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WEALTH

June 26, 2015

A monthly commentary on personal finance and investments, by Randal van Eijnsbergen

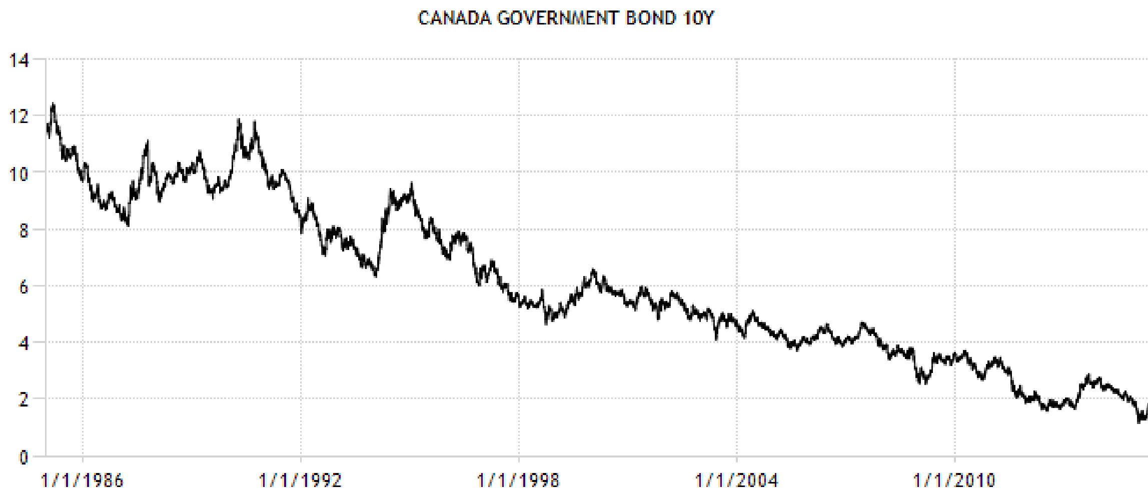
Year-to-Date Performance:

Source: Market Q

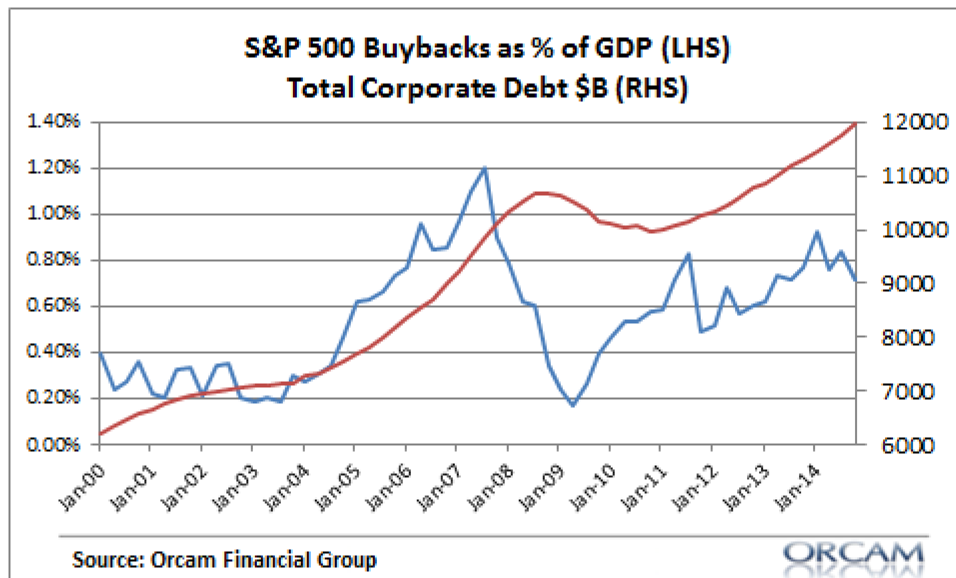
Personal Wealth Management

Things Change

Investors have subscribed to a balanced portfolio theory that mixed bonds and stocks according, primarily, to a client's age and risk tolerance. "Your age in bonds" was a common adage, and it worked reasonably well. Not only would bonds pay their interest, but for the last 20 years they also surfed the wave of falling interest rates. As illustrated in the chart of the Canadian 10-year bond yield below, the near-constant fall accelerates returns of longer-duration bonds thereby enhancing bond portfolio performance. That being said, many bond funds still only eked out a 5% net annualized return in the last decade.



Now, with numerous reasons for rates to likely increase or at least not go much lower, bond investors will be facing head- instead of tail- winds. In addition, sovereign debt has grown significantly and, as per the chart below, low rates have ballooned corporate debt (red line). So, as far as debt or bonds are concerned, markets will be facing high supply and low demand! Not exactly an enticing combination.



