Jeanne Mockard at Putnam Investments

On May 29, 1996, Jeanne Mockard considered three pairwise choices among possible investments for the two preferred stock mutual funds she managed for Putnam Investments. Institutional salespersons at other firms called her daily with offers to sell her preferred stocks. From various calls that day, she had culled six potential investments—but she limited her action to buying only three of these, to concentrate her buying power and to avoid unnecessary redundancy. The reality was that these investment opportunities might remain open only for a few hours. Other investors were almost certainly considering these opportunities. Competing with other institutional investors, she sought to improve the return on her fund within strict investment guidelines set by Putnam. Current capital market conditions were buoyant (see Exhibit 1). The yield curve was moderately sloped, but had risen since the beginning of 1996, reflecting analysts' expectations of inflation as the U.S. economy completed its fifth year of expansion. And there were rumors of a change in the tax code that would affect the tax advantages enjoyed by corporate investors in preferred stocks. Mockard needed to decide quickly what action to take on these six investment opportunities.

1 A yield curve was simply a graph of the market yields on U.S. Treasury securities by maturity. An example is given in Exhibit 1. A steeply rising curve would indicate that yields on debt instruments would vary significantly with maturity. A relatively flat yield curve would indicate that yields were relatively insensitive to maturity. The slope and height of the curve change with variations in market conditions.
PUTNAM INVESTMENTS

Mockard worked for a large, well-known investment management company located in Boston, Massachusetts. Owned by Marsh & McLennan, Putnam offered a family of 41 mutual funds available for investment by the general public. Putnam also managed funds for specific clients in the United States and globally, such as pension trusts, 401(k) plans, and charitable institutions that were not open to the public. Putnam's public funds were grouped into four investment categories and had assets of $147 billion.

1. **Growth funds** included 14 funds focusing on investing in fast-growing companies and sought to maximize the value of investment over time. These funds were segmented by region (e.g., United States, Asia, Europe), industry (e.g., health, natural resources), and size of company (e.g., small emerging companies, large established growth companies).

2. **Growth and income funds** as the name suggests, balanced their emphasis on growth and income investing. These included eight funds with specialties ranging from a balanced blend of stocks and bonds, or on a particular industry (e.g., utilities), and to a focus on particular securities (e.g., convertible securities).

3. **Tax-free funds** included seven funds aimed at investing in bonds and money-market instruments issued by states and municipalities in the United States. Income from these was exempt from federal income tax in the United States, and from certain state and local taxes.

4. **Income funds** sought to offer a regular stream of income through investing in bonds and dividend-paying stocks. These included 12 funds emphasizing current income (rather than growth) and varying among U.S. government debt securities, corporate debt, and corporate preferred stocks.

The two funds that Jeanne Mockard managed were classified as income funds.

Putnam was known in the financial community for its highly disciplined approach to investing. In recent years, the public had learned that prominent managers at other fund companies were pursuing investment strategies that deviated sharply from their advertised fund objectives. For example, one equity growth fund manager had deployed a significant portion of the fund’s assets into U.S. government securities in the expectation of sharp interest rate changes. In another instance, equity funds had invested in interest-rate swaps and options. In a third case, a conservative equity fund was revealed to hold 10 percent of its assets in Mexican bonds. Fund investors were outraged, because these mutual funds had advertised that they would invest in growth stocks. Putnam funds were not involved in these unhappy incidents. Indeed, the company prided itself on the clarity of investment focus achieved at each fund, largely through careful delineation of excluded types of investments, and of investment concentration limits. The Putnam approach required managers who were disciplined “team players,” not the solo “superstar” managers who had been lionized by the press in recent years.

