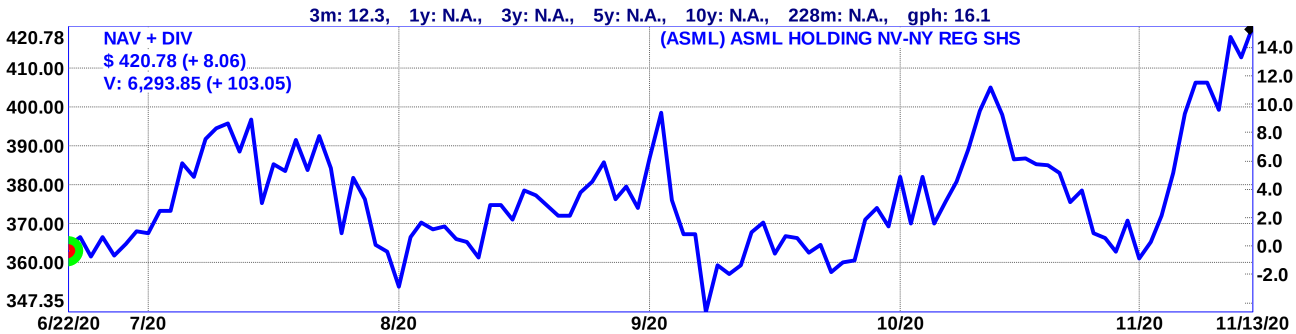
Wenzel
Analytics
Inc

Preferred Stocks and Notes

11/15/20

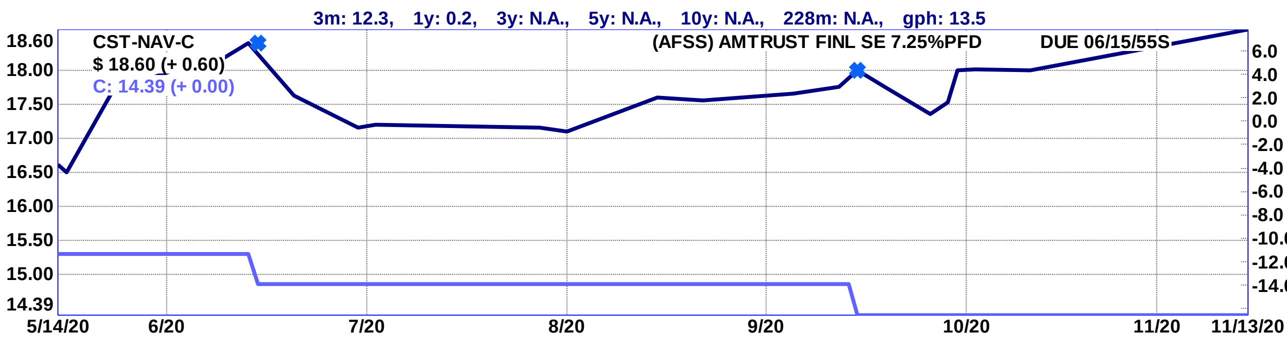
Why buy preferreds

ASML Holding is a growth stock I bought as part of a momentum portfolio on June 22. After ups and downs it is currently up 16.1%. Yesterday I received the first dividend of a mere $20 on a holding of $6,300.



While it is up $1,000, that could disappear tomorrow and given the ups and downs, it well might. Until the stock is sold, unrealized gains are all hypothetical. It's funny money.

Contrast that with a preferred stock paying dividends or a preferred note paying interest.



The preferred note was purchased 12/3/2018 for $17.55/share which for 300 shares came to $5,270. The interest is 10.3% of the $5,270 every year, which is cash in my account entirely independent of what price the market assigns to the stock. Once a distribution is paid there is nothing hypothetical about it. The money is not taken back when the stock price drops. While the price is up 13.5%, which is fickle just like our first example, with this preferred (AFSS) I have another 10.3% annually cash paid out and in the account. The bottom blue line on the chart shows how the cost basis declines with each disbursement. **Charts showing only price change can be very deceptive when the real objective is the steady 10.3% in income**. AFSS happens to be callable, meaning that the company could buy it from me at any time for $25, providing a 34% gain (Yield-to-Call) on the sale above the current market price of $19.92 and 42% above the initial cost of $17.55.

An alternative to mutual funds.

