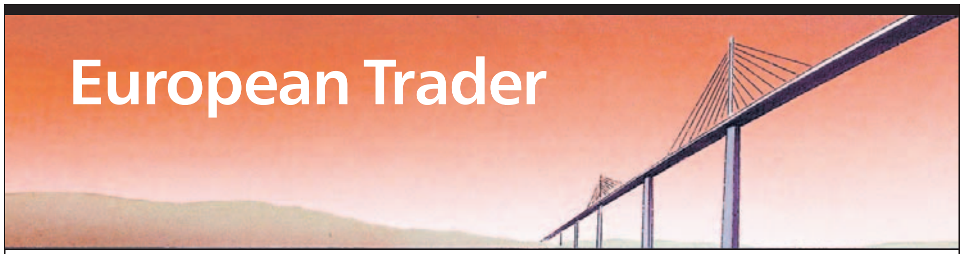


Cheap Income Plays

By Eric Uhlfelder

AFTER A BROAD SELLOFF IN PREFERRED STOCKS DURING THE SECOND HALF OF the year, several U.S. exchange-traded preferreds from European issuers have be-come more attractive income plays. These include investment-grade offerings from global insurers **Aegon** and **Prudential,** and the Dutch bank **ING Groep**.

Although preferreds initially held up well when the Federal Reserve started pushing up interest rates, the average preferred has lost more than 10% since June, and some have slid as much as 20% since July. That was largely caused by the 10-year Treasury yield breaking through 3%. That is the benchmark for pricing these preferreds, which are issued in denominations of $25 to appeal to small investors.

Domestic and foreign companies issue these securities on U.S. exchanges to raise capital that's typically perpetual. That means it doesn't need to be paid back like a bond at a set time and price. This places preferreds lower down on the capital structure, pushing up dividend yields, which are often taxed at a cheaper rate than interest on debt.

The recent price correction has increased their attractiveness, especially if you believe that long yields are pretty close to their peak. Barry McAlinden, a senior credit strategist at UBS' Chief Wealth Office, thinks that 10-year yields will not move much above 3.2% over the next year, which he believes bodes well for preferreds.

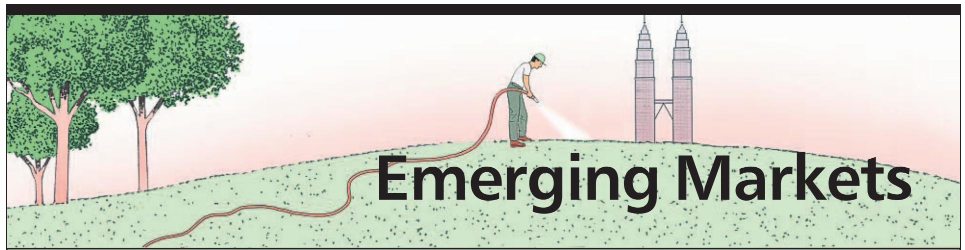
In early November, the 10-year Treasury yield hit 3.24%—its highest level since 2011. But Treasuries have since rallied, with the yield cut to 2.74%. This should have reversed the selloff of preferreds, but hasn't. **Aegon (AEH), Prudential (PUK.A), and ING Groep (ISF)** are now paying yields well north of 6%, taxable at the low rate of 15% to 20%, which makes their payout equivalent to a bond yield above 7%. They now trade at prices that protect investors against losses in case these preferreds are called—which the issuers can do at any time.

In mid-June, Aegon preferred was trading at $26.40; on Dec 24, it closed at $24.80, paying a current yield of 6.43%. Prudential's was selling at $27 in early July; it's now trading at $25.18 with a yield of 6.45%. And in early July, ING's issue hit $26.40 before sliding to $25.11, paying 6.35%.

