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What everyone needs

Evan Lorenz and Fabiano Santin write:

The Fed's dovish tilt following the fourth-quarter plunge in stock prices has done income-famished investors no favors. Since Nov. 8, 10-year Treasury yields have sunk to 2.6% from 3.2%. Since December, junk-bond yields have plunged to 6.4% (that is, before factoring in defaults) from 8.1%. Where to turn for income? A trio of fixed-rate preferred-stock suggestions follows.

The decline in rates has taken its toll on the investment appeal of the fixed-to-floating-rate bank-preferred shares about which *Grant's* waxed bullish. Such securities pay a fixed dividend, usually for the first five years, and thereafter a floating dividend. Last year we wrote about the Wells Fargo & Co. Series Q fixed-to-floating-rate preferred, priced to yield 5.85% to the March 15, 2023 call date. That yield has dropped to 4.7%, indicating that the market believes Wells will retire the shares. Well and good except for the value proposition, which shrinks along with the yield.

Other preferred stocks, too, have lost in investment merit what they had gained in popularity: the PNC Financial Services Group, Inc. Series P (which yields 3.6% to the May 2022 call), the Citigroup, Inc. Series K (4.4% to November 2023), the Morgan Stanley Series E (3.9% to October 2023), the Fifth Third Bancorp Series I (4.1% to December 2023), the Goldman Sachs Group, Inc. Series J (4.3% to May 2023), the Northern Trust Corp. Series C (3.1% to October 2019), the Charles Schwab Corp. Series C (2.3% to December 2020) and the JPMorgan Chase & Co. Series AA (3.1% to September 2020).

You may recall the special treatment that so-called qualified dividends receive from the Internal Revenue Service (*Grant's*, May 4, 2018). Hold these securities for more than one year, and you pay the long-term capital-gains rate on price appreciation and income alike. That's a 20% rate at the federal level, compared with the top marginal ordinary-income rate of 37%.

Blue-state residents might prick up their ears. The qualified dividend rate for a New York City dweller—after adding in the 16.5% tribute that he or she is privileged to pay to the accounts of the city and state and Obamacare—comes to 36.5%. California residents shell out an all-in 37.1% rate. It's almost certainly lower than the comprehensive state, local and federal charge they bear in the normal course of things.

The securities discussed below enjoy federal tax treatment at the qualified rate (where you choose to live is your business). Each offers a respectable yield pick-up from the 10-year Treasury though without the government's credit quality. And, of course, each would suffer in price if interest rates shot up again.

One such specimen is the triple-B-minus-rated Wells Fargo Series X 5½% Non-Cumulative Preferred (CUSIP 94988U672). The shares, of which $1.15 billion are outstanding, are callable starting Sept. 15, 2021, at the $25 par value. At $25.03 a share, the Wells stock yields 5.5% to call, equivalent to 5.9% for Treasurys, or 7.5% for other taxable interest for a tax-bludgeoned New York City resident, who may pay a combined rate of as much as 53.5%. If not called next year, the strip yield is the same, since the stock trades near par.

Wells shows a tier-1 common-equity ratio of 11.7%; it earned an 11.7% return on equity in 2018. Given its recent unwanted regulatory attention, we conjecture that the bank will strive to err on the side of conservative financial practice. As of Dec. 31, non-performing loans amounted to 0.67% of total loans; reserves covered the nonperformers by 101%.

The double-B-plus-rated KeyCorp Series F 5.65% Non-Cumulative Preferred (CUSIP 493267876) is another potential source of yield; $425 million's worth are outstanding, and the shares are callable at the $25 par value beginning Dec. 15, 2023. Priced at $24.78, the Series F sports a yield-to-call of 5.9% (tax-equivalent for New York City residents to a 6.3% yield on a Treasury or an 8% yield on other taxable income). KeyCorp is America's soon-to-be tenth-largest commercial bank following the merger between BB&T Corp. and SunTrust Banks, Inc. In 2018, KeyCorp earned a 12.3% return on equity. The bank's tier-1 common-equity ratio is 9.9%. As of Dec. 31, non-performers amounted to 0.64% of total loans; reserves covered 162.8% of them.

Rounding out our selections is the Arch Capital Group Ltd. 5.45% Series F Non-Cumulative Preferred (CUSIP 03939A107), callable on Aug. 17, 2022. The Series F trades at $23.64 for a yield-to-call of 7.2%, or 5.8% if the shares go unretired. There are $330 million's worth outstanding, and they are rated triple-B by S&P and Fitch.

A long-time equity-market outperformer, Arch is a property-and-casualty-insurance company based in Bermuda that returned 16.5% a year over the past two decades vs. 7.5% for the property-and-casualty component of the S&P 500 and 7% for the Nasdaq composite. Last year, Arch wrote $4.7 billion in net premiums, of which 25% came from residential-mortgage policies, 21% from casualty and professional lines and 14% from the property, energy, marine and aviation sector. The insurance company's rating is single-A-plus, and its unsecured debt is split-rated (Baa1/single-A-minus).

In 2018, operating income rose to $909 million, producing a return on equity of 10.7%, up from $447 million and 5.7%, respectively, from the prior year. Total assets foot to $28.8 billion, and the company appears to be well-capitalized with $8.6 billion in common equity, $780 million in preferreds and $1.7 billion in debt. Arch's investment portfolio is conservatively invested with only 5% of the total allocated to high-yield and non-rated debt and 8% to triple-B securities.

Do even such yields as these fail to produce the income with which to live the life that a reader of *Grant's* so richly deserves? Address complaints to Jerome Powell, Chairman of the Federal Reserve Board, Washington, D.C., 20551.

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