Preferred securities

Wealth Management

Preferred securities combine elements of both stocks and bonds, and while holders of preferred securities are higher in the capital structure than common shareholders, they generally don't have the right to vote in a company's affairs. The two main types of preferred securities are $25 par and $1,000 par. The $25 par can be issued as either fixed-for-life or fixed-to-floating and most are listed on a major stock exchange. The $1,000 par is traded over-the-counter like traditional bonds and are fixed-to-floating.

Potential investor

Preferred securities are most suitable for investors with long-term investment horizons who are looking for periodic fixed rate scheduled payments (payments may be subject to certain events) and typically offer higher yields compared to other fixed income products. Yields will usually reflect the preferred securities' credit ratings (where they are rated by the major rating agencies) and where they fall in the capital structure. Preferred securities may not be suitable for every investor and should be evaluated based on their investment needs and risk tolerance.

Traditional preferred stock

- Rank senior to common stock, but junior to all debt in a company's capital structure.
- Pay a dividend as opposed to interest income.
- Dividends are typically paid quarterly if declared by the board of directors.
- Most preferred stock issues are perpetual with a five-year noncallable period.
- Preferred stocks may be either cumulative or noncumulative. If they are cumulative, in the event of a dividend deferment, the deferred dividend payments need to be paid back by the issuer.
- Preferred shareholders do not typically have voting rights except under certain circumstances.
- Preferred shareholders do not have the same rights as debt holders and generally cannot initiate legal action against the issuer in case of failure to pay (deferred dividends).
- Par value is generally $25 and $1,000.

Debt securities (baby bonds)

- Rank senior to common stock and traditional preferred securities.
- Rank on equal footing to the issuer's $1,000 par corporate bonds (e.g., $25 par senior notes are equal in the corporate debt hierarchy to their $1,000 par senior notes).
- Usually issued with a maturity date, typically long-dated 30 to 60 or more year maturities, and may be noncallable for five years from issue date.
- Interest payments are usually quarterly and at the stated rate.
- Most are noncumulative and if there is a missed interest payment the event may cause default. If they are cumulative, in the event of an interest deferment, the deferred interest payments must be paid by the end of the stated deferral period.
- Par value is generally $25.

Fixed and floating rate preferred securities

The $25 preferreds may be issued as fixed-for-life or fixed-to-floating, while the $1,000 preferreds are issued as fixed-to-floating.

A fixed-for-life security is issued with a fixed coupon, which will pay the stated interest until it is called or until it matures. That issue will pay the stated coupon until it is called, or until it matures.

On the other hand, floating rate preferred securities have the coupon set in relation to a benchmark index. With some structures, the coupons adjust immediately, but the most popular structure is the fixed-to-float.

Most fixed-to-float preferred securities have a fixed coupon from the issue date until the first callable date. If the issue is not called, the coupon is then determined by adding a spread (stated on the issue date) to a specified benchmark index for that particular security.

Taxation

Preferred securities will either pay dividends or interest. Investors should consult their tax advisor. Any security that is eligible as QDI is taxed at the individual's capital gains rate. If it is not QDI eligible, then the interest is taxed as ordinary income. Some corporations that purchase certain preferred stocks may receive a DRD (Dividends Received Deductions) tax advantage. The kind of tax form that is issued (1099-DIV, 1099-INT, K-1) will depend on the underlying structure of the preferred security.

Risks

Preferred securites' market performance and income are influenced by multiple factors, including but not limited to the following:

- Interest rates
- Credit quality and rating changes
- Default risk
- Deferral risk
- Event risk
- Tax law changes
- Term of investment and call dates
- Special call provisions
- Liquidity

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