ABSTRACT

The long, gradual decline in bond yields that started in the mid-1980s has culminated in an environment of very low interest rates. This has motivated many investors to seek assets that provide higher income. The high dividend payments offered by preferred stocks have naturally attracted the interest of these investors and their favorable tax treatment increases their attractiveness to taxable investors.

This paper examines the case for investing in preferred stocks. We begin by providing background information, and we then proceed to discuss the benefits and risks of investing in preferred stocks. Subsequently, we analyze the return behavior of preferred stocks, including the characteristics of expected return, volatility, and correlation with other asset classes. Finally, we address the issues institutional investors would face once the decision has been made to invest in preferred stocks. We conclude with a brief summary and a recommendation that a dedicated allocation to preferred stocks is not recommended for most institutional investors.

INTRODUCTION

Preferred stocks[1] represent a class of ownership in a company that has a higher claim than common stock-holders but that is subordinate to bond-holders. Preferred stocks are senior to common equity because preferred stock-holders generally have a prior claim to the earnings and assets of a company. However, it is junior to debt for the converse reason. Hence, the cash flow from preferred securities is more risky than interest payments on debt but less risky than dividends on stock.

Preferred securities normally pay a dividend that is higher than both the dividend offered on common shares and the coupon payment on bonds. In essence, in exchange for potentially higher income and a higher priority of claim in the event of a company's liquidation, holders of preferred securities primarily forgo the potentially larger future capital appreciation associated with common stocks.

Because preferred stocks combine the features and characteristics of both equity and debt securities, they are often referred to as "hybrids."

History

From 1980 through the mid-1990's, the preferred stock market evolved dramatically. During that period, two important changes took place. First, preferred stocks, which had previously been issued primarily by regulated utilities, became an important financing vehicle for a variety of financial services firms[2]. Second, their popularity with investors surged in 1993 when new preferred shares were issued that were fully taxable for all shareholders, and hence

[1] Throughout this paper, we use the terms preferred securities, preferred stocks, and preferred shares inter-changeably.

[2] Tier-one capital is the core measure of a bank's financial strength from a regulator's point of view. Counting Trust Preferred Shares as tier-one capital allows a bank to further leverage its balance sheet. Outstanding issues of Trust Preferred Shares are scheduled to be phased out completely by 2015.

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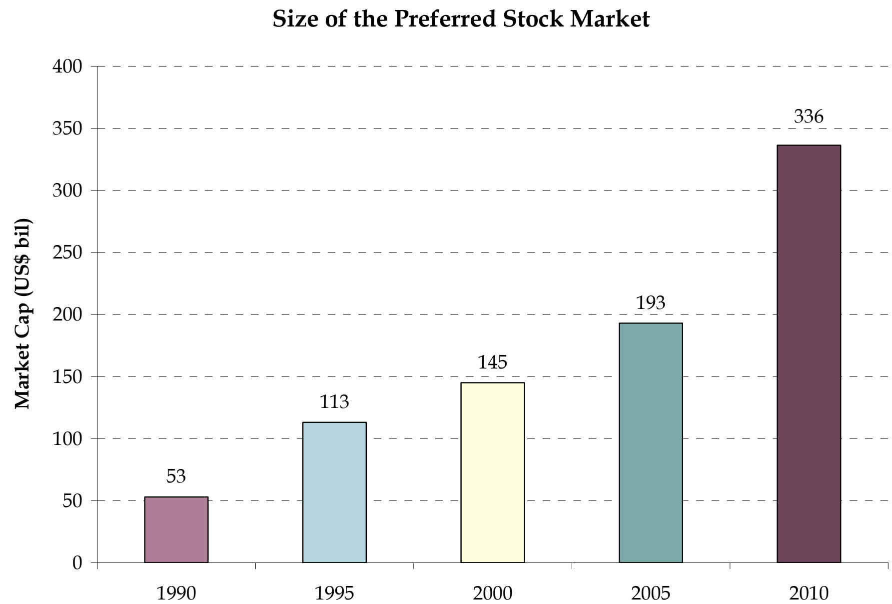
offered higher yields than their pre-1993 predecessors (changes in tax law have been important throughout the history of preferred shares).

