PREFERRED STOCK INVESTING
Fifth Edition

By
Doug K. Le Du

Doug K. Le Du publishes two preferred stock research newsletters – the *CDx3 Newsletter* and *CDx3 Research Notes*.

The purchase of *Preferred Stock Investing* includes a subscription to the *CDx3 Newsletter*. The *CDx3 Newsletter* is emailed to readers each month and is free to you. The *CDx3 Newsletter* provides preferred stock investing news, research articles, marketplace charts and much more.

To activate your free subscription to the *CDx3 Newsletter* point your web browser to www.PreferredStockInvesting.com and look for the free *CDx3 Newsletter* sign up feature.

CDx3 Research Notes is available to subscribers to the CDx3 Notification Service – my preferred stock research and email notification service for preferred stock investors. Read more about the CDx3 Notification Service at www.PreferredStockInvesting.com.

The preferred stock research data for this book was gathered between 2006 and June 2013. Chapter 17 presents the investing results, using the CDx3 Income Engine method explained throughout this book, for all qualifying preferred stocks issued between January 2001 and December 2012.

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And a big thank you goes to my readers and subscribers who, since 2003 when I wrote my first research paper regarding preferred stock investing, have provided many thoughts, comments, questions,

insights and encouragement. I am thankful to receive your supportive email messages every day and please know that I read them all. I am hopeful that you find my continued commitment to preferred stock research interesting and helpful.

FORWARD

The only problem with bank Certificates of Deposit (CDs), as far as I can see, is that you never seem to make any real money from them. One day I "ran the numbers." By the time you subtract income taxes and inflation, you've wiped out much (if not all) of your CD's interest income. Once I realized this fact, CDs became as comfortable as an ice cream headache.

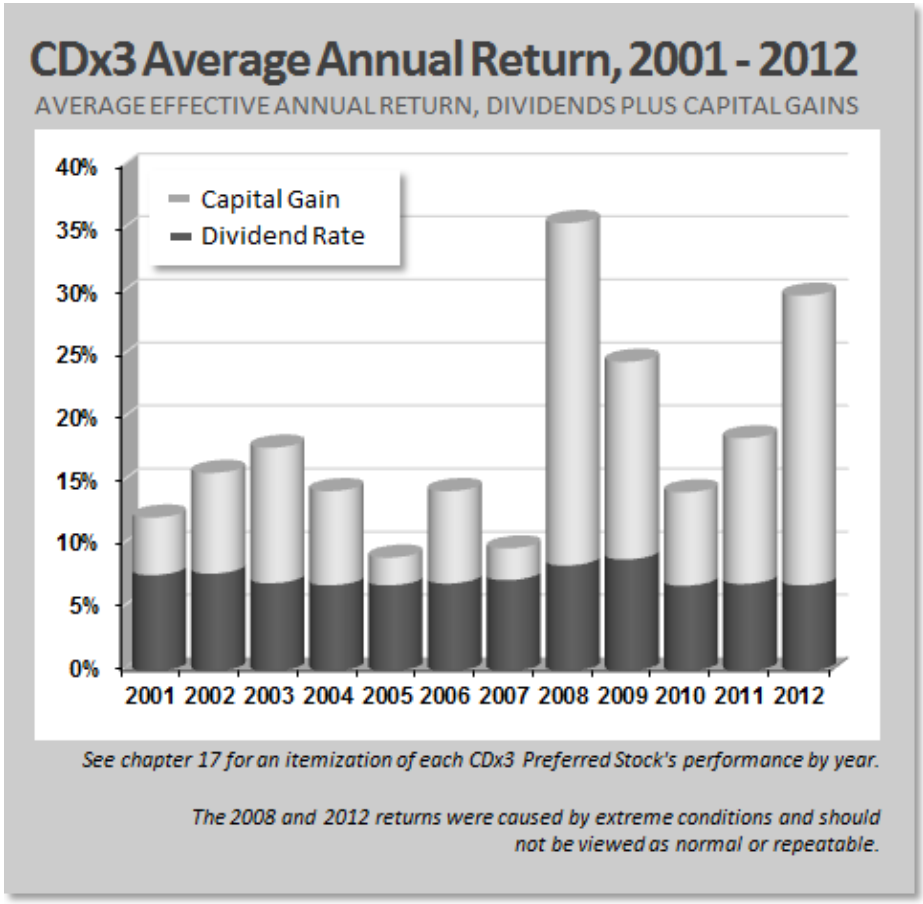
Take this common example: say you buy a 12-month bank CD for $1,000 that pays 2% annual interest. You're going to make $20 in interest income from this CD. But that $20 is subject to income tax. Let's say the income tax rate is a combined (federal plus state) 40%; so, subtract $8 off of your $20 for income taxes. Now you're down to $12. After twelve months, inflation eats away another 2% of your $1,000. So you lose another $20 to inflation. Subtracting this $20 out of your remaining $12, and guess what – you've just lost $8 on that 2% CD.

And yet bank CDs are sold as low risk money makers every day.

With all of the investments that the U.S. economy offers us, doesn't it seem like there would be a way to make a respectable return at acceptable risk?

My background in economics, statistics and as a Managing Director at one of the world's largest management consulting firms provided me with the tools to answer that question. It took some doing to be sure – years actually.

But look at the results:



By selecting, buying and selling the highest quality preferred stocks as described throughout this book you can collect fixed quarterly dividend income plus pile on a nice capital gain (if you so choose) downstream. The result is a return that is several times what bank CDs can earn.

That's why I call my preferred stock investing method the "CD Times Three Income Engine" or "CDx3 Income Engine" for short.

This book is organized into six Parts that walk you through selecting, buying and selling the highest quality preferred stocks.

Part I will show you a variety of metrics and charts that you can use to monitor the key aspects of the preferred stock marketplace that drive returns.

I know that many preferred stock investors are worried about what will happen to the value of their preferred stock portfolio once interest rates head back up. Don't be. Rather than trying to scare you with generalities, I will use real data to walk you through the relationship between interest rates and preferred stock market prices.

You'll learn about the ten CDx3 Selection Criteria in Part II. This is the filter that has repeatedly saved preferred stock investors. The ten selection criteria successfully filtered out the preferred stocks from every failed bank during the Global Credit Crisis that started in June 2007. Preferred stock investors were protected again as the Eurozone melted down shortly thereafter and again throughout the LIBOR manipulation scandal that erupted in late-2012.

Once you know how to select the highest quality preferred stocks from a sea of pretenders, we'll move on to the art of buying in Part III. You'll learn a simple technique that you can use to buy your preferred stock shares for a substantial discount (below these security's $25 par value), even in today's high-priced preferred stock market. I'll also show you a technique used to upgrade your portfolio right along with increasing rates.

Part IV describes how you can add a capital gain onto the top of the great dividends you've been earning in the meantime. This is the magic that produced the returns illustrated by the chart on the previous page.

Part VI wraps up the book with some tips regarding building and managing your preferred stock portfolio as a single income generating machine. Doing so generates compounding monthly income, shifting the CDx3 Income Engine into overdrive. Appendix A and B provide you with the websites and other resources that you can use to be a very successful preferred stock investor.

By investing in the manner described here, the CDx3 Income Engine promotes risk-averse investors out of the low-to-no return garbage heap into the comfortable sunshine of respectable returns at acceptable risk.

And in this book, I'm going to teach you how to do it.

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INTRODUCTION

There's no shortage of investment books out there; so, first, I want to thank you for buying this one. You'll be very glad you did.

The investing method described throughout this book is called the "CD Times Three" Income Engine or "CDx3" Income Engine for short.

The CDx3 Income Engine:

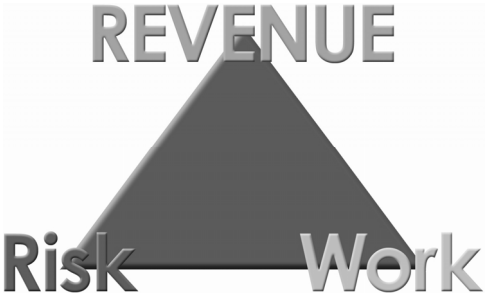
Use the highest quality preferred stocks to earn above average dividend income while simultaneously creating multiple downstream capital gain opportunities.

The CDx3 Income Engine has consistently delivered returns that are well beyond those that are possible with bank CDs, hence the name CDx3. There are, of course, more risks involved with investing in securities of any kind. After reading chapter 8 "*Managing the Risks*," you'll have to decide if the risk/reward trade-off is for you.

I am about to teach you how to select, buy and sell the highest quality preferred stocks. Since I update *Preferred Stock Investing* every couple of years, the techniques that I will focus on in this *Fifth Edition* will be those that are most relevant to the economic conditions that we are facing in 2013 and are expected to be facing during the two years that follow – a high demand market with relatively low rates, relatively high prices and an expectation of gradually increasing rates on the horizon (if the Federal Reserve and many Wall Street analysts have their way).

The ten selection criteria presented in chapter 7 filter out most of the preferred stocks trading on today's stock market. These ten criteria successfully filtered out the preferred stocks from all of the failed banks during the Global Credit Crisis that began during the summer of 2007 – IndyMac, New Century, Fannie Mae, Freddie Mac, Lehman Brothers, Bear Stearns, Washington Mutual, CIT Group – all of them.

The ten CDx3 Selection Criteria were specifically designed to integrate with the Three Rules of Market Price Predictability (chapter 3) in order to meet the three objectives of the CDx3 Income Engine: (1) maximize revenue while (2) minimizing risk and (3) minimizing work.



Stock investing books have a lot of similarities – most tell you that if you buy certain stocks under certain conditions then sell them later under certain conditions you will make lots of money.

This investing book, *Preferred Stock Investing,* departs from all others in two ways:

1) This investing book shows you how to make a respectable rate of return (several times what bank CDs can give you) using "investment grade" preferred stocks, not common stocks, bonds or mutual funds; and

2) This investing book uses examples to educate you on how the CDx3 approach works. But unlike other investing

> books, I will subject every CDx3 Preferred Stock issued since January 2001 to the CDx3 Income Engine and show you, in detail, the results for each one. Then you can decide for yourself how well it works. Some authors essentially ask you, the reader, to take their word that their approach really works. Others present a few very carefully selected examples to support their case. I'm not going to ask you to take my word for it; I'm not going to cherry pick a few choice examples that happen to fit. You'll see the results in chapter 17.

The CDx3 Income Engine approach does not even require much of your time. No more time than you would spend looking at your monthly bank statement.

You will not have to become a "day trader" continually hunched over your computer studying arcane charts. Besides, did you know that over 70% of day traders lose money? But for every loser, there's a winner and we're going to be on the right side of that deal – making the money.

The investing approach described throughout this book – the CDx3 Income Engine – is for investors looking to earn several times the return on money that they would otherwise be investing in other income oriented investment instruments - CDs, corporate bonds or Treasury Notes.

The CDx3 Income Engine is *not* for investors who need a current income portfolio that generates something north of twenty percent in order to stay afloat. That type of return is very difficult to attain and involves a much higher degree of risk than CDx3 Investors are comfortable with.

Having said that, I would encourage any investor or investing group to consider dedicating at least a portion of their holdings to a CDx3

Portfolio. The CDx3 Income Engine approach relies on relatively safe, fixed-rate preferred stocks that meet very specific selection criteria and, when bought and sold using the approach I'm about to describe to you, generate a substantially better return than CDs or bonds. But it's never going to be twenty or thirty percent and it would be irresponsible for me to say, or for you to believe, otherwise.

The Dow Jones Industrial Average (DJIA) opened on January 2, 2001 at 10,646. After remaining relatively flat for twelve years, the Cyprus event[1] in early 2013, combined with the U.S. Federal Reserve's monetary policies, caused the DJIA to clear 15,000 in May 2013 (source: *MarketWatch.com*). By investing in the common stock market, as reflected by the DJIA, you would have made about $4,354 (about three percent per year) on the original $10,646 that you invested over twelve years earlier (almost all of this in early-2013).

CDx3 Preferred Stocks issued between January 2001 and December 2012, on the other hand, generated annual returns in excess of 9% year in and year out (see page 253 for annual values).

Since preferred stock shareholders always get paid their dividends prior to the same company's common stock shareholders, these results provide a rare example of a lower risk investment providing a higher return over the same period (much more regarding risk in chapter 8).

Throughout This Book

There are a variety of terminology and other conventions that I use throughout this book.

[1] The Cyprus event that occurred during early 2013 and discussed in chapter 9 pushed the U.S. common stock market to record highs.

Exchange-Traded Debt Securities

Exchange-traded debt securities (ETDs) are very similar to, and often mistaken for, preferred stocks but are actually individual bonds (not a fund) that trade on the stock exchange rather than the bond market. If you have been investing in preferred stocks for a while you may very well hold ETDs without knowing it since most brokerages will list them as a preferred stock in your account.

ETDs are recorded on the issuing company's books as debt while preferred stocks are classified as equity. Since bondholders typically have seniority over preferred stock shareholders in the event of default, the same company's ETDs are viewed as having less investment risk (although there is generally very little price distinction between a company's ETDs and preferred stocks).

Some ETDs even offer a survivor's option that may allow your beneficiaries to cash them in (at the par value) in the event of your death.

Do not confuse ETDs with Exchange-traded Notes (ETNs) or Exchange-traded Funds (ETFs). ETNs and ETFs, as funds composed of multiple securities, are pegged to the performance of an index; ETDs are individual securities.

Throughout *Preferred Stock Investing* I treat ETDs just like preferred stocks and include them in my usage of the term.

Effective Annual Return Calculations

There are a variety of calculations used to derive the annual return of an investment. Each has its strengths and weaknesses; the one you use depends on what it is you are trying to determine.

For the reasons explained in chapter 16, the Effective Annual Return (EAR) formula is superior to other methods when being

applied to a preferred stock investment in that it is more flexible as well as more accurate. Chapter 16 walks you through the EAR calculation and provides the Excel spreadsheet formulas for using it.

Interest or Dividends

Most of the cash that you receive from preferred stocks is classified for tax purposes as either dividend income or interest income. For simplicity, throughout this book I refer to the cash you receive each quarter from your CDx3 Preferred Stock investments as "dividend" income.

Your broker will provide you with the proper IRS 1099 form that classifies your income. You can also refer to the prospectus of your preferred stock for this classification or contact the issuing company. Just remember, the authority to classify your investment income lies solely with the U.S. Internal Revenue Service, not your broker and not the issuing company.

Next Week's Grocery Money

Like any investment, reaping a return assumes that the entity you are investing in stays in business. While there has never been a case where the issuing company of a CDx3 Preferred Stock has gone out of business, this is not to say that it cannot happen or that it never will happen.

Market prices of preferred stocks fluctuate over time (frequently with changes in interest rates as we'll discuss in great detail in chapter 5). Money that you invest in the stock market should be long-term money that you can use to take advantage of these swings. Investing is no place for next week's grocery money.

The CDx3 Income Engine relies on buying at the right time then selling at the right time and knowing how to recognize the right

conditions when they are upon you. The right selling conditions may be several quarters downstream so there may be times when some patience is in order. Remember though that you'll be earning above average dividend income in the meantime.

Recommendations and Advice

Never invest your money based on advice from someone who is not familiar with your investment goals, resources and risk tolerance.

CDx3 Preferred Stocks are regular preferred stocks that meet the ten CDx3 Selection Criteria presented in chapter 7. They are not to be taken as recommendations to buy or not to buy. How well a specific CDx3 Preferred Stock meets your individual investing needs is a decision that only you can make. My purpose here is to help you make more informed decisions regarding your preferred stock investments.

Website References

Website references presented throughout this book were current at the time this edition of *Preferred Stock Investing* was written in 2013. But please note that the public and private organizations that own these websites may change their web address or content at any time.

If you use the website references presented herein and get that annoying "website not found" message, the site has probably moved to another address. Using your favorite search engine to locate the new address should get you back under way.

Summary of the CDx3 Income Engine

Here is the CDx3 Income Engine in a nutshell:

The CDx3 Income Engine:

Use the highest quality preferred stocks to earn above average dividend income while simultaneously creating multiple downstream capital gain opportunities.

The CDx3 Income Engine uses a combination of dividend income and capital gain income to produce great returns. Annual dividend rates paid by CDx3 Preferred Stocks are between 6% and 9%. Selling downstream for a capital gain pushes your effective annual return the rest of way – generally well over 10% (chapter 17 presents the investing results for every CDx3 Preferred Stock issued since January 2001).

If you want to purchase CDx3 Preferred Stocks for their very respectable 6% to 9% annual dividend income and leave it at that, great. But what if you could earn much more than that without additional risk or effort? That's where the CDx3 Income Engine comes in.

CDx3 Investors buy their CDx3 Preferred Stocks at a point in time when research shows that the market price tends to be relatively low, less than $25.00 per share, and hold their CDx3 Preferred Stocks until:

1) You can sell for the Target Sell Price (chapter 14); or
2) The issue is "called" (bought back from you) by the issuing company (if so, they are required to pay you $25.00 per share regardless of your original purchase price)[2].

[2] There are additional techniques that allow you to add further gains to a preferred stock investment. We'll discuss "Upgrading," "Piling-On" and the "Double-Dip" techniques in Parts III and V.

Either way, CDx3 Investors buy for less than $25 per share and sell for at least $25 per share so you are positioned to realize a capital gain in addition to the above average dividend income in the meantime.

So the key questions become how to buy for less than $25 per share (even during a period of high demand when others are paying far more for the same shares) and how do you know when to look for the "Target Sell Price" or the arrival of the call date (much more on this in Part IV). And that's what this book is going to teach you how to do and show you the results.

Specifically, this book is organized into six parts that will describe how you, as a preferred stock investor, can put the CDx3 Income Engine to work for you.

Part I: The Preferred Stock Market

Part I of this book provides you with an explanation of the preferred stock market including what a preferred stock is, the three types of preferred stocks, how they differ from other income investments and how a new preferred stock is created and comes to market.

But the most important topic of Part I will be found in chapter 3 – The Three Rules of Market Price Predictability. These are the three rules that push the market price of CDx3 Preferred Stocks in the short-term of one dividend quarter, the longer-term over the life span of the security and what I call the "end-term" once the preferred stock can be retired by the issuing company.

The Three Rules of Market Price Predictability are what make the CDx3 Income Engine run and I'll show you several examples of these three rules in action throughout this book.

Part II: Selecting the Highest Quality Preferred Stocks

To qualify as "CDx3 Preferred Stocks" regular preferred stocks must meet the ten CDx3 Selection Criteria presented in chapter 7. For example:

1) The issuing company must have a *perfect track record* of never having suspended dividends on a preferred stock, and remember most of these are multi-billion dollar decades-old companies;
2) The dividends must be *'cumulative'* meaning that if the issuing company misses a dividend payment to you they have to make it up to you later (they still owe you the money); and
3) Carry an *investment grade* Moody's creditworthiness rating.

Chapter 8 is titled "Managing the Risks" and will identify common risks faced by preferred stock investors, especially during periods of high demand, low rates and high market prices. The discussion will describe what to watch out for and provide insights regarding how to manage and limit your exposure to such risks.

Part III: Buying the Highest Quality Preferred Stocks

At this writing in early 2013, interest rates are being kept low by the monetary policies of the Federal Reserve, devastating savers. For this and other reasons, the demand for high quality U.S. preferred stocks is very high, resulting in relatively high market prices.

According to the Federal Reserve and many Wall Street analysts, these relatively low rate/high price conditions are likely to persist for some time. Consequently, Part III's discussion regarding purchasing

preferred stocks below their $25 par value will focus on how to do so during such conditions.

Part III will also discuss how you can upgrade your preferred stock portfolio using a technique that allows you to protect your principal and keep up with rising interest rates in the future. Real CDx3 Preferred Stocks are used as examples of how to execute this technique.

Part IV: Selling the Highest Quality Preferred Stocks

Because U.S. preferred stocks are in such demand, market prices are relatively high so piling a capital gain on top of the great dividend income that these securities provide is pretty easy to do during such conditions.

But how do you know if you are better off by selling today or holding onto your CDx3 Preferred Stock a little longer and collecting more dividend payments?

Chapter 14 shows you the Target Sell Price calculation – during a high priced market, selling may be in your best interest if the market price exceeds the Target Sell Price of your CDx3 Preferred Stock.

By using the Target Sell Price as a guide, the guesswork and emotion of making selling decisions is eliminated for you.

You will also learn about the "built-in buyer" of your CDx3 Preferred Stocks. If you decide not to sell for your Target Sell Price, every CDx3 Preferred Stock has a built-in buyer in the form of the issuing company itself who may purchase your shares back from you for $25 per share at a specific future point in time.

Chapter 15 describes this built-in buyer and how you can determine if they are likely to purchase your CDx3 Preferred Stock shares back from you downstream.

Whether you sell your shares for a market price at or above the Target Sell Price or hold your shares, collecting more dividend income before selling sell to your built-in buyer downstream, the CDx3 Income Engine provides CDx3 Investors with multiple capital gain opportunities (should you decide to sell).

Part V: Results of the CDx3 Income Engine

While Parts II, III and IV explain selecting, buying and selling CDx3 Preferred Stocks, Part V shows you the results. Chapter 16 starts off this Part by identifying the various calculations commonly used to determine the return of a preferred stock investment, explaining the pros and cons of each.

The results of using the CDx3 Income Engine method since January 2001 through December 2012 are then presented in a series of tables. It is these tables that provide the data for the chart that appears on the back cover of this book.

During a high demand market, preferred stock investors are often looking at high, but unrealized, capital gains. I wrap up Part V with a presentation of two techniques that, while not part of the CDx3 Income Engine method, can allow preferred stock investors to use an unrealized capital gain to get paid twice on the same principal without a net capital loss.

Part VI: Building Your CDx3 Portfolio

By the time you get to Part VI you will understand how to screen, buy and sell the highest quality preferred stocks and the results that have been realized since January 2001 by doing so.

Part VI describes how to get started building and managing your CDx3 Portfolio. Chapter 17 illustrates the distribution of dividend

payment schedules used by CDx3 Preferred Stocks and how you can use this distribution to generate monthly income.

And chapter 21 walks you through the mechanics of setting your bid price and placing your first CDx3 Preferred Stock buy order using an online trading account.

Now let's get to it. It's time to learn about preferred stock investing using the CDx3 Income Engine.

PART I

The Preferred Stock Market

It is important to understand a few things about the preferred stock market itself. As you are about to see, knowing a few basic characteristics of CDx3 Preferred Stocks and the forces that drive their market prices is essential for taking advantage of various economic conditions.

Specifically:

- ✓ Chapter 1 explains why the CDx3 Income Engine uses high quality preferred stocks to achieve its objectives (maximize revenue while minimizing risk and work) rather than some other type of investment (such as bonds, CDs or common stocks);
- ✓ Chapter 2 describes the three different types of preferred stocks, their role in today's preferred stock marketplace and how new preferred stocks come to market;
- ✓ Chapter 3 presents how the Three Rules Of Market Price Predictability move the market price of CDx3 Preferred Stocks at specific points in time;
- ✓ Chapter 4 shows you how to know the preferred stock marketplace that you are investing in. This chapter discusses metrics for assessing the trade-off between risk and reward. Also presented are methods for taking a point-in-time snapshot of the preferred stock marketplace as well as quantifying market movement over time to identify trends. Instructions for free updates to these charts are also included; and
- ✓ Chapter 5 discusses the Federal Reserve's monetary policies and what preferred stock investors should be paying attention to over the next couple of years.

WHY PREFERRED STOCKS?

Preferred stocks are one of the most, if not the most, underused and misunderstood investments available to individual investors.

There is nothing complicated about preferred stocks. You buy and sell them using unique trading symbols much like other securities such as common stocks or bonds. And they pay you a periodic (mostly quarterly) dividend that is of a fixed amount much like a certificate of deposit (CD) from your local bank (monthly).

But before explaining the difference between preferred stocks, common stocks, bonds and bank CDs let me shed some light on what a preferred stock is.

Preferred Stock – Why the Fancy Name?

Preferred stocks have been around for many years. In fact, there are still several preferred stocks trading that were issued during the 1930s (E.I. du Pont, DD-B, pays 4.50% and was issued on October 21, 1937).

Originally, and for several decades, preferred stocks were primarily sold by utilities. Although many still think of them as being issued by utilities alone, that has not actually been the case since the early 1990s. Today all kinds of companies issue preferred stocks.

To raise money companies can either (1) borrow money or (2) sell off part of their company in the form of common stock shares or preferred stock shares. Either way, there is a cost associated with raising cash - the "cost of money."

Interest from Bonds versus Dividends from Stocks

When you buy a bond, you are essentially loaning the company cash in exchange for a return in the form of interest and a promise saying that, at some future point, they will give you your principal back.

Their obligation to pay you back shows up on the company's balance sheet as "debt" like any other loan. The company is now indebted to you along with their other lenders. The company is allowed to deduct the interest payments to you off of their taxes as a cost of doing business.

When you buy a share of a company's *common* stock there is no promise whatsoever of any future return. Nor is there any obligation to pay you any type of return.

If the company does well and is profitable, a portion of those profits may be shared with you, or not, as determined by the company's board of directors.

Since purchasers of a company's common stock are paid their return, if any, out of the company's profits (according to how many shares you own), and these payments are at risk depending upon how well the company does, you are considered to be one of the company's owners; you have an "equity" position in the company.

The return, if any, which you realize on your shares of common stock is a dividend rather than interest.

Where interest is a business expense as the cost of borrowing money on a loan, dividends are a distribution of the company's profits to its

owners. So where bond investors receive and pay taxes on *interest* payments from the company, common stockholders receive and pay taxes on *dividend* income.

Since the tax treatment of interest and dividend income is different, there may be a tax difference to you by investing in bonds versus common stocks. Your tax advisor should be able to guide you on this point.

Now to Preferred Stocks

Preferred stocks have a unique trading symbol and typically trade on the New York Stock Exchange (NYSE), so you buy them just as you would a common stock (more on preferred stock trading symbols in a moment).

A given company can have several "series" of preferred stocks trading at any time; that is, over time, as the company needs cash for various projects it can issue a preferred stock series (series A, B, C, etc.). Each series is described in an accompanying document called a "prospectus" (see chapter 8 regarding some points to look for when reviewing the prospectus of a preferred stock).

The prospectus spells out the obligations that the issuing company has to investors who purchase a share of that series preferred stock, such as the dividend rate that will be paid to you, the payment schedule and much more.

When you purchase a share of a company's preferred stock you are considered to be an owner – you have "equity" in the issuing company.

But unlike common stock, preferred stocks pay a fixed periodic dividend to you. You are going to receive the same dividend amount every period. It does not fluctuate, so you know, in advance, what your payments are going to be (although there is such a thing as a variable rate preferred stock but these are rare and have their own set of risks;

see chapter 7). Consequently, preferred stocks are seen as lower risk than the same company's common stock.

Further, if the company is running low on cash and does not have enough to pay the dividends to both its common and preferred stock shareholders, those holding the preferred stock shares get paid first and in full before common stockholder see a dime – you have preferred status; hence the name "preferred stock."

Preferred stock dividends, being known in advance, are therefore more related to a company's *cash flow* than to this quarter's *profits*.

What do you give up with preferred stock?

In exchange for the lower risk, fixed known dividend payments and getting to stand in line in front of common stockholders, preferred stockholders must give up their voting rights. That means that you will not be asked to vote in corporate elections or on company policy decisions.

But let's face it – unless you own hundreds of thousands or even millions of shares, no one in any corporate boardroom is waiting breathlessly for your ballot to arrive.

For most of us, giving up voting rights in exchange for the benefits of preferred stocks is a no-brainer. I'll talk more about managing the risks associated with preferred stock investing in chapter 8.

So now you have a basic idea of the difference between bonds, common stock and preferred stock.

Certificates Of Deposit (CDs)

Another income alternative for individual investors is Certificates of Deposit (CDs) that you buy at your local bank. Let me say up front that I am not a fan of CDs for a variety of reasons, the biggest reason being that you cannot make any real money investing in a bank CD.

You are told that you can make good money by flashy advertisements, but some pretty simple math makes it clear that this is just not the case and it never has been.

As I showed you in the Forward to this book, by the time you subtract off inflation and the income taxes on the interest that CDs pay, your actual gain is little or nothing (or even negative).

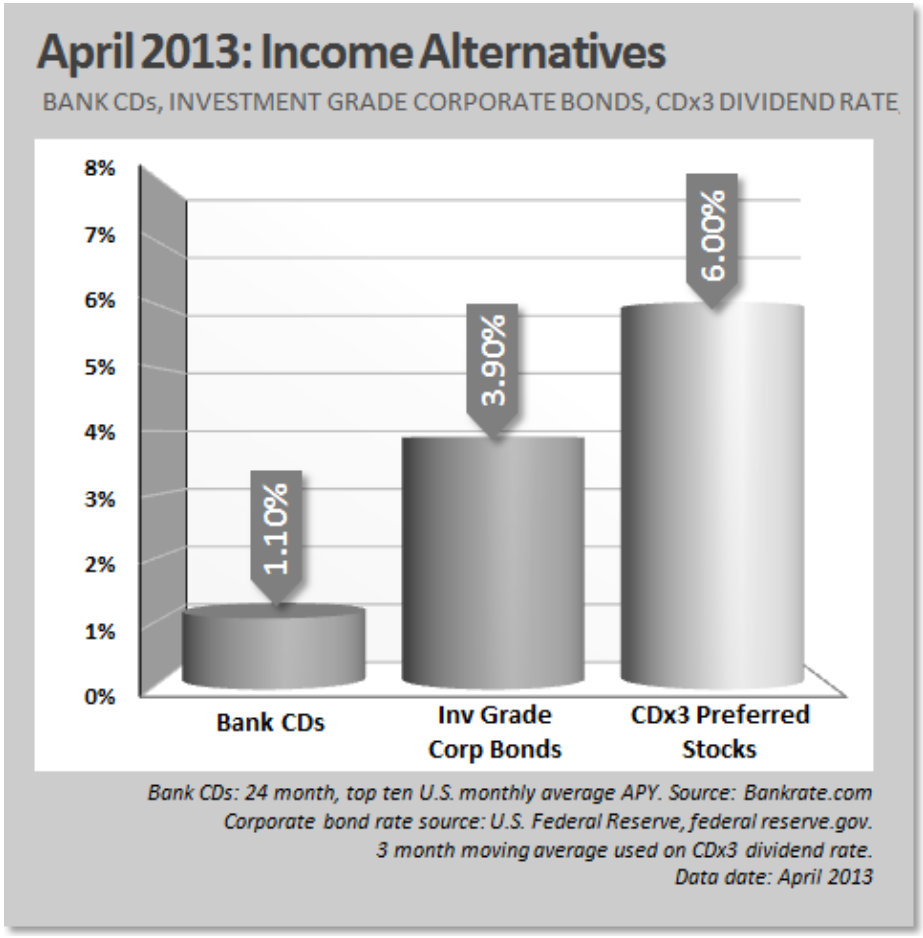
While bank CDs may be an appropriate place to temporarily store some cash that you will need shortly, I hesitate to call them an investment.

Side-By-Side Comparison

The U.S. economy is bigger than the next three world economies combined (including China, Japan and Germany)[1]. With all of the investment opportunities that the U.S. economy offers us, it just seems to me that individual investors should be able to earn a respectable return at acceptable risk – even when interest rates are relatively low.

At any point in time, investors have to choose between the alternatives that are being offered by the market, not the market that used to exist and not the market that might exist some year in the future. The Federal Reserve's zero-rate monetary policies have produced the following alternatives for risk-averse income investors.

[1] Source: *International Monetary Fund*. Based on estimated 2012 GDP



Once you subtract taxes and inflation[2], the Fed's monetary policies are producing negative net returns for the first two alternatives (bank CDs and investment grade corporate bonds). For risk-averse income investors, investment grade preferreds continue to offer a very attractive choice compared to the alternatives that are available to us.

[2] 2.07% for 2012. *Source: inflationdata.com*

Also, by comparing some of the key investment features of bank CDs, bonds, common stocks and preferred stocks you will be able to see why I feel that preferred stocks can offer a very good investment alternative for individual investors, brokers and their clients and investment groups.

Need Two Streams of Income

First, in order to earn a respectable return you are going to need more than just a single stream of interest or dividend income.

Interest rates from bank CDs and bonds and dividend rates paid by common stocks and preferred stocks are rarely above 10%. Depending on economic conditions, CDs, bonds and common stocks will pay far less than 6% (although there are a few exceptions) while investment grade preferred stocks pay between 6% and 9%.

So we know from the start that in order to earn something close to, or beyond, 10% annually, we are going to need more than just dividend income.

Specifically, we are going to need two income streams: fixed periodic income plus the ability to sell the investment downstream for more than we originally paid, adding that profit to the fixed periodic income that we have been earning along the way.

By adding a downstream capital gain to our fixed periodic income we stand a pretty good chance of getting over the 10% bar.

The following table compares various characteristics of bank CDs, bonds, common stocks and preferred stocks. A quick look at the table makes it pretty clear why the CDx3 Income Engine uses preferred stocks.

	Bank CDs	Bonds	Common Stocks	Preferred Stocks
Fixed Periodic Income	Yes	Yes	Varies	**Yes**
Capital Gain Income Opportunity	No	Yes	Yes	**Yes**
Positive Return After Inflation and Taxes	No	No	Unknown	**Yes**

While bank CDs generate fixed periodic (monthly) interest income, they offer no opportunity for a capital gain whatsoever; in fact, as I presented in the Forward, the value of your original investment will often be lower than it was originally, in real dollars, when you get your principal back from the bank.

And as the bar chart on page 22 illustrates, the Fed's low rate monetary policies have left the interest earned from bonds exposed to a negative net return after inflation and taxes as well.

Preferred stocks pay a fixed dividend well above that being paid by competing bank CDs, offer the opportunity for a great capital gain on top of that dividend income and do so at acceptable risk – if you know how to identify the highest quality preferreds, which you will be learning momentarily.

Combining the two income streams – fixed periodic dividends plus a downstream capital gain – does the trick as you can see by the chart on the back cover of this book and as itemized for you in chapter 17.

What I Really Like About Preferred Stocks

The double dose of income - dividend income now plus capital gain income downstream – that can be earned by investing in the highest

quality preferred stocks - CDx3 Preferred Stocks - is just the beginning of what I really like about them.

The more I research CDx3 Preferred Stocks, the more aspects of them I find that are pretty easy to warm up to.

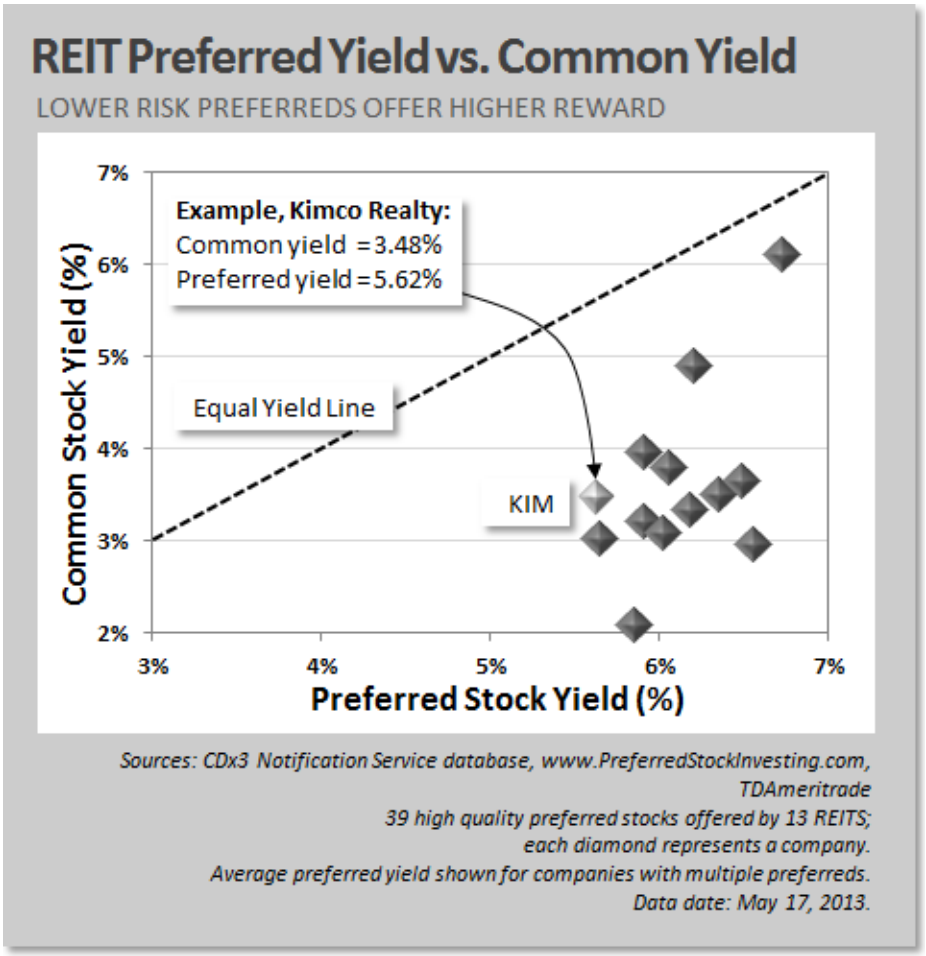
And I'm not talking about the obvious things like above average dividend income, monthly income generation or the great dividend track record. As you will see later, you get all of these characteristics with CDx3 Preferred Stocks automatically.

I'm talking about other details and mechanics that make CDx3 Preferred Stocks very easy to like.

Lower Risk for Higher Reward

I know that lower risk for higher reward sounds like voodoo, but look at this chart.

Each diamond shows the annual common stock dividend yield and the average annual preferred stock dividend yield being paid on May 17, 2013 by a given company (REITs). If a company's common stock provided the same dividend yield as its preferred stock, that company's diamond would fall right on the "equal yield" line.



But notice that that is not the case; preferred stocks issued by the same company are providing a higher yield.

Remembering that preferred stock shareholders are paid their dividends prior to the same company's common stock shareholders, preferred stock investors, by definition, have less investment risk. But as the chart shows, preferred stock dividends are usually greater than the dividends paid by the same company's common stock shares – lower risk for higher reward.

Less Volatility

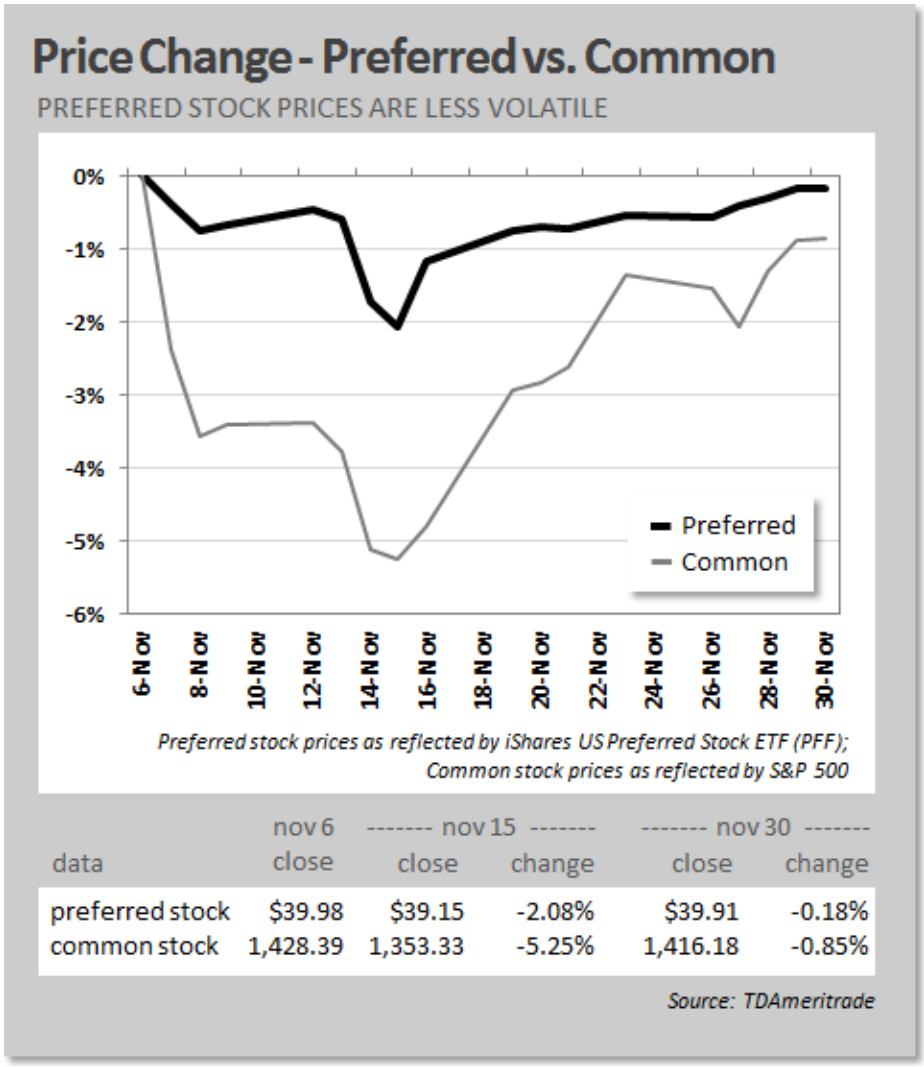
The market prices of investments that have a known return do not tend to bounce around as much as the market prices of alternatives with lesser known returns. With a known return, the speculators - those fairly certain that they know something that is unknown to others - are removed from the market.

Preferred stocks tend to show less market price volatility than common stocks for this very reason. In almost all cases, preferred stocks pay a dividend of a known amount on a known schedule.

The November 6, 2012 presidential election provided a rare opportunity to directly measure the lower price volatility of preferred stocks compared to their common stock cousins.

In the aftermath of the November 6 elections, the S&P 500 Index of common stock prices fell by 5.25% (November 15, 2012) before gradually regaining most of that loss over the subsequent weeks. By plotting the movement of preferred stock market prices over the same period, we have a rare opportunity to directly compare the volatility of preferred stocks to common stocks in response to a known event.

Over the last three weeks of November 2012, the market prices of preferred stocks, as reflected by the iShares US Preferred Stock ETF (PFF), followed the same pattern. But note how much less volatile the market prices of preferred stocks were over this period.



	nov 6	------- nov 15 -------		------- nov 30 -------	
data	close	close	change	close	change
preferred stock	$39.98	$39.15	-2.08%	$39.91	-0.18%
common stock	1,428.39	1,353.33	-5.25%	1,416.18	-0.85%

Source: TDAmeritrade

While common stock prices dropped 5.25%, preferred stock prices fell less than half of that amount (-2.08% on November 15).

Because preferred stocks have a fixed, known-in-advance dividend return, their market prices tend to be much more stable than those of common stocks.

Early Warning System

Wouldn't it be great if you had a light mounted on your wall that would start flashing if there was something risky going on with one of your preferred stocks?

CDx3 Preferred Stocks have a built-in "early warning system" that lets you know in advance if your "pay-attention" light should be flashing.

Remember why they are called "preferred stocks." Preferred stockholders get paid our dividends each quarter prior to common stockholders.

Every quarter, companies that issue CDx3 Preferred Stocks have to announce whether or not they have enough cash to pay the upcoming dividends to holders of their *common* stock.

When doing so, the company may increase their common stock dividend, decrease it, eliminate it entirely or leave it the same. As long as the issuing company pays a *common* stock dividend, even if it is $0.0000001 per share, you, as a *preferred* stockholder, know that you are going be getting paid your full dividend amount.

In other words, as long as common stockholders are going to be getting paid (any amount at all), preferred stockholders, by law, are going to be getting paid first and in full.

So the common stock dividend announcements that company's make act as an early warning system for preferred stock shareholders.

Companies make these announcements every quarter a few weeks before the dividends actually get paid. So, if you find yourself concerned about your next preferred stock dividend payment, just keep an eye on the company's *common* stock dividend announcements.

These announcements are made with the quarterly financial reports that are filed with the Securities and Exchange Commission (SEC) and the schedule for upcoming announcements (made during quarterly conference calls with Wall Street analysts) is generally posted on the company's website under Investor Relations[3].

Dividends Based On Your Number of Shares

This point is especially important to remember: preferred stock investors are paid *based on the number of shares you own*, not the then-current market price and not on your original purchase price.

When your dividends are calculated, the issuing company multiplies the declared dividend rate by a fixed dollar amount (not the current market price nor your purchase price) called the "par value."

In the case of CDx3 Preferred Stocks, this fixed dollar amount is $25.00. For example, a CDx3 Preferred Stock that has a declared dividend rate of 6% is going to pay you $1.50 per year in dividend income *for every share that you own* (6% x $25) *regardless of the market price*.

Current market price and your purchase price are *irrelevant* to your dividend income; it's all about how many shares you own.

Unlike common stock investors, savvy preferred stock investors savor, rather than fear, a period of falling market prices. When shares

[3] CDx3 Notification Service subscribers: clicking on "The Companies" tab on the CDx3 Notification Service website provides a link to the transcripts for these quarterly conference calls.

become relatively cheap, it is time to accumulate more of them for bargain prices and build your portfolio of dividend-paying shares.

The point bears repeating – with preferred stocks you are paid *based on the number of shares you own*, not the then-current market price. While common stock investors, looking for a big run up in value (buy low, sell high) are staking their fortunes on market price behavior, preferred stock investors seek to accumulate more shares.

Do not fall into the trap of using *common* stock investing metrics to evaluate the success of your *preferred* stock investment.

Buy For Less Than $25 and Boost Your Yield

As described above, preferred stock dividends are calculated using a fixed par value ($25 per share in our case). In other words, you get paid as if you have purchased your shares for $25.00 each, whether or not you actually have.

What that means is that if you can figure out a way to purchase your CDx3 Preferred Stocks for a price less than $25.00 per share (which I am about to teach you how to do), you are actually making more than the declared dividend rate (6% in our above example).

The return on the money you actually have invested (your "yield") is actually higher than the declared dividend rate when you purchase your shares for less than $25.00 each.

Take a look at this yield table.

Your Purchase Price	Declared Dividend Rate							
	6.00%	6.50%	6.75%	7.00%	7.25%	7.50%	7.75%	8.00%
$25.00	6.00%	6.50%	6.75%	7.00%	7.25%	7.50%	7.75%	8.00%
$24.75	6.06%	6.57%	6.82%	7.07%	7.32%	7.58%	7.83%	8.08%
$24.50	6.12%	6.63%	6.89%	7.14%	7.40%	7.65%	7.91%	8.16%
$24.25	6.19%	6.70%	6.96%	7.22%	7.47%	7.73%	7.99%	8.25%
$24.00	6.25%	6.77%	7.03%	7.29%	7.55%	7.81%	8.07%	8.33%
$23.75	6.32%	6.84%	7.11%	7.37%	7.63%	7.89%	8.16%	8.42%
$23.50	6.38%	6.91%	7.18%	7.45%	7.71%	7.98%	8.24%	8.51%
$23.25	6.45%	6.99%	7.26%	7.53%	7.80%	8.06%	8.33%	8.60%
$23.00	6.52%	7.07%	7.34%	7.61%	7.88%	8.15%	8.42%	8.70%
$22.75	6.59%	7.14%	7.42%	7.69%	7.97%	8.24%	8.52%	8.79%
$22.50	6.67%	7.22%	7.50%	7.78%	8.06%	8.33%	8.61%	8.89%
$22.25	6.74%	7.30%	7.58%	7.87%	8.15%	8.43%	8.71%	8.99%
$22.00	6.82%	7.39%	7.67%	7.95%	8.24%	8.52%	8.81%	9.09%
$21.75	6.90%	7.47%	7.76%	8.05%	8.33%	8.62%	8.91%	9.20%
$21.50	6.98%	7.56%	7.85%	8.14%	8.43%	8.72%	9.01%	9.30%
$21.25	7.06%	7.65%	7.94%	8.24%	8.53%	8.82%	9.12%	9.41%
$21.00	7.14%	7.74%	8.04%	8.33%	8.63%	8.93%	9.23%	9.52%

Notice that for every dollar below $25 that you purchase your CDx3 Preferred Stocks for, your actual yield will jump up between about 0.25% and 0.40%.

Market Price Predictability

Another aspect of preferred stocks that I really like is that there are many more “knowns” than with common stocks and we’re going to use that fact to our advantage in the coming chapters.

This is especially true when it comes to the predictability of the market price of CDx3 Preferred Stocks.

It's not that you will know what the market price is going to do on any given day. That requires clairvoyance which is always in incredibly short supply.

But, short of being clairvoyant, there are short-term, longer-term and "end-term" aspects to the market price behavior of CDx3 Preferred Stocks that make common stock investing look like little more than throwing darts at a dart board.

Seems like a bold statement, and I guess it is. After all, you're probably not used to the words "market price" and "predictable" appearing in the same sentence within an investing book. Being able to predict (within a certain margin of error) what the market price of an investment is going to be on a specific date in the future seems like a hunt for the fountain of youth.

But like Galileo once said "all truths are easy to understand, once they are discovered."

So now you know what a preferred stock is and why the CDx3 Income Engine uses high quality preferred stocks, rather than some other form of investment, to achieve its three objectives – maximize revenue while minimizing risk and work.

For the remainder of this Part of *Preferred Stock Investing,* I will explain how a new preferred stock is created (this will become very important when you are looking to buy a preferred stock for a discounted price) and the Three Rules of Market Price Predictability that drive the market price of CDx3 Preferred Stocks in specific ways and at specific times.

Once you understand how the market price of CDx3 Preferred Stocks tends to move at different periods of time and under different market conditions, I will conclude this Part by providing you with some tools that allow you to directly monitor the U.S. preferred stock market, its risk/reward characteristics and its trends.

TWO

CREATING A NEW PREFERRED STOCK

The task of creating a new CDx3 Preferred Stock involves a sequence of steps executed in a very specific order by a myriad of organizations both public and private.

As a CDx3 Investor, this sequence of events is important to you since, as you will learn in Part III, there comes a point when a new CDx3 Preferred Stock is generally available to be purchased at a substantial discount.

While we will not get into the reasons why this occurs just yet, suffice it to say that knowing when it occurs can become a very important piece of information.

Before diving into the sequence of events that ultimately leads to a new CDx3 Preferred Stock hitting the market for your consideration, I want to provide you with a brief summary of the three types of preferred stocks.

I'll also provide some additional information regarding Exchange-Traded Debt Securities (ETDs) which, while technically a bond, trade very much like a traditional preferred stock.

Types of Preferred Stocks

There are three types of preferred stocks – traditional preferreds, trust preferreds and third-party trust preferreds. While the attributes of these three types – cumulative, convertible, mandatory convertible, variable or fixed-rate – can vary, there are just three types.

The distinction between them has tax treatment consequences to the issuing company, but to the CDx3 Investor the distinction is largely irrelevant and the dividend income is all the same. But, for those who intend on wading through the provisions of the prospectus language[1], knowing the difference between them may clear a few things up.

Let's take them one at a time.

Traditional Preferred Stocks

Prior to the early 1990's traditional preferred stocks were primarily issued by utilities. Since then, however, many different kinds of companies have seen the light.

Today, in addition to utilities, traditional preferred stocks are issued by insurance companies, banks, brokerage firms and real estate companies with an interest in apartments, shopping centers, self-storage units, medical facilities, shipping logistics centers, hotels, entertainment venues and office buildings.

Dividends that are paid to you by traditional preferred stock, being dividends rather than interest, are not tax deductible for the issuing company.

Some traditional preferred stock dividends are eligible for special 15% tax treatment as specified by the 2003 Tax Relief Act (a popular political football that increases the uncertainty regarding the benefits

[1] It is always a good idea to review the prospectus before investing. For tips regarding how to simplify this chore see page 144.

of such eligibility), although qualifying issues usually come with more investment risk.

Let me show you what I mean. Since January 1, 2004 (the era of the Act) there have been 255 preferred stocks issued that qualify for the Act's 15% dividend tax treatment.

Of these 255 tax-advantaged traditional preferreds only 142 carried an "investment grade" credit rating from Moody's (CDx3 Selection Criterion number 4). Of these remaining 142, only 76 meet the "cumulative" dividend requirement (CDx3 Selection Criterion number 6) and 55 of these are actually municipal bond-backed funds issued by Nuveen (with coupon rates of about 2.5%), leaving us with 21 issues.

But 11 of the remaining 21 were issued by foreign companies (CDx3 Selection Criterion number 7), leaving just 10 of the original 255 tax advantaged traditional preferred stocks.

Of the remaining 10, three have been redeemed and are no longer trading. Of the remaining seven, only four pay a dividend of 6.0% or higher (CDx3 Selection Criterion number 1) and one has a par value greater than $25 (CDx3 Selection Criterion number 10; we'll learn much more about the CDx3 Selection Criteria in chapter 7).

One of the remaining three is the Series A traditional preferred stock issued by Gabelli Global Gold, Natural Resources and Income Fund (AMEX: GGN-A). Note that GGN-A does not qualify as a CDx3 Preferred Stock since by purchasing GGN-A shares you are actually buying shares in a specific non-diversified investment fund, not a company. And dividends from GGN-A are conditional upon the continuation of a Aaa rating by Moody's of the fund (a specific investment grade sub-category).

The remaining two tax advantaged traditional preferred stocks are GGN-A from GAMCO Global Gold (6.625%) and GDV-D from Gabelli (6.000%).

