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Preferred Stock Primer

A Short Guide to Preferred Stocks and the S&P U.S. Preferred Stock Index

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- In the textbook world of capital structure, a company can raise capital either by borrowing or selling ownership interests, i.e., issuing debt or issuing equity. In the real world, quite a few securities exist which combine the characteristics of debt and common stock. Preferred stocks are one such class of securities.
- The size of the U.S. preferred stock market has quadrupled in the last 15 years to over U.S. $214 billion.
- Preferred stocks may offer yields that are higher than bond market yields, money market yields and common stock yields. This is useful for investors seeking high current income and endowments and foundations seeking income in the range of 5% or more to match their replacements needs.
- Preferred stock returns have low correlations with common stock returns, making them good diversifiers for certain portfolios. They have also relatively low correlations with bonds, with expected volatility and returns between those of common stocks and bonds. This makes them a good complement to a bond portfolio.
- Almost all of the total return of preferred stocks comes from dividends, and these securities lack the price appreciation potential of equities. Other risk factors include reinvestment risk and liquidity risk.
- The S&P U.S. Preferred Stock Index is designed to serve the investment community's need for an investable benchmark representing the U.S. preferred stock market. The index includes preferred stocks issued by U.S. entities that meet criteria relating to minimum size, liquidity, exchange listing and time to maturity. As of March 5, 2007 it had 50 constituents and an indicated yield of 6.45%.

Introduction to Preferred Stocks

What are preferred stocks?

One of the most concise and precise definitions of preferred stocks is offered by Wikipedia – "A preferred stock, also known as a preferred share or simply a preferred, is a share of stock carrying additional rights above and beyond those conferred by common stocks."

The additional rights are principally the following:

- The right to dividends before dividends on common stock are paid. The dividends may be fixed or floating, and may be cumulative or non-cumulative.
- A claim on liquidation proceeds, equivalent to par or liquidation value. This claim is senior to the claims of common stocks, which have only a residual claim.

Where do preferred stocks fit in the traditional capital structure?

In the textbook world of capital structure, a company can raise capital either by borrowing or selling ownership interests, i.e., issuing debt or issuing equity. In the real world, quite a few securities exist which combine the characteristics of debt and common stock. Preferred stocks are one such class of securities.

General Creditor Standings

	Class	*Seniority*
Debt	Secured Debt	↓
	Unsecured Senior Debt	
	Unsecured Subordinate Debt	
	Preferred Stocks	
Equity	Common Stocks	

Source: Standard & Poor's

Why do companies issue preferred stocks?

Capital Adequacy Requirements:

One of the biggest groups of preferred securities issuers are banks and related financial institutions. Regulators require banks to have adequate capital to support their liabilities and require that they hold a certain minimum level of Tier 1 capital. Tier 1 capital includes equity, disclosed reserves and preferred securities. Since preferreds are typically cheaper to issue than equity, banks issue preferred stocks quite often.

Balance Sheet Management:

When evaluating balance sheets, investors often prefer lower debt to equity ratios. Issuing preferred securities as opposed to traditional debt keeps the debt to equity ratio lower.

Ratings:

Credit rating agencies often award an "equity credit" to preferred securities in the analysis of capital structure. All other things being equal, this will contribute to more favorable analysis by ratings agencies for the preferred issuance as opposed to a bond issuance.

Investor Preferences:

Preferred securities have found a clientele in income-seeking individual investors and institutions such as foundations and endowments looking for replacement income. The appetite for preferreds among these income-seeking investors provides a market for firms seeking capital.

