Preferred Stock

Preferred stock is neither a typical, nor a highly exotic investment. Nonetheless, many investors have only a vague understanding of the security.

Preferred shares are a form of stock issued by corporations who also issue common shares. Once the shares are issued, they trade on an exchange just like common shares. Preferred stock differs from common in that it has a greater claim on dividends, but no voting rights.

Often the dividends paid by preferred shares are fixed, and typically they are higher than those paid by the company's common shares. Similar to a bond, preferred stock includes yearly payments that are stated as a coupon (5% of the face value) or a dollar amount ($5 preferred). Unlike bonds, these payments are considered dividends and therefore not legally binding.

Preferred shares do not have the same price movement as common stock—they are less volatile, which makes them less risky on the downside but less profitable on the upside. Preferred stock can be viewed as a stock-bond hybrid.

» Why Companies Issue Them

A company will issue preferred stock as opposed to bonds to strengthen the balance sheet. The proceeds from preferred stock sales are considered equity and can improve the company's debt-to-equity ratio, while issuing more bonds means taking on more debt and, in turn, having a higher debt-to-equity ratio. In addition, a company making dividend payments can lower or suspend those payments if cash is needed, while interest payment obligations to bondholders must be met.

Of course, companies can issue either preferred or common stock to strengthen the balance sheet, but since preferred stock typically doesn't carry the same voting rights as common stock, issuing preferred shares does not dilute the ownership interest of current common shareholders. Dilution of earnings will lower earnings per share numbers, a common data point used to analyze a company's value.

Issuing preferred shares is, however, a more expensive way for a company to raise capital than issuing bonds, since dividends paid to preferred shareholders are paid from aftertax profits. In contrast, bondholders are paid interest, which is deductible and therefore paid from pretax dollars.

On the other hand, *owning* preferred shares of other companies is a profitable parking spot for corporate cash because corporations are exempt from taxes on most preferred dividend income.

» How They Work

Most preferred share offerings carry a unique set of rights and stipulations that must be examined on an individual issue basis. However, there are features that are common to many.

First, a company cannot pay common shareholders a dividend until all preferred dividends have been paid. Also, if a company goes bankrupt, preferred shareholders are in line after all company debt has been paid, but before common shareholders can be paid.

Dividends on preferred shares are not legally binding, but it is unlikely that a company will skip a preferred dividend unless under exceptional stress. Most of the dividends are a fixed amount, stated as either a percentage of face value or a fixed dollar amount. However, some companies issue adjustable-rate preferred stock, which means the dividend payment can vary and is based on a number of factors stipulated by the company.

Most preferred shares also have a cumulative dividend right, which means any unpaid dividends accumulate and all dividends will be paid in full at a later time, before any common shareholder dividends can be paid. While most preferred stock is cumulative, be aware that some preferred shares are non-cumulative so that if a dividend payment is missed, the company has no obligation to make these payments at a later date.

Some preferred shares will have provisions prohibiting the issuance of new preferred shares with a senior claim, meaning subsequent preferred shares issued have a lower claim on receiving dividend payments.

Preferred shares are unique from company to company, and an endless combination of rights and privileges makes it essential that investors know all the caveats of the stock before purchasing.

» Variations

There are many variations of this investment. Two of the most popular are convertible and callable.

Convertible preferred stockholders have the right to convert their preferred shares into shares of common stock at a specified price. This way, investors are getting the higher dividend payment while holding the preferred shares and can also cash in on any gains in the common stock price should the price rise substantially. Once the shares are converted, shareholders will lose the higher preferred dividend payment and be treated as a common shareholder.

Callable preferred shares include a provision that gives the issuer the right to buy back the stock at a certain price, usually the par value, and retire it. This tends to occur if interest rates fall to a lower rate than the promised dividend payment rate, allowing the issuing company to borrow money more cheaply in the open market.

Another, less common, variation is participating preferred stock, in which stockholders receive a payment in addition to the fixed dividend that is based on a percentage of either net income or dividends paid to common shareholders.

» How to Trade

Preferred stock trades on an exchange, just like its common stock counterparts. The ticker symbol will usually contain extra letters to denote a different class of shares.

The New York Stock Exchange (NYSE) lists preferred stock with a PR tacked onto the ticker symbol. If a company has multiple offerings of preferred shares, the ticker symbol can contain an additional letter denoting shares higher in the payment hierarchy.

Because each issue of preferred shares has different features, the price at which they trade will vary from each other, and from the common shares. Common stock prices will be more volatile because capital appreciation is the foremost way investors make money. Because they are similar to bonds, preferred share prices tend to fluctuate with market interest rates.

You can purchase preferred shares from most brokers who trade common stock and usually for a similar fee, but always check commission schedules before you place a trade.

Like bonds, preferred shares are rated by various ratings companies including S&P, Fitch, Moody's, and A.M. Best. Most companies will have the credit ratings available to investors, but you can also search the rater's Web site to find ratings on specific preferred shares. S&P, Fitch, Moody's and A.M. Best allow you to search their databases for free after site registration.

» Investor Suitability

Preferred shares act more like fixed-income investments, so this type of investment would suit a more conservative investor. The price is less volatile so investors will not feel a big drop in the share price if there is negative news about the company. Primarily, investors make profits from preferred stock because of the high dividend payments, not price appreciation.

Potential investors should also be aware that the market for preferreds tends to be dominated by corporate investors who are exempt from taxes on 80% of the dividend income. Individual investors are not allowed this tax relief so the dividend income is not as attractive to individual investors compared to corporate investors.

» Tax Implications

For individual investors, paying taxes on preferred share dividends and gains can be tricky. Depending on how the payments are qualified by the company, tax treatment can vary. Some dividends are treated as ordinary dividends, which, effective May 6, 2003, through December 31, 2008, are taxable at a 15% maximum rate. Other companies qualify the payments as interest, so different tax rules apply. The only way to really find out how taxes will affect a certain offering is to delve into the prospectus.

» The Pros

- Dividend payment priority over common shareholders
- Higher dividends than common stock
- Cumulative dividends
- Lower downside risk than common stock

» The Cons

- Potential to miss out on price appreciation
- No voting rights
- May have negative tax implications

~By Cara Scatizzi
AAII Associate Financial Analyst