

## Preference shares – a buy for tax-sensitive investors looking for yield

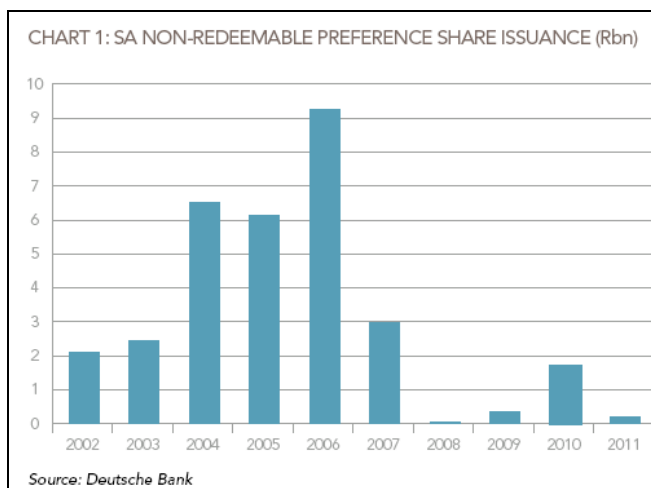
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By Karl Leinberger, Chief Investment Officer  
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When we tell clients that we think preference shares (of the non-redeemable variety\*) are a buy, we get varying reactions from surprise to shock. Preference shares are distrusted and almost universally disliked in the retail market. And it shows in the price (i.e. prices are low and yields are attractive).

To understand why this is the case, we need to consider the history of the local preference share market:

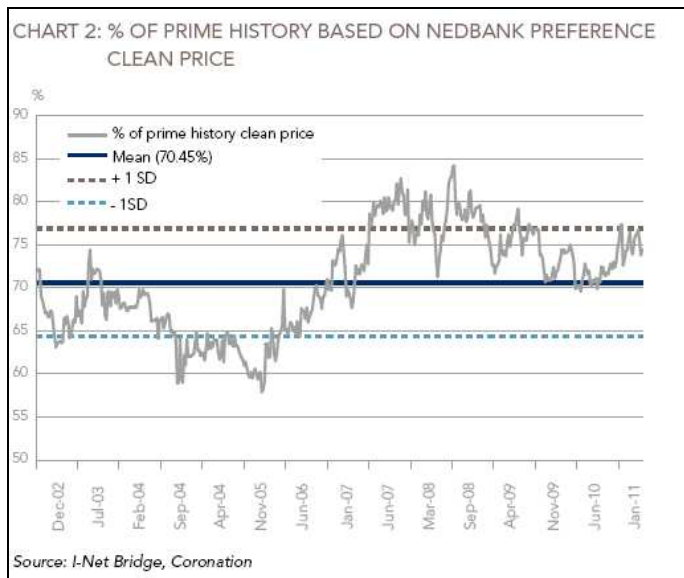
- Preference shares were introduced into our market with much fanfare in the early to mid-2000s. They were sold as a tax-efficient instrument that moved 'lock, stock and barrel' with the banking sector's prime interest rate.
- Investors unfortunately then bought into the concept and:
  - took *excessive exposure* to preference shares (see chart 1 which shows the market issuance of preference shares over the last decade);
  - at the *wrong price* (i.e. although the dividends were tax free, investors were buying them at yields that were just too low); and
  - *without understanding* the capital risk that one is exposed to in the instrument.



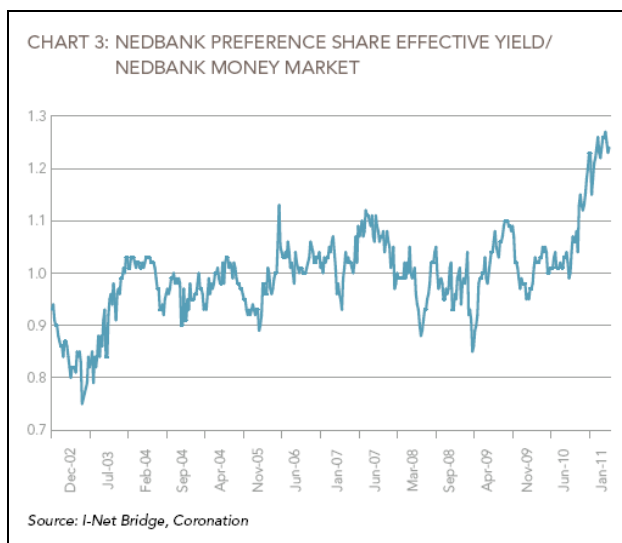
This 'fear and loathing' has created a buying opportunity for the investor that is prepared to put emotion aside and focus on the fundamentals. We believe that preference shares are a great buy for tax-sensitive investors for the following reasons:

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- *Yields are very attractive:* a limited appetite for preference shares has resulted in low prices (high yields):
  - *Versus history:* Chart 2 shows the yield offered by the Nedbank preference share, an instrument that has been in issue for much of the last decade and consequently our best proxy for the broader preference share market. The graph shows how expensive preference shares were in the early 2000s (when investor interest was high) and how much cheaper they are today (now that investor interest is low).



- *Versus other yielding assets:* Chart 3 shows the yield earned on the Nedbank preference share as a percentage of rates Nedbank offers in the money market (as a proxy for overnight cash). This graph clearly illustrates the scale of the opportunity. Preference shares currently offer a higher yield than the money market. Think about that for a second! Dividends on preference shares are presently not taxed (see point below on upcoming changes in tax legislation), while the interest earned in the money market attracts tax up to 40% (once the annual interest exemption has been earned).



- *The closure of dividend income funds.* Tax-sensitive investors are heavily invested in dividend income funds and when these close in February next year (due to a tightening of the tax legislation) these investors will be forced to look at tax-efficient alternatives.
- *Upcoming changes in tax legislation will be very positive for preference shares.* The changes to our tax system for dividends from STC to one of withholding tax, will take effect on 1 April 2012. The mechanics are quite complicated, but the bottom line is that dividends on non-redeemable preference shares will be grossed up for the withholding tax that investors will now have to pay SARS. For the man in the street this change is tax and cashflow neutral. But pension funds are not subject to the withholding tax, and there is a reasonable chance that the asset class re-rates once pension funds start buying an asset which has become 10% more attractive to them (10% is the dividend withholding tax).

We believe that the opportunity is compelling. It is our experience that you should never allow yourself to feel too comfortable when you are thinking the same as everyone else in the room...

Buy preference shares, not in spite of their de-rating over time but because of it! But remember that nothing in life is for free. Preference shares come with the following health warnings:

- *Credit risk:* They sit lower in the capital structure than debt, so one needs to invest with a Fund Manager that actively manages credit risk on your behalf (inherent in the Coronation Preference Share Fund or any of our asset allocation funds).
- *Liquidity:* Preference shares are illiquid. Although this is not an issue for most investors, those who are investing tens of millions into this asset class need to be aware of this constraint.
- *Capital risk:* Preference shares re-rate and de-rate over time based on demand and supply for the instruments. This exposes investors to capital risk. However, we believe that investors should focus on the percentage of prime at which they bought (consequently secured for the duration of their holding) and ignore the daily mark to markets they will experience on the instrument.
- *Tax risk:* The views in this article are relevant for non-redeemable preference shares only and not the more exotic variations available.

*\*Non-redeemable preference shares (also sometimes called perpetual preference shares) are the only preference share where the issuer has expressly committed to gross up the dividend when the upcoming tax changes on dividends are implemented. Being perpetual in nature, the income is clearly a dividend and unlikely to be classified as interest for tax purposes.*

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