The Hybrid Advantage: Why Preferreds Are Preferred

By John Deysher

The last few years have been tough for yield-oriented investors. Interest rates are low, credit spreads are at historical lows and the world is awash in liquidity.

As a total return–oriented portfolio manager, I'm constantly on the lookout for income vehicles that can augment our holdings in low-yielding common stocks. One solution: preferred stocks.

How They Work

Preferred stocks have been around for over a century. They represent a slice of a company's capital structure that is senior to the common shares, but subordinate to the debt (both secured and unsecured).

Dividends aren't guaranteed and must be declared by the board of directors, usually on a quarterly basis. The dividend is usually a specific dollar amount per share or a percentage of par/stated value (normally $25–$50/share).

Unlike bonds, preferreds have no maturity date at which point principal may be reclaimed. However, they can be called/redeemed by the issuer.

Here is a short run-down on the pros and cons of preferreds.

Preferred Advantages

- ***Preferred status:*** Dividends must be paid on the preferred before they can be paid on the common. In a sale, liquidation or bankruptcy reorganization, the interests of the preferred usually come ahead of those of the common (but behind the debt holders).
- ***Liquidity:*** Most preferreds trade on an exchange or NASDAQ in round lots of 100 shares, making them easier to purchase than bonds which trade in $25,000 lots.
- ***Tax advantages:*** Dividends on many preferreds often qualify for the 15% qualified dividend income federal tax rate, which expires December 31, 2010. Always confirm whether or not a preferred qualifies for qualified dividend income treatment. If yes, put it in a taxable account; if no, put it in a retirement account. Preferreds that qualify for the lower tax rates usually pay slightly less than those that don't. Generally, favorable qualified dividend income treatment is not available to REIT preferreds or trust preferreds, where the dividend is actually tax-deductible interest. Qualified treatment is available on some foreign issues, but be sure to examine if there's any foreign taxes withheld on payment, which can be a burden to recover.
- ***Accumulation:*** Most, but not all, preferreds, are cumulative, meaning if a full dividend is not paid each quarter, it accumulates indefinitely until paid. No common dividends can be paid until dividends in arrears are paid. Holders of a cumulative preferred may not receive dividends for a quarter or even years. Then, should the firm's fortunes improve, the cumulative dividends will be paid. Some investors will buy "broken" preferreds paying no dividends at big discounts to par/stated value, which they'll hold until the arrearage is cured (not a certainty), at which point the shares normally rebound.

Preferred Disadvantages

- ***Minimal voting rights:*** Preferred owners can rarely elect directors. However, if the firm wants to issue senior securities, merge, or fundamentally alter the financial structure, the preferred owners usually have the right to vote on these matters.
- ***Callability:*** Almost all preferreds are callable at par/stated value at the issuer's option, normally at a specified price after a specified time from issue date, usually five years. In the declining interest rate environment of recent years, many preferreds have been called, leaving holders with the challenge of replacing a high dividend income stream. Companies are constantly looking to lower their cost of capital and refinancing a high-cost preferred is one of the most logical ways to do this.
- ***Vulnerable to interest rate risk:*** Like most fixed-income vehicles, existing preferreds will rise in price if interest rates fall and decline in price if interest rates rise. Generally, preferreds fare better than bonds when interest rates are rising and worse than bonds when interest rates are falling. Nonetheless, you are best off buying them in a stable or declining interest rate environment and avoiding them if you think interest rates will rise.
- ***Vulnerable to credit risk:*** Deterioration in company fundamentals could inhibit the ability to make preferred dividend payments. An issuer will eliminate a preferred dividend before it will default on its debt. Many preferreds are rated by Moody's and/or Standard & Poor's and investors should stick with preferreds that are rated investment grade (BBB/Baa) or better. A ratings downgrade is a sign that trouble may be brewing. To see how deteriorating fundamentals can hurt a preferred issue, take a look at the recent action in the preferred issues of sub-prime lenders like New Century, NovaStar, Fremont General and others. Losses were huge, as investors questioned their ultimate viability.