More recently, there was a burst of issuance of preferred shares in late 2007 and early 2008 as financial institutions sought sources of additional capital during the darkest moments of the Global Financial Crisis.

The following chart[3] illustrates the growth in the market for publically-traded preferred shares in the United States.



Features of Preferred Stock

The key terms and features of preferred securities can vary significantly from one preferred security to another.

Convertability

Some preferred stocks are convertible into common stock at a predetermined ratio, providing the potential to retain upside in an investment while reducing downside risk.

Cumulative Dividends

Preferred stocks are generally "cumulative" with respect to dividends, meaning that any and all preferred dividends that are in arrears must be paid to the preferred stockholders before the payment of any common stock dividends.

Early Redemption

Many preferred securities have optional, mandatory, or conditional provisions that permit the issuer to redeem, or call, the securities.

[3] Sources: S&P, Bloomberg, BofA Merrill Lynch Global Research.

Maturity

Preferred securities may have a stated maturity date; however, many are perpetual and do not. Additionally, even if there is a stated maturity date, the issuer may have the option to extend that date one or more times.

Payment Features

Preferred securities usually make payments in the form of either interest or dividends (depending on the structure) based on the par (face) value of the security. Dividends are typically paid on a quarterly basis. The dividends on preferred stocks may be paid at either a fixed or variable rate, though fixed rates are more common.

Taxes

Not all income from preferred securities is taxed the same way. Different issues from the same issuer may be structured differently and have different tax consequences.

Voting Rights

Preferred shares are typically non-voting. This feature eliminates preferred stockholders' right to vote proxies.

Yield

Preferred securities usually provide more attractive yields than securities that are more senior in the capital structure. Current yield is the most commonly used yield calculation for traditional preferred securities.

Types of preferred stocks

There are several varieties of preferred stocks, but they tend to fall into two primary categories: traditional preferred stock and trust preferred stock (TruPS). Traditional preferred shares are a senior form of equity that ranks above common shares but below corporate debt in the capital structure. Dividends from traditional preferred stocks are taxed not as income but as capital gains, which may be an attractive characteristic from the perspective of taxable investors.

Trust preferred securities are hybrids consisting of a preferred security issued by a trust set up by the issuer and funded by the debt securities of the issuer. Because these debt issues, like any other bonds, have stronger protections on interest payments than traditional preferred stocks, trust preferred shares rank higher than traditional preferred shares in the capital structure. Trust preferred securities also tend to have fixed maturity dates to match the maturity of the bonds held in trust. Dividends from trust preferred stocks are taxed as ordinary income. Of note, the Dodd-Frank bill calls for the treatment of Trust Preferred Securities as tier-one capital to be phased out from 2013 to 2015, so it is quite possible that this particular segment of the preferred stock market will shrink in coming years.

Why do companies issue preferred stocks?

Banks and related financial institutions comprise the largest group of issuers of preferred shares. This is because: 1) preferred shares are included as core capital when regulators are determining whether a bank has adequate capital to support its liabilities; and 2) preferred shares are typically cheaper to issue than common equity.