High Quality Tax Advantaged Preferreds

THESE TWO MEET THE CDx3 SELECTION CRITERIA (OUT OF 255 SINCE THE ACT)

Symbol	Preferred Stock Name	Div Rate	Call Date	Liquid Price	Moody's
GGN-A	GAMCO Global Gold, Nat Res & Inc Trust, 6.625% Series...	6.625%	10/16/2012	$25.00	A1
GDV-D	Gabelli Dividend & Income Trust, 6.00% Series D Cumulative	6.000%	11/03/2010	$25.00	Aa3

Source: CDx3 Notification Service database, www.PreferredStockInvesting.com

For most CDx3 Investors, any savings from the 15% tax rate is overcome by the additional risk and/or relatively low dividend payments. The CDx3 Income Engine favors lower risk over lower taxes.

Trust Preferred Stocks

Trust Preferred Stocks (TRUPS), typically issued by bank holding companies, have been favored by preferred stock investors for many years but, due to the provisions of section 171 of the 2010 Wall Street Reform Act, are now going away.

I mentioned in the Introduction that when a company pays *interest* (on a loan or other form of debt) that interest is tax deductible off of the issuing company's taxes.

But *dividends* paid to stockholders, including the company's preferred stockholders, are a distribution of profits and are therefore not tax deductable to the issuing company. Interest payments are tax deductible, dividend payments are not.

Trust preferred stocks involve a bit of Wall Street sleight of hand that leaves the issuing company in a position whereby they are able to deduct the cost of your dividends, hence delivering a tax advantage to the issuing company.

This maneuver is transparent to you, the investor. When a company wants to issue a trust preferred stock, the issuing company sets up a separate company called a trust. The trust issues a preferred stock to the marketplace (which you buy) generating cash for the trust.

The trust loans the issuing company that cash in exchange for debt notes (a loan). The company pays interest on this loan to the trust which the trust, in turn, uses to pay your dividends.

Notice by this structure the issuing company is paying interest (to the trust) which is tax deductible. You receive your dividends from the trust so you don't know or care about the difference.

The net result is that the issuing company is able to turn your *dividend* payments into a tax deduction. Nice trick. Remember though that the trust receives interest from the issuing company which the trust is obligated to pay income tax on. But, with a trust preferred stock, the burden of doing so is passed from the issuing company to the trust.

Banks issued TRUPS because the value of the securities used to count toward a key measure of the bank's reserves that regulators call "Tier 1 Capital." Banks are required to meet certain minimum levels of Tier 1 Capital and by issuing TRUPS most banks were able to stay on the good side of these regulators.

But that changed in 2010. TRUPS offer cumulative dividends (meaning that if the bank skips a dividend payment to you, they still owe you the money downstream). What good are bank reserves if someone other than the bank (namely, shareholders) has a claim to the cash? The Wall Street Reform Act disallows cumulative securities from being counted toward Tier 1 Capital reserves for this reason.

This provision removed the primary reason that banks issued these TRUPS to begin with. In order to comply with the new regulations, banks have been issuing new non-cumulative traditional preferred

stocks and using the proceeds to redeem (buy back from shareholders) their TRUPS. Exchange-traded debt securities, discussed momentarily, have made a terrific substitute for preferred stock investors.

Third-Party Trust Preferred Stock

Third-party trust preferreds are similar to trust preferreds in that they involve the creation of a trust company from whom you actually purchase your preferred stock shares.

But where trust preferreds are structured to provide a tax benefit to the issuing company, a third-party trust preferred is created for the sole purpose of generating a profit to the issuing company (usually a brokerage firm).

The brokerage firm (the first party) sets up a trust company from whom you (the second party) are going to be buying preferred stock. The brokerage firm then buys high quality preferred stocks or debt securities (like bonds) issued by another company (the third party) on the open market. These securities are sold to the trust as backing for preferred stock that the trust issues to you, the investor, at a mark up over the original open market cost.

This structure is little more than a mechanism for a brokerage company to buy high quality preferred stocks at retail (on the open market that you have access to as well as they do) and resell them to you at a higher price.

Exchange-Traded Debt Securities

While exchange-traded debt securities (ETDs) are not a 'type' of preferred stock, they are so similar to traditional preferred stocks that many preferred stock investors hold ETDs shares without actually realizing it. Most brokerage systems will even categorize ETDs as preferred stocks on your statements.

Most ETDs pay quarterly dividends, have a $25 par value, are callable five years after introduction and offer about the same return as preferred stocks. And just as the dividends paid by high quality preferred stocks are classified frequently as interest income, so is that paid by ETDs.

But ETDs are recorded on the company's books as debt rather than equity because they are actually bonds and they trade on the stock exchange under a unique trading symbol just like preferred stocks, rather than the bond market.

As of early 2013, there were 138 ETDs trading on U.S. stock exchanges, 126 of these on the New York Stock Exchange. While NYSE-traded fixed-rate preferred stocks are currently offering an annual dividend yield of 6.17%, the 126 NYSE-traded ETDs issues are currently offering the same 6.17% return.

Limiting the universe to just the highest quality issues that most risk-averse preferred stock investors seek, the average annual dividend yield from high quality preferreds is 6.14% compared to a very similar 6.19% for high quality ETDs issues.

As a group, ETDs have stronger ratings than preferred stocks due to their senior standing. Just as preferred stock shareholders have payment priority over the same company's common stock shareholders, bondholders rank higher than preferred shareholders. So, as bonds, ETDs offer a very similar return but with lower investment risk than the same company's preferred stocks.

Also with ETDs, we pick up a few additional industry segments beyond those that typically issue preferred stocks so our diversification opportunities improve as well. We've seen ETDs from manufacturing companies (Ford Motor Company), entertainment outfits (CBS) and telecommunication firms (Comcast).

Throughout the rest of this book, ETDs will be treated as traditional preferred stocks unless otherwise noted.

Setting the Declared Dividend Rate

Once the issuing company decides what type of preferred stock (traditional, trust or third-party trust) to bring to market they move on to drafting up the prospectus which, of course, includes the task of setting the declared dividend rate (also referred to as the coupon rate).

While it may seem a bit counterintuitive, the issuing company does not set the declared dividend rate. Rather, the declared dividend rate is identified by a group of investment bankers referred to as the "underwriters."

The underwriters are the ones who actually purchase the new preferred shares from the issuing company; the issuing company gets cash, the underwriters get the new preferred stock shares. The date of this transaction is published as the Initial Public Offering (IPO) date.

The underwriters turn right around and sell these shares to brokers ("dealers") who, in turn, sell them to you in response to any buy order that you have placed with them.

The underwriters do not want to ever get stuck with the shares that they purchased from the issuing company. So the underwriters need to know, for a fact and in advance, that the dealer/brokers are going to buy the shares from them.

The dealer/brokers, of course, feel the same way. They need to know that investors (including large pension funds, large companies and individual investors like us) are going to buy the shares as well.

In other words, starting with the underwriters, there needs to be confirmation that there is demand in the market for the issuing company's preferred stock shares before the shares are actually issued.

So the question to the underwriters becomes "What dividend rate do these new preferred shares have to pay for the market to buy them at $25.00 per share?"

Many factors go into this analysis, but the underwriters ultimately come back to the issuing company and agree to purchase the new preferred stock shares. But only if the issuing company is willing to set the declared dividend rate that the underwriters have determined the market will accept (i.e. that there is demand for in the marketplace) at $25 per share.

Once the issuing company and the underwriters agree on the declared dividend rate for the new preferred stock issue, the prospectus is finalized and filed with the SEC.

Three Steps to Market

With a few exceptions, once the prospectus is filed with the SEC the new preferred stock issue goes through three more steps:

1) Obtain regulatory approval, submit a trading application to the New York Stock Exchange (NYSE) and request credit agency rating. The issuing company receives the underwriter's cash at this time. This is the official Initial Public Offering (IPO) date, even though the shares are not yet available to the general public; then

2) Distribute the shares to dealer/brokers using the wholesale Over-The-Counter (OTC) stock exchange under a temporary trading symbol (more on this in a moment)[2]; then

[2] CDx3 Notification Service subscribers: This step triggers the "now trading" email alert that you receive for new issues.

3) Transfer trading to the retail NYSE under the permanent trading symbol once the trading application is approved[3].

Your local broker usually becomes aware of a new preferred stock once its trading application has been approved by the NYSE at step 3.

By following the instructions in chapter 7, you will usually be aware of new preferred stocks well before your local broker knows about them.

Preferred Stock Trading Symbols

When buying and selling CDx3 Preferred Stocks you need to know how the financial services industry denotes preferred stock trading symbols.

The methods currently used to identify a preferred stock are the result of automating a system that was designed long ago in a non-automated world.

Temporary Trading Symbols

As just described, a new preferred stock will usually begin wholesale trading on what is called the Over-The-Counter stock exchange (OTC) while waiting for the NYSE to approve the trading application.

In chapter 9 you will learn all about the OTC, how it works for you as a preferred stock investor and when to use it to your financial advantage.

When a new preferred stock becomes available for purchase on the OTC it is provided with a temporary trading symbol that is usually (but not always) five characters in length.

[3] CDx3 Notification Service subscribers: This step triggers the "X becomes Y" email alert.

The Series P preferred stock introduced by Public Storage, Inc. on October 4, 2010, for example, traded on the OTC under the temporary trading symbol PSAPL for six days prior to its transfer to the NYSE where its permanent symbol became PSA-P. Your broker automatically transfers any shares of PSAPL that you may have purchased on the OTC and PSA-P shows as the new trading symbol on your statement.

Permanent Trading Symbols

The trading symbol for a *common* stock is the same regardless of which online service you use to reference the stock. International Business Machines, for example, is referenced by the symbol "IBM" regardless if you are using TDAmeritrade, Yahoo! Finance or MarketWatch.

Unfortunately, this is not the case with preferred stocks. There are several standards for the trading symbols of preferred stocks depending on which online service you are using. So, if you type a preferred stock symbol into an online service and get an "invalid symbol" message, try one of the other naming conventions that I describe here.

Let's take an example where Public Storage Inc. introduces a new preferred stock. Since companies can introduce several issues of new preferred stocks in a very short period of time, the financial services industry, for the most part, has settled on the convention of identifying each issue with a sequential letter designation. The first issue would be identified as series A, the second issue would be identified as series B and so on.

Public Storage's common stock trades on the New York Stock Exchange under the symbol PSA. When Public Storage introduced their first preferred stock issue, it was identified by the following symbols, depending on the service you were querying:

Preferred Stock Symbol Cross-Reference

HERE IS HOW THE SYMBOL 'PSA-A' IS DENOTED BY VARIOUS ONLINE SERVICES

online service	convention	example
BigCharts	.P	PSA.PA
E*Trade	.PR.	PSA.PR.A
Fidelity	/P and PR	PSA/PA, PSAPRA
Google Finance	<hyphen>	PSA-A
Interactive Brokers	<space>PR	PSA PRA
MarketWatch	.PR	PSA.PRA
Morningstar	PR	PSAPRA
NYSE	PR	PSAPRA
Quantum Online	<hyphen>	PSA-A
Schwab	+ and /PR	PSA+A, PSA/PRA
Schwab StreetSmart	p	PSApA
Scottrade	p and P	PSApA, PSAPA
Seeking Alpha	.P	PSA.PA
T. Rowe Price	<space>PR	PSA PRA
TDAmeritrade	<hyphen>	PSA-A
Yahoo Finance	-P	PSA-PA

Source: "Preferred Stock Trading Symbol Cross-Reference Table" and as reported by readers. See seekingalpha.com/article/306446 for updates

In practice, this is not as confusing as it seems since most of us use one or two online services, so the various symbol conventions used by others becomes irrelevant. Throughout this book I use the hyphen convention so the series A preferred stock from Public Storage is referred to as PSA-A here.

You may want to earmark this table. If you are a new preferred stock investor you will understand the value of this table when you go to enter your first buy order (discussed in chapter 21).

THREE

THE THREE RULES OF MARKET PRICE PREDICTABILITY

One of the many very appealing aspects of preferred stock investing is that you know an enormous amount about the behavior of their market price at various points in time.

There is nothing predictable about the future pricing of common stocks. With preferred stocks, however, there is a great deal of predictability; predictability that, when you understand it, provides CDx3 Investors with a respectable return at acceptable risk.

Unlike common stocks, preferred stocks have to play by certain rules which I'll describe in a moment. Common stocks, on the other hand, are completely freewheeling. Their market price at any point in time depends completely on the moods and decisions of buyers and sellers and is therefore subject to often dramatic jumps from one day to the next.

While the daily market prices of preferred stocks change as well, the forces that act upon them are very different from the forces that act upon common stocks.

The market price of a preferred stock is heavily influenced by three specific rules:

1) The Rule of Buyer/Seller Behavior;
2) The Rule of Rate/Price Opposition; and
3) The Rule of Call Date Gravity.

The first of these rules, the Rule of Buyer/Seller Behavior, influences the market price of a preferred stock during the short-term of a given dividend quarter.

The Rule of Rate/Price Opposition pressures the market price of a preferred stock for its entire life span until the Rule of Call Date Gravity kicks in (much more on this later).

The third rule, the Rule of Call Date Gravity, explains distortion in the market price of a preferred stock that can occur once the security becomes "callable" by the issuing company. We'll be learning much more about how to take advantage of the call date in chapter 15.

These three rules work in harmony to influence the market price of preferred stocks in a manner that is predictable enough to allow you to purchase shares at a time that tends to favor buyers. And if you're a seller, these rules allow you to determine the price that you are going to sell your preferred stock shares for and the specific date that price is most likely to occur.

And the best part is that, since you will know the date that your "Target Sell Price" (discussed in chapter 14) is most likely to occur, there is no point in checking the price every day. By using the CDx3 Income Engine approach, there is nothing to do the rest of the time; just check the market price of your preferred stock one day each quarter, a day that you will know way in advance – that's all there is to it.

Rule #1: The Rule of Buyer/Seller Behavior

If I name a preferred stock, could you tell me what the market price is *most likely* to be three months from now?

If not, you will be able to in just a couple of minutes.

Notice that I said "...most likely..." There can always be outside influences that distort the results away from what an otherwise perfect market would do.

Fortunately, as we will discuss at length in chapter 14, we can measure that distortion and make adjustments accordingly. But for now let's talk about the generic case.

Buyers and sellers of any type of dividend paying security have three behaviors in common:

1) All buyers of preferred stocks (as well as buyers of any other kind of investment) want the same thing – the lowest price;
2) And all sellers of preferred stocks want the same thing – the highest price; and
3) Buyers and sellers would rather receive their dividend cash sooner rather than later (if I offered you $100 today or the same $100 three months from now, which would you pick?).

Because CDx3 Selection Criterion number 3 (discussed in chapter 7) requires that CDx3 Preferred Stocks pay their dividends quarterly, these three predictable behaviors of buyers and sellers influence the market price of preferred stocks in a predictable way – the Rule of Buyer/Seller Behavior - within any given dividend quarter.

Wouldn't it be great if you could put the buyers and sellers together and watch the buyers try to outbid one another on a preferred stock that you owned, raising the price higher and higher? And wouldn't it be

even greater if you knew *in advance* when – the exact date – they were going to reach this "highest bid" maximum price?

If you knew when buyers and sellers were going to reach such an agreement on the price of a preferred stock that you owned – and you knew it in advance – you wouldn't even have to watch the bidding day in and day out; you'd just need to show up on the date when the price peaks and collect your profits. It wouldn't really matter what went on the rest of the time.

Much of the time, with preferred stocks, you can do exactly that. The predictable nature of the behavior of buyers and sellers converges with a legal requirement (that I will discuss later in this chapter) and tends to elevate the market price of your preferred stock over the course of a dividend quarter.

We're Only Human

Let's say you buy a share of a preferred stock for $25.00 on the first day it is available for public purchase. And let's say the declared dividend rate on your preferred stock is 8.0%. That's $2.00 per year or $0.50 per quarter in dividend income to you.

You're now sitting there tapping your toe, trying to stay calm in anticipation of receiving your first dividend payment.

The closer you get to the end of the first quarter, the more excited you get.

Finally, you are one day away from "payday." The day before you're going to make a cool five dimes, I give you a call and offer you $25.30 for your share.

Remember, the dividend you are going to receive the very next day is $0.50 so you'll be up $0.50 if you wait until tomorrow.

Why would you sell your share to me the day before and lose out on the much anticipated dividend that you are going to be receiving the very next day (not to mention all future dividends thereafter)?

Answer: you wouldn't; and neither would anyone else.

In fact, you would make it clear to me that you would not sell your share to me for any less than, say, $25.49 (getting your money one day early is apparently worth a penny to you).

In the financial services industry, the date when it is determined who gets the upcoming quarterly dividend payment is called the "ex-dividend date." If the stock trading public was allowed to name this date they would have probably called it the "dividend determination date" because that's exactly what it is.

The ex-dividend date is the first day of a new dividend quarter and whoever owns the preferred stock when the stock market opens on the morning of the ex-dividend date gets the dividend for the previous (just ended) quarter.

Therefore, as the ex-dividend date gets closer, the buyers of a share of preferred stock will tend to bid up the market price offered to you; your shares take on more value as the end of the dividend quarter approaches.

The fact that, given the choice, people would rather have $100 today than the same $100 paid to them three months from now is called the "time value of money."

The time value of money is what drives the Rule of Buyer/Seller Behavior. Investors would rather receive a dividend payment sooner rather than one that occurs later.

Preferred stocks that are closer to their respective paydays have more value than otherwise identical preferred stocks that are further away and the market price is pressured upward accordingly.

So now you understand that the market price of a preferred stock will tend to rise as the end of the dividend quarter approaches (again, this is the general case; we will discuss adjusting for market conditions later).

Back to my original question to you: if I name a preferred stock, could you tell me what the market price is most likely to be three months from now? The U.S. Securities and Exchange Commission (SEC) gives it away:

> "With a significant dividend, the price of a stock may move up by the dollar amount of the dividend as the ex-dividend date approaches…"[1]

> **#1: Rule of Buyer/Seller Behavior:**
>
> Within the short-term period of a dividend quarter and without outside influences, the market price of a preferred stock will tend to rise as the end of the dividend quarter approaches and do so by the amount of the quarterly dividend.

Remember the objectives of the CDx3 Income Engine - maximize revenue while minimizing risk and work. Because of the Rule of Buyer/Seller Behavior, if you are considering selling a preferred stock you only need to check the market price one day per quarter – the last day of the dividend quarter when the market price tends to be relatively high, favoring sellers (minimizing work).

Early Dividend Quarter Price Drop

Just as the upward pressure on the market price of a preferred stock is highest on the last day of a dividend quarter, price pressure is lowest

[1] Source: *www.SEC.gov/answers/dividen.htm* (the missing 'd' is not a typo)

during the early days of a dividend quarter, just after the ex-dividend date has passed and for all of the same reasons.

Returning to our previous scenario, let's say that I decline your counter offer of $25.49. So the next day, the day of the ex-dividend date, you still own your share of this preferred stock so you get the $0.50 dividend.

Now that you've collected, you call me back and say "hey Doug, how would you like to buy this preferred stock share from me today – same price, $25.49?"

Nice try. You already collected the dividend for the quarter. If I buy it from you now, I have to wait another three months to get the next dividend. If you're going to sell a share of preferred stock in the early days of a dividend quarter (on or shortly after the ex-dividend date), you are going to have to lower your price by about the amount of the quarterly dividend.

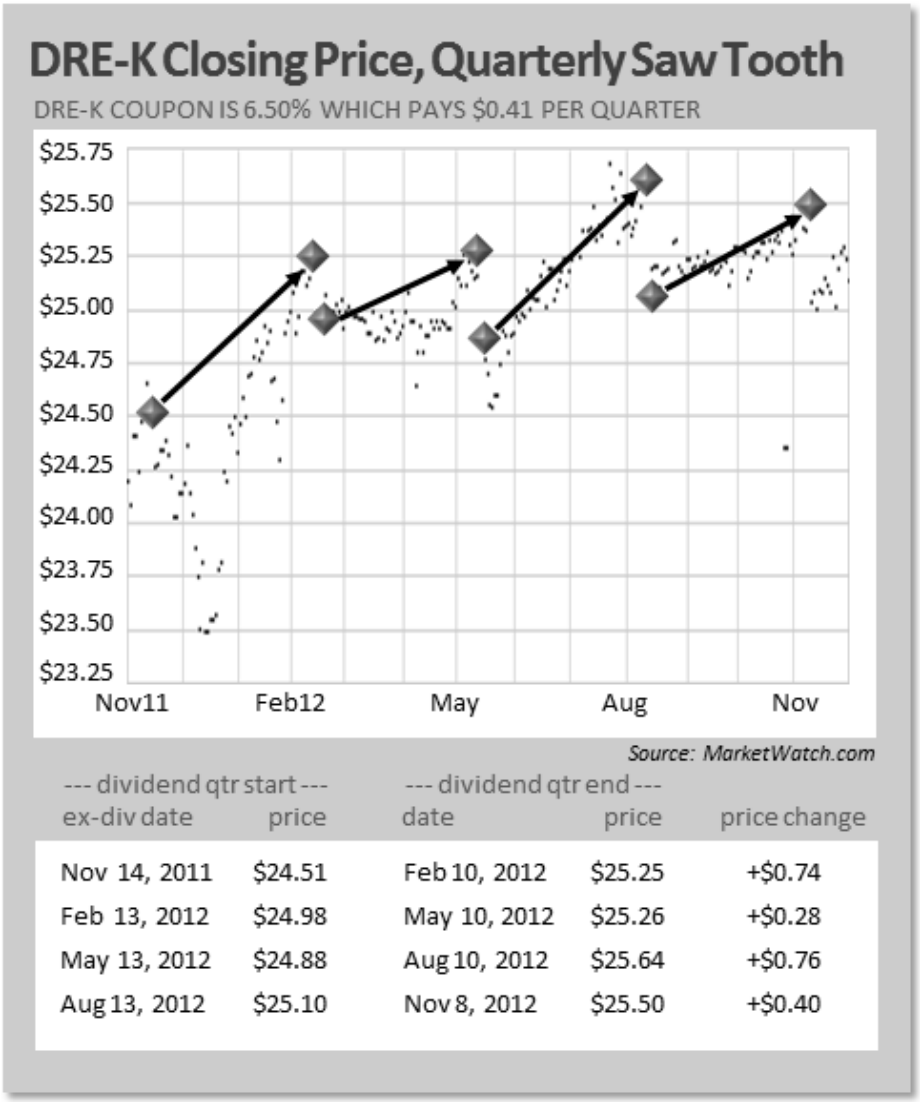
For those looking to buy, however, this is an equally great time to look for bargains (much more on this in Part III).

Result: The Quarterly Saw Tooth

Let's look at an example of the Rule of Buyer/Seller Behavior in action.

Duke Realty (DRE) is a $4.3 billion real estate investment trust (REIT) specializing in industrial, office and healthcare properties throughout the United States. The company was founded in 1972 and is headquartered in Indianapolis. On January 16, 2004, Duke introduced DRE-K, a 6.5% CDx3 Preferred Stock. At 6.5%, DRE-K pays an annual dividend of $1.625 per share ($25 par value times the 6.5% dividend rate) which is $0.41 per share each quarter to shareholders.

The following chart shows DRE-K's closing price (as dots) throughout its four 2012 dividend quarters.



--- dividend qtr start ---		--- dividend qtr end ---		
ex-div date	price	date	price	price change
Nov 14, 2011	$24.51	Feb 10, 2012	$25.25	+$0.74
Feb 13, 2012	$24.98	May 10, 2012	$25.26	+$0.28
May 13, 2012	$24.88	Aug 10, 2012	$25.64	+$0.76
Aug 13, 2012	$25.10	Nov 8, 2012	$25.50	+$0.40

Notice how the Rule of Buyer/Seller Behavior pushes the market price of DRE-K up as the end of each dividend quarter approaches.

Once the ex-dividend date arrives to start the next dividend quarter, the price drops again by approximately the amount of the quarterly dividend (if there are no "outside influences" making it do otherwise – discussed later) and the cycle, predictably, starts over for another quarter.

The resulting saw tooth pattern is visible in the above DRE-K example.

So, back to my question: to determine what the market price of a preferred stock is most likely to be three months from now you need to look up (1) the most recent ex-dividend date which you can find using your online broker's system or at MarketWatch.com, (2) the closing market price on that day and (3) the quarterly dividend amount that the preferred stock in question pays.

Add the quarterly dividend amount to the closing market price on the last ex-dividend date. The resulting price is the market price that this preferred stock is most likely to reach by the end of the dividend quarter three months from now.

In the above DRE-K example, the market price on the first day of the first quarter shown (the ex-dividend date) was $24.51.

Add DRE-K's $0.41 quarterly dividend amount to the quarter start price of $24.51. In a perfect market, the most likely market price for DRE-K at the end of the dividend quarter three months later (February 10, 2012) would be $24.92 ($24.51 + $0.41).

The actual price of DRE-K at the end of that first 2012 dividend quarter was $25.25, $0.33 more than what we would have expected in a perfect market.

The Rule of Buyer/Seller Behavior pushed the market price right through the roof. What happened?

Characteristics of an Imperfect Market

The Rule of Buyer/Seller Behavior says that, over a quarter, the market price of a preferred stock will tend to go up by the amount of the quarterly dividend ($0.41 in the case of our DRE-K example) if there are not any "outside influences" (meaning other market pressures that push the price up or down by more than the amount of the quarterly dividend).

But markets are rarely perfect. Sometimes there will be excess demand that pushes the market price up more than we would expect or, conversely, less market demand resulting in a lower market price.

Continuing with our DRE-K example, the table below the chart shows the effects of "outside influences" in three of the four 2012 dividend quarters. The increase in DRE-K's price during the first and third quarters seen on the chart indicates excess demand (with price increases of $0.74 and $0.76, respectively) while the second quarter indicates waning demand for this security (with a price increase of only $0.28).

2012 was a year of transition for the preferred stock marketplace as companies took advantage of relatively low rates by issuing new preferreds and using the proceeds to redeem their older, more expensive issues – they refinanced (referred to as "deleveraging"). There was a bumper crop of new preferred stocks issued during the year ($17.1 billion through June 2012 compared to $5.7 billion a year earlier), but also a higher number of redemptions.

But there were six other factors occurring during 2012 that also put upward pressure on the market prices of U.S.-issued preferred stocks:

1) Throughout 2011, investors were very worried that the Fed was going to have to start increasing rates in order to hold off inflation. Such a rate increase could put downward pressure on preferred stock market prices (see page 82 for actual data on this mechanism) so the more nervous among us were staying away from fixed-rate securities. That fear subsided substantially as 2012 got underway, bringing such investors back in as buyers.
2) The large number of preferred stock redemptions during the year created a vast group of suddenly cash-rich preferred stock investors all looking to replace their shares. This group entered the market as highly motivated buyers nearly simultaneously.
3) In addition to increased redemptions being caused by the availability of relatively low rates, the provisions of the Wall Street Reform Act that affect bank-issued trust preferred stocks (discussed on page 38) also triggered an increase in the number of redemptions of these securities throughout 2012 due to the January 1, 2013 implementation date of these provisions.
4) Eurozone investors began an exodus from European positions and started moving their funds to U.S. fixed-income assets, especially investment grade preferreds and corporate bonds. In March 2012, for example, net buying of U.S. financial assets including long-term equities, notes and bonds totaled $36.2 billion, up from $10.1 billion the month before[2].
5) The Federal Reserve's "Quantitative Easing" and "Operation Twist" monetary policies put substantial downward rate pressure on the alternatives that many income investors favor. Yields on bank Certificates of Deposit and investment grade corporate bonds, for example, fell to 1.1% and 3.6%, respectively (see the chart on page 74). Since these earnings are completely

[2] *Source: Bloomberg research.*

wiped out by taxes and inflation, many turned to the next step up the risk ladder throughout 2012 - high quality exchange traded debt securities and high quality preferreds, putting more upward pressure on prices.

6) A June 7, 2012 announcement by the Federal Reserve regarding compliance by U.S. banks to new international banking regulations (Basel III) opened the 90-day "premature call" window of trust preferred stocks, triggering more redemption announcements for bank-issued TRUPS[3]. Tens of billions of dollars started flowing into the cash accounts of preferred stock investors, starting with shareholders of STI-Z from SunTrust on Wednesday, July 11, 2012, suddenly creating another large group of motivated buyers looking to replace their shares. The premature call window, which allows these TRUPS to be redeemed regardless of their published call dates, closed on September 5, 2012.

These six events ("outside influences") pushed up the market prices of U.S. preferred stocks to varying degrees throughout 2012 and you can see how the Rule of Buyer/Seller Behavior was affected by the excess demand throughout much of the year in our DRE-K example above.

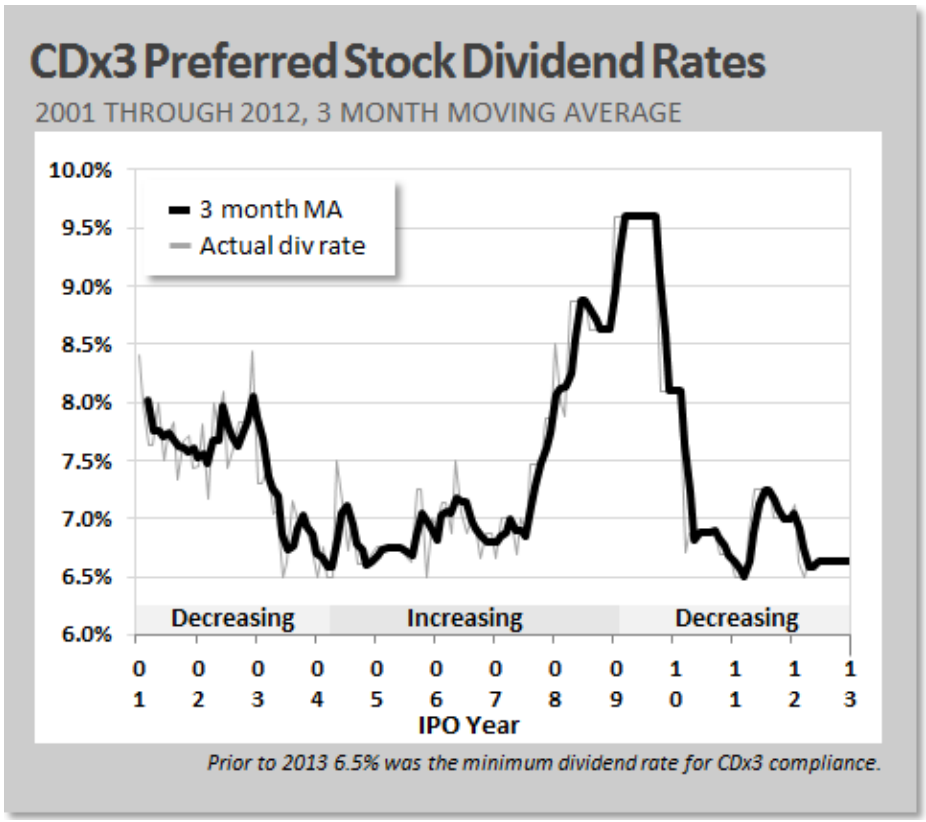
The extent to which the Rule of Buyer/Seller Behavior manifests itself will vary, but the upward pressure that it puts on the market price of a preferred stock throughout a given dividend quarter is always present.

[3] See "*Preferred Stock Investors About To Be Cash-Rich Thanks To New Fed Action*" at SeekingAlpha.com/article/695061

Rule #2: The Rule of Rate/Price Opposition

As with all money rates, dividend rates being offered by newly introduced preferred stocks move up and down over time. And as they do, the CDx3 Income Engine is always producing income for you, although the nature of that income will change.

This chart shows the dividend rate (coupon) offered by new CDx3 Preferred Stocks that were introduced between 2001 and 2012. I've used a statistical technique called a 3-month moving average to smooth the raw data (shown in gray) out so that trends are easier to see.



As I am about to explain, during periods of high dividend rates the CDx3 Income Engine produces piles of dividend income for dirt cheap market prices. And once rates swing back downward, the CDx3 Income Engine will compensate for the corresponding drop in dividend income by producing vast amounts of capital gain income.

It is the Rule of Rate/Price Opposition that makes this magic happen for preferred stock investors.

$25.00 per share is a magical value in the marketplace for preferred stocks. A new preferred stock starts its life on its IPO date at this price and, five years later, reaches its call date when the issuing company can redeem (call) the issue and purchase your shares back from you for $25.00 per share (chapter 15 will show you how to determine the likelihood of a call). Until or unless the issuing company calls the issue, you will continue to receive your quarterly dividends.

What happens to the market price in between the IPO date and the day it is called is driven by the second of our Three Rules of Market Price Predictability – the Rule of Rate/Price Opposition.

While the Rule of Buyer/Seller Behavior affects the market price of a preferred stock during the short-term period of a dividend quarter, the Rule of Rate/Price Opposition acts upon the market price of a preferred stock, to one extent or another as we will see, for its entire life span (as long as conditions do not favor a call; more on this in a moment).

Like the last section, let me start this section with a question: if I name a preferred stock that has been around for, say, a year or two, can you tell me if its current market price is more likely to be higher or lower than $25 per share (without looking)?

Here's how the Rule of Rate/Price Opposition allows you to answer that question.

Rates Down, Prices Up and Vice Versa

The Rule of Rate/Price Opposition describes the relationship between the declared dividend rate at which companies can issue new preferred stocks (i.e. the "going dividend rate") and the market price of older, previously issued preferred stocks.

In short, the direction of the going dividend rate and the market prices of older issues will move in opposite directions; they oppose each other. Rates down, prices up and vice versa.

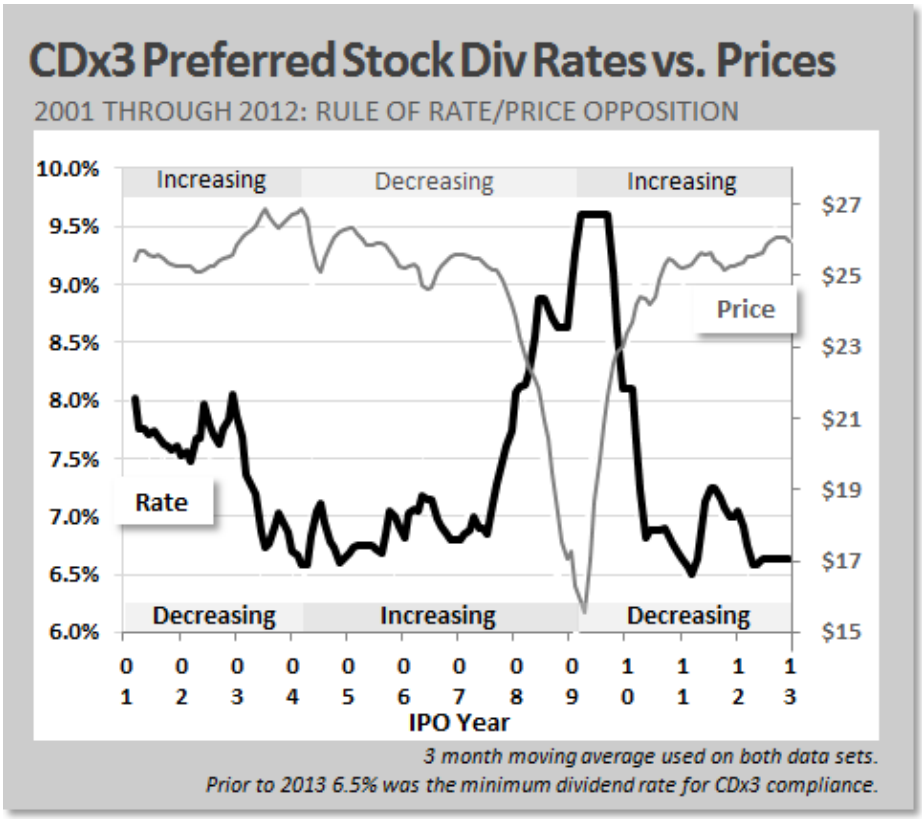
Look at it this way - let's say that you purchase a new CDx3 Preferred Stock that pays a 7.0% annual dividend. By definition, all newly issued preferred stocks cost $25 per share so let's further say that this is the price you paid.

After some time goes by you check again and find that new preferred stocks are now being introduced with a dividend rate of 6.0% (at, as required, a market price of $25); dividend rates are decreasing.

Well, if the current going dividend rate of 6.0% is commanding $25 per share from the buyers of the world, what do you think has happened to the market price of the CDx3 Preferred Stock that you purchased earlier that pays 7.0%? It will tend to exceed $25, of course.

If a 6% preferred stock has a market price of $25 then the market price of a previously issued preferred stock that pays 7% will tend to be greater than $25. Should you choose to sell, you are looking at a nice capital gain in addition to the 7% dividend income that you have been collecting in the meantime.

Capital gain plus dividend income in the meantime – the CDx3 Income Engine.



I've added an average market price line to our chart with its scale on the right. The top line reflects the average market price of CDx3 Preferred Stocks from January 2001 through December 2012.

This time frame includes a wide variety of economic conditions that resulted from everything from terrorist attacks (2001), two wars (2002), recession (2003), a housing bubble (2006), a burst housing bubble (2007), a Global Credit Crisis (2007 – 2009) and another recession and persistent unemployment (2009+). But notice that regardless of economic conditions or the causes of them, the Rule of Rate/Price Opposition continues to function the same way.

That's an enormous benefit to you as a preferred stock investor; you do not need to become an economics expert in order to understand how dividend rates and market prices of preferred stocks are going to behave.

While dividend rates of newly issued CDx3 Preferred Stocks were relatively stable through 2002 (as were prices), the 2003 recession pushed rates down from as high as 8.5% to less than 7% in just a few months. Note the corresponding increase in prices throughout 2003.

Then, beginning in the back half of 2004, dividend rates of newly issued CDx3 Preferred Stocks started to recover, rising gradually through 2006 and into early 2007. Per the Rule of Rate/Price Opposition, market prices of CDx3 Preferred Stocks gradually declined accordingly.

#2: Rule of Rate/Price Opposition:

The direction of dividend rates works in opposition to the direction of the market price of preferred stocks. When the average dividend being offered by newly issued preferred stocks is decreasing, the market price of older, previously issued preferred stocks will tend to increase; but when dividend rates go back up, the market price of previously issued preferred stocks tends to go back down.

Rule #3: The Rule of Call Date Gravity

The Rule of Call Date Gravity is a rule that delivers a great selling opportunity to CDx3 Investors. Therefore, some of this discussion I am going to leave until Part IV when we talk about selling a preferred stock for a capital gain.

For now, let's understand what the call date is and how it works.

As I did with the previous two rules, let me start the explanation of the Rule of Call Date Gravity with a question: if I were to identify a newly issued preferred stock, what will the market price be five years from now (assuming no unusual market conditions)? Once you understand the Rule of Call Date Gravity you will be able to answer that question (no clairvoyance required).

After explaining how this works, I'll show you a chart of a trust preferred stock from Wells Fargo that illustrates the Rule of Call Date Gravity in action.

When a company issues a preferred stock, they do so at a promised dividend rate that will be paid to you. The issuing company also promises, in the prospectus, to pay you this dividend, each quarter, for a certain minimum period of time; that is, if dividend rates drop, the company cannot cancel your dividend the next day in order to reissue the preferred stock at the new, lower rate.

Once they issue the preferred stock at a declared dividend rate, they're stuck with it – until the call date[4].

If the issuing company "calls" your shares, the preferred stock is said to have been "called" or "retired" or "redeemed."

And in the event of a call, the issuing company must pay you $25.00 per share (the "par" value, also provided in the prospectus). It does not matter what the current market price is on the call date nor does it matter what you originally paid for your shares. $25.00 per share, that's what you're going to get.

But the issuing company is not *required* to call (buy back from you) your shares. They will only do so if market conditions favor a call. If market conditions do not favor calls, you will notice that the list of

[4] Chapter 8 provides an explanation of some rare circumstances that allow the issuing company to redeem your shares prior to the published call date.

great preferred stocks available to buyers to pick from just keeps getting longer. But don't worry about that now; in chapter 15 I'll show you how to determine if the issuing company is likely to call your preferred stock or not.

Remember, the call date for every preferred stock is public knowledge as published in the prospectus. Everyone in the world knows when the call date is and that, if the issue is called, the issuing company is going to pay the holder $25 per share.

So, what do you think happens to the market price of a preferred stock as the call date approaches (five years after its introduction)? If the market believes that conditions favor a call, the market price will trend toward $25, of course. No one is going to pay you much more than that once the issuing company re-gains the right to purchase the shares back at that price.

Back to my original question: what will the market price of a newly issued preferred stock be five years from now (assuming no unusual market conditions)?

Answer: $25 per share (your friends will be surprised and justifiably impressed). Market conditions have to favor a call, as we will see in chapter 15; but, assuming that they do, there is a 91% chance that the issuing company (your "built-in buyer") will call your shares.

#3: Rule of Call Date Gravity:

If market conditions favor a call, the market price of a preferred stock will tend to move toward $25.00 per share as the call date approaches.

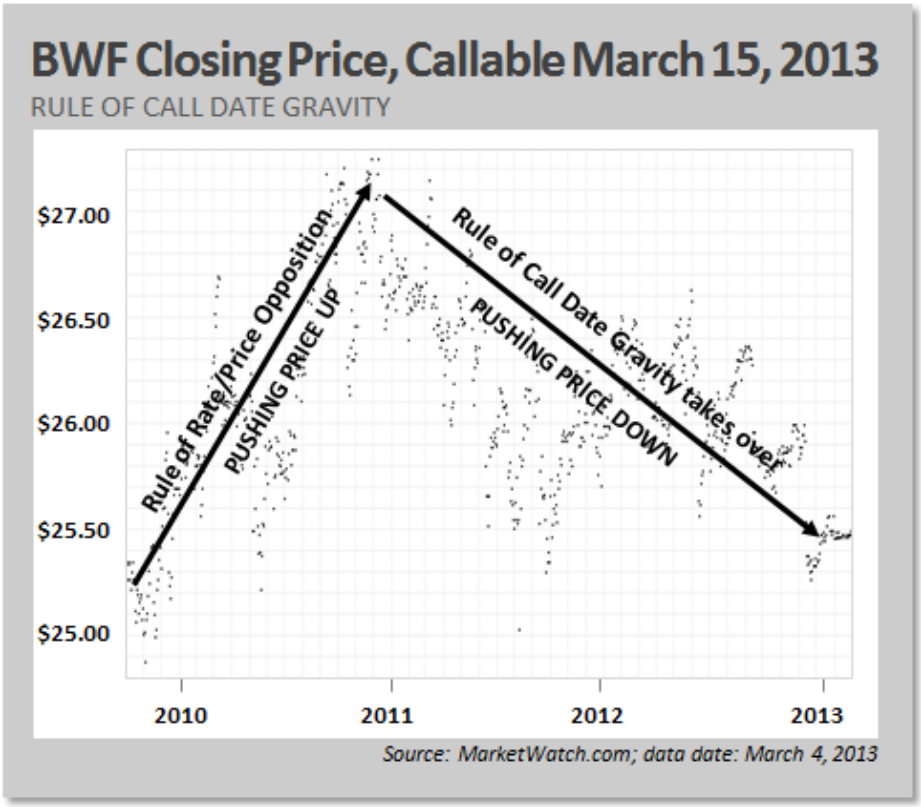
Let's take a look at the market price behavior of a real preferred stock that found itself in this very situation as its call date approached in March 2013.

Wells Fargo & Company is a $188 billion banking services company founded in 1852 and headquartered in San Francisco. On March 7, 2008 Wells Fargo introduced a trust preferred stock paying an annual dividend of 7.875% under the trading symbol BWF.

Wells Fargo is obligated to pay holders of BWF this 7.875% annual dividend until BWF's call date on March 15, 2013. On, or at any time after, that date the company has the right to purchase BWF back from its holders by paying them $25 per share[5].

Here is the closing market price for BWF beginning in late 2009 when dividend rates offered by newly introduced CDx3 Preferred Stocks had been decreasing for several months (refer to the chart on page 59).

[5] See chapter 8 for exceptional conditions that can trigger a premature redemption.



Earlier we saw how the Rule of Rate/Price Opposition makes dividend rates and market prices of preferred stocks move in opposite directions. The above chart for BWF clearly shows this mechanism, with the market price rising during 2010 when rates were decreasing.

But beginning in 2011, the market price of BWF starts to drop and never looks back. Even though dividend rates were decreasing at the time, the market price of BWF was decreasing as well – counter the Rule of Rate/Price Opposition. So what happened?

Rule versus Rule

What you are seeing in the above chart for BWF is nothing less than the Rule of Call Date Gravity overwhelming the Rule of Rate/Price Opposition in the marketplace for preferred stocks.

As BWF's March 15, 2013 call date approached, the market clearly believed that conditions favored the call of BWF by Wells Fargo.

In January 2011 the going dividend rate being offered by newly issued preferred stocks was about 6.75% but Wells Fargo still had to pay out dividends at an annual rate of 7.875% to BWF shareholders. As March 2013 approached, dividend rates had fallen even further (down to about 6.0%), reinforcing the market's belief that Wells Fargo was likely to call BWF on, or near, its March 15, 2013 call date.

And they were right. On January 30, 2013 Wells Fargo announced that they would be redeeming BWF on its published call date of March 15, 2013.

With the going dividend rate closer to 6.0% in March 2013, Wells Fargo would be able to introduce a new preferred stock and use the proceeds to redeem all outstanding shares of BWF (a very common method of "refinancing"), saving themselves 1.875% in dividend expense. While 1.875% may not seem like much, BWF had 63 million shares outstanding so just by refinancing at 6.0%, the company saves itself over $29 million per year in dividend expense.

If market conditions favor a call, the Rule Of Call Date Gravity will overwhelm the Rule Of Rate/Price Opposition as the call date approaches and the market price of a preferred stock will approach $25 accordingly.

This is important to you as a CDx3 Investor. Knowing that the Rule of Call Date Gravity may pull the market price of your preferred stock back to $25, and do so at a specific time, helps you to decide when or if

to sell your preferred stock. I'll show you how to determine the likelihood of a call later in chapter 15.

Price Behavior of a Redeemed Preferred Stock

Before leaving this discussion of price predictability of preferred stocks, I wanted to provide you with another layer of detail regarding the final payment that shareholders receive from the issuing company in the event of a call.

The final payment amount is always going to be a bit more than $25 per share. The reason is that, in addition to the $25 par value, the issuing company is also going to owe you for the final partial dividend quarter, the number of days that have accrued since the previous dividend payment was made.

When a redemption is announced[6], the partial final dividend is usually referred to as the "accrued distribution" in the announcement but, annoyingly, is rarely provided in the press release, forcing all shareholders to reach for their calculators.

The final accrued distribution amount of a redeemed preferred stock is calculated using this formula:

[accrued distribution] =
{ ([par value] x [div rate%]) / 360 } x ([number of days] - 1)

The [number of days] value is the number of days between the first day of the current dividend quarter (the day after the most recent dividend payment) and the announced call date (but not including the announced call date itself, so you need to subtract one day).

[6] CDx3 Notification Service subscribers: To see preferred stock call announcements click the "PS News" tab on the CDx3 Notification Service website.

The final payment amount received by shareholders will therefore be equal to the [par value] ($25 in our case) plus the [accrued distribution]. The next time you receive a redemption notice for one of your preferreds you can use the above formula to figure out the exact amount of your final payment.

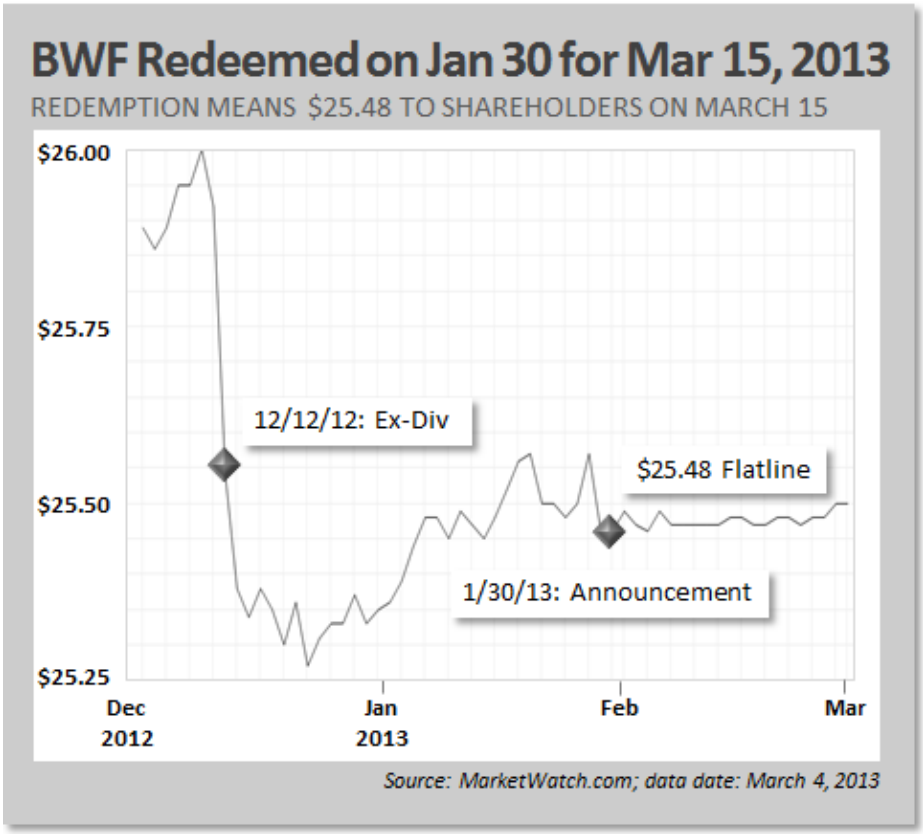
Returning to our BWF example, in their January 30, 2013 redemption announcement for BWF the bank stated "*This issue will be called for redemption on March 15, 2013 at $25.00 per share plus any accrued distributions*."

Using the above accrued distribution formula, the final payment for BWF should be (and was) $25.48 per share:

$25 + { ([$25] times [7.875%]) divided by 360 } times ([90] - 1)

As you might guess, once a redemption announcement is made, the market price of the preferred stock will jump right to this amount and stay there (plus or minus a few pennies) until the announced call date arrives.

Here is the closing market price of BWF in the days preceding and following the January 30, 2013 redemption announcement from Wells Fargo.



The Rule of Buyer/Seller Behavior presented at the beginning of this chapter dutifully causes the price to drop following the December 12, 2012 ex-dividend date. As the price starts to climb again, half way into the next (and last) dividend quarter, Wells Fargo announces the redemption of BWF on January 30, 2013.

Notice how the market price of BWF, following the January 30, 2013 redemption announcement, snaps right to $25.48 and stays there.

I hope that you are starting to appreciate what I mean when I say that one of the many beauties of preferred stocks, and investing in them, is that there are many more "knowns."

Largely because preferred stocks have a known par value ($25) and pay a known, fixed dividend on a known schedule, investors know much more about what they are getting into before they invest. In the world of investing, that is a huge advantage to the investor.

Taking advantage of these known characteristics of preferred stocks often means knowing when market conditions are ripe for you to do so. As the Three Rules of Market Price Predictability illustrate, it's really a matter of knowing a few key pieces of information about the preferred stock that you are interested in and the current marketplace.

The next chapter shows you some easy to access (and free) charts that allow you to stay on top of the marketplace for preferred stocks.

FOUR

KNOWING THE PREFERRED STOCK MARKET

As investors, we can only invest in the market that is in front of us, not the market that used to exist, not the market that we wish existed and not the market that may exist in the future.

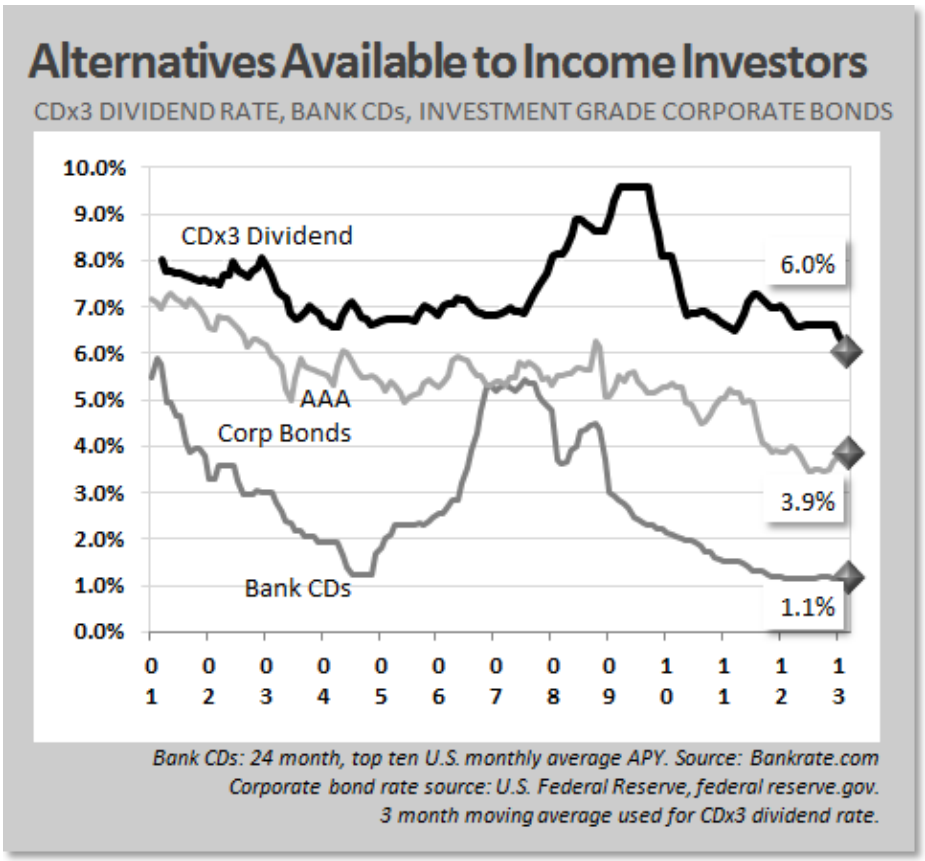
As obvious as that sounds, it implies that the information needed by preferred stock investors to understand the market that they are investing in is available. As you probably know, such information about the preferred stock marketplace – easy to find and read charts and metrics – is difficult to come by.