Some money-management companies aimed to offer the highest returns in any investment category. Skeptics believed that this goal motivated fund managers to take unusual risks, since returns were largely determined by risks. Putnam, however, aimed more conservatively to rank in the top half of an investment category consistently over time.
PUTNAM PREFERRED-INCOME FUND AND PUTNAM DIVIDEND-INCOME FUND

The two funds that Mockard managed focused on investing in corporate preferred stocks. The Putnam Preferred-Income Fund was an open-ended fund with assets of about $121 million.2 The Putnam Dividend-Income Fund was a closed-ended fund with assets of about $115 million.3 Each fund held 70 to 90 separate issues of securities. The investment strategy for one of these funds was described as follows:

The fund seeks to achieve its objective by investing at least 80 percent of its total assets (taken at current value) in investment-grade adjustable-rate preferred stock4 and . . . common or preferred stocks, which pay dividends that are generally higher than the average dividend paid by the stocks included in the Standard & Poor's 500 Composite Stock Price Index. Under normal market conditions, the fund will invest at least 65 percent of its total assets in preferred stock. The fund may also invest up to 20 percent of its total assets in government and investment-grade corporate debt securities and high-quality, short-term money market instruments.5

The 65 percent limit was an absolute minimum: 80 percent was the target minimum. Mockard could not invest in securities rated less than Baa or BBB at the time of investment, nor could her funds hold more than 5 percent of their assets in any one issuer.

The Putnam Dividend-Income Fund currently held a three-star rating from Morningstar Mutual Funds, indicating average return and risk within its fund category. Exhibit 2 presents the Morningstar report on Putnam Dividend-Income Fund at mid-1996. (The Putnam Preferred-Income Fund was not covered by Morningstar.)

PREFERRED STOCK

Preferred stock differed from common stock in having preference over the common in dividend payments and in distribution of assets in the event of liquidation of the firm. Because preferred stock was viewed legally as equity, it held no special right to draw the firm into bankruptcy proceedings. Preferred dividends were typically cumulative, meaning that if a preferred dividend payment were missed, the obligation to pay that dividend would remain, and would take precedence before any common dividends could be paid. Preferred stockholders usually had rights to elect some directors to the firm’s board in the event that preferred dividends were not paid. Otherwise, preferred stockholders had no voting privileges.

2An open-ended fund had a variable number of shares outstanding, depending on the inflows into the fund by investors. Transactions in fund shares were between investors and the fund. The assets under management could vary due to changes in market value of fund assets and variations in the number of shares outstanding.
3A closed-ended fund had a fixed number of shares outstanding. Transactions in fund shares were between investors. The assets under management were relatively fixed as a result (i.e., except for changes in market values of fund assets).
4The dividend rates on adjustable-rate preferred stocks were adjusted every 90 days to reflect any changes in benchmark interest rates, such as the yields on U.S. Treasury securities.
5Putnam Preferred Income Fund Prospectus, April 1, 1996, 8.
Preferred shares typically carried a stated liquidation value, such as $25 per share. The dividend on the preferred stock could either be expressed in dollar terms per share, or as a "coupon rate" or "dividend yield of stated value" equaling the dollar dividend divided by the liquidation value. Because the market values of preferred stock typically fluctuated, preferred stock returns could also be quoted as "strip yields."  

A paradox was that preferred-stock dividend yields were often at or below yields on bonds of similar risk—even though preferreds were subordinate to bonds. If market returns were determined by risk, preferred yields should be higher. This paradox might be explained by an unusual tax feature of preferred stocks. Dividends from preferred stocks were subject to a "dividends received deduction" (DRD) of 70 percent when the owner of the shares was another corporation. This meant that 70 cents of every dollar of preferred dividends received by corporations would not be taxed. To compare the yields on preferred stock with other securities, it would be necessary to "gross up" the preferred stock yield to a pretax equivalent. Thus, a preferred stock bearing a dividend yield of 7 percent would have a pretax equivalent yield to a corporate investor of 9.6 percent (where the corporate investor had a marginal tax rate of 35 percent). If the DRD were reduced to 50 percent, the pretax equivalent yield in this example would fall to 8.9 percent; if DRD were reduced to 20 percent, the pretax equivalent yield would fall to 7.8 percent. In comparison, Exhibit 1 gives pretax yields on corporate bonds.