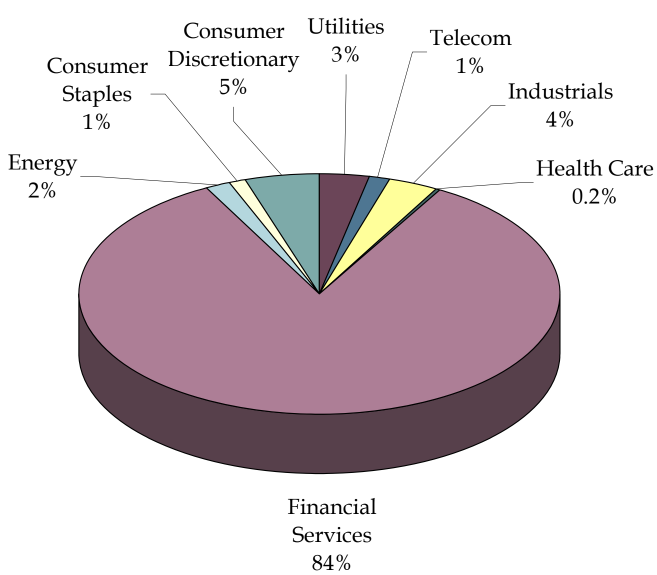
Along a similar theme, issuing preferred shares allows a company (not just banks) to maintain a lower debt to equity ratio than if they issued traditional debt. This may be attractive to both investors and creditors. This includes the major credit rating agencies, which often award an "equity credit" 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.

In addition, preferred stocks are advantageous because they are non-recourse nature allows a degree of payment flexibility that bonds do not offer. In addition, non-convertible preferred stocks do not dilute equity-holders' control or claim to future dividends. However, the firm usually forgoes the tax deductibility of debt interest payments.[4]

Composition of the Preferred Stock Universe

The universe of companies who issue preferred shares is dominated by the financial services industry (see the following chart). This is primarily because certain types of preferred stocks may be a source of non-dilutive tier-one capital for banks when calculating capital adequacy ratios. Nine of the ten largest holdings were issued by global banking institutions, with Ford being the exception.

Sector Allocation of Preferred Stock Issues
(As of 12/31/10)



While the preferred stock universe is comprised of shares listed on U.S. exchanges, because it is market-cap weighted, its exposure is truly global. The ten largest issues all derive significant revenues from outside the U.S., and four of the institutions are based outside the U.S. (HSBC, Barclays, ING, and Deutsche Bank).

Similar to debt, certain preferred stock issues are given a quality rating by agencies such as S&P and Moody's based on the perceived ability of the issuer to make good on their obligation

[4] Source: Moody's Investors Service.

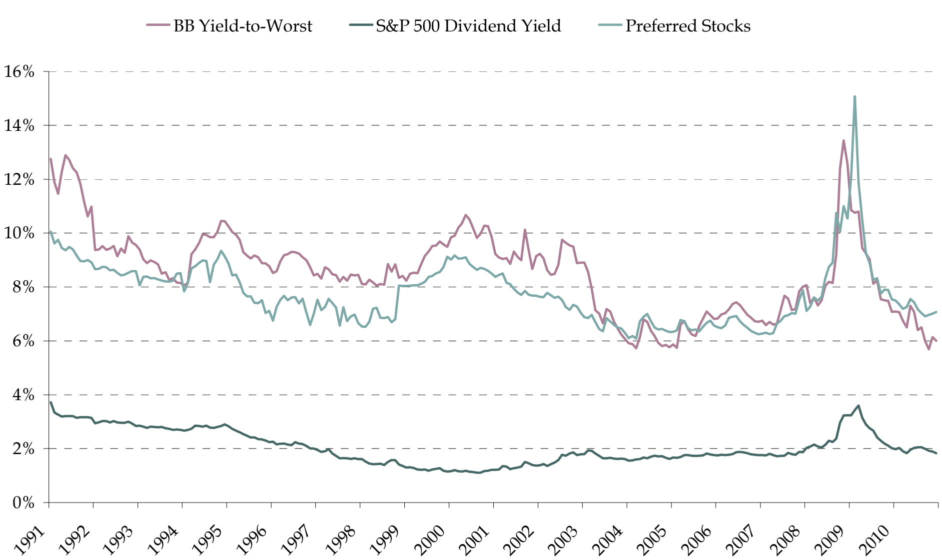
to preferred shareholders. Because preferred stock dividends are lower in the capital structure, preferred stock will generally maintain a credit rating several "notches" below debt issued by the same company. Hence, a large segment of preferred equity issues are rated below investment grade, even though the parent company may maintain an investment grade rating (see the following table).

