

Investing in Preferred Stocks

What do Verizon (telecommunications), Citigroup (financial institution), Duquesne Light (utility), HRPT Properties (real estate), Disney (media conglomerate), and Amerada Hess (oil and gas) all have in common? Though their industries and market capitalizations vary widely, all of these companies issue preferred stock. This investment category is enjoying renewed popularity in the face of volatile common stock prices, historically low bond yields, and money market funds with returns of less than 5%. Investors looking for income-producing securities were attracted to preferred yields that could reach 10% and averaged around 7% in 2006, compared to about 6.2% for high-quality long-term corporate bonds.

Many individual investors are taking a hard look at the role that preferred stock can play in their portfolios. Preferred stock is generally issued with a \$25 par value, as opposed to \$1,000 for most corporate bonds, placing these equities well within the reach of the average investor. In fact, individual investors are major buyers of preferreds, which contributes to these stocks' price stability.

In addition to the traditional preferred stocks that pay fixed dividends, you can buy other forms such as adjustable-rate preferreds, trust preferreds (which pay interest rather than dividends), and convertible preferreds that can be turned into common stock. This wide range of options makes buying preferred stock more difficult than you might think. In this chapter, you'll learn about preferred stock and the advantages they offer investors.

LEARNING GOALS

After studying this chapter, you should be able to:

LG 1 Describe the basic features of preferred stock, including sources of value and exposure to risk.

LG 2 Discuss the rights and claims of preferred stockholders, and note some of the popular issue characteristics that are often found with these securities.

LG 3 Understand the various measures of investment worth, and identify several investment strategies that can be used with preferred stocks.

Preferred Stocks

LG 1

LG 2

preferred stock

a stock that has a prior claim (ahead of common) on the income and assets of the issuing firm.

HOTLINKS

For more information on preferred stock, see Learning Center at Briefing.com at:

www.briefing.com/FreeServices/Education/edu_PREFERRED_Stock.htm

What would you think of a stock that promised to pay you a fixed annual dividend for life—nothing more, nothing less? If you're an income-oriented investor, the offer might sound pretty good. But where would you find such an investment? Right on the NYSE, Nasdaq, or AMEX, where hundreds of these securities trade every day, in the form of *preferred stock*—a type of security that looks like a stock but doesn't behave like one. Because preferreds contain elements of *both* debt and equity, they are viewed as a type of *hybrid security*.

Preferred stocks carry fixed dividends that are paid quarterly and are expressed either in dollar terms or as a percentage of the stock's par (or stated) value. They are used by companies that need money but don't want to raise debt to get it; in effect, they are widely viewed by issuers as an alternative to debt. Companies like to issue preferreds because they don't count as common stock (and, therefore, don't affect EPS). However, being a form of equity, they don't count as debt, either—and therefore don't add to the company's debt load. There are today nearly a thousand OTC and listed preferred stocks outstanding. Many of them are issued by public utilities, although the number of industrial, financial, and insurance issues is rapidly increasing.

Preferred Stocks as Investment Vehicles

Preferred stocks are available in a wide range of quality ratings, from investment grade to highly speculative. Table 16.1 provides a representative sample of some actively traded preferred stocks. It shows the types of annual dividends and dividend yields that these securities were providing in March 2006.

Advantages and Disadvantages Without a doubt, the number one reason that investors are attracted to preferred stocks is the current income they provide. Take another look at Table 16.1—note the *very attractive dividend yields* these securities offer. Such returns compare favorably to those available on other fixed-income securities and dividend-paying common stocks, and they

TABLE 16.1 A Sample of Some High-Yielding Preferred Stock

Issuer	Annual Dividend	Market Price	Dividend Yield
AMB Property	\$1.69	\$25.25	6.7%
Alabama Power	1.46	24.95	5.9
Bank of America	3.38	52.75	6.4
Citigroup	3.12	52.20	6.0
Cleveland Electric	2.25	26.65	8.4
Disney	1.75	25.70	6.8
El Paso Energy	2.38	36.10	6.6
Host Marriott	2.50	26.00	9.6
ING Group	1.80	25.75	7.0
Public Storage Co.	2.00	25.17	7.9

Note: All of these issues are straight (nonconvertible) preferred stocks traded on the NYSE.

Source: Wall Street Journal, March 23, 2006.

explain in large part why income-oriented investors are so attracted to these investment vehicles. Another reason for investing in these securities is the level of safety they offer investors. That is, despite a few well-publicized incidents, *high-grade* preferred stocks have an excellent record of meeting dividend payments in a timely manner—certainly an important consideration to income-oriented investors. A final advantage is the low unit cost (\$25 to \$50 per share) of many of the issues, which gives even small investors the opportunity to actively participate in preferreds.

While preferreds do, indeed, pay hefty dividends, most of them unfortunately *do not qualify for the preferential tax rate* (of 15% or less). The reason: During the 1990s, Wall Street created a new type of preferred stock, so-called *trust preferreds*, that actually qualified as debt for tax purposes—meaning the dividends paid by the issuer could be treated as a tax-deductible expense. As a result, what was initially intended as a big windfall for the issuer has turned into a *big disadvantage* for investors. It's estimated that about two-thirds of all outstanding preferred stocks don't qualify for the new tax treatment, though that's expected to change as the more traditional preferred stocks (which pay dividends from after-tax profits) start making a comeback. Until then, let the buyer beware!

