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After-tax edge

Equities are volatile, junk bonds are rich and cash is, still—even with the upcreep in the London interbank offered rate—blah. Where to turn for income? Now in progress is a bullish review of certain tax-advantaged preferred stocks.

The arithmetic is straightforward. Capital-gains tax rates top out at 20%, ordinary federal-income rates at 37% (to these add the 3.8% Obamacare Medicare surtax as well as state and local taxes applicable to high-earners). Qualified preferred dividend income, like most garden-variety dividend income, is taxed at the former rate, interest income at the latter. To qualify for the former (under the Jobs and Growth Tax Relief Reconciliation Act of 2003), you must hold your preferred shares for a certain number of days prior to the ex-dividend date (more than 60 of the 121-day period beginning two months prior to the ex-dividend date, to be exact). High-frequency traders need not apply.

Banks are the largest issuers of these qualifying preferreds. To secure eligibility for taxation at the 20% rate, the shares must exhibit equity-like characteristics, for instance, they must be undated, i.e., perpetual, and their dividends may be neither guaranteed nor cumulative. Even so, preferred holders rank higher than common equity on the totem pole of credit. If a bank finds it necessary to reduce its payout, the common is likely to be first on the chopping block. (The mortgage REIT preferreds discussed in the Oct. 6 issue of *Grant's* do not qualify because the REIT structure already has built-in tax advantages, including, thanks to the 2017 tax reform, a reduction in the rate on REIT distributions to 29.6% from the prevailing top federal bracket, now 37%, not counting that 3.8% surtax.)

Fixed-to-floating preferred stocks hold obvious appeal in a time of rising interest rates. Such securities are issued with a fixed coupon that converts to floating, typically after five or 10 years from issuance. It is at the point of conversion that the shares become callable at par. Hence, the prices of such preferreds are more usually stable than the corresponding common. Preferreds issued by U.S. Bancorp and Wells Fargo & Co. featured in the Jan. 26 issue of *Grant's*. Unmentioned in that analysis was the tax dimension.

Qualifying preferreds are usually issued with $25 par value; dividends are payable quarterly. "Yield to call" is the yield received if the shares are redeemed on the first call date. "Strip yield" is the yield obtained by dividing the current coupon by the preferred's "clean" price (share price minus the accrued coupon). "Tax-equivalent yield" is the yield one would need to earn on interest income, subject to ordinary income-tax rates, to match the after-tax yield on qualifying preferreds.

Consider, for starters, PNC Financial Services Group, Inc.'s Series P preferred stock (CUSIP: 693475857, rated triple-B-minus). It pays a 6 1/8% dividend and trades at $27.21 per share for a 3.7% yield to call at $25 in May 2022. The yield is equivalent to a 4.83% on run-of-the-mill fixed income for those in the highest tax bracket (taking into account only federal income tax and the 3.8% Medicare tax).

"It's certainly no bargain," observes colleague Fabiano Santin, "but it earns something for mortals who need to gen-

Preferreds at a glance

Preferred stock	S&P rating	Last price	Yield-to-call	Next call date	Yield-to-call (tax-equivalent)	Strip yield	Reset spread
PNC Financial Services Group, Inc.'s Series P	BBB-	$27.21	3.8%	5/1/2022	4.8%	5.6%	406.7bps
Citgroup, Inc.'s Series K	BB+	27.53	5.1	11/15/2023	6.5	6.3	413
Morgan Stanley's Series E	BB+	28.14	4.6	10/15/2023	5.9	6.4	432
Goldman Sachs Group, Inc.'s Series J	BB	25.70	4.8	5/10/2023	6.2	5.3	364
Fifth Third Bancorp's Series I	BB+	28.41	4.0	12/31/2023	5.2	5.9	371

source: The Bloomberg

erate income and beats by 209 basis points the 2.74% offered on comparable Treasurys. Meanwhile, one enjoys a strip yield of 5.6% (the tax-equivalent of 7.26%). If the shares are not called, the coupon changes to a floating rate based on the three-month Libor plus 407 basis points. That rate resets quarterly, which would produce a dividend yield of 5.93% based on today's 2.36% rate on the three-month Libor."

Pittsburgh-based PNC operates in retail, corporate and institutional banking as well as in asset management. It's the sixth-largest bank in the United States. On the March 31 statement date, it showed $379 billion in assets and $44 billion in common equity. PNC owns a 22% minority stake in Blackrock, Inc. worth $18 billion though carried (at year-end, under the equity method of accounting) at $7.7 billion. Net charge-offs to average loans were running at 0.21% at the end March vs. an allowance for losses of 1.18% of total loans.