S&P Rating[5]	%
AAA/AA	2
A	18
BBB	37
BB or below	36
Non-rated	7

THE BENEFITS OF INVESTING IN PREFERRED STOCKS

The first thing that attracts most investors to preferred equities is the income component. Preferred stocks have historically offered yields significantly larger than those provided by investment grade corporate bonds or the dividend yield of most common stocks. In fact, their yields have resembled those for "BB"-rated bonds since 2003 (see the following chart[6]). Because of their lower position in the capital structure, investors demand a higher yield from preferred shares than from traditional bond issues.

Historical Yields



5 Source S&P; as of June 30, 2011.

6 The source for yield-to-worst on "BB"-rated bonds is Credit Suisse. The sources for S&P 500 dividend yield are Standard & Poor's and Professor Robert Shiller. The source for the yield-to-maturity on fixed-rate preferred stocks is BofA Merrill Lynch.

Since preferred stocks have priority over common stocks for dividend payments, they theoretically represent a lower risk investment. Preferred stock returns are not perfectly correlated with common stock returns, and they have exhibited relatively low correlations with bonds, meaning that they may offer some diversification benefits. In addition, hedge funds who engage in capital structure arbitrage strategies will often invest in preferred stocks.

NATURE OF RISKS IN PREFERRED STOCKS

Because of their hybrid nature, preferred stocks have risks in common with both the bond market and the equity market. We outline some of the more unique risks below.

Default/Impairment Risk

In a dividend impairment, the preferred stock issuer fails to make timely payments of the preferred dividend to the stock-holder. The stock-holder may eventually receive all, some, or none of the expected cash flows. Many preferred securities carry a payment deferral feature, which allows the issuer, at its discretion, to suspend or defer all or a portion of dividend or interest payments. Along similar lines, certain preferred securities permit the issuer, at its discretion, to extend the maturity date (if any) one or more times, which would ultimately delay final repayment of the security's principal. In other words, they offer none of the covenants or buyer protections that bond-holders usually receive.

Interest Rate Sensitivity

Prices of preferred securities may be impacted by changes in interest rates. If interest rates rise, the value of the preferred shares would need to fall in order for the dividend yield to be as competitive as it was before the change in rates. If interest rates fall, the opposite would hold true. However, the relative change of preferred yields is usually less dramatic than that of bonds. Further, changes in interest rate should have a greater effect on long-term and perpetual preferred securities.

Callability

Many preferred securities carry call or other early redemption provisions that allow the issuer to redeem the security upon certain events or at its discretion. An issuer will often exercise a call provision when prevailing interest rates drop below the rate at which the security was originally issued.

Liquidity

In general, preferred stocks are less liquid than common stocks. Therefore, they may incur modestly higher market impact and spread costs during normal environments and meaningfully higher transaction costs during stressed environments.

PERFORMANCE CHARACTERISTICS OF PREFERRED STOCKS

Historical Return and Volatility

In theory, returns for preferred stocks should be less volatile than for common stocks because of the large income component, which stabilizes performance. Furthermore, preferred stocks are ahead of common equity in the capital structure. Thus, if a company defaults or faces bankruptcy, its preferred equity-holders have access to the company's assets before its common equity-holders. Preferred stocks investors consequently have a greater chance of recovering at least part of their investment.

In contrast, because preferred shares are lower in the capital structure than traditional bonds issued by the same company, they will by definition be more risky than traditional investment grade bonds. Therefore, preferred stocks should theoretically produce returns between investment grade bonds and equities, while also exhibiting volatility between the two assets classes. Because of their hybrid nature, the performance of preferred stocks might be expected to most closely resemble the return behavior of high yield bonds.

