Benefitting From Tax Loss Selling in Preferred Shares

As the end of the year approaches, celebrating the holiday season is usually top of mind for most investors. But for some, they might have to pause for a while to think about implementing strategies to minimize their taxes before the New Year arrives. Though an unavoidable consequence of investing, the less taxes they pay, the better off they are.

Although investors can use a variety of different strategies to reduce their tax bill, tax loss selling is usually one which attracts increased attention at year-end, particularly from those who have realized capital gains during the year.

What is tax loss selling?

Basically, a tax loss selling strategy involves selling securities at a loss. The loss is used to offset capital gains realized during the current year. Any loss that is greater than the current year's gains can be carried back for up to three years to offset any capital gains in these prior years. This effectively means that investors can potentially get a refund on taxes already paid for up to three previous years. If the losses are not used in the current year, they can be carried forward indefinitely to offset any gains made in future years.

Using preferred shares to implement a tax loss selling strategy

During the year, several categories of equity and fixed income securities made significant gains. However, preferred shares were the only asset class with a negative return over the one-year period ending October 31, 2019 on the S&P/TSX Index, which means that they are among the best options for executing a tax loss selling strategy in the current year.

During this period, the S&P/TSX Preferred Share Index fell by -7.66%. Comparatively, all other major asset classes were up significantly. For instance, the S&P/TSX Composite Index was up by 13.21%, while the iShares Core Canadian Universe Bond Index gained 10.15%. (See Table below for more details)

Total Return Performance		YTD	1 Year
Fixed Income			
Canada	iShares Core Canadian Universe Bond Index ETF	7.58	10.15
US Aggregate	Bloomberg Barclays U.S. Aggregate Index	8.85	11.51
US High Yield	Bloomberg Barclays High Yield Index	12.53	9.15
Global	Bloomberg Barclays Global-Aggregate Index - Hedged	7.81	9.78
Preferred Shares			
Canada	S&P/TSX Preferred Share Index	-0.20	-7.66
US	S&P Preferred Stock Index	15.79	11.61
Equities			
Canada	S&P/TSX Composite Index	18.05	13.21
US	S&P 500 Index	23.16	14.32
Global	MSCI ACWI Index - Hedged	20.28	13.20

Source: Bloomberg, as at October 31, 2019.

So why did preferred shares lose ground?

Preferred shares remain a good investment which provides strong tax-advantaged yields. Typically, they tend to move in sync with the equity markets. However, as the equity markets recovered from losses made last year, preferred shares were slower to recover.

They also came under pressure due to interest rate cuts. As a result, investors sold off their fixed reset preferred shares during the first eight months of the year on the back of a decline in the coupon reset reference rate, namely the Government of Canada 5-year rate, which fell from 2.17% at the beginning of the year to 1.19% at the end of August. Incidentally, fixed-reset preferred shares constitute over two thirds of the total preferred shares market in Canada.

The decline in interest rates was largely due to on-off trade tensions between the US and China which spurred concerns about slowing global growth and the potential of a recession in the US. As a result, central banks in the developed world, including the US Federal Reserve and the European Central Bank, as well as those of emerging markets, cut interest rates to alleviate the impact of a potential economic slowdown, causing global yields to plummet.

Why take losses now?

Tax loss selling typically occurs towards the end of the year, mostly in December. Historical experience shows that prices tend to decline during the first two weeks of the month, largely on higher volumes resulting from tax loss selling. They are generally flat in the third week of December, before returning to November month-end levels in the final week of the month.

It would be prudent to engage in tax loss selling in November. Given that many investors might still want to invest in preferred shares, which have the potential to rise higher, they will get a chance to buy back these shares before the year ends.

If investors sell their preferred shares and realize a capital loss in November, they will have 30 days to repurchase the shares, if they choose to do so, and be able to use the losses to offset any capital gains. Otherwise, the CRA would consider the loss a superficial loss, if similar shares are repurchased within a thirty-day period.

