

Preferred Stock Primer

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.
- ❑ Preferred stock returns have low correlations with common stock returns, making them good diversifiers. They also have relatively low correlations with bonds, with expected volatility and returns between those of common stocks and bonds. This characteristic makes them a good complement to a bond portfolio.
- ❑ As preferred stocks rank lower in creditor standings than other forms of debt, credit risk is higher than senior debt. This is of particular concern in environments where default risk is high. Other risk factors include reinvestment risk and liquidity risk.
- ❑ Preferred stocks offer yields that are higher than bond market yields, money market yields and common stock yields.
- ❑ 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 February 27, 2009, the S&P U.S. Preferred Stock Index had 72 constituents and a yield of 16.1%. In more normal market conditions, yields have been in the range of 5% to 8%.

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

		<i>Class</i>	<i>Seniority</i>
Debt {		Secured Debt	↓
		Unsecured Senior Debt	
		Unsecured Subordinate Debt	
Equity {		Preferred Stocks	
		Common Stocks	

Source: Standard & Poor's

Why do companies issue preferred stocks?

Capital Adequacy Requirements:

One of the biggest group 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?

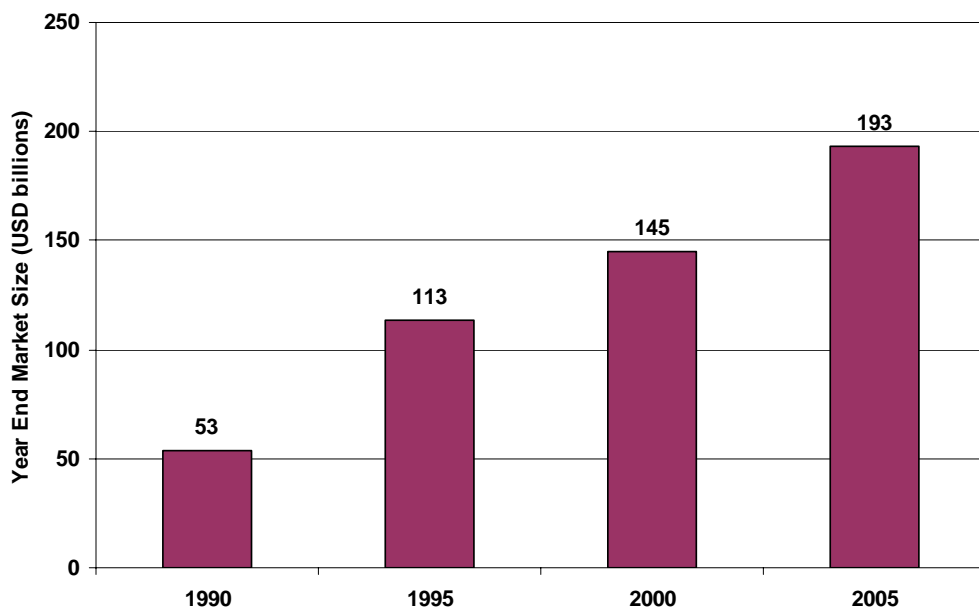
There are many types of preferreds and preferred trademark names. However, most preferreds are based on two main structural models: *Traditional Preferreds* and *Trust Preferreds*. Traditional Preferreds are closer to stocks and are generally REIT preferreds, foreign preference shares trading in the U.S. and straight preferred stocks issued by U.S. corporations. Traditional preferreds are a senior form of equity which rank above common shares but below corporate debt in creditor standings. Dividends from traditional preferreds are taxed as capital gains. Trust Preferreds are closer to bonds and thus rank higher in general creditor standings than regular preferreds. Dividends from trust preferreds are taxed as ordinary income. As of February 27, 2009, the S&P Preferred Stock Index contained 35 trust preferreds out of a total 72 constituents.

How big is the preferred stock market?

The modern era for preferred stocks started in the early 1990s. Since then, the preferred stock market has grown rapidly, quadrupling in size by 2005 to \$193 billion. Concerns about default and conversion risk shrunk the market to about \$100 billion in early 2008. For a comparative perspective, the total size of the U.S. stock market was in the range of \$9.5 trillion; and the U.S. corporate bond market was in the range of \$4 trillion.

These figures refer to publicly traded preferreds. There is a large market in privately placed preferreds, the size of which is difficult to gauge.

