

## Preferreds Remain Attractive

This paper updates an analysis we published in January 2009.<sup>1</sup> We provide a brief recap of market events since that time and explain why we believe that preferred securities in general, despite a sizable rally over the past three months, remain extremely attractive for long-term investors.

Figure 1: Merrill Lynch Preferred Indices, Price Return

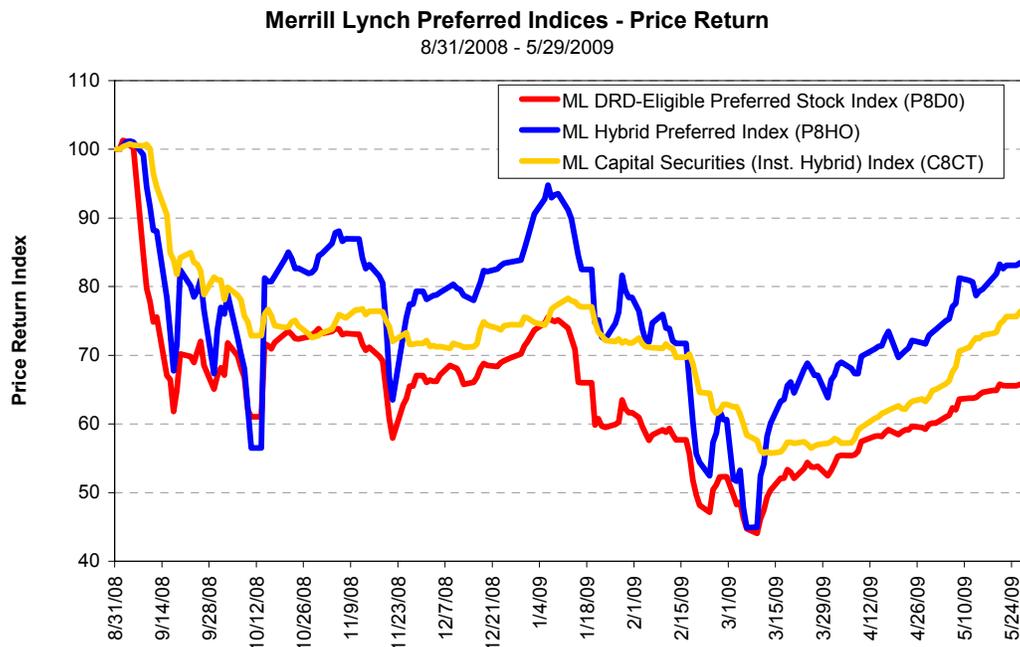


Figure 1 plots the price return (indexed to 100 on 8/31/08) for three Merrill Lynch preferred indices representing DRD-eligible, \$25-par taxable, and institutional taxable preferreds.<sup>2</sup> After stabilizing late in 2008, preferred securities tumbled again in January and February, reaching new lows in early March 2009. This massive selloff was driven by a sharply weakening economy (inflation-adjusted Gross Domestic Product fell at an average annual rate of 6% in 2008:Q4 and 2009:Q1), falling asset prices (including home and stock prices), and serious talk of widespread nationalization of U.S. banks (in part brought on by policy uncertainty as the Obama administration came into office). In those dark days in late February and early March 2009, rationality seemed to have vanished while investor fear ran rampant.

Suddenly, however, investors came to believe that all was not lost. There were several important catalysts for this change in sentiment. First, on February 25, 2009, Treasury

<sup>1</sup> *Preferred Valuation after the TARP*, Flaherty & Crumrine Incorporated, January 5, 2009. Available at [www.preferredincome.com](http://www.preferredincome.com) or [www.fcclaymore.com](http://www.fcclaymore.com).