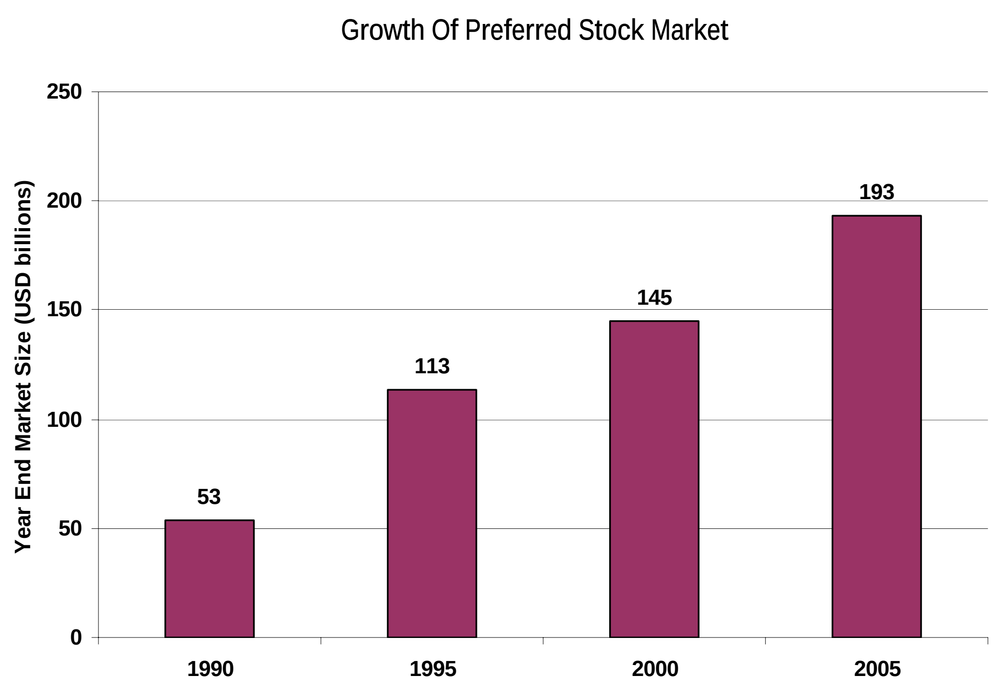
What are the different kinds of preferred stocks?

There are many types of preferreds and preferred trademark names. However, most preferreds are based on two main structural models: *Traditional Preferreds* and *Hybrid Preferreds.* Traditional Preferreds are closer to stocks and are generally REIT preferreds, foreign preference shares trading in the U.S. and straight preferred stocks issued by U.S. corporations. Hybrid Preferreds are closer to bonds and trade under a variety of trademark names. Most of the size and liquidity of the preferred stock market comes from the latter category.

How big is the preferred stock market?

As of March 2007, the total market cap of preferred stocks trading in the U.S. was approximately $214 billion. For a comparative perspective, the total size of the U.S. stock market was in the range of $16 trillion; and the U.S. corporate bond market was in the range of $5 trillion.

The modern era for preferred stocks started in the early 1990's. Since then, the preferred stock market has grown rapidly and has quadrupled in size.



Source: Standard & Poor's

Investing in Preferred Stocks

What are the advantages of investing in preferred stocks?

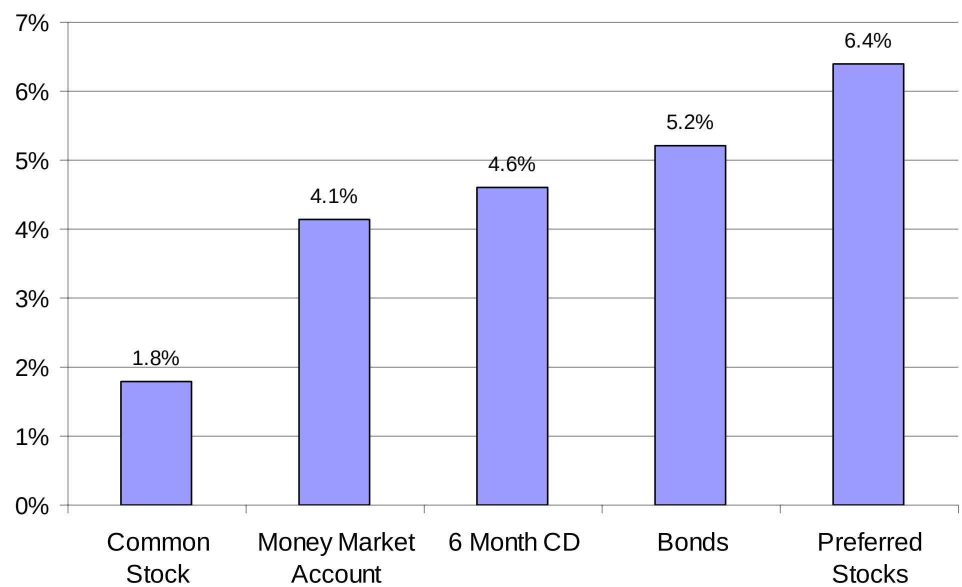
- Preferred stocks offer yields that are higher than bond market yields, money market yields and common stock yields.
- Preferred stock returns have low correlations with common stock returns, making them good diversifiers. They have also relatively low correlations with bonds, with expected volatility and returns between those of common stocks and bonds. This makes them a good complement to a bond portfolio.
- Endowments and foundations may have a distribution rate of 5% to 6% per year. They can use the 5% to 7% yields of a diversified preferred stock portfolio to invest for their replacement needs.

