It is with no small amount of trepidation that I offer an investment column that contains in its title the phrase “Agency Preferred Stock.” Many are the community banks that purchased these items in the early stages of their issue, which was in the 1999-2000 period.

Interest rates were of the high-and-rising category at that point, and many portfolio managers were uneasy with longer-duration securities. Hundreds of investors heard a story about agency preferreds and took a flyer on an issue or two or three.

The Theory, 2000-Style
I know exactly the story you were told, because I said it to a number of community bankers myself. It went something like this:

Bond Salesman: Mr. Banker, if you want to swap out of your munis, we need to do something that has a reasonable risk-reward profile. These agency preferreds have an AA rating by both agencies and a two-year duration because they reset every 24 months. They also have a 70 percent Dividend Received Deduction (DRD), so you can consider them surrogate munis. And did I mention their tax-equivalent yield is 8.50 percent for the first two years?

Mr. Banker: I’ll take some.

A bit of explanation about these items is in order. The coupon will generally reset every 90 days to two years, although there are also fixed rate preferreds. The floating rate issues will have a coupon that is commonly based on the two-year Treasury rate plus or minus a margin. The early issues would reset to the two-year minus about 10 basis points.

The DRD allows an investor to exclude 70 percent of the coupon payments from federal income tax. This made for easy logic that they could replace longer munis and, in the process, shorten durations and not give up any yield. Then 2001 and 2002 hit.

The Practice, 2002-Style
As these began to approach their first reset, many of you noticed your market values began to deteriorate. This seemed counter-intuitive to many of us whose heads were buried in the debris of record mortgage prepayments and call options being exercised. We figured the price should remain relatively stable no matter what the curve looked like or what the absolute coupons were. We were wrong.

As the coupons began resetting lower, investors figured out that as the coupon dropped, the tax-equivalent spread fell further. For an issue that is owned at par, the tax-equivalent yield is about 36 percent above the coupon. This also means the spread to the Treasury curve will fall 36 percent more than the actual coupon. So, to compensate new investors properly, the variable that had to give was price. And give it did.
Let us use the Fannie Mae Series F as an example. Its original coupon in March 2000 of 6.295 percent produced a tax-equivalent yield of 8.56 percent for most banks. When the first reset came about in March 2002, the coupon fell to 3.55 (275 basis points), but the tax-exempt yield fell to 4.83 (373 basis points). By now, the market price had fallen to around 90 cents on the dollar, and it was clear that these had much more price volatility than originally thought.

Another round of resets in 2004 brought the coupon and market values even lower. Although there was some coupon relief in 2006, by the end of that year market values were still hovering around 75 cents on the dollar.

**Fast Forward to 2007**

Now for some better news. The market values on these seasoned issues have almost all improved significantly this year, some by as much as 10 percent. There are several causes of this bounce:
- Fannie Mae’s and Freddie Mac’s financial condition is perceived as more stable (remember agency preferreds are lower on the food chain than agency notes or mortgage-backed securities), and management is more transparent.
- Coupons are the highest they’ve been since 2000.
- A number of these will have another year before they could reset lower.
- We could be in for range-bound yields for a while, which takes some fear of falling yields out of some investors’ thought processes.

Depending on when the reset dates are timed to occur, the market values could actually rise during rising rate environments. Using the Fannie Mae’s F’s as an example again, the next time the coupon will change is March 2008. If the two-year part of the curve were to see rates rise as March approaches, the value will almost certainly rise with it.

**Lessons Learned**

Many community banks were made to impair their Agency Preferred Stock holdings in the last several years. If your bank was among them, going forward its yields have improved, as its new “book” value determines its returns. Also, since the market values have improved since impairment, your bank is recognizing gains on its calculation of GAAP capital via the Available-for-Sale adjustment.

If you haven’t yet impaired your bank’s positions and don’t have the appetite to realize any losses on sale (to be sure, these are still around 10 percent under water), at least there’s the comfort of knowing that there can be market value recovery. These are not on a one-way trip to Enronville.

This story will have several more chapters. I’ll write them as the story unfolds over the next several reset dates.

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