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Personal preference

Fabiano Santin writes:

You have cash and a problem: How to earn income with an acceptable level of risk? You could buy investment-grade bonds, but you won't get rich off the 2.8% yield on offer (a 97 basis-point pick-up over Treasurys, near the lowest spread since the financial crisis). Or you could get higher yields (and risks) by delving into junk bonds. However, the 5.1% yield on sub-investment-grade issues is only a 329 basis-point pick-up over Treasurys, a level that is below the long-term default rate (4.2%) and not far from the 303 basis-point spread reached in 2018, the past decade's nadir.

There is, however, one corner of the market that may tick the box: bank preferred shares. First, the downsides: To qualify as loss-absorbing capital, banks have the option to stop paying preferred dividends at any time and dividends are non-cumulative. The securities are often not very liquid, and prospective buyers may find themselves stuck with shares that never mature. While preferred dividends are typically fixed for five years after issuance, the payout rate resets quarterly thereafter.

But there are pluses to the asset class, too. Bank preferreds get qualified tax treatment, i.e., hold the shares for a year, and dividends are taxed at the long-term capital-gains rate. So, a wealthy Californian at the top marginal 54.1% bracket earning 2.2% on Goldman Sachs Group, Inc.'s 4% senior notes due March 3, 2024 (A3/BBB+), which barely yields over 1% after tax, could consider Goldman's 5% Series P preferred shares (Ba1/BB; $1.5 billion outstanding; CUSIP: 38148BAD0) at 101½ that yield 4.5% to the November 2022 call date, or 2.8% after tax.

The Bank of David Solomon shows a tier-1 common-equity ratio of 13.6% on Sept. 30 and earned an 11.6% return on equity in the first nine months of 2019. Nonperformers amounted to 0.82% of total loans at the end of the third quarter, and reserves covered dud loans by 95%.

Citigroup, Inc., a crisis-era ward of the state, is today profitable and well-capitalized. On Sept. 30, the bank had a tier-1 common-equity ratio of 11.6% and generated a 9.5% return-on-equity in the first three quarters of 2019. Nonperforming loans amounted to 0.50% of total loans at the end of the third quarter; reserves covered the nonperformers by 338%.

The Citigroup Series C 6.3% preferred shares (Ba1/BB+; $1.75 billion outstanding; CUSIP: 172967HQ7) could be another option. Callable on May 15, 2024, the shares change hands at 108.3 and yield 4.2% to the call, or 256 basis points over Treasurys.

Or you may prefer to stick to the even safer, investment-grade junior securities of JP Morgan Chase & Co. The Series X 6.1% preferreds (Baa2/BBB-; $1.6 billion outstanding; CUSIP: 48126HAC4) change hands at 109.5 and are callable on Oct. 1, 2024 for a 3.9% yield to call, 226 basis points more than Treasurys. The Series X compare favorably to the bank's 3⅝% senior notes due May 13, 2024, which pay 2.1%, or 50 basis points over Treasurys.

Jamie Dimon's bank shows a tier-1 common-equity ratio of 12.3% on Sept. 30 and earned a 13.9% return on equity in the first nine months of 2019. Nonperforming loans amounted to 0.52% of total loans at the end of the third quarter, and reserves covered the nonperformers by 267%.

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