Preferred Stocks Can Complement Stock And Bond Portfolios

	Bonds	**Common Stocks**	**Preferred Stocks**
Annualized Returns	5.43%	1.92%	6.46%
Annualized Volatility	4.27%	14.09%	4.35%
Correlations	63.5%	-3.3%	

Source: Standard & Poor's. Figures are from Dec 31, 1998 to February 28, 2007. Common stocks refer to the S&P 500, bonds refer to the iBoxx U.S. Domestic Overall Index and preferred stocks refer to the ML Master Preferred Stock Index. The ML Master Preferred Index is reprinted by permission. Copyright © 2007 Merrill Lynch, Pierce, Fenner & Smith Incorporated. Further reproduction or distribution is strictly prohibited

Preferred Stocks Have High Yields



Source: Standard & Poor's, Lehman, BankRate. Yields for common stocks are for the S&P 500, yields for bonds are for the Lehman Aggregate Index, yields for preferred stocks are for the S&P U.S. Preferred Stock index, money market account yields refers to nationwide average as per www.bankrate.com and 6 month CD yield refers to nationwide average as per www.bankrate.com. Data as of March 6, 2007

What are the risks of investing in preferred stocks?

In general, the risk characteristics of preferred stocks fall in between those of bonds and stocks.

- Preferred stocks have very little price appreciation potential. Almost all of the total return comes from dividend payments. For example, the price return index value of the S&P U.S. Preferred Stock Index has been virtually unchanged since inception through February 2007, while the total return index value has increased by over 29%[1].
- Some preferred stocks come with a call or mandatory conversion feature. This results in reinvestment risk should the preferred stock be called or converted. However, a broadly diversified portfolio of preferred stocks would reduce reinvestment risk.
- Preferred stocks can default. This is extremely rare. For example, since inception through February 2007, only one constituent of the S&P U.S. Preferred Stock Index has defaulted. Some reports have estimated the default rates of investment grade hybrid preferreds at less than 0.2%.[2]
- In general, preferred stocks have lower liquidity than common stocks. Therefore, buying or selling individual preferred stocks may involve higher market impact and spread costs.
- Preferred stocks are often rated by ratings agencies and may drop in price if their ratings are reduced. Conversely, their prices may increase and their indicated yields drop if there is a ratings upgrade.

What are tax consequences of preferred stocks dividends?

Some preferred stocks have qualified dividend distributions that are taxed in the same manner as qualified dividends of common stocks. Others have their dividends charged as interest income and are subject to higher tax rates. Those that do have qualified dividend distributions have holding period requirements that are higher than those for common stocks. Investors need to contact their tax advisors to assess their tax situation. The favorable tax treatment for some preferreds is a result of tax laws passed in 2003, and this may change in the future.

What are different avenues of investing in preferred stocks?

There are three main methods of investing in preferred stocks – closed-end funds, direct investment in individual securities and exchange-traded funds. (Open-end mutual funds are rare.) Each comes with distinct advantages and disadvantages.

Three Methods Of Investing In Preferred Stocks

	Direct Investment in Preferred Stock	Closed End Fund	Exchange Traded Fund
Nature of investments	Active stock picking by investor or broker.	Active stock picking by manager.	Exposure to broad market
Expense ratio	None	1% to 2%	0.5% to 0.6%
Brokerage cost	Yes	Yes	Yes
Tailored for individual situation	Yes	No	No
Diversification	No	Yes	Yes
Large premiums and discounts relative to net asset value	No	Yes	No

Source: Standard & Poor's.

[1] The base date for the index is September 19, 2003. The index was publicly released on September 15, 2006 and history prior to that date is back calculated.
[2] "The Case for Preferred Securities," Principal Global Investors, 2006.