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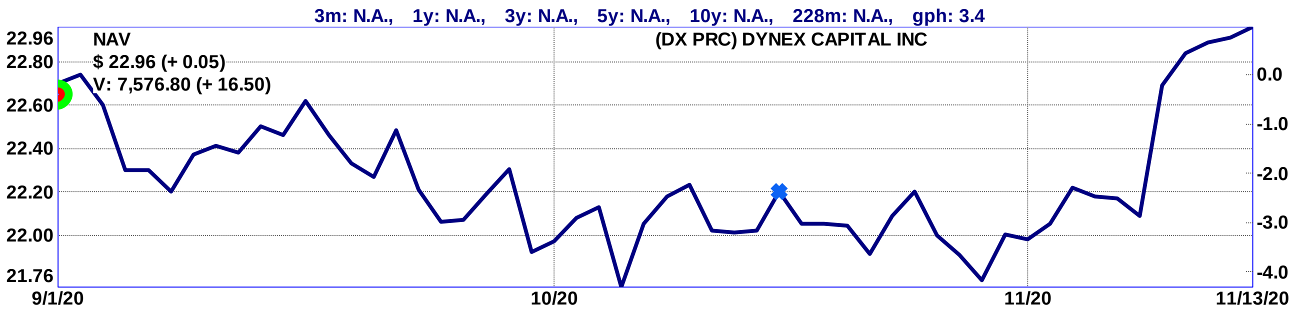
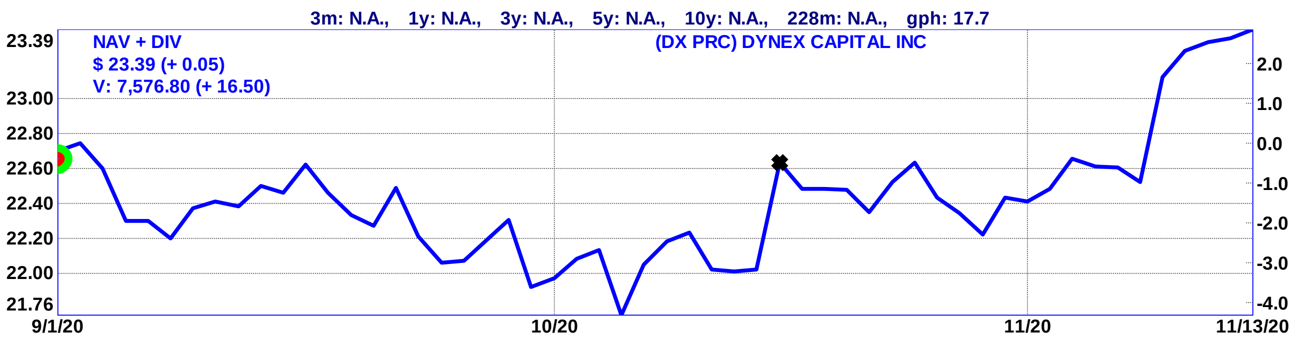
Both of these positions are higher risk and presented here for purposes of illustration, not as recommendations.

AFSS is not a typical preferred. Let's look at Dynex Capital Inc. (DX PRC). The purchase was 9/1/2020 of 330 shares at $22.64 per share. The annual dividend is 6.9% times $25 until the call date of 4/15/25. The X on the chart below marks the first dividend of $142.31. The jump up to the X on the second chart more than first chart is the dividend. To date the price increase is 1.41%, not a lot, but with the quarterly dividend of 1.9% of the current price, the percent change to date is 3.4% or 17.7% annualized. The current yield is 7.5% and the yield-to-call is 9.5%. (Terms defined below.)

Price Only



Price and Dividend



The dividends act like a rachet and result in some strong secure returns (with prudent buying) from some rather ordinary looking charts.

More about how preferreds work

The preferred stocks I buy are initially offered for a par value of $25. They are callable in five years, meaning the company can buy back the preferred for $25 per share five years from the initial offering. I may buy or sell it for more or less than the $25 at any time during that five-year window, or after the call date if not called. If a preferred is callable, it may be bought back tomorrow, or run for years paying the stated dividend percentage on the $25. Preferred notes are typically listed in the same databases as preferred stocks and share most of the same features such as the $25 par value but typically have a termination date. Preferred stocks may be callable but not terminate and run forty years or be perpetual as specified in the prospectus. Rising interest rates could create lower prices offsetting the dividends if sold before called. Preferred notes are also senior to preferred stocks in the capital structure.

We buy common stocks based on reasons and expectations of a price increase. However, we don't know what the price will be in the future and our consequent opportunities to take a profit at any given point in time. Similarly, dividends on common stocks are declared quarterly by the board of directors. We expect a consistent or even increasing dividend, but we don't know what future dividends will be. With preferred stocks and notes we know that the dividend will be the dividend rate times par (usually $25) specified in the original prospectus until it is called.

