



# Preferred Stocks Primer

Everything You Need to Know About Preferreds

## Contents

Preferred Stock Basics .....	2
Baby Bonds .....	3
Calling Preferreds .....	3
Terminology .....	3
Optimizing Preferred Stock Returns .....	4
Preferred Stock Risks .....	5
Preferred Stock Tax Issues .....	6
Evaluating Preferred's Issuer Financial Strength .....	6-7
Preferred Stock Glossary .....	8-9

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# Preferred Stock Basics



Corporations issue preferred stocks to raise cash. Although you buy or sell them the same way you trade regular stocks, preferreds are more like bonds than common stocks. Investors buy them for the steady dividends, which typically equate to 4% to 8% yields. Although a few pay monthly, most preferreds pay dividends quarterly.

Unlike common stocks, you're won't enjoy much share price appreciation if your company comes up with a hot product. Further, in most cases, the dividend never goes up either.

The term "preferred" means that a firm must pay the dividends due on its preferred shares before it pays any common stock dividends. Also, in theory, if a company goes bankrupt, preferred holders have priority over common stock shareholders. However, when a company fails, both common and preferred shareholders usually get nothing.

Finally, another meaningless distinction: unlike common stock holders, preferred shareholders don't get to vote on company proposals. But, in fact, individual common shareholders have almost no influence on any corporation's policies.

## Dividend Yields

When a company issues a preferred stock, it sets the annual dividend and sells the shares at a preset price, typically \$25, but some are also issued at \$10, \$50 or \$100.

The initial yield, called the "coupon rate," is the annual dividend divided by the issue price. For instance, the yield on shares paying \$1/year on shares issued at \$25 is 4.0%.

However, since preferreds trade on the open market just like regular stocks, the actual trading price depends on supply and demand. Thus, if the shares mentioned above slip to \$24, the yield to new investors (market yield) rises to 4.2% (\$1 divided by \$24).

## Preferred Stock Ticker Symbols

Companies that issue preferred stocks typically sell more than one series, for instance, Series A, Series B, etc. Ticker symbols are not standardized and vary from website to website. However they typically start with the issuer's common stock symbol and end with the series designator. For instance, the ticker for Bank of America (BAC) Series N preferreds might be BAC-N, BAC-PN, BACPRN, etc.

To find the ticker on a particular website, use the symbol lookup function and enter the common stock ticker. Most sites respond with a list of all tickers starting with those letters. From that list, find the ticker ending with the desired series designator. After you've done that once or twice, you'll probably be able to find additional preferreds on the same site without needing the lookup function.

# Baby Bonds



Baby bonds also known as debentures or notes, are similar to regular preferreds. However, they represent unsecured debt, that in the event of default, ranks junior to secured debt, but senior to other preferreds and common stock. Since they pay interest, not dividends, baby bonds are not eligible for the 15%/20% tax rates on qualified payouts.

Similar to cumulative preferreds, specified interest payments can be deferred indefinitely, but the issuer is still on the hook for any skipped payments. However, unlike real bonds, deferring of interest payments won't necessarily put the issuer in default (bankruptcy) status.

## Calling Preferreds

Preferreds have minimum 30-year maturities and some are perpetual, meaning that the issuing firm is not obligated to redeem them. However, most Preferred stocks are “callable,” meaning that the issuer has the right to call (redeem) them at the “call price” after a specified date (call date), typically five-years after issue. The call price is usually the original issue price, but in some instances is slightly higher.

The issuer is not obligated to redeem the shares at the call date, nor at any other time prior to the maturity date.

Issuers are most likely to call their preferreds if interest rates have dropped and they can save money by calling existing preferreds and selling a new series paying lower rates. Otherwise, they may have no incentive to call them. Thus, depending on prevailing interest rates, preferreds might continue to trade for years after the call date.