The S&P U.S. Preferred Stock Index

What is the S&P Preferred Stock Index?

The S&P U.S. Preferred Stock Index is designed to serve the investment community's need for an investable benchmark representing the U.S. preferred stock market. The index includes preferred stocks issued by U.S. entities that meet criteria relating to minimum size, liquidity, exchange listing and time to maturity. The index is calculated with a modified capitalization-weighted scheme, with modifications being made to index shares to prevent single stock concentration.

How many preferred stocks are there in the index?

The index does not have a fixed number of securities. As of March 2007, the index had 50 preferred stocks. The number of constituents has varied between 38 and 55 in the past[3]. Standard & Poor's expects the number to increase in the future as the preferred stock market becomes more active and liquid.

What types of preferred stocks are included in the index?

Preferred stocks issued by a company to meet its capital or financing requirements are eligible. These include floating and fixed-rate preferreds, cumulative and non-cumulative preferreds, preferred stocks with a callable or conversion feature, and trust preferreds. Some trust preferreds issued by a company to meet its capital requirements carry a brand name or moniker – these are included. However, structured products and brand name products issued by financial institutions that are packaged securities linked to indices, baskets of stocks or another company's stock are excluded. Special ventures such as toll roads or dam operators may issue preferred-like securities – these are also excluded.

How often are preferred stocks added and removed from the index?

The index is rebalanced once a year in September, when index shares and constituents are reviewed. Corporate actions such as maturity, conversion, calls and delistings are treated according to a set of rules. The complete methodology is available on the web at www.indices.standardandpoors.com.

What proportion of the index constituents has QDI (qualified dividend income)?

As of March 5, 2007, Standard & Poor's estimates that 20 of the 50 constituents, amounting to 37% of the index weight, had QDI. Please note that this is an estimate only and may vary with time. Further, the favorable tax treatment for some preferreds is a result of tax laws passed in 2003, and this may change in the future. Finally, there are holding period requirements for income being classified as QDI, and instruments linked to the index may not meet these requirements. Index users should consult their tax advisors for their individual tax situation.

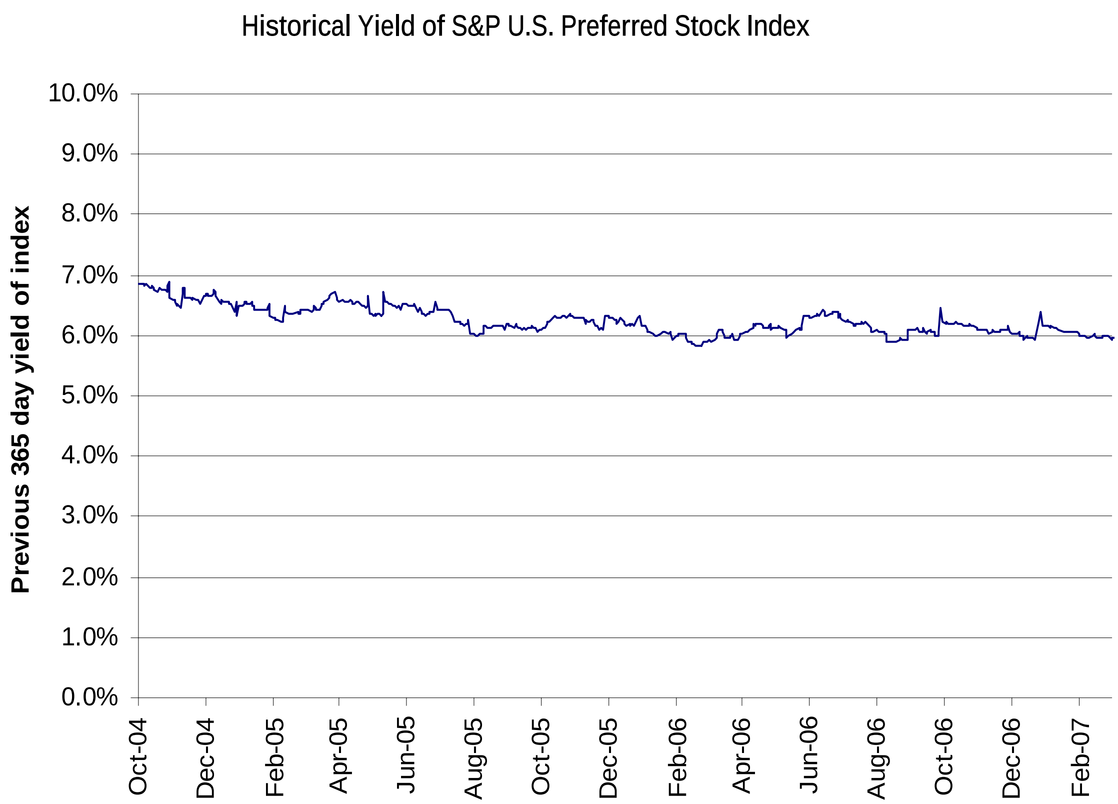
What is the ticker for the index?

