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Wednesday, April 15, 2015

First Quarter 2015

In a blog post in March, Bill Gates, who is a director of Berkshire Hathaway, wrote that he thought “Warren Buffett Just Wrote His Best Annual Letter Ever”. It contains a history of Buffett’s 50 years of ownership of Berkshire. It also includes an essay by Berkshire Vice-Chairman Charlie Munger that explains Buffett’s past success and makes some observations about Berkshire’s future. I’ve included Munger’s piece for those who like to receive feature articles. The entire letter is available at www.berkshirehathaway.com.

Perhaps it was Warren Buffett who said that he shrugs off investment successes as good luck but seriously studies his mistakes (of which he says in the 50th anniversary issue that his biggest single mistake was buying Berkshire Hathaway, then a failing textile manufacturer). If mistakes are a learning experience, lately I’ve learned a lot. Over the last 12 months the TSX Energy group is down 14.1% (the Exploration and Production sub-sector is down 30.1%) and the Materials sector is down 8.2% (the Metals and Mining sub-sector is down 17.1%). None of that is surprising, at least given the crash in oil and gas and metal prices. It is easy enough to say that any investment in the extractive industries have been a mistake this year.

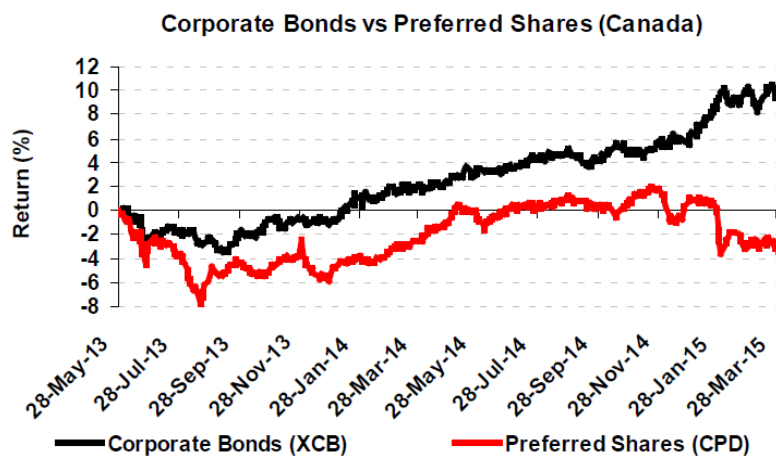
Losing money where you don’t expect to is always special and this quarter I would like to discuss the arcane world of preferred shares¹. Preferreds nowadays are mostly either; floating rate, perpetual or rate-resets. The dividend rate for a perpetual is set when the security is issued and does not change. Most preferreds issued in recent years are rate-resets. With rate-resets, the coupon is set at a pre-defined spread over the Government of Canada 5-year bond yield at the reset date. The holder can then choose between locking their dividend payment in for 5 years or, receiving a floating payment. In recent years I have been mistakenly worried that interest rates might go up and have considered floating rate and rate-reset preferreds as a hedge against that possibility. Therefore I have had a little money invested in preferreds in non-registered accounts where I can get the benefit of the Canadian dividend tax credit or, for US residents, qualified dividend income.

¹ Preferreds straddle the line between stocks and bonds. They are issued with a fixed par value, like a bond, but they have no fixed maturity date. They pay dividends like stocks. Preferred shares are senior to common stock but rank behind debt in a company’s capital structure.



Since the Bank of Canada surprised the financial markets in January by cutting its key interest rate by 0.25% to 0.75%, 5-year bond yields have fallen 0.60% down to 0.76%. Before January the prevailing assumption, not just mine, had been that interest rates would be higher in the future, not lower, and that rate-reset preferreds would have their dividends reset higher, not lower, on their reset dates. The price of a perpetual preferred, as with a bond, falls when interest rates rise. The idea that preferred shares would fall when interest rates fall is novel. Rate-reset preferreds now dominate the preferred share markets and they have plunged as interest rates have fallen. Exhibit 1 shows that preferred shares have underperformed bonds in the last two years:

Exhibit 1: Preferred Shares have Significantly Underperformed Bonds in the Last few Years