What if the company can't pay the dividend? Cumulative preferreds have to make up dividend payments in the event the company has a cash flow problem and doesn't pay the dividend. Preferred dividends can only be suspended if dividends on the common stock are canceled. I have about sixty-five different preferreds in the accounts I manage. Given the recent cashflow crunch related to the business impacts of Covid-19, especially for hotels, only one has suspended the dividend. Given its rising price, I assume the market does not see it as a bankruptcy risk and expects the dividend. Cumulative or non-cumulative is usually stated in the name of the preferred along with the dividend rate. The cumulative designation is more important as an indicator of quality than as a protection for consistent dividends.

How to work preferreds

If a preferred is purchased for $20 and has an 8% dividend, it pays $2.00 per share per year (.08 x 25). Changes in the price of preferreds have nothing to do with this income stream and are irrelevant to the investor buying for dividend income. Prices below $25 are only relevant if wanting to buy. Prices above $25 are a signal to take profits and avoid the loss coming from a call at $25 if not compensated by the dividends. In recent years I find that price appreciation gives about a third of the total return, although that will vary depending upon interest rate trends.

When buying a common stock, one doesn't really know what direction the price will take and what the selling price will be. Many investors look at the price and computed value of their stock holdings and are nervous about a possible decline. Prices going up or down have no impact on one's wealth unless one sells. To cope with this anxiety, it is helpful to separate realized gains from unrealized gains. Realized gains from dividends, interest and gains or losses from sales are not hypothetical. They are real and will not change, (although they may be taxed). When monitoring preferred portfolios, it is more useful to track dividends and gains or losses from sold positions than to track current prices. We act based on the decisions we have made resulting from what we choose to watch and monitor.

Current prices are irrelevant if one is investing for income unless prices are in serious decline because the company is headed for bankruptcy or interest rates are skyrocketing. Rising interest could cause a price decline posing a risk if one needs to sell prior to the preferred being called and the current yield is minimal. Another reason to watch prices is if a preferred is trading above par ($25) and callable or approaching a call date, one should sell for a profit and avoid the loss resulting from a call at $25.

For the patient buyer of preferred stocks, one knows that the selling price will be $25 unless one chooses to sell before it is called**.**

When buying compare Current Yield and Yield-to-Call

The preferred purchased for $20 with an 8% dividend would have a **Current Yield** (CY) of 10% ($2 dividend/$20). Since the dividend rate is fixed and the purchase price is fixed, this current yield becomes **Yield-on-Cost** and will continue at that rate independent of consequent price fluctuations. Current yield can also be used to evaluate a position.

If the same preferred stock with a current yield of 10% is callable in two years, the **Yield-to-Call** (YTC) would be 24%. This is calculated by taking the current yield and adding the gains of $5 per share ($25-$20) spread over two years. Of course, it may not be called in two years, in which case we continue to receive the current yield of the initial purchase which becomes Yield-on Cost and in cash is $25 times the dividend rate of the initial prospectus.

Risks

One risk is inflation, diminishing the value of the Yield-on-Cost cash flow. A second risk as stated above, is that rising interest rates could create lower prices offsetting the dividends if sold before called.

A third risk is bankruptcy. It is prudent to watch the price and financial health of the corresponding common stock. A rapidly declining price on a preferred relative to the general market points to a possible bankruptcy risk. Evaluating company fundamentals for bankruptcy risk is very different than evaluating for potential price gains. The company doesn't need to grow rapidly, indeed such a company would rarely issue preferred stock. All we need is for the company to survive. My rule-of-thumb is that anything selling below $20 per share is higher risk. Very roughly, I find that a common stock with a 4% dividend has risks comparable to a preferred with an 8% dividend.

Preferreds are issued in part because they show up on the company's balance sheet as equity rather than debt. Companies list preferreds if they need capital and preferreds are a better option than issuing bonds or common stocks. Companies growing quickly through networking effects need little capital and do not issue preferreds.

Most dividends are taxed as ordinary income, although it is not hard to fill a portfolio with preferreds that have qualified dividends.

Many preferreds have limited liquidity and are therefore off limits to institutional investors in that many preferreds could not absorb a million-dollar order to buy or sell. What is a problem for most investors can be an opportunity for me if it is less of a problem for me than for large buyers or buyers in higher tax brackets. Limited liquidity is a niche opportunity for the individual investor. While most market orders on most stocks execute in less than a second, there is no reason one can't wait for an hour or even a day to get a trade execution. That is still much faster than selling a house.