Another drawback of preferred stocks is their susceptibility to inflation and high interest rates. That is, like many other fixed-income securities, preferred stock values go down when rates go up. Thus, these securities simply have not proved to be satisfactory long-term hedges against inflation. Still another disadvantage is that preferred dividends may be suspended, or “passed,” if the earnings of the issuer drop off. Unlike the coupon payments on a bond, dividends on preferreds have no legal backing, and failure to pay them does not lead to default. Preferreds also lack substantial capital gains potential. Although it is possible to enjoy fairly attractive capital gains from preferred stocks when interest rates decline dramatically, these amounts generally do not match the price performance of common stocks.

Sources of Value With the exception of convertible preferreds, the value of high-grade preferred stocks is a function of the dividend yields they provide. More specifically, the value (or market price) of a preferred stock is closely related to prevailing market rates: As the general level of interest rates moves up, so do the yields on preferreds, and their prices decline accordingly. When interest rates drift downward, so do the yields on preferreds, as their prices rise. Just like bond prices, therefore, *the price behavior of a high-grade preferred stock is inversely related to market interest rates*. Moreover, its price is directly linked to the issue's level of income. That is, other things being equal, the higher the dividend payment, the higher the market price of an issue. Given these factors, the price of a preferred stock can be defined as follows:

Equation 16.1 ►

$$\text{Price of a preferred stock} = \frac{\text{Annual dividend income}}{\text{Prevailing market yield}}$$

This equation is simply a variation of the standard dividend yield formula, but here we solve for the price of the issue. (You might also detect a similarity between this formula and *the zero-growth dividend valuation model* introduced in Chapter 8—see Equation 8.7.) The equation shown here (16.1) is

INVESTOR FACTS

CAN YOU “TRUST” PREFERRED?—Not all stocks labeled “preferred” pay dividends; in fact, *trust* preferreds pay interest. For example, Citigroup issues both types of preferreds: F-class shares, which pay dividends of 6.365% and have a par value of \$50; and S-class shares, which pay interest income of 6% and have a par value of \$25. Because of the different tax treatment accorded to dividends and interest income, the after-tax yields for these stocks will be considerably different. In fact, with the lower rate for qualified dividends, traditional preferred stocks, whose dividends are eligible for the 15% (or lower) rate, carry a big advantage over trust preferreds, whose income is taxed at ordinary income rates.

conversion feature allows the holder of a convertible preferred to convert to a specified number of shares of the issuing company’s common stock.

HOTLINKS

Read about variable-rate preferred stock at:

http://askmerrill.ml.com/publish/marketing-centers/products/inv401_Variable-RatePreferredStock

used to price preferred stocks and to compute the future price of a preferred, given an estimate of expected market yields. For example, a \$2.50 preferred stock (meaning the stock pays a dividend of \$2.50 per year) would be priced at \$20.83 if the prevailing market yield were 12%:

$$\text{Price} = \frac{\$2.50}{0.12} = \underline{\underline{\$20.83}}$$

Note that as market yield decreases, you get higher preferred stock prices, thus giving you the inverse relationship between price and yield.

The yield that a preferred stock offers (and therefore its market value) is a function of not only market interest rates but also the issue’s credit quality: *The lower the quality of a preferred, the higher its yield.* Such behavior is, of course, compatible with the risk-return tradeoffs that usually exist in the marketplace. Fortunately, preferred stocks are rated, much like bonds, by Moody’s and Standard & Poor’s. The value of a preferred is also affected by issue characteristics such as call features and sinking-fund provisions. For example, freely callable preferreds normally provide higher yields than noncallable issues because of their greater call risk. Quality and issue features, however, have only slight effects on price behavior over time, and they certainly do not compare in importance with the movement of market yields.

■ Issue Characteristics

Preferred stocks possess features that not only distinguish them from other types of securities but also help differentiate one preferred from another. For example, preferred stocks may be issued as convertible or nonconvertible, although the majority fall into the nonconvertible category. A convertible preferred has a **conversion feature** that allows the holder to convert the preferred stock into a specified number of shares of the issuing company’s common stock. Because convertible preferreds are, for all intents and purposes, very much like convertible bonds, they are discussed in Chapter 10. For our purposes here, we will concentrate on *nonconvertible issues*, although many of the features we are about to discuss apply equally to convertible preferreds. In addition to convertibility, investors should be aware of several other important features of preferred stocks; they include the rights of preferred stockholders and the special provisions (such as those pertaining to passed dividends or call features) that are built into preferred stock issues.

Rights of Preferred Stockholders The contractual agreement of a preferred stock specifies the rights and privileges of preferred stockholders. The most important of these deal with the level of annual dividends, the claim on income, voting rights, and the claim on assets. The issuing company agrees that it will pay preferred stockholders a (minimum) fixed level of quarterly dividends and that such payments *will take priority over common stock dividends*. The only condition is that the firm generate income sufficient to meet the preferred dividend requirements. However, the firm is not legally bound to pay dividends. Of course, it cannot pass dividends on preferred stock and then pay dividends on common stock. To do so would violate the preferreds’ prior claim on income.

adjustable-rate (floating-rate) preferreds

preferred stock whose dividends are adjusted periodically in line with yields on certain Treasury issues.

preference (prior preferred) stock

a type of preferred stock that has seniority over other preferred stock in its right to receive dividends and in its claim on assets.

cumulative provision

a provision requiring that any preferred dividends that have been passed must be paid in full before dividends can be restored to common stockholders.

in arrears

having outstanding unfulfilled preferred dividend obligations.

noncumulative provision

a provision found on some preferred stocks excusing the issuing firm from having to make up any passed dividends.