The comparison of standard preferred stocks to bonds was not completely inappropriate: both were regarded as fixed-income securities, and investors in either participated in the growth in value of the enterprise. The value of preferred stocks was sensitive to changes in interest rates. Finally, like debt, preferred stocks often could be redeemed (or "called") before maturity at the option of the issuer. But preferred stock usually ranked behind debt in priority in liquidation of the firm. Furthermore, the dividends paid on preferred stock were not deductible from income for purposes of computing corporate tax—unlike interest payments, which were deductible.

Given the similarities of preferred stock to debt, and yet the disadvantages of preferred compared to debt, many observers wondered what might motivate corporations to issue preferred stock. The range of answers suggested that preferred stock resolved difficult trade-offs in managing the corporate capital structure. For instance, preferred stock looked like equity to creditors (and therefore was thought to expand the borrowing base of the firm), but looked like a liability to common stockholders (and therefore increased the financial leverage of the firm). This hybrid-like nature of preferred stock was of special interest to firms facing a nontrivial risk of bankruptcy: accumulated unpaid dividends were not debts of a corporation and thus could not trigger bankruptcy proceedings. Preferred stock was equity, and yet it did not carry votes, it did not dilute the voting control of common stockholders. Finally, in regulated industries (such as electric power generation) it might be

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6Strip yield was calculated as the dollar dividend/(current price − accumulated dividends).

7The estimate of a pretax equivalent yield of preferred stock assumes that in an efficient market securities of equivalent risk will offer the same return after taxes. Thus, the dividend yield of preferred stock (PDY) should have the following relationship to the pretax yields (YTM) of other securities that are not subject to the DRD:

\[
(\%_{DRD} \times \text{P DY}) + [(1 - \%_{DRD}) \times (1 - r) \times \text{P DY}] = \text{YTM} \times (1 - r)
\]
possible to pass the tax disadvantage of preferred dividends on to customers—electric utilities were large issuers of preferred stock.

In the spring of 1996, rumors circulated that the Clinton administration was considering reducing the dividends received deduction from 70 percent to 50 percent. This would have the effect of somewhat lowering the attractiveness of preferred stock as an investment medium for corporations.

Adjustable-Rate Preferred Stock

A special variety of preferred stock featured a coupon rate that would reset every 90 days to float at a target level above some benchmark rate such as the market yield on U.S. Treasury securities. Adjustable-rate preferred stock (or "ARPS") was attractive to corporate treasurers looking for an investment in which to place a firm's excess cash balance for a period of time. Because the yield varied, the market value of the investment would remain relatively fixed, ensuring that the treasurer would not have to explain extraordinary gains or losses in securities to his or her board of directors. In addition, the yields on ARPS offered a premium return compared to yields on U.S. Treasury instruments or other short-term money market instruments. For a corporate investor, this yield would be augmented by the 70 percent dividends received deduction.

Yield on an ARPS
With Collar at 4% and 10%

Typically, the dividend yield on ARPS would be allowed to vary within a set range, between a minimum and maximum. The upper and lower bounds formed a "collar." The

8The exception to this rule was when the market yields varied above the collar maximum or below the minimum.
figure above gives a graph of the possible yields offered an investor by a collar set at 4.0 and 10.0 percent. Suppose that within the collar, yields would be set to equal the yield on a specific U.S. Treasury security plus 200 basis points. The floor would protect the investor against an unusually low yield; the ceiling would protect the issuer against an unusually high yield. The width of the collar was a matter of choice to the issuer at the time the ARPS was originally issued. In general, a wider collar meant that the investor bore more uncertainty about the return to be received at the next reset date; a narrower collar meant less uncertainty.

