

The Canadian preferred share market had a difficult end to the year, as did all risky assets, as the global economy slowed but central banks seemed determined to continue tightening financial conditions. Five-year interest rates fell because of risk-off trade, adding to the pressure on preferred shares. Capital markets were dealing with several concerns including interest rate hikes by the U.S. Federal Reserve, slowing growth in China, geopolitical issues related to Brexit negotiations, the Italian budget, and China/U.S. trade tensions. Global risky assets declined in value and volatility increased as the S&P 500 Index fell 13.5% over the quarter and West Texas Intermediate (WTI) oil fell 38% to \$45.41 per barrel.

The BMO 50 Preferred Share Index fell 11.3% in the fourth quarter, while the broader S&P/TSX Preferred Index was down 10.0%, due to the global risk-off trade, the fall in five-year Canada interest rates from 2.34% to 1.89% and preferred share market specific reasons. The relatively new structured preferred share autocallable notes sold in 2016 worked out well but the more recent vintages have not, with prices falling 15-25% in the quarter. We believe they are an inappropriate investment and the pool does not hold these securities. There was also a large amount of retail selling as seen by exchange-traded fund (ETF) outflows. Within the BMO 50 Preferred Share Index, perpetuals were the best-performing sector, down only 3.55%, while rate re-sets fell 12.48% and floaters plunged 17.21%.

Issuance was light in the fourth quarter with three issues totalling \$800m while five redemptions were announced for \$863m, a net decrease of \$63m during the quarter. Additionally, Royal Bank of Canada announced the redemption of three more non-viability contingent capital (NVCC) issues totalling \$700m that will take place in February 2019. Two bank re-set new issues had very low re-set spreads and thus sold off quickly as the market fell. Back-end spreads on new issues are again becoming too low, so we have been avoiding the issues and looking to pick up product in the secondary market with better total return expectations. Issuance is expected to pick up as banks continue to redeem legacy preferred shares and additional tier-one bonds that they must replace with new preferred shares.

The Fed raised rates by 25 basis points at its late December meeting. It was considered a dovish hike as Fed Chairman Jerome Powell took a much more cautious outlook on rate increases for 2019. The Fed's Dot Plot decreased the number of hikes expected in 2019 from three to two hikes. The Bank of Canada also raised overnight rates by 25 basis points to 1.75% in October, as the bank of Canada wanted to continue removing its accommodative stance. But later in the quarter, the Bank of Canada indicated that it would take a more balanced approach going forward given the headwinds facing the economy.

Performance summary

First Asset Preferred Share ETF (the "Fund") returned -8.26% during the quarter while its benchmark, the BMO 50 Preferred Share Index, returned -11.3% during the quarter, as interest rates fell and as investors sold risky assets.

Contributors to performance

The main contributor to the Fund's performance was sector allocation, with an overweight in the perpetual sector and an underweight in the fixed/floater sector. The best performing floating rate preferred shares in the Fund were the Citigroup N, that benefited from rising Libor yields and the Bank of Nova Scotia D that benefitted from rising T-bill rates.

Additionally, the Fund's selection of securities within the fixed/floaters sector helped performance. The top-performing securities were all non-NVCC bank issues that we believe will be redeemed at their next re-set date due to the loss of capital treatment. The Bank of Nova Scotia Y and Z and the Bank of Montreal Q were the top three non-NVCC bank issues.

Detractors from performance

The main detractors were all individual security selections within the fixed/floater sector. As interest rates fell in the fourth quarter, rate re-sets were hit hard. The main security underperformance came from positions in TransAlta H and F due to weaker credit quality and poor execution of its business plan. As well, AltaGas G fell because of a stretched balance sheet and an acquisition that was not well received by the market.

Market outlook

The outlook for the preferred market is positive to start the year following a very weak fourth quarter. All risky assets sold off into the end of the year and we would expect some bounce back to start the year. Interest rates are very likely to be in a tight range with central banks likely on the sideline for most of the year due to a slowing global economy.

Fund Performance (%)

	1 Month	3 Month	6 Month	YTD	1 Year	2 Year	3 Year	5 Year	SI ¹
First Asset Preferred Share ETF	-0.47	-8.26	-6.72	-5.9	-5.9	2.2	–	–	5.29
BMO Capital Markets 50 Preferred Share Index	-1.81	-11.26	-10.08	-8.51	-8.51	3.65	5.15	0.75	6.32
S&P/TSX Preferred Share TR Index CAD	-1.58	-10.01	-8.57	-7.93	-7.93	2.28	3.82	0.33	5.83
S&P 500 TR Index USD	-9.03	-13.52	-6.85	-4.38	-4.38	7.94	9.26	8.5	9.83

Source: First Asset as at December 31, 2018

¹Inception date: May 11, 2016

Use of Benchmark: The BMO Capital Markets 50 Preferred Share Index (the "BMO Index") is a market value weighted index that represents the Canadian preferred share market and includes 50 Canadian preferred share issues that are listed on the TSX which satisfy specific inclusion criteria. The Index is used as a benchmark to help you understand the Fund's performance relative to the general performance of Canadian preferred shares within the broader Canadian preferred shares market. The S&P/TSX Preferred Share Index is designed to track the performance of the Canadian preferred stock market. The Index is used as a benchmark to help you understand the Fund's performance relative to the general performance of the broader Canadian preferred shares market. The S&P 500 Total Return Index tracks 500 large-cap U.S. stocks representing all major industries. The Index is used as a benchmark to help you understand the Fund's performance relative to the general performance of the broader U.S. equity market.

Definitions:

Fixed Rate Preferred Shares (fixed): A type of preferred share that has a fixed dividend rate, similar to a fixed-income security.

Floating Rate Preferred Shares (floaters): A floating rate preferred share pays a quarterly (sometimes monthly) dividend that "floats" in relation to a reference rate, typically the prime rate.

Rate Reset Preferred Shares (re-sets): This kind of preferred share pays a fixed dividend rate until its reset date. Upon its reset date, if the preferred share is not called by the issuer, the holder has two options. A new fixed dividend rate reflecting the current interest rate environment can be locked-in until the next reset date; or at reset date, the holder can exchange the issue for a floating rate preferred share.

Perpetual Preferred Shares: This type of preferred share has no maturity date and pays a fixed dividend for as long as it remains outstanding. Due to its long duration, a perpetual preferred share can be very sensitive to credit spreads and interest rates.

Risky Assets: A risk asset is any asset that carries a degree of risk. Risk asset generally refers to assets that have a significant degree of price volatility, such as equities, commodities, high-yield bonds, real estate and currencies.

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Signature Global Asset Management

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Investment Philosophy

The Signature investment philosophy aims to deliver the best possible risk-adjusted returns in today's complex environment and is based on these key elements:

- The globalization of the world economy has resulted in increased complexity, requiring specialized knowledge.
- The increased interconnectivity of the global economy demands collaboration.

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