Although most preferred stocks are issued with dividend rates that remain fixed for the life of the issue, in the early 1980s some preferreds began to appear with floating dividend rates. Known as **adjustable-rate** (or **floating-rate**) **preferreds**, these issues adjust their dividends periodically in line with yields on specific Treasury issues, although minimum and maximum dividend rates are usually established as a safeguard for investors and issuers.

Even though they hold an ownership position in the firm, preferred stockholders normally have no voting rights. However, if conditions deteriorate to the point where the firm needs to pass one or more consecutive quarterly dividends, preferred shareholders are usually given the right to elect a certain number of corporate directors so that their views can be represented. And if liquidation becomes necessary, the holders of preferreds are given a prior claim on assets. These preferred claims, limited to the par or stated value of the stock, must be satisfied before the claims of the common stockholders. Of course, this obligation does not always mean that the full par or stated value of the preferred will be recovered, because the claims of senior securities (like bonds) must be met first.

Finally, when a company has more than one issue of preferred stock outstanding, it sometimes issues **preference** (or **prior preferred**) **stock**. Essentially, this stock has seniority over other preferred stock in its right to receive dividends and in its claim on assets in the event of liquidation. Therefore, preference stocks should be viewed as *senior preferreds*. They're usually easy to pick out in the financial pages because they use the letters *pr* instead of *pf* in their quotes.

Preferred Stock Provisions There are three preferred stock provisions that investors should be well aware of *before* making an investment in a preferred security. Especially important is the obligation of the issuer in case any dividends are missed. In addition, you should determine whether the stock has a call feature and/or a sinking fund provision. Let's start by looking at how passed dividends are handled, which depends on whether the preferred stock is issued on a cumulative or a noncumulative basis.

Fortunately for investors, most preferred stocks are issued on a **cumulative** basis. This means that any preferred dividends that have been passed *must be made up in full* before dividends can be paid to common stockholders. Any outstanding unfulfilled preferred dividend obligations are said to be **in arrears**, and so long as dividends on preferred stock remain in arrears, a corporation may not make dividend payments on common shares. Assume, for example, that a firm normally pays a \$1 quarterly dividend on its preferred stock but has missed the dividend for three quarters in a row. In this case, the firm has preferred dividends in arrears of \$3 a share. It must meet these past dividends, along with the next quarterly dividend, before it can pay dividends to common shareholders. The firm could fulfill this obligation by paying, say, \$2 per share to the preferred stockholders at the next quarterly dividend date and \$3 per share at the following one (with the \$3 covering the remaining \$2 in arrears and the current \$1 quarterly payment). If the preferred stock had carried a **noncumulative provision**, the issuing company would have been under no obligation to make up any of the passed dividends. Of course, the firm could not make dividend payments on common stock either. But it could resume such payments simply by meeting the next quarterly preferred dividend. Other things being equal, a cumulative preferred stock should be

INVESTOR FACTS

HOW TO HIDE FROM RISING RATES

—One of the biggest fears of fixed-income investors (including preferred stock investors) is rising interest rates. To hedge against rising rates, investors often turn to *adjustable-rate preferreds*, whose cash dividends are adjusted quarterly to reflect market conditions. The dividends on adjustable preferreds usually have a floor and a ceiling, but that still leaves plenty of room to move up or down with market rates. When rates move up, rather than the price of the issue going down, the dividend payment goes up instead. Bottom line: There's far less price volatility with adjustables than with fixed-rate preferreds.

more highly valued than an issue without such a provision. That is, the cumulative feature should increase the price (and in so doing, lower the yield) of these issues.

Since the early 1970s, it has become increasingly popular to issue preferred stocks with call features. Today, a large number of preferreds carry this provision, which gives the firm the right to call the preferred for retirement. Callable preferreds are usually issued on a *deferred-call basis*, which means they cannot be retired for a certain number of years after the date of issue. After the deferral period, usually five to seven years, the preferreds become freely callable. Of course, such issues are then susceptible to call if the market rate for preferreds declines dramatically. This explains why the yields on freely callable preferreds should be higher than those on noncallable issues. As with bonds, the call price of a preferred is made up of the par value of the issue and a call premium that may amount to as much as one year's dividends.

Another preferred stock feature that has become popular is the *sinking-fund provision*. This provision specifies how all or a part of an issue will be paid off—amortized—over time. Sinking-fund preferreds actually have *implied* maturity dates. They are used by firms to reduce the cost of financing, because sinking-fund issues generally have *lower* yields than nonsinking-fund preferreds. A typical sinking-fund preferred might require the firm to retire half the issue over a 10-year period by retiring, say, 5% of the issue each year. Unfortunately, the investor has no control over which shares are called for sinking-fund purposes. Sinking-fund provisions notwithstanding, many preferred issues today actually have *explicit* maturity dates. These began to appear in the 1990s, when, as noted earlier, Wall Street started creating trust preferred stocks that qualified as debt for tax purposes. So, as is customary with bonds, preferred stocks also started coming out with maturity dates, most of which were very lengthy—often 30 to 50 years.

CONCEPTS IN REVIEW

Answers available at: www.myfinancelab.com

- 16.1** Define a *preferred stock*. What types of prior claims do preferred shareholders enjoy? How do *trust preferreds* differ from traditional preferreds?
- 16.2** In what ways is a preferred stock like equity? In what ways is it like a bond?
- 16.3** What are the advantages and the disadvantages of investing in preferreds?
- 16.4** Distinguish a *cumulative* preferred from a *callable* preferred. Do cumulative dividend provisions and call features affect the investment merits of preferred issues? Explain.