The Preferred Line-Up

Now that you know the preferred basics, let's talk more about the types of preferreds:

- Straight preferreds,
- Trust preferreds and third-party trust preferreds, and
- Convertible preferreds.

Straight Preferreds

These are your plain-vanilla issues, which pay a fixed dividend on par/stated value.

For example, we own the 9⅜% cumulative participating callable preferred stock ($12 par) of Ameritrans Capital Corporation, a specialty finance company. Upon declaration by the board of directors we're entitled to an annual dividend of $1.125 ($12 × 9⅜%), which is paid quarterly.

Since this preferred now trades around $12 per share, our yield is about 9.4%. The high yield indicates investors are concerned about the firm's ability to continue to pay the dividend. Fortunately, the fundamentals are improving and the balance sheet is getting better. We're hopeful the improving credit quality will ultimately be reflected in a higher preferred price, providing an attractive total return.

Trust Preferreds

These preferreds are backed by a bond issue held in trust, and they provide the increased safety of bonds with the liquidity of stocks. The bond interest flows through to the preferred holder, making them tax deductible to the issuer but fully taxable to the preferred holder—in other words, the dividends do not receive the favorable 15% maximum tax rate.

Trust preferreds come in two flavors: those created by the company issuing the bonds, and those created by a broker-dealer using bonds it buys from the issuer for that purpose.

Company-issued trust preferreds are usually a bit riskier. They often have a provision allowing dividends to be suspended for up to five years under certain conditions.

Broker-created trusts (known as third-party trusts) don't have this risk and are usually rated higher than company-issued trusts.

Major issuers of trust preferreds include many utility, industrial, financial and communications firms. Denominations are $10 or $25 and redemption provisions can be tricky, so step carefully.

One advantage of this particular type is that, upon liquidation, a trust preferred's debentures generally rank as junior debt, ahead of a company's traditional preferred or common shares.

Convertible Preferreds

These preferreds provide the owner with the right to exchange a share of preferred stock for a share (or shares) of common stock in the same company. The number of common shares received is set by the exchange ratio, which won't change. Upon conversion, the owner has the rewards and risks of a common shareholder.

Generally the yield on a convertible preferred is well in excess of the common stock dividend yield.

Because of the dividend, the convertible preferred will usually decline less if the common stock declines, providing a cushion on the downside. If the common stock rises, the convertible will also rise, sometimes as fast as the common.

The convertible preferred provides the best of both worlds—downside protection and upside potential. To the issuer, a convertible offers the chance to raise cash without giving away equity too cheaply, or paying a high interest rate on a bond.

As an example, we own the Series I convertible, voting, 11% cumulative preferred ($6.00 stated value) of Aristotle Corporation, a leading manufacturer and distributor of educational, health and agricultural products. The Series I convertible pays a $0.66 a share (11% × $6) per year dividend which, on a

preferred price of $8.40, yields about 7.9%. Each share may convert to 0.5 shares of common for a 90-day period beginning June 17, 2007. If we don't convert within the window, the preferred becomes a straight preferred. The common stock pays zero.

As with any convertible investor, we face the question: Should we convert?

Assuming the common stays around the current price of $10 per share, my guess is we won't.

We'd be giving up $8.40 of preferred value and an attractive yield for $5 of common value ($10 × 0.5) with no yield—not a good deal. However, if we don't convert we'll lose the convertibility feature forever. That's OK because we can still "convert" at any time by selling our then-straight preferred shares and investing the proceeds in the common stock.

We would thus give up the dividend income in return for appreciation potential.

Evaluating Preferreds

Since a preferred holder lacks the enforceable claim to interest and principal at maturity that is enjoyed by a bondholder, and the right to participate in residual profits enjoyed by the common holder, sound analysis is essential. The investor must demand an extra margin of safety because of the discretionary nature of the dividend payment. Indeed, a generally profitable firm that incurs temporary losses is likely to suspend preferred payments, even though its cumulative profitability is more than adequate to make the payments.

For that reason, for a proper evaluation you need to focus on the following questions:

Do you like the company's fundamentals?