Finally, in practice, most issuers would not call preferreds trading significantly below their call prices. There is no point in paying \$25 per-share if they could be had for less? So, instead, they would simply buy them on the open market at prevailing prices when they want to redeem them.

## Terminology

### Coupon Rate

The Coupon rate simply defines the annual dividend amount based on the issue price.

### Market Yield

The market yield is the annual return based on the current trading price. **Your** market yield is your annual return based on the price **you paid** for the shares, not the call or issue price.

### Yield-to-Call

During normal markets, preferreds issued at \$25 typically trade up to \$26 or \$27 per share. However, they could still be called at \$25. Thus, if you paid \$27, you would lose \$2 per share if they were called while you held them. Yield-to-call is the average annual return you would earn if your preferreds were called at their call price on the call date. That's a worst case scenario because most preferreds are not called that soon.

# Optimizing Returns



## Trading Below Call Price

Ideally, you would like to buy preferreds below their issue price, which is typically the same as the call price. Assuming that the issuing corporation is a solid player and won't renege on its dividend obligations, the preferreds will eventually move back up to their issue price. If that happens, you would earn a higher dividend yield and capital appreciation as well. For instance, suppose that you pay \$23 for 7.0% preferreds issued at \$25. Instead of 7%, your market yield would be 7.6% plus 9% capital appreciation if they were called at \$25.

## Trading Above Call Price

However, in strong markets, most preferreds trade above their call prices. For instance, \$25 preferreds typically trade in the \$26 to \$29 range. Keep in mind that if you pay \$27, you'll lose that \$2 premium when and if your preferreds are called at \$25.

You could use this bond calculator ([bit.ly/DivDet\\_YTCCalc](http://bit.ly/DivDet_YTCCalc)) to find yield-to-calls (YTCs). Although it's intended for showing bond yields to maturity, it works just as well for preferred YTCs. Simply enter the current and call price (labeled bond par value), the preferred coupon rate (e.g. 5.25) and the years to call (years until maturity). Enter the years to call to one decimal place, e.g. 2.2 for two years and three months, 2.5 for two years and six months, etc.

As a rule of thumb, I suggest requiring a minimum 6.0% YTC for buying investment grade preferreds, and 7.0% YTC for unrated, or junk-rated preferreds. Of course, those are my ideas, your requirements may vary.

## When to Sell?

In practice, it's usually more profitable to sell a preferred trading for significantly above its call price before it's actually called. I suggest selling investment-grade bonds when their YTCs fall below 3.5%, and unrated, or junk-rated preferreds when their YTCs fall below 4.5%.

## D.D.'s Preferred's Portfolio Typically Holds 25-30 Buy-Rated Preferreds

Click for: [Preferred Dividend Calendar](#)

DD Risk Rating: one is lowest risk, three is average, and five is highest risk. Rating reflects our estimated risk of a dividend suspension.

Ticker	Portfolio Details	Recent Price	Mkt. Yield	Call Date	S&P	15%/20% Tax Rate	DD Risk Rtg.	Yield to Call
<b>SCHW-D</b>	<b>Charles Schwab 5.95%</b> <small>Preferreds listed in green are 'buy' rated.</small>	26.08	5.7%	6/1/21	BBB	Y	2	4.0%
Charles Schwab 5.95% Series D Non-cumulative. Pays 3/1, 6/1, 9/1, 12/1. Call Price \$25.00. Annual dividend: \$1.4875. One of the largest U.S. stock brokers, primarily serving retail clients. Eligible for corporate holders' dividends received deduction.								
<b>CHMI-A</b>	<b>Cherry Hill 8.20% A</b>	24.96	8.2%	8/1/22		N	3	8.3%
Cherry Hill Mortgage 8.20% Series A Cumulative. Pays 1/15, 4/15, 7/15, 10/15. Call Price \$25.00. Annual dividend: \$2.05. <small>Not credit rated</small> Cherry Hill is a Real Estate Investment Trust (REIT) that invests in government backed residential mortgages, mortgage servicing rights, and other residential mortgage assets.								

