Preferred Share Liquidity & Scalability

The Case for ZPR

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Exchange Traded Funds have some profound structural differences from mutual funds. All mutual fund activities, whether they are purchases or redemptions, have an impact on the underlying security price. ETFs, however, trade in a Secondary market between Seller & Buyer. These Secondary market trades do not have an impact on security prices because the existing unit transfers from one market participant to another.

ETF creations or redemptions will have an impact on security prices, but this activity is modest compared to trade volume. The chart below shows the creation/redemption activity of BMO Laddered Preferred Share Index ETF (ZPR), broken down by year.

	Creation/Redemption	Total Volume	% of Total Volume
2012	2,550,000.00	2,488,868.00	102.5%
2013	66,750,000.00	91,988,230.00	72.6%
2014	20,750,000.00	54,464,024.00	38.1%
2015	67,775,630.00	162,324,016.00	41.8%
2016	111,982,119.00	305,245,874.00	36.7%

Source: BMO Global Asset Management

A few things to point out compared to bond ETFs:

As ZPR has matured over the years, the secondary liquidity on the ETF has increased with ZPR being one of the more widely traded ETFs in Canada. This secondary liquidity is helpful as it allows investors to buy and sell without new units being created/redeemed. In 2016, for every $1 of ZPR traded, only $0.367 of the underlying market needed to be accessed.

- This is higher than the $0.13 of BMO High Yield US Corporate Bond Hedged to CAD Index ETF (ZHY), however, as demand in preferred shares has been significantly higher with flows mainly being one-way (subscriptions). As a result you would expect this number to be higher. In recent weeks, when markets have been more steady, we have not seen trading volume decline, but have seen less subscription/redemption activity. We would expect the creations/redemptions as a percentage of volume to lessen if the preferred share market were to normalize.
- Also, the numbers will be skewed higher due to the custom creation orders we have been doing over the last several years.

It's also important to note that the dynamics of the preferred share market have changed dramatically in recent years:

- While the size of the underlying market has not grown in recent years (due to banks calling back non-Basel 3 compliant issues) and with recent new issue activity being low, liquidity has improved in certain ways.
  - There are more institutional investors in the market now and also preferred share funds (mutual fundss and ETFs), so this allows for easier block trading activity as larger players can offset trades with other larger players.
  - With more ETFs available, market makers can create/redeem ETF units and hedge themselves with other ETFs rather than the underlying shares.
  - ETFs rebalancing on a quarterly basis creates liquidity events for us. We moved to a monthly rebalancing, which has benefitted us because our trade sizes are smaller and more digestible.

To conclude, while liquidity on preferred shares are certainly less liquid than common shares, Preferred shares can be more liquid when traded within an ETF. This is particularly true as the preferred share market is an inventory based market and larger players are now involved that can supply liquidity.

BMO Global Asset Management