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Preferred Stocks

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Investors who are currently looking for decent yield from fixed income securities are finding scant possibilities. Bond yields depend on and are priced off the Treasury Yield Curve. Investors looking for yield want to see an elevated and upward sloping curve. Instead, they are confronted with a curve that is very low and flat. This phenomenon is the result of the Federal Reserve's policy to flood the market with liquidity and support asset prices. The Fed has so far accomplished this very effectively, boosting asset recoveries across the board since the March 2020 low, but hurting conservative investors looking for decent bond yields.

This is where preferred securities come in. Preferred securities labor in relative obscurity compared to their common stock and bond brethren, but can be attractive investments under current circumstances by offering predictable and relatively high income. In this article, we explain the pros and cons of preferred securities (a.k.a. preferreds). Known as hybrid securities, preferreds have characteristics of both stocks and bonds. Preferreds occupy a relatively obscure segment of the fixed-income market, and their hybrid nature makes them quite difficult to understand.

Straight Preferreds

Like bonds, preferreds are typically issued with a fixed par value, usually $25, and pay quarterly income based on a fixed percentage of par value, like bonds' coupon rate. Preferred stocks are generally perpetual securities with no maturity. But they may be callable at the issuer's option at some future date, usually at par value or slightly above that. In the event of bankruptcy, preferred stockholders have a priority claim on the issuer's assets which is junior to debt holders but senior to common stockholders.

There are many varieties of preferred stocks, and the terms specific to an individual issue can differ significantly. The basic types of preferred stock include the following:

- **Cumulative preferred stock**, which requires dividends to accrue in the event the issuer does not make timely payments. The unpaid dividends are called dividends in arrears and must be paid by the issuer before making any dividend payments on the issuer's common stock.

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* Most of this article is copied verbatim from the Winter 2010 issue of PDV *Observations*.

- **Non-cumulative preferred stock**, which does not offer the benefit of dividend accruals. If the issuer decides not to make dividend payments, it is not obligated to pay the delinquent dividends at a later time. However, no dividends can resume on the issuer's common stock without initiating them again on the preferred stock first.
- **Callable preferred stock**, which gives the issuing company the right to redeem the preferred stock at a specified date and price (much like callable bonds).
- **Participating preferred stock**, which confers the right to receive, in addition to regular dividends, additional payments based on certain specified circumstances.
- **Convertible preferred stock**, which can be converted into common stock at a predetermined time and price.

Trust Preferred Securities

Preferreds come in the form of **trust preferred securities (TruPS),** issued by a special trust set up by the company raising funds. The special trust buys bonds of the issuer company, and in turn issues TruPS to third-party investors. The TruPS sale proceeds are passed through the trust and transferred back to the company in payment for its bonds. The maturity of the TruPS typically matches that of the bonds in the trust, with the bond interest payments used to pay the dividends on the TruPS. Like traditional preferred stocks, TruPS generally are issued with a par value of $25, pay quarterly dividends, and are callable at the issuer's option a few years following issuance. In the event of bankruptcy, TruPS are senior to the issuer's straight preferred and common stocks but junior to its debt.

The structure of TruPS offers certain advantages to the company raising funds over traditional preferred stocks. Because (unlike preferred dividends) the interest paid on the bonds is deductible, the issuer enjoys a lower cost of funding via TruPS. However, taxable corporations generally find TruPS less desirable investments than traditional preferred stocks, because such corporations do not enjoy dividends-received exclusion tax benefits associated with TruPS dividends.

Positive Attributes

Preferreds have several positive attributes. First, they pay higher yields than similarly rated bonds and the common stock of the preferred security issuer. Second, preferreds typically pay income quarterly rather than semi-annually like bonds, allowing for more frequent compounding. Third, preferred dividends must be paid before common stock dividends. Fourth, preferreds tend to go down less than common stocks during poor market conditions, because their relatively high yields act as partial price support and because of their superior position in bankruptcy.