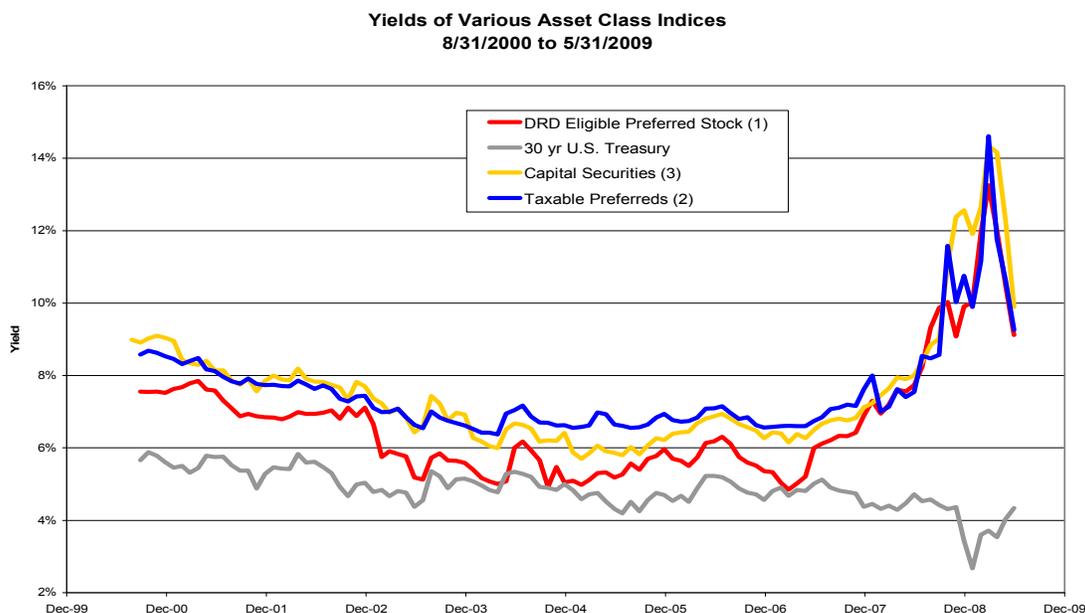
<sup>2</sup> The Merrill Lynch indices used throughout this article are: Merrill Lynch 8% Capped DRD-Eligible Preferred Stock Index (P8D0), Merrill Lynch 8% Capped Hybrid Preferred Securities Index (P8HO), and Merrill Lynch 8% Capped Corporate US Capital Securities Index (C8CT). More information about the Merrill Lynch indices and the Barclays Capital indices (denoted in parentheses in the accompanying graphs) can be found in Appendix B.

announced details of its Capital Assistance Program for banks, which clarified that further government assistance for banks would not subordinate existing preferred holders.<sup>3</sup> Just two days later, Citigroup announced an offer to exchange preferred stock for common stock at prices that, while at a discount to par value, represented a substantial premium to then-current market prices.<sup>4</sup> Third, in late February and early March, several large banks, including JP Morgan Chase, Bank of America, Citigroup, and Wells Fargo announced that they were profitable in January and February. Finally, beginning in March, we began to see some signs that the pace of contraction in the economy was improving: Initial jobless claims began to stabilize, retail sales rose unexpectedly, and home sales (though not home prices) picked up a bit. Subsequent economic data has confirmed this improvement. The economy is still shrinking, but the pace of deterioration has moderated significantly.

With preferred securities priced for a much worse experience than the Great Depression, even a difficult recession looked pretty good, especially when (1) bank nationalization looked increasingly unlikely, (2) preferred securities holders were being treated fairly in any recapitalization, and (3) some big banks were making money. As a result, the three Merrill preferred indices mentioned above have rallied between 43% and 87% from their early March lows through the end of May.

This begs the question, are preferreds still attractive? We think the answer is, yes. The following paragraphs explain why.

Figure 2: Preferred and Treasury Yields



<sup>3</sup> See *U.S. Treasury Capital Assistance Program (CAP) for Banks and Implications of the Citigroup Preferred Exchange Offer*, Flaherty & Crumrine Incorporated, February 27, 2009. Available at [www.preferredincome.com](http://www.preferredincome.com) or [www.fcclaymore.com](http://www.fcclaymore.com).

<sup>4</sup> The subsequent rally in Citigroup common stock has pushed the exchange value of the preferreds above par value currently.

