PREFERRED SHARE MARKET UPDATE

Hank Cunningham **August 10, 2020**

Recently, the preferred share market has attracted a significant bid, with an accompanying price rally. ZPR, a popular preferred ETF, has surged some 45% since its low in March.

The catalyst for this change was the introduction of a Tier 1 financing method for the chartered banks. The specific issue that kicked this rally off was the $1.75 billion Royal Bank 4.54% due November 24 2080. This is a Limited Recourse Capital Note (LRCN) and was only sold to institutional investors. As the interest is a tax deduction for RBC, its effective capital cost was 3.1%.

The Office of the Superintendent of Financial Institutions (OSFI) has encouraged this type of financing as opposed to the use of bail-ins in the retail preferred share sector. Immediately, and assuming the other banks follow suit, it brings into play the prospect of certain rate-reset preferred shares being called.

In an excellent and well-attended presentation on Thursday, July 30, Phil Mesman of Picton Mahoney walked through this new approach and indicated, in his view, that there remains the possibility of further opportunities in the preferred market. There are many variables to consider, most importantly is whether the other banks will follow suit once they emerge from their earnings blackout period. This makes it difficult to offer specific advice to investors.

To participate in this market, advisors may consider the following Picton Mahoney funds:

Picton Mahoney Fortified Income Alternative (run by Phil Mesman):

This is a long/short credit fund in Liquid Alternative and ETF format (TSX:PFIA). It is benchmark agnostic and targets a net return of 5-7% over a credit cycle, with a monthly income of 4% (coupon pass through). Currently, Phil has a 5% weight in the preferred share trade, which is usually less than 2%. This fund is negatively correlated to Government bonds and investment grade bonds.

Returns as of July 29, 2020

Picton Mahoney Income Funds	1 Day	WTD	MTD	QTD	YTD
Fortified Income Alternative Fund (F)	0.12%	0.39%	2.05%	2.05%	2.84%
Fortified Income Alternative Fund - ETF Series	0.12%	0.38%	2.04%	2.04%	2.83%

What makes this income solution unique?

- Little to no interest rate exposure; it is hedged out.
- Generates stable income by clipping coupons from defensive corporate bonds.
- Generates capital gains via event-driven credit investing; finding idiosyncratic opportunities such as take outs, mergers and acquisitions, restructurings, refinancing and credit upgrades.

- Generates alpha by shorting expensive bonds and bonds issued by corporations with deteriorating or weak financials.
- Strategy and process are repeatable in any environment and are not dependent on macro forces such as falling interest rates.

Successful fixed income investing moving forward will require return streams from multiple low or uncorrelated sources, which is why these income strategies are an excellent complement to any fixed income portfolio as a hedged corporate bond sleeve.

Picton Mahoney Fortified Arbitrage Plus Fund

A newer idea, this fund doesn't specifically pay out an income stream but has bond-like volatility with capital gain returns. It is available as non-levered or with 2x leverage (Arbitrage Plus).

Returns as of July 29, 2020

Picton Mahoney Alternative Funds	1 Day	WTD	MTD	QTD	YTD
Fortified Arbitrage Alternative Fund (F)	-0.04%	0.08%	1.88%	1.88%	5.93%
Fortified Arbitrage Plus Alternative Fund (F)	-0.07%	0.16%	3.71%	3.71%	11.54%

Why should investors consider this?

- Merger Arbitrage Plus should produce 6-8% returns, but with the volatility of a bond fund, which helps stabilize the portfolio without giving up a ton of return.
- Investors can buy it as a mutual fund.
- Rated medium risk at most dealers and offers daily liquidity.
- Taxed as capital gains.

How it Works

The Merger Arbitrage Fund seeks to profit from mergers and acquisitions of large publicly traded companies such as Amazon and Whole Foods, Whistler and Vail, and Burger King and Tim Hortons. It is not dependent on the direction of any market – only whether the deals close. Picton Mahoney managers have a combined 30+ years of experience in dedicated M&A investing; they do not speculate on whether two companies will come together, instead they invest only in announced and legally binding transactions. Historically, announced deals have a closure rate of greater than 95%. The example below is exactly what they look for – very simple, vanilla deals.

An All-Cash Example: Berkshire Hathaway buys Precision Castparts

On August 10, 2015 Berkshire agreed to buy Precision Castparts for $235 in cash. Precision's stock price immediately traded up to $230.92. The discount to $235 was in case the deal didn't close. An investor who bought Precision at $230.92 and held it until the deal closed on January 29 2016, would have made $4.08 ($235 - $230.92) or 1.77%. Since the hold time was only 5.5 months, the annualized return was 3.71%, despite any volatility in the S&P 500. The Arbitrage Plus Fund added 1x leverage to this position and thus the annualized return was 7.42%.

For further discussion, please speak to your Odlum Brown Portfolio Manager or Investment Advisor.