

Preference shares still looking attractive

PREFERENCE shares, in terms of price, have held up remarkably well in the current equity market maelstrom.

The asset class has had a good six months and still seems set to perform well and generate attractive returns going forward. This follows two years of falling prices in response to the series of interest rate hikes, and the resultant sell-off.

Moving into 2009, we expect a modest price recovery as the Reserve Bank continues to lower its prime rate of lending, which means that now would be a good time to lock in yields at these prices. Should interest rates fall rapidly, preference shares are likely to out perform the money market. Currently, the Coronation Preference Share Fund is yielding approximately 11,2% (after fees), while the Coronation Money Market Fund is yielding around 11% (after fees), but this yield will fall away sharply when interest rates are reduced. Preference shares can provide some capital gain, whereas money market funds don't, as interest rates are reduced. However, investors should bear in mind that preference shares are slightly higher risk, and have shown material price volatility in the short term.

Preference shares are best suited to the long-term investor looking for an attractive after-tax yield on their investments. Due to their tax-efficient nature, they are also great for higher-net-worth individuals who want to diversify their exposure and reduce their taxable income. Most preference shares pay dividends of around 70% to 75% of the prime rate. However,

due to the declining price of preference shares in recent years, the effective yields are now closer to 80% of prime, as investors are paying a lot less for this instrument which is contractually obliged to pay 70 to 75% of prime as a dividend.

While we expect the yields on these instruments to come down as a result of falling interest rates, investors can still expect some capital gain in addition to the dividend. While bank preference share dividends are non-cumulative as opposed to corporate issues being cumulative, we believe that our local banks are very well capitalised and the risk of a skipped dividend to be minimal. The Coronation Preference Share Fund, now in its third year, has a 67% exposure to South Africa's top four banks, with the balance in corporate preference shares.

An actively managed portfolio of preference shares reduces company specific risks and allows investors to participate in the upside offered by relative mispricing between preference shares that occurs over time.

•Tania Miglietta is a portfolio manager at Coronation Fund Managers.

TANIA MIGLIETTA