The Bloomberg tickers for the price return and total return indices are SPPREF and SPPREFTR respectively. Reuters tickers are .SPPREF and .SPPREFTR.

[3] ibid. footnote 1.

What is the yield of the index?

As of March 5, 2007 the indicated yield of the index was 6.45%. In the past two years, the historical yield has been fairly stable, staying between 5.8% and 6.9%.



How does one compare net yield of an ETF linked to this index to other income-oriented ETFs and instruments?

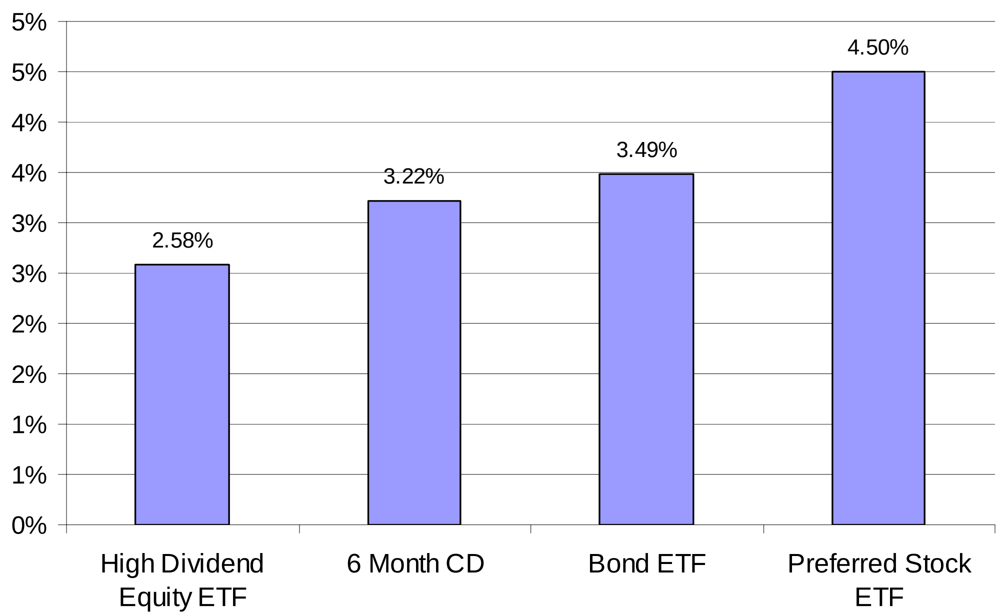
The table below summarizes how one could compare the net yield from the index compared to other income-oriented instruments.

Net Yields From Income Oriented Investments – An Illustration

	High Dividend Equity ETF	6 Month CD	Bond ETF	Preferred Stock ETF
Gross Yield	3.50%	4.60%	5.20%	6.45%
QDI %	100.00%	0.00%	0.00%	35.00%
After tax gross yield	2.98%	3.22%	3.64%	5.00%
Expense ratio	0.40%	0.00%	0.15%	0.50%
Net yield	2.58%	3.22%	3.49%	4.50%

Source: Standard & Poor's. Based on hypothetical estimates for gross yield, expense ratios and QDI %. QDI % refers to the assumed portion of the yield coming from QDI sources. For after tax gross yield calculation purposes, QDI portion of the yield is taxed at 15% (tax rate for qualified dividends) and the non-QDI portion is taxed at 30% (assumed marginal tax rate). The net yield is after tax gross yield minus the expense ratio.

Illustrative Example Of Net Yield For Taxable Accounts



Source: Standard & Poor's. Based on Net yield from table above.

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