Unfortunately, there is not a robust data set available for measuring the historical return behavior for preferred stocks. The most widely-used benchmark, the S&P U.S. Preferred Stock index, only has returns going back to October 2003. Still, the behavior of the markets since that period includes a very significant stress test (i.e., the Global Financial Crisis of 2007-2008) and a market recovery in which to examine the behavior of preferred stocks relative to other asset classes.

The portrait of the preferred stock market that is painted by this data set is not flattering. The volatility of preferred shares has been higher not only than that for high yield bonds, but also for common stocks (see table below). Yet the returns have not kept pace with either of these "risky" asset classes.

Return Characteristics (October 2003 – June 2011)[7]

	Investment Grade Bonds	High Yield Bonds	*Preferred Stocks*	Common Stocks
Annualized Return	5.0%	9.0%	4.9%	6.5%
Standard Deviation	3.5%	11.2%	21.6%	15.7%

The following chart shows the annual returns for investment grade bonds, high yield bonds, preferred equities, and public equities since late 2003. The chart serves as pictorial evidence that preferred shares have exhibited risk similar to that of high yield bonds or even common equities.

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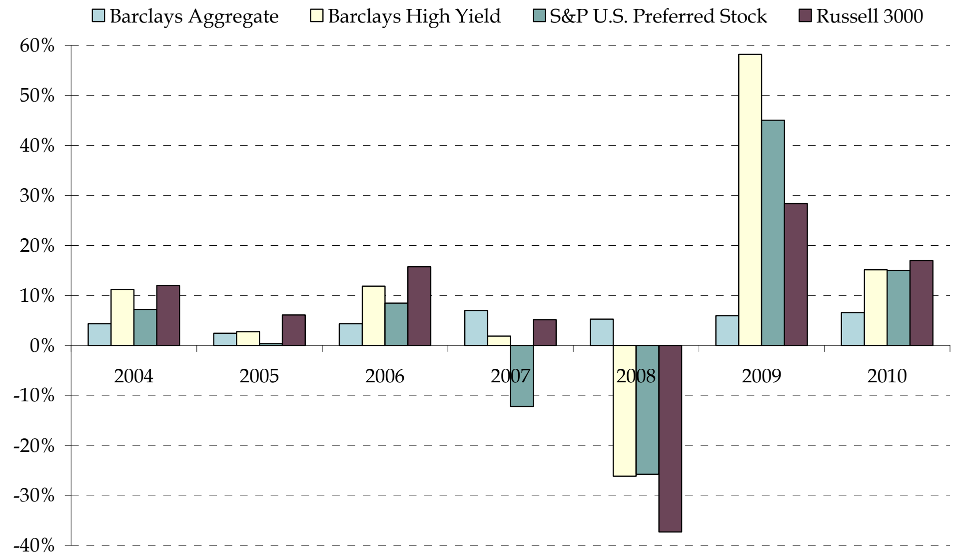
[7] The period from October 2003 marks the inception of the S&P U.S. Preferred Stock index. Data for Return Characteristics and Correlation Matrix tables are based on the following indices: Bonds are measured as the Barclays Aggregate index; High Yield Bonds are measured as the Barclays U.S. High Yield index; Preferred Stocks are measured as the S&P U.S. Preferred Stock index; Common Stocks are measured as the Russell 3000 index; Financial Services Stocks are measured as the S&P 1500 U.S. Financial Services index.

Calendar Year Returns



Correlations

Historically, preferred equities have been moderately correlated with common equities and high yield bonds (see correlation matrix below). Interestingly, and despite the significant composition of financial services stocks in the preferred stock index, correlations with the financial services sector have not been substantially higher than they are with the broader stock market.