Preferred Portfolio listings include all the data you need to make buy/sell decisions including recent price, dividend pay dates, market yield, call date, yield to call, dividend tax status, DD's proprietary risk ratings and S&P credit ratings when available.

# Preferred Stock Risks



Preferred stock investors face three major risk factors: 1) dividend suspension and/or company bankruptcy, 2) rising interest rates, and 3) low trading volumes.

## **Dividend Suspension/Bankruptcy**

Firms facing cash flow problems will be tempted to suspend paying preferred stock dividends, and in the worst case, might file for bankruptcy. Either of those events would sink preferred share prices.

Consequently, preferred investors must understand the issuing corporation's fundamental outlook before buying. Preferreds issued by marginal corporations will look tempting because they will be trading at big discounts to their issue price.

Many preferred stocks are rated by bond rating agencies such as Moody's and Standard & Poor's (S&P). They use a combination of letters, numbers, and plus or minus signs such as AAA, BA1 or B- to rate the preferreds. The details vary between agencies, but all ratings starting with A, and three letter ratings starting with B, indicate investment quality.

S&P's Investment quality ratings are AAA, AA, A, and BBB. Below investment quality (best to worst) are BB, B, CCC, CC, C and D. S&P may add a "+" or "-" to indicate that a rating falls near the top or bottom of a rating category.

Moody's investment quality ratings, are Aaa, Aa, A, and Baa. Below investment quality (best to worst) are Ba, B, Caa, Ca, and C. Moody's may add a "1," "2," or "3" to a rating to indicate that it falls near the top or bottom of a rating category (1 is best).

Since issuers must pay Moody's or S&P to be rated, not all preferreds are rated. Unrated preferreds aren't necessarily risky, but they require more work since you'll have to do the financial strength analysis on your own.

Beware; bond-analysts sometimes overlook the obvious. For instance, in 2007, many didn't realize that falling home prices would reduce the value of mortgages secured by those homes. Thus, it's up to you to keep up with the news and avoid industries with obvious problems.

## **Interest Rate Risk**

After the issuers' financial strength, prevailing interest rates are the most important factor controlling preferred share prices. If market rates rise, preferreds typically drop, and vice versa. Here's why.

If you bought \$25 preferreds with a 6% coupon rate, your dividends would total \$1.50 annually. Now, say that prevailing preferred rates rise to 7%, meaning that new buyers would be collecting \$1.75 per share. If you do the math, you'd find that you'd have to cut your preferred share price down to \$21.42 before its \$1.50 dividend equates to a 7% yield.

Conversely, if interest rates drop, investors would be willing to pay more for your shares because they are yielding better than market returns. Thus, the best time to own preferreds is when the outlook for corporate interest rates is steady or, even better, headed down.

## Trading Volumes

Some preferred stocks are not widely followed and are lightly traded. Those are risky business because the lack of trading volume makes it difficult to move in or out of a position at a reasonable price. Avoid preferred stocks trading less than 4,000 shares daily, on average.

## Preferred Stocks Tax Issues



The dividends from some preferreds are subject to the maximum 15%/20% dividend tax rate (qualified dividends), while others are taxed as ordinary income. That can make a big difference. For instance, \$1.00 of dividends taxed at 15% nets out to roughly the same amount as \$1.30 taxed at the maximum 39.6% ordinary tax rate.

Generally, dividends from preferreds issued by regular corporations (both U.S. and foreign) are considered qualified dividends while those issued by tax-exempt firms such as Real Estate Investment Trusts (REITs), Business Development Companies (BDCs) and farmers cooperatives are not. Also, payouts characterized as interest rather than dividends such as those paid by debt securities such as notes and debentures (e.g. Baby Bonds) are not eligible for the 15%/20% maximum tax rates.