Figure 3: Preferred Securities to US Treasury Yield Spreads

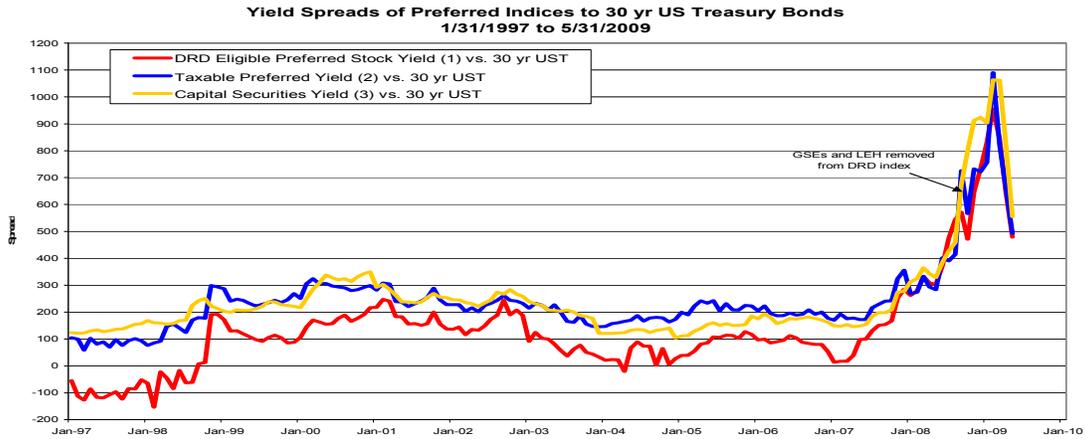


Figure 4: Preferred Securities to Corporate Bond Yield Spreads

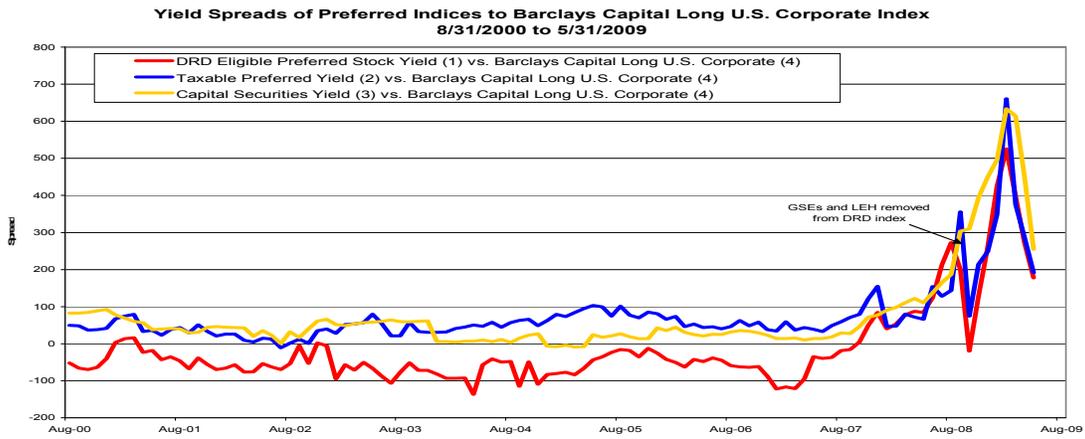
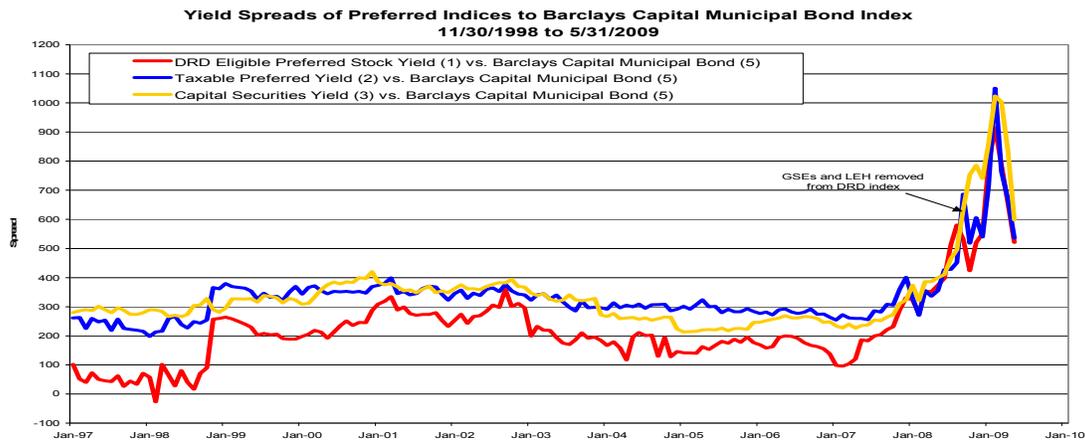


Figure 5: Preferred Securities to Municipal Bond Yield Spreads



### *Historically High Yields*

Even after their recent rally, preferred securities represent the highest-yielding investment grade fixed income asset class. Preferreds remain historically cheap to Treasuries, investment grade corporate bonds, and municipal bonds. Figures 2 through 5 show the historical yields and yield spreads to Treasuries, corporates, and municipals for the three Merrill Lynch preferred indices to which we are referring in this paper. The graphs show that while preferred yield spreads are not as wide as they were in early March, they remain very cheap to other benchmark fixed income investments using any historical benchmark other than the past few months.

