

PREFERRED STOCKS

A special category of securities worth exploring.

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Stocks that tend to pay sizable dividends. Institutional and individual investors buy preferred stocks because they offer fixed dividends - in fact, dividend yields are typically greater than those of common shares.¹

Preferred stocks are occasionally called hybrid securities, because they have characteristics of debt instruments as well as equities. Let's review some of their features and pitfalls.

Priority dividend payouts. As the "preferred" adjective implies, these shares are a step above common stock. If you own preferred stock in a company, you will get your dividend first; all the common shareholders will get theirs second. You also have preference if a corporation declares bankruptcy or liquidates and sells assets. In that instance, debt holders are paid first, then the preferred shares, and finally the common shares.

Dividend determination. Dividends paid out on preferreds are akin to coupon payments on a bond. A preferred stock obviously doesn't have a maturity date like a bond, but it does have a par value, which is used to figure out the payouts. (A good stock research website can help you find the par value and preferred dividend rate of return.) You determine the preferred dividend by multiplying the preferred dividend rate percentage by the par value.

If you need to figure out the market value of a preferred stock, you can do that simply. Divide the dividend amount by the yield (required rate of return stated by the issuer). A visit to a stock research website will give you the yield percentage on a preferred.

Similarly, the price of a preferred stock equals the preferred dividend divided by the yield percentage.

Accumulating dividends. Sometimes a corporation can't pay dividends to preferred shareholders. If that's the case, the company will often let the preferred stock dividends accumulate until cash flow improves.

The five kinds of preferreds. Most preferred stocks are cumulative - that is, any missed dividend payments accumulate for an eventual payout. Most preferreds are also callable - that is, the stock issuer has a chance to call (redeem) the shares at par value. Yields on preferred shares sometimes include premiums in recognition of this risk.

Some preferred stocks are convertible, with embedded options allowing you the chance to exchange preferred shares for common ones. (Sometimes a provision is allowed that gives the issuer the chance to call for the conversion.)

Some preferreds are participating - when a company does well, the dividends from these shares may be greater than the published yield. Finally, when a corporation issues multiple rounds of preferred stock, there may be preference-preferred shares; if you own shares from the first issuance, your preferreds take priority over preferreds issued later.

Possible pitfalls. So what is the downside of owning a preferred stock? Well, they do present potential and actual disadvantages. When a market sector heats up and common shares take off, preferreds often lag behind. Interest rate hikes can reduce the value of preferred shares. Additionally, you have no voting rights as a preferred shareholder.

Ratings. There is no "official" rating system for preferred stocks; however, the big credit agencies that rate bonds rate preferreds as well. Standard & Poor's and Moody's do, and when they downgrade, it can hit a preferred stock hard. Preferred stocks rated beneath BBB- at Standard & Poor's or beneath Baa3 by Moody's are considered junk preferreds.² If you have to go outside of S&P or Moody's to find a preferred stock's rating, that's a red flag - it might mean that it couldn't get a decent rating from S&P or Moody's.

A preferred stock investor would do well to research a company's financial ratios and cash flow, and its interest coverage ratio (higher is usually better).

Consider the variables. Preferred stocks have looked attractive to retirees and others seeking consistent dividends. Rather than explore them alone, you should see a financial consultant who can help you thoroughly understand your options in this area and compare them to other choices you may have.

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Citations.

¹ mercurynews.com/columns/ci_14249188 [1/23/10]

² kiplinger.com/magazine/archives/2003/10/preferred.html [10/03]