Correlation Matrix (October 2003 – June 2011)

	Bonds	High Yield Bonds	*Preferred Stocks*	Common Stocks	Financial Services Stocks
Bonds	1.00				
High Yield	0.25	1.00			
Preferred Stocks	*0.27*	*0.55*	*1.00*		
Common Stocks	0.10	0.74	*0.57*	1.00	
Financial Stocks	0.13	0.62	*0.59*	0.87	1.00

Importantly, their behavior has been relatively uncorrelated with investment grade bonds. This seems to run counter to the widely-held belief that preferred stock returns are driven by changes in interest rates. Perhaps more compelling evidence of the lack of a meaningful link between preferred stocks and interest rates is provided by the near-zero (0.07) correlation between the S&P U.S. Preferred Stock index and the change in yield for intermediate-term government bonds.[8]

[8] We used the change in yield for the Ibbotson Associates U.S. Government Intermediate-Term Bond index as a proxy for changes in interest rates.

Correlations with Interest Rates (October 2003 – June 2011)

	Bonds	High Yield Bonds	*Preferred Stocks*	Common Stocks
Change in Interest Rates	-0.71	0.31	*0.07*	0.24

Return Behavior in Various Environments

Preferred stocks have performed well when investors' expectations about the economy are positive and the outlook for corporate America is good. Conversely, in recessionary periods, preferred stock returns have lagged.

The following table[9] shows how preferred stocks have performed in a variety of market environments since 2003. On average, preferred stocks have produced positive returns during periods when stocks and bonds have likewise produced gains. Similarly, preferred stocks tended to decline during periods when stocks and bonds produced losses.

Market Environment	Average Monthly Return for Preferred Stocks	% of Periods Preferred Stocks were Positive	Capture Ratio
Stocks Up	2.5%	84%	81%
Stocks Down	-3.1%	34%	75%
Bonds Up	1.8%	78%	197%
Bonds Down	-2.1%	41%	291%

IMPLEMENTATION ISSUES

Market Liquidity

As of December 2010, there were 224 preferred stock issues included in the S&P U.S. Preferred Stock index, with an aggregate outstanding issuance of approximately $336 billion. This represented less than one-tenth of the total market value of corporate debt tracked by Barclays.

Liquidity for the preferred stock market does not approach that for common stocks, because of the small relative size of the preferred stock market and the limited number of participants in this area of the market. The bid-ask spread is similar to that for most high yield bonds. Consequently, it is more expensive to trade preferred stocks than it is to trade common stocks.

9 Represents the period from October 2003 – June 2011. "Up" periods are months when the asset class produced a positive return, while "down" periods are months when the asset class produced a negative return. Average returns are monthly. The "capture ratio" is a measure of how much of the market's performance preferred stocks "captured"; it is measured by dividing the average monthly return for preferred stocks by the average monthly return for the asset class.