Valuing and Investing in Preferreds

LG 3

As we just saw, although preferred stocks may be a form of equity, they behave in the market more like a bond than a stock. Therefore, it seems logical that *preferreds should be valued much like bonds*, with market interest rates and investment quality playing key roles. Similarly, when it comes to investing in preferreds, you would expect interest rates (either the level of market interest

rates or the movements therein) to play key roles in preferred stock investment strategies. And that's exactly what you find, as the two most widely used preferred stock strategies involve either going after high levels of current income or seeking capital gains when market rates are falling.

■ Putting a Value on Preferreds

Evaluating the investment suitability of preferreds involves assessing comparative return opportunities. Let's look now at some of the return measures that are important to preferred stockholders, and then at the role that agency ratings play in the valuation process.

Dividend Yield: A Key Measure of Value Dividend yield is critical to determining the price and return behavior of most preferred stocks. It is computed according to the following simple formula:

Equation 16.2 ►

$$\text{Dividend yield} = \frac{\text{Annual dividend income}}{\text{Current market price of the preferred stock}}$$

dividend yield
a measure of the amount of return earned on annual dividends.

Dividend yield is a measure of the amount of return earned on annual dividends, and is the basis upon which comparative preferred investment opportunities are evaluated. (It is basically the same as the *dividend yield* used in Chapter 7 with common stocks and is comparable to the *current yield* measure used with bonds, as described in Chapter 11.)

Here's how dividend yield works: Suppose an 8% preferred stock has a par value of \$25 and is currently trading at a price of \$27.50 per share. For preferreds whose dividends are denoted as a percentage of par (or stated) value, the dollar value of the annual dividend is found by multiplying the dividend rate (in this case, 8%) by the par value (\$25). Thus, the annual dividend on this stock is $0.08 \times \$25 = \2 . Therefore, the dividend yield in this example is

$$\text{Dividend yield} = \frac{\$2}{\$27.50} = \underline{\underline{7.27\%}}$$

As you can see, at \$27.50 a share, this preferred is yielding about 7.3% to investors. If the price of this preferred moves down (to, say, \$21 a share), the dividend yield increases (in this case, to about 9.5%). In practice, we would expect investors to compute or have available a current dividend yield measure for each preferred under consideration and then to make a choice by comparing the yields on the alternative preferreds—along with, of course, the risk and issue characteristics of each.

HOTLINKS

For preferred stock terms, visit:

www.briefing.com/FreeServices/Education/edu_Preferred_Stock.htm

Expected Return Whereas long-term investors may consider dividend yield a key factor, that's not necessarily the case with short-term traders. Instead, these traders generally focus on anticipated price behavior and the expected return from buying and selling an issue over a short period of time. Thus, *the expected future price of a preferred* is important to short-term traders. Expected price can be found by first forecasting future market interest rates

and then using that information to determine expected future price. To illustrate, suppose a preferred stock pays \$3 in dividends and its yield is expected to decline to 6% within the next three years. If such market rates prevail, then three years from now, the issue will have a market price of \$50 (using Equation 16.1, $\text{annual dividend} \div \text{yield} = \$3 \div 0.06 = \$50$). This forecasted price, along with the current market price and level of annual dividends, would then be used in either the expected return or holding period return formula to assess the return potential of the investment.

To continue with our example, if the stock were currently priced at \$28 a share, it would have an *expected return* (over the three-year investment horizon) of a very attractive 30.3%. This can be found by using *the IRR approach* we first introduced in Chapter 4 and then applied (as a measure of expected return) to common stocks in Chapter 8 and to bonds in Chapter 11. Basically, you'd want to find the discount rate, in the present-value-based yield formula, that equates the expected future cash flows from this preferred to its current market price of \$28 a share. (The preferred's cash flows are the \$50 price in three years, plus the annual dividends of \$3 a share over each of the next three years.) As it turns out, that discount rate equals 30.3%; at that rate, the present value of the future cash flows amounts to \$28 a share. (As an aside, *this problem can readily be solved with a financial calculator* by letting $N = 3$, $PV = 28$, $PMT = -3$, $FV = -50$ and then solve for I . Try it. You should end up with a value (return) of 30.34.)

You now have a measure of the relative attractiveness of this preferred stock. Of course, other things (like risk) being equal, the higher the expected return, the more appealing the investment. (Note that if the above performance had occurred over a period of six months, rather than three years, you would use the *holding period return* measure to assess the potential return of this preferred. See Chapter 4 for details.)

book value (net asset value)
a measure of the amount of debt-free assets supporting each share of preferred stock.

Book Value The book value (or net asset value) of a preferred stock is a measure of the amount of debt-free assets supporting each share of preferred stock. In this regard, note that it's the *total book value of the firm* that's of concern here, not just the amount of preferred equity listed on the balance sheet. That's because, relative to common equity, preferred shareholders have a prior claim on all the net assets of the firm. Thus, book value per share is found by subtracting all the liabilities of the firm from its total assets and dividing the difference by the number of preferred shares outstanding. This measure, in essence, reflects the quality of an issue with regard to the preferred's *claim on assets*. Obviously, a preferred with a book value of \$150 per share enjoys generous asset support and more than adequately secures a par value of, say, \$25 a share. Net asset value is most relevant when it is used relative to an issue's par (or stated) value. Other things being equal, *the quality of an issue improves as the margin by which book value exceeds par value increases*.

fixed charge coverage
a measure of how well a firm is able to cover its preferred stock dividends.