JEANNE MOCKARD

Mockard joined Putnam Investments in 1990 upon completion of her MBA degree. Initially, she worked as a securities analyst. She assumed responsibility for the two funds in 1993. In May 1996, she held the title of senior vice president. Mockard described her work this way:

I compete for securities, for good investments. There are only a couple of other funds with a specific focus on preferred stock like mine. However there are a large number of mutual funds with at least a little appetite for preferred stocks. In addition, I compete with large corporations like IBM and Disney who invest their excess cash directly into preferred stocks.

On the other side, I compete for investors to buy shares in my funds. A few of the investors are private individuals, but most are corporations. The smaller firms that invest in the funds consider me their cash management/investment office. We offer them a chance to diversify their risk and gain ready access to market dealers who bring me their investment ideas.

The size of my fund is a competitive advantage in this market. To make money here, you have to be a big player. People come to me when they want to do a deal. I network a lot, so that preferred stock traders call me; and so that I know whom to call. The market in preferred stocks is different from common equities where you have up-to-the-minute electronic information. Information about preferreds is exchanged more by word-of-mouth. Information is simply less available. Also, the market in preferreds is not as liquid as the market for common—I simply can’t buy every issue that’s out there. When an opportunity to invest does come along, I have to think carefully and strategically, since the opportunity may not reappear for a while.

Though my focus is preferred stocks, I have to have an opinion on where interest rates are headed. Preferreds are income securities, and thus affected by changes in the interest rate environment. You need a real appreciation of the yield curve. Adjustable-rate preferreds trade off of the short end of the curve, because they are reset every 90 days against the short-term Treasury rate. Perpetual preferreds trade more in relation to the long end of the yield curve.

I’m like a brand manager. I have a clear idea of my customer and the market segment I’m trying to serve. I can’t be all things to all people. My goal is to invest mainly in perpetual preferred stocks, balanced with some adjustable-rate preferreds and sinking fund preferreds⁹ to dampen the swings in value as interest rates move. I have to practice a strategy of “disciplined opportunism.” I want to serve the investor and the mission of the fund. I also want to beat the

⁹Sinking fund preferreds are preferred stocks that have a scheduled amortization or repayment over time, similar to long-term debt. The preferred issue “sinks” as it is repaid.
Merrill Lynch preferred stock index—the benchmark for “the market” in the preferred stock arena; I aim to wind up in the top half of the league tables in my segment.

I spend 50 percent of my time traveling. I talk to companies to assess investment risk, and to anticipate the private actions of corporate executives beforehand. I go to conferences to get a sense of industry trends. The content of this work always surprises me. I love what I do. You have to be interested in everything. No two days are alike. It’s not an orderly job. Market developments constantly require you to decide how to manage your time best.

PUTNAM’S ECONOMIC AND MARKET OUTLOOK

Dr. Robert Goodman, managing director and senior economic advisor at Putnam, described the company’s outlook on the economy in the following way in his summer 1996 Commentary:

As we enter the second half of 1996, confusion and uncertainty about economic prospects abound. The confusion has manifested itself in a rise in long-term government bond yields to more than 7 percent and an equity market that has been stuck in a broad trading range for most of the year. While traders in both bonds and stocks are at risk in such environment, history suggests that investors with long-term horizons can take advantage of these circumstances.

Chief among the uncertainties currently facing investors is the prospect of increased inflation as we go forward. Anxiety about accelerating inflation stems from a rise in commodity prices, such as the recent spurt in gasoline prices, and the possibility of wage increases if economic growth should reaccelerate. In my view, both of these concerns have been exaggerated in the media and on Wall Street.

Since 1979, the bond market, battered by brutal experience, has imposed a very real and severe constraint on the ability of the Fed to pursue an inflationary monetary policy. The bond market vigilantes, as these defenders of price stability have been called, have been responsible for the downtrend in interest rates and inflation that took place throughout the 1980s and continues today. Should the Fed embark upon a policy deemed to be inflationary by bond market participants, bonds would be sold in anticipation of that inflation and long-term interest rates would rise.