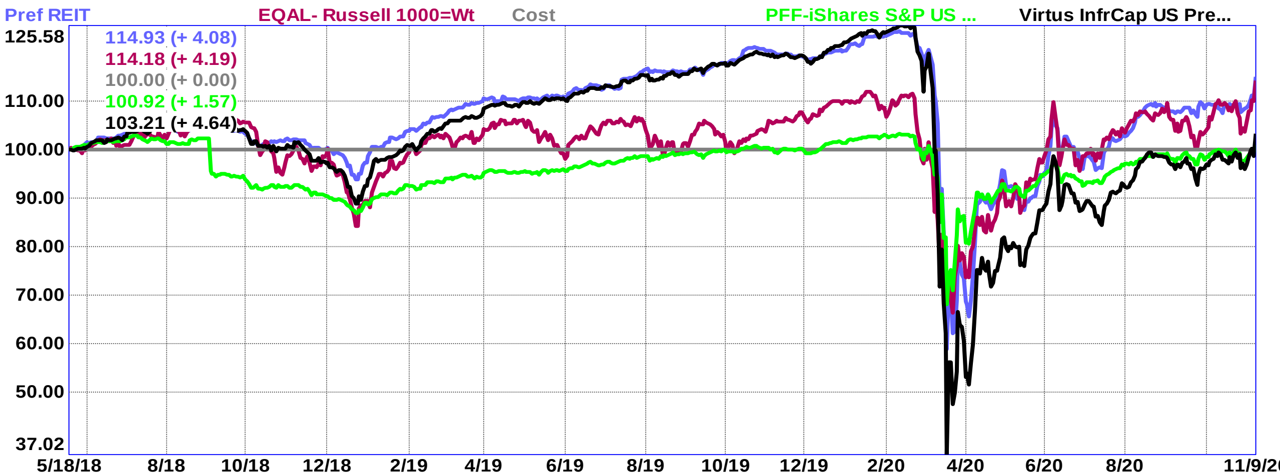
There are both mutual funds and exchange traded funds (ETFs) comprised of preferred stocks, some managed and some built on indexes. In part because of the liquidity disadvantage, they tend to not do near as well as purchasing individual positions to fill a portfolio.   The funds tend to also be leveraged and thus more volatile.

A fund example

An example is Virtus InfrCap US Preferred ETF (PFFA). PFFA is a managed ETF of about $200 million invested in about 150 preferred stocks. A statistically significant correlation was found between the investment in each preferred stock and the exchange trading volume of each stock indicating that even a relatively small ETF is constrained by liquidity more than the individual investor investing in smaller amounts.

PFFA borrows about 20% against its $200 million in holdings. The individual investor, as illustrated by Wenzel Analytics preferred holdings, is able to compete favorably because of the margin impacts on volatility and the liquidity constraints. This is illustrated by the chart below showing relative performance since the inception of the PFFA.

Virtus InfrCap Preferred ETF compared to Wenzel Analytics preferred REITs



Performance was comparable up until February of 2020. Current fund performance is flat from when it started. The Equal-Weighted Russell 1000 is up about 10% as are the Wenzel Analytics preferred REITs.

PFF is an indexed ETF of preferred stocks. Similar charts comparing PFF and PFFA to non-REIT preferreds held by Wenzel Analytics show similar results.

Wenzel Analytics has considerable overlap with PFFA in the positions held, with 43% of Wenzel Analytics preferred dollar holdings also found in PFFA. Current yields for Wenzel Analytics preferreds average **10.4**% compared to **7.7**% for PFFA (medians 8.3% to 7.5%). Yield-to-Call yields for Wenzel Analytics preferreds average **41.6**% compared to **14.7**% for PFFA (medians 15.6% to 10.4%).

The chart also illustrates how easy it is to mistakenly evaluate preferreds by their current price, which dropped considerably with the markets in March of 2020. This created buying opportunities. A chart of dividends paid relative to cost and relative to current price would be very different than a price chart. Income relative to price has gone up dramatically. (My software does that for individual positions, as illustrated above, but not for portfolios.)

Conclusion

While there are many other features that one can pursue or want to avoid, such as fixed/floating rates or the sacrifice in yield in return for the assurances offered by a Moody's rating, I have tried here to capture the main features of buying preferred stocks and notes. As with any investment strategy, one needs to balance expected returns against desired risk in an overall allocation and within the allocation to preferreds.

I have found investing in preferreds more profitable and less volatile than for common stocks. More detailed reporting on performance results of preferred portfolios and in comparison to other portfolios can be found in the Performance Summary document published quarterly at WenzelAnalytics.com. More information about preferreds is also at the website.