Fixed Charge Coverage Fixed charge coverage is a measure of how well a firm is able to cover its preferred dividends. Here, attention is centered on the firm's ability to service preferred dividends and live up to the preferred's preferential *claim on income*. As such, fixed charge coverage is important in determining the quality of a preferred stock. Fixed charge coverage is computed as follows:

Equation 16.3 ►

$$\text{Fixed charge coverage} = \frac{\text{Earnings before interest and taxes (EBIT)}}{\text{Interest expense} + \frac{\text{Preferred dividends}}{0.65}}$$

Note in this equation that preferred dividends are adjusted by a factor of 0.65. This adjustment is used with “traditional” preferred stocks and takes into account the fact that *a company pays dividends from the earnings that are left after taxes*. The adjustment factor (0.65) implies a corporate tax rate of 35%, which is a reasonable rate to use for our purposes here. By making the indicated adjustment, you essentially place preferred dividends on the same basis as interest paid on bonds, which is a tax-deductible expense. *Normally, the higher the fixed charge coverage, the greater the margin of safety*. A ratio of 1.0 means the company is generating just enough earnings to meet its preferred dividend payments—not a very healthy situation. A coverage ratio of 0.7 suggests the potential for some real problems, whereas a coverage of, say, 7.0 indicates that preferred dividends are fairly secure.

As noted with the common stock interest coverage ratio (see the times interest earned measure in Chapter 7, Equation 7.7), fixed charge coverage is often computed with EBITDA in the numerator, rather than EBIT. Since earnings before interest, taxes, depreciation, and amortization will normally be more than EBIT, use of EBITDA will result in a higher coverage ratio—something that should be taken into consideration when assessing this measure. Also, if you’re dealing with one of the newer debt-like preferreds, then you can *drop the adjustment factor (0.65) in the denominator*, because preferred dividends are treated just like interest expense in these cases. Doing so will, of course, lead to a higher fixed-charge coverage—the denominator will be smaller, so other things being equal, the fixed-charge coverage ratio will be higher.

Agency Ratings Standard & Poor’s has long rated the investment quality of preferred stocks, and since 1973, so has Moody’s. S&P uses basically the same rating system as it does for bonds; Moody’s uses a slightly different system. For both agencies, the greater the likelihood that the issuer will be able to pay dividends promptly, the higher the rating. Much like bonds, the top four ratings designate *investment-grade* (high-quality) preferreds. Although preferreds come in a full range of agency ratings, most tend to fall in the medium-grade categories (a and baa), or lower. Generally speaking, higher agency ratings reduce the market yield of an issue and increase its interest sensitivity. Agency ratings not only eliminate much of the need for fundamental analysis, but also help investors get a handle on the yield and potential price behavior of an issue.

HOTLINKS

Moody’s Preferred stock ratings definitions are at:

www.aufhauser.net/securities/FixedIncome/Ratings_Moody.htm

To learn more about credit ratings, visit Fitch Ratings Resource Library definitions at:

www.fitchratings.com/corporate/fitchResources.cfm?detail=1

Investment Strategies

There are several investment strategies that preferred stockholders can follow. Each is useful in meeting a different investment objective, and each offers a different level of return and exposure to risk.

Looking for Yields This strategy represents perhaps the most popular use of preferred stocks and is ideally suited for serious long-term investors. *High current income* is the objective, and the procedure basically involves seeking out

those preferreds with the most attractive yields. While yield is necessarily a key variable, consideration is also given to such features as the quality of the issue, whether the dividends are cumulative, the existence of any call or sinking-fund provisions, and, of course, whether the dividend qualifies for the new preferential tax rate.

Certainty of income and safety are important in this strategy, because yields are attractive only as long as dividends are paid. Some investors never buy anything but the highest-quality preferreds. Others sacrifice quality in return for higher yields when the economy is strong and use higher-quality issues only during periods of economic distress. Whenever you leave one of the top four agency ratings, you should recognize the speculative position you are assuming. This is especially so with preferreds, since their dividends lack legal enforcement.

Like common shares, most preferreds pay dividends on a quarterly basis. Even so, some special breeds of preferred stocks offer not only attractive yields but also monthly income. One of these is a type of hybrid security known as a **monthly income preferred stock (MIPS)**, for short). However, as the nearby *Investing in Action* box explains, although these securities do offer attractive yields, they are a very unusual type of investment vehicle. As such, you should learn as much as you can about these and other specialty securities before investing in them.

monthly income preferred stock (MIPS)

a type of preferred stock that offers attractive tax provisions to the issuers, and attractive monthly returns to investors.

Trading on Interest Rate Swings Rather than assuming a “safe” buy-and-hold position, the investor who trades on movements in interest rates adopts an aggressive short-term trading posture. This is done for one major reason: *capital gains*. Although a high level of return is possible with this approach, it comes with higher risk exposure. Because preferreds are fixed-income securities, the market behavior of *investment-grade issues* is closely linked to movements in interest rates. If market interest rates are expected to decline substantially, attractive capital gains opportunities may be realized from preferred stocks. Indeed, this is precisely what happened in the mid-1980s, and again in the early 1990s (1991 through 1993) and in 2000–2003, when market interest rates dropped sharply. During such periods, it’s not uncommon to find preferreds generating *annual* returns of 20% to 30%, or more.

