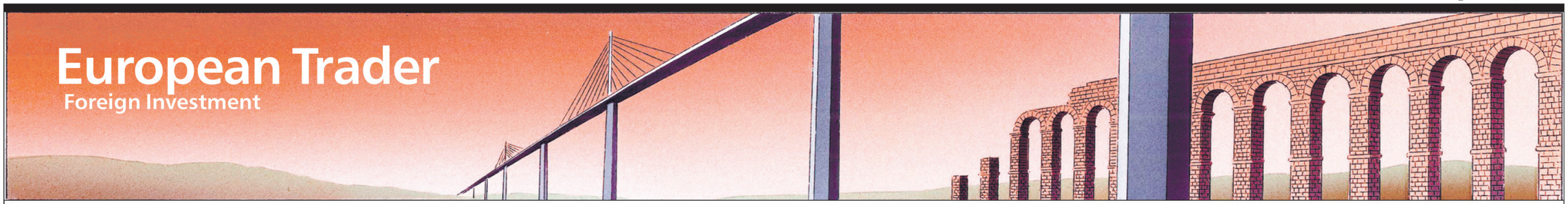

Playing Royal Bank's Dividend-Suspended Preferreds

by Eric Uhlfelder

THERE AREN'T MANY FREE LUNCHES FOR FIXED-INCOME INVESTORS THESE days. But the **Royal Bank of Scotland** might be serving up one, in the form of dollar-denominated preferred shares that offer a shot at double-digit returns over the next year.

During the darkest days of the 2008-2009 financial crisis, prices of these securities fell into the low single-digits on fears that the bank would go under or would be nationalized, wiping out investors. But the U.K. let the bank (ticker: RBS) remain independent—albeit under a heavy watch–by recapitalizing its balance sheet, in return for an 85% stake. Through 2009, Royal Bank kept paying preferred dividends. But the European Union Competition Committee thought that wasn't cricket, because the British government essentially was making the payments through its huge capital infusion. The panel demanded dividends be halted for two years, starting in April 2010. The affected stocks included Big Board-listed series M, N, P, Q, R, S and T preferreds. (See page M35.)

Over the past several years, the bank has been experiencing a cosmic makeover. From 2008 to the end of 2010, its core Tier 1 capital, a key gauge of a bank's health, climbed from 4% to 10.7%, well above the Basel III banking standard of 8%. Over that span, leverage fell from 28.7% to 16.9%. The net annual loss from continuing operations has drastically fallen from £23.52 billion ($38.42 billion) to £1.03 billion ($1.68 billion). And Royal Bank intends to restart dividend payments on the seven suspended preferreds in May 2012.

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Brian Gonick, principal of the New York hedge fund Senvest, thinks these shares—which all have risen into the high teens—could appreciate by another 15% to 17% over the next year, after which owners would be entitled to the dividends. The hedge-fund manager estimates this rise would produce an average yield of 7.8%. On the S series, that yield implies a May 2012 share price of $21.15—versus a recent trade at $17.85. Gonick bases his numbers on the rising price of Royal Bank's series F preferreds, on which the payout wasn't suspended. Its yield has fallen nearly a full percentage point over the past four months, to 8.1%. And Gonick expects further yield decline as the bank's credit quality improves.

What are the main risks to this trade? In Gonick's view, they are inflation and the possibility that the U.K. economy tanks. Either could widen yield spreads over U.S. Treasuries, restricting further gains in preferred prices.

Greg Phelps, a senior portfolio manager of Manulife Asset Management, who runs $4 billion in closed-end preferred funds, is less sanguine. While he believes that the dividends will be reinstated, he expects investors to demand a much higher yield premium, leaving little room for further price appreciation. Preferred dividends benefit from being taxed at the flat Bush-era rate of 15%. Phelps cautions that prices could drop if the preferential tax rate isn't extended past 2012.

But with investors likely to be as yield-hungry in a year as they are today, there's a good chance these preferreds will continue to climb…so long as the bank's fortunes continue to do likewise.

Last week , the Stoxx Europe 600 index rose 0.6%, to 281.68, ignoring rising crude oil prices and Portugal's bailout request.

Portugal became the third euro-zone domino, after Greece and Ireland, to request financial aid from the European Union and the International Monetary Fund. It's thought to need about €80 billion, and a package is expected to be readied in May.

Meanwhile, the spreads between Spanish bond yields and those of benchmark German paper were stable at about 185 basis points—1.85 percentage points. And the euro rose to 1.44, a 15-month high against the dollar, after the European Central Bank raised its main refinancing rate Thursday by 25 basis points, to 1.25%. It was the first rise since July 2008. ■

ERIC UHLFELDER, the author of *Investing in the New Europe,* covers global capital markets from New York.