PNC has a Basel III common-equity tier-1 capital ratio of 9.6%, or 260 basis points higher than the 7% to be required on Jan. 1, 2019. In compliance with the minimum ratio, a bank is permitted to distribute dividends, repurchase shares and pay its executives more than they're worth. Note that the Fed may (or, then, again, may not) raise capital requirements by an additional 250 basis points in the tier-1 ratio as a "countercyclical capital buffer" (the Basel committee's terminology) in 2019 and beyond.

"A bit more juice can be obtained by stepping down the rating ladder with Citigroup, Inc.'s Series K preferred shares (CUSIP: 172967341, rated double-B-plus)," Santin continues. "They pay a fixed coupon of 6⁷/₈% until the November 2023 call date, when the coupon, if not called, resets quarterly to three-month Libor plus 413 basis points. The yield is 5.07% to that call at the current price of $27.53 a share, or 6.53% on a tax-equivalent basis, which is 367 basis points more than comparable Treasurys. Meanwhile, the preferred pays a strip yield of 6.34% (the tax-equivalent of 8.16%). At the current Libor rate, the dividend yield would be 5.99%."

Big and accident-prone, Citi ended the first quarter with $1.9 trillion in total assets and $183 billion in common equity. Designated too big to fail—that is, a "global systemically important bank"—the bank must hold an equity buffer higher than that of smaller banks, such as PNC. The minimum common-equity tier-1 ratio in 2019 is 10% which, currently showing 12.1%, Citi cleanly exceeds. May it remain on the straight and narrow.

And may Morgan Stanley do the same. The investment bank's Series E preferred shares (CUSIP: 61762V200, rated double-B-plus) trade at $28.14 for a yield to call of 4.58% in October 2023, or 5.89% on a tax-equivalent basis, which is 304 basis points more than comparable Treasurys. Holders enjoy a strip yield of 6.34% (the tax-equivalent of 8.16%). After that call date, the 7¹/₈% coupon resets quarterly to three-month Libor plus 432 basis points. If reset to today's Libor, the dividend yield would be 5.95%.

Nearly 60% of Morgan Stanley's $6.1 billion in 2017 earnings stemmed from M&A advisory fees, the issuance and trading of equity and bonds, corporate lending, and other investment-banking activities. Wealth management, which includes brokerage and recurring advisory fees to individuals and small and medium-sized businesses, contributed 40% of profits. As of March 31, the balance sheet showed $860 billion in assets and $69.5 billion in common equity (which the market values at $93.5 billion), well above the $8.5 billion preferred-stock layer.

Morgan Stanley has itself to thank for the tight regulatory leash against which its front office must occasionally strain. No financial institution borrowed more at the Federal Reserve's discount window during the crisis, as Bloomberg reported in 2011; the grand total was $107 billion. No wonder, then, that the Times Square-headquartered investment-banking giant shows a 15.6% common-equity tier-1 ratio, compared to the 10% minimum requirement that takes effect next year.

Another option are the Goldman Sachs Group, Inc.'s Series J preferred shares (CUSIP: 38145G308, rated double-B) trading at $25.70 for a 4.85% yield to call on May 2023, or 6.24% on a tax-equivalent basis to regular fixed income, 342 basis points more than comparable Treasurys. The strip yield stands at 5.36%, the tax equivalent of 6.90%. After the May 2023 call date, the coupon resets quarterly to three-month Libor plus 364 basis points, which, today, would deliver a yield of 5.8%.

Goldman is another too-big-to-fail institution. Like Morgan Stanley, it turned itself into a bank under the U.S. Bank Holding Company Act of 1956 at the depths of the 2008 crisis. In effect, the Bank of Blankfein traded a federal backstop for a hovering federal regulatory presence—not a bad thing from the preferred holder's perspective. On March 31, $72 billion in common equity (now trading at $90 billion by the market) and $11.2 billion in preferreds supported $974 billion in assets. Goldman's common-equity tier-1 ratio was 10.7% at year-end, 70 basis points higher than the regulatory minimum.

Finally there are the Fifth Third Bancorp's Series I preferred shares (CUSIP: 316773605, rated double-B-plus), which trade at $28.41 or at a 4.03% yield to the December 2023 call; that's 5.19% on a tax-equivalent basis, which is 233 basis points more than what is offered on comparable Treasurys. The strip yield is 5.86%, the tax equivalent of 7.54%. If it floated today, the yield would be quoted at 5.37% based on three-month Libor plus 371 basis points.

At the end of the first quarter, Fifth Third's balance sheet showed total assets of $142 billion and a loan book of $92 billion. Its allowance for loan losses amounted to 1.24% of its loan book and the ratio of loss reserves to nonperforming loans was 252%. It's subject to a minimum common-equity tier-1 ratio of 7% in 2019, which, on March 31, it easily exceeded with 10.8%. The $14.7 billion equity layer serves as a cushion to $1.3 billion in preferreds outstanding.

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