

Thoughts on Preferred Valuation in a Turbulent Market

The high-profile default of Lehman Brothers Holdings and the government bailouts of Fannie Mae, Freddie Mac, and AIG precipitated an unprecedented selloff in the preferred securities market. Yields on preferred securities are now at levels that appear to us extremely cheap on both an absolute and a relative basis, but investors rightly question if preferred prices today are low enough to compensate for higher risk of defaults going forward. One way to address this is to ask the question, how bad can defaults be on a diversified preferred portfolio to reduce returns to a particular level?

We start by observing that banking is the cheapest sector of the preferred market today. As of September 19, 2008, an investor could buy a portfolio of bank preferreds that are rated, on average, A-minus at an average dollar price of \$67½ with an annualized yield (the dividend divided by the purchase price) of 11.16%. At the same time, the yield on the 10-year Treasury note was 3.81% annualized. Given the strains in the banking sector currently, we assume that defaults will run at a high rate for the next two years, declining by one-half each year for the next four years, and stabilizing at 0.25% per year in the final four years of our 10-year investment horizon. (The default rate of 0.25% per year represents the average default experience on Moody's investment grade credits from 1994-2007.) Assuming *no recovery* on any defaulted preferred and *no price appreciation*, and *ignoring any impact of dividend deferral*¹ over the investment horizon, defaults can run at 18.0% for the first two years, 9.0%, 4.5%, 2.2%, and 1.1% for the next four years, respectively, and 0.25% for the last four years to equal the return on the Treasury note. Applying those default rates and assumptions over the 10-year horizon, fully 42.2% of the hypothetical bank preferred portfolio can default and still earn the same as the Treasury note. Once again, that's not where the hypothetical portfolio loses money – that's where it breaks even to Treasuries – assuming no price appreciation on the preferreds, no deferrals, and no recovery upon default.

To put that 42.2% cumulative default rate in perspective, about 38% of depository institutions went out of business from the end of 1928 until 1939. Most of those failures happened in the first three years of the Great Depression, which ties in well with our model's assumption of front-end loaded defaults. The main point is that today's prices for preferreds suggest that *the market is pricing in more bank failures over the next decade than occurred during the Great Depression*. This is not a rational expectation, in our view. During the Great Depression, the Federal Reserve tightened monetary policy, exacerbating the credit crunch, and there was no federal deposit insurance, facilitating multiple banking panics as depositors rushed to pull deposits from weakened institutions.

¹ The model ignores the possibility of dividend deferral, whereas virtually all preferreds give the issuer the right to defer dividends. Although dividend deferral (but not default) by financial companies is relatively rare historically, it is a risk that the model does not incorporate. We attempt to compensate for this by making the conservative assumption that recovery upon default is zero, whereas the historical recovery rate on defaulted preferreds, according to Moody's Investors Service, is approximately 13% of par. Nonetheless, a high rate of dividend deferral would reduce the breakeven default rates generated by this analysis.

In contrast, today the Fed is flooding the market with liquidity, and bank deposits under \$100,000 are federally insured, which has kept deposits growing, and the government is currently working on a plan to assist banks in offloading bad assets from their balance sheets. There is little doubt that bank failures will run higher than normal over the next decade, but we believe there is a huge amount of room for investors to make money in bank preferreds between “higher than normal” and 42.2% cumulative defaults. (As of September 19, 2008, the portion of each Fund invested in bank preferreds was 30.4% in PFD and 23.1% in PFO. See the portfolio section of the Fund’s web site for details.)

Taking this analysis one step further, how bad could defaults be on an even broader portfolio of preferred securities? The table below shows the weighted average annualized yield² and weighted average price³ of the portfolio assets (excluding cash) of the Flaherty & Crumrine Preferred Income Fund (PFD) and the Flaherty & Crumrine Preferred Income Opportunity Fund (PFO). Assuming no change in holdings, defaults on these portfolios – which include utilities, insurance, finance, energy, and other sectors in addition to banks (see the portfolio section of the Fund’s web site for details) – can equal 15.9-16.0% for the next two years and total 38.4-38.6% over the 10-year period ending in September 2018 and still equal the return on Treasuries. Once again, these are extraordinarily high levels of breakeven defaults for such diversified portfolios. We admit that it’s *possible* that defaults will be worse than these breakeven levels over the coming years, but our current assessment is that it’s highly *improbable*.

Of course, we are not predicting and cannot predict what actual default rates will be, and it is possible that the Funds’ portfolio holdings would be disproportionately affected by defaults. We also cannot predict when the preferred market will return to more rational pricing, nor can we rule out further price declines in the short run, which may compel the Fund to sell more assets in order to meet certain asset coverage requirements on the Fund’s leverage. Finally, preferred prices are unusually volatile currently, and the results of this analysis could change materially and quickly. This is an unprecedented time in the preferred market, and we recognize that almost anything can happen over the short run. However, we believe that long-term investors in preferreds should be well rewarded at today’s prices.

Flaherty & Crumrine Incorporated
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² Annualized Yield equals the stated annualized dividend or interest rate divided by the closing price of the preferred security as of the valuation date.

³ Price equals the closing price of the preferred security as of the valuation date divided by its par liquidation preference.

Fund (Values as of 9/19/08)	Annualized Portfolio Yield⁴	Average Price (Percent of Par Value)⁵	Starting Default Rate⁶	Breakeven Cumulative Defaults⁷	Breakeven IRR⁸
PFD	10.22%	75.73	16.0%	38.6%	3.81%
PFO	10.16%	77.33	15.9%	38.4%	3.81%

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⁴ The Annualized Portfolio Yield equals the dollar-weighted average Annualized Yield of portfolio holdings, excluding cash.

⁵ Average Price equals the dollar-weighted average Price of portfolio holdings, excluding cash.

⁶ Starting Default Rate is the annual default rate, applied quarterly, for the first two years. Modeled defaults in subsequent years decline by 50% per year for the next four years and then are held constant at 0.25% annualized for the remaining four years of the 10-year horizon.

⁷ Breakeven Cumulative Defaults equals the total percentage of defaults the portfolio can incur, under the modeling assumptions described herein, so that the portfolio's internal rate of return equals the yield on the 10-year Treasury note. Model assumptions include no change in portfolio holdings, no recovery upon default, no change in preferred prices, and no possibility of deferral.

⁸ Breakeven IRR is the internal rate of return on the preferred portfolio under the modeling assumptions. It is equal to the simple annual yield on the 10-year Treasury note as of the valuation date.