Fixed-to-floating rate perpetual preferreds — the fixed rate alternative

Wealth Management

Preferred stocks have long been a source for corporations to access long-term capital with income-oriented investors benefitting from the attractive yields on these securities. These issues occupy a unique position on a company's balance sheet — between common stock and debt. They are considered to be equity but rank ahead of common stock in terms of dividend payments and priority in the event of liquidation while ranking below debt in terms of priority. Because they are "subordinate" to the debt of an issuer, these securities will usually carry a lower credit rating than that debt. Preferreds paying a fixed rate (usually higher than the common dividend) will see their price move inversely to interest rates, like debt securities. These fixed rate preferreds are most commonly issued as $25 par securities and are "perpetual," meaning that preferreds do not have a maturity but are callable at some point after issuance. Dividends on preferred shares may be cumulative or non-cumulative and while representing ownership in the company, preferred investors, unlike common shareholders, generally do not have voting rights.

Fixed-to-floaters offer an alternative

In addition to the traditional $25 par fixed rate issues, investors have the option of investing in a recent addition to the preferred security universe — fixed-to-floating rate perpetual preferreds. These hybrid securities carry a fixed coupon for a specified period of time which then begins floating at a spread, determined at issuance, over a specified benchmark — typically three-month LIBOR. These "reset spreads" have most commonly ranged from 3% to 4.5% and the dividend adjustments can be either quarterly or semiannually depending on the specific issue. Currently dominated by financial issuers, these fixed-to-float securities are issued in initial increments of $25 par or $1,000 par.

Exhibit 1

Issuer	Coupon	Maturity	Call feature	Price/ share	Current (strip) yield	YTC/reset
XYZ INC. Fixed-to-float noncumulative perpetual preferred	6.125% to 11/15/20; then quarterly @ USD LIBOR 3-month +4.478%	Perpetual	Callable @ $1000 beg. 11/15/20	$1022.50	5.99%	5.59% (11/15/20)

Hypothetical terms of a typical issue.

Dividends

The coupon is fixed at issuance for a period of time: typically five, seven or 10 years — after which they become callable by the issuer any time upon 30-days' notice. This initial rate is usually higher than other fixed rate alternatives of similar duration due, in part, to the subordinate standing of these structures. With the passage and implementation of the Dodd-Frank Wall Street and Consumer Protection Act, fixed-to-float dividends paid by banks are noncumulative in order for the securities to qualify as Tier 1 capital and the issuer is not obligated to make up any missed payments, should that occur.

If the issuer doesn't exercise the call option the preferred issue's dividend rate will begin to float and reset for as long ieas the issue remains outstanding. The reset dates coincide with the dividend payment date which will also typically be quarterly or semi-annually.

As illustrated in Exhibit 2, the potential exists for the coupon rate to reset lower in a declining rate environment. However, one potential benefit of this structure is that in a rising rate environment, fixed-to-float perpetuals can provide for higher dividend payments and greater price stability as the coupon will periodically reset and reflect those higher rates.

Exhibit 2

USD LIBOR 3-month	Potential coupons (@ USD LIBOR 3-month + 4.478%)
	6.125% initial rate
0.75%	5.228%
1.25%	5.728%
1.75%	6.228%
2.25%	6.728%
3	7.478%

Hypothetical reset scenarios.

Tax advantaged

A feature of current tax law is that many preferred issues generally provide for favorable income tax treatment. Dividends of many of these securities are treated as "Qualified Dividend Income" (QDI) eligible for individuals and "Dividend Received Deduction" (DRD) eligible to corporations. QDI dividends are dividends that qualify to be taxed at long-term capital gains rate which can be substantially lower than the rate for ordinary income. The DRD also offers substantial tax relief for corporate investors. Investors should seek advice from their tax advisor regarding their specific situation. It is important to note that while the vast majority of fixed-to float preferred issues are QDI or DRD eligible, investors should be aware that some issues may actually be debt structures and would not qualify.

Risk factors

- **Credit risk —** Full faith and credit of the issuer which, if it were to decline, would expose investors to deteriorating prices and, in the extreme, default.
- **Noncumulative** — Risk of missed dividends without the obligation to ever make up the payments.
- **Callable —** The issue could be called early which could expose investors to reinvestment risk.
- **Interest rate risk —** If rates decline and the shares remain outstanding, investors would realize lower coupons/income streams.
- **Duration —** Investors should be willing to accept the added duration risk of a perpetual in the event that the issuer does not call their shares.
- **Market risk —** Depending on market conditions, investors could realize a capital loss should a preferred need to be liquidated.

In summary

Fixed-to-floating rate perpetual preferreds:

- Ranks senior to common stock; subordinate to company debt
- Par values of $25 or $1,000
- May provide higher income versus fixed rate alternatives, to the call date
- May provide price stability and higher income against rising interest rates
- May qualify for favorable tax treatment
- Noncumulative
- Perpetual, unless called

For more information on these and other investment opportunities, please contact your RBC Wealth Management® financial advisor.