

Desjardins

Canadian Preferred Share Fund



QUARTERLY COMMENTARY AS OF SEPTEMBER 30, 2020

PORTFOLIO MANAGER:
Desjardins Global Asset Management

INCEPTION DATE:
April 11, 2016

CIFSC CATEGORY*:
Preferred Share Fixed Income

The preferred share market kept up momentum gathered in the second quarter. The benchmark index posted a return of +11.4% for the period. All structure types ended the quarter with positive returns, but rate-reset preferred shares recorded the best performance.

A new product was introduced on the Canadian bond market in the third quarter: limited recourse capital notes (LRCNs). Due to the changes imposed by the regulatory authority for issuing regulatory capital following the great financial crisis of 2008, banks have been limited in the products they can use to meet their Tier 1 capital needs (Additional Tier 1 [AT1] or other Tier 1 capital instruments). Issuing preferred shares was the solution for this type of capital. Since the preferred share market was small compared to the corporate bond market, the banks wanted to reintroduce an AT1 product on the Canadian bond market to have greater flexibility. The Office of the Superintendent of Financial Institutions (OSFI) has accepted the product as a capital instrument, with certain conditions.

Not only can this new product serve as a substitute for preferred shares in the AT1 tranche (up to 50%), but given the current market situation, it's clearly less expensive for financial institutions to issue this type of instrument than preferred shares. As a result, financial institutions will be turning away from the primary preferred share market for a while. In addition, existing preferred shares will likely be redeemed by the issuers in order to substitute them with LRCNs.

This was a key contributor to the growth seen on the preferred share market over the period, particularly by bank and insurance companies, which also had access to this new debt instrument. It will clearly be a game changer for the preferred share market in the long term.

Another factor that had a positive impact on the market's performance was Royal Bank's redemption of its shares for a total of \$1.5 billion. The redemption itself wasn't a surprise, as the shares weren't non-viability contingent capital (NVCC) instruments, but the fact that the bank redeemed them all at once was unexpected.

Late in the quarter, TD Bank announced the redemption of one of its securities, a fixed-rate perpetual share, which is an NVCC instrument. This was the first NVCC preferred share to be redeemed, and TD Bank paid a premium to carry it out, another sign that market capitalization on the preferred share market will likely decline.

Desjardins

Quebec Balanced Fund



QUARTERLY COMMENTARY AS OF SEPTEMBER 30, 2020

PORTFOLIO MANAGER:
Desjardins Global Asset Management

INCEPTION DATE:
June 20, 1997

CIFSC CATEGORY*:
Canadian Neutral Balanced

There were no subscriptions on the primary market during the period. Companies operating in sectors other than the financial sector don't appear to be willing to fill the vacancies left by the banks.

While a number of factors call for caution as the fourth quarter begins, preferred shares remain an attractive asset class in the medium term. Despite the quarter's growth, the current levels still offer interesting returns, at least compared to many other types of investments. The introduction of LRCNs and their impact on the primary market, as well as the share redemptions by banks and, potentially, insurance companies, should support the market.

The portfolio underperformed the index by 42 basis points. The securities selected among rate reset preferred shares and a slight overweighting in fixed-rate perpetual shares explain this underperformance.

*CIFSC refers to Canadian Investment Funds Standards Committee. The CIFSC has the mandate to standardize the classification of mutual funds in Canada. <http://www.cifsc.org/>.

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