### *Default Tolerance*

Because preferred yield spreads remain high historically, preferred securities in general can tolerate very high default rates and still deliver attractive returns. We updated the breakeven default analysis that we did in our January paper, using the same model and assumptions.<sup>5</sup> Figure 6 shows the results for the three Merrill Lynch indices we discussed above.

Figure 6: Breakeven Default Table for Merrill Lynch Preferred Indices

| <b>Merrill Lynch Index Values (as of 5/29/2009)</b> | <b>Annualized Portfolio Yield<sup>6</sup></b> | <b>Average Price (Percent of Par Value)<sup>7</sup></b> | <b>Starting Default Rate<sup>8</sup></b> | <b>Breakeven Cumulative Defaults<sup>9</sup></b> | <b>Breakeven IRR<sup>10</sup></b> |
|---|---|---|--|--|-----------------------------------|
| DRD Pfd (P8D0)                                      | 8.64%   | 80.06   | 13.34%                                   | 33.5%  | 3.49%                             |
| Hybrid Pfd (P8HO)                                   | 9.10%   | 77.49   | 14.37%                                   | 35.5%  | 3.49%                             |
| Cap Securities (C8CT)                               | 9.62%   | 70.36   | 15.52%                                   | 37.7%  | 3.49%                             |

Putting these default rates into the perspective of the Great Depression, from the end of 1928 to 1939, cumulative default rates on Moody's investment grade, Baa-rated, and all-rated (including speculative grade) issuers were 6.7%, 10.2%, and 28.0%, respectively. Results for banks were even worse. Roughly 38% of depository institutions failed over that 10-year period, most of them during the first three years.

Given breakeven cumulative default rates of between 33.5% and 37.7%, the market is now pricing in a scenario for the preferred market that falls somewhere between the default experience of all-rated issuers (28%) and banks (38%) *during the Great Depression*. That does represent a move back toward rationality compared to earlier in

<sup>5</sup> See Appendix A for a description of the model.

<sup>6</sup> The Annualized Portfolio Yield equals the dollar-weighted average Annualized Yield of index securities.

<sup>7</sup> Average Price equals the dollar-weighted average Price of index securities.

<sup>8</sup> 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.

<sup>9</sup> Breakeven Cumulative Defaults equals the total percentage of defaults the portfolio can incur, under the modeling assumptions, so that the portfolio's internal rate of return equals the yield on the 10-year Treasury note.

<sup>10</sup> 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.

the year, when markets were pricing in default rates significantly *worse* than during the Great Depression. In our opinion, however, current breakeven default rates are still much too high, for the following reasons:

- The Merrill preferred indices are comprised of investment grade preferreds only. Thus, one should expect defaults on index securities would be lower, even if defaults for all-rated companies run as high as they did during the Great Depression.<sup>11</sup>
- Fiscal and monetary policies are hugely expansionary, credit markets are recovering, and business and consumer confidence have improved. The recession has begun to moderate, making Depression-era economic scenarios increasingly unlikely.
- Banks are regaining access to private capital. In the wake of the government's Supervisory Capital Assessment Program (SCAP), or 'stress tests,' many of the nation's largest 19 bank holding companies have raised substantial amounts of common equity capital, through either sales of common stock or voluntary exchanges of preferred securities into common stock. These actions should leave these banks with adequate capital even in the event of significantly worse than expected defaults.<sup>12</sup> They also reinforce the equity capital cushion that supports the remaining preferred securities at these institutions.

In short, it seems to us that the market is still pricing in another Great Depression even though that scenario appears more and more remote. That spells opportunity to us. We update January's table of scenarios in Appendix A.

#### *Could Preferred Prices Go Back Down Again?*

We have learned over the course of this financial crisis that preferred securities prices can move more sharply and to greater levels of misvaluation than we ever thought possible. As a result, the short answer to the above question has to be, yes. However, it's plain in hindsight that the valuations of early March 2009 were much too low, and we do not expect that they will go back there.<sup>13</sup> The fact that prices have been lower should not prevent long-term investors from buying today if valuations are still attractive. Although we anticipate that volatility is likely to remain high over the coming quarters, we continue to see good upside potential in preferred securities over the long term – and high income while we wait.

