

Preferred stock: An alternative for fixed-income investors?

Investors who are wary of increasing the growth portion of their portfolio often decide to augment their fixed-income investments with cash equivalents such as Treasury bills or CDs, for example. Some investors still may consider stocks, but they are looking for those that offer healthy dividends, rather than putting the potential for growth at the top of their wish list. Bonds are likely to be under consideration as well.

Preferred stock: a hybrid

Some investors are turning to preferred stock as a way to gain a measure of safety along with a satisfactory income stream.

Preferred stock represents a mix of regular common stock and a bond. Similar to common stock, a share represents partial ownership in a company and pays dividends. The company books list the shares as equity on their balance sheet.

But preferred stock bears many characteristics of a bond: It has a set maturity (often 30 to 40 years) and, at that maturity, pays the investor par value. Dividends, as is the case with bond coupons, cannot be tampered with when a company's earnings fall significantly. Ownership of preferred shares generally does not entitle a shareholder to vote his or her shares, a key characteristic of common stock. But, on the plus side, preferred stock has priority over common stock in the event of bankruptcy and in the repayment of dividends (hence, the "preferred" in its name).

Why preferred stock?

First, a bit of history: Preferred stock surged in popularity in the 1990s. Prior to 1993 it was more favored by corporate investors because much of the income earned was deductible. (Individual investors were not allowed the deduction.) Beginning in 1993, new preferreds were issued that were fully taxable for all shareholders, offering higher yields than their pre-1993 predecessors.

Here's why preferred stock may be more attractive than bonds to investors seeking fixed-income investments: Dividends are more frequent—quarterly, rather than the more

usual twice-a-year payment offered with bond coupons. Because it trades on the stock market, information about preferred stock may be more readily accessible. And cost (generally, \$25 a share) is less than the \$1,000 price of a new corporate bond, allowing beginners to take a small step, rather than a plunge, into the world of preferred stock.

The other side of the coin

That's all good news. But investors must weigh some significant downsides to investing in preferred stock.

As is the case with any bond, preferreds carry substantial interest-rate risk. When interest rates rise, their value will drop. What's more, an investor generally can't expect to share in the "good times" when a company is successful, common stockholders will see the value of their shares rise while preferred shareholders are unlikely to enjoy any additional investment rewards.

From a tax perspective, preferred shares may not make sense for top-bracket taxpayers. Because they don't have the same potential for long-term capital gain, the investor generally is left with taxable dividend income (at a tax rate of 15% currently) from his or her investment. Of course, this obstacle may be overcome for a time, when preferreds are held in a tax-deferred retirement account. (It's also important to note that not all dividend income from preferred shares qualifies for the low rate.)

In an era of collapsing corporate giants, investors cannot ignore the possibility of bankruptcy. A preferred stockholder may see dividends suspended. And because they have slightly longer maturities, preferred shares generally are subordinate to corporate bond issues. In other words, if a company runs into bad times, owners of preferred stock are ahead of common stockholders in the line, but stand behind bondholders.

Evaluating preferred stock

Investors taking a serious look at preferred stock need to ask a few questions. For example:

- *Is the preferred issue cumulative?* With cumulative preferred stock, generally, dividends will accrue even if they are not actually paid. When a company hits a temporary setback but later recovers, the preferred stockholder is entitled to receive all the dividend payments missed.

- *What are the call provisions?* Most preferred stock has provisions that allow companies to redeem preferred shares at par after a specific date. A company is most likely to call preferred stock when interest rates have dropped. Therefore, investors should look for a high yield to call, not just an attractive current yield.

Are the shares “participating” or “nonparticipating?” Participating preferred shares offer an added bonus. Shareholders may receive additional dividends based upon a predetermined formula using the company’s profits as a measure (referred to as a “participation dividend”). Participating preferred shares are the exception rather than the rule.

Are the shares convertible? With convertible preferred stock, share value is closely tied to the price of the company’s common stock. Convertible preferreds may be exchanged for common stock at a set price at some specified future date.

Doing the research

Finally, as with any investment, it’s important to do the research.

Before adding a company’s preferred stock to one’s portfolio, an investor should understand what the company does and how it generates its income. Just as important as an analysis of the company, however, is the risk analysis—how likely is it that the company will be able to pay the required dividends?

One measure of a company’s ability to handle its debt is its EBITDA coverage ratio. EBITDA is earnings before interest, taxes, depreciation and amortization. The ratio is EBITDA divided by interest expense plus preferred dividends. The higher the ratio, the more attractive the preferred stock.

For quick reference, an investor may gain some insight from a look at how a company’s preferred stock is rated by S&P or Moody’s. As a general rule of thumb, if the preferred stock’s rating is below a “B,” it is considered “junk.” Anything above is considered investment grade.

To learn more

If you are interested in finding out more, one of our investment specialists will be glad to explain this investment in more detail and help you decide whether, in your particular circumstances, preferred stock deserves a place in your portfolio.

Any developments occurring after January 1, 2008, are not reflected in this article.