A Preferred Way to Generate Yield

In the current environment investors must dig a little deeper and into less traversed areas of the capital markets to find value. In this article we provide a base knowledge of preferred equity shares, discuss the benefits and risks associated with owning them, and provide comparisons versus other asset classes. **This article lays the groundwork for a forthcoming article that will analyze a sub-sector of the preferred market and make a specific trade recommendation.** Fixed-income investors in search of stable income and sufficient yield but wary of excessive risks are likely settling for assets that are sub-optimal. For instance, High-yield corporate debt yields have fallen to near record low levels and yield spreads versus safer fixed-income assets are at their tightest levels in at least the last 20 years. As stated in ?High Risk in High Yield? ? *?As such, the risk/reward proposition for HY appears negatively skewed, and chasing additional outperformance at this point in the cycle appears to be a fool?s errand.?* Equity investors can find somewhat dependable, high-single-digit/low- teen dividend yields in the Master Limited Partnership (MLP) and Real Estate Investment Trust (REIT) sectors. The primary risk of these investments is price volatility which can frequently negate the dividend and much more in adverse conditions. Fortunately for higher income seekers, there is the preferred stock sector that lies between equity and fixed- income assets in corporate capital structures. This sector tends to be largely underfollowed and not well understood. Because of its relative obscurity and inefficiencies, it can present rewarding options versus other highly followed markets.

What is Preferred Stock?&#2013266080;

Preferred stock is a class of equity issued primarily by financial companies. In a textbook corporate capital structure, preferred shares are a hybrid of debt and equity. In the event of a corporate default, preferred shareholders have a claim on the company?s assets that is secondary to unsecured creditors, such as debt holders, but superior to common equity holders. This hierarchy applies to the distribution of dividends in the normal course of business as well. Debt coupons are paid in full first, then preferred dividends and lastly common equity dividends. To help offset the risk of non-payment of a preferred dividend, most issues are cumulative, meaning that any missed dividends must be paid before any common equity dividends are paid. Preferred stock is most commonly issued at a $25 price (par value) and price changes from that point are based on changes to the dividend yield. For example, if a company?s credit conditions are deteriorating or if interest rates in general rise, the price of preferred shares will decline to produce a higher current dividend yield. Prices of preferred shares tend to be relatively stable compared to underlying equity shares. In this respect they are much more bond-like, with price changes a function of the general creditworthiness of the issuer, supply and demand for the issue and the general level of interest rates. Unlike bonds, most preferred offerings do not have a fixed maturity date. &#2013266080;However, most issues are callable, which allows the company to repurchase the shares at par ($25) after a specified call date. Dividends paid on preferred shares are taxed as long-term capital gains, in contrast with bond coupons which are taxed as income. The following are key risks to preferred shares:

- Callable- The ability of the issuer to call, or repurchase, the securities at par ($25) is a risk if the shares are trading above $25. Obviously, the incentive to call preferred shares increases as the price rises. In assessing this risk, the yield - to -call should be calculated.
- Interest Rate Risk- Like bonds, the price of preferred shares will rise as interest rates fall and fall as rates rise.
- Credit Risk- Preferred shares fall behind debt in the credit structure. As such, the loss in the event of default could be severe. Further, deterioration of a company?s credit situation will likely push prices lower.
- Voting Rights- Preferred shareholders do not have voting rights and therefore the holder?s influence on the company?s management is greatly limited.
- Liquidity- Shares are not as frequently traded as those of common stock. Therefore, bid/offer spreads can widen at times. For those looking to trade in large share blocks, patience over a longer period is required, a contrast with the immediacy of execution for most common shares.

Performance and Risk Comparisons

The table below compares total return performance and yields for the ETF?s of preferred shares and other comparable asset classes. We include a modified Sharpe Ratio which calculates the current dividend/coupon yield to price volatility (risk). This ratio provides a gauge of the amount of risk incurred per unit of dividend. The traditional Sharpe Ratio is backward looking, comparing prior total return performance versus volatility over the same period.

ETF Alternatives

Sector	Ticker	Description	Total Return (annualized) 1 year	3 years	5 years	Dividend Yield	Modified Sharpe
Preferred	PGF	Preferred	2.60%	6.11%	7.51%	5.28%	1.04
Equity	AMLP	MLP	4.86%	3.73%	-2.08%	7.65%	0.34
Equity	VNQ	REIT	5.11%	8.19%	9.41%	5.52%	0.39
Equity	XLU	Utilities	3.73%	10.97%	11.21%	3.59%	0.26
Fixed Income	JNK	Junk Debt	1.46%	6.36%	3.82%	5.69%	0.91
Fixed Income	LQD	Inv. Grade Debt	-1.99%	3.14%	3.77%	3.64%	0.71

Performance over the last five years has favored preferred shares over corporate debt and has been mixed versus higher yielding equity choices. Importantly, if we presume that price volatility stays at current levels, preferred stocks offer the highest dividends/coupon per level of risk (modified Sharpe).&#2013266080; It is important to note that volatility has been abnormally low for all asset classes over the last five years, and investors in all of the assets shown should expect and account for higher volatility going forward.

Summary

Since preferred shares are not widely followed, they can offer investors a value proposition that is elusive in the more traditional markets at times. However, like all higher-yielding securities, they offer above-average yields for a reason. In the case of preferred shares, this is attributable to lower levels of liquidity, and the real and present danger of credit risk. Given the credit assessment required to invest in preferred shares, experience in the fixed- income markets is beneficial in assessing the risks. As stated above, financial companies are among the most frequent issuers of preferred shares. As such, a bank/financial system-centric economic crisis as experienced in 2008 could be devastating. The preferred ETF (PGF) declined nearly 70% through 2008 and early 2009. Once the Fed halted the decline in the financial sector with the provision of excess liquidity, bailouts, and favorable accounting changes, the sector roared back. By January 2010, PGF had totally recovered all losses while the ETF representing equities of the financial sector (XLF) was still down over 50% from its 2008 highs. Importantly, PGF made all dividend payments during the crisis, and the dividend amounts were on par to slightly higher than those preceding the crisis. As mentioned, we will soon follow-up to this article with a recommendation of a unique preferred sector and specific shares.