Wenzel Analytics Inc

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Re: Preferred Stocks

Former Clients,

In this time of confinement, I have delved into preferred stocks and become almost evangelical about them as you will see below. To lock in a **9 %** yield plus have opportunities for significant gains is attractive for the income investor – or for most investors if they look at their long-term returns. If you are interested and it fits your allocation, I'd welcome walking through more of the details and strategy, then possibly helping you create a portfolio or be available to manage on your behalf.

I have begun offering coaching on preferred investing on a volunteer basis to individuals with limited resources and wanting additional retirement income. I'm looking for those who have an interest in self-administering and investable assets between $25k and $100k. After orientation, we would do the selections together on Zoom and I would send notices when recommending a sale or we need to do additional buying because of calls. It might lend itself to a group, I don't know. Feel free to refer individuals for whom you think it might be appropriate.

Overview of How Preferred Stocks Work

1. Preferred stocks pay a prescribed dividend rate times par, usually $25. Like interest on a bond, this dividend rate doesn't change until the preferred is bought back (called). Dividends on common stocks can change every quarter. An 8% preferred dividend times $25 provides a **Yield-on-Cost** of 10% if purchased for $20. Most preferreds can be called back five years following the initial offering (IPO). While we can sometimes buy ahead of the IPO for a discount, most often the preferred we buy will have less than five years before the call date, or the call date may have already expired. If the call date has expired the preferred could be called tomorrow or run for years. The point here is that since the purchased price doesn't change and the dividend doesn't change, the Yield on Cost is fixed for as long as we hold the preferred stock.
2. A common stock can go up 10% but then go down 10%. A 10% dividend is collected and thus locked in. It works like a rachet and is not subject to a market decline.
3. There are three reasons to sell a preferred stock. One is if the company is headed for bankruptcy. This is rare and has never happened for preferreds issued by Business Development Companies or agency REITs. Impending bankruptcy is signaled by a persistent drop in the price of the common stock. The other reason to sell is if the preferred stock is selling for more than $25. If it is trading at $27, we want to sell, pocket the capital gains and not take the risk of it being called for $25 and our losing $2 per share. A third reason to sell is if rising interest rates make the original Yield-on-Call not look so appealing, there is a possibility the stock will not be called for years, and better opportunities are available. Thirty-year Treasuries are selling for well under 2%. A rise in rates is not eminent.
4. Besides Yield-on-Cost, the other important metric is **Yield-to-Call**. Assume in the above example that the preferred is purchased for $20 per share and is callable in two years for the $25. If it is called in two years, the capital gains would be $5 or $2.50 per year. Added to our Yield-on-Cost, that gives a Yield-to-Call annual return of **22.5%**. Of course, it may not be called in two years, in which case we ride with the Yield-on-Cost of 10% until it is called, or the price rises above $25.

Lee Wenzel
(952) 944-2699
Lee@WenzelAnalytics.com
www.WenzelAnalytics.com

Wenzel Analytics, Inc.
Registered Investment Advisor
8666 Westwind Circle
Eden Prairie, MN 55344

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My Experience

Fifty-one percent of the money I manage is in seventy different preferred stocks. The **Yield-on-Cost** of current holdings is 9.0%. The **Yield-to-Call** is **19.3%.** I have been dramatically increasing our allocation to preferred stocks because of the attractive returns and protection against a market downturn. The prices have been increasing and the bargains are harder to find, especially for those with qualified dividends.

I was tempted to give you unrealized returns based on current market prices; then I reminded myself that that is irrelevant except for finding opportunities to buy or sell. In my client reporting not showing price changes for preferred stocks, only showing dividends. Gains on sales are only a maybe and we don't know when they will occur. Emotionally we respond and act based on what we see. We are looking for current income, not some future possibility. Fear is what accounts for investors having only half the gains of the funds in which they invest. If I'm managing the preferred portfolio for you, I will do the watching. Why become emotionally involved with a price going up or down when the stimulus is irrelevant?

Even without any capital gains, which with preferreds run about a third of all returns, the 9% Yield-on-Cost compares favorably to my overall book of business return of 7.7% for the past five years - and it has less risk because of the rachet effect of collected dividends.

Is this too good to be true? Why is this available and why is it not more widely implemented?

1. Buying preferreds requires a different set of glasses when looking at company fundamentals. We're not looking for growth potential or value stocks poised for price appreciation. All we care about is if the company is stable and will survive to pay the dividends and eventually buy back the stock. Common stock investors look at preferreds through their common stock glasses and think the preferreds look funny. Bond investors think the same thing. I find that that explains most of the articles I've found that are critical of preferred stocks.
2. The most attractive returns are from preferreds with low trading volumes. The volumes are not high enough for an institutional investor, ETF or mutual fund to buy a million dollars' worth without driving up the price, or to then sell the position without driving down the price. That is why the funds of preferreds perform relatively poorly. There is a lot of difference between a high-volume stock trading in a fraction of a second and selling a house in three months. Most trades execute within an hour, but for some it to takes a day or two. If we want to sell within a few months rather than just collect the income, we shouldn't be buying low-volume preferreds.
3. About a fourth of preferreds pay qualified dividends, giving a better tax rate. If the taxes are a bigger problem for the high-income investor than for the lower-income retired investor, that becomes a competitive advantage for the lower-income investor.
4. When reviewing a list of preferreds it is amazing how often I find preferreds with a negative Yield-to-Call. Someone is not tending their garden. It takes a systematic investor to set up and evaluate what should be purchased and then implement a monitoring system. And as I said, the water is too shallow for the professionals with their systems to swim in the preferreds.
5. Most investors drill down in depth analyzing individual positions and stories. The way to buy preferreds is to have an exhaustive database from which to evaluate, and then compare the variables mentioned here (Yield-on-Cost, Yield-to-Call, and quality measures of survivability). Within these parameters one can choose higher risk and return, or lower risk and lower returns. While there are more wrinkles than we can get into here, such as fixed/floating rates, foreign vs domestic and preferreds issued by various

types of REITs or other companies, the story is in the strategy and features I'm outlining here rather than in the story of an individual stock such as Zoom or Tesla which are what excite most investors.

6. Getting a steady income becomes boring after a while. It is more exciting to bet on a volatile stock, or even on whether the current market will go up or down. The only excitement is if a preferred stock moves up in price towards a call and is then called or moves above the par value and can be sold for a gain.