Flaherty & Crumrine Incorporated  
June 2, 2009

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<sup>11</sup> The portfolios of the closed-end investment companies managed by Flaherty & Crumrine Incorporated hold both investment-grade and below-investment-grade preferred securities.

<sup>12</sup> 'Stress Tests' Signal New Phase to Bank Recapitalization, Flaherty & Crumrine Incorporated, May 11, 2009. Available at [www.preferredincome.com](http://www.preferredincome.com) or [www.fcclaymore.com](http://www.fcclaymore.com).

<sup>13</sup> That is not so say a repeat of the March 2009 low is impossible, just that it is extremely unlikely.

Appendix A: Scenario Return Table for Merrill Lynch Preferred Indices (10-year Horizon beginning May 29, 2009)

| <b>Merrill 8% Capped DRD-Eligible Preferred Stock Index (P8D0). Starting Price = 80.06, Annualized Portfolio Yield = 8.64%</b>    |                     |              |                      |               |   |  |
|---|---------------------|--------------|----------------------|---------------|---|--|
| Starting Default Rate   | Cumulative Defaults | Ending Price | Ending Current Yield | Preferred IRR | Scenario Description                                    |  |
| 22.48%  | 49.6%               | 80.06        | 8.64%                | 0.00%         | Zero Return   |  |
| 13.34%  | 33.5%               | 80.06        | 8.64%                | 3.49%         | Breakeven to UST 10-yr                                  |  |
| 15.59%  | 37.8%               | 80.06        | 8.64%                | 2.62%         | Bank default rate in Great Depression                   |  |
| 10.73%  | 28.0%               | 80.06        | 8.64%                | 4.51%         | Default rate for all rated bonds in Great Depression    |  |
| 3.31%   | 10.2%               | 80.06        | 8.64%                | 7.48%         | Default rate for Baa-rated bonds in Great Depression    |  |
| 3.31%   | 10.2%               | 90.00        | 7.69%                | 8.30%         | Same as above, but average price recovers to 90% of par |  |
| <b>Merrill 8% Capped Hybrid Preferred Securities Index (P8HO). Starting Price = 77.49, Annualized Portfolio Yield = 9.10%</b>     |                     |              |                      |               |   |  |
| Starting Default Rate   | Cumulative Defaults | Ending Price | Ending Current Yield | Preferred IRR | Scenario Description                                    |  |
| 23.42%  | 51.1%               | 77.49        | 9.10%                | 0.00%         | Zero Return   |  |
| 14.37%  | 35.5%               | 77.49        | 9.10%                | 3.49%         | Breakeven to UST 10-yr                                  |  |
| 15.69%  | 38.0%               | 77.49        | 9.10%                | 2.97%         | Bank default rate in Great Depression                   |  |
| 10.73%  | 28.0%               | 77.49        | 9.10%                | 4.93%         | Default rate for all rated bonds in Great Depression    |  |
| 3.31%   | 10.2%               | 77.49        | 9.10%                | 7.95%         | Default rate for Baa-rated bonds in Great Depression    |  |
| 3.31%   | 10.2%               | 90.00        | 7.83%                | 8.98%         | Same as above, but average price recovers to 90% of par |  |
| <b>Merrill 8% Capped Corporate US Capital Securities Index (C8CT). Starting Price = 70.36, Annualized Portfolio Yield = 9.62%</b> |                     |              |                      |               |   |  |
| Starting Default Rate   | Cumulative Defaults | Ending Price | Ending Current Yield | Preferred IRR | Scenario Description                                    |  |
| 24.47%  | 52.6%               | 70.36        | 9.62%                | 0.00%         | Zero Return   |  |
| 15.52%  | 37.7%               | 70.36        | 9.62%                | 3.49%         | Breakeven to UST 10-yr                                  |  |
| 15.69%  | 38.0%               | 70.36        | 9.62%                | 3.42%         | Bank default rate in Great Depression                   |  |
| 10.73%  | 28.0%               | 70.36        | 9.62%                | 5.42%         | Default rate for all rated bonds in Great Depression    |  |
| 3.31%   | 10.2%               | 70.36        | 9.62%                | 8.49%         | Default rate for Baa-rated bonds in Great Depression    |  |
| 3.31%   | 10.2%               | 85.00        | 7.96%                | 9.76%         | Same as above, but average price recovers to 85% of par |  |

These scenario returns were generated using a default model that applies a quarterly default rate to a portfolio of preferred securities. We assume that: (i) defaults run at a high, constant rate for the first 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; (ii) there is no recovery upon default; (iii) preferred prices remain unchanged unless noted otherwise; (iv) defaults occur at the end of each quarter, and (v) there are no dividend deferrals. Although dividend deferral (but not default) by financial companies is relatively rare historically, it does happen, and 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 our default model.