One-third of the U.S. population (100,000,000 people) began retiring in 2011 and 10,000 Americans turn sixty years of age every day. With preferred stock investors, to a large degree, coming from this same group, the lack of information regarding preferred stocks is appalling; a condition that is unlikely to change any time soon.

This chapter presents a variety of charts and metrics that allow you to know the market that you are investing in. Later in this chapter I will provide you with instructions for getting updates to these charts as time goes by (for free).

Income, Inflation and Taxes

This chart illustrates the primary investing alternatives that are available to risk-averse income-oriented investors - CDx3 Preferred Stocks (black top line), bank certificates of deposit (bottom line) and investment grade corporate bonds (lighter gray line in the middle).



Because bank CDs are federally insured they are always going to offer the least return of these three alternatives. Corporate bonds, while not insured, rank senior to preferred stocks in the unlikely event

of a default so bonds provide a higher return than bank CDs but a lower return than similar quality preferred stocks.

But as the above chart illustrates, the big problem with bank CDs and corporate bonds is that their gains are eliminated by inflation and income taxes. The Federal Reserve's stated policy for U.S. domestic inflation is between 2% and 2.5% per year. 2012 came in at 1.70%[1]. Bank CDs, at 1.1%, are upside down before even getting to the taxes that savers have to pay on the interest earnings.

The $39 annual earnings from a $1,000 bond is subject to a $15.60 tax (assuming a 40% combined tax rate), leaving $23.40. But inflation eliminates about $20 of your $1,000 principal, leaving you with a meager $3.40 on your $1,000 investment a year later.

With inflation and taxes wiping out the return from bank CDs and investment grade corporate bonds, high quality preferred stocks offer an attractive alternative to risk-averse income-oriented investors.

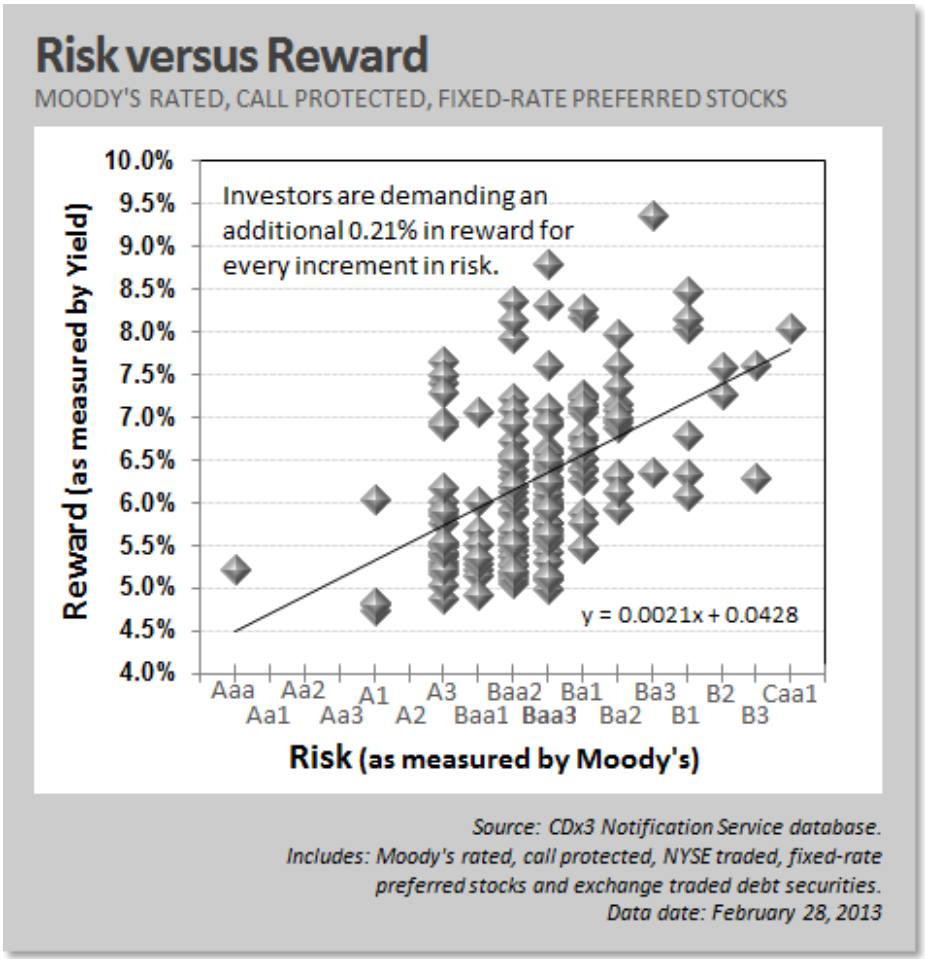
Measuring Risk versus Reward

42% of newly licensed 16 year old drivers get into a police-reported car accident within their first year of driving[2]. Note that I said "police-reported;" do you think that 16 year olds call the police every time they wreck the family car? The actual number is much higher.

And yet we share the road with these teens every day. Taking the risk is worth the reward we receive by being able to go grocery shopping, visit with friends and family and so on. We take the risk.

[1] Source: U.S. Bureau of Labor Statistics, www.bls.gov
[2] Source: National Safety Council, *Injury Facts*

Investing works much the same way. This chart illustrates the trade-off that preferred stock investors make between risk (as measured by Moody's ratings) and reward (as measured by dividend yield). Each diamond represents a Moody's-rated, call-protected[3] fixed-rate preferred stock on February 28, 2013.



[3] A preferred stock that has yet to reach its published call date is said to be "call-protected."

Preferred stocks are rated by various companies that specialize in such things like Moody's Investors Service, Standard & Poor's, Fitch Ratings and others. These ratings attempt to quantify the creditworthiness of the issuing company with respect to their obligations promised by the security's prospectus and are therefore used as a proxy for investment risk by investors.

Security ratings have two categories: investment grade for the strongest issues and speculative grade for weaker issues. Each category is further divided into subcategories. For ratings issued by Moody's, the investment grade category has ten subcategories (strongest to weakest): Aaa, Aa1, Aa2, Aa3, A1, A2, A3, Baa1, Baa2 and Baa3 (why a scale of 1 to 10 was impossible is unclear). Speculative Moody's ratings are Ba1, Ba2, Ba3, B1, B2, B3, Caa1, Caa2, Caa3, Ca and C.

Using these Moody's ratings as a measure of investment risk, the above chart plots the reward (as measured by dividend yield) of each preferred stock at each level of risk. As expected, the higher the risk the higher the reward that investors are demanding.

At the end of February 2013, investors wanted an additional 0.21% in dividend yield for each increment in risk on the Moody's scale.

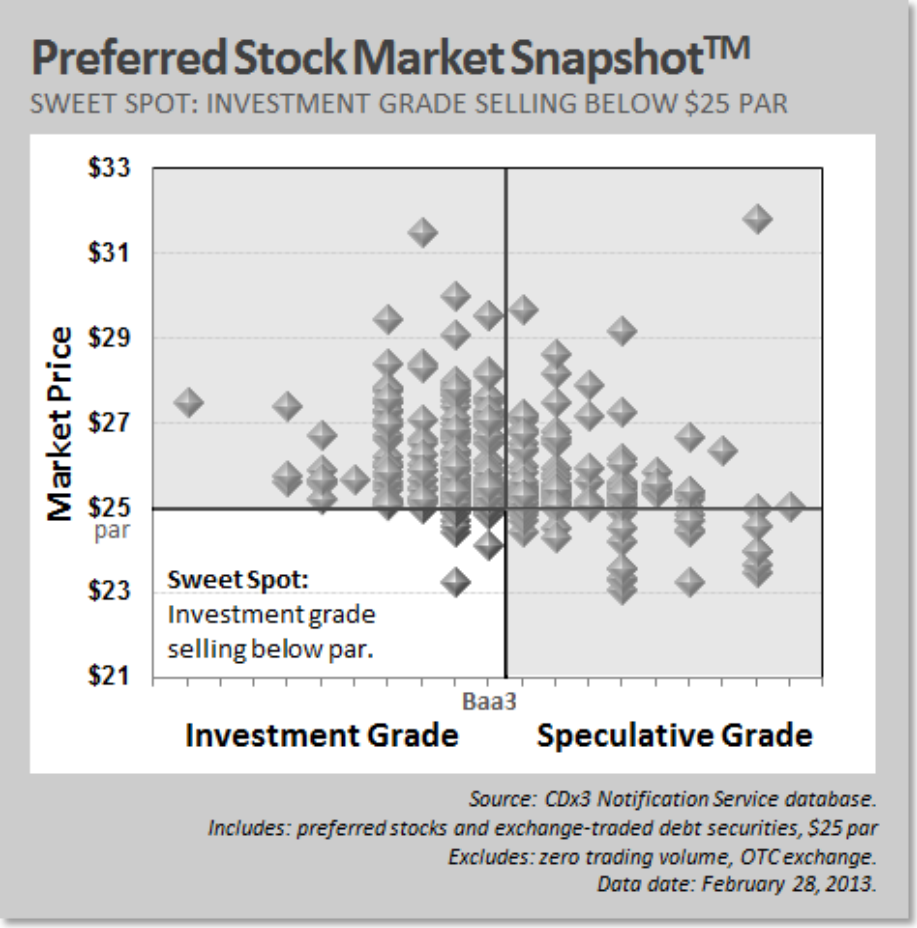
Notice that I have added a "best-fit" trend line to the chart. While the 0.21% trade-off between reward and risk is interesting, what can be more telling is how this number (the slope of the best-fit line) changes over time. If your fellow preferred stock investors are becoming more risk averse, the slope of this line will increase. Conversely, the line will flatten if investors decided that they are willing to take more risk for the same amount of reward.

Knowing the trend of the risk versus reward behavior of your fellow preferred stock investors can become very important when deciding how much risk you are willing to take.

Preferred Stock Market Snapshot™

The Preferred Stock Market Snapshot™ chart divides the U.S. preferred stock market into four quadrants along the primary criteria that most preferred stock investors are looking for: investment versus speculative grade and those trading below versus above $25 per share.

The sweet spot is an investment grade rating available for a market price that is below the $25 par value of these securities (lower-left).



As you might guess, the number of preferred stocks that show up in each quadrant changes substantially from one day to the next as prices move, older issues are redeemed by their issuing companies, ratings change (up or down) and new issues are introduced to the marketplace. So this is another chart that, while always interesting and meaningful, is best viewed repeatedly over time.

February 2013 produced what very well may have been the highest priced market for U.S. preferred stocks in recent history primarily due to the Cyprus event described on page 154.

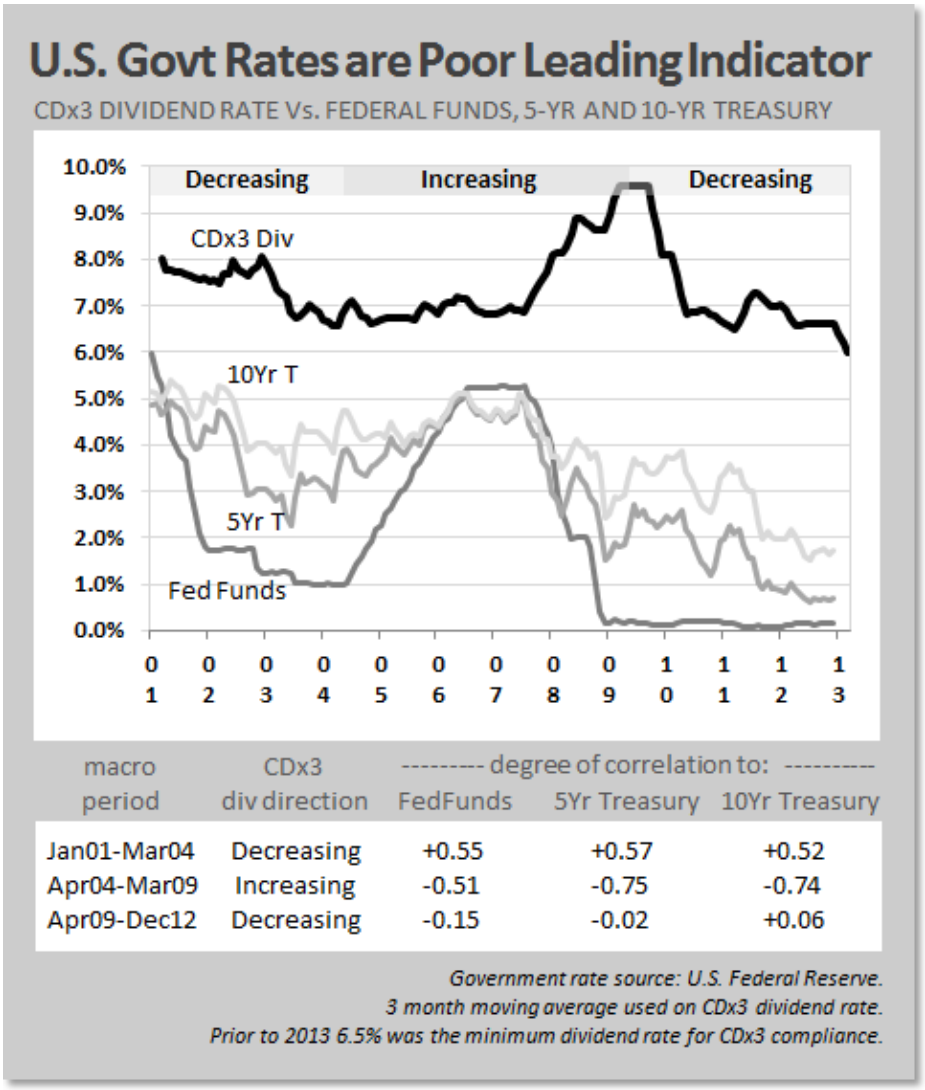
While the sweet spot on the Preferred Stock Market Snapshot™ chart usually hosts a few dozen issues (investment grade available for less than $25), there were 18 such issues at the end of February 2013.

Knowing whether there are relatively few or substantially more sweet spot candidates than usual at any point in time can be very important for a preferred stock investor who is considering a purchase. How picky can you be? How far up the risk or price ladder do you have to go in order to find more choices?

The Preferred Stock Market Snapshot™ chart shows you two key characteristics of the U.S. preferred stock marketplace at a glance, helping you to quickly answer such questions.

The Relationship to U.S. Government Money Rates

Preferred stock investors are frequently advised to keep a sharp eye on the interest rates of various government instruments as a sort of indicator of what they can expect for the dividend rates to be offered by new preferred stocks. But the actual data show little or no relationship between the direction of U.S. government money rates and the direction of preferred stock dividend rates.



macro period	CDx3 div direction	--------- degree of correlation to: ---------- FedFunds	5Yr Treasury	10Yr Treasury
Jan01-Mar04	Decreasing	+0.55	+0.57	+0.52
Apr04-Mar09	Increasing	-0.51	-0.75	-0.74
Apr09-Dec12	Decreasing	-0.15	-0.02	+0.06

While the relationship between the three government money rates is pretty easy to spot, the notion that high quality preferred stock dividend rates follow along is less obvious. There are periods where preferred stock rates and government money rates seem to be

somewhat related, moving in the same direction, but there are just as many occasions where they seem to move in entirely opposite directions.

Look at the correlation coefficients below the chart. A value of 0.0 indicates no correlation while a value of 1.0 indicates a perfect correlation. Negative correlation values are heading in the wrong direction entirely, indicating that as CDx3 Preferred Stock dividend rates were heading in the indicated direction, the government rates were heading in the opposite direction – exactly backwards from the relationship that preferred stock investors are often told to look out for.

Interestingly, the dividend rate offered by newly issued CDx3 Preferred Stocks is highly correlated to changes in the federal funds rate from two years earlier (+0.78, not shown); that is, if you slide the federal funds rate line two years to the right, it lines up pretty nicely with the CDx3 Preferred Stock rates.

But this is where the difference between two things being correlated versus there being a cause-and-effect relationship is important to pay attention to. For example, traffic on the Golden Gate Bridge and the tides under the bridge are highly correlated (since both are tied to lunar cycles), but one does not cause the other.

Correlation is different than cause-and-effect. When companies and their underwriters are about to introduce a new preferred stock and are trying to set the dividend rate, they do not look back two years to see what the federal funds rate used to be; nor does the Federal Reserve, when setting the federal funds rate, do so in order to bring about a specific preferred stock dividend rate two years later. While correlated with a two year delay, the notion that changes in the federal funds rate cause a change in the dividend rate offered by new preferred stocks two years later is contrary to what we know about the processes involved.

The advice often given to preferred stock investors regarding the strong relationship between government money rates and preferred stock dividend rates is not supported by these data, certainly not to the extent needed to provide the basis for a preferred stock investing strategy.

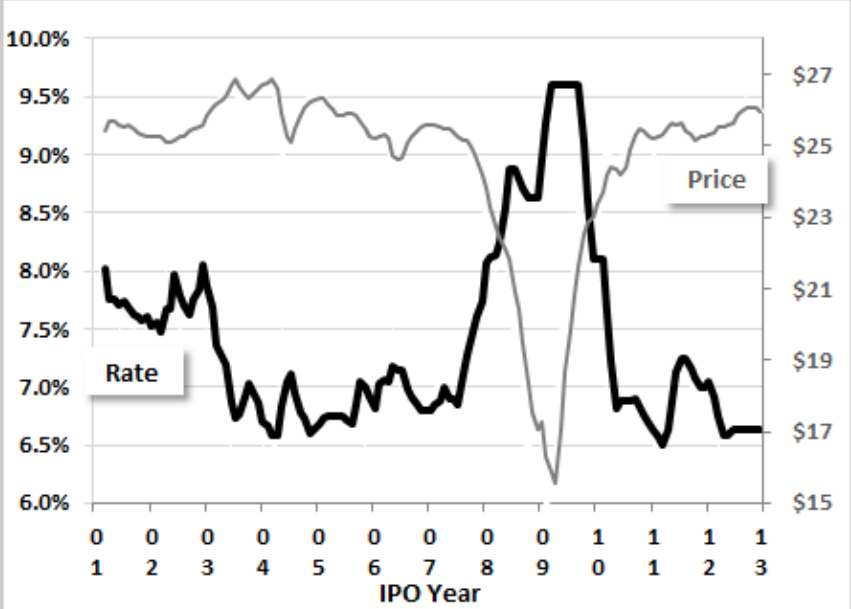
Price as Predictor

When looking for an indicator of what direction the dividend rate offered by upcoming new preferred stocks is likely to be, the direction of the market prices of currently trading issues can be very useful.

Here is the same Rule of Rate/Price Opposition chart initially presented on page 62 except I have now added the correlation coefficients below the chart.

Prices are a Strong Indicator of Div Rates

HIGH CORRELATION PLUS CAUSE-AND-EFFECT



macro period	CDx3 price direction	CDx3 div direction	correlation coefficient
Jan01-Mar04	Increasing	Decreasing	-0.82
Apr04-Mar09	Decreasing	Increasing	-0.92
Apr09-Dec12	Increasing	Decreasing	-0.86

3 month moving average used on both data sets.

Remember that the black line is the dividend rate (coupon) offered by newly issued CDx3 Preferred Stocks. Look at the impressive correlation coefficients compared to what we saw with government money rates on page 80. When prices go up dividend rates offered by new issues go down (the Rule of Rate/Price Opposition).

Importantly, because of what we know about how prices and dividend rates for new preferred stocks are set we can also say that price is a *leading* indicator. Prices change first, then changes in the dividend rates being offered by new preferred stocks follow.

The reason is that when underwriters are trying to determine the dividend rate for a new preferred stock that is about to be introduced one of the primary factors they consider is the current yield of similar preferred stocks that are currently trading.

Current yield is determined by the current market price at any point in time. In other words, current yield is set immediately and repeatedly all day long.

The process of introducing a new preferred stock, however, usually takes a few weeks. So today's preferred stock prices can act as a leading indicator of what we might expect from the dividend rates offered by new issues a few weeks from now.

Because of what we know about the processes involved, we can not only say that there is a high correlation between today's preferred stock market price movements and the dividend rates to be offered by upcoming new preferred stock issues (-0.80 overall), but a cause-and-effect relationship as well.

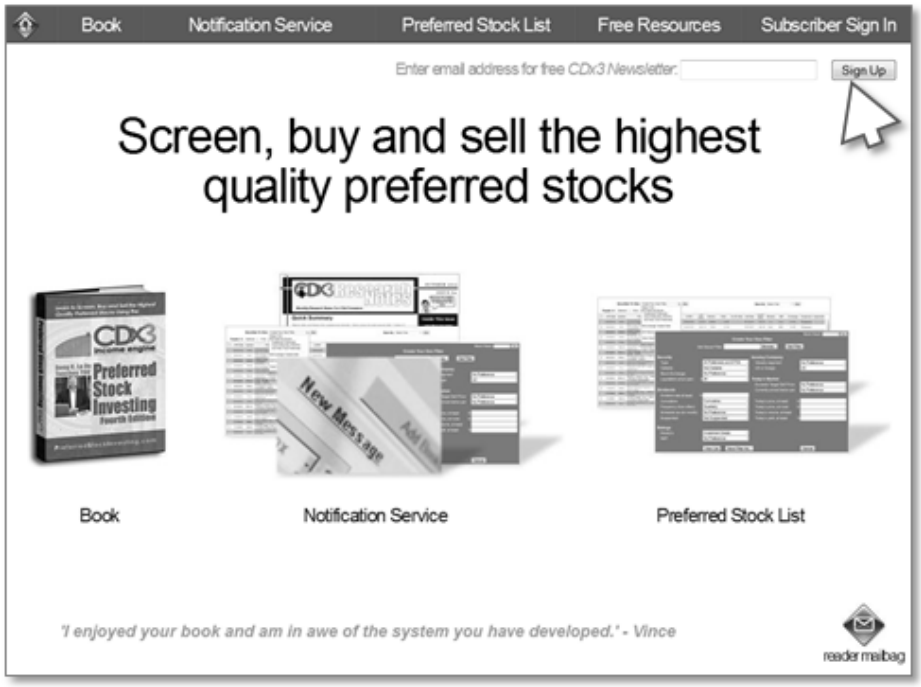
Free Updates to Preferred Stock Charts and Metrics

Your purchase of *Preferred Stock Investing* includes a subscription to my free *CDx3 Newsletter* – a monthly preferred stock investing newsletter where I provide readers with ongoing research regarding the highest quality preferred stocks and the market that they trade within.

The charts that are presented within this chapter are periodically updated and published in *CDx3 Newsletter* articles that you can sign up to receive for free (no spam, ever).

The *CDx3 Newsletter* is delivered by email directly to your desktop during the first week of every month.

Just go to my website at www.PreferredStockInvesting.com, enter your email address in the upper-right corner and click the Sign Up button.



As interesting as these key charts are, their real value to preferred stock investors comes with observing how they change over time.

The CDx3 Perfect Market Index

No discussion regarding knowing the preferred stock market would be complete without explaining the CDx3 Perfect Market Index[4]. I developed the CDx3 Perfect Market Index several years ago.

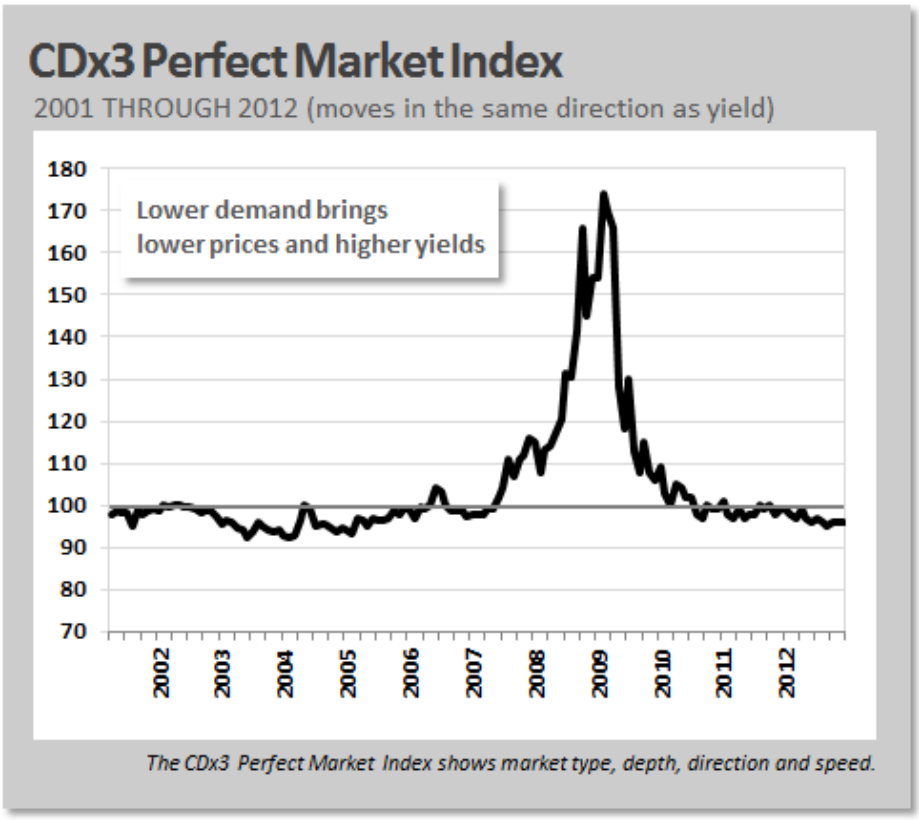
By calculating and charting the index each month, we can see (1) the type of preferred stock market we are in (one with higher demand or lower demand), (2) the direction of the market, (3) the magnitude of the change in the market from one month to the next and (4) the speed of that change over time.

The value of the CDx3 Perfect Market Index reacts to preferred stock market events using a proprietary formula. A value of 100 represents a theoretical 'perfect market' for CDx3 Preferred Stocks.

By charting how today's market conditions (dividend rates and market prices) compare to the theoretical perfect market, we can monitor the direction and magnitude of change in the marketplace for CDx3 Preferred Stocks from month to month.

Here is the CDx3 Perfect Market Index chart from 2001 through 2012.

[4] The CDx3 Perfect Market Index is updated monthly and provided to CDx3 Notification Service subscribers.



Type of Market

The demand for preferred stocks fluctuates over time. Since the CDx3 Perfect Market Index is sensitive to changes in the dividend rates and market prices of CDx3 Preferred Stocks, CDx3 Investors can use the index to determine the type of market we are in.

A CDx3 Perfect Market Index below 100 indicates that we are in a high demand market for CDx3 Preferred Stocks (such as most of the period prior to and following the Global Credit Crisis). During periods of high demand average market prices will be above par ($25 per share) and newly introduced issues will start offering lower dividend

rates (per the highly correlated relationship established by the chart on page 83).

Conversely, a CDx3 Perfect Market Index value that is above 100 indicates weaker demand, a market where average market prices are falling and dividend rates offered by new issues are increasing accordingly.

Looking at the above chart you can see how the CDx3 Perfect Market Index signaled weakening demand and the beginning of the Global Credit Crisis for CDx3 Preferred Stocks in June 2007 when the index jumped above 100.

Depth of the Market

It's one thing to know whether demand for CDx3 Preferred Stocks is relatively high or low. But it is also important to know the *depth* of current market conditions.

By depth I mean "*how close to a perfect market are we?*"

The CDx3 Perfect Market Index shows us not only whether demand is high or low, but by seeing how close the current value is to the horizontal line at 100, we can also judge the depth of the current market.

Take a look at how the CDx3 Perfect Market Index measured the falling demand for CDx3 Preferred Stocks during the Global Credit Crisis (2007 -2009).

When you look at the above CDx3 Perfect Market Index chart you are seeing the very face of the Global Credit Crisis as it impacted the market for CDx3 Preferred Stocks. During this period, CDx3 Preferred Stocks, the highest quality preferred stocks available, paying annual dividend rates close to 9%, were available for market prices well below $20 per share (that means your actual yield, in many cases, exceeded 11% per year). Demand plummeted, prices dropped and dividend rates

offered by new issues (and the yields of previously issued preferreds) soared.

Conversely, during recessionary periods (2003, 2010) investors seek safety in lower risk alternatives. The CDx3 Perfect Market Index reported values below 100 each month, indicating high demand for CDx3 Preferred Stock and the higher market prices that result.

Direction of the Market

Anyone who has been caught inside their car during a flood can tell you that it is not only important to know how deep the water is at the moment but whether or not it is continuing to get even deeper.

The CDx3 Perfect Market Index chart not only tells you how far away from the theoretical perfect market we are (depth), but it also tells us whether or not we are heading toward it or away from it (direction).

The direction of the market for CDx3 Preferred Stocks is determined by simply looking at the slope (up or down) of the CDx3 Perfect Market Index line.

A word of caution here- the CDx3 Perfect Market index chart is not a Ouija board; it cannot tell the future. In terms of indicating direction, it is not "predictive" and should not be used as a forecasting tool.

Having said that, when we were sitting around in June 2008 looking at the prior month's CDx3 Perfect Market Index chart and headlines of bank failures, increasing loan delinquency rates and stories of a confused Federal Reserve Board were in the news every day, it did not take a rocket scientist to guess that the July 2008 index value was likely to head upward, indicating continued weakening of demand and lower prices.

Speed of the Market

A monthly change in the CDx3 Perfect Market Index of less than five points is within the normal background noise of a normal market. Since market prices for CDx3 Preferred Stocks change all day long there is going to be some movement in the index just as a matter of business being done every day.

A change greater than five points, one way or the other, is more significant. And monthly changes in the index beyond ten points will only occur if you've heard about it in the news. By that I mean that changes in the market for CDx3 Preferred Stocks that result in a 10+ point swing in the CDx3 Perfect Market Index only happen as a result of a collection of events that make the financial news for at least a solid week – big events.

One such month was November 2008 when the CDx3 Perfect Market Index dropped from 166 to 145, a whopping decrease of 21 points in one month.

November 2008 was the month when the U.S. Treasury decided to pump hundreds of billions of dollars into cash-starved banks by investing in them. Under its TARP program, Treasury bought 5% custom-made preferred stocks in these banks. Going forward, if the government ever wanted to see their billions again they would have to be certain that these banks did not fail; the government had offered implicit protection to these banks.

The market prices of CDx3 Preferred Stocks offered by these banks shot up by over 35% within weeks. The increasing demand for CDx3 Preferred Stocks is illustrated by the CDx3 Perfect Market Index in November 2008. CDx3 market prices returned to their pre-crisis levels in August 2010.

The charts and metrics presented in this chapter allow you to directly observe the characteristics of the U.S. preferred stock marketplace at any point in time.

The next chapter describes the key components of the Fed's monetary policy that are likely to be the most relevant to preferred stock investors going forward. These are the components that are most likely to drive the changes that we will see over the next couple of years, each of which will have a direct impact on your preferred stock buying strategy.

Don't forget to take advantage of my offer to provide you with periodic updates to these charts and metrics by signing up for my free *CDx3 Newsletter*.

FIVE

MONETARY POLICY

The previous chapter provides key metrics that allow you to understand the preferred stock marketplace and what it is offering to you as a preferred stock investor at any point in time.

This chapter is more forward looking in that it describes what you should be watching for over the next year or two. You may be surprised to learn that the U.S. unemployment rate is starting to become more meaningful than many other leading indicators for preferred stock investors.

Over the last several years a variety of programs have been unleashed in an effort to stimulate the U.S. economy. Fiscal policy (taxes, government spending) as determined by political leaders in Washington, D. C. has been largely ineffective leaving the heavy lifting to the U.S. Federal Reserve and its monetary policies (interest rates, money supply).

Once the Fed backs off of its rate-lowering policies, market forces will presumably put upward pressure on rates which, in turn, should ultimately produce preferred stocks that pay higher dividend rates and better (lower) overall market prices for such securities. All of which is great for buyers.

So when is that likely to happen?

There are two Fed initiatives to keep an eye on - the Quantitative Easing (QE) program and the federal funds rate policy.

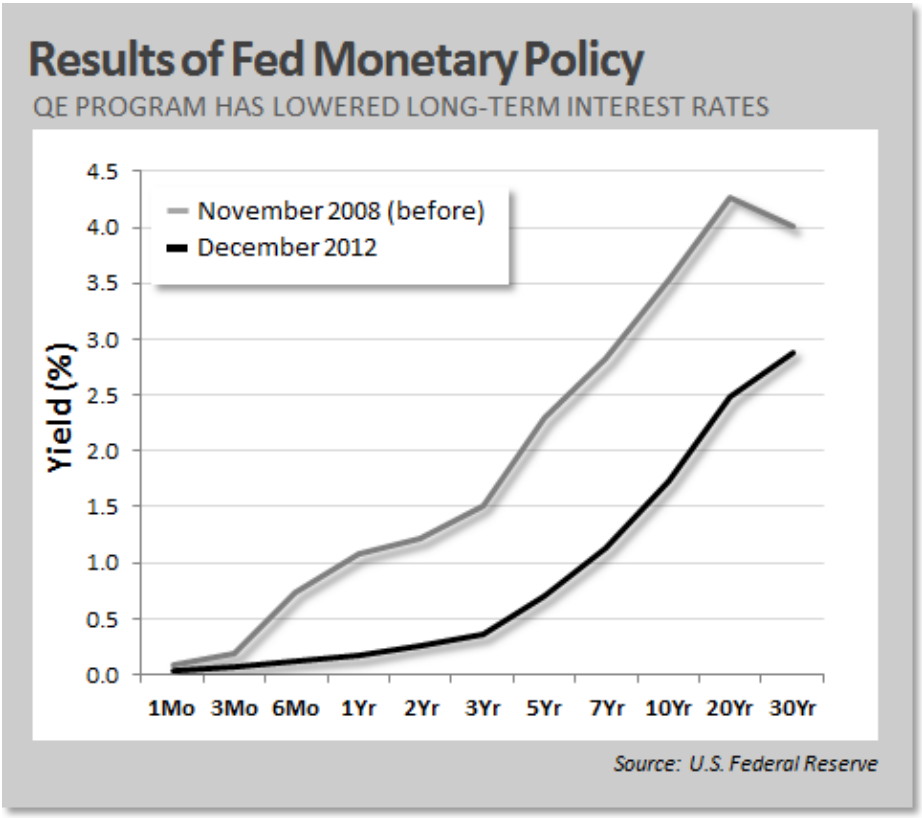
Quantitative Easing

The Fed launched its $1.73 trillion QE program in December 2008, a program that continues at this writing in the spring of 2013. The QE program was augmented with a similar initiative called Operation Twist that ran from October 2011 through 2012.

Both the QE and Operation Twist initiatives were designed to lower the interest rates on long-term debt by making huge purchases of treasury bonds (currently $85 billion per month). Doing so reduces the supply of such securities which raises prices and, in turn, lowers yield.

One of the primary objectives of the Fed's QE program is to increase employment, the idea being that with lower borrowing costs, companies would be more willing to invest (in the form of employment commitments and other business growth that result in additional jobs).

This chart shows the resulting reduction in the yield of U.S. treasury bonds. The top (gray) line shows the “yield curve” at the end of November 2008, prior to the Fed’s launch of the QE program the following month. The bottom (black) line shows the yield curve at the end of December 2012. Notice how the QE program has been successful in lowering long-term interest rates (I’ll show you the effect on unemployment in a moment).



As the economy strengthens the Fed will start to ease off their bond purchases, slowly backing out and returning interest rates to regular market forces.

When the Fed announces that it is going to start doing so, it would not be surprising to see an initial knee jerk reaction in the form of a selloff of fixed rate securities (bonds and preferred stocks). I'll show you a chart that illustrates the knee jerk reaction of fearful sellers in chapter 11 when we discuss how to keep up with increasing interest rates. But many savvy preferred stock investors are likely to view this reaction as a buying opportunity.

The Fed's balance sheet has now swelled to $3.3 trillion (May 2013), an indication of how much potentially inflationary new money has been pumped into the economy. While it is not possible to know with any certainty when the Fed will start to end its QE program, in an April 2013 Bloomberg survey of 21 primary bond dealers who deal directly with the Fed[1], 12 forecast an end to the Fed's Quantitative Easing (QE) program in mid-2014 or later.

Federal Funds Rate

In addition to the Fed backing out of the QE program, preferred stock investors should also keep an eye on changes to the federal funds rate.

The federal funds rate is an interest rate that is foundational to the cost of money at various levels of the economy. It is the interest rate that member banks pay for overnight loans between each other. By manipulating the federal funds rate, the Fed is able to influence higher level rates.

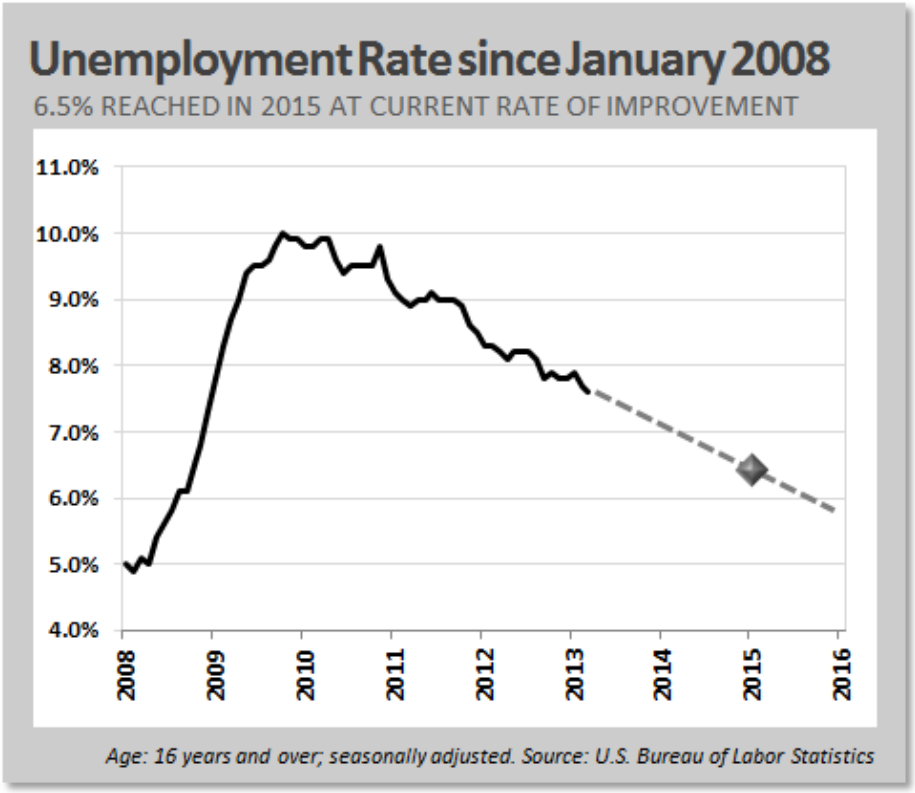
The Fed set the federal funds rate at a historically low "zero to 0.25%" in December 2008 and the rate has been there ever since. Rates offered by fixed-rate securities (bonds and preferred stocks) ultimately followed along (see chart on page 80).

The Federal Reserve has a stated policy that the unemployment rate must fall below 6.5% before they will consider raising the federal funds rate. That is an unprecedented statement about future policy from the Fed and it provides preferred stock investors with a real gift.

[1] http://www.bloomberg.com/news/2013-04-21/dealers-say-no-end-to-qe-in-2013-as-hatzius-sees-2016-rate-rise.html

The Fed's announcement regarding the unemployment rate provides us with a leading indicator of a change to the federal funds rate.

The U.S. economy has to add a net of about 180,000 jobs per month just to break even, let alone push unemployment down. In the judgment of most economists and other financial analysts, unemployment is unlikely to fall below 6.5% until at least 2015.



By extending the current rate of improvement in the unemployment rate into the future, you arrive at 6.5% in early-2015. Further, in the same April 2013 Bloomberg survey, 15 of the 21 primary bond dealers

also estimated that it will take until at least June 2015 for the Fed to raise the federal funds rate.

These data imply that the unemployment rate is at least as important for preferred stock investors to watch as any changes in the Fed's QE program. The unemployment rate presented in the above chart is updated every month by the U.S. Bureau of Labor Statistics at the following web page:

http://data.bls.gov/pdq/SurveyOutputServlet?request_action=wh&graph_name=LN_cpsbref3

In chapter 8 we'll take a closer look at how changes to the federal funds rate impacts preferred stock investors by analyzing what happened the last time this key rate was increased.

In this Part of *Preferred Stock Investing* you have learned about the marketplace for CDx3 Preferred Stocks. You now have an understanding of how new CDx3 Preferred Stocks are introduced to the market, the Three Rules of Market Price Predictability that influence the market price at specific times and in specific ways and how to directly observe marketplace behavior over time, be it during a period of relatively high or relatively low demand.

Going forward, any indication that the Fed is backing out of their QE program (in the short term) and/or starting to increase the federal funds rate (in the longer term) are signs that you should start paying attention to prices and dividend rates. An unemployment rate that falls below 7% should serve as an early warning system for preferred stock investors – additional buying opportunities will become available soon.

Now it's time to put this knowledge to work. In Part II I am going to show you how to select the highest quality preferred stocks.

PART II

Selecting the Highest Quality Preferred Stocks

Preferred stock investors want the same thing that every other investor wants – the highest return at the lowest risk. But, looking at the 1,000 to 2,000 preferred stocks that are available to you at any time, which one do you pick?

The CDx3 Income Engine method of investing in preferred stocks relies on just the highest quality preferred stocks – those that, my research shows, provide respectable returns at acceptable risk.

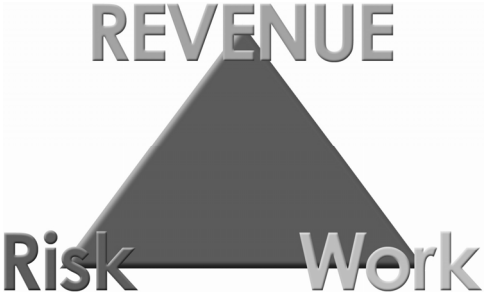
In this Part of *Preferred Stock Investing*:

- ✓ Chapter 6 describes the three objectives that the CDx3 Income Engine is designed to meet and explains how we will measure our progress toward each objective. This chapter also discusses how the objectives of the nine preferred stock Exchange-Traded Funds (ETFs) are inconsistent with the interests of preferred stock investors;
- ✓ Chapter 7 shows you the ten CDx3 Selection Criteria that allow you to identify the highest quality preferred stocks while filtering out the pretenders; and
- ✓ Chapter 8 discusses some of the risks that come with investing in preferred stocks and teaches you to use the CDx3 Selection Criteria to help manage those risks.

SIX

THE CDx3 INCOME ENGINE OBJECTIVES

When I started researching the market price behavior of preferred stocks in 2002, I established three specific objectives that I was looking to meet: (1) maximize revenue while (2) minimizing risk and (3) minimizing work.



These three objectives focused my research then and continue to do so today. Every aspect of the CDx3 Income Engine is driven by this simple triangle.

Objective #1: Maximize Revenue

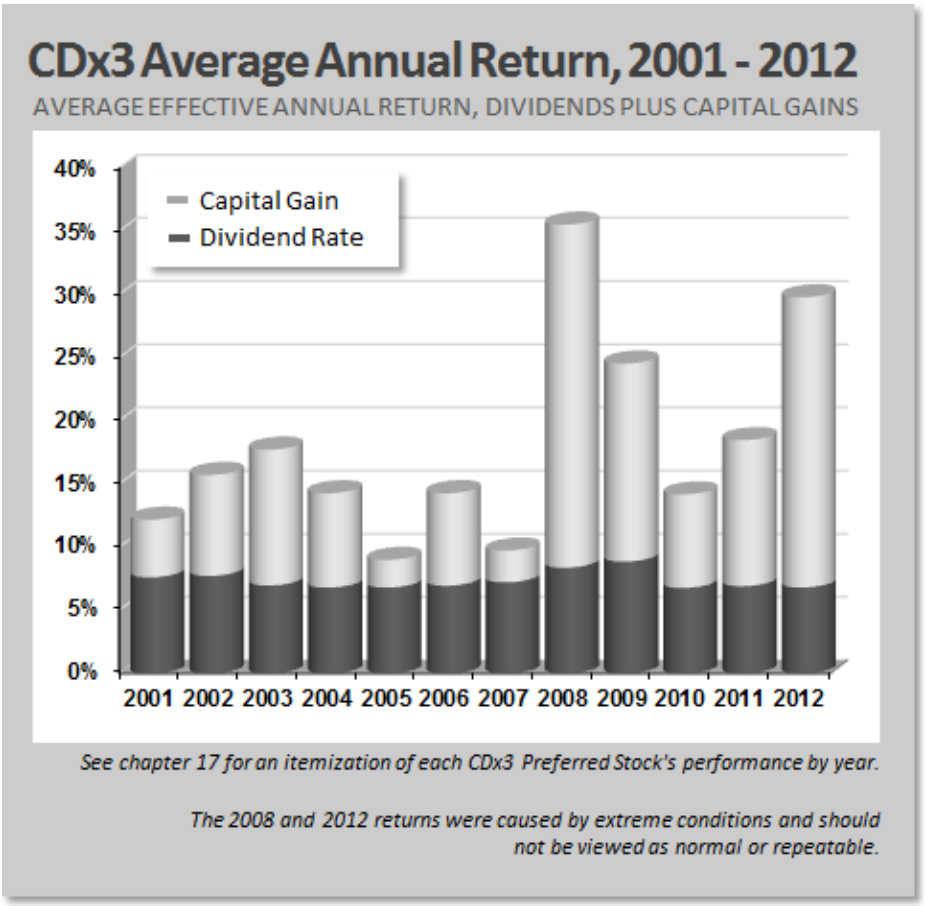
The revenue that one makes from an investment is measured by the effective annual return.

Chapter 16 discusses a variety of return calculations and their pros and cons. As explained there, the effective annual return calculation is most applicable to a preferred stock investment.

The effective annual return of a preferred stock investment can be calculated when you know the purchase price, the sell price, the declared dividend rate and the length of time the investment was held (i.e. how many dividend payments you received).

The CDx3 Income Engine is designed to produce revenue in excess of 10% per year. It does so by piling a downstream capital gain on top of above average dividend income. Since the declared annual dividend rates paid by CDx3 Preferred Stocks range from 6% and 9%, getting over the 10% hump is usually not that tough – if you know when to sell (which is the subject of Part IV of this book).

The following chart illustrates the average effective annual return generated by the CDx3 Income Engine since January 2001 (using all CDx3 Preferred Stocks).



Note that the Global Credit Crisis that began in June 2007 ushered in the largest buyer's market for CDx3 Preferred Stocks in history. Cash strapped banks pushed dividend rates way up throughout 2008 and 2009. Using the Target Sell Price as a guide (discussed in chapter 14), CDx3 Investors were able to sell these high payers for incredible returns throughout 2010.

To see where my annual averages come from, take a look at chapter 17 where I itemize the effective annual return that you would have earned from each CDx3 Preferred Stock issued since January 2001.

The first objective of the CDx3 Income Engine, maximize revenue, means that we are looking to earn an effective annual return of at least 10% from our CDx3 Preferred Stock investments.

Objective #2: Minimize Risk

What is low risk to one investor may be unacceptably high risk to another so this objective is hard to precisely quantify.

A way of getting around this problem is to use a yardstick that everyone is familiar with and then compare the risks inherent with preferred stock investing to that yardstick.

Since risk is a relative term (high risk compared to what?), we need to compare preferred stock investment risk to the risk of an alternative investment that everyone is familiar with.

Certificates of Deposit (CDs) that you buy at your local bank serve this purpose nicely. Those new to investing as well as seasoned day traders and retired brokers all have a common understanding of what a bank CDs is, how it works and, for our purpose here, the level of risk that comes with a bank CD.

Preferred stocks carry more investment risk than bank CDs but the rewards are far greater as well. When I talk about the objective to "minimize risk" what I am looking for is a way to invest in select preferred stocks that, as a group, get the level of investment risk as close to that of a bank CD as I can get it.

Another point regarding the investment risk profile of bank CDs - the federal government learned many valuable lessons from the savings and loan crisis of the late-1980's, one of which was that the

$100,000 insurance *per account* was way too generous. Depositors were smart enough to figure out that all they had to do with their retirement nest egg was spread it over multiple accounts. The claims by depositors when the savings and loan industry melted put the insurer (the Federal Savings and Loan Insurance Corporation – FSLIC) out of business.

The federal government no longer extends their insurance on a per account basis. Rather, since the savings and loan crisis the current coverage is per *depositor*. Insuring that retirement nest egg over a number of accounts no longer protects you (you have to use multiple banks, which very few CD depositors take the trouble to do).

The trampoline-sized safety net that we use to enjoy underneath bank CDs is now closer to the size of a postage stamp.

But I think that we can agree that compared to other fixed-income investment alternatives, CDs are a low risk choice. My "minimize risk" objective then is to get as close to that level of risk as I can while still meeting the other two CDx3 Income Engine objectives.

Objective #3: Minimize Work

Just so that it's clear, when I say "minimize work" I am talking about doing so without having to subscribe to the CDx3 Notification Service in order to meet this objective. While it is true that subscribers to the CDx3 Notification Service extend minimum work toward managing their CDx3 Portfolio, you can implement the CDx3 Income Engine on your own by following the explanations and using the resources provided throughout this book.

What good is an investment method if it requires so much work that no one on the planet would have any interest in doing it? Very few people, given the choice, hope to spend endless hours day after day hunched over their computer staring at stock charts.

That's what "day traders" do. In addition to the enormous penalty to their golf game, social life and other obligations, most of them lose money.

And what might be minimum work to one investor may be a completely unacceptable workload for another, so we have the "relative term" problem again just like we did with "minimize risk."

Somewhere between not even needing to get out of bed in the morning and becoming a day trader is an amount of work that most of us would find acceptable when managing our preferred stock portfolio.

Just as we did with the last objective - minimize risk - we have to establish a common understanding of what constitutes an acceptable, but minimum amount of work needed to manage your preferred stock investments. We need another yardstick that is familiar to everyone.

To manage our bank accounts we all spend a certain amount of time each month checking over the bank statements. It does not take much work and there is benefit to knowing that you and your bank are in agreement about what's going on with your money (including how much you think you have).

In other words, we know that most people find that the amount of work needed to review their monthly bank statements is an acceptable amount of work given the benefits.

The CDx3 Income Engine will allow you to be a successful CDx3 Investor without extending any more work than you already do in order to review your monthly bank statements – that's our yardstick. While you may choose to expend more effort, you will not need to do so in order for the CDx3 Income Engine to work for you.

Preferred Stock ETFs – A Misalignment of Objectives

Exchange Traded Funds (ETFs) are like mutual funds, composed of multiple individual securities, but ETFs trade on the stock exchange just like any other stock. ETFs are not to be mistaken for Exchange-Traded Debt Securities (ETDs) discussed in chapter 2. There are nine ETFs that are composed of various types of preferred stocks[1], offering convenience to the investor since purchasing a share of the ETF gets you a fractional position in each of the preferred stocks within the fund.

Beyond convenience, however, preferred stock ETFs offer little to preferred stock investors. Preferred stock investors are risk-averse investors seeking stable dividend income over the long-term. But maximizing dividend income while minimizing risk is not the objective of those managing a preferred stock ETF.

ETFs are managed such that the market prices of the securities within the ETF follow the movement of a particular index. Investors cannot invest in an index, but they can buy a share of an ETF that attempts to follow the movement of that index. Those managing the ETF buy and sell shares of the underlying securities accordingly.

Such indexes tend to be industry or commodity specific. Standard & Poor's Technology Select Sector Index, for example, reflects the movements in the market prices of various technology related stocks. Investors wanting to invest in the technology industry as reflected by

[1] iShares S&P US Preferred Stock Index Fund (PFF), PowerShares Preferred Portfolio (PGX), PowerShares Financial Preferred Portfolio (PGF), SPDR Wells Fargo Preferred Stock ETF (PSK), Market Vectors Preferred Securities ex Financials ETF (PFXF), iShares International Preferred Stock ETF (IPFF), First Trust Preferred Securities and Income Fund (FPE), Global X SuperIncome Preferred ETF (SPFF), Global X Canada Preferred ETF (CNPF).

S&P's index can buy shares of the SPDR Technology Section ETF (XLK).

Most preferred stock ETFs include a substantial exposure to speculative grade preferred stocks. Remember, the objective of the fund manager is for the market price of the ETF to mimic the movement of the targeted index. While including speculative grade securities provides the fund manager with a valuable index-matching tool, doing so exposes the preferred stock investor to investment risk that those building their own portfolio of individually selected preferred stocks would probably avoid.

Preferred stock investing is all about maximum dividends at minimum risk whereas preferred stock ETF management is all about managing price movement to match an index.

Those are very different objectives.

The ETF model was invented to provide investors with an easy way to invest in an industry or commodity without having to buy individual securities (while providing visibility to real-time pricing). ETFs offer convenience to the investor.

Preferred stock ETFs, however, represent an effort by Wall Street to apply a model designed for industry and commodity market investing to a type of equity security. Preferred stocks are neither an industry nor a commodity and, not surprisingly, the objectives of the ETF model are inconsistent with those of risk-averse preferred stock investors.