Size of Preferred Stock Market



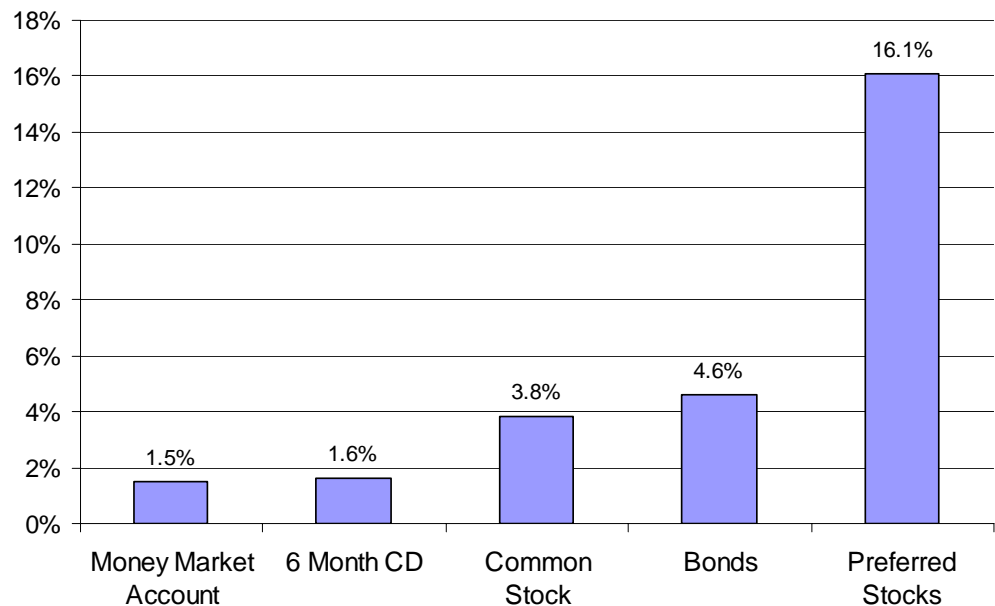
Source: Standard & Poor's

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.
- When preferred stocks trade at very high yields and at large spreads against senior debt there is a potential to execute risk arbitrage strategies that benefit from price appreciation if yields return to more normal levels.
- Preferred stock returns have low correlations with common stock returns, making them good diversifiers. They also have 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.
- Preferred stocks may be useful in capital arbitrage strategies due to their position in creditor standings between that of equity and other forms of debt, and due to the presence in many preferred stocks of an option to convert to common shares.

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 February 28, 2009.

Preferred Stocks Can Complement Stock And Bond Portfolios

	Bonds	Common Stocks	Preferred Stocks
Annualized Returns	4.03%	-6.63%	-12.15%
Annualized Volatility	4.71%	14.11%	21.12%
Correlations	30.9%	49.1%	

Source: Standard & Poor's. Figures are from Feb 29, 2004 to February 27, 2009. Common stocks refer to the S&P 500, bonds refer to the iBoxx U.S. Domestic Overall Index and preferred stocks refer to the S&P Preferred Stock Index.

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 can default. This is usually rare in normal market conditions. For example, over three years ending September 2006, only one constituent of the S&P U.S. Preferred Stock Index had defaulted. Some reports have estimated the default rates of investment grade hybrid preferreds at less than 0.2%.¹ However, default rates can increase in times of credit stress, particularly among the principal issuing base of banks. For example, the recent credit crisis saw several defaults and forced conversions of preferred stocks.
- 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.
- 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 may drop if there is a ratings upgrade.
- Historically, preferred stocks have generally shown 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 over four years ending October 2007, while the total return index value has increased by nearly 27%.² However, since that time the index has decreased by 55% in line with increases in yields in the preferred stock market, which reflects greater perceived credit risk.

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.

¹ "The Case for Preferred Securities," Principal Global Investors, 2006.

² 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.

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%	0.4% to 0.5%
Brokerage cost	Yes	Yes	Yes
Tailored for individual situation	Yes	No	No
Diversification	No	Yes	Yes
Premiums and discounts relative to net asset value	No	Yes	Maybe

Source: Standard & Poor's.

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 February 2009, the index had 72 preferred stocks. The number of constituents has varied between 38 and 74 in the past³. 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 February 28, 2009, Standard & Poor's estimates that 30 of the 72 constituents, amounting to around 40% 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?

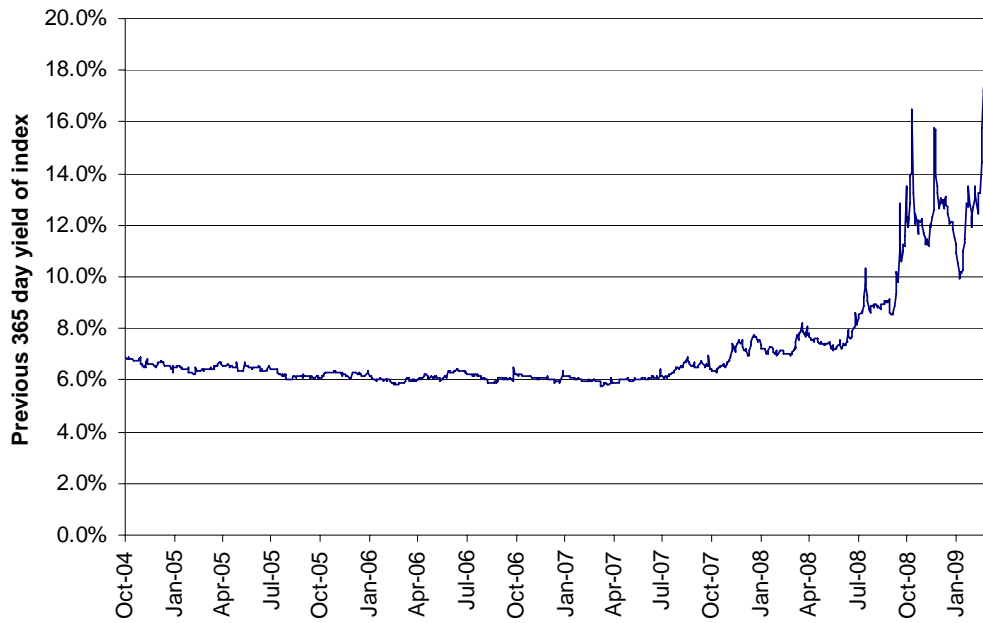
The Bloomberg tickers for the price return and total return indices are SPPREF and SPPREFTR respectively. Reuters tickers are .SPPREF and .SPPREFTR.

³ ibid. footnote 1.

What is the yield of the index?

As of February 28, 2009 the yield of the index was 16.11%. While the yield had been fairly stable, staying between 5.8% and 6.9% from 2004 through late 2007, it has since greatly increased reflecting increased default risk in the preferred stock market.

Historical Yield of S&P U.S. Preferred Stock Index



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