Thomas Jay Barrett, Jr.
Jay Allan McCormick

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Tax-savvy investors looking for more return during a time of low yields might consider preferred stocks currently paying 7% and higher. Preferred stocks are different from common stocks. They are called “hybrids” because they come in many flavors and have attributes of both fixed income and common stock.

Banks and utilities have recently been cranking out preferreds at higher than historical rates to repair their balance sheets and capital base. Preferred stock is a nice complement to CDs and bonds. They are also tax-favored compared to CDs and bonds since qualified preferred stock dividends are taxed at a maximum of 15% . . . unlike corporate bond interest taxed at ordinary income tax rates.

Preferred stocks, like common stocks, represent ownership in a company but generally do not have voting rights, are issued with a fixed par value and pay dividends based on a percentage of that par value. They have a liquidation value and are called “preferred” because preferred stock holders stand ahead of common stock holders in bad times, although they still stand behind debt holders.

Like pizza, there can be lots of toppings to choose from including non-callable, callable, floating rates, perpetual rates, cumulative, convertible, and sub-ordinated. Like fixed income, preferred stock is generally priced relative to interest rates, particularly long-term treasury rates. The price and return is like a “teeter-totter” meaning that as interest rates rise, the price drops just as the price rises as interest rates decline. Currently, a 25 year preferred stock with a five year call provision is returning about two hundred and fifty basis points over a long term treasury. Like long-term bonds, investors buy preferreds for cash income and try not to worry too much about value changes. Like long-term bonds, investors are promised the return of their capital at some point, but that can a very long time.

It’s also worth noting that, unlike US Treasury bills, bonds and notes, and CDs, the return of that capital is not a federal guarantee. The issuing company can fail and the resulting liquidation can wipe out the equity positions as well as a big chunk of debt obligations. The recent airline industry experience is a great example of this sort of meltdown.

The bottom line is that diversification is just as important for a fixed income portfolio as it is for equities. All financial instruments carry some degree of risk which is mitigated by diversification. We currently recommend roughly 5% of a fixed income portfolio be allocated to a selection of four or five (or more) preferred stocks.

1600 Broadway, Suite 930 • Denver, Colorado 80202 • Phone: (303) 861-4835 • Fax: (303) 813-1561
E-mail: tbarrett@helminvest.com or jmccormick@helminvest.com