While preferred stock ETFs may appeal to investors who hold convenience as a primary objective, it is not clear that the convenience offered by preferred stock ETFs is greater than the benefits of creating your own high quality preferred stock portfolio from individually selected issues.

So now you know the three objectives of the CDx3 Income Engine and what is meant by each one:

1) Maximize Revenue: 10%+;
2) Minimize Risk: As close to a bank CD as we can get; and
3) Minimize Work: No more effort than looking over your bank statement.

Let's move on to the implementation of these objectives, the business of selecting the highest quality preferred stocks from all of the pretenders.

SEVEN

IDENTIFYING CDx3 PREFERRED STOCKS

Most preferred stock investors do not just want a big list of preferred stocks to look at; rather, they want to know how to invest in them.

Most websites that provide lists of preferred stocks do not (a) identify the highest quality issues for you nor do they (b) provide any information whatsoever regarding the best time to consider buying or selling preferred stocks. They simply provide lists of preferred stocks of widely varying accuracy and currency. Anything beyond that is up to you[1].

This is largely due to the fact that gathering and filtering such data can be time consuming and therefore costly. When we send out a CDx3 Buyer's Notification message making subscribers aware of a new CDx3 Preferred Stock, for example, we compile data from six different sources in order to validate the information.

[1] There are a variety of resources that allow you to view lists of preferred stocks – some are free while others request a fee. All have their strengths and weaknesses. I have listed several of them in Appendix A for your reference.

Consequently, those who put in the time and bear the costs for compiling and maintaining preferred stock lists often request a fee (including the CDx3 Notification Service).

Be forewarned; this is one area where there is a direct relationship between the quality and ease of getting your hands on the information you are after and the cost associated with doing so.

Meet Uncle EDGAR

When a company is going to be issuing a new preferred stock they are required to file a form with the U.S. Securities and Exchange Commission (SEC). The SEC provides a very powerful web-based service that allows you to see recent filings for free called the Electronic Data Gathering and Retrieval system – EDGAR.

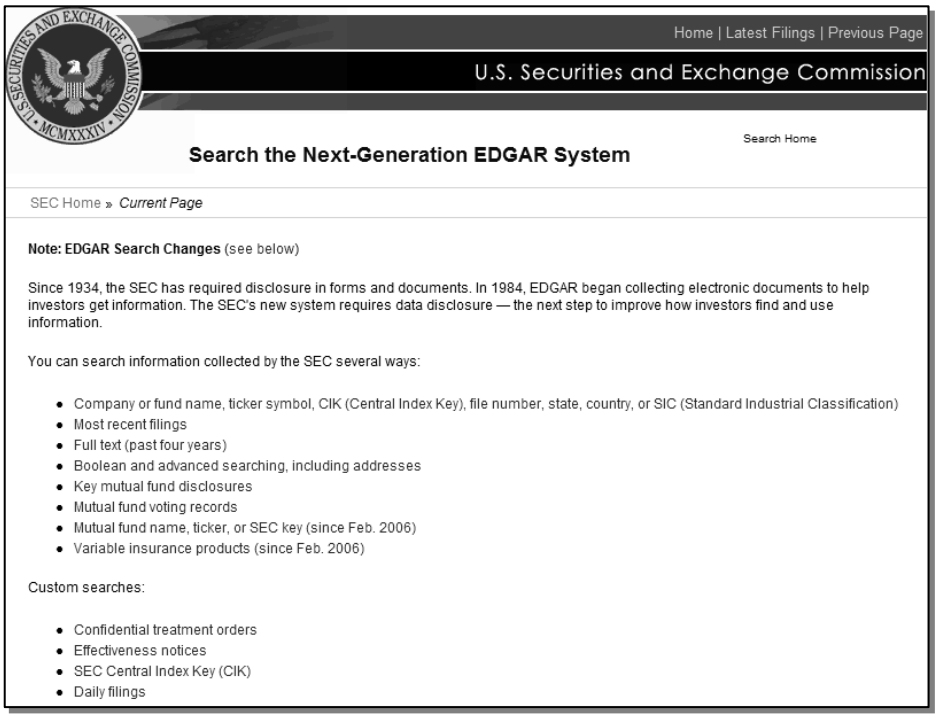
EDGAR provides a variety of search capabilities that can be, at times, confusing and mind boggling.

However, the SEC is the official source of all corporate filings and if you want to identify CDx3 Preferred Stocks for free you have to use EDGAR.

You can access EDGAR at:

http://www.sec.gov/edgar/searchedgar/webusers.htm.

Here is what the EDGAR website looks like.



No government agency would be complete without a lot of forms, each of which have several versions and form numbers. The SEC is no exception.

When companies issue a new preferred stock they almost always use SEC form number 424(b)(5), 424(b)(4), 424(b)(2), SWF or FWP. The good news is that EDGAR allows you to search by form number; the bad news is that these same forms are used for many different purposes, not just for issuing new preferred stocks.

From the EDGAR website click on "Most recent filings" and you will be presented with the page that allows you to search by form number.

Remember, this EDGAR page performs a search of the "most recent filings" only so you will need to do this regularly (several times per

week). The SEC also provides search tools that allow you to search historical filings as well as the actual text of filings, rather than just searching by form number or company name. If using the Most Recent Filings feature to search by form number is too bothersome you might try one of these other options.

Learning to use EDGAR is time consuming and cumbersome; but it is the mother lode of all filings and it is free. If you want to do this for free, you are going to have to get to know EDGAR.

If you would rather someone else do the work for you there are choices other than the CDx3 Notification Service. However, these other sites present entirely unfiltered lists of preferred stocks and provide no information, analysis or strategy regarding the market conditions that tend to favor the buyers and sellers of preferred stocks whatsoever.

For those who would rather someone else do the work we offer the CDx3 Notification Service which you can read more about in Appendix B and at www.PreferredStockInvesting.com.

The CDx3 Selection Criteria

The CDx3 Income Engine method integrates the Three Rules of Market Price Predictability (chapter 3) with ten specific selection criteria in order to support three objectives (chapter 6). The ten selection criteria (the "CDx3 Selection Criteria") presented in the following pages were first published in 2006 with the first edition of this book and have been protecting preferred stocks investors ever since.

The fact that I spent years developing these criteria is irrelevant; what matters are results in the real world. The extreme conditions of the Global Credit Crisis (2007—2009) put the CDx3 Selection Criteria to the ultimate test. How did the criteria do?

The 57 preferred stocks issued by the eight banks that failed during the crisis were unable to meet the CDx3 Selection Criteria while the 13 preferred stocks that the criteria let pass were issued by the four banks that were saved through acquisition.

In 70 out of 70 cases the CDx3 Selection Criteria, first published a year before the crisis, got it exactly right month after month.

Global Credit Crisis Results

BANKS FACING BANKRUPTCY, JUNE 2007 - MARCH 2009

Bank Facing Bankruptcy	Preferred Issues	Met CDx3 Selection Criteria?	Saved?
Bear Stearns	1	NO	NO
CIT Group	3	NO	NO
Fannie Mae	16	NO	NO
Freddie Mac	21	NO	NO
IndyMac	0	NO	NO
Lehman Brothers	11	NO	NO
New Century	2	NO	NO
Washington Mutual	3	NO	NO
	57		
Countrywide (by BAC)	2	**YES**	**YES**
Merrill Lynch (by BAC)	3	**YES**	**YES**
National City (by PNC)	4	**YES**	**YES**
Wachovia (by Wells Fargo)	4	**YES**	**YES**
	13		

In 70 out of 70 cases the CDx3 Selection Criteria got it right.

The degree to which you apply these ten criteria is a personal decision. That is, there is such a thing as preferred stocks that, while not meeting all ten of these criteria, may still be consistent with your personal goals, resources and risk tolerance. But unless otherwise indicated, I will use "pure" CDx3 Preferred Stocks to illustrate the characteristics of the CDx3 Income Engine throughout this book[2].

The computer models that I use to research the market price behavior of preferred stocks allow for the specification of a filter (selection criteria). Tightening or loosening the filter either lets fewer or more preferred stocks through, respectively.

If the filter is too tight (too many selection criteria), you virtually eliminate your investment risk (the good news) but you've done so by eliminating all preferred stocks from consideration (the bad news); that is, there is nothing left to invest in.

On the other hand, if the filter is too forgiving you end up with lots of preferred stocks to choose from but the risk associated with doing so goes up as well.

By iteratively adjusting the computer model, I was able to identify ten specific selection criteria – the filter – that produce results that take advantage of the Three Rules of Market Price Predictability (chapter 3) while simultaneously meeting our three objectives (chapter 6).

In the following pages I will present the CDx3 Selection Criteria and then a table that shows you how each of these ten criteria supports the three objectives of the CDx3 Income Engine.

[2] CDx3 Notification Service subscribers: The "CDx3 Compliance Score" that you see with every security in the CDx3 Notification Service database indicates how many of the ten CDx3 Selection Criteria the security is able to meet.

To be considered a CDx3 Preferred Stock, a regular preferred stock must:

1) Pay a fixed dividend rate that is at least 0.50% above the "bottom of the barrel";
2) Become callable five years after IPO;
3) Pay dividends quarterly;
4) Be rated "investment grade" by Moody's Investors Service;
5) Be issued by a company that has a perfect track record of never having suspended the dividend payments on a preferred stock (and these are mostly decades old, multi-billion dollar companies);
6) Have a "cumulative" dividend obligation;
7) Be issued by a U.S. company;
8) Not be convertible to common stock in the future;
9) Have easy (online) access to the prospectus at IPO; and
10) Have a "par" value of $25.00.

Very important note: notice that these criteria do not select or eliminate preferred stocks from any specific industry; they just select the highest quality issues. If you are after preferred stocks from industries other than those that result from applying these criteria you are going to have to take more risk (i.e. eliminate one or more of these criteria). These criteria result in the highest quality issues *regardless of industry*.

These ten selection criteria allow you to select the highest quality preferred stocks from the 1,000 to 2,000 trading every day. As an investor, having an objectively and consistently applied set of criteria

upon which you base your investing decisions is far superior to relying on emotion – either elation or fear.

#1 Pay a fixed dividend rate that is at least 0.5% above the "bottom of the barrel"

Historically, regular high quality preferred stocks have typically had declared dividend rates ranging from 6.0% to 9.0%. But that changed during 2012 with the "bottom of the barrel" falling closer to 5.5%.

On the low end, CDx3 Preferred Stocks draw the line at 0.5% above the bottom of the barrel rate, whatever that happens to be at the time. At the time of this writing, that means that 6.0% is the minimum dividend rate for CDx3 compliance (on the high end there is no fixed limit – we'll be happy to take as much as they want to give us).

Leaving 0.5% of room beneath where you are investing and the bottom of the barrel rate becomes important to our principal protection and selling strategies which you will learn about in Part IV.

Also avoid "variable dividend rate" issues where the dividend rate varies depending on various, currently unknown, conditions. Variable rate preferred stocks sound like a good idea, especially during a period of low rates. The idea is that preferred stock investors will be able to ride the wave up when rates start to rise in the future.

But the higher dividend payout that many are looking forward to from variable rate preferred stocks is unlikely to ever materialize.

Variable rate preferred stocks typically pay a minimum but lower than market rate at the start (usually pegged to the London Interbank Offered Rate - LIBOR - or some other similar index) with a promise that if rates move up above the starting rate in the future, so will the rate paid by the preferred.

But since rates have now remained low for an extended period, the variable rate preferred stocks offered by today's market (with a couple of remaining exceptions) have now reached their respective call dates and can be redeemed at any time by their issuing companies.

At the future point where the rate on their variable rate preferreds adjusts higher than issuing a new security would cost them, these companies are much more likely to issue a new fixed rate preferred and use the proceeds to redeem their variable rate preferred shares.

It is much more likely that today's variable rate preferred stocks will be redeemed at the first sign of increased dividend expense to these companies, leaving today's buyers with little to show for their patience.

Another drama that is currently playing out involves the LIBOR manipulation scandal that first boiled over into the financial press during the summer of 2012. Several big European banks are surveyed daily as to the interest rate they are paying for interbank borrowing (similar to the federal funds rate in the U.S.). As we now know, beginning as far back as 2005, several of these banks have been manipulating the LIBOR (lower). The U.K.'s Barclays Bank and Swiss bank UBS were fined $450 million and $1.5 billion, respectively, by international investigators for their role.

Securities (including the dividend rate paid by many variable rate preferreds) and other instruments valued at $300 trillion are pegged to the LIBOR. At this writing, the investigation is continuing so the extent of damages dating back to 2005 have yet to be determined, but CDx3 Investors who have observed this criterion have avoided this drama entirely.

Most risk-averse preferred stock investors avoid variable rate preferred stocks since there is no way to know the likely return on your investment. In addition to an unknown return, today's variable rate preferred stocks are unlikely to deliver their primary benefit (an

increasing dividend rate) that current buyers of such securities are banking on.

#2 Become Callable Five Years after IPO

The issuing company of a CDx3 Preferred Stock re-gains the right to purchase your shares back from you, at $25.00 per share, five years after the issue is introduced to the marketplace. This date, five years after the IPO date, is referred to as the "call date" (or "redemption date").

By selecting preferred stocks that become callable five years after their IPO date we are able to switch on the power of the Rule of Call Date Gravity (see page 63).

When the whole world knows that on a specific future date the issuing company of your preferred stock can purchase it from whomever owns it any time they wish, and, if they do, they are required to pay a specific price per share, the market price can behave very differently as that date approaches.

Knowing what the market price of any investment is likely to be at some future point is a rare gift. By selecting only preferred stocks that have a known, fixed call date we bestow that rare gift onto ourselves.

We want to fix the call date at a specific, known point in time for CDx3 Preferred Stocks. Doing so allows us to take advantage of the known changes in the market price that your CDx3 Preferred Stock may realize as the call date approaches. In chapter 15 I'll show you how to take advantage of an approaching call date.

#3 Pay Dividends Quarterly

This selection criterion provides another point of integration with the Three Rules of Market Price Predictability (chapter 3).

By selecting preferred stocks that all pay their dividends quarterly we can use the Rule of Buyer/Seller Behavior (page 49) to buy and sell CDx3 Preferred Stocks at a point in time that is known in advance.

The Rule of Buyer/Seller Behavior tells us that the market price of a CDx3 Preferred Stock will tend to rise as payday (the ex-dividend date) approaches, assuming no extraordinary "outside influences."

As I will show you in Parts III and IV, because of this rule, CDx3 Investors purchase their CDx3 Preferred Stocks early within the issue's dividend quarter – a time that favors buyers since the market price tends to be relatively low.

Similarly, we tend to sell late in the dividend quarter when market prices tend to be relatively high, favoring sellers (discussed in Part IV).

By fixing the length of the dividend period over which the Rule of Buyer/Seller Behavior plays out for all of your CDx3 Preferred Stocks, you are able to approach your buying and selling decisions with complete consistency. You will always be buying and selling when the market price tends to most favor your doing so, hence maximizing your current dividend yield and downstream capital gain opportunities.

#4 Moody's Investment Grade

As individual investors who are generally not spending their days researching companies and markets, but want to invest in them, we need a way to compare the relative investment risk associated with one alternative to another.

There are three primary companies that rate the long-term creditworthiness of companies and their preferred stocks: Moody's Investors Service, Standard & Poor's and Fitch Ratings. Mostly for accessibility reasons, Moody's ratings are used for the purpose of helping to identify CDx3 Preferred Stocks.

Moody's Investors Service is a subsidiary of Moody's Corporation which employs about 6,800 employees in 22 countries. Their analysts are experts on specific industries, the companies within those industries and the specific activities of those companies.

Moody's core business is to know these companies and their activities well enough to pass judgment, given a very specific set of standardized criteria, on the company's creditworthiness – good to know when you are considering purchasing a preferred stock.

> **Moody's puts it this way:**
>
> Credit ratings and research help investors analyze the credit risks associated with fixed-income securities. Such independent credit ratings and research also contribute to efficiencies in fixed-income markets and other obligations…by providing credible and independent assessments of credit risk.

By specifying that CDx3 Preferred Stocks must be among the highest rated by Moody's (referred to as "investment grade" as opposed to "speculative grade") you, as a CDx3 Investor, automatically realize the benefits of the accumulated knowledge and judgment of the Moody's analysts regarding the issuing company. The label "investment grade" speaks for itself.

The Global Credit Crisis identified some holes in the way credit agencies produce their ratings. One of the major problems was that the massive mortgage foreclosure rate that began in late-2007 exceeded the limits of their statistical models; statistical models that have been honed over many decades and acknowledged worldwide for their uncanny accuracy.

Despite their flaws, the fact is that individual investors have little choice but to rely on these ratings as a proxy for investment risk.

Using an alphanumeric scale, Moody's investment grade rating category includes ten sub-categories: A for really good, B for pretty good, etc. Then they started slicing the boloney really thin – Ba is slightly better than B and Baa is a little bit better than Ba and Baa3 (and higher) is "investment grade." What they ended up with is the following scale, highest to lowest:

Aaa, Aa1, Aa2, Aa3, A1, A2, A3, Baa1, Baa2, Baa3

The Risk versus Reward chart on page 76 illustrates the relationship between Moody's ratings (risk) and preferred stock yield (reward). As illustrated there, the relation is a fairly strong one. Despite the credibility erosion that these rating agencies suffered during the Global Credit Crisis, preferred stock investors clearly use them as an important indicator of risk.

Investment grade means what it says and it is very difficult for a company to obtain and maintain this preferred stock rating from Moody's. To be considered a CDx3 Preferred Stock, Moody's has to provide the security with an investment grade credit rating – Baa3 or higher.

You can use Moody's website (www.Moodys.com) to look up the current rating of a CDx3 Preferred Stock. The easiest way is to use the CUSIP[3] number. You must register with Moody's first but there is no fee requested.

If you want to read more about Moody's creditworthiness rating system, you can go to the State of California Treasurer's website at www.treasurer.ca.gov/ratings/moodys.asp (among many other sites).

[3] CUSIP stands for Committee on Uniform Security Identification Procedures and is a standard security identification numbering system. Every CDx3 Preferred Stock has a unique CUSIP number.

#5 No Suspended Dividends - Ever

In order to be considered a CDx3 Preferred Stock a regular preferred stock must meet all ten CDx3 Selection Criteria. By looking over the resulting survivors they really jump out at you. These are multi-billion dollar outfits, most with recognizable names, some not.

For the most part, what you end up with are America's top companies, companies that, in most cases, are several decades old.

But for one of their preferred stocks to qualify as a CDx3 Preferred Stock they have to have a perfect track record of never having suspended dividends on a preferred stock – ever.[4]

Unless you are a subscriber to the CDx3 Notification Service (in which case this research is done for you), figuring out if a company has a perfect track record with their preferred stock dividends can be a bit time consuming (not to mention tedious).

For a particular preferred stock that you may be considering, the quickest way to see if the issuing company has ever suspended its dividend is to contact the company's Investor Relations department (see the company's website) and ask them.

Remember, as a publicly traded company it would be very unlikely (and incredibly irresponsible) for them to provide you with misinformation in answer to this question. They are required by law to disclose this information under federal penalty. You may have to ask more than one person as a newbie who answers the phone may not know the answer.

There are also free online resources but their data history may be limited. Using a web page at MarketWatch.com, for example, you can look up the dividend track record of any preferred stock that you may

[4] My data on preferred stock suspensions goes back to 1936.

be considering. Google Finance at Google.com/finance has a similar function.

For example, on April 24, 1997 National Westminster Bank introduced a new preferred stock with the trading symbol NW-C. This preferred stock has been paying out a 7.763% dividend to its shareholders every quarter since then.

Here's how to use MarketWatch.com to see the dividend payment history (or lack thereof) of a preferred stock. First, point your web browser to www.MarketWatch.com.

Remember from page 46 that different online services have adopted different trading symbol conventions for preferred stocks. If you are using MarketWatch.com to see dividend history, NW-C is NW.PC at MarketWatch.com.

Type NW.PC in the MarketWatch search field (upper-right corner) and click the Search button.

The current market activity surrounding this very old preferred stock is displayed, including its current market price and a nifty little chart.

A quick way to access the dividend history is to now click on the Charts tab located just above the chart. Setting the "Time" window for the chart to "All Data" will cause the chart will refresh with a "D" symbol showing the dividend payment history (be sure the Upper Indicator is set to "Show All Events" or "Show Dividends").

A missing D indicates a missed dividend.

For NW-C, this is quite a chart. When you use this technique with more recently introduced preferred stocks the chart will not be nearly as cluttered.

#6 "Cumulative" Dividend Obligation

In addition to meeting all of the other CDx3 Selection Criteria, to be considered a CDx3 Preferred Stock a regular preferred stock must carry the "cumulative" dividend obligation.

At the beginning of this chapter I showed you how to locate the prospectus of a preferred stock for free (the SEC's EDGAR system). The prospectus of a preferred stock is a legal document that the issuing company must file with the SEC and explains the obligations and limitations placed on the issuing company with respect to the particular preferred stock issue.

The prospectus will include language that defines whether or not the issuing company is allowed to "defer" (delay until a future time) or "suspend" (cancel outright) your dividends.

In cases where the issuing company may defer, but not suspend, your dividend payment(s) the preferred stock's dividends are said to be "cumulative." So in the unlikely event that the issuing company runs into a cash crunch and is unable to pay your dividend on time, their obligation to ultimately pay you that dividend does not go away; it accumulates. They still owe you the money.

Has it ever happened with a CDx3 Preferred Stock? Yes. Once. Citizens Republic Bancorp (CRBC), located in Flint, Michigan, home of the U.S. auto industry, survived the Global Credit Crisis but was unable to take the one-two punch when the auto industry melted down shortly thereafter.

On January 28, 2010, Citizens deferred the dividend payment on CTZ-A, its one and only CDx3 Preferred Stock. But because of the cumulative dividend requirement, the bank was obligated to pay back all skipped dividends when payments were resumed on March 15, 2013 (plus interest).

In most cases where the preferred stock is cumulative, words to that effect will be pretty hard to miss when viewing the prospectus and are often located right in the title on the first page. Other times the key language will be a bit harder to find but using your web browser's Find function while viewing the prospectus can be a big help.

Here's an example from the prospectus of a 2011 CDx3 Preferred Stock from Public Storage:

> **PSA-Q, 6.500%, April 7, 2011:**
>
> Distributions on the Preferred Shares **will be cumulative** from the date of issue and will be payable quarterly on or before March 31, June 30, September 30 and December 31, commencing June 30, 2011…

The prospectus of a cumulative preferred stock will then go on to describe the conditions under which the issuing company is allowed to defer a dividend and when they are obligated to pay you back (usually with interest).

While we can be sympathetic, understanding and show a little patience during extreme circumstances (terrorism, natural disasters), the CDx3 Selection Criteria do not allow the issuer of CDx3 Preferred Stocks to simply walk away from the obligation they have to CDx3 Investors. They must ultimately pay you any deferred dividends.

And remember, issuers of CDx3 Preferred Stocks must have a Moody's creditworthiness rating of "investment grade." What do you think happens to the Moody's rating of a company that has a history of missing dividend payments? It goes down of course, way down.

Not only is the company required to catch up in the extraordinary event that they miss a dividend payment to you, the CDx3 Selection

Criteria's "investment grade" requirement provides a bit of double protection.

#7 Be Issued By a U.S. Company

In addition to having a Moody's rating of "investment grade," having a 100% successful record of never suspending dividend payments and limiting ourselves to just the preferred stocks that have "cumulative" dividends, CDx3 Preferred Stocks are also issued by U.S. companies - no foreign issues.

I do not have any quarrel with foreign companies. Foreign companies make some of the best chocolate, pharmaceuticals and automobiles on the planet.

But the fact that this criterion has saved CDx3 Investors on several occasions for several years now is hard to ignore, especially in the case of several European banks. During the crisis years, European banking authorities implemented a measure that U.S. authorities did not - European banks receiving taxpayer bailout assistance during the crisis were required to stop paying dividends on their preferred stocks.

More recently, this criterion has saved preferred stock investors from the ongoing Eurozone debt turmoil that has affected the risk associated with these European banks.

CDx3 Investors deserve the protections afforded to investors in U.S. securities. Sure, foreign countries have their own stringent securities laws, but how would you, as a non-citizen of those foreign countries, evaluate their enforcement?

Further, CDx3 Investors should have a lot of visibility to events affecting their investments – the bigger and brighter the light shining on the companies with whom you have invested your money the better.

How does that work with the foreign media and corporate reporting requirements (and in a language other than English)?

Foreign issues of preferred stocks are out; too many questions for risk-averse CDx3 Investors.

#8 Non-Convertible Preferred Stocks

A convertible preferred stock is a preferred stock that can be converted to the issuer's common stock at a certain conversion ratio (as specified in the prospectus).

For every share of a convertible preferred stock that you own, you will receive x shares of the company's common stock upon conversion.

The timing of this conversion is generally under your control except in the case of mandatory convertible preferred stocks (where you must convert your shares to the issuing company's common stock as specified in the prospectus).

The CDx3 Selection Criteria eliminate convertible preferred stocks for three reasons:

1) There are too many unknowns associated with the future value of the issuer's common stock. Since the conversion ratio is generally fixed, but the market price of the common stock fluctuates, there is no way to know if this is a good deal or a terrible deal;

2) While the conversion is generally under the holder's control, the issuer can force conversion to happen under certain market conditions (some have provisions where, if the deal gets too good for the investor it is changed to be less favorable). Those conditions are unpredictable. Being subjected to this uncertainty is too much risk and

continually tracking these conditions is too much work for CDx3 Investors; and

3) Once your preferred shares are converted to common shares, you are no longer "preferred." You give up your position of being in front of common stock shareholders for dividend payments once your preferred shares are converted to common shares.

Convertible preferred stocks introduce both uncertainty (risk) and work – two things that the CDx3 Selection Criteria are designed to minimize. Keep it simple and avoid convertible preferred stocks.

#9 Online Prospectus Available

Earlier I showed you how to access the online prospectus of a preferred stock and do so for free using the SEC's EDGAR system.

The provisions provided in the prospectus of a CDx3 Preferred Stock are legally binding and require the issuing company to meet a wide variety of obligations. Without this key document, investors really have no way of knowing what it is they are investing in.

While rare, there are preferred stocks issued as recently as 2002 without online access to this document (IND from ING Groep N.V., 7.05%, July 18, 2002).

Reading a prospectus is a bit onerous but with some practice you'll be able to pick out what matters. If you cannot even get your hands on the prospectus, the deal's off. We'll be buying a different preferred stock. See page 144 for some tips regarding understanding key prospectus provisions.

#10 Have a "Par" Value of $25.00 per Share

When a new CDx3 Preferred Stock is created (see chapter 2) and becomes available to the public for purchase, its opening price target is $25.00 per share. Sometimes referred to as the "par value" or "liquidation preference," this value is specified in the prospectus of a CDx3 Preferred Stock.

Some preferred stocks have a $100 par value, others $50. The custom-made preferred stocks that some banks sold to the U.S. Treasury as part of the Trouble Asset Relief Program (TARP) in 2008 had a par value of $1,000 per share.

But CDx3 Preferred Stocks have a $25.00 per share par value, which is, by far, the most common. As a CDx3 Investor, you will appreciate the complexity that is removed from your CDx3 Portfolio by fixing this value at a constant amount - $25.

A preferred stock must meet all ten of these CDx3 Selection Criteria in order to be considered a CDx3 Preferred Stock.

These ten CDx3 Selection Criteria are specifically designed to support the three objectives of the CDx3 Income Engine - (1) maximize revenue while (2) minimizing risk and (3) minimizing work.

The following table shows how each of these three objectives are supported by the ten CDx3 Selection Criteria.

CDx3 Selection Criteria	Objective
1. Pay a fixed dividend rate at least 0.5% above the "bottom of the barrel"	Revenue Maximization
2. Become callable five years after IPO	Revenue Maximization
3. Pay dividends quarterly	Revenue Maximization
4. Moody's investment grade rating	Risk Mitigation
5. Never suspended dividends	Risk Mitigation
6. Cumulative dividend obligation	Risk Mitigation
7. U.S. companies; no foreign issues	Risk Mitigation
8. Non-convertible preferred stocks	Risk Mitigation
9. Online prospectus available	Work Reduction
10.Have a "par" value of $25 per share	Work Reduction

While new preferred stocks are introduced to the stock market continually, issues that are able to meet the above CDx3 Selection Criteria have historically been introduced at a rate of about one or two per month.

This rate of introduction slowed during the Global Credit Crisis and the recession that followed but so did the rate of "calls" during that period so the supply of CDx3 Preferred Stocks remained fairly stable.

More recently, companies have been issuing a bumper crop of new preferred stocks in order to take advantage of today's lower rates. 46 new preferred stocks (including ETDs) were issued during the first three months of 2013 alone.

Appendix A provides a list of helpful websites, some of which are free while others request a fee. For CDx3 Investors who choose not to subscribe to the CDx3 Notification Service, you can use the resources provided in Appendix A to mine data from various websites (public and private), data services, the issuing companies themselves plus other sources and distinguish one type of preferred stock from another.

As you can see by the above table, five of the ten CDx3 Selection Criteria support the risk minimization objective. Before moving on to the art of buying CDx3 Preferred Stocks, the following chapter identifies some of the primary risks that preferred stock investors should consider before making purchases.

EIGHT

MANAGING THE RISKS

No discussion of an investing approach would be complete without saying a few words about risk and how to manage it.

People take risks every day. I noted earlier that 42% of newly licensed 16 year old drivers get into a police-reported car accident every year. 58% of all licensed teenagers turn in the same annual performance behind the wheel[1].

Think about those numbers. These accident rates make me want to bring my dog inside every time my neighbor's teenager reaches for the keys.

All investments come with a certain amount of investment risk and CDx3 Preferred Stocks are no exception. There are risks. Lightning may, in fact, strike.

But there is much that one can do to substantially reduce the risk of being struck - don't walk around holding a nine iron over your head during a lightning storm; don't stand outside in an open field; get off that metal ladder. In other words, if the risk is known you can build a dome of risk protection and crawl inside of it.

[1] Source: National Safety Council, *Injury Facts*

Stay Inside Your Dome

The less investment risk you have, the easier it is to manage. The number one concern of preferred stock investors is, of course, the bankruptcy of the issuing company. The number two concern is that while the company survives, they stop paying your dividends.

While companies that issue CDx3 Preferred Stocks have merged over the years, there has never been a case of a bankruptcy. And there has only been one case of a missed dividend payment which has since been paid (CTZ-A from Citizens Republic Bancorp, mentioned earlier).

To protect the President of the United States, the Secret Service has what they call a virtual dome of protection. The center of the dome is always represented by the president's physical location; the dome moves accordingly, always.

CDx3 Investors can use this same concept to build their own dome of protection – a collection of complementary measures that, taken together, form a dome within which you invest.

The key to minimizing your investment risk with CDx3 Preferred Stocks is simple – stay inside your dome. And I'm about to show you how to do exactly that.

Increasing Interest Rates Bring Decreasing Prices

During a period of low interest rates, preferred stock investors are often warned about the danger of a drop in market prices once rates start heading back up.

While that caution is valid, it may not be as complete or as applicable as many are often led to believe.

Say you pay $25 today for a share of a preferred stock that pays a 6% dividend. Then rates go up at some point such that new preferreds are now coming out at, say, 7%. Remember, newly introduced

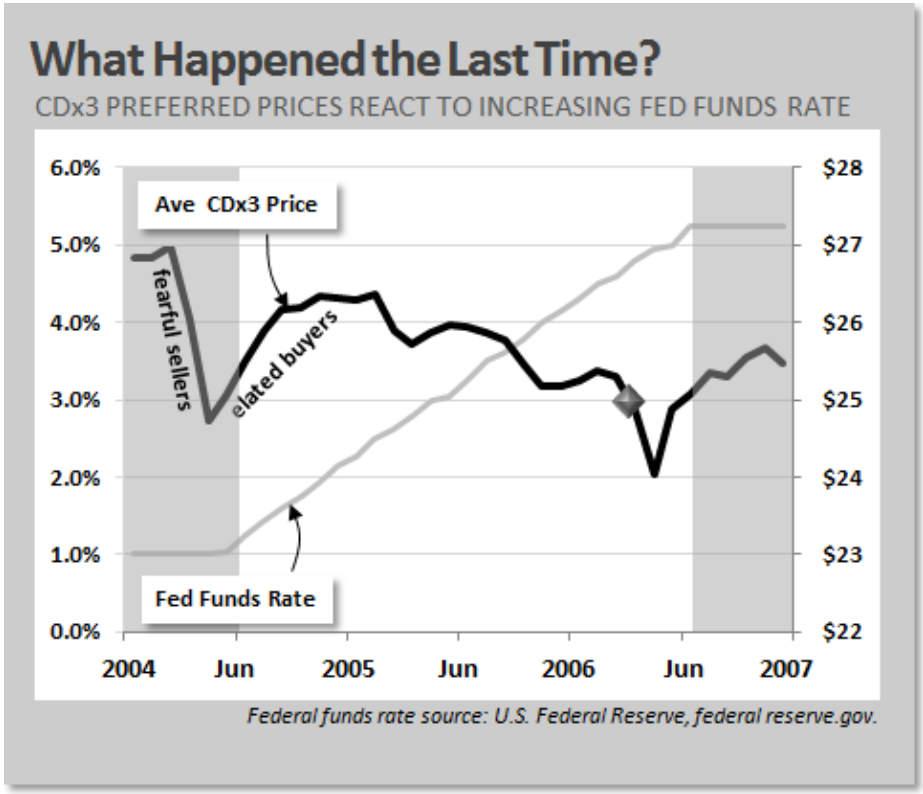
preferreds have a par value of $25 so if $25 gets you 7%, what do you think happens to the market price of your old 6%-er?

It goes down, of course. But by how much and how long does the effect take to kick in?

For most preferred stock investors, a period of falling prices represents little more than a great buying opportunity. Remember, the current market price of a preferred stock is only important if you are planning on buying or selling. Otherwise, market price fluctuations are of little importance to savvy preferred stock investors since your income is based purely on how many dividend-paying shares you own.

But for those fearful of falling prices, it may be helpful to look at some real data.

Take a look at how preferred stock market prices reacted the last time the Federal Reserve implemented a policy of gradual but prolonged 1/4 percent increases in the federal funds rate between July 2004 and June 2006.



In the weeks leading up to the rate increases overly fearful sellers, nervous about a massive rate increase from the Fed, pushed prices down. Bargain hunting elated buyers stepped in, immediately pushing prices back up. But after two or three quarters of consistent 1/4 point rate increases from the Fed, the market fell into an equally consistent pattern of very gradually decreasing prices.

Interestingly, CDx3 Preferred Stock market prices took twenty-two months to fall back to their $25 starting point (gray diamond); a net reduction in preferred stock prices did not occur for twenty-two months after the Federal Reserve started increasing the federal funds rate.

CDx3 Preferred Stock dividend rates were flat during the three years covered by this chart (2004 - 2006)[2], paying about 7% ($1.75 per year per share) or $5.25 per share in total dividend income to preferred stock investors. Preferred stock market prices started 2004 at $26.83 and fell to $25.47 by the end of 2006, a drop of $1.36 per share over the same three year period.

As always, CDx3 Preferred Stocks continued to pay their dividends during this period of steadily increasing rates. Those dividends made up for the price drop several times over. Preferred stock shareholders ended up ahead by $3.89 per share despite a whopping 4.25% increase in the federal funds rate.

While there is a relationship between increasing interest rates and decreasing preferred stock market prices, the above chart illustrates the nature of the relationship in terms of degree and reaction time.

The types of rate increases that we see as we emerge from a struggling economy are more likely to be minor, gradual and announced in advance than major and sudden. It therefore seems likely that any downward pressure on preferred stock market prices, once rates start heading back up, would be just as minor and gradual.

> When it comes to the relationship between interest rates and preferred stock market prices, what is true of direction also appears to be true of magnitude.

If the Federal Reserve has their way, the relatively low interest rate environment that has been with us since 2009 will be the norm for quite some time.

[2] See chart on page 74.

While it is not possible to know for certain how the market will react once interest rates start back up, it is not clear that preferred stock investors are best served by giving up 6+% annual returns for fear of the effects of future rate increases.

Common stock investors make the bulk of their income from market price changes (buy low, sell high). Falling market prices are therefore seen by common stock investors as a time to sell in order to cut their losses.

Preferred stock investors, on the other hand, make their income from dividends. Dividends are paid solely based on the number of shares that you own, not the current market price and not your original purchase price. So preferred stock investors tend to see a period of falling prices as a time to add more dividend-paying shares for bargain prices, boosting their income and yield.

When prices are falling, most preferred stock investors are buying more shares – *the exact opposite of how a common stock investor views a period of falling prices*.

Applying common stock thinking to a preferred stock investment can often lead to disappointing results.

Use CDx3 Selection Criteria #4 Through #8

Half of the ten CDx3 Selection Criteria are designed to support the objective of minimizing investment risk:

- #4 - Be rated "investment grade" by Moody's Investors Service;
- #5 - Be issued by a company that has a perfect track record of never having suspended the dividend payments on a preferred stock;
- #6 - Have a "cumulative" dividend obligation;

- #7 - Be issued by a U.S. company; and
- #8 - Must not be convertible to common stock in the future.

These five risk mitigation components of the CDx3 Selection Criteria are cumulative; that is, to be considered CDx3 Preferred Stock quality, a company's preferred stocks must meet all of these five criteria. So these criteria are layers of protection, one on top of the other, between you and risk.

The Perpetual Ownership Trap

Preferred stock investors who purchase shares at the bottom of the rate barrel expose themselves to what I call "the perpetual ownership trap." Victims of the perpetual ownership trap find themselves the permanent owner of a low-paying preferred stock, an ownership position that they are unable to ever sell without realizing a capital loss.

The perpetual ownership trap only presents itself during a period of low dividend rates and is easily avoided. Here's how the trap works.

As I will describe in Part IV, preferred stock shareholders who are interested in ultimately selling their shares for a capital gain have two primary ways of doing so: (1) on the open market by placing a sell order with your broker or (2) hold the shares until the issuing company "calls" the security (buys your shares back from you for $25)[3].

In the perpetual ownership trap scenario, the market price of your shares falls below your original purchase price and stays there, eliminating the possibility of selling for a capital gain on the open market. Further, because the declared dividend rate paid by your shares (the coupon rate) is so low, the issuing company has no reason

[3] Chapter 18 also describes two lesser-used but often very effective selling strategies: "Piling-On" and the "Double-Dip."

to ever call the security. You cannot sell your shares for a gain nor does the issuing company ever buy your shares back from you.

Obviously, one way out of the trap is to just sell at a loss. But it is much better to avoid the trap to begin with.

CDx3 Selection Criterion number 1 (see page 118) allows you to easily avoid the perpetual ownership trap. By leaving a 0.5% cushion between you and the bottom of the barrel rate, you buy yourself time to react once interest rates start back up.

The perpetual ownership trap is only an issue for preferred stock investors who ignore the 0.5% cushion rule and buy shares at the bottom of the rate barrel rate; that's not going to be us.

Lack of Liquidity

"Liquidity" is a fancy Wall Street term that sounds like something more complicated than it is. When a stock is said to be highly liquid or barely liquid, that just means that there is a lot of action (buying and selling) or little action, respectively. Just look at the volume of shares that are trading each day and you'll be looking at the liquidity.

This is another area where individual preferred stock investors can be misinformed by those more accustom to common stock investing. Since there are more common stock investors throughout the world than preferred stock investors, the daily trading volume of preferred stocks can appear light by comparison.

Where popular common stocks might trade several hundred thousand or even millions of shares in a day, popular preferred stocks will typically trade tens of thousands of shares daily. Those used to bigger numbers will advise that you are unlikely to be able to buy or sell a position with so few shares being traded.

But liquidity is only meaningful as it relates to the specific number of shares that you are trying to trade. As a rule of thumb, I have rarely had a problem trading shares when my order was for 5% to 7% of the daily trading volume. Such an order, placed in the morning, will typically fill the same day without any trouble. How "liquid" a specific preferred stock is depends on how many shares you are trying to trade.

Another issue with low volume securities is that the market price can bounce around more than those with a higher volume. As described earlier in this chapter, preferred stock investors are generally less sensitive to market price fluctuations than common stock investors; for us, it is all about accumulating dividend-paying shares.

But you don't want to get taken advantage of either, so if you are contemplating a trade for a low liquidity preferred stock it might be a good idea to watch the price over a few days.

Take Advantage of Corporate Longevity

The CDx3 Selection Criteria do not specifically include or exclude preferred stocks from companies that are of a certain age. There is no criterion that says anything like "...and the issuing company must have been in business since at least 1950..."

And yet, most of the companies that issue CDx3 Preferred Stocks are multi-billion dollar businesses that have been in business for decades.

As we'll see in Part IV regarding how you go about selling a CDx3 Preferred Stock, depending on market conditions those inclined to be sellers are usually only going to own a CDx3 Preferred Stock for about two or three years and some times less than one year[4].

[4] Refer to the Sell Date data provided in chapter 17.

The chances that these companies would be in business for decades and just happen to go bust during the precise sliver of time that you happen to own one of their preferred stocks is extremely slim to begin with. Relative to the longevity of these businesses, you are going to be in and back out in a relative blink of the eye in most cases.

Understanding Key Prospectus Provisions

No one likes reading a security's prospectus. These important documents are written by lawyers for lawyers so are often hard to digest for the rest of us. Here are a few things to look for in the prospectus of a preferred stock that might make this task a bit easier for you.

1) *Cumulative versus non-cumulative*: A preferred stock that pays cumulative dividends[5] will usually include the word "cumulative" right in the title of the security itself. But frequently not. If the title does not specify whether or not the security's dividends are cumulative or non-cumulative, use your web browser's Find function to search for the words "defer" (for cumulative preferreds) or "suspend" (for non-cumulative preferreds).

2) *Change of control*: Real Estate Investment Trusts (REITs) have started including a standard provision in their preferred stock prospectuses. The new provision, referred to as the "anti-Waldenization provision" is a risk-lowering provision for preferred stock investors[6]. But ironically, many

[5] CDx3 Preferred Stocks offer cumulative dividends meaning that if the issuing company misses a dividend payment to you, they are required to make it up to you in the future. They still owe you the money. See page 126 for an example.
[6] See "*New REIT Preferred Stock Prospectus Language Protects Preferred Stock Investors*" at SeekingAlpha.com/article/471301.

of those who read it can easily misinterpret the new language as increasing their investment risk.

The new provision goes on at some length describing what will happen to shareholders in the event that there is a change of control of the company. The language prevents a raiding company from stripping the REIT of its property assets (without which the raided company would have no way of paying dividends to preferred stock shareholders).

3) *Premature redemption*: Preferred stocks have a "call date" that is clearly specified in the prospectus (usually five years after IPO). The issuing company re-gains the right to redeem the shares (buy back from you) on that date. Until then, they are obligated to continue paying your dividends.

   But under rare conditions, some preferred stocks are able to be called prior to their published call date. This ability to prematurely redeem a preferred stock will be spelled out in the prospectus usually under a section titled "Redemption" or "Optional Redemption" and comes up most commonly with bank-issued preferred stocks.

   For example, historically banks issued trust preferred stocks (TRUPS) primarily because these securities counted toward a key measure of a bank's reserves ("Tier 1 Capital")[7]. But standard TRUPS prospectus language says that if the government changes the formula for Tier 1 Capital (a "capital treatment event") that they, the bank, will have 90 days to prematurely call the TRUPS since a change in the formula would be like changing the rules after the game has started (and some prospectuses include no such 90 day limitation).

[7] See page 38 for an explanation of trust preferred stocks and Tier 1 Capital.

> The Wall Street Reform Act, signed into law in July 2010, changed the formula for Tier 1 Capital (with a January 1, 2013 implementation date) thereby making such TRUPS redeemable for at least the 90 days that followed.
>
> Starting during the late summer of 2010, banks have been redeeming their TRUPS, some well before their published call dates.
>
> To see if a bank-issued preferred stock that you hold or are otherwise interested in can be prematurely redeemed prior to its published call date, searching the prospectus for the phrases "capital treatment event" or "90 days" or "redemption" usually takes you to the right spot.

It is also a good idea to read the Risks section of the prospectus of a preferred stock that you are considering purchasing. This section tends to read quite a bit like the potential side effects disclaimer on a prescription medication. Those who take the Risks section too literally will find themselves rarely investing in anything (or even going outside). So use your best judgment here and try not to read too much into these provisions.

Diversify Your CDx3 Portfolio

Decades ago preferred stocks were only issued by utilities, but now many types of businesses offer them allowing you to salt your portfolio with holdings from different segments of our economy. Here are some examples:

- Utilities (Dominion Resources)
- Self-storage units (Public Storage)
- Insurance (Prudential)
- Commercial centers (PS Business Parks)
- Retail shopping (Vornado)

- Manufacturing (Ford Motor Company)
- Shipping/logistics (ProLogis)
- Communications (Comcast)
- Healthcare (Duke Realty)
- Hotels (Hospitality Properties)
- Entertainment (CBS Broadcasting)
- Apartments (UDR, Inc.)
- Regional Banks (BBT Corporation)
- Broker/Banks (Wells Fargo)

CDx3 Preferred Stocks provide an excellent opportunity to not only earn great income, but also diversify your portfolio at the same time.

This type of investment diversification allows you to take advantage of boom times and spread your risk during periods when the economy slows down.

For example, during stronger economic times the demand for the services of shipping and logistics centers ramps up as more goods are being moved around the world and hotels see more travelers.

When times are tighter, demand for apartments increases and self-storage units fill up.

And let's not forget why they are called "preferred" stocks to begin with – we get to stand in line before the holders of common stocks in the event of a cash crunch.

By combining (1) the excellent track record of the CDx3 Selection Criteria, even under the most extreme of economic circumstances, (2) the sliver of time that you will own a particular CDx3 Preferred Stock in relation to the longevity of the companies that can meet these

criteria and (3) diversifying your CDx3 Portfolio across multiple industries, you can build a very powerful risk mitigation dome.

By using what you have learned so far in this chapter you will start to see which CDx3 Preferred Stocks are most consistent with your personal financial resources, goals and risk tolerance.

Now that you know how to pick out CDx3 Preferred Stocks from a sea of pretenders and manage your risk while doing so, let's see how to use the Three Rules of Market Price Predictability to buy CDx3 Preferred Stocks for less than $25 per share.

PART III

Buying the Highest Quality Preferred Stocks

This Part of *Preferred Stock Investing* shows you how to buy the highest quality preferred stocks while protecting your principal.

We are going to see a change in economic conditions over the next couple of years - lower rates with higher prices now (2013, 2014) followed by a period of higher rates with lower prices later (2014, 2015). The four chapters within this Part present buying techniques in the order that you are likely to use them over the next couple of years:

- ✓ Chapter 9 shows you a great technique for buying new issues for a discounted market price below $25, even for the same shares that others are going to be paying much more for;
- ✓ Chapter 10 explains some of the opportunities that exist with "less than perfect" preferred stocks (those that meet nine of the ten CDx3 Selection Criteria). This chapter shows you what you have to give up if you want to increase the number of available candidates;
- ✓ Chapter 11 explains a technique called "Upgrading" that allows you to keep up with increasing interest rates in the future. Upgrading allows you to trade in a low payer for a higher payer and have cash left over; and
- ✓ Chapter 12 provides you with a tool called the "CDx3 Bargain Table" that allows you to quickly identify purchase candidates during a period of increasing rates. Ultimately, the Federal Reserve will return rates to market forces. Whether you are looking to maximize dividend income or capital gains, the CDx3 Bargain Table is the tool you will need as a preferred stock investor in a Fed-free marketplace.

NINE

BUYING NEWLY ISSUED PREFERRED STOCKS BELOW $25

Historically, the average dividend rate offered by preferred stocks runs about 7%. But that changed during 2012. The early-2013 average dividend rate offered by new issues was 6.36% selling for an average market price of $25.68 per share[1].

I'm going to show you how to purchase your preferred stock shares for a market price less than $25 in just a moment, even in a relatively high-priced market when others pay much more for the same shares. But first, let's understand why preferred stock prices are relatively high. These key activities are driving the market prices of today's preferred stocks and are likely to remain doing so for the next couple of years.

Key Activities that are Driving Prices

While it would be convenient to lay all of the blame for these low-rate, high-priced conditions at the feet of the U.S. Federal Reserve,

[1] Data date: May 17, 2013

doing so would be unfair. There are other culprits, both domestic and foreign.

Understanding these drivers is important to preferred stock investors because it informs our view of the future. While clairvoyance is always in short supply, understanding what the market for preferred stocks is likely to be like over the next couple of years, and the reasons why, gives us a basis for how we should approach our preferred stock purchases today.

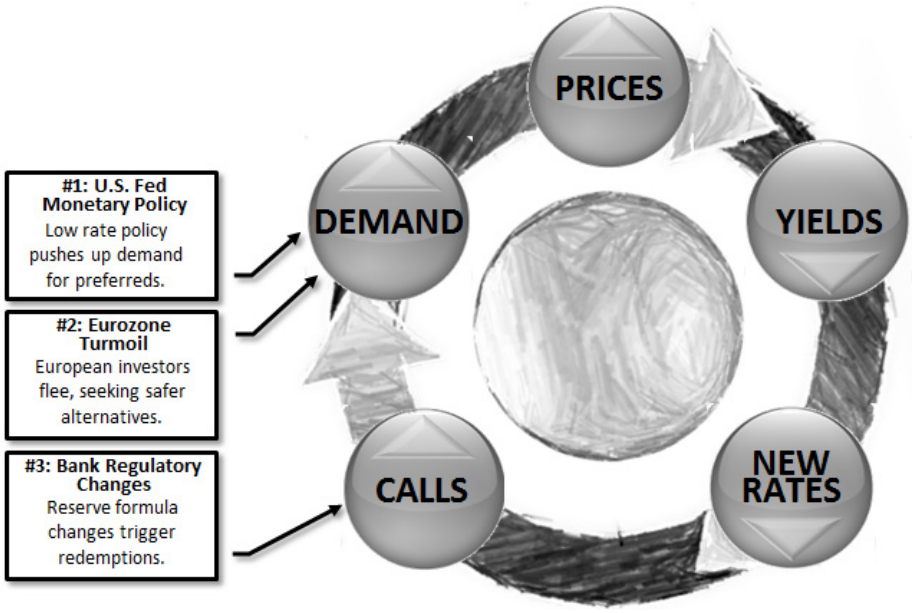
It's all about demand. Like any other product that is subject to a group of buyers and sellers within a competitive market, an increase in demand for fixed-dividend preferred stocks leads to an increase in market price. Higher prices, in turn, drive down the yield of the investment since the investor has to invest more of their money in order to receive the return; higher prices produce lower yields.

Companies and their underwriters contemplating the introduction of a new preferred stock use the prevailing dividend yield of similar issues as a benchmark indicator when setting the new issue's dividend rate. If yields are falling, the dividend rates offered by new issues will fall right along with them.

When companies are able to issue a new preferred stock at a lower dividend rate than their older issues, they will tend to do so and use the proceeds generated by the introduction of the new preferred to redeem the outstanding shares of their older, more expensive issues. So when new preferreds are coming out at lower rates there tends to be an increase in redemptions of older, higher payers (calls go up).

An increase in redemptions produces a large group of suddenly cash rich buyers looking to replace their just-called shares. These preferred stock investors simultaneously enter the market as buyers, increasing demand for preferred stocks. Until conditions change, the cycle continues to feed on itself.

While there are a number of factors that drive this cycle, and new events can obviously occur at any time, there are three primary drivers pushing up the demand for high quality preferred stocks in today's marketplace: (1) the low rate monetary policy of the U.S. Federal Reserve, (2) turmoil in the Eurozone and (3) bank regulatory changes.



The low rate monetary policy of the U.S. Federal Reserve has decimated savers (those who rely on income from bank CDs and bonds), eliminating about half of this group's income over the last few years. As rates have fallen, many savers have switched to high quality preferred stocks in a quest for yield.

Turmoil in the Eurozone has also caused an increase in demand for U.S. securities. The Cyprus event during early-2013[2] pushed the U.S. stock market to record highs and preferred stock market prices increased right along with those of their common stock cousins.

While the low rate policies of the Federal Reserve and European turmoil serve to directly push up the demand for high quality preferred stocks, changes in banking regulations (domestic and international) have a less direct effect.

As explained on page 145, the domestic Wall Street Reform Act, signed into law in July 2010, and the subsequent international Basel III bank regulatory changes have served to increase calls of bank-issued trust preferred stocks (TRUPS). The increase in TRUPS redemptions has pushed former TRUPS shareholders into the market as newly cash-rich buyers seeking to replace their redeemed TRUPS shares.

These are the three primary activities that have been putting upward pressure on the prices of high quality U.S.-issued preferred stocks for the last couple of years. Until there is a significant change in one or more of these activities, market prices are likely to remain higher than they would otherwise be.

With these key activities putting upward pressure on market prices, preferred stock investors are often finding themselves in a position of having to pay more than a preferred stock's par value when making a purchase. In the event of a downstream call, shareholders receive the security's par value from the issuing company in exchange for their shares so shares purchased for a price above the par value result in a capital loss to the investor.

[2] European banking officials announced a new bailout model where the central banks of struggling countries (starting with Cyprus) would be required to seize portions of citizen's savings accounts. Fearful that their country may be next, many European investors instantly reacted by moving their money into U.S. and other markets.

But the reverse is equally true; savvy preferred stock investors can add a layer of principal protection to their investment by purchasing their shares for a market price below the security's par value[3].