As is probably clear by now, this strategy is identical to that used by bond investors. In fact, many of the same principles used with bonds apply to preferred stocks. For example, it is important to select high-grade preferred stocks, because interest sensitivity is a key ingredient of this strategy. Moreover, margin trading is often used to magnify short-term holding period returns. A basic difference is that the very high leverage rates of bonds are not available with preferreds, because they fall under the same, less generous margin requirements as common stocks. The investment selection process is simplified somewhat as well, because neither maturity nor the size of the annual preferred dividend (which is equivalent to a bond’s coupon) has any effect on the *rate of price volatility*. That is, a \$2 preferred will appreciate just as much (in percentage terms) as an \$8 preferred for a given change in market yields.

Speculating on Turnarounds This speculative investment strategy can prove profitable if you’re nimble enough to catch a trading opportunity before everyone else does. The idea is to find preferred stocks whose dividends have

INVESTING *in Action*

MIPS: More Than Higher Yields and Monthly Income?

In 1993 Goldman Sachs & Co., a leading investment banking firm, invented *monthly income preferred stock*, or MIPS, which looks like a win-win arrangement: The issuer gets a tax deduction. The investor gets high *monthly* income, as well as the upside potential inherent in a stock. Here's how they work: XYZ Corporation creates a limited liability company (LLC) that sells MIPS to the public and lends the proceeds to the parent corporation. The parent pays interest to the LLC on the loan, which in turn is paid to MIPS holders in the form of monthly dividends.

For the issuer, the payments are tax-deductible, even though MIPS are not considered straight debt and thus do not raise the corporation's debt ratio. MIPS are typically listed on the New York Stock Exchange, like many preferred stocks. For the investor, MIPS offer higher yields than certificates of deposit and money market funds. They also provide higher yields than corporate bonds and conventional preferred stock. Also, MIPS payments are made monthly, whereas bonds pay interest every six months and stocks pay dividends quarterly.

Not everyone thinks MIPS are great. Despite the term *preferred* in their name, MIPS are quite low on the issuing corporation's list of obligations. If an issuer gets into financial trouble, MIPS holders stand toward the end of the repayment line. The second drawback is that

if interest rates fall, the issuer can redeem the securities at par without paying a penalty. That leaves the investor stuck with cash to reinvest at lower rates. The third drawback has to do with your taxes. Corporations set up partnerships to issue these securities, which means that you get a K-1 instead of a Form 1099 for your tax return. Most K-1s aren't sent out until mid-March, and they're a more complicated document than 1099s. You'll spend more time on your taxes—or your accountant will. Indeed, a high accounting fee could even wipe out the higher yields that MIPS offer. And, if these dividends are actually interest payments, then they won't qualify for the new preferential tax rates!

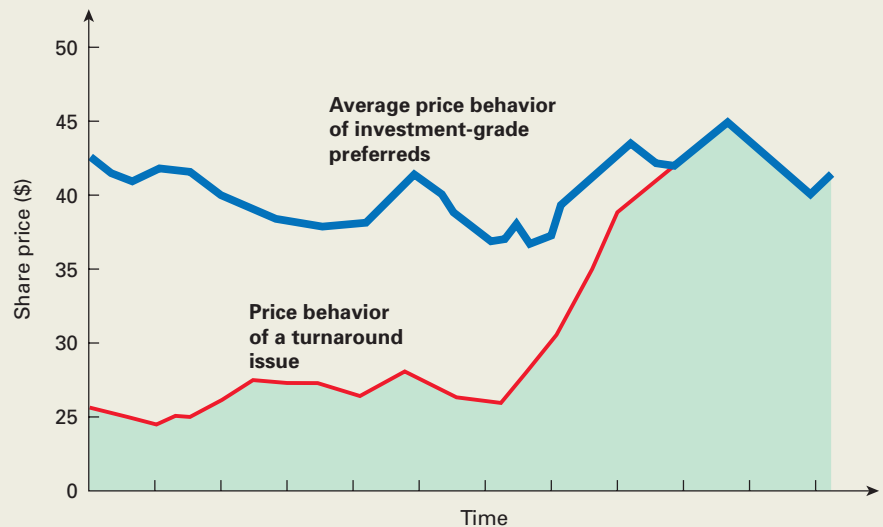
Don't like MIPS? Then look at QUIPS, PRIDES, and PINES—some of the other types of hybrid specialty preferreds. *Quarterly Income Preferred Securities*, or QUIPS, are structured like MIPS but pay cumulative quarterly distributions. *PRIDES, Preferred Redeemable Increased Dividend Equity Securities*, are similar to convertible securities and are sold in units that comprise an interest-bearing security, which provides stable cash flow, and a contract obligating the investor to purchase an underlying security at maturity. *PINES, Public Income Notes*, are unsecured, unsubordinated debentures sold in small share amounts, such as \$25. Because they pay a fixed interest amount yet are traded on stock exchanges, PINES represent a hybrid between bonds and preferred stocks.

gone into arrears and whose rating has tumbled to one of the speculative categories. The price of the issue, of course, would be depressed to reflect the corporate problems of the issuer. There is more to this strategy, however, than simply finding a speculative-grade preferred stock. The difficult part is to uncover a speculative issue whose fortunes, for one reason or another, *are about to undergo a substantial turnaround*. This strategy requires a good deal of fundamental analysis and is, in many respects, akin to investing in speculative common stock.