... What we are likely to experience going forward are shifts in relative prices among commodities, reflecting underlying demand conditions in the marketplace. But these price changes should not be translated into a generalized inflation spiral.

Nevertheles, until investors accept this analysis, the bond market will be buffeted by fears of renewed inflationary pressure. It is quite possible, therefore, that for a time interest rates may rise to levels exceeding long-term equilibrium. In my opinion, long-term bond yields above 7 percent are not sustainable and, when they are available, represent good value relative to the average rate of inflation we are likely to experience over the longer run.

THE SIX INVESTMENT OPPORTUNITIES

Exhibit 3 presents data summarizing the three pairwise choices that Mockard needed to decide on soon. The exhibit gives information that she used to make buy-or-sell decisions quickly. This information included the credit ratings of the issues determined by Moody’s and S&P (Exhibit 4 gives the rating definitions of these categories). The “Ex date” was the
next date in 1996 after which purchase of the security would not entitle the investor to the next quarterly dividend. The strip yield was calculated simply as the annual dividend of the security divided by the current price less accrued dividends. The "spread vs. 30 year" was the difference between the strip yield and the yield on the 30-year U.S. Treasury bond. YTC stands for yield to call, the preferred's internal rate of return yield calculated as if the issuer were to redeem the issue at the earliest possible date, indicated by "call date." These data were drawn by Mockard's assistant from a Bloomberg terminal.

- **Decision A:** An institutional salesperson at R.W. Baird had called to say that two preferred issues from Georgia Power had come on the market. These issues were perpetual preferreds and were similar in many respects. The Series Q carried a coupon of $1.9875 per share, while the Series R carried a coupon of $1.9375 per share.

- **Decision B:** An institutional salesperson at Salomon Brothers called to offer perpetual preferred issues on two different companies: Travelers Insurance and Merrill Lynch. The Travelers issue carried a coupon rate of 9.25 percent, whereas the Merrill Lynch issue carried a coupon rate of 9.00 percent.

- **Decision C:** An institutional salesperson at Lehman Brothers offered Mockard two different issues of adjustable-rate preferreds. One, issued by Texas Utilities, held a current coupon rate of 6.5 percent, and a collar that would permit coupon rates between 6.5 and 13 percent. The other issue, from Puget Sound, offered a current coupon of 6.31 percent and a collar that would permit coupon rates to vary between 4 and 10 percent.

Mockard needed to decide quickly between the alternatives within each pair of opportunities. As she turned to the data, she reflected on the possible impact of changes in the environment. Interest rates had been rising all spring; how would Putnam's interest-rate outlook affect the three decisions? Also, the Clinton administration might lower the DRD. How, if at all, should this possible change influence her thinking?
EXHIBIT 1
Capital Market Conditions
(May 29, 1996)

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<thead>
<tr>
<th>U.S. Treasury Obligations</th>
<th>Yield</th>
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</thead>
<tbody>
<tr>
<td>90-day bills</td>
<td>5.18%</td>
</tr>
<tr>
<td>1-year notes</td>
<td>5.74%</td>
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<tr>
<td>2-year notes</td>
<td>6.24%</td>
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<tr>
<td>5-year notes</td>
<td>6.63%</td>
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<tr>
<td>10-year bonds</td>
<td>6.85%</td>
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<tr>
<td>30-year bonds</td>
<td>6.92%</td>
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<table>
<thead>
<tr>
<th>Long-Term Corporate Debt Obligations</th>
<th>Yield</th>
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<tr>
<td>AAA</td>
<td>7.63%</td>
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<tr>
<td>AA</td>
<td>7.73%</td>
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<tr>
<td>A</td>
<td>7.99%</td>
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<tr>
<td>BBB</td>
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<tr>
<td>BB+</td>
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<td>BB/BB-</td>
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<tr>
<td>B</td>
<td>10.38%</td>
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<tr>
<th>Other Instruments</th>
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<tr>
<td>Prime rate loans</td>
<td>8.25%</td>
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<tr>
<td>Discount rate</td>
<td>5.00%</td>
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<tr>
<td>Certificates of deposit (90-day)</td>
<td>5.36%</td>
</tr>
<tr>
<td>Commercial paper (6 months)</td>
<td>5.42%</td>
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</table>