But how is a preferred stock investor supposed to purchase shares for a market price that is below the security's par value ($25 per share in our case) when market prices are generally higher than that?

Using the Over-The-Counter Stock Exchange

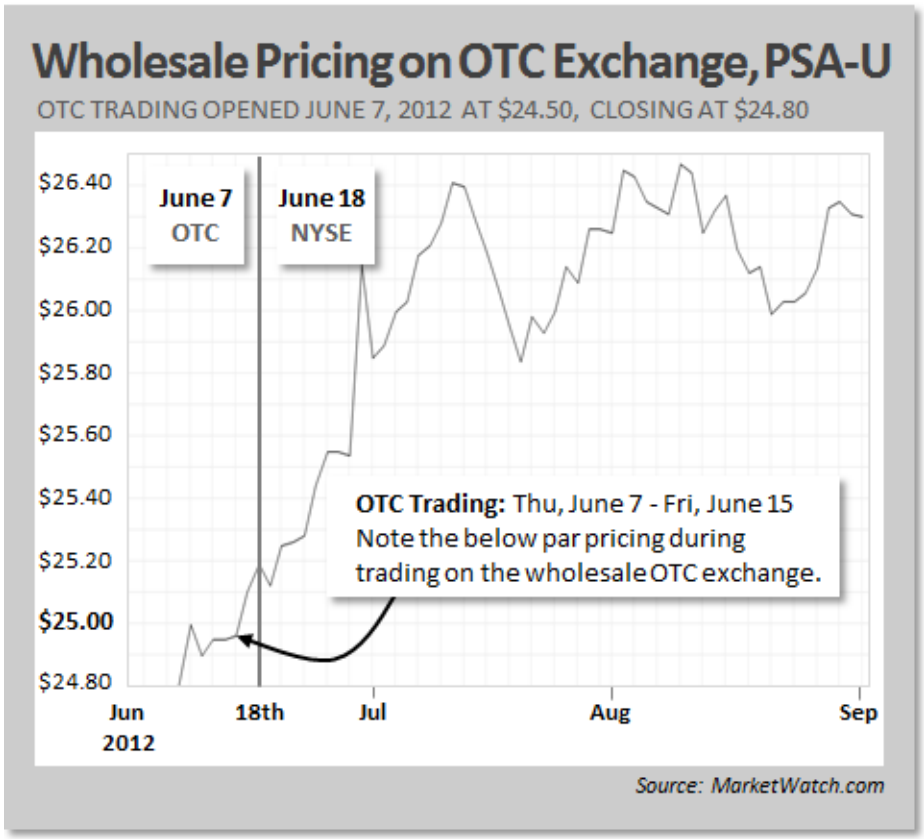
Newly issued preferred stocks have a lot of appeal for a number of reasons. For one, new issues usually have a longer remaining dividend payout period than issues that have been trading for a while.

Also, since preferred stocks tend to attract long-term investors, the daily trading volume of older preferred stocks is often lighter when compared to that of newer issues. Shareholders intent on holding their shares until the preferred stock is retired are not actively trading so there are not as many sellers in the market each day of many older issues. Consequently, those looking to make a purchase often find that newly issued preferred stocks can be more convenient to buy.

But during a period of high prices, the most compelling reason to purchase newly issued preferred stocks is that savvy preferred stock investors can usually do so for a discounted price, a price that is usually below $25 per share. And now I am going to show you how to do it.

[3] Chapter 18 presents very beneficial exceptions to this "buy below par" rule.

In June 2012 Public Storage introduced their Series U preferred stock. PSA-U was introduced on June 7, 2012 but, as you can see on the below chart, if you were looking to purchase shares on the New York Stock Exchange (NYSE) you were not able to do so until June 18th, eleven days later.



But obviously, looking at this chart, somebody was buying shares of PSA-U prior to June 18, 2012 and at pretty favorable pricing too.

What happened to PSA-U during these initial days, the time between its introduction and the beginning of trading on the NYSE and who were these other investors who were able to buy the new shares?

It is during this phantom period, while newly issued CDx3 Preferred Stocks are "off the radar," that CDx3 Investors are able to purchase new CDx3 Preferred Stock shares for less than $25 per share.

Motivated Sellers

Typically when a new CDx3 Preferred Stock is issued it takes the New York Stock Exchange a bit of time (usually about two weeks, sometimes more, sometimes less) to approve the trading application filed by the issuing company and assign a trading symbol.

When a new CDx3 Preferred Stock is issued to the marketplace a group of underwriters provides the issuing company with the cash in exchange for the new shares. And we're not talking about small amounts of money here either; the underwriters are out real money usually measured in tens or even hundreds of millions.

Once the underwriters have purchased the new shares from the issuing company they are very anxious to turn around and sell those shares to "dealer/brokers" who, in turn, sell them to you.

In other words, the holders of the shares at this point in the process, before the CDx3 Preferred Stock actually shows up on the NYSE, are what a real estate agent refers to as a "motivated seller." The underwriters are in no mood to simply sit and wait until the NYSE gets around to assigning a trading symbol; the underwriters want to sell the new shares to the dealer/brokers as quickly as possible and they are not going to wait for the NYSE.

To sell the new shares to the dealer/brokers as quickly as possible, the financial services industry invented a "pre-market" trading venue where new shares of CDx3 Preferred Stocks are bought and sold prior

to transferring over to the NYSE. This pre-market is called the Over-The-Counter (OTC) stock exchange.

And the best part is that, in addition to the big guys, individual investors like you and me can trade on the OTC, too.

Swim with the Big Fish

When the underwriters buy the new shares from the issuing company, they receive a commission for their services of about 3%, so the net price per share paid by the underwriters for the new shares is usually about $24.25[4].

As the process unfolds, this $0.75 per share underwriter commission provides some wiggle room for discounts to downstream participants as the process continues to make its way to you and me.

When the underwriters sell the new shares to the dealer/brokers, the underwriters may set the wholesale price at, say, $24.50. At this price, the underwriters make a very quick $0.25 per share on what is usually several million shares for what is essentially a few hours of work and very little risk.

The dealer/brokers turn around and sell the new shares to investors like us. Depending on how quickly they want or need to unload the new shares, they might set their "ask" price at, say, $24.75.

> Armed with a web browser and an online trading account, individual investors can access the OTC just like the big guys. By inserting yourself into the trading action on the OTC, you can usually purchase newly issued CDx3 Preferred Stocks for less than $25 per share.

[4] Underwriters paid $24.2586 for PSA-U shares. See page 1 of PSA-U's prospectus: http://www.sec.gov/Archives/edgar/data/1393311/000119312512263629/d361439d424b5.htm

Once the shares make their way onto the NYSE and out into the open market the original underwriter's commission has usually been fully absorbed by the players in the pre-market and is no longer available after OTC trading.

Other Reasons for the Discounted OTC Prices

Beyond the underwriter and dealer/broker's need to sell the new shares quickly, there are two other reasons why CDx3 Investors can purchase a newly issued CDx3 Preferred Stock for less than $25.00 per share while it is trading on the OTC.

First, the visibility of the OTC is much lower than that of the major stock exchanges like the NYSE. Low visibility leads to lower prices.

Secondly, the Rule of Buyer/Seller Behavior (page 49) tells us that there is upward pressure on the market price of a CDx3 Preferred Stock as the end of the dividend quarter (payday) approaches. That means that there is less upward pressure on the market price at the beginning of a dividend quarter, which is when new CDx3 Preferred Stocks are usually introduced.

Both of these lesser factors put downward pressure on the market price of a newly issued CDx3 Preferred Stock while it is trading on the OTC stock exchange.

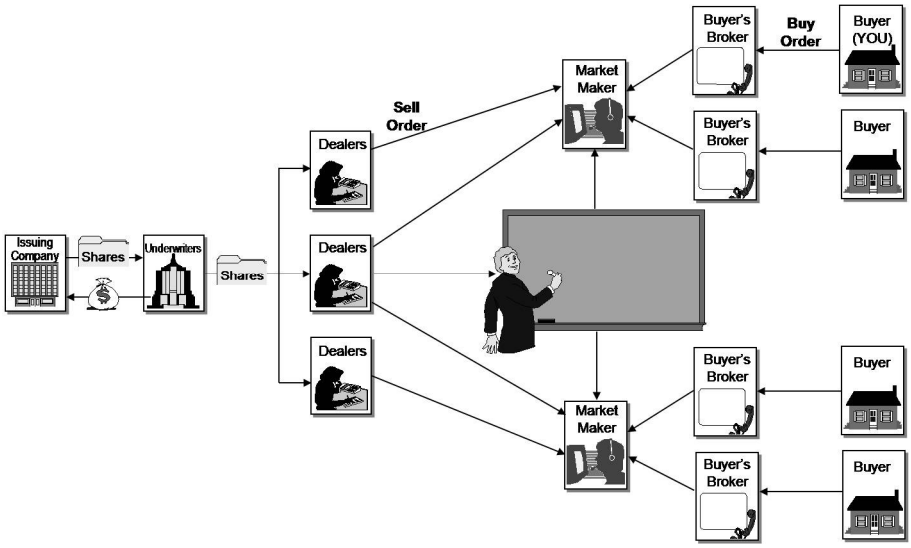
The Role of the OTC Market Maker

The OTC is not as automated as the much higher volume major exchanges. In fact, part of the OTC process that your broker goes through (on your behalf) involves *manual* processing.

Consequently, a buy order that you enter for a CDx3 Preferred Stock trading OTC may take a little longer than you may be used to.

To help out, there is a third party involved called a "market maker." Only certain market makers handle certain preferred stocks on the OTC, so sometimes there can be delays between your broker, trying to place your buy order, and the market maker.

As illustrated on the following diagram of the OTC, the market maker is where your buy order is actually matched up with someone else's sell order and the deal is made.



The market maker actually works the deal between your broker (representing you, the buyer) and the seller by telephone. The results are posted on an electronic bulletin board, but broker systems are limited with respect to how much of the bulletin board they have access to.

You should check with your broker (online brokerage or traditional brokerage) and ask them if they can process an "over-the-counter" preferred stock purchase. This should not be a problem but, as explained below, processing over-the-counter transactions is more

cumbersome for your broker (not for you), whether they are an online or traditional brokerage. TDAmeritrade (www.TDAmeritrade.com), for example, has made a real commitment to handling OTC preferred stock transactions.

While being traded over-the-counter, a new CDx3 Preferred Stock will have a temporary trading symbol that is updated when it transfers to the NYSE[5]. Once the NYSE approves the trading application, a new permanent trading symbol is assigned and any shares that you purchased under the temporary OTC symbol are transferred over automatically by your broker.

Since broker systems have very limited electronic access to pending OTC trades, you will usually have to call your broker to get the current Bid and Ask prices for CDx3 Preferred Stocks while they are trading OTC. When you do so, your broker will put you on hold and call the market maker.

While buying a CDx3 Preferred Stock while it is trading OTC is not as automated as doing so from the NYSE, do not be deterred. Depending on market conditions, this may be the last time that your new CDx3 Preferred Stock will be available to you for a market price less than $25.00. Believe me; it's worth the phone call to your broker.

2012 OTC Results

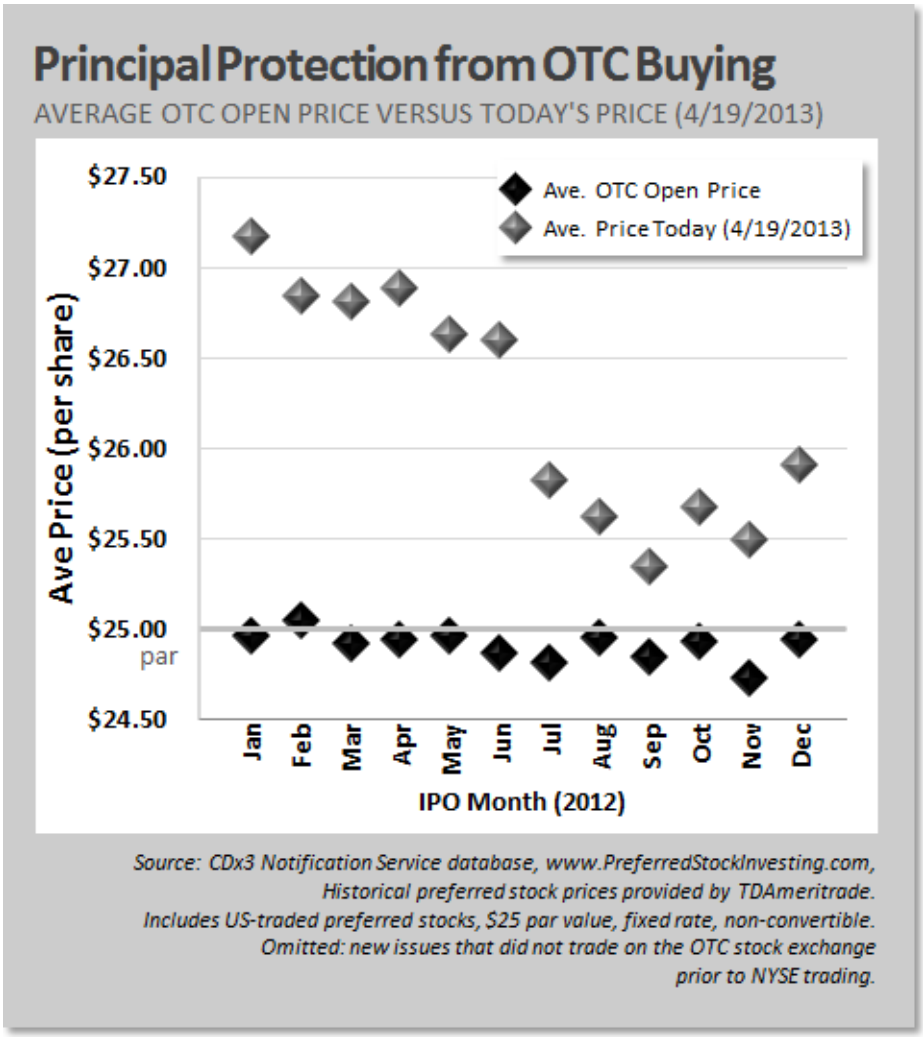
While many preferred stock investors view a period of falling prices as a time to add more dividend-paying shares to their holdings, principal protection strategies are important to those needing to sell their shares during such times.

[5] The temporary OTC trading symbol for the PSA-U example we saw on page 156 was PSAML.

The lower your original purchase price is the less exposed your principal is to a future period of falling prices; prices have to fall further before your principal is affected.

Using the OTC exchange to purchase newly issued preferred stock shares at wholesale prices can therefore provide a valuable principal protection strategy.

This chart illustrates the principal protection benefit of buying newly issued preferred stock shares on the OTC stock exchange during 2012 - a period of low interest rates and high demand.



The black diamonds show the average opening OTC market price for new preferred stocks introduced during each month of 2012 (generally below these security's $25 par value). The gray diamonds show the market price for those same preferred stocks on April 19, 2013 (NYSE trading).

Note how, in all cases, the black diamonds (average OTC open price at introduction) are lower than the gray diamonds (April 19, 2013 price). Here's the month-by-month breakdown of this strategy.

2012 OTC Price Performance

PRICES INCREASED BY AN AVERAGE $1.32 PER SHARE (4/19/2013)

IPO month	OTC count	ave div rate	ave OTC open	ave price (4/19)	ave gain (4/19)
JAN	6	6.550%	$24.97	$27.18	$2.21
FEB	3	6.583%	$25.05	$26.85	$1.80
MAR	7	6.868%	$24.93	$26.82	$1.89
APR	6	6.730%	$24.95	$26.90	$1.95
MAY	7	6.800%	$24.97	$26.64	$1.67
JUN	3	6.833%	$24.87	$26.60	$1.73
JUL	10	7.195%	$24.82	$25.83	$1.01
AUG	11	6.427%	$24.96	$25.63	$0.67
SEP	10	6.508%	$24.85	$25.35	$0.50
OCT	8	6.753%	$24.94	$25.69	$0.75
NOV	8	6.269%	$24.74	$25.50	$0.76
DEC	5	7.305%	$24.95	$25.92	$0.97
	7.0	**6.743%**	**$24.91**	**$26.24**	**$1.32**

Source: CDx3 Notification Service database, www.PreferredStockInvesting.com, Historical preferred stock prices provided by TDAmeritrade. Includes US-traded preferred stocks, $25 par value, fixed rate, non-convertible. Omitted: new issues that did not trade on the OTC stock exchange prior to NYSE trading.

Take January 2012 as an example. The six preferred stocks that were introduced on the OTC exchange during January 2012 opened for an average price of $24.97. On April 19, 2013 those same six issues were selling for an average price of $27.18, a $2.21 per share increase.

Overall, the market prices of the 84 preferred stocks introduced during 2012 using the OTC exchange have increased by an average of $1.32 per share.

As companies continue to take advantage of today's relatively low rates the bumper crop of new preferred stock issues that we saw during 2012 shows no signs of letting up. Fifty-three new preferred stocks (including exchange-traded debt securities) were issued during just the first quarter of 2013.

As long as rates remain relatively low, purchasing newly issued shares for wholesale prices during OTC distribution is an important principal protection strategy for preferred stock investors.

Because underwriters and dealer/brokers are very anxious to sell newly issued CDx3 Preferred Stock shares in order to recoup their investment quickly, you are able to use the Over-The-Counter stock exchange to purchase shares for a market price below $25, effectively taking a piece of the $0.75 per share commission out of the underwriter's pocket and putting into your own.

You now know how to buy newly issued CDx3 Preferred Stocks for less than $25 per share, even during a high demand market when average market prices exceed that value.

TEN

BUYING LESS THAN PERFECT PREFERRED STOCKS

The number of preferred stocks trading on U.S. stock exchanges varies every day as new issues are introduced and older issues are redeemed. But for the last two or three years there have been about 1,000 issues available for preferred stock investors to pick from.

The previous chapter explained how to buy newly issued CDx3 Preferred Stocks for less than $25 per share by using the Over-The-Counter stock exchange. Using the OTC is a neat trick and allows preferred stock investors to get some great prices on the highest quality issues - the same issues that others end up paying much more for during periods of high demand.

But what about buying *previously issued* preferred stocks for less than $25 per share? Of the 1,000 preferred stock trading every day surely there are some "less than perfect" candidates that are still worth considering, especially if we can get them for a market price below their $25 par value.

And there are. I see them every day.

But because market prices change continually throughout every trading day, the only way to comb through the characteristics of 1,000

individual preferred stocks in time to take advantage of a good price is to have a computer do the work for you.

Prior to the availability of a preferred stock search engine that could search for issues priced below their par value, finding less than perfect but still acceptable preferred stocks for bargain prices involved an enormous amount of entirely wasted effort since prices would change before the task could be completed.

But when armed with such a search engine, finding less than perfect but still acceptable preferred stocks that are available for less than their $25 par value takes less than one second.

Less Than Perfect Preferred Stocks

During high demand periods, when prices rise and yields fall, many preferred stock investors will relax one or more of the ten CDx3 Selection Criteria (chapter 7) in order to have more choices with typically higher yields. Doing so, however, also increases investment risk but it may be risk that you feel is worth taking.

Let's take a look at the market for “less than perfect” preferred stocks. For the reasons explained on page 57, the preferred stock market in early 2013 was a very high demand market characterized by correspondingly high market prices.

First, I used the CDx3 Notification Service database to produce a list of preferred stocks that meet nine of the ten CDx3 Selection Criteria from chapter 7 (any nine)[1].

The resulting list of 347 securities was more than I can deal with here so I further limited the list to just those issues that are call-

[1] CDx3 Notification Service subscribers: on the CDx3 Hotlist row of the subscriber’s website, click on the CDx3 Compliance score of 9 to see this list.

protected (have yet to reach their respective call dates) and are available for a market price at or below the security's $25 par value.

This table shows the ten less than perfect preferred stocks identified by the search engine and summarizes the strengths and weaknesses of each security when measured against the CDx3 Selection Criteria.

	CDx3 Selection Criteria										
Symbol	Div at least 6.0%	5-Year Call Date	Quarterly Divs	Investment Grade	Divs Not Suspended	Cumulative Divs	U.S. Issuer	Non-Convertible	Online Prospectus	$25 Par Value	CDx3 Compliance Score
NEE-J	N	Y	Y	Y	Y	Y	Y	Y	Y	Y	9
CWHO	N	Y	Y	Y	Y	Y	Y	Y	Y	Y	9
SNHN	N	Y	Y	Y	Y	Y	Y	Y	Y	Y	9
DLR-G	N	Y	Y	Y	Y	Y	Y	Y	Y	Y	9
VNO-L	N	Y	Y	Y	Y	Y	Y	Y	Y	Y	9
DDR-K	Y	Y	Y	N	Y	Y	Y	Y	Y	Y	9
DM-B	Y	Y	Y	N	Y	Y	Y	Y	Y	Y	9
MILL-C	Y	Y	Y	N	Y	Y	Y	Y	Y	Y	9
PEB-C	Y	Y	Y	N	Y	Y	Y	Y	Y	Y	9
RSO-B	Y	Y	Y	N	Y	Y	Y	Y	Y	Y	9

The table on the next page provides some of the details for these same ten securities including their call dates and market prices on Friday, April 19, 2013.

Ten "Less Than Perfect" Preferred Stocks

Call-Protected and Available for Less Than $25 Par Value
(April 29, 2013)

IPO Date	Symbol	Preferred Stock Name	Div Rate	CUSIP	Last Price	Volume	Yield	Ex-Div Date	Call Date	Liquid Price	↑ Moody's	S&P
1/15/2013	NEE-J	NextEra Energy Inc., 5.00% Series J Junior Sub Debentures...	5.000%	65339K886	$25.00	808735	5.00%	04/10/2013	1/15/2018	$25.00	Baa2	BBB
7/24/2012	CWH-O	CommonWealth REIT, 5.75% Senior Notes due 8/1/2042	5.750%	203233705	$24.55	35373	5.86%	01/16/2013	8/01/2017	$25.00	Baa3	BBB-
7/19/2012	SNHN	Senior Housing Properties Trust, 5.625% Senior Notes...	5.625%	81721M208	$24.98	80597	5.63%	04/11/2013	8/01/2017	$25.00	Baa3	BBB-
4/02/2013	DLR-G	Digital Realty Trust, 5.875% Series G Cumulative Redeemable	5.875%	253868889	$24.95	85861	5.89%		4/09/2018	$25.00	Baa3	BB+
1/16/2013	VNO-I	Vornado Realty Trust, 5.40% Series L Cumulative Redeemable	5.400%	929042844	$24.86	453693	5.43%	03/13/2013	1/25/2018	$25.00	Baa3	BBB-
3/25/2013	DDR-K	DDR Corp., 6.25% Dep Shares Class K Cumulative Redeemable	6.250%	23317H805	$24.86	21885	6.29%		4/09/2018	$25.00	Ba1	B+
1/25/2013	DM-B	Dolan Co., 8.50% Series B Cumulative	8.500%	25659P501	$22.00	1363	9.66%	03/13/2013	1/31/2018	$25.00	NF	NF
9/28/2012	MILL-C	Miller Energy Resources, 10.75% Series C Cumulative...	10.750%	600527204	$22.27	6900	12.07%	02/13/2013	11/01/2017	$25.00	NF	NF
3/11/2013	PEB-C	Pebblebrook Hotel Trust, 6.50% Series C Cumulative...	6.500%	70509V407	$24.96	12550	6.51%	03/27/2013	3/18/2018	$25.00	NF	NF
9/25/2012	RSO-B	Resource Capital Corp., 8.25% Series B Cumulative Redeemable	8.250%	76122W500	$24.80	11283	8.32%	12/28/2012	10/02/2017	$25.00	NF	NF

Evaluating Less Than Perfect Preferred Stocks

Note that since this list includes market price as a criteria, the list changes continually so reproducing such a list at some future time will almost certainly produce a different result than seen here.

Remember, each of these ten securities are able to meet nine of the ten CDx3 Selection Criteria, are call-protected and are available for a market price below their $25 par value.

For many preferred stock investors facing high demand market conditions, preferred stocks that have those strengths are worth consideration even though they may be less than perfect.

The first three of these ten securities (NEE-J from NextEra Energy, CWHO from CommonWealth REIT and SNHN from Senior Housing Properties Trust) are ETDs (bonds that trade on the stock exchange). Since the above tables are sorted by Moody's rating (strongest ratings first), it is not too surprising that the ETDs float to the top of the list. These three ETDs are "double investment grade rated" meaning that they enjoy investment grade ratings from both Moody's and S&P.

DLR-G from Digital Realty provides an example of how a preferred stock may not be fully CDx3 compliant in the eyes of a database search engine even though a preferred stock investor may consider it perfectly acceptable.

DLR-G offers a dividend rate of 5.875%. CDx3 Selection Criterion number one (see page 118) requires that we leave at least 0.5% of room above the "bottom of the barrel rate" that the market is offering. Doing so adds a layer of principal protection to your investment while also helping you to avoid the "perpetual ownership trap" described on page 141. At the time this list was produced, the dividend rate needed to

meet CDx3 Selection Criterion number one was 6.0%, nudging out DLR-G by a mere 0.125%.

But because Digital Realty is a real estate investment trust (REIT), a portion of the dividend income you receive from DLR-G is very likely to be taxed as a long-term capital gain rather than as regular income. In that event, the net return provided by DLR-G could actually be greater than an otherwise identical preferred stock that offers a slightly higher dividend rate.

Whether or not DLR-G is a good choice for you is, of course, a personal decision that only you can make but it provides a good example of how a less than perfect preferred stock may still be worthy of consideration.

Take a look at DDR-K from DDR Corporation. DDR is a $5.6 billion (market cap) REIT founded in 1965 specializing in retail centers. DDR-K, a traditional preferred stock, was issued on March 25, 2013 so it is call-protected until April 9, 2018. DDR-K offers a 6.25% dividend rate, 0.25% above the minimum needed for CDx3 compliance. While the Ba1 Moody's rating is one notch short of Moody's investment grade category, many have argued that the rating formulas used by rating agencies do not accommodate REITs as well as they should, often resulting in lower ratings than are due[2].

What to Think About NF and WR Ratings

Ratings are an area where many preferred stock investors show some flexibility when considering less than perfect issues. The last four issues listed show "NF" as the rating from both Moody's and S&P. NF means Not Found. While it is tempting to think that the issuing company was too nervous about the result to have their security rated there are other reasons that a preferred stock will be unrated.

[2] *REIT Cash Is King*, by Simon Wadsworth.

For example, the fee charged by the rating agencies may be too steep to justify for preferred stock issues that are for a relatively small number of shares.

Another rating that can keep an otherwise high quality preferred stock from reaching the investment grade category is "WR." A WR rating stands for "Withdrawn."

The rating agencies have, and aggressively enforce, a policy that if a company wants a security rated then that company must have all of their securities rated. The company is not allowed to withhold one security from being rated without the rating agency withdrawing all ratings for all other securities issued by that company. If a company withholds a security from being rated, the rating agencies will withdraw the previously issued ratings on the company's other securities and assign the WR rating to all of them.

Consequently, many companies do not have any of their securities rated. In these cases you will see ratings of NF or WR for their preferred stocks.

The rating agencies certainly cost themselves quite of bit of investor confidence a few years ago, a hole that they are still digging out of. For better or worse, however, investors continue to use these ratings as a proxy for investment risk (see the risk versus reward chart on page 76).

Despite the problems, these rating agencies have a decades long history of getting these ratings right. Regarding unrated preferreds specifically, a rating of NF (Not Found) or WR (Withdrawn) is not necessarily a bad thing. But remember that a company that is able to secure investment grade ratings for their securities generally does so.

ELEVEN

KEEPING UP WITH INCREASING INTEREST RATES

Preferred stock investors are frequently told that they should fear a period of increasing interest rates. The most common refrain is that when rates start heading up, the value (market price) of your preferred stock shares will plummet, leaving your previously gleaming nest egg a dull and near-worthless pittance.

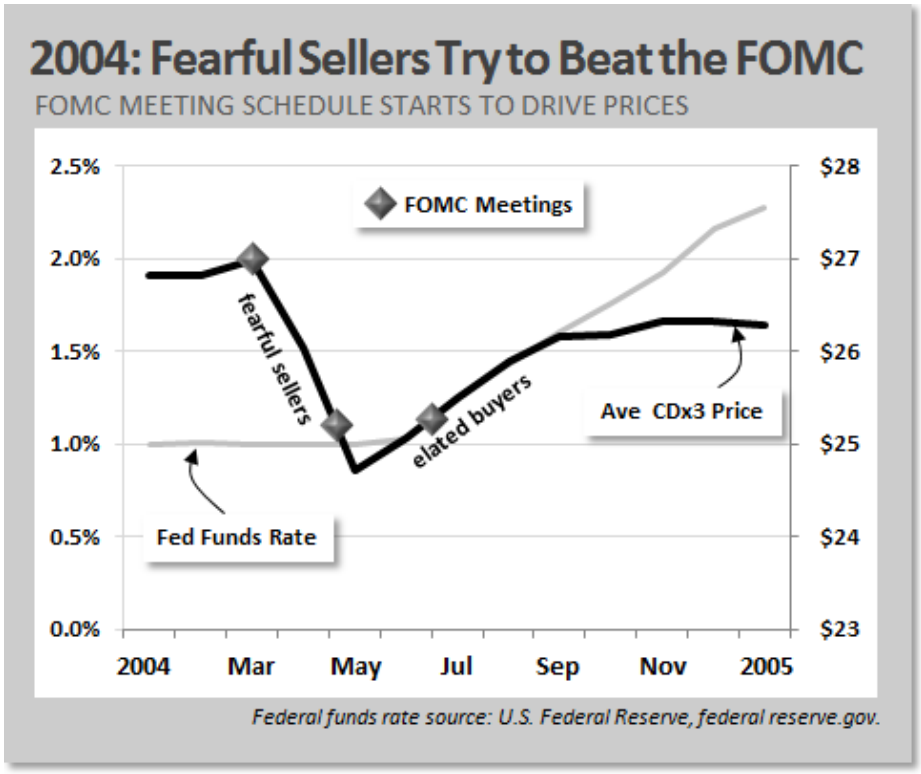
Increasing rates have been painted to be the preferred stock investor's boogeyman.

Let's leave the fear to others. In this chapter I am going to show you some real data that supports a technique for taking advantage of a period of increasing interest rates. While others are shaking in the corner, we're going to be making money.

On page 138 I showed you a chart that illustrated what happened to CDx3 Preferred Stock market prices the last time the Fed started increasing the federal funds rate (2004). As shown on that chart, fearful sellers, concerned that increasing rates were going to push prices off a cliff, started selling. But it was their own selling that caused prices to drop in early 2004 (the Fed did not start increasing the federal funds rate until June 30 of that year).

What to Watch For and Where to Look

This chart zooms in on 2004 showing average CDx3 Preferred Stock market prices (black line, right scale) and the federal funds rate (gray line, left scale).



The Federal Reserve's Open Market Committee (FOMC) meets eight times per year. It is at these meetings that the Fed decides what to do with interest rates (if anything). The three gray diamonds on this chart indicate the average CDx3 market price on the FOMC's first three meeting dates of 2004.

Fearful preferred stock investors were playing a game of musical chairs during early-2004, trying to anticipate when the Fed was going to increase rates. As the March 16, 2004 FOMC meeting approached, investors showed little concern that the Fed was going to change their 1.0% rate policy. Prices stayed high.

Here is the Fed's statement after their March 16 meeting (the term "policy accommodation" is Fed speak for low interest rates).

> **March 16, 2004:**
>
> The Federal Open Market Committee decided today to keep its target for the federal funds rate at 1 percent...with inflation quite low and resource use slack, the Committee believes that ***it can be patient in removing its policy accommodation***.

Even though the Fed came out of their March 16 meeting saying they could "remain patient," fearful sellers felt that they had pushed their luck as far as they dare and started selling their positions. Note the price drop after March 16.

But it was the subtle change to this language that the Fed made after its May 4 meeting that removed all doubt.

> **May 4, 2004:**
>
> The Federal Open Market Committee decided today to keep its target for the federal funds rate at 1 percent...with inflation low and resource use slack, the Committee believes that ***policy accommodation can be removed at a pace that is likely to be measured***.

This language change was not an accident. With this statement, investors knew that the Fed was about to start increasing the federal

funds rate. The music had finally stopped, the uncertainty removed. At that point, elated buyers realized that the fearful sellers had over-reacted earlier and stepped in to scoop up high quality preferred stocks at bargain prices.

At its next meeting on June 30, 2004 the Fed increased the federal funds rate by 1/4 percent and continued doing so after every meeting for the next two years.

This is the type of language change that preferred stock investors want to be watching for in these FOMC statements. The FOMC meeting schedule is published a year in advance on the following web page:

http://www.federalreserve.gov/monetarypolicy/fomccalendars.htm

The same web page includes the meeting minutes that are posted immediately following each meeting.

So What's The Plan?

So how are preferred stock investors who are concerned about falling market prices going to get a jump on the timing?

Preferred stock investors should not be fearful of the bottom suddenly dropping out of preferred stock prices at the hands of the Federal Reserve. With an economy that is sure to still be fragile, it is unlikely that the Fed will make an unexpected announcement of a massive increase in interest rates.

Rather, the Fed will be very careful when making any change in policy. Any upcoming increase in interest rates is sure to be very gradual and leaked to the market gradually and well in advance. So no one should be feeling like there is a surprise attack on your nest egg coming that you need to stay awake at night worrying about.

Combining stated Fed policy with historical market behavior gives you a huge advantage. With the information that I have provided here and in chapter 5, a plan emerges for making an informed judgment regarding when interest rates are likely to start increasing.

You now know what to watch for (an unemployment rate dropping below 7%), where to look for it (the Bureau of Labor Statistics[1]) and when to pay attention (the FOMC meeting dates and statements published at the above URL).

While not impossible, dramatic or sudden changes to the Fed's relatively low rate monetary policy seem unlikely in the meantime.

Now let's look at a technique that you can use to keep up with increasing rates once the day comes when they start heading up, a technique I call "upgrading."

Upgrading – Trade in A Low Payer for A Higher Payer

Upgrading takes advantage of market price disparities that tend to occur during periods of stable or increasing rates.

The objective of upgrading is to sell a preferred stock that you currently own and use the proceeds to buy another such that (a) your dividend income goes up and (b) you have cash left over.

When rates head back up, this simple technique can help add another layer of principal protection to your preferred stock portfolio. All you need is a list of preferred stocks sorted by their current market price.

Using data from April 2013, let’s see how it’s done. This table is a screen image taken on April 19, 2013 from the CDx3 Notification

[1] http://data.bls.gov/pdq/SurveyOutputServlet?request_action=wh&graph_name=LN_cpsbref3

Service database. The list is sorted by market price (the Last Price column) with the highest priced CDx3 Preferred Stocks listed first.

In this list of ten CDx3 Preferred Stocks there are twelve upgrade opportunities. Can you spot them?

IPO Date	Symbol	Preferred Stock Name	Div Rate	↓ Last Price	Call Date	Moody's
4/13/2011	VNO-J	Vornado Realty Trust, 6.875% Series J Cumulative Redeemable	6.875%	$27.33	4/20/2016	Baa3
2/29/2012	HCN-J	Health Care REIT, 6.50% Series J Cumulative Redeemable	6.500%	$27.08	3/07/2017	Baa3
1/18/2012	HPT-D	Hospitality Properties Trust, 7.125% Series D Cumul...	7.125%	$26.99	1/15/2017	Baa3
9/09/2011	DLR-E	Digital Realty Trust, 7.00% Series E Cumulative Redeemable	7.000%	$26.84	9/15/2016	Baa3
2/09/2012	REG-F	Regency Centers Corp., 6.625% Series 6 Cumulative Redeemable	6.625%	$26.76	2/16/2017	Baa3
2/17/2012	NNN-D	National Retail Properties, 6.625% Dep Shares Series...	6.625%	$26.71	2/23/2017	Baa3
8/24/2010	KIM-H	Kimco Realty Corp., 6.90% Class H Dep Shares Cumul...	6.900%	$26.44	8/30/2015	Baa2
1/10/2012	PSB-S	PS Business Parks, 6.45% Dep Shares Cumulative , Series...	6.450%	$26.37	1/18/2017	Baa3
3/29/2012	DLR-F	Digital Realty Trust, 6.625% Series F Cumulative Redeemable	6.625%	$26.26	4/05/2017	Baa3
3/09/2012	ARE-E	Alexandria Real Estate Equities, 6.45% Series E Cumul...	6.450%	$26.00	3/15/2017	Baa3

Here's the trick: a table with *no* upgrade candidates, once sorted by their current market price, will also show the dividend rates in sorted order, highest to lowest. But notice that that is not the case here. The Div Rate column starts out okay—6.875% down to 6.500%; so far, so good. But then, after HCN-J's 6.500%, the next Div Rate is *higher*. We go from HCN-J's 6.500% *up* to HPT-D's 7.125%.

Bingo. VNO-J for HPT-D is our first upgrade candidate.

If you own shares of VNO-J, which pays 6.875%, you could sell them for $27.33 and use the proceeds to buy HPT-D at $26.99. HPT-D pays a higher 7.125% dividend rate and you will have $0.34 per share in cash left over.

Notice that in this upgrade you are paying $26.99 for HPT-D. Preferred stock investors should avoid purchasing shares for a market

price above the security's $25 par value. Purchasing HPD-D at $26.99 exposes you to a potential capital loss of $1.99 per share in the event that Hospitality Properties calls HPT-D downstream.

But what if you were reimbursed for any potential future capital loss in advance? Remember, you have $2.33 per share in your pocket right now from your sale of VNO-J (assuming that you originally paid $25 per share for your VNO-J shares); that's more than enough to reimburse you in the event that Hospitality Properties calls HPT-D someday. You have already been reimbursed for any future capital loss.

Here are the twelve upgrade opportunities from the above list.

	SELL			BUY			RESULTS	
	Sym	Div Rate	Price	Sym	Div Rate	Price	Div Gain	Cash Gain
1	VNO-J	6.875%	$27.33	HPT-D	7.125%	$26.99	0.250%	$0.34
2	VNO-J	6.875%	$27.33	DLR-E	7.000%	$26.84	0.125%	$0.49
3	VNO-J	6.875%	$27.33	KIM-H	6.900%	$26.44	0.025%	$0.89
4	HCN-J	6.500%	$27.08	HPT-D	7.125%	$26.99	0.625%	$0.09
5	HCN-J	6.500%	$27.08	DLR-E	7.000%	$26.84	0.500%	$0.24
6	HCN-J	6.500%	$27.08	REG-F	6.625%	$26.76	0.125%	$0.32
7	HCN-J	6.500%	$27.08	NNN-D	6.625%	$26.71	0.125%	$0.37
8	HCN-J	6.500%	$27.08	KIM-H	6.900%	$26.44	0.400%	$0.64
9	HCN-J	6.500%	$27.08	DLR-F	6.625%	$26.26	0.125%	$0.82
10	REG-F	6.625%	$26.76	KIM-H	6.900%	$26.44	0.275%	$0.32
11	NNN-D	6.625%	$26.71	KIM-H	6.900%	$26.44	0.275%	$0.27
12	PSB-S	6.450%	$26.37	DLR-F	6.625%	$26.26	0.175%	$0.11

Look down the Results columns (far right) and notice how different upgrades can appeal to different investors.

Those seeking to maximize their dividend income would find upgrade number 4 appealing since it improves your dividend income

gain by .625%. Alternatively, investors looking to maximize their cash position would focus on upgrade number 3 since it improves your cash position by a whopping $0.89 per share. If improving your risk profile is the most important consideration, upgrade number 8 trades in a Baa3 rated security (HCN-J) for one with a higher Baa2 rating (KIM-H).

Each of these twelve upgrades involves trading in one CDx3 Preferred Stock for another and each opportunity leaves you holding a security with an increased dividend rate.

Using this simple technique can provide preferred stock investors with a way to make adjustments to their CDx3 Portfolio, keeping up with increasing interest rates with cash left over.

As I have described before, many preferred stock investors view a period of falling prices as a time to add more dividend paying shares at bargain prices. These preferred stock investors see falling prices as a time to buy, not sell.

But for those who may have to sell positions during such a period and therefore give more weight to principal protection, keeping an eye on the unemployment rate and the Fed's Quantitative Easing program should serve as an early warning system to start paying attention.

And once rates do start heading back up, look for opportunities to keep pace by using the upgrading technique. Doing so will provide you with increasing dividend income and cash left over.

TWELVE

BUYING 'FED-FREE' PREFERRED STOCKS

The U.S. Federal Reserve has intentionally distorted the market for income-generating securities by its Quantitative Easing program[1] and by keeping the federal funds rate at "zero to 0.25%." While low rates persist, using the wholesale Over-The-Counter (OTC) stock exchange as described in chapter 9 allows CDx3 Investors to purchase newly issued CDx3 Preferred Stocks for a market price below $25 per share; the same preferred stock shares that others will pay much more for.

And the Upgrading technique described in chapter 11 helps you to keep up once rates start increasing, boosting your dividend income and cash flow along the way.

Ultimately, however, the Fed will back out and the market will be returned to buyers and sellers but there is no way to know when that will occur. While the smart money seems to think that the Fed will start raising the federal funds rate in 2015, that eventuality could occur much sooner or much later.

To keep its content current, I update *Preferred Stock Investing* every other year. While this fifth edition focuses on the low-rate

[1] See page 94.

conditions that are currently in front of us and are expected to remain so for the next couple of years, I wanted to include this chapter describing how to take advantage of a "Fed-free" preferred stock market.

Just remember that the remainder of this chapter discusses a technique that CDx3 Investors use to identify purchase candidates during market conditions that have yet to reappear. But those conditions, characterized by higher dividend rates being offered by new CDx3 Preferred Stocks for lower market prices, will reappear once we return to a Fed-free marketplace.

As the Fed exits the market, sub-$25 prices will be much more common than we see today; buying higher paying CDx3 Preferred Stocks for less than $25 per share will be commonplace (with or without using the OTC stock exchange).

While the technique for identifying purchase candidates during high-rate/low-price conditions that I am about to show you will work whenever such conditions presents themselves again, the data that I will use here to illustrate this technique is from the end of June 2011.

The CDx3 Bargain Table

We are going to create a powerful table that I call the “CDx3 Bargain Table.”

If you were to create a CDx3 Bargain Table in today's low-rate/high-demand/high-price environment you would find that it contains relatively few choices. But as the Fed exits the bond market the number of CDx3 Preferred Stocks that appear on your CDx3 Bargain Table will increase. During the historically low-demand market of the crisis years, for example, the CDx3 Bargain Table identified dozens of CDx3 Preferred Stocks to pick from.

In a Fed-free marketplace, do-it-yourself CDx3 Investors will be able to follow these steps and the result will always be a list of the highest quality preferred stocks that not only meet your goals but are at a point in time that tends to favor buyers.

First, I will describe the characteristics of the CDx3 Bargain Table then I will conclude this chapter by explaining an easy way to put one together with information you are already collecting as a do-it-yourself CDx3 Investor[2].

Less Than $25 per Share

As explained on page 154, preferred stock investors add a layer of principal protection by purchasing shares for a market price that is less than the security's par value ($25 per share for CDx3 Preferred Stocks). So when looking for CDx3 Bargain Table candidates, that's your first criterion. Only issues that can be purchased at or below $25 per share will be considered.

Just Beginning a New Dividend Quarter

For your CDx3 Bargain Table you are looking for CDx3 Preferred Stocks that are at a point in time that tends to favor buyers. This is where we can use the Rule of Buyer/Seller Behavior from page 49. A preferred stock that is closer to the end of its dividend quarter (payday) will tend to take on more value in the marketplace than an otherwise identical preferred stock that is further away.

That means that the market price of a CDx3 Preferred Stock that has just completed one dividend quarter and is now about 90 days away from its next payday will tend to be lower than it would be

[2] CDx3 Notification Service subscribers: The current CDx3 Bargain Table is generated automatically for you in real-time when you click on the CDx3 Bargain Table Hotlist on the CDx3 Notification Service website.

otherwise; preferred stocks that are beginning a new dividend quarter are at a point in time that tends to favor buyers.

So when you put together your CDx3 Bargain Table you want to include CDx3 Preferred Stocks that are beginning a new dividend quarter this month (not all CDx3 Preferred Stocks use the same quarterly schedule; see page 276).

Not Likely or Able To Be Called

A CDx3 Preferred Stock that is about to be called by its issuing company does not usually attract a lot of buyers since, once the shares are redeemed, the issuing company pays shareholders $25 per share and that's the end of that. There are no further dividend distributions past that point.

So *when market conditions favor calls* (e.g. periods of lower dividend rates), your CDx3 Bargain Table should not include CDx3 Preferred Stocks that are beyond their respective call dates.

But if *market conditions do not favor calls* (e.g. periods of higher dividend rates), CDx3 Preferred Stocks that have exceeded their call dates are just as much in play as those that have yet to reach their call dates and can be included in your CDx3 Bargain Table.

As described in chapter 3, whether or not market conditions favor calls of previously issued CDx3 Preferred Stocks depends largely on whether or not the issuing company can save money by issuing a new preferred stock and using the proceeds to buy back the shares of the older issue.

To save money with this "refinancing" maneuver, dividend rates from five years earlier have to have been higher, otherwise market conditions do not favor calls since there is no savings to be had by the issuing company (see page 127 for an example). Once preferred stock dividend rates go back up that's exactly the situation we will have;

future rates are going to be higher than today's historically low rates, bringing calls to a halt.

Therefore, as dividend rates increase you will be able to include CDx3 Preferred Stocks that are beyond their published call dates in your CDx3 Bargain Table.

Two Quarters Old

When dividend rates for newly issued CDx3 Preferred Stocks are increasing, prices of previously issued CDx3 Preferred Stocks are falling (good news for buyers). Initially priced at $25 per share, a new CDx3 Preferred Stock's market price will often fall to more favorable pricing (below $25) within the first two dividend quarters.

I attribute this pattern to two factors:

1) Preferred stock investors generally favor issues with a longer remaining dividend payout. A just-introduced preferred stock with 20 dividends left before its call date is more valuable than one with 18 remaining dividends before becoming callable. That preference often becomes noticeable in the market price when there is a two quarter difference; and

2) Since newer issues are coming out with higher dividend rates, older issues are not as valuable. Depending on how aggressively rates are going up, the commensurate price drop usually occurs within two dividend quarters.

When dividend rates are increasing a little patience often increases your sub-$25 choices. Looking at just-introduced issues while dividend rates are increasing could lead you to pay more than you need to for the same shares. During a period of increasing dividend rates, your CDx3 Bargain Table should include CDx3 Preferred Stocks that are at least two dividend quarters old.

Example: Ending-June 2011 CDx3 Bargain Table

To summarize, for your CDx3 Bargain Table you are looking for CDx3 Preferred Stocks that meet the following conditions:

1) Issues that are available for a market price less than $25;
2) Issues that are just beginning a new dividend quarter, the point in time when the Rule of Buyer/Seller Behavior tells us that the market price will tend to favor buyers;
3) If market conditions do not favor calls, include issues that have exceeded their call dates; and
4) Issues that are at least two quarters old (as long as dividend rates offered by new issues are increasing).

Here are the sixteen CDx3 Preferred Stocks that met these criteria during the higher rate/lower price environment of late-June 2011 (sorted by market price)[3].

[3] Data date for the CDx3 Bargain Table example in this chapter is June 29, 2011.

Ending-June 2011 Purchase Candidates

CDx3'S AVAILABLE BELOW $25, EARLY DAYS OF NEW DIV QUARTER

Symbol	↑ Last Price	Ex-Div Date	Call Date	Moody's
PLD-S	$23.96	06/15/2011	12/30/2008	Baa3
PLD-R	$23.99	06/15/2011	11/28/2008	Baa3
MSZ	$24.66	06/28/2011	10/15/2011	Baa2
PLD-L	$24.68	06/30/2011	6/23/2008	Baa2
PSB-P	$24.73	06/13/2011	1/17/2012	Baa3
CFC-A	$24.76	06/28/2011	4/11/2008	Baa3
VNO-G	$24.82	06/13/2011	12/22/2009	Baa3
VNO-I	$24.85	06/13/2011	8/31/2010	Baa3
WRI-D	$24.87	06/01/2011	4/30/2008	Baa3
WRI-E	$24.87	06/01/2011	7/08/2009	Baa3
MJH	$24.95	06/13/2011	12/31/2006	Baa3
VNO-H	$24.95	06/13/2011	6/17/2010	Baa3
KIM-F	$24.99	06/29/2011	6/05/2008	Baa2
PL-A	$24.99	06/27/2011	9/25/2007	Baa3
VNO-F	$24.99	06/13/2011	11/17/2009	Baa3
PLD-P	$25.00	06/30/2011	8/25/2011	Baa2

Source: CDx3 Notification Service database, www.PreferredStockInvesting.com. Data date: June 29, 2011

Since market conditions did not favor calls at the end of June 2011, this table (generated from the CDx3 Notification Service database at the time) includes CDx3 Preferred Stocks that had exceeded their call dates as well as those that had yet to reach their call dates.

Because all of our candidates are in the early days of a new dividend quarter (or would be the following day), the Rule of Buyer/Seller Behavior tells us that their market prices will tend to be relatively low[4].

By using the Rule of Buyer/Seller Behavior we have now identified, out of the 1,077 preferred stocks that were trading on U.S. stock exchanges at the time, the sixteen highest quality issues that were at a point in time that most strongly favored buyers on June 29, 2011.

Making a Purchase Consistent with Your Goals

With the candidates identified, the next step is to determine which one(s), if any, to purchase. Which CDx3 Preferred Stock candidate is the best fit for your personal financial goals, resources and risk tolerance?

Only you can answer that question. Different CDx3 Investors are going to have differing investment objectives. Some might want to steer their purchases toward the highest dividend income producers while others may favor longer-term capital gain opportunities, for example.

Maximum Dividend Yield

Let's add a couple of columns that will serve to identify the real bargains even further.

[4] CDx3 Notification Service subscribers: Use the 'Ex-Div Calendar' tab on the CDx3 Notification Service website to see a list of CDx3 Preferred Stocks organized by their ex-dividend date calendar.

For those who favor dividend income, we can add a column that shows the declared dividend rate that each of our candidate CDx3 Preferred Stocks pays (found right on the cover page of the prospectus and also provided in chapter 17).

Once we have the declared dividend rate for each candidate, it is a very simple matter to calculate the "yield" (the return that you are making in dividend income on the money that you actually have invested) since we already have the current market price.

Here are our sixteen candidates with additional columns showing their respective dividend rates and yields[5]:

[5] The formula for Yield seen in these tables is the same as that used by brokerage systems for dividend paying securities and can be found on page 242.

Ending-June 2011 Purchase Candidates

DIVIDEND RATE (COUPON) AND DIVIDEND YIELD COLUMNS ADDED

Symbol	↑ Last Price	Ex-Div Date	Call Date	Moody's	Div Rate	Yield
PLD-S	$23.96	06/15/2011	12/30/2008	Baa3	6.750%	7.04%
PLD-R	$23.99	06/15/2011	11/28/2008	Baa3	6.750%	7.03%
MSZ	$24.66	06/28/2011	10/15/2011	Baa2	6.60%	6.69%
PLD-L	$24.68	06/30/2011	6/23/2008	Baa2	6.500%	6.58%
PSB-P	$24.73	06/13/2011	1/17/2012	Baa3	6.70%	6.77%
CFC-A	$24.76	06/28/2011	4/11/2008	Baa3	6.75%	6.82%
VNO-G	$24.82	06/13/2011	12/22/2009	Baa3	6.625%	6.68%
VNO-I	$24.85	06/13/2011	8/31/2010	Baa3	6.625%	6.67%
WRI-D	$24.87	06/01/2011	4/30/2008	Baa3	6.75%	6.79%
WRI-E	$24.87	06/01/2011	7/08/2009	Baa3	6.95%	6.99%
MJH	$24.95	06/13/2011	12/31/2006	Baa3	7.25%	7.26%
VNO-H	$24.95	06/13/2011	6/17/2010	Baa3	6.75%	6.76%
KIM-F	$24.99	06/29/2011	6/05/2008	Baa2	6.65%	6.65%
PL-A	$24.99	06/27/2011	9/25/2007	Baa3	7.25%	7.25%
VNO-F	$24.99	06/13/2011	11/17/2009	Baa3	6.75%	6.75%
PLD-P	$25.00	06/30/2011	8/25/2011	Baa2	6.85%	6.85%

Source: CDx3 Notification Service database, www.PreferredStockInvesting.com.
Data date: June 29, 2011

Now we are really getting somewhere. If you are looking for the best dividend income performers, they have just been identified for you.[6]

You can see how your actual yield increases, when compared to the declared dividend rate, when the Rule of Rate/Price Opposition pushes the market prices of our candidates down below $25 per share.

Knowing the dividend yield is very important since this value, unlike the declared dividend rate, takes into account your purchase price[7]. For example, look at PLD-R and WRI-D. Both of these CDx3 Preferred Stocks have the same investment grade rating (Baa3) and 6.750% dividend rate. But because PLD-R's market price is sufficiently lower than WRI-D's ($23.99 versus $24.87, respectively), your dividend return (yield) is actually higher with PLD-R.

Those looking to maximize their dividend return would be better off with PLD-R than WRI-D even though the two securities have the same declared dividend rate.

This example illustrates how just picking the CDx3 Preferred Stock with the highest declared dividend rate is not necessarily the best move for those looking for the highest dividend income performer.