So what is the solution? Alternative asset classes such as opportunistic market-neutral or hedge funds, solid dividend-paying equities or, at the moment, select rate-reset preferred shares (see top picks below). Since many Canadian dividend-payers are already fully valued as a result of investors seeking to compensate for said lower bond returns going forward, I contend investors must look further down the food chain towards up-and-coming equities (risk tolerance permitting). These are solid, proven

businesses that might not pay a dividend yet or have not graduated into the "large cap" leagues. Again, one of the best ways to discover the real contenders in this weight class is through data such as earnings growth, revenue growth, margins etc… All of these things can be screened and are embodied in my data driven ideas, which, to date, have significantly outperformed both the S&P 500 and TSX Composite indices.

Markets

U.S. markets made new highs in June while the TSX ambled lower due to resource exposure and pull-backs in our arguably over-valued stalwarts such as the banks and rails. Gold and oil have remained range-bound. The start of summer doldrums? Not so fast. The U.S. rally has extended to the small-caps and pockets of strength are starting to emerge among Canadian juniors. Gold's season is from early July until October and its convenient drop, on US Dollar strength due to Greece concerns, provides a nice entry point at possibly just the right time.

The U.S. Federal Reserve Board stated they are still on track for a rise in interest rates before year-end. Precedents show that the first rate hike need not kill the bull, but that the second one should be more of a concern.

Strategy & Top Picks: Jumping on the dip in Preferred Shares:

Canadian Preferred shares (prefs) have taken it squarely on the chin since the Bank of Canada came out with their surprise rate cut in January. With some prefs, such as those below, down 10% to 30% since late last year. My research and logic leads me to the conclusion that they have been excessively over-sold and that there is now an excellent opportunity for good yields and likely even capital gains. To corroborate this view, I cornered a friend and award-winning fixed-income fund manager, who agreed with the timing and potential of this idea.

The deal is that these Fixed-Reset prefs (60% of the pref market) reset their dividend every 5-years at a pre-set premium to whatever the Canadian 5-year bond is paying at the time. The Enbridge pref below, for example, will reset to 2.51% above the GoC 5-year, which currently sits at around 1%.

Therefore one important factor is the reset or call date. This is when the next 5-year dividend re-set occurs. For those that occur this year, ensuing dividends may not be much to get excited about. But keep in mind that this has already been taken into account in the now-lower pref share prices. (Most are issued at $25 – which is the price the dividend is still calculated from – and many now trade in the $18 to $23 range, thereby bumping up yields.) The prefs that caused concern were those re-setting in the near term and/or with low re-set premiums. There was certainly reason for such issues to take a haircut. But what happened was that *most* of the Fixed-Reset's were dragged down in the fray.

And herein rests the opportunity. You can get into the Enbridge prefs 26% below their issue price, collect a 5.4% dividend until June, 2018 at which time it will be re-set to 2.51% above the prevailing GoC 5-year. In my opinion, while that new yield would be 3.61% if nothing changes (or 4.82% based on the current $18.20 price) if bond yields rise – as I expect and we are already beginning to see in the States – your new yield could be quite respectable.

There are a few other considerations.

- Credit quality – aim for the middle for yield without excessive risk.
- Callability – issuers with multiple prefs outstanding may choose to call or let them mature on their re-set date, so those with the highest re-set premiums have a greater chance of that happening. I.e. you may only receive your return until said date and then cash – but at the full $25 value!
- Rate hike gains potential – if the GoC raises rates or we see the bond markets fall, these prefs could recoup their losses relatively quickly for a capital gain to those who bought at currently depressed levels.
- Preferred tax treatment – dividends are favourably treated in non-registered accounts. A 5% dividend could be equivalent to 6.67% interest income (this depends on tax brackets…)

Consider a couple of prefs to take advantage of this price reduction:

Enbridge Series F: Price: $18.50, current yield: 5.46%, Reset date: June 1, 2018, Reset-premium: 2.51% over GoC 5-years:

Source: Market Q

Brookfield Renewable Power series C: Price: $21.20, current yield: 5.23%, Reset date: July 31, 2019. Reset Premium: 2.94% over GoC 5-years:

Source: Market Q

Previous Top Picks:

February 2015: Avigilon, Sun Life, Manulife, Rio Alto Mining.
March 2015: AGT Food & Ingredients, Parex Resources.
April 2015: FA Hamilton Capital European Bank ETF
May/June 2015: Autocanada covered call options

Last But Not Least: Watch those Golds

As mentioned above, gold and gold equities typically bottom in the summer. Last year the failure of them to do so was blamed on the rout in the energy sector around that time. This year global monetary policy and signs of inflation may just make the trade work. Solid mid- to large-cap producers are trading at wild discounts to historic norms. As a matter of fact, most have bounced twice from similar levels this year already. History dictates, and I strongly believe, that the resource markets will enjoy another rally in the not-too-distant future. Some of the best strategists I follow, some with a contrarian bent, strongly agree. Some of the

best fund managers I follow have already stepped in. The smart money is starting to test the waters. Make sure you have a decent gold position. At current prices your upside far outweighs your down and that is an attractive risk/reward tradeoff.

Call me anytime to discuss. All the best. Cheers,

Randal

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