THE PREFERRED ALTERNATIVE
Many individual investors wanting regular income at an attractive yield have been increasingly turning to a market that has long been dominated by corporations and institutional investors—preferred stock. Preferreds are considered an equity security, but in reality preferred stock is more similar to a bond. This security pays a fixed dividend and typically yields two to four percentage points higher than dividend yields on common stock of the same issuer.

CHARACTERISTICS OF PREFERRED STOCK
Senior Security
Preferred stock is an equity security representing ownership in the issuing company and paying dividends that are deemed to be senior to the dividends received by common shareholders but junior to bondholders of the company. Most preferred shares are cumulative, meaning that the dividends accrue if the issuer misses a payment. No dividends are paid on the common stock until the dividend payments on the preferred stock are fully satisfied. Keep in mind that unlike common stockholders, preferred shareholders do not participate in the potential for increased dividends.

Favorable Yields
Investors seeking improved yields and current income may find preferreds an attractive investment, with yields that typically range between ½ to ¾ percent higher than those available on an issuer’s bonds.

Price Volatility
Preferred stock possess bond-like features, yet are not as price sensitive to interest rates. In general, prices will rise as interest rates fall and prices will move lower as rates rise, very similar to the price fluctuations of long-term bonds. In addition, other factors affect prices, such as when certain industries come in and out of favor and/or other general market factors.

Credit Risk
Preferred stock typically receives a credit rating similar to bonds. These ratings provide an indication of the likelihood that the issuer will continue to make timely dividend payments on their preferred stock. Generally, an issuer’s preferred stock ratings are two notches below issuer’s senior debt, which is reflective of the junior claim of the preferred.

Smaller Initial Investment
With most new preferred issues offered at $25 per share, it usually takes a smaller commitment of funds to efficiently build a diversified preferred stock portfolio than it does with bonds.

Liquidity
Lower par values appeal to individual investors, which tends to broaden distribution of preferreds and enhance liquidity. Unlike many other fixed-income investments, most preferreds are listed on major stock exchanges, which tends to improve visibility and strengthen marketability of the shares.

Capital Gains Potential
Preferreds offer the investor the opportunity for capital appreciation. When preferreds trade at a discount to par, investors can invest in these securities relatively inexpensively and earn a favorable yield on the dividends received, and should the outlook for the issuer become more favorable or interest rates fall, they can earn a capital gain on the shares. Of course, capital losses are also possible if the share price deteriorates subsequent to the time of purchase.

THE DIVIDEND RECEIVED DEDUCTION FOR CORPORATIONS
Corporations have historically invested in preferred stocks because of the favorable tax treatment of the preferred stock dividends. U.S. corporations that are subject to corporate income tax are generally allowed to exclude 70 percent of the dividend income they receive from their taxable income. This is known as the dividend received deduction (DRD).
In other words, for a company in the maximum 35 percent corporate tax bracket, the tax rate on dividends would be only 10.50 percent. This is calculated as the taxable portion of the dividend \((100\% - 70\% = 30\%) \times 35\% = 10.5\%\). In order to qualify for the DRD, the corporation must hold these securities for a minimum of 46 days, and the preferred stock must be issued by a domestic corporation and be structured as a “straight” preferred issue and not a fixed rate capital security structure.

**PREFERRED STOCK STRUCTURES**

**Traditional Preferred Stock**
Commonly known as straight preferred, these securities represent an equity ownership in a publicly held domestic corporation while having similar characteristics to bonds. Issuers, ranging from utilities and industrials to financial institutions, pay a fixed quarterly dividend, much the same as a traditional interest payment on a bond. With the attraction of well-recognized issuers of preferreds that are typically listed on the NYSE, individual investors also benefit from the yields that are higher than comparable fixed rate corporate bonds, for example. In addition, investors benefit from the exchange-listed liquidity and a fixed income stream that makes the preferred stock more stable then their common stock counterpart.

**Fixed Rate Capital Securities**
While traditional preferred stock has been available to investors for many years, a new type of preferred was developed several years ago, which has similar characteristics to preferred stock while allowing the issuing company to deduct the interest. Known as Fixed Rate Capital Securities (FRCS), they have been issued under various trademark names, including MIPS, MIDS, QUIPS and TOPRS, but they generally fall into two basic categories:

**Junior Subordinated Debentures**—These are the simplest form of fixed rate capital securities. With this structure, rather than setting up a separate company to issue preferred stock, the company issues the debentures directly to investors.