Also, to be eligible for the qualified rates, you must hold the preferred for more than 90 days during the 180-day period beginning 90 days before the ex-dividend date. Of course, none of those rules apply if you hold your preferreds in an IRA or other qualified retirement account.

Corporations that have invested in other firm's preferred shares, in most instances, enjoy a dividend received deduction that allows them to exclude 70% of dividends received from their taxable income. Quantum Online ([quantumonline.com](http://quantumonline.com)) specifies whether a specified preferred qualifies for the corporate dividend received deduction.

## Evaluating Issuer's Financial Strength



Your main concern when you analyze a preferred stock is determine whether the issuer will have sufficient resources to continue paying the required dividends. It doesn't matter if the issuer's recent earnings came in below analysts' estimates or if it said that next quarter sales would be lower than previously forecast.

### Quick Check

Rather than donning green eyeshades and getting out your calculator, you can tell a lot about a firm's ability to pay its preferred stock dividends by first checking its common stock share price. In a nutshell, issuers with common stock prices above \$50 per share are unlikely to run into problems meeting their commitments while those with shares trading below \$5 are risky bets. Obviously, there's going to be gradations between those two levels but sticking with preferreds issued by firms with common shares trading above \$20 per share should keep you out of trouble.

## Cash Flow Statements

Checking cash flow statements is the best way to determine a firm's ability to meet its financial commitments, whether preferred stock dividends, bond interest payments, or whatever. Here's what you need to know.

A cash flow statement contains three sections:

**Net Cash from Operating Activities:** the cash that moved in or out of a company's bank accounts resulting from its main business. Reported net income is always the top line of the operating cash flow section. Then, all of the **non-cash** items used when calculating net income are listed and reversed out, resulting in the bottom line of that section: **operating cash flow**. It's a red flag pointing to possible accounting shenanigans when operating cash flow is less than reported net income.

**Cash from Investing Activities:** includes capital expenditures (purchase and sale of property, buildings, and equipment) and of short-term investments.

**Cash from Financing Activities:** includes common stock dividends paid, cash from stock sales and buybacks, and from issuance and repayment of debt and stock buybacks. Preferred stock dividends are accounted for in the net income calculation.

## Free Cash Flow & Surplus Cash Flow



You can calculate “free cash flow” by subtracting capital expenditures (Cash from Investing Activities) from operating cash flow (Net Cash From Operating Activities). If a firm does not pay common stock dividends, free cash flow is excess cash that a firm does not need to fund its basic operations.

If a company does pay common share dividends, calculate “surplus cash flow” by subtracting dividends paid (Cash From Financing Activities) from free cash flow. For non-dividend payers, free cash flow and surplus cash flow are the same.

If a positive number, surplus cash flow is excess cash that could be used for expansion, cutting debt, raising dividends, etc. However, if surplus cash flow is negative, the firm must depend on raising additional cash either by borrowing or by selling more shares to fund its current obligations.

When evaluating preferred stocks, give preference to those issued by firms with positive surplus cash flow.

## Too Many Preferreds - Too Little Time?

Let DIVIDEND DETECTIVE Do the Analysis For You

[DividendDetective.com](http://DividendDetective.com)

# Preferred Stock Glossary

**Adjustable Rate:** annual dividend varies depending on predefined factors.

**Baby Bonds:** a.k.a. debentures or notes, similar to regular preferreds except that in the event of default, rank senior to other preferreds and common stock.

**Callable:** issuer has the right, but not the obligation, to redeem shares at issue price, or other specified price, after a specified date.

**Call Date:** earliest date that shares can be called. Usually five years after issue date.

**Call Price:** price issuer will pay for redeemed shares. Usually the same as the issue price.

**Change of Control:** Issuer is acquired, which may allow early redemption.

**Convertible:** holders have the right to convert preferred shares to common stock at predetermined ratio after specified date. This gives preferred holders a chance to benefit from the common stock's share price appreciation.