Sources: Bloomberg Business News; Standard & Poor's Current Statistics.
## EXHIBIT 2
### Morningstar Report

### Putnam Dividend Income

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<tr>
<th>Performance Objective</th>
<th>Income</th>
<th>Market Capitalization</th>
<th>Dividend Yield</th>
<th>Expense Ratio</th>
<th>Annualized Total Return (%)</th>
<th>1-Year</th>
<th>3-Year</th>
<th>5-Year</th>
<th>Since Inception</th>
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</thead>
<tbody>
<tr>
<td>High</td>
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<td>-</td>
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<td>-</td>
<td>-</td>
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<td>-</td>
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</table>

**Recent Average Rank: No. 117 of 121
**

<table>
<thead>
<tr>
<th>Recent Performance</th>
<th>1-Year</th>
<th>3-Year</th>
<th>5-Year</th>
<th>Since Inception</th>
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<tbody>
<tr>
<td>Return (Total)</td>
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<td>-</td>
<td>-</td>
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<tr>
<td>Expense Ratio</td>
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<tr>
<td>Median</td>
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<tr>
<td>Percentile Rank</td>
<td>-</td>
<td>-</td>
<td>-</td>
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</tr>
</tbody>
</table>

**Morningstar Rating:** 4/5 stars

**Risk:** Low

**Summary:** Invests in dividend-paying corporate and government bonds, plus a small portion of equities.

**Reasons for Rating:**
- The fund's low-risk strategy makes it a good choice for conservative investors.
- The fund's historical performance is strong, with a consistent track record.
- The fund's fee structure is competitive.

### Manager

- **Robert M. Hostutler, Ph.D., CFA.**
- **Portfolio Manager:** Since 1988
- **Co-Managers:**
  - Charles R. L. Adams
  - John F. Noonan
  - John R. Spence

**Average Annual Net Asset Value: $11.20
**

**Net Assets: $1.20
**

**Dividend Income:**
- **Income:** 3.21%
- **Capital Gain:** 0.00%
- **Other Income:** 0.00%

**Income Sources:**
- **Interest:** 3.21%
- **Dividend:** 0.00%
- **Other:** 0.00%

**Portfolio Overview:**
- **Public Shares:** 99.99%
- **Private Shares:** 0.01%

**Top Ten Holdings:**
- **Energy:** 23.84%
- **Health Care:** 11.14%
- **Financials:** 10.89%
- **Consumer Discretionary:** 9.21%
- **Utilities:** 8.74%

**Top Ten Sector Holdings:**
- **Energy:** 23.84%
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**Top Ten Countries:**
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- **Canada:** 0.01%

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### EXHIBIT 3
Summary of Investment Opportunities