**Trust Originated Securities**—the name implies, these are issued by a trust. The proceeds of the preferred stock issue are invested by the trust in junior subordinated securities issued by the parent company. In addition to having the characteristics of traditional preferred stock mentioned above, investors should be aware that most FRCS also have a dividend deferral option. This allows the issuer to defer dividend payments for up to 20 quarters (five years). Most issues with this feature prohibit the company from declaring any common dividends until accumulated dividends on FRCS have been paid in full. Because FRCS are considered original issue discount (OID) securities for tax purposes, the investor would have to continue reporting and paying taxes on the dividend income, even if it is not paid by the company.

**Foreign Preferred Stock**
Also known as Yankee preferred stock, these U.S. dollar denominated securities are issued in the U.S. by foreign issuers. Yields are typically higher than preferreds issued by U.S. corporations, because Yankee preferreds are not eligible for the DRD and typically have lower name recognition than domestic preferreds. An important aspect of some foreign preferreds is the fact that the dividend may be subject to a withholding tax imposed by the issuer’s country. As an example, the United Kingdom imposes a 15 percent withholding tax on U.S. shareholders. Investors can reclaim this tax, however, if the shares are not held in a tax-deferred account, by filing a tax credit on their tax returns using Form 1116.

**Adjustable Rate Preferred Stock**
Dividends on adjustable rate preferred stock are reset quarterly to reflect market rates. The yield is adjusted to a specified percentage of the higher of the 3-month Treasury bill discount rate, the 10-year constant maturity Treasury rate or the 30-year constant maturity Treasury rate. These securities are structured with minimum and maximum dividend yields known as “collars”, and they are DRD eligible for corporations. Generally, the yield on these issues would be lower than that of “straight” preferred of the same issuer. Individual and corporate investors benefit from adjustable rate preferreds by owning a security that potentially insulates them against adverse changes in the shape of the yield curve, in addition to changes in the absolute levels of interest rates.
TAX CONSEQUENCES
Dividends from traditional perpetual preferred stock are reported on Form 1099-Div, similar to dividends on equity securities. Due to the dividend deferral option of Fixed Rate Capital Securities, these issues are categorized as OID (original issue discount) securities, even though they have a fixed rate coupon. Because of this feature, dividends from most FRCS are reported on Form 1099-OID. FRCS that have been issued under the limited partnership structure report their dividends on Schedule K-1, and investors report their dividends as partnership income. Since the income tax laws are complex and always subject to change, investors should discuss existing IRS guidelines with their tax accountant or legal advisor.

PRICE AND YIELD CALCULATIONS
The following are definitions and examples of some common price and yield calculations related to preferred stock. For illustrative purposes, assume an investor purchases preferred stock at a price of $25 per share paying a 7.50 percent dividend, or $1.875 per share per year.

Accrued Dividend
Preferred stock trades “flat,” which means it does not include any explicit consideration of interest earned since the last dividend was paid. However, in theory there are a certain number of days interest earned on the preferred shares from the time the last dividend was paid to the time the shares are purchased. This represents an implied accrued dividend. Example: Shares purchased today that last paid a dividend 60 days ago imply an accrued dividend of $0.31 per share, calculated as follows: $1.875 / 360 days x 60 days = $0.31.

Current Yield
The annualized dividend divided by the current preferred share price results in the current yield, which is a measure of the expected annual return on the investment. Example: Shares paying an annualized dividend of $1.875 with a current price of $25 offer a current yield of 7.50%, calculated as follows: $1.875 / $25 = 7.50%.

Stripped Price
The market price of preferred shares minus the implied accrued dividend produces the stripped price. Example: Shares priced at $25 which have an accrued dividend of $31 per share have a stripped price of $24.69, calculated as follows: $25 – $31 = $24.69.

Stripped Yield
The annualized dividend divided by the stripped price results in the stripped yield. Example: Shares paying an annualized dividend of $1.875 with a stripped price of $24.69 offer a stripped yield of 7.59 percent, calculated as follows: $1.875 / $24.69 = 7.59%.

Getting Monthly Income
Individual investors who need monthly income can achieve it by investing in a combination of three issues of preferred stocks. Many preferreds pay dividends quarterly in one of three cycles: (1) January, April, July, and October; (2) February, May, August and November; or (3) March, June, September and December. Purchasing three different preferred stocks that each pays dividends on one of these three cycles will provide regular monthly income to the investor.

International investing involves special risks not associated with U.S. domestic investments, such as foreign currency exchange rates, differences in financial accounting practices and possible political or economic instability. This information is not to be used as the primary basis of investment decisions. Please consult your Piper Jaffray financial advisor for more information.

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