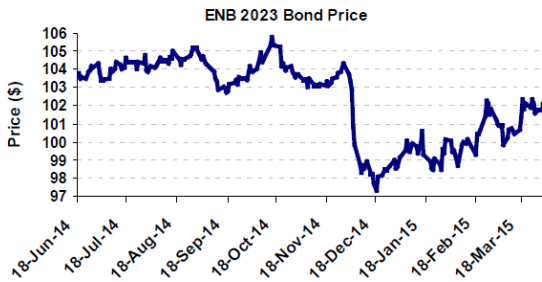
Source: Bloomberg, RBC DS

Preferred shares are also distinctively illiquid which creates special risks and opportunities for investors. As Howard Marks wrote recently: **“Usually, just as a holder’s desire to sell an asset increases (because he has become afraid to hold it), his ability to sell it decreases (because everyone else has also become afraid to hold it)”** (original emphasis). Contrarians can, I think, profit from the bouts of selling occurring in preferred share issues. Although they have been a small part of our fixed income portfolios in the past I think they could play a more important role by year end. We will always have some liquid reserves, but for income, preferreds are becoming more attractive.

One specific example of how poor liquidity can magnify price changes in the markets is the case of Enbridge preferreds. Late last year Enbridge announced that it would ‘drop down assets’ by transferring some pipelines to a subsidiary. This news had a very positive effect on Enbridge shares but a negative effect on Enbridge debt. The two charts below from RBC DS’s Mikhial Pasic contrast the performance of Enbridge bonds, which have recovered since December and, Enbridge preferreds, which have not. The difference I think might be explained, at least in part, by the relatively poor liquidity of the preferred shares:

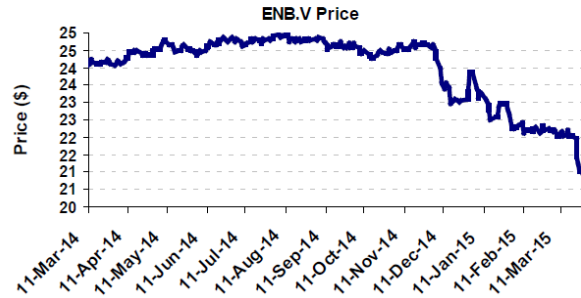


Exhibit 2: Enbridge Bonds are Well off the Lows



Source: Bloomberg, RBC DS

Exhibit 3: Enbridge Preferred Shares Hitting New Lows



Source: Bloomberg, RBC DS

From time to time I have switched from one preferred issue to a comparable one in order to harvest a capital loss for tax purposes. Today I have singled out one specific issue to illustrate how a rate-reset preferred works. The Brookfield Preferred Series X was issued on February 8, 2011 at \$25 per share. The dividend was set at \$1.15 per share so the initial yield when the shares were \$25 was 4.60% ($\$1.15/\$25 \times 100\% = 4.60\%$). On June 30, 2017 the dividend will be reset for another 5-year period to the 5-year Government of Canada bond yield plus 1.80%. If the 5-year bond yield stays at 0.70% and the preferred's price was \$25, the dividend yield would be 2.50% ($1.80\% + 0.70\%$), which is \$0.63 per share. Today, the Series 28 preferred shares trade around \$17, far below the \$25 issue price. The anticipated dividend yield would be 3.70% ($\$0.63/\$17 \times 100\% = 3.70\%$). This, I think, compares favorably. The 6.7% dividend (the original \$1.15 dividend divided by today's \$17 price) that will be paid to June 30, 2017 is not too shabby either. If that wasn't confusing enough, there is another possibility. Every 5 years the holders of the Series 28 preferred have the option of converting into a Series 29 which will pay a floating quarterly dividend rate.

Preferred shares are not my usual topic but they are becoming of greater interest to me and I can certainly understand if they are not to you. This quarter's letter is short because my subject is boring but also because I am typing it myself. Last quarter my colleagues Isabelle and Margarita typed my letter while I was away on holiday. This quarter it is payback time.

Sincerely,

George Stedman, CFA
Portfolio Manager, Vice-President
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