SLATER ASSET MANAGEMENT

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Slater Quarterly Recap

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LYZ920F
Lysander-Slater Preferred Share Dividend Fund

TSX:PR
Lysander-Slater Preferred Share *Active*ETF

The Canadian Preferred Share market lost ground in April and May, but recovered some of those losses in June. Overall, the S&P/TSX Preferred Share Total Return Index (the "Index") was down 2.07% in Q2/23. Similarly, Series F of the Lysander-Slater Preferred Share Dividend Fund (the "Fund"), and the Lysander-Slater Preferred Share *Active*ETF (the "ETF") were down 2.0% and 1.91%, respectively, on a total return basis.

On a year-to-date basis however, the Fund and ETF outperformed the Index, with total returns of +1.38% and +1.46%, respectively, vs. +0.15% for the Index.

Persistently high inflation continued to worry the Bank of Canada ("BoC") and the U.S. Federal Reserve ("Fed"), whose response was to raise interest rates further in the quarter. The BoC increased its target for the overnight rate by 25 basis points to 4.75%, and the Fed raised its range by 25 basis points to 5.0%-5.25%. Quantitative tightening, which has been in place since early-2022, has yet to sufficiently rein in inflation.

Projections for monetary policy going forward resulted in high interest rate volatility in Q2. For instance, the 5-year Canada bond yield (the benchmark for fixed-reset Preferred Shares) fluctuated between 2.85% and 3.86%, and finished the quarter at 3.68%. High interest rate volatility lead to relatively high price volatility in the Preferred Share market.

At a certain point, with short-term treasuries yielding as high as 5.0%, investors had plenty of attractive risk-free fixed income alternatives to choose from. We used this as an opportunity to increase our cash and equivalent positions to between 15% and 30%, mainly using Canada T-bills. The strategy worked well for us, as both the Fund and ETF finished 1st quartile in terms of YTD performance among Preferred Share mandates.

Recent proposals contained in the Canadian Federal Budget have suggested that dividends received by institutions and corporations (such as insurance companies) may become taxable starting in 2024. While the headline likely contributed to price weakness in April and May, we believe that the impact of such a change in taxation on the Preferred Share market would likely be muted by several factors, including the following:

1) With exposure to Preferred Shares currently estimated at $2.7 billion, the dominance of insurance companies in the sector has declined significantly;

2) The proposed tax changes would not force insurance companies to sell their Preferred Shares. Selling, if it were to happen, would likely be done using “block” trades, allowing for minimum market disruption; and

3) Insurance companies have historically been loyal, long-term investors in Preferred Shares, using their stable and consistent income stream to meet insurance and pension payment obligations.

Our view is that the Canadian Preferred Share market is undervalued relative to other high-yielding asset classes, especially if the 5-year Canada bond yield can hold above 3.0%. The risk to our outlook is that a severe recession occurs, resulting in extreme downward pressure on bond yields.

With this in mind, we have reduced some of our cash and equivalent positions in favour of discounted fixed resets with reset dates in late-2023 and early-to-mid 2024. At current prices, issues rated in the P2 category offer yields-to-reset in the 8%-10% range; issues in the P3 category offer yields-to-reset above 10%. We believe today’s historically wide yield spreads will eventually result in upward price movement for the sector.

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