Highest Capital Gain Opportunity

Beyond dividend income there are additional investment objectives that this table can help us with.

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[6] Remember that we are looking at June 2011 data. My intent here is to show do-it-yourselfers how to build a CDx3 Bargain Table so that you will be able to do so when the time comes (a market environment where dividend rates are higher and market prices are lower).

[7] See chapter 16 for a presentation of the various calculations used to measure the return of a preferred stock investment and the pros and cons of each.

What if you are more interested in positioning yourself for the highest capital gain, rather than current dividend income?

Remember, in the event that the issuing company of a CDx3 Preferred Stock "calls" the issue, you will receive $25.00 for every share that you own, regardless of your purchase price or the then-current market price.

For CDx3 Investors who are interested in a longer-term capital gain opportunity we can add a column to our CDx3 Bargain Table that shows the capital gain opportunity in the event that your "built-in buyer" (the issuing company) calls the issue and buys it back from you for a price of $25.00.

Note that the following table is the same as those presented above but I have changed the format here so that I can add a couple of calculated columns.

Sym	Last Price[8]	Ex-Div Date	Call Date	Rating	Div Rate	Div Yield	Cap Gain (if called)
PLD-S	$23.96	06/15/11	12/30/08	Baa3	6.750%	7.04%	**$1.04**
PLD-R	23.99	06/15/11	11/28/08	Baa3	6.750%	7.03%	1.01
MSZ	24.66	06/28/11	10/15/11	Baa2	6.600%	6.69%	0.34
PLD-L	24.68	06/30/11	06/23/08	Baa2	6.500%	6.58%	0.32
PSB-P	24.73	06/13/11	01/17/12	Baa3	6.700%	6.77%	0.27
CFC-A	24.76	06/28/11	04/11/08	Baa3	6.750%	6.82%	0.24
VNO-G	24.82	06/13/11	12/22/09	Baa3	6.625%	6.68%	0.18
VNO-I	24.85	06/13/11	08/31/10	Baa3	6.625%	6.67%	0.15
WRI-D	24.87	06/01/11	04/30/08	Baa3	6.750%	6.79%	0.13
WRI-E	24.87	06/01/11	07/08/09	Baa3	6.950%	6.99%	0.13
MJH	24.95	06/13/11	12/31/06	Baa3	7.250%	**7.26%**	0.05
VNO-H	24.95	06/13/11	06/17/10	Baa3	6.750%	6.76%	0.05
KIM-F	24.99	06/29/11	06/05/08	Baa2	6.650%	6.65%	0.01
PL-A	24.99	06/27/11	09/25/07	Baa3	7.250%	7.25%	0.01
VNO-F	24.99	06/13/11	11/17/09	Baa3	6.750%	6.75%	0.01
PLD-P	25.00	06/30/11	08/25/11	Baa2	6.850%	6.85%	0.00

Where MJH might catch the interest of those looking for dividend income (7.26% yield), PLD-S would be worth considering for those seeking to position themselves for a nice capital gain in the event of a call ($1.04 per share).

Which one you invest in, if any, gets back to your personal goals, resources and risk tolerance. But I think that you can see how this simple table is able to identify the real bargains for you.

Through the iterations of this table, we have seen how those who favor dividend income can quickly identify their strongest candidates. Similarly, by adding the last column, CDx3 Investors who favor longer-term capital gain opportunities can see their best choices.

[8] Closing market prices on June 29, 2011.

But what about CDx3 Investors who want the best of both worlds?

Best Overall Return

By looking at the above table, can you spot the top three CDx3 Preferred Stocks that, in the event of a call on their call date, offer the highest *overall* return? The two lowest cost issues, PLD-S and PLD-R, are pretty obvious; but what about the CDx3 Preferred Stock with the third best overall return?

As first described on page 102, the "effective annual return" (EAR) of an investment considers (1) the declared dividend rate, (2) your purchase price and (3) the number of dividend payments that you will receive before selling on the sell date.

Once calculated for each of our candidates (using the EAR formula provided in chapter 16), the effective annual return will show us the CDx3 Preferred Stocks that will produce the highest overall return on our investment.

The CDx3 Bargain Table identifies the CDx3 Preferred Stocks that are most likely to offer strong financial performance for CDx3 Investors who have varying investment objectives.

At the end of June 2011, the average interest rate being paid by a bank Certificate of Deposit was 1.41%[9]. Now take a look at the last column that I just added on the far right of the CDx3 Bargain Table on the next page.

Compare the EAR column to the Dividend Rate column. By adding a capital gain on top of our dividend income we are able to boost the overall return.

[9] 24-months, $10k; source: *bankrate.com*.

CDx3 Bargain Table
(Ending June 2011)

Sym	Last Price	Ex-Div Date	Call Date	Rating	Div Rate	Div Yield	Cap Gain (if called)	EAR
PLD-S	$23.96	06/15/11	12/30/08	Baa3	6.750%	7.04%	**$1.04**	**10.13%**
PLD-R	23.99	06/15/11	11/28/08	Baa3	6.750%	7.03%	1.01	**10.03%**
MSZ	24.66	06/28/11	10/15/11	Baa2	6.600%	6.69%	0.34	7.79%
PLD-L	24.68	06/30/11	06/23/08	Baa2	6.500%	6.58%	0.32	7.62%
PSB-P	24.73	06/13/11	01/17/12	Baa3	6.700%	6.77%	0.27	**9.24%**
CFC-A	24.76	06/28/11	04/11/08	Baa3	6.750%	6.82%	0.24	7.64%
VNO-G	24.82	06/13/11	12/22/09	Baa3	6.625%	6.68%	0.18	7.33%
VNO-I	24.85	06/13/11	08/31/10	Baa3	6.625%	6.67%	0.15	7.24%
WRI-D	24.87	06/01/11	04/30/08	Baa3	6.750%	6.79%	0.13	7.31%
WRI-E	24.87	06/01/11	07/08/09	Baa3	6.950%	6.99%	0.13	7.52%
MJH	24.95	06/13/11	12/31/06	Baa3	7.250%	**7.26%**	0.05	7.60%
VNO-H	24.95	06/13/11	06/17/10	Baa3	6.750%	6.76%	0.05	7.78%
KIM-F	24.99	06/29/11	06/05/08	Baa2	6.650%	6.65%	0.01	6.85%
PL-A	24.99	06/27/11	09/25/07	Baa3	7.250%	7.25%	0.01	7.48%
VNO-F	24.99	06/13/11	11/17/09	Baa3	6.750%	6.75%	0.01	6.95%
PLD-P	25.00	06/30/11	08/25/11	Baa2	6.850%	6.85%	0.00	7.03%

For the purposes of calculating the Effective Annual Return, I have used the call date as the sell date for those CDx3 Preferred Stocks that had yet to reach their respective call dates by the end of June 2011 (PSB-P, PLD-P). For TRUPS I used January 1, 2013 for the sell date which is the effective date of section 171 of the Wall Street Reform Act (MSZ, CFC-A, MJH, PL-A). For all others, I also used January 1, 2013 as the sell date for comparability.

The third best overall return comes from PSB-P at 9.24%.

Using the Rule of Buyer/Seller Behavior to make your purchases at a point in time that tends to favor buyers, and doing so for a market price less than $25.00 per share, adds a layer of principal protection and positions you for a downstream capital gain in the event of a call while generating respectable dividend income in the meantime.

Whether you are looking for high current dividend income, a longer-term capital gain opportunity or the strongest overall return in the event of a call, the CDx3 Bargain Table identifies the strongest candidates for your consideration.

Time Saving Tip for Do-It-Yourselfers

Subscribers to the CDx3 Notification Service have a one-click "HotList" available to them on the CDx3 Notification Service website that, when clicked, generates the CDx3 Bargain Table automatically.

For do-it-yourselfers, here's a time-saving tip for producing your own version of the CDx3 Bargain Table.

In chapter 7 I showed you how to use the U.S. Securities and Exchange Commission's online EDGAR system to identify new CDx3 Preferred Stocks. As you do so, it will save you tons of time if you keep track of the dividend payment quarter used by each.

The simplest way to do this is to create three "watchlists" for CDx3 Preferred Stocks, one for each quarterly dividend schedule, in your broker's online system (some systems refer to watchlists as "portfolios"). So you will have a watchlist for CDx3 Preferred Stocks that use the January-April-July-October dividend schedule, a second watchlist for those that use the February-May-August-November schedule and a third for those that use the March-June-September-December schedule (the calendar quarter).

Your broker's system will provide the ex-dividend dates, current market prices and yields automatically. Whenever you want to

generate a CDx3 Bargain Table just pull up the watchlist for the month just ended and you will have a list of CDx3 Preferred Stocks that are in the early days of a new dividend quarter. Sort the list by market price and eliminate all of those that are priced above $25. You'll have your list of purchase candidates for your CDx3 Bargain Table.

To add the EAR column, use your broker system's download function to get the watchlist data onto your computer in spreadsheet format. Then copy the EAR formula on page 245 into your spreadsheet and you'll have it.

Until the Federal Reserve exits the bond market and returns rates to the control of buyers and sellers, using the Over-The-Counter stock exchange to purchase newly issued CDx3 Preferred Stocks will generally allow you to do so at wholesale market prices (below $25 per share).

But the time will come when dividend rates increase and market prices become more attractive. During those Fed-free conditions, the CDx3 Bargain Table will help you to identify purchase candidates that not only meet all ten of the CDx3 Selection Criteria, but are also at a point in time that tends to favor buyers.

PART IV

Selling the Highest Quality Preferred Stocks

If you decide to just hang on to your CDx3 Preferred Stocks and enjoy the great dividend income, that's your business.

But if the market price increases to a point where it may be worth selling, this Part of *Preferred Stock Investing* explains how to do so at the right time.

Specifically:

- ✓ Chapter 13 shows you the dividend income that CDx3 Preferred Stocks have provided since 2001 and identifies two capital gain opportunities that allow you to pile more income on top – selling for the Target Sell Price or selling to your "built-in buyer;"
- ✓ Chapter 14 describes how to know if you are better off by holding on to a CDx3 Preferred Stock or by selling it using the Target Sell Price as a guide; and
- ✓ Chapter 15 shows you how an approaching call date can affect your investing decisions. Research is presented here that allows you to assess the likelihood that your CDx3 Preferred Stock will be called by your built-in buyer.

THIRTEEN

ADDING CAPITAL GAINS TO GREAT DIVIDEND INCOME

Over the last several chapters you have learned how, when and where to purchase CDx3 Preferred Stocks during various market conditions. And always for less than $25 per share.

As soon as you purchase a CDx3 Preferred Stock, the CDx3 Income Engine starts sending dividend income your way at a steady pace. For "traditional" preferred stock investors, that's good enough. Since the dividend rates paid by CDx3 Preferred Stocks usually range from about 6% to 9%, just cashing the nice quarterly dividend checks meets the goals of many individual investors.

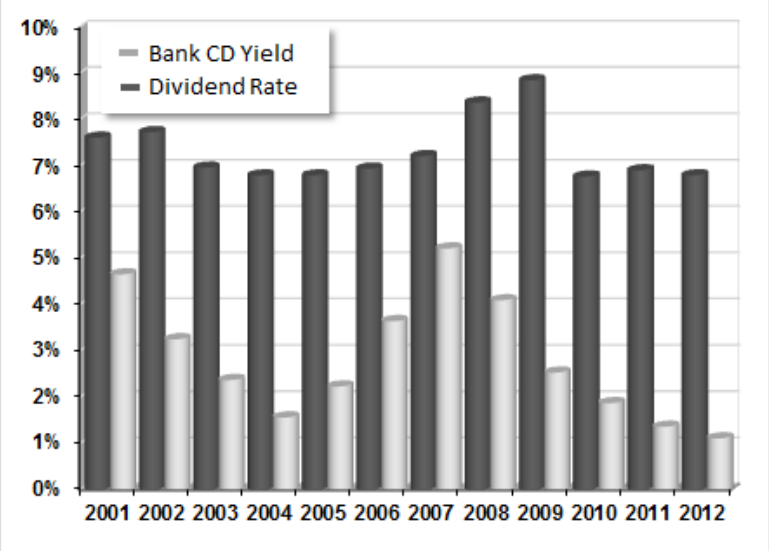
Think about that. The least rate of return that you can expect to receive on a CDx3 Preferred Stock is the declared dividend rate. And that's if you purchase your shares at $25.00 per share.

Remember, since the dividend is based on a $25 share value, your return (your yield) is actually higher than the declared dividend rate when you purchase your shares for less than $25 as you learned to do in Part III.

The below chart shows the average annual dividend rate that you would have earned had you purchased every CDx3 Preferred Stock issued since January 2001 for $25 per share.

CDx3 Dividends vs. Bank CD Yield

CDx3 PREFERREDS OUTPERFORM BANK CDs BY AN AVERAGE OF 3.15x



year	ave CDx3 div rate	ave bank CD Yield	times better
2001	7.61%	4.66%	1.63x
2002	7.73%	3.26%	2.37x
2003	6.96%	2.38%	2.93x
2004	6.80%	1.57%	4.33x
2005	6.80%	2.24%	3.03x
2006	6.94%	3.65%	1.90x
2007	7.21%	5.22%	1.38x
2008	8.37%	4.10%	2.04x
2009	8.85%	2.54%	3.48x
2010	6.77%	1.88%	3.60x
2011	6.91%	1.37%	5.04x
2012	6.80%	1.12%	6.07x
	7.31%	**2.83%**	**3.15x**

See chapter 17 for an itemization of each CDx3 Preferred Stock's performance by year.
Bank CDs: 24 month, top ten U.S. average APY. Source: Bankrate.com

As illustrated by this chart, the dividend rate paid by CDx3 Preferred Stocks, before we even talk about the possibility of adding a downstream capital gain, is substantially higher than the interest rates earned by bank CDs.

You'll have to decide if the lower investment risk associated with bank CDs is worth the lower income opportunity that this chart makes clear. But I think knowing what the exact difference is can be an important piece of information to have when making that decision.

The traditional advice given to preferred stock investors is to buy them for the nice quarterly dividends and ignore the fluctuations in market price. If you're not planning on selling your preferred stock, what difference does it make whether the current market price is higher or lower than the price you paid some time ago?

Richard Young, who has been publishing a very successful investment newsletter for over 20 years, puts it this way:

> "Preferreds trade like long bonds, meaning values fall in an environment of advancing long-term interest rates. Pay no attention to volatility in values on your brokerage statement. You are investing simply for a flow of cash to spend or to compound. That's it. Forget capital gains.[1]"

While I generally agree with Mr. Young's conservative investment approach, he and I part company on this point.

Many investors cannot stand to pass up a significant money making opportunity, especially when it requires next to no extra time, effort or risk. "Forget capital gains." I don't think so; not when I can increase my income by taking them at the right time. Leaving this kind of

[1] Richard Young's *Intelligence Report*

money on the table goes against the primary objective of the CDx3 Income Engine – maximize revenue.

I used to be a "traditional preferred stock investor" until I realized that I could substantially increase my income by selling at the right time and for no more time or effort than I was already expending. At that point, the opportunity to take the capital gains got pretty hard to ignore.

It's up to you, but walking away from the capital gain, when all you have to do is check the market price of your CDx3 Preferred Stock *once per quarter*, can be hard to do.

Never Sell At a Loss

The first objective of the CDx3 Income Engine is to maximize your revenue. Never sell at a loss. As I am about to explain throughout this chapter, with CDx3 Preferred Stocks there is no need to.

In Part III you learned how to always purchase your CDx3 Preferred Stocks for a market price below $25 per share. During low or stable rate conditions you do so by using the wholesale Over-The-Counter exchange as explained in chapter 9.

As new issues transition to the retail NYSE or if rates continue to fall, the market price of your shares will generally exceed $25 per share (see the chart on page 163 for 2012 results). By paying less than $25 per share, those interested in selling are often able to add a nice capital gain on top of the great dividend income that they've been collecting in the meantime.

Two Chances to Sell For a Capital Gain

As the Rule of Rate/Price Opposition explains, as dividend rates swing up and down over time, preferred stock market prices tend to move right along with them but in the opposite direction.

During a high demand market (market prices above $25 per share), you are going to have two opportunities to sell for a nice capital gain if you choose to be a seller:

1) Selling for the Target Sell Price; or
2) Selling to your "built-in buyer."

As chapter 14 will explain, the Target Sell Price calculation helps you answer the often-asked question "Am I better off selling now and taking a capital gain or holding and collecting more dividend income?"

If you choose to forego selling and taking the capital gain, your next selling opportunity will come from the issuing company itself. If market conditions favor a call and the issuing company buys your shares back from you at $25 per share once the call date has arrived, you will have collected more dividend income (since you did not sell earlier for the Target Sell Price), but your capital gain will be less than it would have been.

A high demand market is all about deciding how much money you want to make and how quickly you want to make it.

Chapter 15 shows you how to determine the likelihood that the issuing company of your CDx3 Preferred Stock will call your shares once the call date arrives.

Which of these two capital gain opportunities to take advantage of (if at all) is, of course, up to you.

But because you know from the previous chapters how to purchase CDx3 Preferred Stocks for a market price less than $25.00, there will come a day when you are staring at a nice capital gain if you sell. You're going to have a decision to make.

The following two chapters explain these two selling opportunities – selling for your Target Sell Price (chapter 14) and selling to your built-in buyer (chapter 15).

FOURTEEN

SELLING FOR THE TARGET SELL PRICE

The Target Sell Price, as you are about to learn, helps answer the question: "Am I better off selling my preferred stock now for a capital gain or holding onto my shares longer and collecting more dividend income?"

The answer, of course, depends on the price that you can sell your shares for. But at what market price are you better off by selling rather than holding?

Answering that question can be a real hair-puller so let's look at an example.

In chapter 3 I described a scenario where you paid $25.00 for a single share of a fictional CDx3 Preferred Stock that pays an 8% dividend ($0.50 per quarter).

By selling to me at $25.49 the day before the ex-dividend date (the last day of the dividend quarter), you will miss out on any downstream capital gain, not to mention all future quarterly dividends. Why, then, would you sell to me for a measly *one* quarter's worth of dividend cash?

Answer: You wouldn't. You'd also want to be compensated for the future capital gain opportunity and dividend income that you'd be giving up.

During a high demand market (when dividend rates are *decreasing* and market prices have exceeded $25 per share) sellers of CDx3 Preferred Stocks can frequently demand up to *four* quarters worth of bonus revenue. More than that and you are going to miss out on some great prices; less than that and you're leaving money on the table.

Using that guideline, in our fictional example you would ask me for not $25.49, but for $27.00 ($25 + (4 x $0.50)).

But we all know that market prices are not going to be relatively high forever. There will come a time when dividend rates start increasing again and market prices start heading back toward $25. As demand softens and prices weaken (but are still above $25 per share), sellers of CDx3 Preferred Stocks will have to lower their expectations, finding themselves able to only demand three, two or even only one quarter's worth of bonus revenue.

Calculating the Target Sell Price

So the number of quarter's worth of bonus revenue that you can demand when selling a CDx3 Preferred Stock depends on the strength of demand in the market.

Target Sell Price:

During a high demand market the Target Sell Price that you would be looking for on the last day of each quarter (when market prices tend to peak due to the Rule of Buyer/Seller Behavior) is calculated using the following formula:

$25 + ([number of bonus quarters] x [quarterly dividend amount])

We'll get to the calculation of the number of bonus quarters later in this chapter. Once you know the Target Sell Price of your CDx3 Preferred Stock, it is now a matter of continuing to collect your quarterly dividend checks until the market price exceeds the Target Sell Price.

When to Look For the Target Sell Price

But wait. One of the three objectives of the CDx3 Income Engine is to minimize work. No one wants to spend their days staring at their computer screen, watching the market price of your CDx3 Preferred Stock with your computer mouse carefully poised over the sell button.

This is where the Rule of Buyer/Seller Behavior (page 49) takes the work out of selling CDx3 Preferred Stocks. The Rule of Buyer/Seller Behavior tells us that the market price of a CDx3 Preferred Stock will tend to increase as the last day of the dividend quarter approaches (the day prior to the quarterly ex-dividend date).

Because of the Rule of Buyer/Seller Behavior, if you want to know if the market price of your CDx3 Preferred Stock has exceeded its Target Sell Price you usually only need to check the market price on the last day of the dividend quarter.

If you're not going to be around on the last day of the dividend quarter you can just tell your broker to sell if the market price exceeds

the Target Sell Price or you can use the trade trigger[1] feature of your online trading account.

The rest of the time, enjoy your golf game.

I will discuss how to set the number of bonus quarters when calculating the Target Sell Price of a CDx3 Preferred Stock in a moment. But first, let's look at an example and see how you would have done when you sold a real CDx3 Preferred Stock.

Kimco Realty (NYSE: KIM) is a $10 billion Real Estate Investment Trust (REIT) founded in 1966 and headquartered in New Hyde Park, New York. The company is the largest owner and operator of community shopping centers in the United States. Kimco's 896 properties include 131 million square feet of leasable space.[2]

On August 24, 2010, KIM issued a CDx3 Preferred Stock paying a 6.900% annual dividend under the trading symbol KIM-H. KIM-H has a call date of August 30, 2015.

In August 2010 CDx3 dividend rates were stable so the number of bonus quarters value for KIM-H was 2 quarters of bonus revenue (more on this in a moment).

With an annual dividend rate of 6.900%, you will earn $0.431 per quarter for every share of KIM-H that you own. Using the formula for the Target Sell Price presented earlier, your Target Sell Price for KIM-H is therefore $25.86 ($25 + (**2** x $0.431)).

[1] Most online brokerages, such as TDAmeritrade, provide the capability to set up a trade trigger in advance. You specify the trading symbol of the CDx3 Preferred Stock that you want to sell and the market price that you want to sell at. The system automatically monitors the daily market price for you and creates a sell order if the market price hits the amount you specified.

[2] As of December 31, 2012. Source: *www.kimcorealty.com*

Below is a table that shows the closing price of KIM-H on the last day of each dividend quarter (the day that the quarterly "peak price" is most likely to occur) during its first year of trading (2011).

Qtr Starts On Ex-Dividend Date	Qtr Ends On Day Prior To Next Ex-Dividend Date	Market Price On Quarter Start Date	Looking For Target Sell Price	Market Price On Quarter End Date
Dec 30, 2010	Mar 29, 2011	$ 24.10	$ 25.86	$ 25.10
Mar 30, 2011	Jun 28, 2011	$ 24.82	$ 25.86	$ 25.73
Jun 29, 2011	Sep 28, 2011	$ 25.42	$ 25.86	$ 25.81
Sep 29, 2011	Dec 29, 2011	$ 25.83	$ 25.86	$ 27.72

Notice that you can see the quarterly saw tooth pattern described on page 53; the market price of KIM-H increases each quarter then drops as a new quarter begins (the Rule of Buyer/Seller Behavior in action).

On the day prior to each of these quarterly ex-dividend dates, when the Rule of Buyer/Seller Behavior is most likely to push up the market price to its peak for the quarter, you check the market price of KIM-H to see if it meets or exceeds your Target Sell Price of $25.86.

Looking at the above table, at the end of the first quarter, on March 29, 2011, you would have seen that the market price was $25.10. This is less than your Target Sell Price of $25.86. So, as a CDx3 Investor, you would not have sold on that date.

The same happens when you check the market price of KIM-H for the next quarter ending June 28, 2011. No sale yet since the market price on the last day of the June 2011 quarter ($25.73) is less than the Target Sell Price that you are looking for.

You pocket another quarter's worth of dividend income and on the last day of KIM-H's third dividend quarter (September 28, 2011) you

see that the market price is $25.81, just missing your Target Sell Price of $25.86. Back to your golf game.

Qtr Starts On Ex-Dividend Date	Qtr Ends On Day Prior To Next Ex-Dividend Date	Market Price On Quarter Start Date	Looking For Target Sell Price	Market Price On Quarter End Date
Dec 30, 2010	Mar 29, 2011	$ 24.10	$ 25.86	$ 25.10
Mar 30, 2011	Jun 28, 2011	$ 24.82	$ 25.86	$ 25.73
Jun 29, 2011	Sep 28, 2011	$ 25.42	$ 25.86	$ 25.81
Sep 29, 2011	Dec 29, 2011	$ 25.83	$ 25.86	**$ 27.72**

Three months later on December 29, 2011 you once again check the market price of KIM-H looking for your Target Sell Price of $25.86.

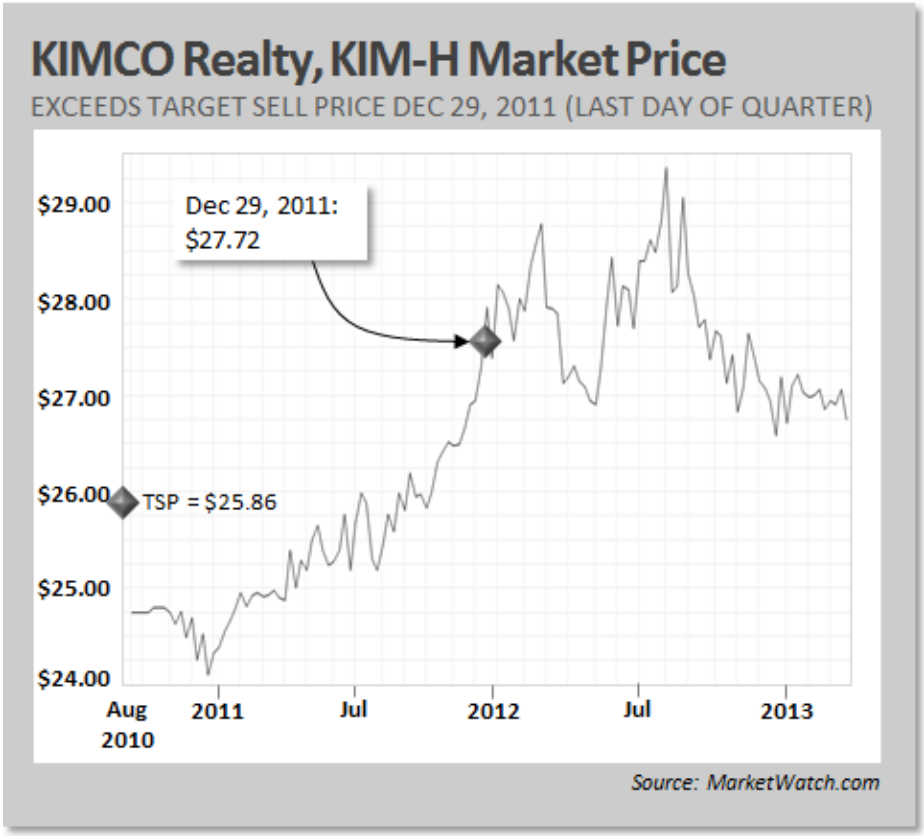
Looking at the above table, your Target Sell Price presents itself on that date. The price on that day, in fact, not only hits your $25.86 Target Sell Price, but blows right past it to $27.72.

How would you have done on your investment in KIM-H? As described in chapter 9, if you were following the method described there for buying your shares, you would have purchased KIM-H on the wholesale Over-The-Counter stock exchange for less than $25 per share[3]. For our purposes here, however, I will use $25.00 as your original purchase price.

Selling your shares on the last day of the December 2011 dividend quarter (peak market price for the quarter), you would have earned $1.94 in dividends[4] plus $2.72 in capital gain for a total gain of $4.66 per share. That's an effective annual rate of 18.24% on your original $25.00 investment.

[3] KIM-H traded on the OTC exchange under the temporary symbol KIMRZ for about $24.75 until it transitioned to the NYSE on September 17, 2010.
[4] The first quarter's payment included an extra $0.21 to cover the extra days since the August 24, 2010 IPO.

Here's the closing price chart for KIM-H from its IPO in August 2010 through March 2013.



Increasing demand for high quality preferred stocks started pushing up prices very quickly during 2011. On December 29, 2011, the last day of its fourth dividend quarter, the market price of KIM-H exceeded its Target Sell Price, closing at $27.72 on that day.

While you could have sold for a higher price at other times, doing so would have required continual monitoring of KIM-H's market prices

violating the third objective of the CDx3 Income Engine, minimize work. By following the Rule of Buyer/Seller Behavior, you captured a great price on December 29, 2011 and only had to check the market price once every three months.

By the way, in August 2010, if you had purchased a 24-month bank CD instead of this CDx3 Preferred Stock, your annual return would have been about 1.84%[5].

Determining the Number of Bonus Quarters

In chapter 3 I explained a concept known as the "time value of money." It is the time value of money that makes the Target Sell Price, and its "number of bonus quarters" parameter, work.

For example, let's say you own a preferred stock that pays an 8% annual dividend; that's $0.50 per share per quarter in dividend income to you. As long as you own your shares when the market opens on the morning of the ex-dividend date, you are going to receive $0.50 per share from the issuing company.

But what if you could sell your shares the day before the ex-dividend date (when the market price tends to most favor sellers) for $2.00 per share more than your original purchase price? Pocketing a $2.00 per share capital gain is a whole year's worth (four quarters) of dividend income that you can receive right now in one shot.

$2.00 per share now or $2.00 per share spread out over the next year; which would you choose?

Many investors would rather have the money sooner rather than have the same money later (the time value of money – sooner is better). And that's why the Target Sell Price formula is structured the way it is.

[5] 24-month average U.S. bank CD APY. Source: *BankRate.com*

Here is the formula for the Target Sell Price again:

Target Sell Price = $25 + ([number of bonus quarters] x [quarterly dividend amount])

Notice that this formula adds some number of quarter's worth of dividend income to the "par value" of a preferred stock ($25 in our case). The number of quarter's worth of dividend income is what I refer to as the "number of bonus quarters."

There are two factors to consider when setting the number of bonus quarters parameter of the Target Sell Price calculation: (1) the competitive position of the CDx3 Preferred Stock when compared to others that are being issued at the time and (2) the direction of dividend rates. After explaining how this works I'll show you a table that allows you to set the number of bonus quarters with ease.

Competitive Position

CDx3 Preferred Stocks that pay a higher dividend will tend to command a higher market price. We would therefore assign a higher number of bonus quarters value to higher dividend payers which, in turn, would result in a higher Target Sell Price.

But there is a bit more to it than that. Investors, especially large institutional investors such as pension fund managers, also consider the remaining dividend payout potential of a preferred stock.

A CDx3 Preferred Stock that has a larger remaining payout potential tends to take on more value than one that is closer to its call date, even if the older issue has a somewhat higher dividend rate.

The competitive position of a CDx3 Preferred Stock is therefore only meaningful when compared to its peers (those of similar age and, therefore, with a similar remaining dividend payout).

So when we assign the number of bonus quarters value we do so at the time of introduction when the issue is new and compare its dividend rate to its other relatively new peers issued at about the same time. Such groups of peer CDx3 Preferred Stocks live their life in the marketplace together and compete directly for investor dollars until they are retired.

CDx3 Preferred Stocks of similar age that offer higher dividend rates have a stronger competitive position and will receive a higher number of bonus quarters value than weaker peers.

Direction of Dividend Rates

When dividend rates are *decreasing*, there is upward pressure on market prices so you can command a higher selling price (i.e. raise the number of bonus quarters); when dividend rates are *increasing*, there is downward pressure on market prices so you will have to lower your expectations (i.e. lower the number of bonus quarters).[6]

The below table provides the number of bonus quarters depending on the competitive position of a CDx3 Preferred Stock you are considering and the dividend rate direction.

[6] The investing results presented in chapter 17 use the direction of dividend rates as they existed at the time of introduction. Assessing dividend rate direction at the time of sale may produce a one quarter difference in the number of bonus quarters value in some cases but would involve a substantial amount of continuous effort since recalculating all Target Sell Prices would be required each time rate direction changes occur (violating objective #3 of the CDx3 Income Engine – minimize work). Using the $25 par value in the Target Sell Price formula, rather than purchase price, mitigates much of this anomaly.

Competitive Position	Rates Decreasing	Rates Stable	Rates Increasing
Best	4	4	3
Strong	4	3	2
Weak	3	2	1
Worst	2	1	1

Example: 2003

Let's look at an example of how to use the above table to derive the number of bonus quarters. The following table lists the first five CDx3 Preferred Stocks introduced during 2003, a time when CDx3 dividend rates were *decreasing*.[7]

Look at the dividend rates (third column) being offered by businesses up until early April 2003 when WRI-D and CFC-A were issued:

IPO Date	Sym	Div Rate	Quarterly Dividend	Number of Bonus Qtrs	Target Sell Price
02/03/03	RNR-B	7.300%	$ 0.46	4	$26.85
03/31/03	REG-C	7.450%	$ 0.47	4	26.86
04/04/03	WRI-D	6.750%	$ 0.42	3	26.27
04/08/03	CFC-A	6.750%	$ 0.42	3	26.27
04/08/03	NXL-E	7.625%	$ 0.48	4	26.91

A change in the dividend rate of 0.25% or more is considered significant. What were the financial gurus at Weingarten Realty Investors (WRI) and Countrywide Financial (CFC, since acquired by

[7] See the CDx3 dividend rate chart on page 59.

Bank of America) thinking? Talk about cheap. I understand that rates were declining at the time, but why the big rush?

If you bought these five CDx3 Preferred Stocks, you are obviously going to have a more difficult time selling WRI-D and CFC-A with their miserly dividend rates.

This is a clear case where you are not going to be able to demand the same premium (four quarters worth of bonus revenue) when you sell these two (WRI-D and CFC-A) that you can when you sell the others with their much higher dividend rates. For these two, we can probably get away with demanding *three* quarters of bonus dividend revenue, but certainly not *four*.

And if dividend rates were increasing when WRI-D and CFC-A were introduced (meaning downward pressure on market prices), you probably would have had to set your price expectations even lower – to one bonus quarter per the table we saw on the previous page.

If you are tracking CDx3 Preferred Stocks on your own you already have the information you need to determine the number of bonus quarters. The competitive position of new issues and the direction of dividend rates will be clear as you review new issue introductions (see page 112)[8].

So just by looking at the dividend rate on recent CDx3 Preferred Stock issues, you can use the table on the previous page to determine the number of bonus quarters for your CDx3 Preferred Stocks. Plug that value into the formula on page 217 and you will have your Target Sell Price.

[8] CDx3 Notification Service subscribers: The current direction of dividend rates (decreasing, stable or increasing) is posted on the home page of the CDx3 Notification Service website.

Am I better off selling now for a capital gain or continuing to hold and collecting more dividend income?

By understanding the effect that competitive position and dividend rate direction have on the market prices of CDx3 Preferred Stocks, we have now constructed a simple selling model (the Target Sell Price formula) that helps CDx3 Investors answer that question.

While Part III showed you how to purchase your CDx3 Preferred Stocks for a market price below $25 per share, you now know how to sell a CDx3 Preferred Stock for more than $25 per share using the Target Sell Price as a guide.

Looking at the tables in chapter 17, we see that there have been 170 CDx3 Preferred Stocks issued between January 2001 and December 2012. Of these, using the Target Sell Price would have resulted in the sale of 145 issues.

The CDx3 Income Engine:

Use the highest quality preferred stocks to earn above average dividend income while simultaneously creating multiple downstream capital gain opportunities.

You've just learned how to create one of those downstream capital gain opportunities by looking for the Target Sell Price on the last day of the dividend quarter (per the Rule of Buyer/Seller Behavior, page 49). Now let's look at selling your CDx3 Preferred Stock to your "built-in buyer," the issuing company itself.

FIFTEEN

SELLING TO YOUR 'BUILT-IN BUYER'

The CDx3 Income Engine produces respectable results by piling a capital gain on top of the above average dividend income you are earning in the meantime.

In the previous chapter you learned how to determine the market price at which you may be better off selling a CDx3 Preferred Stock rather than holding it – the Target Sell Price.

You also learned when the market price of a CDx3 Preferred Stock is most likely to reach, or exceed, the Target Sell Price during any given dividend quarter – the last day, per the Rule of Buyer/Seller Behavior (the day prior to the ex-dividend date).

But what if the Target Sell Price never presents itself or, even if it does, what if you're enjoying the dividend income so much you simply decided not to sell?

The CDx3 Income Engine provides you with two capital gain opportunities - (1) selling for your Target Sell Price on the last day of a dividend quarter (as described in the previous chapter) and (2) selling to your "built-in buyer" (the issuing company itself) when the call date arrives.

The opportunity to sell to your built-in buyer is where the Rule of Call Date Gravity (page 63) comes in; when market conditions favor a

call, the market price of a CDx3 Preferred Stock will tend toward $25 as the call date approaches.

When Market Conditions Favor a Call

So how do you know if your CDx3 Preferred Stock is likely to be called by the issuing company or not?

To answer that question, we are going to use three of the ten CDx3 Selection Criteria:

- #1 – fixed-rate dividend;
- #2 – callable five years after IPO; and
- #10 - $25 par value

Because of these three CDx3 Selection Criteria you will be able to determine the likelihood that the issuing company of your CDx3 Preferred Stock is going to call (buy back from you at $25 per share) your shares.

The short answer is that the issuing company will tend to call your shares if it benefits them to do so. So the question really becomes, "When's that?"

Refinancing a CDx3 Preferred Stock

The likelihood of a call is directly related to the declared dividend rate of your CDx3 Preferred Stock. The higher the declared dividend rate, the more likely the call (once the call date arrives five years after its IPO date[1]).

[1] There are rare circumstances where the issuing company is allowed to call a CDx3 Preferred Stock prior to its published call date. See the discussion regarding a premature redemption on page 145.

If the issuing company can save money by issuing a new CDx3 Preferred Stock at a lower dividend rate than your five year old issue, the issuing company is motivated to call your old CDx3 Preferred Stock.

For example, let's say you purchase a new CDx3 Preferred Stock that has a declared dividend rate of 8% and hold it for five years. If the "going dividend rate" five years from now is, say, 7%, the issuing company of your now five year old CDx3 Preferred Stock can save 1% in annual dividend expense by issuing a new CDx3 Preferred Stock at 7% and using the proceeds to call (buy back from you) your old 8% shares.

The going dividend rate is just the declared dividend rate being paid by the most recently issued CDx3 Preferred Stocks.

By taking advantage of the fact that today's going dividend rate is lower than it was five years ago, the issuing company is able to "refinance" and save themselves a bunch of money.

Let's take a look at a real example of this refinancing mechanism in action.

Public Storage, Inc. (NYSE: PSA) is a $28 billion California company (market cap) founded in 1972. PSA operates over 2,200 locations in the United States and Europe, totaling more than 142 million square feet of net rental storage space.[2]

In April 2006, Public Storage issued a CDx3 Preferred Stock (PSA-I) with a 7.250% declared dividend rate.

Five years later in April 2011 the going dividend rate had dipped under 7%. That month the financial gurus at Public Storage filed with the U.S. Securities and Exchange Commission for a new preferred

[2] As of December 31, 2012. Source: *publicstorage.com*

stock (PSA-Q) paying a dividend rate of 6.500% - 0.75% lower than their Series I preferred stock from five years earlier (PSA-I).

The "Use Of Proceeds" section of a prospectus will disclose what the issuing company intends on doing with the proceeds of a new preferred stock offering. The prospectus for the new PSA-Q says the following:

> "We estimate net proceeds from this offering of approximately $315.1 million, after all anticipated issuance costs. We expect to use the net proceeds from this offering to redeem depositary shares representing interests in our 7.25% Cumulative Preferred Shares, Series I at $25.00 per share…"

By issuing a new CDx3 Preferred Stock (PSA-Q) at 6.5% and using the proceeds to call PSA-I, Public Storage saved themselves several million dollars *per year* in dividend expense.

Not bad for just filling out a form and sending it to the SEC.

When CDx3 dividend rates are falling, businesses are increasingly likely to issue new preferred stocks (such as PSA-Q) in order to refinance their old higher dividend rate (7.250%) preferred stocks (PSA-I) at the new, lower rate (6.500%). Consequently, the number of preferred stocks that are issued during a period of relatively low dividend rates tends to go up.

When rates are falling, you, as a buyer of CDx3 Preferred Stocks, will tend to have more new issues to pick from in part due to this refinancing mechanism[3].

[3] While common, issuing a new lower dividend paying preferred stock in order to generate the proceeds needed to call an older higher dividend paying issue is not the only option that the issuing company has when executing a call. Occasionally the issuing company will issue a bond (which typically carries a lower interest rate) in order to buy back an old higher dividend paying preferred stock. This approach, however, has limits since it converts equity (the preferred stock) into debt (the bond) on the company's books making the company appear less attractive to investors.

When Is It Enough?

In the previous example we saw how saving 0.75% in dividend expense was enough to tip the scales and motivate Public Storage to issue a new CDx3 Preferred Stock and use the proceeds to call (buy back from you at $25 per share) an older, higher paying issue.

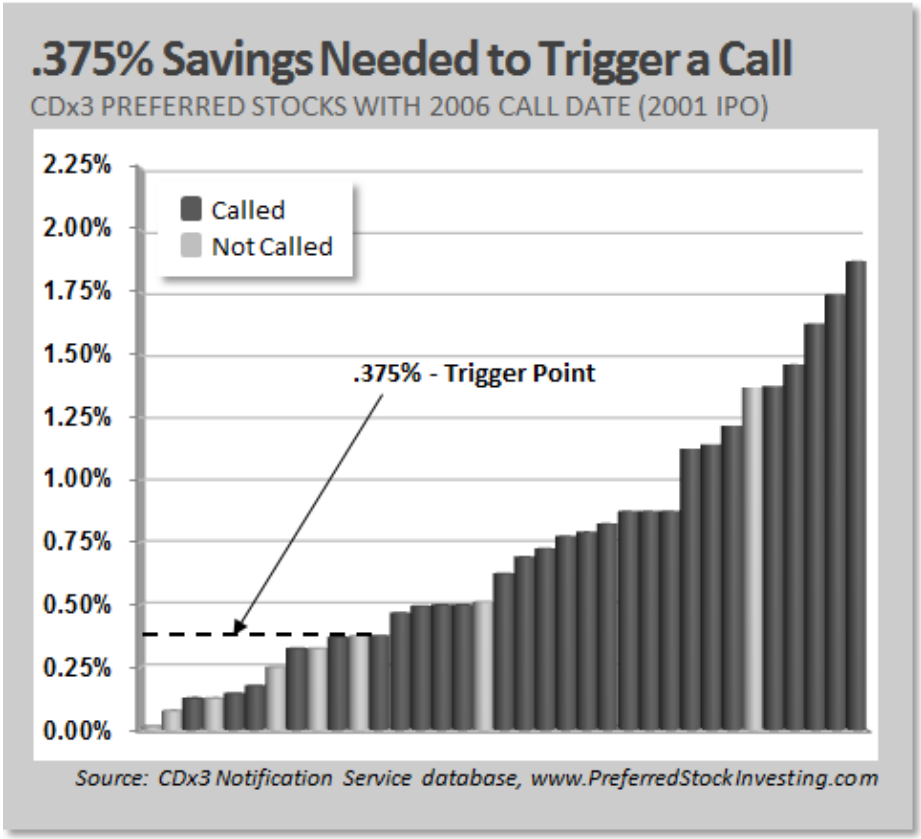
With a 0.75% savings available, market conditions obviously "favored a call" (as the Rule of Call Date Gravity puts it).

But would Public Storage have called your shares of PSA-I if they could have only saved, say, 0.50%, by doing so? What about if they could have only saved 0.25%, would your "built-in buyer" still have purchased your shares back from you?

In other words, where's the line? When is the savings enough to motivate the issuing company of a five year old CDx3 Preferred Stock to buy your shares back from you once the call date arrives? How much lower does the "going dividend rate" on the call date have to be than the declared dividend rate on your five year old shares for the issuing company to execute a call?

The answer is a scant .375% (3/8%). Less than one-half of a percentage point savings on the dividend rate is all it takes to motivate the issuing company of a CDx3 Preferred Stock to call a five year old CDx3 Preferred Stock when its call date arrives.

Can there be exceptions? Sure. I'll talk more about that in a moment. But take a look at this data from CDx3 Preferred Stocks with 2006 (pre-crisis) call dates. These were issued during 2001 when dividend rates were relatively high with many issues paying more than 8%.



Five years later, in 2006, the average CDx3 dividend rate was less than 7%, so there were savings to be had for issuing companies choosing to call their 2001 CDx3 Preferred Stocks on or near their 2006 call dates.

Of the 12 CDx3 Preferred Stocks where the savings to the issuing company was less than .375% (3/8%), six were called and six were not.

But of the remaining 23 CDx3 Preferred Stocks issued during 2001 where the savings was greater than .375% to the issuing company, 21 (all but two) were called[4].

Likelihood of a Call:

The implication of this analysis is that when the issuing company of a CDx3 Preferred Stock can save at least 0.375% in annual dividend expense, there is a 91% chance that they will call the issue on or near its call date.

With this 0.375% savings guideline in mind, take a look at the chart on page 59 that illustrates the dividend rate of CDx3 Preferred Stocks issued since 2001. During the crisis years, cash-starved banks were issuing CDx3 Preferred Stocks offering dividend rates all the way up to 9.6% (BBT-B)[5]. The high rate securities (which were all TRUPS - Trust Preferred Stocks) issued during the crisis years of 2008 and 2009 were issued with call dates occurring between 2013 and 2014, respectively.

But as of early-2013, all of these high paying TRUPS (and many more) have been redeemed by their issuing banks; they were called prematurely, prior to their published call dates.

Exceptions to the 0.375% Savings Guideline

There are times when the 0.375% savings guideline does not apply. Regulatory changes within the domestic and international banking industry, for example, triggered a standard prospectus provision that allowed banks to prematurely redeem their TRUPS prior to the published call dates of these securities (see page 145 for a more detailed explanation).

[4] Over time, variations in regulatory, commission and other costs can affect this value.
[5] For a list of CDx3 Preferred Stocks issued during 2008 and 2009 see page 262.

Another exception can involve pending litigation being faced by the issuing company. For example, on October 4, 2012 Bank of America announced the redemption of six publicly traded TRUPS valued at $5.133 billion. At the time, BAC had a total of 66 preferred stock issues outstanding, 29 of which were publicly traded. While the 0.375% savings guideline would lead us to believe that BAC would redeem the six issues with the highest dividend rates (of which there were plenty to pick from), that was not the case.

There were eight TRUPS with higher dividend rates than the six redeemed securities; each of the eight would have delivered a greater financial savings to the bank. With one exception (BAC-Z, 6.0%), the securities that were skipped over were those TRUPS originally issued by Countrywide and Merrill Lynch. The redeemed six TRUPS were all securities that were originally issued by BAC.

At the time, BAC was embroiled in a mountain of litigation surrounding issues related to these acquired institutions, at the center of which was the question of how separable these business are from their BAC parent.

While we may never know for sure the extent to which the pending litigation played a role, dividend expense savings was obviously not the main consideration that determined which outstanding securities to redeem.

Another exception to the 0.375% savings guideline can occur when the issuing company decides to redeem outstanding preferred stocks with cash rather than issue a new lower-rate security. While most bank-issued TRUPS were redeemed during 2011 and 2012, JP Morgan's remained trading long after the bank could have called them.

Then on April 8, 2013 the bank announced the redemption of the majority of its outstanding TRUPS (eight issues) for May 8, 2013 using $5 billion of cash on hand.

While the above analysis shows a 91% likelihood that a 0.375% dividend savings is enough to trigger a preferred stock call, less common circumstances such as premature redemptions, litigation considerations and balance sheet management also influence such decisions.

I'll wrap up this chapter with a brief discussion that describes the market price behavior of a preferred stock that is an obvious call candidate. If you look at the market price chart of such a preferred stock you will notice that the price is not only above $25, but it actually increases every day until the next ex-dividend date arrives. Why would anyone pay more than $25 for a preferred stock that is about to be called?

Call Date Influence on Market Price Behavior

Earlier in its life, when the call date is still several years in the future, there is no way for investors to gauge whether or not a call is going to become likely. So, for the first several years after IPO the Rule of Call Date Gravity plays no role in the market price behavior of a CDx3 Preferred Stock whatsoever.

Newer CDx3 Preferred Stocks that are still several years away from their call dates are more attractive to many longer-term investors. As described in the last chapter, longer-term investors often favor newer issues over those that are close to their call dates since the remaining dividend payout is longer.

Consequently, as the call date comes into view, those investing for the longer term turn to newer issues leaving most of the buying and selling of older preferred stocks to short-term investors (aka, speculators). It is the daily trading activity of these short-term

speculators that determines the market price of a preferred stock that has come under the influence of the Rule of Call Date Gravity.

The Positive Return Line

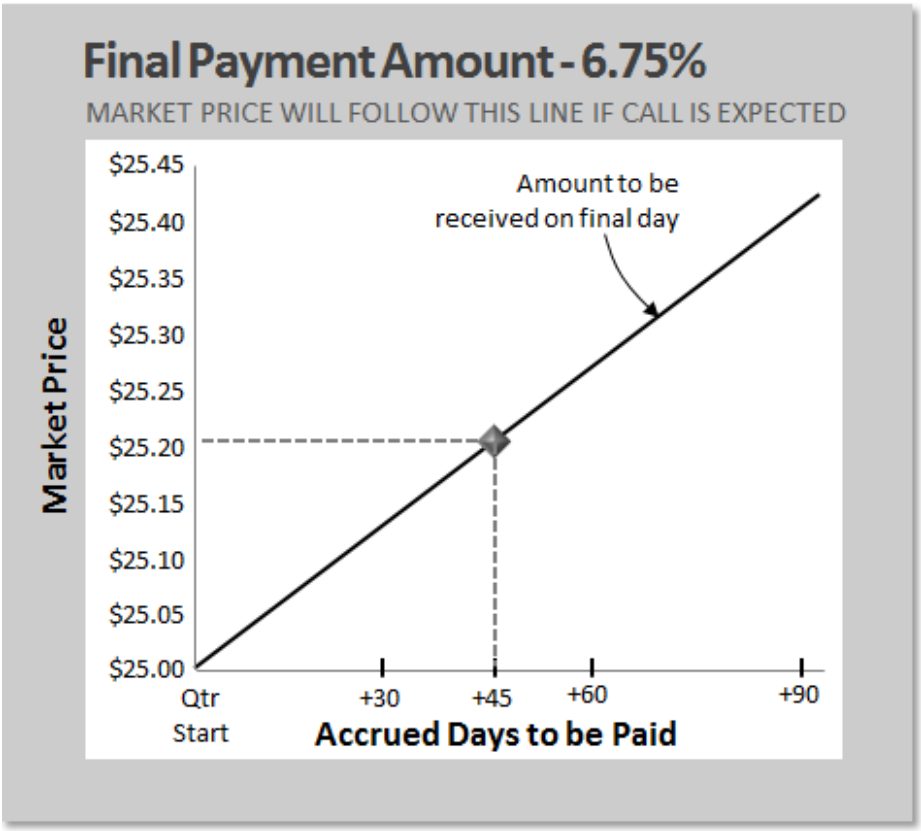
Once the market believes that a call is likely, the amount of the final payment to be received by shareholders on the final day of a CDx3 Preferred Stock's life is what drives its market price.

As discussed on page 69, the final payment to shareholders of a called preferred stock includes two components: (1) the security's par value ($25 in our case) and (2) the accrued distribution amount for the final quarter (or portion thereof).

Prior to a call announcement, the value of the accrued distribution amount increases every day throughout the quarter since the issuing company will owe shareholders for every day that goes by without a call. That is, the more days that pass without a call being announced the more days the company owes you dividends for.

For example, a 6.75% preferred stock pays $0.42 per share each quarter. For calculation purposes, a quarter is considered to be 90 days in length. So if a 6.75% preferred stock is redeemed 45 days into its dividend quarter, the issuing company would owe shareholders the security's $25 par value plus an additional $0.21 per share for a total final payment of $25.21.

The black line on the below chart shows the final payment amount over a 90 day quarter that holders of a 6.75% preferred stock will receive.



Those who purchase shares for a price that is below this line will realize a positive return on their investment in the event that a redemption is announced (that is, their purchase price will be less than the final payment received on the final day). So automated trading systems and short-term speculators buy and sell call candidates such that the market price will tend to be very close to whatever the final payment amount calculates to for the number of remaining days in the dividend quarter (i.e. very close to the line in the above chart).

It is because the accrued distribution amount increases each day that you will see preferred stock shares trading above their par value, even when they are obvious redemption candidates.

This type of speculation is contrary to objective number 3 of the CDx3 Income Engine – minimize work. CDx3 Investors buy at a time when the market tends to favor buyers, sell for a nice capital gain when the market tends to favor sellers and enjoy above average dividend income in the meantime.

During a high demand market (low rates, high prices) CDx3 Investors are always torn between selling their CDx3 Preferred Stocks or holding onto them and continuing to enjoy the great dividend income. It's a nice problem to have.

Since CDx3 Investors always purchase their CDx3 Preferred Stocks for less than $25 per share, the real question becomes - How much capital gain income do you want to pile on top of your great dividend income and when would you like to do so?

Over the last three chapters I have provided you with a couple of tools to help answer that question. You can calculate your CDx3 Preferred Stock's Target Sell Price and just check the market price on the last day of each dividend quarter to see if it is time to consider selling.

Or just hang onto your CDx3 Preferred Stock shares until the call date arrives and let your "built-in buyer" purchase your shares back from you at $25 per share when market conditions return to a point where it pays them (and you) to do so[6].

[6] Remember that companies are not required to call their preferred stocks. The "perpetual ownership trap" is described on page 141.

That's all there is to it. Your choice. Until then you can go back to your golf game and know that the quarterly dividend checks from the highest quality preferred stocks available - CDx3 Preferred Stocks - will just keep coming.