Negative Attributes

As with any investment, preferreds possess some negative attributes. Preferreds (other than possibly participating and convertible preferreds) don't have the upside potential of common

stock, since straight preferreds do not share in growing profits. It is true that growing profits increase the likelihood of continued payment of preferred dividends, potentially raising the credit rating of the preferred and resulting in some price appreciation. Nevertheless, the fixed par value of preferred and any call feature limit any upside. You should note that preferred shareholders have no voting rights, and cannot influence corporate matters like common shareholders can. Also, unlike bond interest, preferred dividends can be deferred at the issuer's discretion. Unless the preferred is ***cumulative***, the issuer does not have to pay accrued dividends. While suspending preferred stock dividends is permissible, doing so could potentially jeopardize the issuer's future sources of capital funding, as it tarnishes the issuer's credibility and makes future debt and equity offerings possibly cost-prohibitive. It is therefore not in the issuer's interest to suspend dividends for capricious reasons, but only as a last resort.

The call feature embedded in many preferreds can also hurt you. If you buy a preferred at a premium to par value (i.e. for more than $25 a share), you could be faced with having part of your high yield negated by being paid back $25 for each preferred share that cost you more than $25. Especially for preferreds that are selling at a premium to par, you should calculate the yield-to-call, which takes into account the premium price you are paying and the likelihood you would incur a capital loss on the call date.

Like bond prices, preferreds' prices also move inversely to interest rates. The degree of movement is proportional to something called duration, which is affected by, among other things, the term to maturity. Since most preferreds have no maturity, they are long-duration assets that are highly sensitive to interest rate movements. Nevertheless, such risk is partly mitigated by the relatively high dividend income payments that tend to shorten duration.

The market for preferreds is much smaller than that for bonds or common stock. As hybrid investments, preferreds can also be confusing to understand. These two factors mean that preferreds can be inefficiently priced from time to time, offering attractive investment opportunities.

As you can see from the foregoing, preferred stocks and TruPS offer both pros and cons relative to common stocks and bonds. As with any fixed-income investment, credit analysis is important prior to investing in preferreds. This is particularly so since preferreds rank below debt in bankruptcy. Cash flow should be ample to comfortably cover fixed-charges that include imputed interest portion of operating rental, taxes due, debt service on all senior debt and all preferred dividends. Ratings on many preferreds are available from major credit rating agencies like Standard & Poor's and Moody's.

Whether a preferred is an attractive investment depends on balancing the higher yields against their undesirable characteristics discussed above. Since the Fed has recently announced its intention to keep short-term interest rates near zero and given the flatness of the yield curve as well as the persistent lack of inflation, this is an appropriate time to consider investing in some preferreds if you are seeking decent, predictable income.

Some year-end tax savings to consider

Louisa Ho, *Senior Portfolio Analyst*

As we approach end of the year, below are some tax savings for you to consider.

Delay RMD until age 72

The SECURE Act that was passed in late 2019 made a significant change to the starting age for required minimum distributions (RMD) from Traditional IRA and other qualified retirement plan accounts. The new rule delayed the starting age for RMD from 70 ½ to 72 for individuals who reach 70 ½ in 2020 or after. For individuals who reached 70 ½ before 2020, the prior rules apply and the age at which their RMDs must start remains at 70 ½.

In general, you should always delay taking withdrawals from your tax-deferred accounts for as long as is permitted by tax law, so your money can continue to grow tax-deferred until the required distributions hit. If you reach the age of 70 ½ in 2020 or later, you now can delay your first RMD to the year in which you reach 72, allowing your money more time for tax-deferred growth.

Skip RMD in 2020

The CARES Act that was passed in March 2020 waives the RMD from Traditional IRA and other qualified retirement plan accounts for 2020. You should skip your 2020 RMD unless you need the money. Doing so leaves the money inside your retirement accounts to earn gains on a tax deferred basis for another year and avoids 2020 taxes relating to the RMDs.

No age limit on Traditional IRA contributions provided you have earned income

The SECURE Act also removed the age limit for regular contributions to a Traditional IRA for tax year 2020 and after. Under the prior rule, you were not allowed to contribute to a Traditional IRA once you have reached age 70 ½.

The new rule means that you can make a contribution to your Traditional IRA regardless of age, *as long as you have earned income*. If you are working and can afford to put money away, you should contribute to your Traditional IRA even after you have reached age 70 ½ to benefit from deferring taxes on any earnings from such contributions.

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