In addition, for a loss to count in the current year, the trade has to settle on or before December 31. Given that the settlement date is two business days after the trade date, the last day for tax loss selling of Canadian preferred shares in 2019 is December 27. If clients sell after that date, the loss will be recorded for tax purposes in the following year.

Effectively, investors can realize losses which can be offset against their capital gains and still be able to remain invested in the asset class.

Preferred shares have scope to head higher

We believe that the Government of Canada 5-year yield will trend higher for the remainder of the year. The probability of a rate cut in Canada has now significantly diminished. Signs of a more conciliatory tone in the US-China talks have eased the pressure on interest rate cuts. The Government of Canada 5-year yield has edged up to nearly 1.5%, leading to a modest increase in the price of preferred shares, especially fixed resets, over the past two months. In fact, the TSX Preferred Share Index has returned 7.64%* since hitting its low on August 28, 2019.

** Total return performance, as at November 22, 2019.*

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Eating your cake and still having it

In spite of their underperformance this year, preferred shares remain a sound investment, with a relatively better risk-reward profile than bonds. In addition, the flow of institutional funds into the space is expected to increase, sending the price of preferred shares higher.

If investors choose to implement a tax loss strategy but would still like to remain invested in the asset class, they may wish to consider exchanging their shares through in-kind transfers for shares of either the Evolve Dividend Stability Preferred Share Index ETF (PREF) or the Evolve Active Canadian Preferred Share Fund (DIVS). Both of these ETFs accept in-kind transfers from single line preferred shares and/or other preferred share ETFs in exchange for units of equivalent value. This strategy qualifies as tax loss selling and may make the process more convenient and efficient for advisors and investors.

These ETFs have broadly diversified portfolios of preferred securities which are trading near their par values and it is very likely that they would not realize any losses during the tax loss selling season.

Here are some key features of Evolve's preferred share ETFs which investors may use to remain invested in preferred shares and still benefit from tax loss selling.

TSX PREF — EVOLVE DIVIDEND STABILITY PREFERRED SHARE INDEX ETF

- Portfolio of 50 high quality Canadian preferred shares
- Minimum rating P3L
- Any rate resets in the portfolio will have a minimum floor feature
- Indicative Yield: 5.25% (as at Oct 31, 2019)
- Management Fee: 0.45%
- ETF Ticker: **PREF**

TSX DIVS — EVOLVE ACTIVE CANADIAN PREFERRED SHARE FUND

- Deep value approach, actively managed by Foyston, Gordon & Payne
- High conviction portfolio of 80 holdings
- Indicative Yield: 6.0% (as at Oct 31, 2019)
- Management Fee: 0.65% (Class A + 0.75% trailer)
- ETF Ticker: **DIVS**
- FundSERV Codes: **EVF100** (Class F); **EVF101** (Class A)

The Evolve team can help coordinate in-transfer transactions using preferred shares with dealer trading desks and assist in getting the best price to buy and sell preferred shares.

SALES TEAM

Sarah Leung
Ontario, Western and Central Canada
Vice President, Sales
416.572.2412 | sleung@evolveetfs.com

Scott Martindale
Western Canada
Senior Vice President, Sales
604.418.9271 | smartindale@evolveetfs.com

Mark Evans
Ontario
Senior Vice President, Sales
416.270.3177 | mevans@evolveetfs.com

Pete Partchenko
Ontario and Central Canada
Senior Vice President, Sales
647.921.2120 | ppartchenko@evolveetfs.com

Patrick Yared
Eastern Canada
Senior Vice President, Sales
514.573.1500 | pyared@evolveetfs.com

Lyes Birem
Eastern Canada
Vice President, Sales
514.430.5444 | lbirem@evolveetfs.com

TRADING ASSISTANCE

Steve Pate
Vice President, Head of Trading
416.572.2107 | spate@evolveetfs.com

Shell Liang
Vice President, Portfolio Manager
416.572.2219 | sliang@evolveetfs.com

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There are risks involved with investing in ETFs. Please read the prospectus for a complete description of risks relevant to the ETF. Investors may incur customary brokerage commissions in buying or selling ETF units.

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