PART V

Results of the CDx3 Income Engine

This Part of *Preferred Stock Investing* shows you how you would have done had you used the CDx3 Income Engine to invest in every CDx3 Preferred Stock issued since January 2001.

Specifically:

- ✓ Chapter 16 identifies methods that are used to calculate the annual rate of return on a preferred stock investment. There are a variety of such calculations, each with its own strengths and weaknesses. Be sure to use the return calculation that tells you what you want to know;
- ✓ Chapter 17 presents the investing results for every CDx3 Preferred Stock that has been issued since January 2001 for those who have used the CDx3 Income Engine as described throughout this book; and
- ✓ Chapter 18 is an extra credit chapter. This chapter presents two additional techniques for buying and selling high quality preferred stocks – "Piling On" and the "Double Dip." I present these techniques here, after the CDx3 Income Engine results in chapter 17, because neither of these two techniques are part of the CDx3 Income Engine method. Both techniques allow you to get paid twice on the same principal so I hope that you are able to make use of them over the next couple of years.

SIXTEEN

KNOWING YOUR RATE OF RETURN

Whether you are considering buying or selling, understanding the potential or actual annual rate of return of a preferred stock investment is important to any strategy. But accurately calculating this key value can be a bit tricky.

There are a variety of calculations, each of which use a variety of assumptions and, therefore, offer values that can vary. The calculation that you use depends on how closely these assumptions align with your objectives.

Some calculations are more useful for certain types of investments than others. Bond investors, for example, are used to analyzing "Yield-To-Call" or "Yield-To-Maturity" values while those investing in bank Certificates of Deposit look at "Annual Percent Return" or "Annual Percent Yield."

While all of these values can be meaningful and interesting, they all have strengths and weaknesses when applied to a preferred stock investment.

Alternative Return Calculations

To be accurate, the return calculation applied to a preferred stock investment needs to accommodate the following realities of these securities and the market they trade within:

1) The first and last dividend period of a preferred stock is typically of a different length and, therefore, the first and last dividend dollar amount is different than the others;
2) Preferred stock investments produce both dividend income and capital gain/loss income;
3) The sell date varies for different investors and rarely occurs on the preferred stock's call date or maturity date;
4) The majority of preferred stocks available to investors on U.S. stock exchanges are trading beyond their call dates;
5) Preferred stock dividends are earned, and therefore must be compounded quarterly (not annually);
6) Some preferred stocks are "perpetual," meaning that they have no maturity date; and
7) The sell price may or may not equal the preferred stock's par value.

If you want to know the expected or actual annual return of a preferred stock investment you need to use a calculation that accommodates these aspects of preferred stocks and how they trade.

Let's take a look at some common return calculations.

Yield-To-Call

Yield-To-Call (YTC) measures the annual return of a bond if the shares are held until the security's future call date (also referred to as Yield-To-First-Call)[1].

Yield-To-Call produces an annual return value that assumes that your shares are redeemed by the issuing company on the security's call date. It also assumes that all dividend periods are of the same duration and dividend payments are of equal amounts.

But preferred stocks are rarely called on their call date. And the first and last dividend quarters are typically not a full quarter in length so the first and the last dividend payments are usually not for the same dollar amount as all other quarters.

Also, YTC cannot be used for most preferred stocks trading on U.S. stock exchanges since the majority are trading beyond their published call dates.

Yield-To-Maturity

Yield-To-Maturity (YTM) is a formula that calculates your annual return assuming that you hold the shares until the security's maturity date[2].

But most preferred stocks have a maturity date that is decades into the future and is therefore commonly ignored by preferred stock investors. The shares are much more likely to be sold by the shareholder (see chapter 14, Selling for the Target Sell Price) or redeemed by the issuing company (see chapter 15, Selling to Your Built-In Buyer) than held until the maturity date so YTM, while getting

[1] For Yield-To-Call formula see http://financetrain.com/how-to-calculate-yield-to-call-of-a-bond
[2] For Yield-To-Maturity formula see http://financetrain.com/how-to-calculate-yield-to-maturity

around the call date problem, is unlikely to reflect the preferred stock investor's actual experience.

Yield-To-Worst

Yield-To-Worst (YTW) is used with bonds that have multiple future call dates (i.e. a call date schedule). YTW uses the Yield-To-Call formula but for a variety of future call dates pursuant to the schedule. Then you pick the worst value. Preferred stocks have one, and only one, call date so YTW cannot be applied to a preferred stock investment.

Current Yield

Most brokerage accounts and online quoting sites, when presenting annual dividend yield for a dividend paying security (including preferred stocks), use current yield, using the following formula:

{ ([$par] x [div rate%]) divided by [$purchase price] } x100

Current Yield (CY) is also referred to as simple yield or dividend yield. The advantage of Current Yield is that the formula does not need to know your sell date or sell price; rather, it reports the annual dividend return for one year using your purchase price and assumes that you will receive four equal dividend payments in that year.

But the downside is that CY assumes that the investor does not reinvest the dividends. Further, CY does not consider the duration of the investment nor does it capture any capital gain or loss that the investor incurs upon sale; its result makes a statement about dividend earnings only. CY is not intended to present the total return of a preferred stock investment.

Spreadsheets and Calculators

Another problem with using yield values, as calculated by an electronic spreadsheet such as Excel or OpenOffice[3] or some financial calculators, is that, pursuant to international standards, these tools produce a result that assumes annual compounding of interest rather than quarterly compounding.

Even if you specifically configure Excel's YIELD function for four payments per year, the returned value cannot be used for an investment that pays quarterly dividends.

For example, if you compare the YIELD function's results for two identical investments, but one pays a single dividend per year while the other pays four quarterly payments per year, the problem with the YIELD function presents itself.

An investment that pays more frequently should calculate to a higher yield (due to quarterly, rather than annual, compounding) but that is not what happens with the bond-oriented YIELD function. The longer the duration of the investment the greater the error becomes.

=YIELD(date(2001,1,1), date(2010,12,31), 8%, 100.00, 150.00, 1, 0)

Follow along in the formula: You purchased this dividend-paying investment on January 1, 2001 and sold it on December 31, 2010 (ten years). It pays an 8% annual dividend. You paid $100 for it originally and you sold it for $150. Dividends are paid 1 time per year at the end of the year. The zero at the end tells Excel to use 30 day months and a 360 day year (this is common for bonds and preferred stocks).

[3] OpenOffice is a free electronic spreadsheet program that emulates Microsoft's Excel. Although there are probably exceptions, functions that work in Excel should also work in OpenOffice. OpenOffice is available for Windows and Mac computers from OpenOffice.org

The above Excel YIELD function calculates an annual yield for this investment of 10.99%.

Now here's the same investment, except I tell the YIELD function that dividends are received four times per year (next-to-last parameter):

```
=YIELD(date(2001,1,1), date(2010,12,31), 8%, 100.00, 150.00, 4, 0)
```

Remember, the more frequently the investor receives dividends the higher the return should be (quarterly compounding is better than annual compounding).

But that's not what happens with Excel's YIELD function (or with many financial calculators). Where the annually paid investment returned a YIELD value of 10.99%, the Excel YIELD function returns an incorrect value of 10.83% when told that dividends are received quarterly. The value should go up, not down.

Some financial calculators and Excel's YIELD function, by international standard, use annual compounding which produces an incorrect result for preferred stock investors.

Effective Annual Return

Preferred stock investors need a return calculation that has much more flexibility than these yield alternatives, a calculation that reflects the realities of investing in preferred stocks as itemized earlier in this chapter.

Such a calculation is called the Effective Annual Return (EAR).

The EAR calculation assumes that the investor not only reinvests their dividends, but does so at the same dividend rate as the preferred stock shares that generated the dividend (more on this in a moment).

If you hold your shares during a period of increasing dividend rates, this assumption will understate your annual return since future dividends, when reinvested, would produce a higher return.

Conversely, if future rates are lower than today the EAR value will slightly overstate your return.

There are two ways to calculate EAR, one that is tedious and very prone to error but can be done with a piece of paper and a regular calculator and a second that is very easy to set up but requires an electronic spreadsheet program (such as Excel or OpenOffice).

I will present the easy electronic spreadsheet method here[4].

Two Steps

EAR for a preferred stock investment is calculated in two steps. The first step deals with the quarterly nature of preferred stock dividends. This is called the "quarterly internal rate of return." Once we have the correct quarterly internal rate of return value for our quarterly dividends, we can annualize that value to produce the EAR in the second step.

Step 1: To calculate the quarterly internal rate of return, use the following RATE function:

RATE([number of div payments], [quarterly div amount],

- [purchase price], [sell price])

Note that the [purchase price] value is entered as a negative number (cash out). I'll show you how to adjust this RATE function to accommodate the first and last partial dividend payments momentarily.

[4] Those signing up for my free "*CDx3 Newsletter*" receive a 22 page special report titled "*Calculating Your Rate Of Return*." The report presents both methods for calculating EAR and compares the results.

Step 2: To produce the EAR with quarterly compounding, use this formula:

((1 + [r])^4) - 1

The "[r]" value is provided by the RATE function in Step 1.

Let's apply this two-step EAR calculation to three real preferred stocks as you would use them in Excel or OpenOffice (the below formulas can be copied directly into your spreadsheet).

Note that while these are real preferred stocks, these scenarios are intended to illustrate how the EAR calculation is performed; the scenarios themselves are entirely fictitious.

Scenario #1:

JPM-C from JP Morgan (JPM), 6.700% coupon, April 2, 2015 call date, $25 par value.

You purchase JPM-C on its March 29, 2010 IPO date for $25.00 and hold it for five years (20 quarters) until JP Morgan calls your shares for par on JPM-C's call date of April 2, 2015. The quarterly dividend paid by this 6.7% preferred stock is $0.42 per share. Your EAR is 6.891%, higher than the 6.7% coupon due to the value of reinvested quarterly dividends.

Step 1: =RATE(20, 0.42, -25, 25) = 1.680% quarterly internal rate of return

Step 2: =((1 + 1.680%) ^ 4) - 1 = 6.891% Effective Annual Return

Scenario #2:

BWF from Wells Fargo (WFC), 7.875% coupon, March 15, 2013 call date, $25 par value.

You purchase BWF on its March 7, 2008 IPO date for $24.50 and hold it until Wells Fargo prematurely calls BWF pursuant to Section 171 of the Wall Street Reform Act on January 1, 2013 (19 quarters). Your EAR is 8.622%. Since BWF is redeemed at its $25 par value, you realize a $0.50 per share capital gain.

Step 1: =RATE(19, 0.49, -24.50, 25) = 2.089% quarterly internal rate of return

Step 2: =((1 + 2.089%) ^ 4) - 1 = 8.622% Effective Annual Return

Scenario #3:

PSB-T from PS Business Parks (PSB), 6.000% coupon, May 14, 2017 call date, $25 par value.

You purchase PSB-T today at $24.36 then sell it for $25.80 on June 30, 2014 (9 quarters). Your EAR is 8.933% since the duration of this investment is shorter than the others (i.e. you made the money quicker) and realized a $1.44 capital gain.

Step 1: =RATE(9, 0.38, -24.36, 25.80) = 2.162% quarterly internal rate of return

Step 2: =((1 + 2.162%) ^ 4) - 1 = 8.933% Effective Annual Return

For most preferred stock investors looking for their annual return, the above two-step EAR calculation produces an adequate result.

Partial First and Last Dividend

By making three minor adjustments to the above quarterly internal rate of return formula (step 1), the purists among us can accommodate the partial first and last dividend payments typically received by preferred stock investors.

New preferred stocks are rarely issued on the first day of a dividend quarter. That is, you will generally receive an extra amount to cover the number of extra days prior to the first regular 90 day dividend quarter.

Similarly, preferred stocks are rarely redeemed on the last day of their 20th dividend quarter. So the final redemption amount will include not just the $25 per share par value but also an extra partial dividend payment to accommodate this final partial period.

Here's the modified quarterly internal rate of return formula.

RATE([number of div payments **plus 1**], [quarterly div amount],

- [purchase price **minus extradays div amt**], [sell price **minus quarterly div amount**])

Note that we have made three modifications to the RATE function.

1) The RATE function assumes that the last dividend payment occurs on the sell date. Set the [number of div payments] parameter to 1 plus the actual number of quarterly dividend payments that you have received from your CDx3 Preferred Stock.

2) The RATE function assumes that all periodic payments are for an equal amount. So in order to accommodate the extra amount that we received for the extra days prior to the first

full dividend, we subtract the extra payment amount off of the [purchase price] [5].

3) Since we have to adjust the [number of div payments] as described in number 1 above, the RATE function will think that we receive one more quarter's worth of dividend income than we actually did. To compensate, remove one quarter's worth of dividend income from the [sell price].

These three modifications to the quarterly internal rate of return formula produce an extremely accurate return value for a preferred stock investment.

University accounting professors will tell you, as one did with me, that the EAR calculation also works for those who consume, rather than reinvest, the quarterly dividends.

The thinking goes that once the dividend is received, the investor will put that cash toward the alternative that provides the highest value, whether or not that value comes in the form of cash (as with reinvesting the dividend) or continued life (as with using the dividend to purchase groceries).

If the investor chooses to buy groceries over reinvesting at, say, 7%, then continued life must have a value of at least 7% to the investor.

So the EAR value properly reflects the return to the investor regardless of how the investor chooses to realize the value of their dividends (more shares or more groceries).

[5] Note that this modification only applies if you purchase a newly issued preferred stock in time to receive its first partial dividend payment.

The following chapter uses the EAR formula presented here to show you how you would have done had you used the CDx3 Income Engine method of preferred stock investing to select, buy and sell every CDx3 Preferred Stocks that has been issued since January 1, 2001.

SEVENTEEN

RESULTS – HOW YOU WOULD HAVE DONE

In this chapter I will present how you, as a CDx3 Investor, would have done had you invested in every CDx3 Preferred Stock that was issued between January 2001 and December 2012 using the CDx3 Income Engine.

The investing results presented in this chapter appear in increasing detail starting with an annual summary and concluding with data tables that provide the most complete level of detail for every CDx3 Preferred Stock issued during the date range covered by this book.

In compiling the tables presented throughout this chapter I apply the buying and selling rules as described throughout Part III and Part IV, respectively, and use the following assumptions:

1) *Purchase date/price*: Except for the crisis years, (June 2007 – 2009) I assume that the investor purchased their shares for $25.00 per share on the IPO date even though most issues were able to be purchased for a lower price during OTC trading (see chapter 9). During the crisis years, when prices plummeted well below $25 per share, the closing market price on the first trading day following the end of the second dividend quarter is used as described on page 187;

2) *Target Sell Price*: The indicated Number of Bonus Quarters is derived using the table on page 219;

3) *Sell date/price*: All indicated Sell Dates are the last day of the preferred stock's dividend quarter (the day prior to the ex-dividend date). Unless otherwise indicated, a sale is recorded when the market price exceeded the Target Sell Price for each security on that date as discussed in chapter 14;

4) *Income per share*: Includes dividends paid plus the capital gain earned upon sale. Unsold issues are therefore not included in these values.

5) *Upgrades not included*: Issues that would have been upgraded per the discussion in chapter 11 are noted in the detailed tables. Since these opportunistic transactions were exchanges of one CDx3 Preferred Stock for another, the results of these sales are not included in any of the totals presented here (average annual sale price, income per share and effective annual return values do not include the noted upgrades);

6) *Upgrade timing*: To reflect actual investor behavior more accurately I assume that the investor would not consider upgrading a newly purchased CDx3 Preferred Stock for at least three months after purchase and only if a dividend gain of at least 0.100% can be realized by doing so; and

7) *Bank CD returns*: Average bank CD values are the average of the top ten Annual Percentage Yield (APY) rates for a 24-month, $10,000 CD offered by U.S. banks in the month indicated by the IPO Date. Source: *BankRate.com*.

Annual Results

The following table summarizes the number of CDx3 Preferred Stocks issued and sold from January 2001 through December 2012 using the CDx3 Income Engine.

IPO Year	# Issued	# Sold	Ave. Days Held	Ave. Div. Rate	Ave. Total Income	Ave. Eff.Ann. Return
2001	35	35	626	7.61%	$5.09	12.17%
2002	27	27	408	7.73%	$4.10	15.71%
2003	19	19	417	6.96%	$3.12	17.71%
2004	13	13	475	6.80%	$2.90	14.26%
2005	7	7	717	6.80%	$4.08	8.99%
2006	25	23	400	6.94%	$2.00	14.27%
2007[1]	15	15	1594	7.21%	$7.92	9.72%
2008[2]	10	10	822	8.37%	$9.58	35.52%
2009	2	2	228	8.85%	$3.70	24.52%
2010	5	5	413	6.77%	$3.36	14.20%
2011	4	4	171	6.91%	$2.04	18.46%
2012[3]	8	8	139	6.80%	$2.07	29.77%

Of the 170 CDx3 Preferred Stocks issued between 2001 and 2012 you would have sold 168 had you been using the CDx3 Income Engine at the time.

[1] See the footnote on page 261 regarding how section 171 of the 2010 Wall Street Reform Act was applied to these sales.
[2] See the footnote on page 262 regarding the 2008 average EAR value.
[3] See the footnote on page 264 regarding the 2012 average EAR value.

Compared to Bank CDs

The below table repeats the Effective Annual Return column from the above annual results, then calculates how much better the CDx3 Income Engine would have done when compared to the average annual yield being paid by bank CDs at the time.

IPO Year	Average Eff. Annual Return	Average Annual CD Yield	Times Better Than CDs
2001	12.17%	4.72%	2.58x
2002	15.71%	3.28%	4.79x
2003	17.71%	2.28%	7.77x
2004	14.26%	1.52%	9.38x
2005	8.99%	2.35%	3.83x
2006	14.27%	3.64%	3.92x
2007	9.72%	5.21%	1.87x
2008	35.52%	4.11%	8.64x
2009	24.52%	2.54%	9.65x
2010	14.20%	1.88%	7.55x
2011	18.46%	1.39%	13.28x
2012	29.77%	1.16%	25.66x

Over the twelve year period covered by this book, the CDx3 Income Engine would have returned to you, on average, over eight times what you would have earned with bank CDs with no more effort than it takes to review your monthly bank statement.

As I've mentioned before, whether or not the lower investment risk from CDs justifies the lower income is a decision that only you can make. But this table gives you an idea of what you would have given up.

Detailed Performance Results

The remaining pages of this chapter present the detailed performance results for every CDx3 Preferred Stock issued between January 2001 and December 2012.

In all cases, the investment results presented in these tables reflect the results that you would have realized had you been investing in CDx3 Preferred Stocks since January 2001 using the method described throughout this book – the CDx3 Income Engine.

The CDx3 Preferred Stocks shown in these tables are sorted by IPO Date. The effective annual return that you would have realized is presented and compared to the average annual yield rate of a 24-month, $10,000 bank CD available at the time that each CDx3 Preferred Stock became available for public sale (the IPO Date).

You now understand the nature of the marketplace for CDx3 Preferred Stocks (Part I) and the mechanics involved with selecting (Part II), buying (Part III) and selling (Part IV) them.

The CDx3 Income Engine:

Use the highest quality preferred stocks to earn above average dividend income while simultaneously creating multiple downstream capital gain opportunities.

In the next Part of *Preferred Stock Investing* we will move on to discuss various aspects of building and managing your CDx3 Portfolio to generate even more income and actually become "self-funding." But first, here are the detailed results tables for every CDx3 Preferred Stock issued since January 2001.

CDx3 Preferred Stock Results
Issued During 2001

	Sym	IPO Date	Div Rate	Sell Date	Sell Price	Inc Per Share	Effective Annual Return	24-Mo CD Rate(%)
1	D-A	1/11	8.400%	01/24/03	$ 27.21	$ 5.99	12.22%	5.48%
2	JPT	2/02	7.500%	04/24/03	$ 27.10	$ 5.83	10.48%	5.88%
3	EDE-D	2/23	8.500%	02/25/03	$ 27.17	$ 5.93	12.08%	5.88%
4	HLI-B	3/01	7.625%	07/09/03	$ 27.65	$ 6.70	10.69%	5.78%
5	ATG-	5/15	8.000%	07/29/02	$ 27.00	$ 4.01	13.15%	4.95%
6	GAB-B	6/14	7.200%	03/14/03	$ 27.28	$ 5.04	11.70%	4.95%
7	SPG-F	7/01	8.750%	06/12/03	$ 28.00	$ 6.83	16.14%	4.65%
8	MJH	7/13	7.250%	06/12/03	$ 27.40	$ 5.52	12.94%	4.65%
9	ECT	7/18	8.250%	07/25/03	$ 27.15	$ 5.84	11.90%	4.65%
10	C-V	7/23	7.125%	05/09/03	$ 27.09	$ 4.88	11.36%	4.65%
11	CMA-Z	7/27	7.600%	06/25/03	$ 27.75	$ 5.94	11.93%	4.65%
12	PL-S	8/20	7.500%	02/10/04	$ 27.09	$ 6.29	10.16%	4.07%
13	WSF	8/24	7.000%	11/03/03	$ 26.77	$ 5.31	9.57%	4.07%
14	PSA-R	9/04	8.000%	06/11/03	$ 27.20	$ 5.34	14.89%	3.85%
15	FBF-L	9/17	7.200%	06/10/03	$ 27.53	$ 5.22	12.01%	3.85%
16	C-Z	9/18	6.950%	03/11/03	$ 26.80	$ 3.96	10.74%	3.85%
17	ONE-	9/24	7.200%	04/09/03	$ 26.84	$ 4.20	11.46%	3.85%
18	FZB-	10/05	8.400%	03/11/03	$ 27.50	$ 5.10	13.86%	3.97%
19	STI-	10/15	7.125%	03/11/03	$ 26.83	$ 3.90	11.26%	3.97%
20	DMG-A	10/17	7.800%	04/24/03	$ 27.19	$ 4.71	12.84%	3.97%
21	PSA-S	10/17	7.875%	06/11/03	$ 27.24	$ 5.10	11.80%	3.97%
22	HIG-C	10/22	7.450%	06/25/03	$ 27.03	$ 4.72	10.94%	3.97%
23	USB-C	10/29	7.350%	07/28/03	$ 26.95	$ 4.73	10.99%	3.97%
24	TMK-T	11/02	7.750%	04/25/03	$ 26.95	$ 4.37	11.90%	3.95%
25	VLY-A	11/02	7.750%	05/27/03	$ 27.30	$ 4.95	13.54%	3.95%
26	HI-V	11/02	7.500%	11/11/03	$ 27.05	$ 5.40	10.98%	3.95%
27	LNC-V	11/13	7.650%	06/24/03	$ 27.65	$ 5.29	12.14%	3.95%
28	GUP-C	11/13	7.375%	06/25/03	$ 27.75	$ 5.29	14.43%	3.95%
29	FRT-B	11/20	8.500%	07/10/03	$ 27.26	$ 5.34	12.38%	3.95%
30	WPF	11/30	7.000%	02/11/03	$ 26.78	$ 3.53	11.55%	3.95%
31	USB-D	12/03	7.250%	06/10/03	$ 27.88	$ 5.20	14.07%	3.78%
32	STI-V	12/05	7.050%	03/11/03	$ 26.80	$ 3.61	11.82%	3.78%
33	BAC-W	12/10	7.000%	03/11/03	$ 26.96	$ 3.73	12.20%	3.78%
34	NCF-	12/10	7.700%	06/10/03	$ 27.55	$ 4.98	13.50%	3.78%
35	TMK-S	12/12	7.750%	07/28/03	$ 27.65	$ 5.34	12.27%	3.78%
		Averages:	**7.610%**		**$ 27.24**	**$ 5.09**	**12.17%**	**4.72%**

2001 Notes:

1. Historical daily market price data for two 2001 CDx3 Preferred Stocks (BSC-X and STA-A) was not available when this table was prepared.
2. The number of bonus quarters value was 4 for all CDx3 Preferred Stocks issued during 2001.

CDx3 Preferred Stock Results
Issued During 2002

	Sym	IPO Date	Div Rate(%)	Sell Date	Sell Price	Inc Per Share	Effective Annual Return	24-Mo CD Rate(%)
1	DTE-A	1/11	7.800%	04/25/03	$ 27.20	$ 4.25	13.99%	3.30%
2	PSA-T	1/16	7.625%	06/11/03	$ 27.16	$ 4.45	12.06%	3.30%
3	BXS-A	1/23	8.150%	06/24/03	$ 27.57	$ 4.98	13.46%	3.30%
4	BAC-V	1/25	7.000%	04/25/03	$ 26.93	$ 3.70	12.12%	3.30%
5	JPM-J	1/29	7.000%	02/10/04	$ 27.11	$ 5.24	10.63%	3.30%
6	PSA-U	2/14	7.625%	06/11/03	$ 27.17	$ 4.31	11.61%	3.30%
7	BGI-T	2/15	8.000%	06/25/03	$ 28.05	$ 5.30	14.20%	3.30%
8	FBF-M	3/05	7.200%	06/10/03	$ 27.75	$ 4.60	12.25%	3.60%
9	MP-E	3/19	7.200%	06/23/03	$ 26.85	$ 3.71	12.17%	3.60%
10	WPD	3/22	6.950%	06/25/03	$ 27.65	$ 4.50	14.74%	3.60%
11	ONB-B	4/09	8.000%	04/25/03	$ 27.05	$ 3.68	15.26%	3.60%
12	CHZ-A	5/16	8.000%	06/25/03	$ 27.34	$ 4.09	13.28%	3.60%
13	ABW-A	5/28	7.625%	06/10/03	$ 27.38	$ 3.91	16.18%	3.60%
14	BRE-B	6/17	8.080%	06/11/03	$ 27.60	$ 4.19	17.36%	3.60%
15	GPE-W	6/17	7.125%	03/25/03	$ 26.81	$ 2.77	15.39%	3.60%
16	KRB-D	6/24	8.125%	12/26/03	$ 27.30	$ 4.88	13.31%	3.60%
17	EOP-G	7/03	7.750%	02/25/04	$ 27.25	$ 5.07	11.72%	3.23%
18	SO-D	7/26	7.125%	06/24/03	$ 27.96	$ 4.17	17.07%	3.23%
19	ZB-B	8/19	8.000%	05/27/03	$ 27.71	$ 3.78	21.18%	2.95%
20	VEL-A	8/20	7.375%	07/24/03	$ 27.25	$ 3.53	14.48%	2.95%
21	PSA-V	9/05	7.500%	06/13/03	$ 27.00	$ 3.07	16.16%	2.95%
22	HRP-B	9/09	8.750%	10/28/03	$ 27.55	$ 4.59	15.00%	2.95%
23	PL-A	9/23	7.250%	06/24/03	$ 27.27	$ 3.21	17.86%	2.95%
24	KRB-E	11/25	8.100%	11/11/03	$ 27.68	$ 4.15	17.10%	3.05%
25	HPT-B	12/06	8.875%	06/26/03	$ 27.53	$ 3.31	28.95%	3.00%
26	LG-A	12/10	7.700%	11/24/03	$ 27.25	$ 3.64	15.97%	3.00%
27	PEG-U	12/16	8.750%	06/24/03	$ 27.90	$ 3.53	30.73%	3.00%
		Averages:	**7.729%**		**$ 27.38**	**$ 4.10**	**15.71%**	**3.28%**

2002 Notes:

1. Historical daily market price data for two 2001 CDx3 Preferred Stocks (CMH- and BAC-X) was not available when this table was prepared.
2. The number of bonus quarters value was 4 for all CDx3 Preferred Stocks issued during 2002.

CDx3 Preferred Stock Results
Issued During 2003

	Sym	IPO Date	Div Rate	Sell Date	Sell Price	Inc Per Share	Effective Annual Return	24-Mo CD Rate(%)
1	RNR-B	02/03	7.300%	11/24/03	$26.85	$2.90	16.17%	3.00%
2	REG-C	03/31	7.450%	11/24/03	$27.00	$2.93	16.26%	2.80%
3	WRI-D	04/04	6.750%	03/02/04	$26.85	$3.03	12.39%	2.60%
4	CFC-A[1]	04/08	6.750%	12/26/03	$26.30	$2.11	11.62%	2.60%
5	NXL-E	04/08	7.625%	12/29/03	$27.10	$3.09	17.20%	2.60%
6	KIM-F	05/09	6.650%	12/29/03	$26.35	$2.07	11.36%	2.40%
7	AMB-L[2]	06/19	6.500%	03/31/04	$26.26	$2.19	12.16%	2.35%
8	DRE-J	07/28	6.625%	02/10/04	$26.35	$1.92	16.24%	2.18%
9	HCP-E	08/18	7.250%	03/10/04	$26.83	$2.50	21.49%	2.18%
10	SWX-B	08/21	7.700%	12/24/03	$27.00	$2.21	18.47%	2.18%
11	LEH-F[3]	08/22	6.500%	11/11/03	$26.62	$1.66	29.48%	2.18%
12	LNC-F	09/05	6.750%	12/24/03	$26.84	$1.96	35.58%	2.05%
13	CRE-E	09/08	7.500%	03/08/04	$27.08	$2.51	21.28%	2.05%
14	IPL-C	09/10	7.100%	02/24/04	$27.99	$3.46	29.94%	2.05%
15	PSA-W	09/26	6.500%	03/10/04	$25.90	$1.33	12.07%	2.05%
16	PLD-F[2]	11/03	6.750%	03/12/04	$26.07	$1.34	11.05%	2.05%
17	AMB-M[2]	11/10	6.750%	04/19/13	$25.00	$16.03	6.92%	2.05%
18	HCP-F	11/28	7.100%	03/10/04	$26.50	$1.66	29.69%	2.05%
19	PLD-G[2]	12/13	6.750%	12/12/06	$25.15	$4.37	7.16%	1.95%
		Averages:	**6.963%**		**$26.53**	**$3.12**	**17.71%**	**2.28%**

2003 Notes:

1. Countrywide Financial acquired by Bank of America, no symbol change.
2. AMB and ProLogis merged in April 2011 and continued business as ProLogis. The original trading symbols at time of issue are used here.
3. LEH-F reached its call date prior to Lehman Brothers Holding bankruptcy in 2008. All LEH-F dividends were paid by Lehman Brothers.

CDx3 Preferred Stock Results
Issued During 2004 And 2005

	Sym	IPO Date	Div Rate(%)	Bonus Qtrs	Sell Date	Sell Price	Inc Per Share	Effective Annual Return	24-Mo CD Rate(%)
1	DRE-K[1]	01/16	6.500%	1	11/11/04	$25.30	$1.31	7.28%	1.95%
2	BRE-C[1]	02/27	6.750%	2	12/07/05	$25.03	$2.56	7.00%	1.95%
3	HE-U	03/15	6.500%	1	09/24/04	$26.33	$1.81	15.20%	1.95%
4	DTE-C	05/26	7.500%	3	08/26/04	$26.75	$1.75	31.96%	1.63%
5	PSA-B	06/18	7.125%	2	09/10/04	$26.05	$1.05	10.88%	1.40%
6	WRI-E	07/02	6.950%	2	11/30/04	$27.10	$2.46	20.79%	1.25%
7	REG-D	08/06	7.250%	3	11/26/04	$26.35	$1.35	8.72%	1.25%
8	VNO-E	08/19	7.000%	2	12/10/04	$26.50	$1.71	14.13%	1.25%
9	PSA-C	09/09	6.600%	1	03/10/05	$25.58	$1.09	9.09%	1.25%
10	DRE-L	11/04	6.600%	1	02/09/05	$25.50	$0.50	10.33%	1.25%
11	VNO-F[1]	11/12	6.750%	2	03/08/06	$25.00	$1.91	6.37%	1.25%
12	BRE-D	12/03	6.750%	2	12/11/12	$25.84	$14.34	7.26%	1.70%
13	VNO-G[1]	12/16	6.625%	1	02/16/07	$25.00	$2.90	6.79%	1.70%
	04-Averages:		**6.838%**			**$26.22**	**$2.90**	**14.26%**	**1.52%**
1	PSA-E	04/22	6.750%	2	09/12/05	$25.85	$1.60	13.55%	2.30%
2	VNO-H[2]	06/14	6.750%	2	11/03/06	$25.05	$2.16	7.09%	2.30%
3	WRB-A[2,3]	07/21	6.750%	2	02/16/07	$25.30	$2.41	7.90%	2.30%
4	REG-E[2]	07/29	6.700%	1	02/16/07	$25.15	$2.24	7.26%	2.30%
5	VNO-I	08/24	6.625%	1	06/12/12	25.5	$13.34	7.00%	2.30%
6	AMB-O[4]	12/07	7.000%	2	01/02/07	$25.94	$2.44	10.12%	2.45%
7	PSA-G	12/27	7.000%	2	12/12/06	$26.26	$2.70	11.15%	2.45%
	05-Averages:		**6.796%**			**$25.52**	**$4.08**	**8.99%**	**2.34%**

2004/2005 Notes:

1. 2004 Upgrades: DRE-K to VNO-F; VNO-F to PSA-I; BRE-C to AMB-O; VNO-G to HPT-C
2. 2005 Upgrades: VNO-H to CFC-B; WRB-A to HPT-C; REG-E to HPT-C
3. BER-A symbol changed to WRB-A on 3/31/2008
4. AMB and ProLogis merged in April 2011 and continued business as ProLogis. The original trading symbols at time of issue are used here.

CDx3 Preferred Stock Results
Issued During 2006

	Sym	IPO Date	Div Rate(%)	Bonus Qtrs	Sell Date	Sell Price	Inc Per Share	Effective Annual Return	24-Mo CD Rate(%)
1	DRE-M[1]	01/06	6.950%	2	08/06/06	$25.00	$0.87	7.13%	2.55%
2	FR-J[1]	01/11	7.250%	3	09/28/06	$25.32	$1.68	9.22%	2.55%
3	PSA-H[1]	01/17	6.950%	2	08/17/06	$25.00	$0.87	7.13%	2.55%
4	MSJ	01/20	6.600%	1	10/12/06	$25.60	$1.48	8.15%	2.55%
5	HRP-C	02/03	7.125%	2	10/27/06	$26.04	$1.99	11.01%	2.55%
6	USB-I	04/07	6.500%	1	01/08/07	$25.58	$1.42	7.78%	2.85%
7	PSA-I	04/27	7.250%	3	12/12/06	$26.36	$2.14	18.24%	2.85%
8	COF-B	05/25	7.500%	3	12/11/06	$26.73	$2.31	19.63%	2.85%
9	TMK-A	06/05	7.100%	2	12/11/06	$26.46	$1.89	15.82%	3.20%
10	KEY-D	06/15	7.000%	2	12/11/06	$26.31	$1.75	14.64%	3.20%
11	DRE-N	06/16	7.250%	2	12/12/06	$26.65	$2.17	18.31%	3.20%
12	C-O	06/28	6.875%	1	09/26/06	$26.05	$1.05	18.16%	3.20%
13	BAC-C	07/27	6.875%	1	10/29/06	$26.18	$1.18	20.90%	3.55%
14	PSA-K	08/04	7.250%	3	08/22/11	$25.00	$9.06	7.45%	3.91%
15	FR-K	08/17	7.250%	3	No Sale Yet				3.91%
16	AMB-P[1,4]	08/21	6.850%	1	02/16/07	$25.28	$1.14	9.38%	3.91%
17	USB-J	08/24	6.600%	1	12/11/06	$25.83	$0.83	15.88%	3.91%
18	C-U	09/11	6.500%	1	12/11/06	$25.45	$0.45	7.78%	4.30%
19	JPM-S	09/25	6.625%	2	12/22/06	$25.95	$0.95	16.51%	4.30%
20	CTZ-A[2]	09/28	7.500%	4	03/11/13				4.30%
21	MSZ[1]	10/06	6.600%	2	01/10/07	$25.31	$0.72	12.07%	4.78%
22	PSA-L[1]	10/17	6.750%	2	02/16/07	*$25.28*	$1.12	9.27%	4.78%
23	NCC-A[1, 5]	10/31	6.625%	2	02/16/07	$25.16	$0.57	9.51%	4.78%
24	CFC-B[3]	11/03	7.000%	3	No Sale Yet				5.29%
25	KEY-E	11/17	6.750%	2	02/15/11	$25.00	$8.44	6.92%	5.29%
	Averages:		**6.941%**			**$26.01**	**$2.00**	**14.27%**	**3.64%**

2006 Notes:

1. Upgrades: DRE-M to PSA-K;FR-J to CTZ-A; PSA-H to FR-K; AMB-P to HPT-C; MSZ to PSB-P; PSA-L to HPT-C; NCC-A to HPT-C.
2. CTZ-A's market price on March 11, 2013 was $31.88, well beyond its $26.88 Target Sell Price, However, the effective annual return for CTZ-A is not able to be calculated since its dividends were not paid on a regular schedule. See explanation on page 126.
3. Countrywide Financial acquired by Bank of America, no symbol change.
4. AMB and ProLogis merged in April 2011 and have continued business as ProLogis.
5. National City Capital acquired by PNC Financial, no symbol change.

CDx3 Preferred Stock Results
Issued During 2007

January – May 2007

	Sym	IPO Date	Div Rate(%)	Bonus Qtrs	Sell Date	Sell Price	Inc Per Share	Effective Annual Return	24-Mo CD Rate(%)
1	PSA-M[1]	01/05	6.625%	2	08/24/10	$25.66	$5.63	7.63%	5.21%
2	PSB-P	01/10	6.700%	2	10/09/12	$25.00	$9.63	6.87%	5.21%
3	HPT-C	02/16	7.000%	3	08/16/12	$25.00	$9.63	7.19%	5.28%
4	NCC-B[1,3]	05/22	6.625%	2	10/08/10	$25.03	$4.53	6.83%	5.20%
5	UDR-G	05/24	6.750%	2	05/13/12	$25.00	$8.44	6.92%	5.50%
	Averages:		**6.740%**						**5.21%**

June – December 2007 (Global Credit Crisis, Low Demand Market)

	Sym	IPO Date	Div Rate(%)	Bonus Qtrs	Purch Price	Sell Date	Sell Price	Inc Per Share	Effective Annual Return	24-Mo CD Rate(%)
6	PSA-N	06/28	7.000%	3	$21.90	09/09/11	$26.41	$11.07	12.98%	5.27%
7	JPM-W[2]	07/27	6.875%	2	$25.02	07/27/10	$25.86	$4.28	8.70%	5.43%
8	FTB-A[2]	08/03	7.250%	3	$24.32	08/15/12	$25.00	$6.27	7.40%	5.34%
9	C-F[2]	08/13	7.250%	3	$23.00	08/15/12	$25.00	$7.95	9.77%	5.34%
10	MER-P[2]	08/17	7.375%	3	$22.63	09/15/12	$25.00	$7.26	8.04%	5.34%
11	NCC-C[2,3]	08/28	8.000%	3	$20.26	09/07/10	$26.65	$7.05	14.95%	5.34%
12	KIM-G	10/02	7.750%	3	$24.14	06/29/11	$26.67	$8.83	11.20%	5.09%
13	FTB-B[2]	10/25	7.250%	2	$21.32	11/15/12	$25.00	$9.18	11.70%	5.09%
14	WB-D[2,4]	11/14	7.850%	3	$24.93	11/24/10	$26.63	$5.56	11.26%	4.98%
15	C-G[2]	11/20	7.875%	3	$24.11	12/15/12	$25.00	$7.78	9.39%	4.98%
	Averages		**7.448%**		**$23.16**		**$25.72**	**$7.52**	**10.54%**	
	2007:		**7.212%**				**$25.56**	**$7.92**	**9.72%**	**5.21%**

2007 Notes:

1. Upgrades: PSA-M to KIM-H; NCC-B to PSB-R.
2. Special legislation applies to these CDx3 Preferred Stocks that makes them highly likely to be called. These CDx3 Preferred Stocks are bank-issued Trust Preferred Stocks (TRUPS) and are subject to the provisions of section 171 of the 2010 Wall Street Reform Act. Unless the issue would have been sold for its Target Sell Price as described in chapter 14 (JPM-W, NCC-C, WB-D), this table uses the call date and $25.00 per share as the sell date and sell price, respectively.
3. National City Capital acquired by PNC Financial, no symbol change.
4. Wachovia acquired by Wells Fargo, no symbol change.

CDx3 Preferred Stock Results
Issued During 2008 (Global Credit Crisis, Low Demand Market)

	Sym	IPO Date	Div Rate(%)	Bonus Qtrs	Purch Price	Sell Date	Sell Price	Inc Per Share	Effective Annual Return	24-Mo CD Rate(%)
1	MTB-A	01/28	8.500%	3	$14.16	03/09/2010	$27.41	$16.44	72.24%	3.99%
2	PNH	02/08	7.750%	1	$24.25	08/26/2010	$26.69	$5.83	13.86%	3.69%
3	DRE-O	02/14	8.375%	2	$24.90	09/13/2010	$26.24	$5.00	11.72%	3.69%
4	KEY-F	02/22	8.000%	1	$15.74	09/09/2010	$26.00	$13.76	46.62%	3.69%
5	STI-Z	02/27	7.875%	1	$22.87	08/26/2010	$26.20	$6.78	16.97%	3.69%
6	BWF	03/07	7.875%	1	$24.70	03/09/2010	$26.69	$4.45	14.73%	4.46%
7	RF-Z	04/28	8.875%	3	$21.25	03/09/2011	$26.74	$9.93	22.89%	3.67%
8	FTB-C	04/30	8.875%	3	$17.21	08/10/2010	$26.85	$12.97	48.60%	3.67%
9	WCO	08/14	8.625%	2	$19.76	03/09/2010	$28.31	$10.71	56.27%	2.83%
10	BBT-A	09/04	8.950%	3	$20.10	03/09/2010	$27.78	$9.92	51.30%	2.83%
	Averages:		**8.370%**		**$20.49**		**$26.89**	**$ 9.58**	**35.52%**	**3.62%**

CDx3 Preferred Stock Results
Issued During 2009 (Rates Peak, Crisis Ends)

	Sym	IPO Date	Div Rate(%)	Bonus Qtrs	Purch Price	Sell Date	Sell Price	Inc Per Share	Effective Annual Return	24-Mo CD Rate(%)
1	BBT-B	07/21	9.600%	4	$26.00	04/27/2010	$28.69	$4.49	24.22%	2.41%
2	BBT-C	11/02	8.110%	3	$25.00	04/27/2010	$26.89	$2.90	24.83%	2.15%
	Average		**8.850%**		**$25.50**		**$27.79**	**$3.70**	**24.52%**	**2.28%**

2008/2009 Notes:

1. The Global Credit Crisis was the best thing that ever happened to CDx3 Investors. Rates went up and prices went down, delivering high payers for bargain prices. Once the market recovered in 2010 all CDx3 Preferred Stocks issued during 2008 and 2009 were sold on their indicated Sell Dates for market prices that exceeded their respective Target Sell Prices. The rapid price recovery during 2010 delivered astounding returns to CDx3 Investors. But this was an exceptional event and should not be viewed as normal or repeatable.

CDx3 Preferred Stock Results
Issued During 2010

	Sym	IPO Date	Div Rate(%)	Bonus Qtrs	Purch Price	Sell Date	Sell Price	Inc Per Share	Effective Annual Return	24-Mo CD Rate(%)
1	JPM-C	03/29	6.700%	2	$25.00	03/26/12	$26.12	$4.47	9.07%	2.04%
2	PSA-O	04/07	6.875%	3	$25.00	09/10/10	$26.40	$2.26	19.06%	2.01%
3	KIM-H[1]	08/24	6.900%	2	$25.00	12/29/11	$27.72	$4.66	18.24%	1.84%
4	PSA-P	10/04	6.500%	1	$25.00	03/12/11	$25.58	$1.39	11.55%	1.71%
5	PSB-R	10/08	6.875%	2	$25.00	03/19/12	$26.86	$4.01	13.06%	1.71%
	Averages:		**6.770%**		**$25.00**		**$26.54**	**$3.36**	**14.20%**	**1.88%**

CDx3 Preferred Stock Results
Issued During 2011

	Sym	IPO Date	Div Rate(%)	Bonus Qtrs	Purch Price	Sell Date	Sell Price	Inc Per Share	Effective Annual Return	24-Mo CD Rate(%)
1	PSA-Q	03/29	6.500%	1	$25.00	06/10/11	$25.64	$1.05	17.82%	1.50%
2	VNO-J	04/07	6.875%	1	$25.00	09/12/11	$25.97	$1.40	24.35%	1.50%
3	CWH-E	10/04	7.250%	3	$25.00	07/27/12	$26.95	$3.76	15.46%	1.50%
5	DLR-E	10/08	7.000%	2	$25.00	03/12/12	$26.06	$1.94	16.22%	1.29%
	Averages:		**6.906%**		**$25.00**		**$26.16**	**$2.04**	**18.46%**	**1.39%**

2010 Notes:

1. KIM-H is used as the Target Sell Price example on page 212.

CDx3 Preferred Stock Results
Issued During 2012

	Sym	IPO Date	Div Rate(%)	Bonus Qtrs	Purch Price	Sell Date	Sell Price	Inc Per Share	Effective Annual Return	24-Mo CD Rate(%)
1	HPT-D	01/18	7.125%	2	$25.00	06/26/12	$26.65	$2.10	37.98%	1.18%
2	REG-F	02/09	6.625%	1	$25.00	06/14/12	$25.95	$1.36	23.68%	1.16%
3	NNN-D	02/17	6.625%	1	$25.00	05/25/12	$25.80	$1.21	20.89%	1.16%
4	HCN-J	02/29	6.500%	1	$25.00	05/25/12	$26.09	$1.50	26.18%	1.16%
5	RJD[2]	03/01	6.900%	3	$25.00	09/11/12	$27.51	$3.37	29.06%	1.13%
6	CTX[2]	03/23	7.000%	3	$25.00	09/25/12	$26.94	$2.82	24.00%	1.13%
7	DLR-F	03/29	6.625%	2	$25.00	09/11/12	$26.68	$2.09	37.95%	1.13%
8	CTU[2]	06/18	7.000%	3	$25.00	09/25/12	$26.68	$2.12	38.43%	1.15%
	Averages:		**6.800%**		**$25.00**		**$26.54**	**$2.07**	**29.77%**	**1.16%**

2012 Notes:

1. For the reasons itemized on page 56, demand for CDx3 Preferred Stocks spiked during 2012 and 2013 pushing up market prices in a very short period of time, well beyond the Target Sell Prices of these 2012 CDx3 Preferred Stocks. The fact that the price increase occurred in a short period of time produced spectacular gains for sellers. The average $2.07 gain occurred within months of IPO. But as rewarding as it was for CDx3 Investors, this was an exceptional event; the effective annual return values, while accurate, should not be seen as normal or repeatable.
2. RJD, CTX and CTU are Exchange-Traded Debt Securities (ETDs). ETDs were added to the CDx3 Notification Service database in 2012. See the explanation of ETDs on page 5.

EIGHTEEN

GETTING PAID TWICE ON THE SAME PRINCIPAL

The previous chapter presented the investing results of selecting, buying and selling the highest quality preferred stocks as described throughout Parts II, III and IV - the CDx3 Income Engine method of preferred stock investing.

Before moving on to the final topic of this book - Building Your CDx3 Portfolio - I wanted to describe a couple of additional preferred stock investing techniques that can be particularly useful during the high demand market conditions that are expected to prevail for the next couple of years.

These additional techniques are not part of the CDx3 Income Engine method since they require a bit more effort than many preferred stock investors will be willing to spend, violating objective #3 of the CDx3 Income Engine - minimize work. But for those willing to extend the effort, these two techniques may be helpful.

I refer to these two techniques as "Piling On" and "Double Dip" both of which allow you, as a preferred stock investor, to get paid twice on the same principal. Whether or not implementing these techniques is worthwhile is a decision that I will leave to you.

Piling On

Market prices for CDx3 Preferred Stocks move up and down over time. During times of low prices (a low demand market), preferred stock investors enjoy higher dividend income as yields increase and coupon rates offered by new issues become more generous. When prices go back up (a high demand market), shareholders have selling opportunities that bring income in the form of capital gains to those who choose to sell.

For CDx3 Investors, income generation swings back and forth between favoring dividends and favoring capital gains.

For the reasons presented on page 56, we are currently in a high demand market for CDx3 Preferred Stocks so investors are seeing huge, but unrealized, capital gains build up in their brokerage accounts. Preferred stock shares purchased for less than $25 using the wholesale Over-The-Counter stock exchange[1] or shares purchased prior to 2011 are generally worth far more than what was originally paid for them (this is especially true for call-protected issues).

By selling your shares and collecting a capital gain, rather than collecting future quarterly dividends, you are essentially being paid the same money but in advance. So any further returns that you earn by reinvesting your original principal are *in addition to* the return that you have already pocketed in the form of capital gain cash.

Even if you reinvest in another preferred stock that provides a lower dividend payment than what you were making on the sold shares, you are getting paid twice on the same principal over the reinvestment period.

Take a look at this example.

[1] Described in chapter 9.

The Sell Side: PSA-Q

Let's say you purchased PSA-Q from Public Storage (PSA) when it was first introduced in April 2011 for $25.00 per share. PSA-Q pays a 6.50% annual dividend (coupon) so that's $0.41 per quarter of dividend income for every share that you own.

PSA-Q is selling for $28.02 on May 7, 2013, so by selling you will realize a $3.02 capital gain per share.

Piling On, Sell PSA-Q

SELLING FOR $28.02 PROVIDES 7+ QUARTER'S WORTH OF INCOME

IPO Date	Symbol	Div Rate	Last Price	Ex-Div Date	Call Date	Moody's
4/06/2011	PSA-Q	6.500%	$28.02	03/11/2013	4/14/2016	A3

Source: CDx3 Notification Service database, www.PreferredStockInvesting.com
Data date: May 7, 2013

That's over seven quarter's worth of dividend income. By selling now, you earn the same income on your $25 principal but do so in advance.

The Buy Side: DLR-G

Having just sold your PSA-Q shares, you now have to decide whether or not to reinvest. By not reinvesting for another seven quarters (and collecting zero return on your newly received cash) you will still be ahead of where you would have been had you not sold PSA-Q to begin with.

Or, you could reinvest your $25 principal and pile on more dividend income.

To get paid twice on the same $25 principal, risk averse preferred stock investors often look for an investment grade preferred stock that is available for a market price at, or very near, its $25 per share par value. It would also be great to choose an issue that is call-protected (i.e. does not reach its call date) for another couple of years or so.

An investment grade, call protected, $25 preferred stock in today's market is going to provide an annual dividend yield of about six percent. That's not quite as high as what you were earning with the PSA-Q shares that you just sold (6.5%), but remember - since you have already been paid for the next seven quarters (in our PSA-Q example), whatever you can now earn by reinvesting your principal is piled on top. By reinvesting, you get paid twice on the same principal for the same time period.

One example (and that's all this is) of a purchase candidate is DLR-G, a traditional preferred stock from Digital Realty (DLR). DLR-G can be purchased for $25.01 (May 7, 2013) and generates a 5.875% annual return (coupon)[2].

Piling On, Buy DLR-G

BUYING DLR-G ADDS ANOTHER $0.37/QTR ON SAME PRINCIPAL

IPO Date	Symbol	Div Rate	Last Price	Ex-Div Date	Call Date	Moody's
4/02/2013	DLR-G	5.875%	$25.01	06/12/2013	4/09/2018	Baa3

Source: CDx3 Notification Service database, www.PreferredStockInvesting.com
Data date: May 7, 2013

[2] Remember that preferred stocks with lower dividend rates are less likely to ultimately be called. Low rate issues are therefore more exposed to the "perpetual ownership trap" described on page 141.

DLR-G does not become callable until April 9, 2018. DLR-G's 5.875% coupon provides shareholders a quarterly dividend of $0.37 per share. Because you are investing the same $25 principal, your total income for the next seven quarters is $5.61 ($3.02 in capital gains from your sale of PSA-Q plus $2.59 from DLR-G's next seven dividends). That's equivalent to $0.80 per quarter compared to $0.41 per quarter had you just held on to your original PSA-Q shares and not sold.

You used an unrealized capital gain to double your income over the reinvestment period. By Piling On you just got paid twice on the same $25 principal.

Double Dip

Where the Piling On technique allows you to use an unrealized capital gain to get paid twice on the same principal, the Double Dip technique allows you to get paid twice on the same principal for a dividend quarter.

The Double Dip is similar to the "Upgrading" technique described on page 179 except that the preferred stock chosen for the buy side is more specific. Recall that the Upgrading technique allows you to trade in a low payer for a higher payer and have cash left over. The same is true of the Double Dip, but the Double Dip technique takes advantage of overlapping dividend periods to provide you with a double dividend payment for the same quarter.

Remember that whoever owns the shares of a preferred stock on its ex-dividend date will receive the upcoming dividend payment for the entire quarter. By choosing your buy side candidate with a dividend period that overlaps that of the preferred stock that you sell, you get paid twice on the same money.

Fixed-rate securities (bonds, preferred stocks) are often said to "trade flat," meaning that since the market price rises as the ex-

dividend date approaches, it does not matter when you make your purchase; your return will be the same.

In a perfect market, that may be true. But as I demonstrated with the Upgrading example on page 179 and have written about in several other forums (and am about to do so with another example here), the preferred stock market is not perfect.

During periods of stable or increasing interest rates, I regularly see cases that clearly demonstrate that, at least during such periods, preferred stocks do not necessarily "trade flat."

Admittedly, to find them with such regularity you need to be armed with a preferred stock database search engine that has the power needed to do so. On May 15, 2013 I used the CDx3 Notification Service database search engine to find the following example of how to do the Double Dip for this section.