See "Thoughts on Preferred Valuation in a Turbulent Market," Flaherty & Crumrine Incorporated, September 19, 2008 for a more complete description of the model and its assumptions. A copy is available at [www.preferredincome.com](http://www.preferredincome.com) or [www.fcclaymore.com](http://www.fcclaymore.com).

The columns in the table denote certain model inputs and outputs. The Starting Default Rate is the scenario default rate for the first two years (thereafter declining by one-half each year to 0.25% for the final four years). Cumulative Defaults represent the total percentage of the original portfolio that has defaulted by the end of the 10-year horizon. The Preferred IRR is the internal rate of return earned on the preferred portfolio given the assumed inputs. The first two scenarios in each section illustrate how high defaults can go to generate IRRs equal to zero and the 10-year Treasury yield. The next three scenarios in each section target various cumulative default rates from the Great Depression (1928-1938). The cumulative default rate of 38% represents failures of depository institutions during the Great Depression; the cumulative default rates of 28% and 10.2% represent the cumulative defaults of Moody's all-rated (investment grade and speculative grade) and Baa-rated rated credits, respectively, over the same period. The last scenario in each section uses the Baa default rate, but increases the ending preferred price, which increases the IRR. Recovery upon default is assumed to be zero in all scenarios. Pricing data is as of 5/29/2009.

## Appendix B: Notes to Market Indices

### *Notes to All Market Indices*

All index returns include interest income (except the preferred price return series shown in Figure 1) and do not reflect any expenses. They are presented on a pre-tax basis and are calculated on a month-end basis. In addition, the index returns are unmanaged and do not necessarily represent any investment products managed by Flaherty & Crumrine.

### *Merrill Lynch Preferred Securities Indices*

Merrill Lynch 8% Capped DRD-Eligible Preferred Stock Index (P8D0), Merrill Lynch 8% Capped Hybrid Preferred Securities Index (P8HO), and Merrill Lynch 8% Capped Corporate US Capital Securities Index (C8CT). These indices are referenced as (1), (2), and (3), respectively, in the accompanying graphs. P8HO is a subset of the Merrill Lynch Fixed Rate Preferred Securities Index that contains all listed, subordinated constituents of the fixed rate index with a payment deferral feature. The fixed rate index includes investment grade DRD eligible and non-DRD eligible preferred stock and senior debt. P8D0 is a subset of the fixed rate index that contains fixed rate preferred securities which qualify for the corporate dividends received deduction and are issued by U.S. corporations and government agencies. C8CT is a subset of the Merrill Lynch Corporate All Capital Securities Index that contains investment grade fixed rate or fixed-to-floating rate \$1,000 par securities that receive some degree of equity credit from the rating agencies or their regulators. All three indices have the issuers capped at 8%.

The yield to maturity for the Merrill Lynch indices is supplied by the Bloomberg mnemonic `MLI_YTM_CONV` and is defined as the average yield to maturity of constituents weighted by market value. The yield to maturity for C8CT after 6/30/2007 calculated by Flaherty & Crumrine using index member data and pricing provided by Merrill Lynch.

### *Barclays Capital Indices*

The Barclays Capital Long U.S. Corporate Index is a subset of the Barclays Capital U.S. Corporate Investment Grade Index that contains publicly issued U.S. corporate securities and global issues that are SEC-registered. The index includes investment grade fixed rate securities in the industrial, utility, and finance sectors. The Barclays Capital Municipal Bond Index includes fixed-rate investment-grade rated bonds issued by municipalities at least at least one year from their maturity date, including general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds. These indices are referenced by (4) and (5), respectively, in the accompanying graphs. Both Barclays Capital indices were formerly known as Lehman Brothers indices.

The yield to maturity for the Corporate Index and the yield to worst for the Municipal Index are obtained directly from the Barclays Capital Live website at <https://live.barcap.com>.

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