**Coupon Rate:** yield based on initial issue price

**Credit Rating:** Preferred issuer may request rating agencies such as S&P or Moody's to rate their preferred's credit using a combination of letters and numbers.

**Cumulative:** depending on the preferred, skipped dividends can be delayed for five-years, or even indefinitely. However, any skipped dividends must be paid before common stock dividends are paid and before the shares are redeemed. Unlike failing to pay required bond interest payments, preferred issuers are not "in default" if they skip preferred dividends.

**Current Yield:** yield based on current share price.

**CUSIP:** unique identifier for each security.

**Debentures:** a.k.a. Baby Bonds or Notes.

**Dividends:** regular monthly, quarterly, semi-annual or annual payments. Depending on the preferred type, may be classified for tax purposes as dividends or interest. Generally, dividends are eligible for "qualified" income tax rates.

**Exchange-Traded Debt Securities:** a.k.a. Preferred Equity Traded (PET) Bonds or Junior Subordinated Debentures. Debt securities such as debentures, notes and bonds that trade like stocks. These unsecured debt instruments rank below secured debt, but senior to preferred and common stocks.

**Ex-Dividend Date:** you must purchase shares prior to the ex-dividend date to receive the corresponding payout.

**Floating Rate:** dividend coupon rate may vary with a defined index (e.g. 3-mo libor) after a specified period, typically five years.

**Investment Grade:** rated "investment quality" by rating agencies such as S&P or Moody's.

**Issue Price:** original share price.

**Junk Rated:** rated below investment quality by rating agencies.

**Liquidation Value:** same as issue price.

**Market Yield:** yield based on current share price.



**Maturity Date:** the date the preferred shares must be redeemed by the issuer, typically 30 to 100 years after issue.

**Non-Cumulative:** Issuer can suspend preferred dividend payouts and is not required to pay any skipped dividends. However, issuer cannot not pay common stock dividends while preferred dividends are suspended.

**Par Value:** same as issue price

**Participating:** annual dividend varies depending on firm's net income or dividends paid to common shareholders.

**Perpetual:** No maturity date meaning that the issuer never has to redeem the preferreds.

**PINES (Public Income Notes):** a.k.a. QUIBS (Quarterly Interest Bonds) or QUIDS (Quarterly Income Debt Securities). Debt securities such as debentures, notes and bonds that trade like stocks. These senior unsecured debt instruments rank below secured debt, but senior to preferred and common stocks.

**Prospectus:** Defines a preferred stock's terms and conditions.

**Qualified Dividend:** qualifies for 15%/20% maximum tax rates. Dividends from regular corporations are generally qualified while dividends paid my tax-exempt firms such as BDCs REITs and MLPs are not.

**Redeemable:** same as "callable."

**Redemption Date:** same as call date.

**Senior Notes:** Issuers cannot skip preferred interest payments (dividends) without going into default.

**Third Party Trust Preferred:** a Trust Preferred issued by a third party such as an underwriter.

**Trust Preferred Securities:** a cumulative preferred variation that provides certain income tax and accounting advantages over traditional preferreds to the issuer, but not for the shareholder. Instead of selling preferreds directly, a corporation sets up a special trust that buys debt securities from the corporation and, in turn, issues preferred shares. If the issuer suspends dividends, shareholders may still be liable for income taxes on the unpaid dividends. **TruPS - Trust Preferred Securities** are Smith Barney's brand name for Trust Preferreds. **TOPrS - Trust Originated Preferred Securities** are Merrill Lynch's brand name for Trust Preferreds.

**Yield to Call:** average annual return you would receive assuming the preferred is called (redeemed) on the call date. Most preferreds are not called that soon, so in practice your actual return would usually be higher than the calculated Yield-to-Call.

**Yield to Maturity:** average annual return you would receive assuming the preferred is redeemed on its maturity date. In practice, most preferreds are called long before the maturity date.

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