COMPLIMENTARY REPORT

-TECHNICAL TOOL SERIES-

Achieving Higher Yields in Low Yield Times

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Interest rates are at all-time lows, making it difficult for investors who depend on safer investments to generate enough income for them to live on. At Signalert Asset Management we utilize a number of strategies to help clients earn attractive returns without taking on too much investment risk. This report introduces one of those strategies that you can use on your own—preferred stocks.

What are preferred stocks?

Preferred stock is a security that pays a fixed, usually high, dividend. Preferred dividends have a lower priority than principal or interest that a company may owe on its bonds or other loans, but a higher priority than common stock dividends.

Companies issue preferred stocks when they want to raise capital without the strict obligations of borrowing. For example, if a company misses a loan or bond interest payment it is in default and will be exposed to bankruptcy reorganization. However, companies can omit common and preferred dividends without having to seek bankruptcy protection. Because of this, preferred stocks are riskier than bonds of the same company and therefore pay higher yields.

Typically, companies can redeem their preferred stock at any time after five years for a fixed price (usually $25) if interest rates have moved lower, much as you might refinance your mortgage after interest rates move lower. However, if interest rates rise after the preferred stock is issued, companies may never have to redeem their preferred stocks.

Benefits of preferred stocks—high yields

Investment-grade bonds are yielding a measly 2%. We currently recommend three preferred stock investments with yields exceeding 5%, which are summarized in the table below.

Name	Ticker Symbol	Current Yield (and share price)	Yield to worst call*
iShares US Preferred Stock Index ETF	PFF	5.3% ($40.20)	Not applicable, holds 295 stocks
Annaly Preferred, class E 7.625%	NLY-E	7.4% ($25.59)	5.1% on 8/27/2017
American Capital Agency 7.75% preferred	AGNCB	7.3% ($26.30)	5.5% on 5/8/2019

** The lowest possible total return—interest earned plus share price change—if the stock is redeemed at $25 on the earliest possible date.*

Risks of preferred stocks—rising interest rates

You should never invest in a stock without understanding both the potential risks and the potential rewards. In the case of preferred stocks, the potential reward is the yield. There are two risks: rising interest rate and default risk.

The prices of existing bonds and preferred stocks fall as interest rates rise. The last time that interest rates rose significantly was in 2013, when the yield on 10-year Treasury notes jumped from 1.6% to 3%. During this time, the preferred stocks recommended above suffered losses of approximately 10%. They recovered those losses and started making new total return highs within a year. Although interest rates do not appear headed much higher anytime soon, you should keep this risk level in mind when you decide how much to allocate to preferred stocks.

In terms of risk versus reward, preferred stocks appear potentially superior to conventional, investment-grade bonds in the face of a moderate jump in interest rates. Note that the investment-grade bond market benchmark (Barclays US Aggregate Bond Index) is paying just 2% (yield to maturity) and had a 5% worst loss back in 2013. That means that it would take 2 ½ years of interest to cover the potential risk of a 1.4% jump in long term interest rates. The recommended preferred stocks are paying 5%-7% and had a worst loss of 10%, meaning that it could take less than two years' interest to cover the potential risk.

Most preferred stocks are issued by banks and other financial institutions. In 2008, preferred stocks lost more than half their value. Preferred stocks in Fannie Mae and Freddie Mac, once thought to be solid, were wiped out. Although nobody can guarantee the future results of any investment, we believe that there is a very low likelihood that this type of loss will be repeated.

Final thoughts

The preferred stock investments recommended here have very attractive yields. However, the exposure to interest rate risk and the concentration in the financial industry make it prudent not to concentrate too much of your wealth in just these investments. I recommend at most 10% of your investment portfolio be allocated to preferred stocks.

We utilize additional strategies for our income-seeking clients, including trading high yield bond mutual funds and floating rate funds. These types of funds have been even riskier than preferred stocks if held continuously, but our trading strategies have made them much safer. If you are interested in a risk-managed investment program designed to generate higher levels of income than you can get from conventional bonds, give us a call.

Dr. Appel began his career with Signalert Corporation in 1996 and is now president of Signalert Asset Management LLC, an investment advisory firm. He oversees all investment policies of the company in addition to advising clients on all aspects of financial matters.

Dr. Appel has written three investment books published by Financial Times/Prentice-Hall ("Investing in Exchange-Traded Funds Made Easy", "Beating the Market Three Months at a Time", and "Higher Returns from Safe Investments"). In addition, he edits Signalert's investment newsletter, Systems and Forecasts, which has been in continuous publication since 1973.

He has written for the Physician's Money Digest, Dental Economics, CBSMarketWatch.com, and Forbes.com. A frequent public speaker, Dr. Appel has appeared on television and has, in addition, served as an economic consultant to the New York State Legislature.

Before entering the field of investment management, Marvin originally trained as an anesthesiologist at Harvard Medical School and Johns Hopkins Hospital. He concurrently earned a PhD in Biomedical Engineering from Harvard University.

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