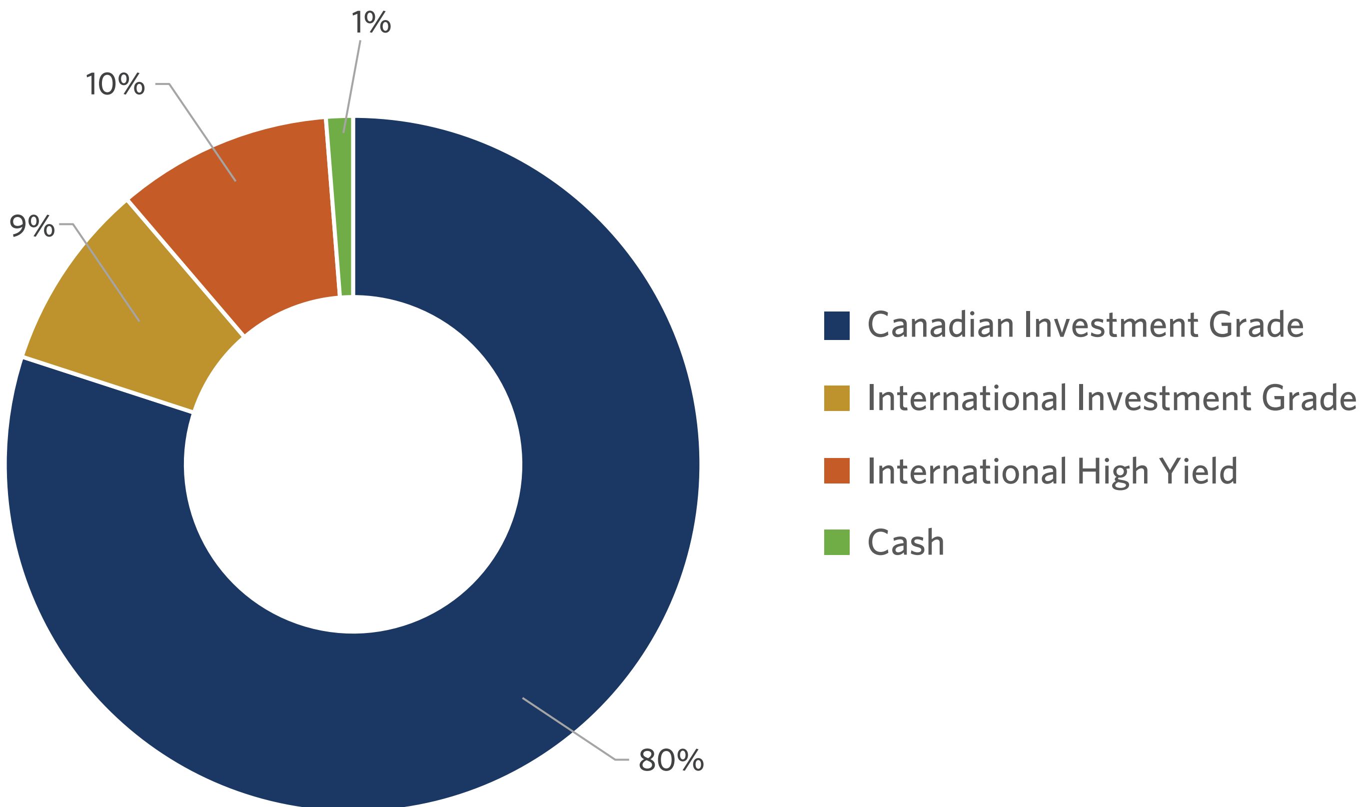
Recommendations for investors

We suggest that you should not view preferred shares as an alternative to investment-grade bonds. Due to key risks, including interest-rate risk, credit risk, deep subordination and conversion risk, we include preferred shares with Aggressive Income investments, along with high-yield bonds. However preferred shares have delivered lower returns with higher risk and less diversification benefits than high-yield bonds have historically. Therefore, we recommend that investors who seek higher income and can tolerate higher risk should consider high-yield bond mutual funds or exchange-traded funds rather than preferred shares. Our recommended allocations to each fixed income asset class are shown in the chart below:

Recommended strategic weights as a share of fixed income investments



Talk with your Edward Jones advisor about reviewing the preferred shares you own to evaluate any actions you should take toward achieving your long-term financial goals.

Diversification does not guarantee a profit or protect against loss.

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