The focus here should be on the company's profitability, growth prospects, financial strength and management depth. Profitability allows dividend payments after any interest payments are made, so accurate analysis is critical. Size and competitive position are equally important as contributors to earnings consistency. The nature of the industry is also important—growth and consumer products industries generally have better long-term prospects than cyclical or declining industries.

What's the capital structure?

Preferreds with no bonds, notes or bank debt in front of them usually do better than those with any type of debt.

Sometimes a company will have multiple classes of preferred shares outstanding, so you should check to make sure which ones are the senior securities. Even if an issuer has no debt or other preferreds senior to your preferred, it may have the right to issue new securities—which would be senior to yours. The only way to find out and protect yourself is to read the prospectus!

What's the call risk?

As mentioned earlier, virtually all preferreds can be called at a certain price (usually par/stated value) after a certain date. Make sure you don't pay a premium to par, only to have the issue called away shortly at par. Generally, an issue approaching a call date will trade close to its call price. Sometimes a preferred will trade at a premium to call price up to and beyond its call date. This indicates investors are betting the issue won't be called, usually because the company lacks the cash to do it.

A convertible preferred may trade at a significant premium to the call price because of the value of the conversion feature. For example, if the Aristotle common mentioned previously was trading at $25 a share instead of $10, the conversion value of the convertible preferred would be $12.50 (0.5 × $25). In this case, the price of the convertible preferred would be driven by its convertibility feature rather than its dividend.

Indeed, many issuers "force" the conversion of a preferred to common by calling the preferred at par or stated value. Continuing with the Aristotle example, if the company called the convertible at the stated value of $6 a share while its conversion value was $12.50, my guess is they wouldn't have many takers. Convertible holders would either convert to common or sell their convertible shares to someone who would. In either case, the issuer succeeds in replacing high-cost preferreds with low-cost common shares.

Is the yield in line with the risk?

The old saying "there's no free lunch" applies to preferred investing. If a yield appears too good to be true, it probably is.

Preferreds that have exceptionally high yields normally have them for a reason. Investors doubt the yield is sustainable because of fundamental issues, and have priced the security accordingly, usually to reflect a looming dividend cut or declining credit quality.

Is there a sinking fund?

The presence of a sinking fund provides an extra measure of protection to a preferred holder by requiring the issuer to set aside cash (usually a percentage of consolidated income) for the express purpose of paying the dividend.

Again, such important details are

Table 1. Some Notable Closed-End Funds Focusing on Preferreds

Fund (Ticker)	Price ($)	Estimated Dividend ($)	Yield (%)	Market Cap ($ Mil)	Discount/ Premium (%)
Ellsworth Fund (ELS)	8.60	0.32	3.7	108	–10
Bancroft Fund (BCF)	20.00	0.80	4.0	113	–12
Putnam High Income Fund (PCF)	8.80	0.56	6.4	200	–8

normally buried in the prospectus.

Preferred Closed-End Funds

For investors who don't want the responsibility of building and maintaining a portfolio of individual preferreds, you might want to look at some closed-end funds. There are both straight and convertible closed-end funds that offer the benefits of diversification, professional management and economies of scale.

Many also trade at less than underlying net asset value, providing the opportunity to buy a dollar's worth of assets at a discount.

[For more information on closed-end funds please see "Rodney Dangerfield Investing: Closed-End Fund Opportunities" by John Deysher in the April 2007 *AAII Journal*, available at AAII.com.]

Table 1 notes some reasonable closed-end fund offerings.

Conclusion

Preferred stocks occupy a unique position in a firm's capital structure and can provide attractive dividends and important tax advantages.

Convertible preferreds offer the upside of the underlying common and the downside protection inherent in the dividend.

Buying high-quality preferreds at steep discounts to par/stated value during times of market turmoil can provide robust total returns.

There are numerous preferreds available, most of which trade on an exchange or NASDAQ (see www.quantumonline.com for a comprehensive listing). Prospectuses may often be found on the EDGAR portion of www.sec.gov.

However, few are followed by Wall Street firms, and all are vulnerable to interest rate and credit risks.

Stringent analysis of operating fundamentals, coverage ratios and balance sheet strength is essential, as are patience and a long-term outlook.

Happy hunting. ➤

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