In essence, the investor is betting that the firm will undergo a turnaround and will once again be able to service its preferred dividend obligations in a prompt and timely fashion. Such a bet obviously involves a fair amount of risk. Unfortunately, although the rewards from this kind of high-risk investing can

FIGURE 16.1**Price Pattern of a Hypothetical Preferred Turnaround Candidate**

Although a turnaround issue seeks the price level of other preferreds of comparable quality and dividend payout, this level also acts as a type of price cap and clearly limits capital appreciation.



be substantial, they are somewhat limited. For example, if a turnaround candidate is expected to recover to a single-a rating, then its capital gains potential would likely be limited to the approximate price level of other a-rated preferreds. This condition is depicted in Figure 16.1. As the figure shows, although price performance may be somewhat limited, it is still substantial and can readily amount to holding period returns of 50% or more. But in view of the substantial risks involved, such returns are certainly not out of line.

CONCEPTS IN REVIEW

Answers available at: www.myfinancelab.com

- 16.5** Describe how high-grade preferred stocks are priced in the market. What role does dividend yield play in the valuation of preferred stocks? Could you use the zero-growth dividend valuation model to value a preferred stock? Explain.
- 16.6** Discuss why dividend yield is critical in evaluating the investment merits of high-grade preferred stocks during periods when market yields are expected to decline.
- 16.7** Identify several investment uses of preferred stocks. Would preferreds be suitable for both conservative and aggressive investors? Explain.

Summary**LG 1**

Describe the basic features of preferred stock, including sources of value and exposure to risk. Preferred stocks are hybrid securities that combine features of both debt and equity. Preferred stocks are considered senior to common: They have a higher claim on

the income and assets of the issuing company. Among other things, this means that preferred dividends have to be paid before the company can pay dividends to its common stockholders. As investment vehicles, preferreds provide attractive dividend yields. When interest rates decline, they can produce capital gains as well.

LG 2

Discuss the rights and claims of preferred stockholders, and note some of the popular issue characteristics that are often found with these securities. Preferreds are considered less risky than common stock because their shareholders enjoy a senior position with regard to dividend payments and asset claims. The most important feature of a preferred stock is its preferential claim on dividends. Investors should also be aware of several other preferred stock provisions, including: the obligations of the issuer in case any dividends are missed (whether the stock is cumulative or noncumulative), whether it is callable, and whether it carries sinking-fund provisions. Also important is whether the preferred's dividends qualify for the new preferential tax rate—most do not.

LG 3

Understand the various measures of investment worth, and identify several investment strategies that can be used with preferred stocks. Except for convertible preferreds, the value of a preferred is generally linked to the dividend yield it provides to investors. Indeed, the price behavior of a preferred stock is inversely related to market interest rates. The principal reason for holding preferreds is their yield. But they can also be held for capital gains purposes by investors willing to trade on interest rates or on turn-around situations.

Key Terms

adjustable-rate (floating rate) preferreds, *p. 16-5*
 book value (net asset value), *p. 16-8*
 conversion feature, *p. 16-4*
 cumulative provision, *p. 16-5*
 dividend yield, *p. 16-7*
 fixed charge coverage, *p. 16-8*

in arrears, *p. 16-5*
 monthly income preferred stock (MIPS), *p. 16-10*
 noncumulative provision, *p. 16-5*
 preference (prior preferred) stock, *p. 16-5*
 preferred stock, *p. 16-2*

Discussion Questions

LG 2**LG 3**

Q16.1 Briefly describe each of the following, and note how each differs from a conventional preferred stock.

- a. Convertible preferreds
- b. Floating-rate preferreds
- c. Prior preferred stocks
- d. Trust preferreds

As an investor, why would you choose a *convertible preferred* over a straight preferred? Why would you choose a *floating-rate preferred* over a (fixed-rate) preferred? Finally, instead of investing in a conventional preferred, why not just invest in a common stock?

- LG 2** **Q16.2** Is it possible for a firm to pass (miss) dividends on preferred stocks, even if it earns enough to pay them? Explain. What usually happens when a company passes a dividend on a cumulative preferred stock? Are common stock dividends affected in any way?

Problems

- LG 3** **P16.1** An adjustable-rate preferred is currently selling at a dividend yield of 9%. Assume that the dividend rate on the stock is adjusted once a year and that it is currently paying an annual dividend of \$5.40 a share. Because of major changes that have occurred in the market, it's anticipated that annual dividends will drop to \$4.50 a share on the next dividend adjustment date, which is just around the corner. What will the new dividend yield on this issue be if its market price does not change? What will the new market price on the issue be if the stock's dividend yield holds at 9%? What will it be if the yield drops to 7%?
- LG 3** **P16.2** The Bullorbear Company has 500,000 shares of \$2 preferred stock outstanding. It generates an EBIT of \$40 million and has annual interest payments of \$2 million. Given this information, determine the fixed charge coverage of the preferred stock—assume the dividends qualify for the preferential tax rate. Given the firm also has \$5.5 million in depreciation and amortization, use EBITDA to find the fixed charge coverage of this preferred.
- LG 3** **P16.3** The Bullorbear Company has 500,000 shares of \$2 *trust* preferred stock outstanding. The firm generates an EBIT of \$40 million and has annual interest payments of \$2 million. Given this information, determine the fixed charge coverage on these trust preferred stocks.
- LG 3** **P16.4** You purchased 100 shares of a \$2.00 preferred stock 1 year and 1 day ago for \$25 per share. You sold the stock today for \$30 per share. Assuming you are in a 25% tax bracket, calculate your after-tax holding period return:
- Assuming the dividends are treated as dividends for tax purposes.
 - Assuming the dividends are treated as interest income for tax purposes.
- LG 3** **P16.5** Assume that you are evaluating several investments, including the stock of a mature company that pays annual dividends of \$2 and is currently trading at \$25. Another investment is a *trust* preferred stock that pays \$2.40 in annual dividends and is also trading at \$25. Given that you do not expect the price of either stock to change, which investment will provide a higher dollar return if you are in a 33% tax bracket?
- LG 3** **P16.6** Select one of the preferred stocks listed in Table 16.1—assume the dividends qualify for the preferential tax rate. Using the resources available at your campus or public library, or on the Internet, determine the following.
- The stock's latest market price
 - Its dividend yield
 - Its fixed charge coverage
 - Its book value per share
 - Its stated par value

