

PREFERRED STOCKS

In portfolio management, the following attributes of preferred stocks should be recognized:

1. A preferred stock may be likened to a bond with an infinite maturity. As with a bond, the rate of income is fixed, and so can never increase; yet, unlike a bond, there is no guarantee that the investment will ever be redeemed at par.
2. Insofar as safety is concerned, all the preferred stocks of a company rank behind all of that company's bonds, both as to payment of dividends and interest and as to the payment of principal in the event of liquidation. In other words, not even the safest preferred of a company is ever as safe as even the riskiest of that same company's bonds.
3. Assuming that the preferred stock is sound, the primary determinant of its price is the level of interest rates. If interest rates go down, the price of the preferred should go up; and, conversely, if interest rates go up, the price of the preferred should go down.

What is more, given that long-term fixed income securities are more sensitive to changes in interest rates and so more volatile than otherwise-equivalent, shorter-term securities, and given that the effective maturity of a preferred, because it never matures, is always longer than that of the longest maturity bond, a preferred is generally more volatile and so more risky than the longest maturity bond, even if, by all other measures, the preferred were as safe as the bond.

4. If a preferred stock (or a bond) is callable, it is even less desirable, from the point of view of the investor, than it would be if it were non-callable. A call feature is for the benefit of the issuer of a security, not the owner. If interest rates go up, the issuer is glad it issued the security because a new issue would require paying a higher dividend (or interest) rate; but the investor is sorry he bought the security because it now sells at less than what he paid for it, and so he is deprived of the opportunity of availing himself of the now current higher rates of return. If interest rates go down, however, the issuer may call in (pay off) the security, returning the investor his money to reinvest at the lower rates of interest now prevailing. I call this a "heads you lose, tails you do not win" type investment.

5. Under current tax law, if a corporation owns the preferred stock of another corporation, the dividend income the corporation receives on that investment is 70% tax-free. This is a benefit available to the corporate investor on a preferred stock holding that is not available to it on a bond holding; and it is a benefit available to the corporate investor that is not available to the individual investor.

Because of this tax benefit that preferreds have for corporate investors, the yields on preferreds—though they may seem high—are actually below their true worth to the individual investor. The situation is comparable to the way individuals in high income tax brackets bid down the yields (by bidding up the prices) on municipal bonds to levels that make them unattractive to individuals in low tax brackets (or in tax-sheltered accounts such as IRAs, pension funds, and charitable institutions).

The point to be made is that, just as municipal bonds, though appropriate for investors in high income tax brackets, are inappropriate for investors in low tax brackets, so, too, preferred stocks, though appropriate for corporate investors, are inappropriate for individual investors.

In short, it should always be possible, in principle, to find for the individual investor, a bond that provides higher income with comparable quality, higher quality with comparable income, or both higher quality and higher income, than that provided by any preferred stock he may own or contemplate owning; and, in practice, it is, indeed, always possible to find such a bond.

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