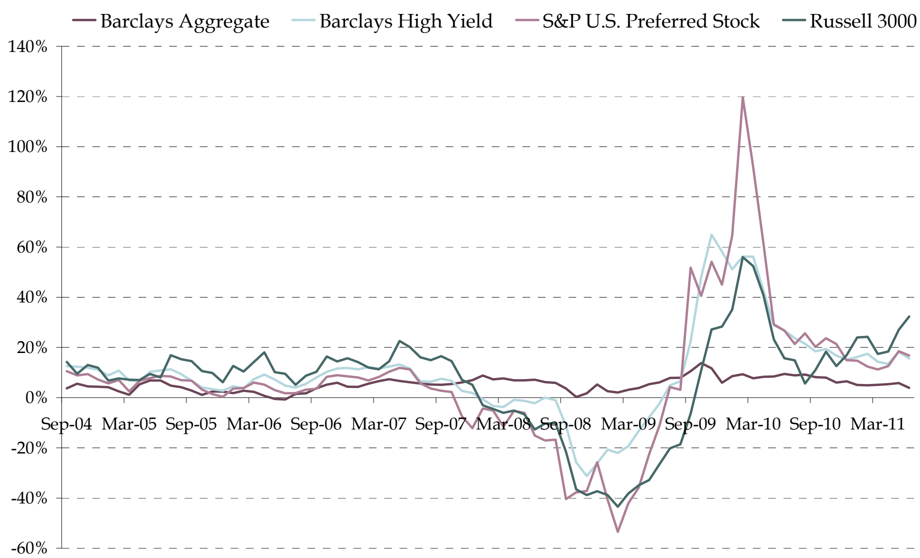
Benchmark

The three most commonly used benchmarks are the S&P U.S. Preferred Stock index, the BofA Merrill Lynch Core Fixed Rate Preferred Securities index, and the Wells Fargo Hybrid and Preferred Securities Aggregate index. All three indices have fairly short histories and are dominated by financial services.[10]

Timing

Because preferred stocks can be quite volatile, the risk of mistiming an entry into the preferred stock market is meaningful. The following chart shows that preferred stocks experienced losses even worse than the broad stock market during the Global Financial Crisis, only to rebound more sharply (producing a nearly 120% twelve-month return!).

Rolling 12-Month Returns



As with any volatile asset class, trying to time the entry into the preferred stock market can be difficult and risky. Some market commentators believe that preferred stocks serve as a leading indicator for the common stock universe, at least when it comes to being influenced by macroeconomic factors (e.g., a financial crisis).[11] This warrants further research, as such a relationship would prove a useful tool for most investors.

Vehicle

Very few firms offer dedicated preferred stock management. In fact, there were only six active managers of open-end preferred stock products listed in the eVestment Alliance universe as of August 2011, with fees ranging from thirty to ninety basis points. There were also ten

[10] The S&P U.S. Preferred Stock index held 224 names as of December 2010 and 84% of its issuance was in the financial services sector. The number of securities included in the index has varied more than would normally be expected, even for a relatively new index. This has been in part due to changes in the inclusion rules by S&P. At one point, the index included just 38 securities.

[11] See, for example, the August 2011 article in Seeking Alpha titled "Preferred Stocks Signaling Another Financial Crisis Ahead."

publicly-traded closed-end funds that invest substantially in preferred stock according to the Closed-End Funds Association.

Investors who desire a dedicated portfolio of preferred securities must decide whether to invest through a separate account or a commingled fund. Total operating costs are often lower for a commingled fund, while separate accounts allow for the customization of the portfolio's mandate or its guidelines. However, the illiquidity of the market suggests that investors who plan to invest less than $25 million in preferred equities utilize a commingled vehicle, so that a diversified portfolio can be constructed and trading costs will not eat away at returns.

ETFs and index funds are also reasonable options for investors seeking preferred equities exposure, with the latter likely to incur lower costs. There are several preferred stock ETFs available, with the fees for each being in the neighborhood of fifty basis points. The publication of an investable index by S&P implies that any of the major index fund providers would be willing to manage a preferred stock vehicle if the size of the mandate is large enough.

Another, and perhaps the most common, mechanism for achieving an allocation to preferred equities is to permit an opportunistic high yield bond manager to allocate a portion of their portfolio to preferred equities. Typically, the manager is limited to holding 5% to 20% of the portfolio in preferred equities.

SUMMARY AND RECOMMENDATIONS

Even though they are considered a hybrid asset class, preferred stocks behave more like stocks than bonds. We anticipate that preferred stocks *should* produce returns similar to those for high yield bonds, while at the same time exhibiting a similar or even higher level of volatility.

If the level of volatility that preferred stocks experienced over the past decade is an indicator of future risk, it is difficult to make a case for establishing a dedicated mandate to preferred stocks. Their risk-return trade-off has not been attractive, nor have they provided a meaningful diversification benefit that investors could not get more efficiently elsewhere (e.g., from high yield bonds).

However, we do think that individual preferred stocks may well be attractive from time to time. As such, we believe that it makes sense to allow opportunistic high yield bond or common stock managers to invest a small portion of their portfolios (e.g., up to ten percent) in preferred stocks.