Comment briefly on the issue's yield and the quality of its claim on income and assets.

LG 1

P16.7 Sara-J Co. has a preferred stock outstanding that pays annual dividends of \$3.50 a share. At what price would this stock be trading if market yields were 7.5%? Use one of the dividend valuation models (from Chapter 8) to price this stock, assuming you have a 7.5% required rate of return. Are there any similarities between the 2 prices? Explain.

LG 3

P16.8 Charlene Weaver likes to speculate with preferred stock by trading on movements in market interest rates. Right now, she believes the market is poised for a big drop in rates. Accordingly, she is thinking seriously about investing in a certain preferred stock that pays \$7 in annual dividends and is currently trading at \$75 a share. What rate of return will she realize on this investment if the market yield on the preferred drops to 6.5% within 2 years? What if the drop in rates takes place in 1 year?

Case Problem 16.1

Penni Shows a Preference for Preferreds

LG 1**LG 2**

Kathleen “Penni” Jock is a young career woman who has built up a substantial investment portfolio. Most of her holdings are preferred stocks—a situation she does not want to change. Penni is now considering the purchase of \$4,800 worth of LaRamie Corporation’s \$5 preferred, which is currently trading at \$48 a share. Penni’s stockbroker, Mr. Michaels, has told her that he feels the market yield on preferreds like LaRamie should drop to 7% within the next 3 years and that these preferreds would make a sound investment. Instead of buying the LaRamie preferred, Penni could choose an alternative investment (with comparable risk exposure) that she is confident can produce earnings of about 10% over each of the next 3 years.

Questions

- If preferred yields behave as Penni’s stockbroker thinks they will, what will be the price of the LaRamie \$5 preferred in 3 years?
- What return will this investment offer over the 3-year holding period if all the expectations about it come true (particularly with regard to the price it is supposed to reach)? How much profit (in dollars) will Penni make from her investment?
- Would you recommend that she buy the LaRamie preferred? Why?
- What are the investment merits of this transaction? What are its risks?

Excel with Spreadsheets

Preferred stock is a unique type of equity and is referred to as a hybrid security—it has characteristics of both bonds and common stock. In practice, preferred stocks are valued more like bonds, with market interest rates and investment quality playing major roles. For those investors interested in preferred stock investing, it is likely that interest rates play a key role in their investment strategies. The 2 main strategies involve either seeking high levels of dividend income or taking advantage of falling market interest rates resulting in capital gains.

Create a spreadsheet to model and answer the following questions related to preferred stock investments.

Questions

- a.** The Scully Corporation issued preferred stock with a stated dividend of 8% of par. Preferred stock of this type currently yields 7% with a par value of \$75. Assume that the firm has 800,000 shares of the preferred outstanding at this time and that the dividends (which qualify for the preferential tax rates) are paid annually. Reviewing its income statement, the EBIT is \$85 million and it has annual interest payments of \$3 million. The firm is in the 30% federal tax bracket.
1. What is the value of Scully's preferred stock?
 2. What is the fixed charge coverage of Scully preferred stock?
- b.** A group of speculators are interested in the Scully preferred stock as the current market interest rates are quite volatile. These speculators hope to gain from the potential movement in market rates. The group believes that the future course of rates will follow a downward trend, which should translate into an increase in their equity value.
1. Given the information about Scully preferred and your valuation calculations from question a, what will be the realized holding period return on this investment if the market yield on the preferred drops to 5% after 1 year?
 2. What will be the realized holding period return on this investment if the market yield on the preferred rises to 8% after 1 year?
-

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Common stock shareholders may receive income from dividends, but this income is not guaranteed. Preferred shareholders, on the other hand, are guaranteed a yield, usually in the form of a fixed dividend payment. Nevertheless, there are some risks involved in owning preferreds. For example, preferred stocks often have a limited life, are usually callable, and are subject to interest rate risk. Interest rate risk is a major problem for fixed-income securities, because inflation may erode the purchasing power of the fixed payments. Despite the existence of interest rate risk, a well-balanced portfolio should include a broad mix of securities, such as stocks, bonds, preferred stocks, foreign investments, and some cash for buying opportunities.

Exercises

1. Determine the current yields on preferred stocks by looking in the *Wall Street Journal*. Are these yields higher than you are receiving on your common stock dividends?
2. Log on to OTIS to view the interest received on your cash holdings by going to "History." Then go to "Analytics" and select "Overnight Interest Rates" to see the rates you have been receiving (you can also go to the help screen and click on "Account Value" to see how the rates are determined). Are the daily interest rates you are receiving higher than the inflation rate?