# PREFERRED STOCKS

## DEFINITION

Preferred stocks are a financial instrument which has characteristics of both equity and debt investments and is considered a hybrid security. They are technically an equity instrument, as they are considered a class of ownership of a company. Preferred stocks usually have no voting rights, but are considered senior to common stock in terms of dividend payments and upon liquidation of the company. They share characteristics with debt securities in that they guarantee regular dividend payments for a specified time and are less volatile than common stock.

## HOW THEY WORK

### EQUITY INSTRUMENT

At their core, preferred stocks are equity instruments, because they are considered a claim for ownership in the issuing company. However, because of its guaranteed income component, its share price tends to be less volatile than that of common stock shares. But they also have less potential for capital appreciation compared to common stock shares. Preferred stockholders have no voting rights, unlike common stock, but have a higher claim on dividends and assets than common stock.

### DEBT INSTRUMENT

Preferred stocks pay a fixed dividend that does not fluctuate, similar to interest payments from a fixed income investment, which is paid either quarterly or semi-annually. A preferred stock's dividend is normally higher than income from other guaranteed investments, since it also carries equity risk. The taxation of dividends paid by preferred stock depends on the security itself – the dividends of some are classified as non-qualified and therefore taxed at ordinary income tax rates while for others, they are qualified dividends, which are taxed at the same rate as long-term capital gains, currently at 15%. Additionally, the company does not have to pay the preferred stock dividend if it lacks the financial ability to do so. But any dividends paid must first be paid out to preferred stockholders before it is paid to common stockholders.

### RISKS

Preferred stocks are generally considered to be slightly more risky than corporate bonds but safer than common stock shares. This is because, in the event of corporate liquidation, preferred stockholders will receive their principal back after all bondholders have been paid, but before common shareholders. Despite this seniority in liquidation, preferred stockholders can still lose their entire investment if there are no funds remaining after paying bondholders and other senior creditors. Similar to bonds, preferred stocks are rated by the same major credit-rating agencies that grade other types of fixed income securities, such as Moody's and Standard & Poor's.

## TYPES OF PREFERRED STOCKS

- **Perpetual** – This type of preferred stock has no fixed date on which invested capital will be returned to the shareholder. Most preferred stock is issued without a maturity date.
- **Cumulative Dividends** – Cumulative preferred stock guarantees that any dividends which go unpaid will be repaid in the future when the issuer is able to resume payments.
- **Participation** – Participating preferred stock has the potential to pay more than its stated dividend rate if the issuer does well financially. This type of preferred stock is fairly rare.
- **Convertibility** – Convertible preferred stock can be converted into a set number of shares of common stock after a certain period of time.

## ADVANTAGES

- **Higher Rates of Interest** – Preferred shares typically offer superior rates than guaranteed instruments such as CDs, fixed annuities, and treasury securities.
- **Preferential Dividend Payout** – Preferred shareholders receive their dividends before anything is paid to common shareholders.
- **Price Stability** – Preferred stock prices are less volatile than common stock and are often less vulnerable to price fluctuation than bonds.
- **Greater Liquidity** – Preferred shareholders can sell their shares at any time without having to pay an early withdrawal penalty such as those that are usually levied by CDs or fixed annuities.

## DISADVANTAGES

- **Lack of Voting Rights** – Preferred shareholders do not have the voting rights that come with common stock. This is because of their preferential treatment in the event of insolvency,
- **Call Feature** – Preferred stocks can be called by their issuers if interest rates fall. Investors are then subject to reinvesting these funds in a lower interest rate environment.
- **Nonpayment of Dividends** – If an issuer experience financial distress, preferred stockholders may not receive any dividends. However, issues with a cumulative feature will pay all previously unpaid dividends when the company is able to meet its obligations.
- **Lack of Capital Gains** – Although preferred stocks pay higher dividends than bonds, they also offer little or no potential for material capital gains of any kind, as they usually trade within a few dollars of their issue price as long as they are outstanding.

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