Volatile Issues

Agency preferred stock prices vary directly with interest rate movements

by C.J. Pickering and Randy Wade

The prices of floating-rate agency preferred stocks can be expected to go down when rates go down and to go up when rates go up. This phenomenon is partially determined by the fact that 70 percent of the preferred stocks’ dividend rates are tax-exempt.

As J.R. Nunn, our old banker-buddy from Tucumcari, N.M., used to say, “Lemme splain it to you.”

Look at the numbers in Table I to see how tax treatments affect the TEY (tax equivalent yield) of preferred stock dividends under high and low rates. Assume that a preferred stock is issued with a variable-rate dividend equal to the two-year Treasury. The TEY of a 2.0 percent dividend is 2.72 percent, or a tax equivalent spread of 0.72 percent to the 2.0 percent dividend. However, the TEY of an 8.0 percent dividend is 10.88 percent, or a tax equivalent spread of 2.88 percent to the 8.0 percent dividend.

Now suppose that the market expects a TEY spread of at least 2.0 percent to the Treasury. Further suppose that, when rates were high, Fannie Mae issued preferred stock with a 6.0 percent dividend equal to the two-year Treasury. This dividend would give the investor a TEY of 8.16 percent, a TEY spread to the Treasury of 2.16 percent.

If the two-year Treasury later falls to 2.0 percent, the resulting Fannie Mae preferred stock dividend will adjust down to 2.0 percent. Table I shows that the new TEY will be 2.72 percent, and the resulting TEY spread will drop to 0.72 percent over the Treasury—well below the 2.0 percent expected by the market. In fact, to give a 2.0 percent TEY spread to the market, the price will have to drop from $51 to around $34 per share.

Fortunately, the market realizes that the $34 price will recover when rates go up, so the actual price drop will be less than the theoretical drop.

One additional note: Since most preferred stocks are callable at par, the theoretical price of $54 in the last column of Table I would be reached only if the stock is non-callable or callable at a price higher than $54.

Actual Issues and Results

Table II Column A, shows that the Fannie Mae Series F, issued in March of 2000, had a floating rate dividend pegged to the two-year Treasury mi-
nu 16 basis points or 6.30 percent when first issued. Since 70 percent of the dividend was tax free, the actual TEY of the initial dividend was 8.57 percent, or a spread to the two-year Treasury of plus 211 basis points, a swing of 227 basis points—from a margin of minus 16 basis points to a spread of plus 211 basis points.

Table II Column C shows that the Fannie Mae Series K, issued in March of 2003, had a floating rate dividend pegged to the two-year Treasury plus 150 basis points or 3.00 percent when first issued. Since 70 percent of the dividend was tax free, the actual TEY of the initial dividend was 4.08 percent, or a spread to the two-year Treasury of plus 2.58 percent.

Table II Column B shows what happened to the Fannie Mae Series F in 2003, when rates fell dramatically from their previous levels three years earlier. The coupon fell from 6.30 percent to 1.34 percent, the TEY fell from 8.57 percent to 1.82 percent and the TEY spread to the two-year Treasury fell from 2.11 percent to 0.32 percent. Since the new Fannie Mae Series K in Column C had a TEY spread to the two-year Treasury of 2.58 percent, the old Fannie Mae Series F needed a TEY spread of 2.58 percent to be competitive. The theoretical price would have fallen to $37 for the TEY spread to equal 2.58 percent. Of course, the actual market price would normally be higher than $37 since the market understands the price appreciation potential when rates return to higher levels.

It is easy to see that the price of most adjustable rate agency preferred stocks must fall when rates fall for their yields to remain competitive. The good news is that preferred stock prices can be expected to rise when rates rise, just as they fell when rates fell.

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