<table>
<thead>
<tr>
<th>Decision</th>
<th>Broker</th>
<th>Security</th>
<th>Number of Shares</th>
<th>Moody’s Rating</th>
<th>S&amp;P Rating</th>
<th>Ex Date</th>
<th>Asking Price</th>
<th>Strip Yield %</th>
<th>Spread vs. 30 Year (b.p.)</th>
<th>YTC</th>
<th>YTC Spread (b.p.)</th>
<th>Call Date</th>
<th>Call Price</th>
<th>30-Year Bond Yield</th>
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<tbody>
<tr>
<td>A</td>
<td>Baird</td>
<td>Georgia Power Series Q $1.9875 coupon</td>
<td>13,500</td>
<td>A2</td>
<td>A</td>
<td>6/13</td>
<td>$25.60</td>
<td>7.88%</td>
<td>+96</td>
<td>6.68</td>
<td>+117</td>
<td>6/297</td>
<td>$25.00</td>
<td>6.92</td>
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<td></td>
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<td>Georgia Power Series R $1.9375 coupon</td>
<td>11,300</td>
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<td>A</td>
<td>6/13</td>
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<td>7.69</td>
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<td>7/297</td>
<td>$25.00</td>
<td>6.92</td>
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<td>Salomon</td>
<td>Travelers Series A 4, 9.25% coupon</td>
<td>212,500</td>
<td>A1</td>
<td>A</td>
<td>5/29</td>
<td>$25.80</td>
<td>8.96</td>
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<td>Merrill Lynch Series A 9.0% coupon</td>
<td>189,870</td>
<td>A1</td>
<td>A</td>
<td>6/13</td>
<td>$28.875</td>
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<td>+100</td>
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<td>+26</td>
<td>12/30/04</td>
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<td>6.92</td>
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<td>C</td>
<td>Lehman</td>
<td>Texas Util. Series A, ARPS, collar: 6.5-13% current coupon = 6.5%</td>
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<td>Baa3</td>
<td>BBB</td>
<td>7/10</td>
<td>$92.18</td>
<td>7.12</td>
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<td></td>
<td></td>
<td>Puget Sound Series B, ARPS, collar: 4-10%, current coupon = 6.31%</td>
<td>200,000</td>
<td>Baa1(^2)</td>
<td>BBB+</td>
<td>7/18</td>
<td>$22.50</td>
<td>6.41</td>
<td>-51(^3)</td>
<td>3.14</td>
<td>3.14</td>
<td>3.14</td>
<td>6.92</td>
<td></td>
</tr>
</tbody>
</table>

\(^1\) The Texas Utilities ARPS yield was 103 percent of the 30-year Treasury bond yield (7.12/6.92).

\(^2\) Puget Sound was listed for a possible downgrade by Moody’s.

\(^3\) The Puget Sound ARPS yield was 93 percent of the 30-year Treasury bond yield (6.41/6.92).

\(^4\) Versus contemporaneous treasuries.
### EXHIBIT 4
Standard & Poor’s Risk Rating Definitions

<table>
<thead>
<tr>
<th>Rating</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>Preferred stock rated AAA has the highest rating assigned by S&amp;P. Capacity to pay dividends and meet redemption requirements is extremely strong.</td>
</tr>
<tr>
<td>AA</td>
<td>Preferred stock rated AA has a very strong capacity to pay dividends and meet redemption requirements and differs from the higher rated issues only in small degree.</td>
</tr>
<tr>
<td>A</td>
<td>Preferred stock rated A has a strong capacity to pay dividends and meet redemption requirements, although it is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than preferred stock in higher rated categories.</td>
</tr>
<tr>
<td>BBB</td>
<td>Preferred stock rated BBB is regarded as having an adequate capacity to pay dividends and meet redemption requirements. Whereas it normally exhibits adequate protection parameters, adverse economic conditions or changing circumstances are more likely to weaken the capacity to pay dividends and meet redemption requirements for preferred stock in this category than in higher rated categories.</td>
</tr>
<tr>
<td>BB, B, CCC, CC, C</td>
<td>Preferred stock rated BB, B, CCC, CC, and C is regarded, on balance, as predominantly speculative with respect to capacity to pay dividends and redemption requirements in accordance with the terms of the obligation. BB indicates the lowest degree of speculation and C the highest degree of speculation. While such preferred stock will likely have some quality and protective characteristics, these are outweighed by large uncertainties or major risk exposure to adverse conditions.</td>
</tr>
</tbody>
</table>

*Source: Paraphrased from Standard & Poor’s Bond Guide.*