The Sell Side: DTZ

Let's say you own shares of DTZ, a 6.5% ETDs issued by DTE Energy in November 2011 with a call date of December 1, 2016. DTZ's next quarterly dividend payment will be made on June 1, 2013 for the quarter beginning March 1, 2013 (preferred stock dividends are always paid for the quarter just ended).

The ex-dividend date for the upcoming June 1 dividend payment is May 15, 2013; whoever owns shares of DTZ when the market opens on the morning of May 15 will receive the upcoming June 1 dividend payment of $0.41 per share.

Double Dip, Sell DTZ

SELL SHARES FOR $27.48 ON MAY 15 EX-DIVIDEND DATE

IPO Date	Symbol	Div Rate	Last Price	Ex-Div Date	Call Date	Moody's
11/29/2011	DTZ	6.500%	$27.48	05/15/2013	12/01/2016	Baa2

Source: CDx3 Notification Service database, www.PreferredStockInvesting.com
Data date: May 15, 2013

On its May 15, 2013 ex-dividend date DTZ was selling for $27.48, $2.48 above your original $25 purchase price. Because you owned your DTZ shares on the morning of May 15 you will receive the upcoming $0.41 per share dividend payment on June 1. You sell your DTZ shares on May 15 for $27.48 per share.

The Buy Side: CTQ

In May 2013 there were 16 CDx3-compliant securities with an ex-dividend date occurring that month. For the Double Dip technique to work you need to find issues that have an ex-dividend date for the same quarter but on a date that occurs *after* the ex-dividend date of the issue you sold (after DTZ's May 15 in this case).

Sorting the list of 16 by ex-dividend date reveals that eight have an ex-dividend date later in the month than DTZ's May 15 date.

By sorting these remaining eight by market price, we can see that there are two CDx3 Preferred Stocks that (1) have a better dividend rate than DTZ's 6.5%, (2) are call-protected until 2016 or later and (3) are available for a market price less than DTZ's $27.48.

Double Dip, Buy CTQ

TWO CANDIDATES FOR BUY SIDE: CTQ, NNN-D

IPO Date	Symbol	Div Rate	↓Last Price	Ex-Div Date	Call Date	Moody's
11/29/2011	DTZ	6.500%	$27.48	05/15/2013	12/01/2016	Baa2
6/02/2011	CTQ	7.375%	$27.38	05/29/2013	6/01/2016	Baa3
2/17/2012	NNN-D	6.625%	$27.20	05/29/2013	2/23/2017	Baa3

Source: CDx3 Notification Service database, www.PreferredStockInvesting.com
Data date: May 15, 2013

Both CTQ from CenturyLink, Inc.'s Qwest Corporation and NNN-D from National Retail Properties are candidates for the buy side of this Double Dip.

For illustration purposes, let's say you use the proceeds from your May 15 sale of DTZ to purchase CTQ for $27.38 per share.

CTQ is a 7.375% ETDs with a call date of June 1, 2016. While purchasing preferred stock shares above their $25 par value exposes the investor to a capital loss in the event of a downstream call, the $2.48 capital gain that you realized when selling DTZ more than reimburses you (and in advance).

You just earned two dividends for the same quarter on the same principal without being exposed to a net capital loss. That's the Double Dip.

PART VI

Building Your CDx3 Portfolio

You've learned how to select, buy and sell the highest quality preferred stocks available – CDx3 Preferred Stocks.

And you've seen the types of rewards that are possible from the CDx3 Income Engine – adding a downstream capital gain on top of great dividend income in the meantime.

This last Part of *Preferred Stock Investing* provides some tips for building and managing your personal CDx3 Portfolio.

Specifically:

- ✓ Chapter 19 explains how to use the magic of compounding to get your CDx3 Portfolio to become "self-funding" and shows you how long that is going to take;
- ✓ Chapter 20 gives you several tips regarding getting up to speed with what is going on right now in the marketplace for CDx3 Preferred Stocks; and
- ✓ Chapter 21 concludes this book with a step-by-step example of how to use an online trading account to buy your first CDx3 Preferred Stock while it is trading on the Over-The-Counter stock exchange. A real CDx3 Preferred Stock issued by Vornado Realty is used.

NINETEEN

COMPOUNDING MONTHLY INCOME

So far in this book we have focused on the pieces and parts of the CDx3 Income Engine – the criteria for selecting a CDx3 Preferred Stock, how the market price of that single CDx3 Preferred Stock tends to behave during different market conditions and the reasons why.

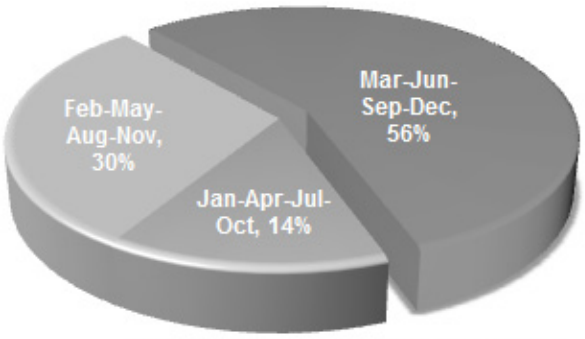
Now let's talk about how to manage your CDx3 Portfolio as a single machine that continuously pumps out income while renewing itself – a perpetual income generating engine.

In this chapter I will discuss the ongoing management of your CDx3 Portfolio. You'll see how (1) your CDx3 Portfolio generates continuous monthly, not quarterly, income and (2) the miracle of compounding shifts your CDx3 Income Engine into overdrive.

Monthly Income from Your CDx3 Income Engine

CDx3 Preferred Stocks pay you a quarterly dividend, but you'll notice in your portfolio that they do not all pay at the same time; that is, the "quarter" of one CDx3 Preferred Stock will be different from that of another CDx3 Preferred Stock.

Here is the dividend payment schedule distribution for all CDx3 Preferred Stocks[1]:



Source: CDx3 Notification Service database, www.PreferredStockInvesting.com

Notice that all CDx3 Preferred Stocks use one of the three following payment schedules:

1) January, April, July, October;
2) February, May, August, November; and
3) March, June, September, December (the calendar quarter).

As you build your CDx3 Portfolio of CDx3 Preferred Stocks, the frequency of dividend income will spread out until you are receiving dividend income each month – not just quarterly.

Also, since you will sell each CDx3 Preferred Stock on the last day of a dividend quarter and the dividend quarters vary from one CDx3 Preferred Stock to the next, your CDx3 Portfolio will ultimately produce capital gain income each month as well.

[1] Data date: May 2013

The Value of Your CDx3 Portfolio

As seen in the above chart, 56 percent of the CDx3 Preferred Stocks in your portfolio will use the calendar quarter (March, June, September, December) when paying your dividends.

Because of the Rule of Buyer/Seller Behavior, the CDx3 Preferred Stocks in your CDx3 Portfolio will tend to increase in value as the end of their dividend quarters approach.

Since a little over half of the CDx3 Preferred Stocks in your CDx3 Portfolio will have the same quarterly schedule, the sum total value of your CDx3 Portfolio will tend to increase a little in March, June, September and December. Similarly, it will tend to decrease in April, July, October and January. This fluctuation is normal.

And remember, preferred stocks pay your dividends based on *how many shares you own*, not the current market price. Your dividend income remains the same regardless of market price gyrations. So the value of the individual CDx3 Preferred Stocks in your CDx3 Portfolio is only important on the day you buy them and on the day that you sell them. Until then, the sum total value of your entire CDx3 Portfolio is just interesting math.

Compounding - The CDx3 Income Engine "Overdrive"

Using the methods described throughout this book, when you sell a CDx3 Preferred Stock you get your original principal amount (the purchase price that you originally paid) back plus the capital gain (the amount above your purchase price that you are able to sell for).

Continuously selling your CDx3 Preferred Stocks, re-investing your original principal and pocketing the capital gain as income, will continue to run along indefinitely. But wait, there's more.

We have all experienced the beauty of compound interest – where you buy a CD for say $10,000. An interest payment (say $25 per month) is made into your CD account so the CD balance is no longer $10,000; it's $10,025. The next month you earn interest on $10,025 – in other words, you earn interest not just on your original $10,000, but on the previously paid interest ($25) as well. This is the magic of "compounding."

The same mechanism works within a CDx3 Portfolio. As seen throughout this book, your CDx3 Portfolio generates ongoing income both in the form of regular dividend payments to you and capital gains if you sell. If you use a portion of your gains to buy another CDx3 Preferred Stock, you achieve the goal of compounding within your CDx3 Portfolio.

That is, the income being generated by the portfolio itself reaches a point where it becomes enough to buy the next CDx3 Preferred Stock. At that point your CDx3 Portfolio is growing with no additional principal from you. As this mechanism continues, this effect starts to happen faster and faster – compounding.

By using all or a portion of the income gained from your CDx3 Portfolio to buy additional CDx3 Preferred Stocks, the portfolio generates even higher returns. The CDx3 Income Engine starts feeding itself at an ever increasing pace. You have shifted your CDx3 Income Engine into overdrive.

The Self-Funding CDx3 Portfolio

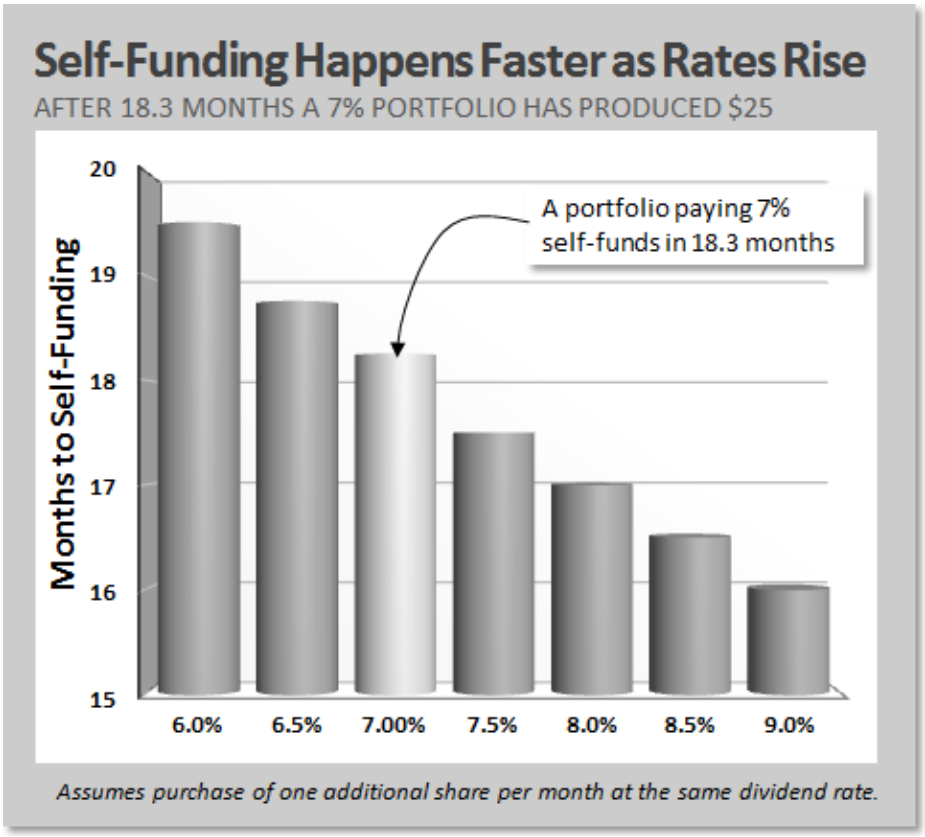
A meaningful metric is the length of time that it takes your CDx3 Portfolio to become "self-funding" as dividend rates move up and down. The "months to self-funding" metric measures the number of months it will take, given the average dividend rates currently being paid by the CDx3 Preferred Stocks in your portfolio, to generate

$25.00 in dividend income – the amount of money needed to purchase your next share of CDx3 Preferred Stock without any "new" money from you.

During periods when dividend rates are relatively low, it takes longer for a CDx3 Portfolio to reach this magic milestone. But the opposite is equally true – the higher that dividend rates go, the sooner your CDx3 Portfolio is going to become "self-funding" where it is generating enough dividend income to fund your next purchase on its own.

Once this milestone is reached, the beauty of compounding kicks in and the whole process starts to speed up.

Here is a chart that shows you how many months, at various average dividend rates, a CDx3 Portfolio will take to reach the point of self-funding (produce $25 in dividend cash). The chart assumes that you build your portfolio by adding one share each month at the same dividend rate.



Notice that as the average dividend rate being paid by the CDx3 Preferred Stocks in your CDx3 Portfolio increases, the length of time that it takes for your CDx3 Portfolio to reach the self-funding milestone gets shorter.

Historically, for example, the average dividend rate being paid by newly issued CDx3 Preferred Stocks is about 7%. Looking at the above chart, at 7% it takes your CDx3 Portfolio about 18 months to generate the required $25.00 in dividend income for that next month's purchase.

This is a simple mathematical model that allows us to gauge this self-funding metric as dividend rates move up and down over time.

As rates increase in the future, your portfolio will reach this milestone sooner.

At this point you have learned how to select, buy and sell the highest quality preferred stocks – CDx3 Preferred Stocks – and use them to earn above average dividend income while simultaneously creating multiple downstream capital gain opportunities.

Before you dive in, I have a few suggestions and tips that should save time, hassle and even some money. Specifically, the next two chapters will show you how to quickly get up to speed on what is happening right now in the marketplace for CDx3 Preferred Stocks and make your first CDx3 Preferred Stock purchase using an online trading account.

TWENTY

GETTING UP TO SPEED

I have put together an extensive array of resources to help you move forward from this point and well beyond. The extent to which you take advantage of these resources depends on how much of the work you want to do yourself.

But first things first; before we talk about the many helpful resources available to you let me provide some tips regarding how to get started as a CDx3 Investor.

What's Going on Right Now

You should get up to speed on what is going on with the marketplace for the highest quality preferred stocks – the current trends, issues and indicators.

Are dividend rates increasing, decreasing or stable (see chart on page 59)? What are prices doing (see chart on page 62)? Are we in a high demand market and if so, is it strengthening or weakening (see chart on page 87)?

Always remember that you are looking for the highest quality preferred stocks that you can purchase for less than $25.00 per share. As market conditions fluctuate over time, the list of such candidates will get longer and shorter but there are always great candidates

available (even if they are "less than perfect" as described in chapter 10).

Activate Your Subscription to the Free *CDx3 Newsletter*

My preferred stock research is ongoing so I publish two monthly preferred stock newsletters: (1) the *CDx3 Newsletter*, which is free to you and (2) *CDx3 Research Notes*, which is just for subscribers to the CDx3 Notification Service.

Subscribers to the CDx3 Notification Service receive both preferred stock newsletters every month.

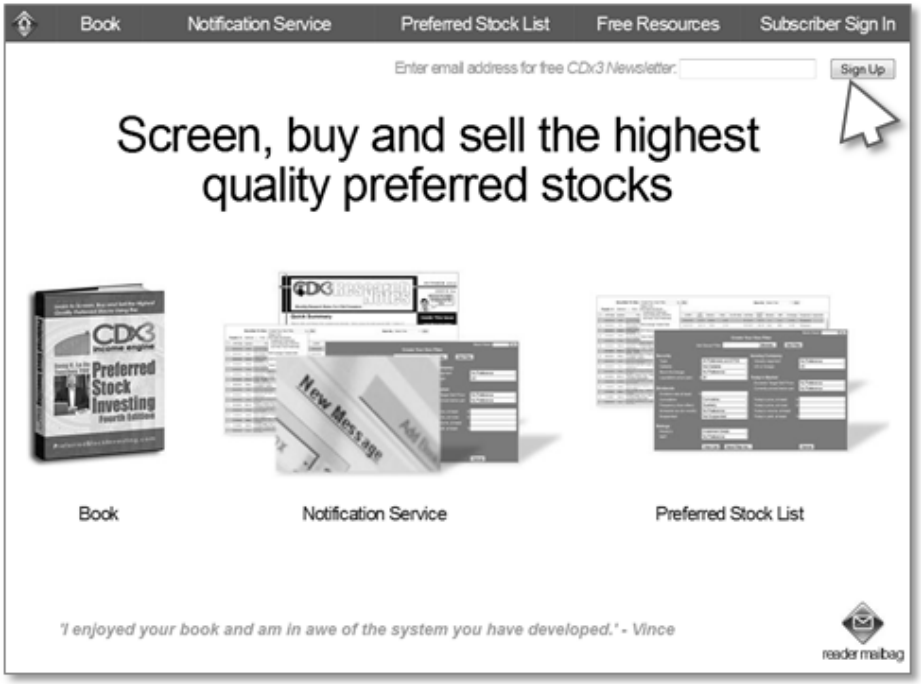
If you choose not to subscribe to the CDx3 Notification Service right away, you should activate your subscription to the free *CDx3 Newsletter*.

When you sign up for the free *CDx3 Newsletter* you will receive an email message that provides you with links to the current issue and to other free CDx3 resources for readers of *Preferred Stock Investing*.

Each monthly issue of the *CDx3 Newsletter* provides readers with a variety of preferred stock research articles, resource updates and special announcements.

As mentioned in chapter 4, the *CDx3 Newsletter* is delivered by email directly to your desktop during the first week of every month.

Just go to my website at www.PreferredStockInvesting.com, enter your email address in the upper-right corner and click the Sign Up button. And don't worry; you will not receive any spam from me.



Receive Free Articles from Me during the Month

Like most researchers, I live online. My web log (or "blog") is where I communicate with readers like you. In between monthly newsletters I frequently post articles for preferred stock investors at:

http://www.PreferredStockInvesting.BlogSpot.com

The articles that I post on my blog are always related to current events that affect the marketplace for the highest quality preferred stock and those investing in them. But don't feel like you have to continually visit my blog to stay current. There is a great feature on the right side of my blog page that allows you to receive an automatic email whenever I post an article.

To help you come up to speed on what is going on right now in the marketplace for CDx3 Preferred Stocks, in addition to activating your free subscription to the *CDx3 Newsletter*, you should sign up to receive my blog articles by email (also free).

Do-It-Yourself or Let Someone Else do the Work

In this section I will point you to a variety of very useful resources. But I have a bit of a dilemma here. As a preferred stock investor myself for many years, I became very frustrated with the lack of reliable tools and information that were easy to access and understand. So in 2003, I started building my own and in 2006 I started offering my tools and resources to other preferred stock investors on a subscription basis. Since I already had the toolkit, why make others go through the years of effort that I had already gone through?

That initial toolkit has grown and evolved over the last decade or so. As you might guess, many of its features are tailored to support aspects of the CDx3 Income Engine documented throughout this book. While the purpose of this section is to provide you with useful resources, it is not possible to do so without describing my toolkit – the Preferred Stock List™ database for do-it-yourselfers and the CDx3 Notification Service for those who would rather someone else do the work.

So please understand that at the risk of this section sounding a bit like a commercial, I have included a discussion of these resources here that I hope you find informative.

The extent to which you avail yourself of these resources is, of course, up to you. The point is to use a combination of resources that

will support you and your personal financial goals, resources and risk tolerance in a way that is comfortable for you and your investing style.

Free Resources

Appendix A provides a convenient itemization and description of the resources that are available to you as a CDx3 Investor. You can be a very successful CDx3 Investor using the free resources that I have identified for you in Appendix A. But doing the research yourself will require putting information together manually from multiple free sources which often leads to errors and delays.

For example, free preferred stock lists often have information that is out of date, incorrect or incomplete. New issues may take weeks or months to appear (long after trading on the wholesale Over-The-Counter exchange explained in chapter 9 has ceased) or current market prices and ex-dividend dates may be missing.

Also, free lists often have limited search capability (such as not being able to find issues that are currently trading for a market price below their par value) or key data will not be sortable, printable or downloadable.

Check out the free resources that I have identified for you in Appendix A and see if you feel that the time and effort needed to use them is worth the cost savings.

Preferred Stock List™ Database and Search Engine

Frustrated with the lack of easily accessible, quality preferred stock information, I designed the "Preferred Stock List™" (PSL) database and search engine for preferred stocks and exchange-traded debt securities.

PSL was used to produce the lists of preferred stocks that you see throughout this book and is available on a subscription basis (PSL runs

entirely within your web browser, no need to download any software onto your computer).

For do-it-yourself preferred stock investors, using my PSL database and search engine will save you an enormous amount of time. I think you'll find that the minor subscription fee is well worth the effort that this powerful one-of-a-kind tool will save you.

Comprehensive CDx3 Notification Service

For those who would rather someone else do the work, I offer the comprehensive CDx3 Notification Service. A subscription to the CDx3 Notification Service includes the Preferred Stock List™ database and search engine plus email notifications of new preferred stocks and exchange-traded debt securities (including when they begin trading on the wholesale Over-The-Counter stock exchange as described in chapter 9), access to experts via the CDx3 Discussion Group, special one-click hotlists of CDx3 Preferred Stocks, detailed Spec Sheets for each issue, ex-dividend date calendars that update in real time, company research, a monthly research newsletter that I write and much more.

The CDx3 Notification Service is the most comprehensive resource available for preferred stock investors by far.

Appendix B includes descriptions and examples of several CDx3 Notification Service features. You can read more about my PSL database and Search Engine (including a tutorial with examples and current subscription pricing) and the CDx3 Notification Service at:

http://www.PreferredStockInvesting.com

At one end of the spectrum you can use the free resources provided in Appendix A and do the research yourself to be a very successful CDx3 Investor. Or you may want to subscribe to the PSL database and search engine – a real time saver for do-it-yourselfers.

On the other end of the spectrum you can subscribe to the comprehensive CDx3 Notification Service and have access to the PSL database and search engine but also receive an email alert when there are buying opportunities and let someone else do the research and calculations for you.

The CDx3 Income Engine is a structured, consistently applied method for preferred stock investors. It is low-speed investing more so than quick-hit trading.

Between the free *CDx3 Newsletter*, my regular blog articles and the other resources described in Appendix A you will be able to get a sense for what is going on in the marketplace for CDx3 Preferred Stocks right now.

Then decide if a PSL or CDx3 Notification Service subscription is right for you or if you want to go it alone. It's up to you.

Watch, listen, ask and learn. Be deliberate. Be patient. Avoid feeling rushed. Start slow and prepare before you invest.

Then invest in the best.

TWENTY-ONE

BUYING YOUR FIRST CDx3 PREFERRED STOCK

Whether you are a do-it-yourself preferred stock investor or a subscriber to the CDx3 Notification Service, the three steps involved in buying a CDx3 Preferred Stock are essentially the same:

1) Open an online trading account (or use your traditional broker);
2) Identify your first CDx3 Preferred Stock to purchase; and
3) Determine the share price that you are willing to pay and how many shares you want to purchase.

Open an Online Trading Account

If you already have an online trading or other brokerage account for your preferred stock trades that you are happy with, great. Otherwise, I can register new subscribers with TDAmeritrade for a bunch of freebees (usually a bunch of free trades but their offer varies) if you want to open a new online trading account with them[1].

[1] TDAmeritrade's offer varies and is usually limited to new non-IRA accounts opened with a $2,000 minimum deposit.

New subscribers receive a special email address to let me know if you would like me to register you for the TDAmeritrade freebees.

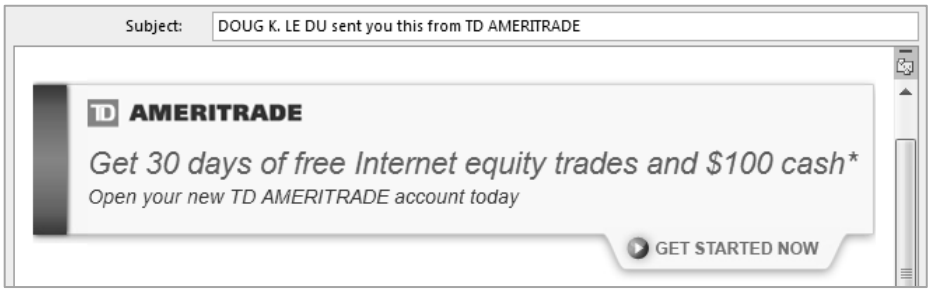
I am not affiliated with TDAmeritrade nor am I in the habit of promoting online brokerage firms. But I do believe in giving credit where it is due and the fact is that TDAmeritrade has made a huge commitment to preferred stock trading (their Over-The-Counter preferred stock trading system is the best available).

And opening a new account with TDAmeritrade is free.

While others ultimately get the job done, you will not be disappointed with the way TDAmeritrade handles your preferred stock trades and I am happy to be able to get this deal for new subscribers.

When I register you for TDAmeritrade's freebees they will send you an email invitation with the specifics of their offer at the time.

Here's a recent example of the email invitation that TDAmeritrade was sending to those whom I registered. This offer has since expired but this example gives you an idea of what the email invitation from TDAmeritrade looks like.



If you want to take them up on their offer just click the Get Started Now button. You must use this button from their invitation email

message in order to get the freebees since this is how they link you to those whom I have registered.

Determine Share Price and Quantity to Buy

Once you have identified the CDx3 Preferred Stock that you wish to purchase you will need to determine how much you are willing to pay for it (your "bid" price) and how many shares you would like to purchase.

Calculating Your Bid Price

By using your online trading account, or by calling your broker, you can find out three key values that will help you to calculate how much you are willing to pay for a share of your CDx3 Preferred Stock.

The three key values are (1) the current "bid" price, (2) the current "ask" price and (3) the last trade price (which you can see at nyse.com, finance.yahoo.com, marketwatch.com and many other stock quoting websites).

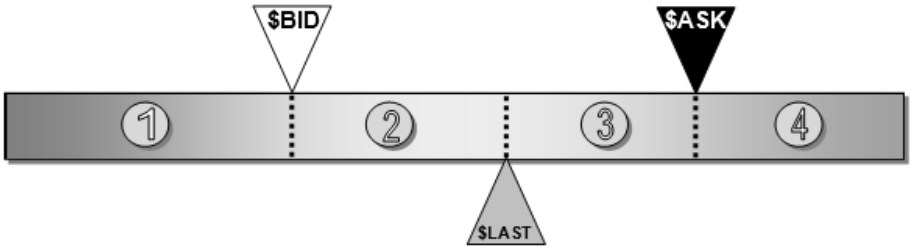
The current bid price is the highest price that the buyers of the world have said that they will pay for a share of this CDx3 Preferred Stock.

The current ask price is the lowest price that the sellers of the world have said that they would be willing to accept.

Not surprisingly, the bid value is always lower than the ask value since it would be silly for the buyers of the world to tell the sellers that they, the buyers, would be willing to pay more than the sellers are asking.

The last trade value is usually somewhere between the bid value and the ask value where buyers and sellers of your CDx3 Preferred Stock

reach agreement on the current value. The last trade value is the current market price of your CDx3 Preferred Stock.



How you position your bid will depend on how badly you want to add this CDx3 Preferred Stock to your CDx3 Portfolio. The above diagram shows four regions. The closer your bid price is to region number 4, the faster it will get processed ("filled") since region 4 represents a bid price that is higher than the ask value.

If, on the other hand, you bid in region number 1, below the current high bidder, do not expect much action anytime soon since there are other buyers in the world who have declared that they are willing to pay more than you are offering.

The Number of Shares to Buy

Have an equal dollar amount invested in each CDx3 Preferred Stock in your CDx3 Portfolio. Doing so makes reviewing your positions much quicker.

If you have $4,000 of this one and $700 of that one and $12,000 of another one, it takes way too much thought to quickly see where you're at compared to a situation where you have, say, $3,000 of each (for example).

Also, for those of you planning on managing your CDx3 Portfolio using an online brokerage account, round your fixed number of shares per purchase to a nice round number like 50 or 200; doing so might save you money.

Unlike full service brokers that charge a percentage, online brokerage services charge you a fixed commission fee (about $10) for each trade. If they can complete your "buy order" in one transaction (i.e. they are able to find a seller to sell your requested number of shares to you), you get charged one commission fee.

If, however, they have to split your order into multiple transactions, you may be charged multiple commission fees (check with your online broker as they vary on this point).

Also, you may be charged additional commission fees if it takes several days to find the number of shares you are attempting to buy. As a rule of thumb, if you are trying to buy more than about 7% of the average daily trading volume of your CDx3 Preferred Stock your buy order may take more than one day to fill.

Generally, you want to make it as easy as possible for your buy order to be processed in a single transaction.

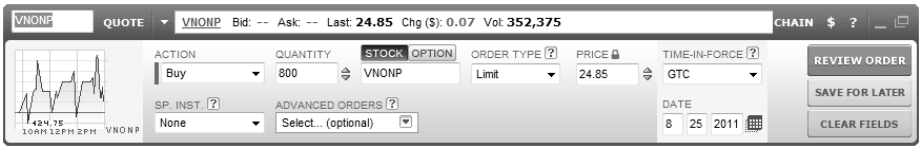
Enter Your Buy Order

If you are using a full service broker for your CDx3 Preferred Stock trades you would just phone your broker with your bid price and number of shares at this point and your broker will enter your buy order for you.

If you are using an online trading account, such as one with TDAmeritrade, you'll be entering your buy order yourself.

Let's say that you've decided to purchase 800 shares of a CDx3 Preferred Stock from Vornado Realty while it was brand new and still

trading on the Over-The-Counter stock exchange under its temporary trading symbol VNONP. Here is how entering your order for VNONP would have looked at TDAmeritrade on April 25, 2011.



As explained in chapter 9, because of the manual nature of the OTC you will have to phone your broker (TDAmeritrade in this example) to get the current bid and ask values for VNONP (the bid and ask values will be blank in your online system).

When you are purchasing CDx3 Preferred Stocks that are trading on the New York Stock Exchange (rather than the OTC as in this example) the bid and ask values will display automatically; no need to phone your broker.

In this example I have set the quantity of shares to purchase to 800.

Notice the Order type is set to "Limit." This means that you are willing to pay *up to* your bid price (which you have set to $24.85 in this example). A limit order tells your broker's system to consider your Bid price a *maximum* value that you are willing to pay, a limit.

If $24.85 is higher than the current bid value, and very close to the ask value, your order will probably be filled fairly quickly.

Also, when buying Over-The-Counter it may be helpful to set the Expiration field to "GTC" as I show here. GTC means "Good Til Canceled." Otherwise, your buy order will expire at the end of the current trading day. By setting the Expiration field to GTC, your buy order is good for 30 days. This will save you the trouble of having to continually check the status of your order or re-enter it tomorrow if it does not fill today.

After you review your order, you would click the Place Order button on the review screen and your buy order for 800 shares of VNONP at $24.85 per share would be placed.

Since in this example you have set your bid price to the same amount as the Last filled trade there should not be too much trouble finding a seller since this is the current market price for VNONP.

Congratulations! You have just purchased your first CDx3 Preferred Stock and did so using the Over-The-Counter stock exchange.

Other than watching the nice quarterly dividend checks roll into your brokerage cash account, there is nothing more for you to do except check the market price at the end of each dividend quarter to see if it is time to consider selling for a nice capital gain.

You are ready to screen, buy and sell the highest quality preferred stocks, either on your own or by using the CDx3 Notification Service.

You are on your way to building your own CDx3 Portfolio and becoming a very successful CDx3 Investor.

The CDx3 Income Engine:

Use the highest quality preferred stocks to earn above average dividend income while simultaneously creating multiple downstream capital gain opportunities.

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APPENDIX A

RESOURCES

As a CDx3 Investor, there are several resources that you have available to you. Some are specific to the CDx3 Income Engine as described throughout this book; some are free websites, while others are websites that request a fee.

CDx3 Income Engine Resources

I research the marketplace for the highest quality preferred stocks and write to you about my observations.

This book provides you with the foundation – the basic methodology for screening, buying and selling the highest quality preferred stocks.

In the context of your personal financial goals, resources and risk tolerance, I hope that my research allows you to make decisions that are more informed about your preferred stock investments than they might be otherwise.

While this edition of *Preferred Stock Investing* is the culmination of several years of research, it does not stop here. My research is ongoing and I continually publish my observations in a variety of forums that are available to you.

In addition to this book, I have organized a wide variety of online resources designed to keep preferred stock investors in touch with the key events that are driving the marketplace for CDx3 Preferred Stocks.

Monthly CDx3 Newsletter
www.PreferredStockInvesting.com

Purchase of this book entitles you to receive the *CDx3 Newsletter*. To activate your subscription go to:

www.PreferredStockInvesting.com

and sign up using your email address.

The *CDx3 Newsletter* is a monthly email newsletter that provides a wealth of ongoing information for CDx3 Investors.

Each issue keeps you up to date on the specific events that are driving the marketplace for the highest quality preferred stocks. Special announcements and free special offers are also part of every monthly issue.

Activate your free subscription to the *CDx3 Newsletter* today.

Preferred Stock Investing Website
www.PreferredStockInvesting.com

From the book's website at www.PreferredStockInvesting.com you can access a variety of resources related to preferred stock investing and the CDx3 Income Engine.

Read all about my two subscription programs - the CDx3 Notification Service and the Preferred Stock List™ database and search engine.

Also, under the Free Resources tab you can access the archives of back issues of the *CDx3 Newsletter*, jump to free preferred stock research articles or test your knowledge about preferred stocks.

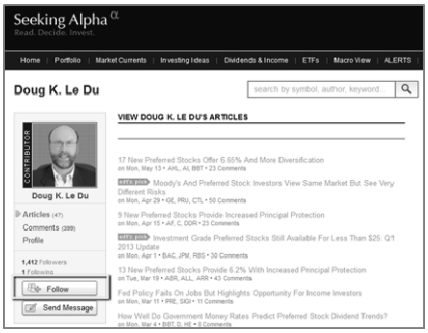
Preferred Stock Investing also makes a great gift. Purchase additional copies in either paperback or eBook format.

Preferred Stock Investing Blog
www.PreferredStockInvesting.BlogSpot.com

I use the Preferred Stock Investing blog to post articles related to current events happening within the preferred stock marketplace. These are frequently (but not always) the same articles of mine that you see at the popular investing website 'Seeking Alpha.'

The Preferred Stock Investing blog also has a news feed of today's preferred stock related new stories and a Q&A section about preferred stocks.

Free Research Articles
www.PreferredStockInvesting.com



I am a contributing writer for the popular investing website 'Seeking Alpha.' Throughout the month I write research articles about preferred stocks and the market-place that they trade within.

To check out my library of research articles go to

www.PreferredStockInvesting.com

and click on the Free Resources tab. There you will find a link to my free research articles at Seeking Alpha. Once you're there, don't forget to click on the Follow button to receive my new articles by email (free).

After you've checked out the free resources that I provide at www.PreferredStockInvesting.com there are numerous preferred stock resources available on the Internet that can be very helpful. Some of these sites are free while others request a fee.

Free Sites And Resources

federalreserve.gov/datadownload - You can download interest rate histories for several decades by using this site's download function.

finance.yahoo.com – Check current pricing of preferred stocks, financial news headlines, company information and much more. This site also allows you to get a price quote for preferred stocks that are trading under a temporary trading symbol on the Over-The-Counter stock exchange.

marketwatch.com – Provides current market prices, the most recent ex-dividend dates and dividend payment charting for preferred stocks.

otcmarkets.com (changed from pinksheets.com) – Has both free and fee-requested functionality. This site provides a resource for over-the-counter trading activity.

sec.gov – Use this site to find prospectuses and a wealth of other interesting information regarding publicly traded companies.

Fee-Requested Sites

The following websites request a fee to access their preferred stock resources.

PreferredStockInvesting.com - The home of my two subscription programs – the Preferred Stock List™ database and the CDx3 Notification Service. You can take a tour of the subscriber's website by clicking on the "Notification Service" tab.

epreferreds.com - Provides information related to fixed-income investments, including preferred stocks.

otcmarkets.com (changed from pinksheets.com) – Has both free and fee-requested functionality. This site provides a resource for over-the-counter trading activity.

quantumonline.com – Provides information on different types of securities, including preferred stocks (requests a fee on the honor system). This site does not provide email alerts, market prices, ex-dividend dates or downloadable data but frequently lists OTC symbols for do-it-yourselfers.

APPENDIX B

THE CDx3 NOTIFICATION SERVICE

In this Appendix I will show you samples of some of the resources that are provided to subscribers to the CDx3 Notification Service. The resources of the CDx3 Notification Service support the CDx3 Income Engine as described throughout this book.

The CDx3 Notification Service is set up to meet the needs of individual investors, brokers and financial planners who have a group of clients interested in preferred stock investing as well as investment groups.

Along with individual investors from all over the world, every major and many smaller brokerage firms throughout the U.S. are subscribers to the CDx3 Notification Service.

Both individual and group subscriptions are available at what I think you will agree is a very reasonable price.

My research into the market price behavior of CDx3 Preferred Stocks is ongoing and my data, observations and conclusions are communicated to subscribers continually and always in plain English for non-experts. To see current subscription pricing go to:

http://www.preferredstockinvesting.com/subscribe.htm

While I am unable to present all of the CDx3 Notification Service features here, you can take a tour of the CDx3 Notification Service website at:

http://www.cdx3investor.com/tutorial.htm.

On the following pages I will present examples of these features of the CDx3 Notification Service:

1) Email alerts for new preferred stocks and exchange-traded debt securities;
2) Detailed Spec Sheets for all preferred stocks and exchange-traded debt securities trading on U.S. stock exchanges;
3) The Preferred Stock List™ database and search engine, available as a separate subscription or as part of a CDx3 Notification Service subscription;
4) The CDx3 Notification Service website with comprehensive resources for preferred stock investors; and
5) The monthly subscriber's newsletter, *CDx3 Research Notes*.

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Email Alerts for New Issues

CDx3 Notification Service subscribers receive up to two email alerts for every newly introduced preferred stock – when/if the new issue begins trading on the wholesale Over-The-Counter stock exchange under its temporary trading symbol (see chapter 2) and when the New York Stock Exchange assigns the permanent symbol and trading begins there (or any other U.S. exchange).

The subject line of the new alert will begin with the words "New Preferred Stock Alert." The example on the following page shows the email alert that subscribers received on April 14, 2013 when a new 6.625% preferred stock from Stag Industrial began trading on the Over-The-Counter exchange under the temporary symbol STGIB.

Each alert message has a consistent format and is organized into four sections – Security Description, Dividend Calculation, Risk Characteristics and Issuing Company.

The security's "CD3 Compliance Score" is also provided (indicates how many of the ten CDx3 Selection Criteria the new issue is able to meet). Characteristics of the new issue that are non-compliant with the CDx3 Selection Criteria are highlighted in red font for easy recognition. In this example, STGIB meets all of the CDx3 Selection Criteria except that it is unrated by Moody's (the NF rating means "Not Found")[1] so STGIB has a CDx3 Compliance Score of 9.

A link to the security's prospectus on file at the SEC is provided, too.

Notice that links are also provided to key information regarding the issuing company (profile, summary, news, financials and ratings). Additional information is provided in each email alert beyond what can fit on a page here including a link to the detailed Spec Sheet that is generated for every issue.

[1] See page 172 for an explanation of the NF and WR ratings.

Email Alert Example

"New Preferred Stock Alert: STGIB (6.625%) Now Trading OTC"

New Preferred Stock Alert: STGIB (6.625%) Now Trading OTC

From: CDx3 Notification Service
To:
Cc:
Subject: New Preferred Stock Alert: STGIB (6.625%) Now Trading OTC

CDx3 income engine CDx3Investor.com

Your User Name:
Your Password:
Your Expiration Date:

April 14, 2013

New Preferred Stock Alert: STGIB (6.625%) Now Trading OTC

A new traditional preferred has begun trading on the Over-The-Counter (OTC) stock exchange under the temporary trading symbol **STGIB** offering a dividend rate of 6.625%.

Stag Industrial, 6.625% Series B Cumulative Redeemable Preferred Stock

CDx3 Compliance Score (1 through 10): 9
(red font indicates non-compliant characteristic, see footnote*).

For a reminder of the three steps that a new preferred stock typically takes to market, please see Preferred Stock Investing chapter 2, 'Creating A New Preferred Stock' or the CDx3 Special Report titled *'Trading Over-The-Counter'* (free to subscribers).

Once the new issue's trading application is approved by the destination exchange (usually the New York Stock Exchange) its current temporary OTC trading symbol will change to a new permanent symbol. You will receive another email notification message at that time.

Security Description

Trading Symbol	STGIB
Stock Exchange	OTOTC
Previous Symbol	
CUSIP	85254J300
Security Type	Traditional Preferred
Convertibility	Not Convertible
IPO Date	04/09/2013
Call Date *	04/16/2018
Liquidation Preference (par) *	$25.00

Dividend Calculation

Dividend Rate (coupon) *	6.625%
Annual Dividend (per share)	$1.6562
Dividend Amount (each period)	$0.4141
Dividend Period (frequency) *	Quarterly
First Calendar Month For Dividend Payments	March

Risk Characteristics (see prospectus)

Cumulative/Non-Cumulative *	Cumulative Dividends
CDx3 Compliance Score (1 through 10)	9
Moody's Rating *	NF
S&P Rating	NF

Issuing Company (see profile | summary | news | financials | ratings)

See more about: CDx3 Notification Service.

Spec Sheet Library

Every preferred stock and exchange-traded security in our database has a corresponding detailed Spec Sheet, formatted for one-page printing.

Our detailed Spec Sheets provide the same information that is sent to subscribers in the email alerts for the security. Each new Spec Sheet is stored in our Spec Sheet Library so CDx3 Notification Service subscribers do not have to worry about having to keep the email alerts; the information is always available in our library.

The Spec Sheet example seen on the following page is for STGIB, the same security featured on the previous page as the email alert example.

The IPO date for STGIB shows April 9, 2013. That is the day that the underwriters purchased the 2.5 million new shares from Stag Industries paying $24.2125 per share. Subscribers received the email alerts seen on the previous page when STGIB became available for OTC trading on April 14, 2013.

STGIB transitioned to the NYSE under the permanent symbol STAG-B a few days later. Subscribers received a second email alert regarding the symbol change and the Spec Sheet was updated accordingly.

Detailed Spec Sheet Example

Spec Sheet for STGIB, OTC Trading (Generated April 14, 2013)

CDx3 Notification Service

Spec Sheet

Generation Datestamp: 04/14/2013 7:17 PT

Stag Industrial, 6.625% Series B Cumulative Redeemable Preferred Stock

CDx3 Compliance Score (1 through 10): 9
(Click here to view the prospectus for this security filed with the SEC)

Security Description

Trading Symbol	STGIB
Stock Exchange	OTOTC
Previous Symbol	
CUSIP	85254J300
Security Type	Traditional Preferred
Convertibility	Not Convertible
IPO Date	04/09/2013
Call Date	04/16/2018
Liquidation Preference (par)	$25.00

Dividend Calculation

Dividend Rate (coupon)	6.625%
Annual Dividend (per share)	$1.6562
Dividend Amount (each period)	$0.4141
Dividend Period (frequency)	Quarterly
First Calendar Month For Dividend Payments	March

Risk Characteristics (see prospectus)

Cumulative/Non-Cumulative	Cumulative Dividends
CDx3 Compliance Score (1 through 10)	9
Moody's Rating	NF
S&P Rating	NF

Issuing Company (see profile | summary | news | financials | ratings)

Common Symbol	STAG
Industry Segment	REIT
US or Foreign	US

Notes:

Preferred Stock List™ Database and Search Engine

I got frustrated having to continually search around the Internet to pull comprehensive preferred stock information together; grabbing this piece of info from one site, another piece from another site and so on. Some had symbols and rates but not prices or ex-dividend dates; some had ex-dividend dates but no ratings; others would not let their data be downloaded…on and on it went.

To add insult to injury, by the time I got the data all together it was out of date. It seemed ridiculous that I and every other preferred stock investor had to do this just to get to a point where a go/no-go decision could be made.

That's when I decided to design the Preferred Stock List™ database and Search Engine (PSL). As annoying as the years of manual data gathering had been, the experience left me knowing exactly what information preferred stock investors needed the most and where to get it. PSL includes current market data (last trade price, volume, current yield), ex-dividend dates, ratings and much more.

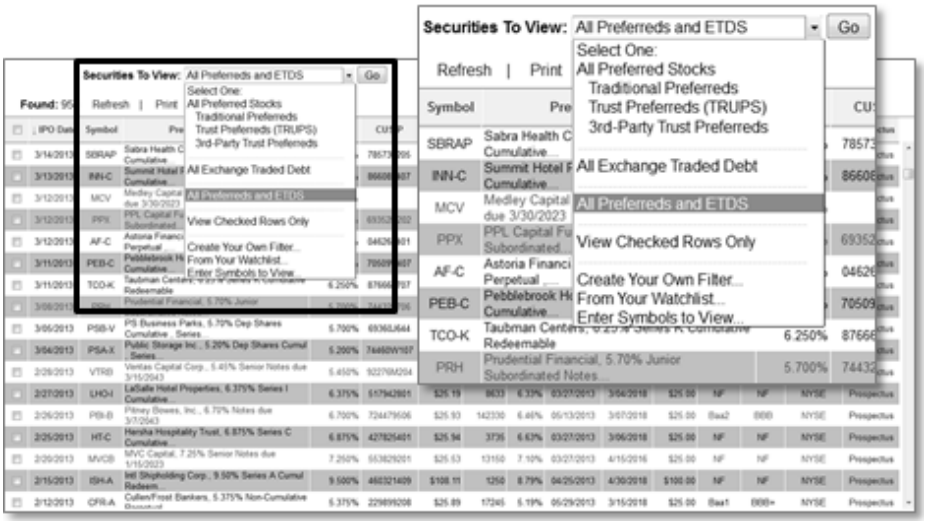
PSL allows you to search, sort, slice and dice every U.S.-traded preferred stock and exchange-traded debt security or any subset.

You can create and save your own watchlists of trading symbols and all of the data is printable and downloadable as a spreadsheet, too. PSL runs right in your web browser so there is no software to install on your computer.

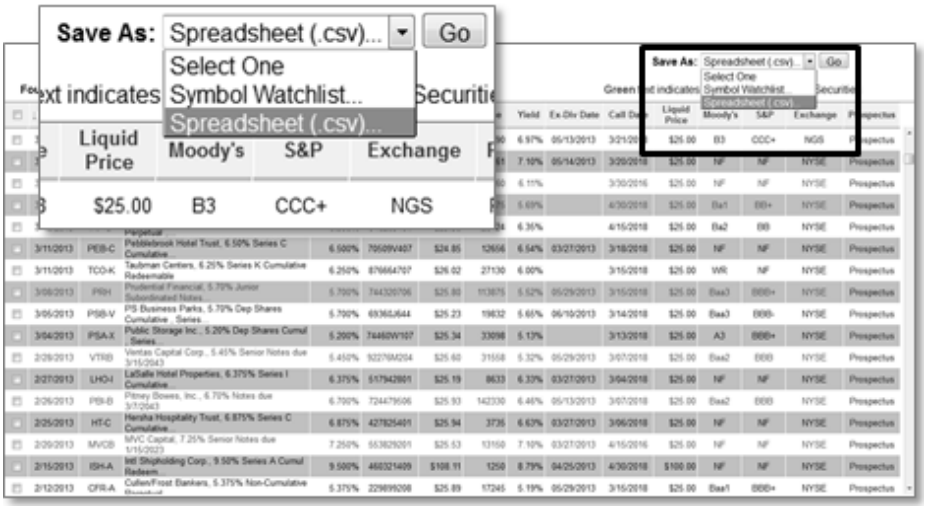
The PSL database and search engine is available to CDx3 Notification Service subscribers or as a separate subscription for do-it-yourselfers.

Preferred Stock List™ (PSL) Database Menu Example

The 'Securities To View' drop-down menu is used to control which securities are retrieved from the database and presented.



The 'Save As' drop-down menu controls download features.



Preferred Stock List™ (PSL) Search Engine Example

The PSL Search Engine allows you to search all U.S.-traded preferred stocks and exchange-traded debt securities. You can specify up to 19 parameters each of which has multiple choices so the combinations are endless.

This example finds CDx3-compliant securities trading below their $25 par value on the Over-The-Counter stock exchange.

The 'Stock Check' feature in the upper-right corner is designed for doing Upgrades as described in chapter 11. Just select the symbol of the preferred stock that you want to upgrade and the PSL search engine will produce a list of upgrade candidates for you.

And notice how you can save your filter parameters for later use. The 'Save Filter As' button (bottom-center) allows you to save your filter while the 'Get Saved Filter' field (top-center) allows you to retrieve it later.

Exclusive Website – The CDx3 Notification Service website is the most comprehensive resource available for risk-averse preferred stock investors. I'll describe a few of the resources here but to see what the site has to offer you can take a tour by going to:

http://www.cdx3investor.com/tutorial.htm

1) **One-Click HotLists –** Right across the top of every page is a collection of "CDx3 Hotlists." In one mouse click you can see special pre-defined lists such as the CDx3 Bargain Table (explained on page 184), call-protected CDx3 Preferred Stocks, CDx3-compliant exchange-traded debt securities and so on.

2) **Ex-Dividend Calendar –** Per the Rule of Buyer/Seller Behavior, the position of a preferred stock within its dividend quarter can favor buyers (early) or sellers (late). The Ex-Dividend Calendar feature displays CDx3 Preferred Stocks grouped by dividend quarter – a great tool for buyers, sellers and those looking to Upgrade, Pile On or Double-Dip (described in chapters 11 and 18).

3) **Access to Experts -** Talk it over with your fellow subscribers. Share ideas, ask questions or read through strategies. This is the largest group of preferred stock investors anywhere.

4) **Company Research –** our company research consolidates key information about the company's that issue the preferred stocks and exchange-traded debt securities in our PSL database.

5) **Announcements** – while our email alerts let you know when a new preferred stock or exchange-traded debt security has started trading, a special feature on the CDx3 Notification Service website searches the Internet and lists announcements of new issues that have yet to start trading. Call announcements are also listed.

***CDx3 Research Notes* newsletter** - The subscriber's newsletter includes articles about the latest research, trends and tips regarding CDx3 Preferred Stocks and the market that they trade within.

CDx3 Research Notes

Monthly Research Notes For CDx3 Investors

FEBRUARY 2013

ISSUE 67

WHAT DO YOU THINK? PLEASE CLICK HERE TO COMMENT ON THIS ISSUE

Quick Summary

"The info provided is very helpful and saves me a lot of time...I'd be lost without this help." Dean H.

Welcome to new CDx3 Notification Service subscribers. This is your first issue of *CDx3 Research Notes*, the non-promotional monthly newsletter exclusively for subscribers to the CDx3 Notification Service.

Underwriters and Preferred Stock Investors Agree on Rewards: The chart on page 2 compares the dividend rate (coupon) set by underwriters on the new preferred stocks that have been issued over the last 90 days with the yield that these same securities are offering in the marketplace. If the underwriters get it right, the market will price the new securities such that the dividend rate and yield are the same in the early days of trading. The chart makes it real obvious how well underwriters have been able to judge today's preferred stock investors.

Market: Moody's Blew Risk Rating for New Preferred Stock 'KFP': Something's not right with KFP, the new preferred stock from KKR Financial. KFP offers a 7.375% dividend, is rated Ba1 by Moody's (one notch below investment grade) and is currently selling for $25.25. For today's market, this sounds like it could be a great deal. In today's market, where Ba1 rated preferreds are yielding 6.050%, KFP is either grossly underprice (representing a potential buying opportunity) or Moody's has misrepresented the investment risk of this security in a big way. The chart on page 3 shows how Moody's blew the call on KFP.

How can I tell why a preferred stock is not 'CDx3 compliant'? The article on page 4 explains a new enhancement that we made during January to our email notification system. The new enhancement allows subscribers to see where the weakness is for new preferreds and ETDs that are unable to meet the CDx3 Selection Criteria from *Preferred Stock Investing*.

CDx3 Calls For February 2013: FPC-A from FPC Capital for February 1, F-A from Ford Motor Company for February 4, VNO-F and –H from Vornado Realty for February 19. To see recent preferred stock call announcements, click the PS News tab on the CDx3 Notification Service website then click on the word "Calls" in the upper-right corner.

Inside This Issue

(click title to see article)

What's Going On Right Now

- Underwriters and Preferred Stock Investors Agree on Rewards
- Market: Moody's Blew Risk Rating for new KFP

What's On Your Mind

- How can I tell why a preferred stock is not 'CDx3 compliant'?

CURRENT INDICATORS

- CDx3 Perfect Market Index:
  Value: 94
  Change: -2
  what's this? | see chart
- CDx3 Preferred Stocks:
  Average Price: $26.55
  Average Yield: 6.272%
  3-Month MovAve: 6.626%
  Change: 0.000%
  Direction: Stable
  see CDx3 Key Rate Chart

10 NOTIFICATIONS

Page 6: Inv grade below $25
01/14: KFNDP Trading OTC
01/14: PSAXL Trading OTC
01/16: ALL-B Trading NYSE
01/16: DUKH Trading NYSE
01/17: PSAXL > PSA-W
01/20: VRNDP Trading OTC
01/23: TANN Trading NYSE
01/23: NEE-J Trading NYSE
01/29: KFNDP > KFP
01/30 LSE-C Trading NYSE

OTHER CDX3 EMAIL

01/03: Jan *CDx3 Newsletter*
01/19: CDx3 Div Rate change
01/26: Jan Seller's Notification
01/31: *CDx3 Research Notes*

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The CDx3 Notification Service is the most comprehensive resource available to preferred stock investors but does not provide individual investment advice. Whether or not it is best for you to buy a specific CDx3 Preferred Stock is a decision that only you can make once you have considered your personal financial resources, goals and risk tolerance.

I do the work, you make the decisions. To subscribe to the CDx3 Notification Service point your web browser to:

http://www.preferredstockinvesting.com/subscribe.htm