Both the Prudential and ING preferreds can be called only at the end of a quarter, assuring minimum payments of $0.41 and $0.40, respectively. The Aegon issue gives only 30 days' notice, which could mean less than a full quarter's payment. But since it's trading below par, investors would receive a capital gain if the security were called, as well as all accrued dividends. And if the companies don't call these shares, investors would continue to collect a tidy, tax-efficient yield.

A further plus for the Aegon and ING issues is that both are cumulative, so if there's ever a suspension in dividends, the companies must pay back all missed payments before restarting the dividend on their common shares. Common dividends are financials' lifeblood. Their survival depends on paying a dividend.

These European preferreds are remnants of a once sizable asset class. The international banking accord Basel III put an end to traditional $25 European bank preferreds by requiring that they be convertible into stock in case of trouble. That way, these securities are able to shift liability from banks (and potentially their nations' central banks) to investors. These Aegon, Prudential, and ING issues are among the few remaining legacy preferreds that won't convert to equity, selling at a compelling price. ■



Caught in the Crosscurrents

By Craig Mellow

EMERGING MARKETS FUND MANAGERS ADVANCED TWO CONSISTENT LINES OF REAsoning for their portfolios during 2018. First, the "fundamentals" remained sound. Governments from Brazil to Indonesia were maintaining historically low inflation and budgetary discipline while growing at close to historical averages. Second, the managers in question bought excellent companies that would thrive (in the long term) regardless of political or economic ups-and-downs.

Investors weren't buying either argument. Politics and the macro environment dominated sentiment, and the **iShares MSCI Emerging Markets** exchange-traded fund (ticker: EEM) dropped about 20%, erasing most of 2017's gains.

The prevailing headwinds came from Washington. President Donald Trump turned his attention to trade disputes. His corporate tax cut supercharged an already-recovering economy, spurring interest rate hikes and an ascendant dollar. Local politics added treacherous crosscurrents: New presidents broke old molds in Brazil, Mexico, and South Africa. Incumbents clung to power with short-sighted economic manipulations in Turkey and India. China, the biggest emerging market by far, struggled for a policy mix that would rein in leverage without choking growth, and for the right response to Trump.

Individual stocks were blown about like wooden ships in these external gales. A January column on attractive value stocks included **Banco do Brasil** (BDORY) and Russia's **Sberbank** (SBER.London), both well-run institutions with solid market shares selling cheap. The former gained 13% during the year as Brazilian president-elect Jair Bolsonaro became an unlikely markets hero; the latter sank nearly 40% as Russia courted further sanctions with more provocative behavior abroad. The most intensive guessing game revolved around **Tencent Holdings** (700.Hong Kong) and **Alibaba Group Holding** (BABA), the Chinese internet giants that spent most of this year falling back toward Earth. A column in March urging caution on both companies proved prescient (most columns urging caution on anything proved prescient this year). A buy call on Tencent in August was premature. The stock lost another 30% by late October, though it has gained most of that back since.

Top-down analysis on countries came a bit easier. Probably my best call of the year was a January column warning that Turkey looked fragile again. Turkish stocks lost 45% this year. I was also right in early September that the panic around Turkey and Argentina would not spread to South Africa or emerging markets globally. Also on point was a July column on Vladimir Putin's economic feet of clay when he was looking like a geopolitical giant after meeting Trump in Helsinki. Russian stocks are off 13% since then.

I was late to the party on Brazil, though. I thought it wise to wait until the first-round election on Oct. 7 to call the Bolsonaro effect. But the market jumped during the preceding weeks and has been flat since then (though a relative outperformer). A May prediction that Argentina would bounce back with an International Monetary Fund rescue package proved too optimistic; the market is off 25% since then. I devoted five columns to Mexico, correctly anticipating a peaceful trade settlement with the U.S. and a rally following the July 1 election, as incoming president Andrés Manuel López Obrador tamped down his leftist firebrand reputation.

What is true is that the headlong development of emerging markets continues to be the drama of our age, which will inevitably lure investors, even if sometimes into blind alleys. The joy and challenge of following them week to week is inexhaustible. ■