A Preference for Preferred Securities

Roosevelt Investments

At Roosevelt, we view preferred securities as a potentially valuable way to enhance income generation. Investment grade preferreds often offer favorable yield levels without compromising credit quality. To the discerning investor, incorporating preferreds can play an important role in an income portfolio.

Although they are often referred to as stocks, preferred securities are more of a cross between stocks and bonds, possessing attributes of both. In general, preferreds do not enjoy the same potential for capital appreciation as common stocks. However, the yields generated by these securities may be higher than bonds of the same company. Given the oft misunderstood nature of the asset class, and our belief in their benefits for income investors, it's useful to review their similarities and differences to equity and debt alternatives.

How are preferred securities similar to common stocks (corporate equity)?

- Preferred securities, like common stocks, are a form of ownership (equity) in a public company.
- As with many common stocks, preferred securities pay dividends, and the dividends owed to preferred holders must be fully paid out before common stock holders may receive theirs.
- Like stocks, some preferred securities trade on a centralized exchange (i.e. the New York Stock Exchange). However, many preferred securities trade on the over-the-counter (OTC) market, via dealer networks and not over an exchange.
- Preferred securities typically have long maturity dates (30+ years) or are perpetual, meaning they have no maturity dates at all. However, most preferreds are callable, meaning that they can be retired well before their maturity date, once the call date has arrived.

How are preferred securities similar to bonds (corporate debt)?

- Similar to bond holders, holders of preferred securities do not have voting rights.
- Both bonds and preferred securities are issued credit ratings. Since preferred securities rank behind bonds on the capital structure, they are usually rated lower than bonds of the same company, a technical reality meant to reflect the placement of preferreds in a company's capital structure.

Preferred Securities Hierarchy in the Capital Structure

Seniority	Creditor Class	Asset Class
Higher	Senior Secured Bank Loans	Debt
	Senior Secured & Unsecured Debt Holders	Debt
	Subordinated Debt Holders	Debt
	Junior Subordinated Debt Holders / Hybrid Preferreds	Preferred Securities
	Traditional Preferred Stockholders	Preferred Securities
Lower	Common Stockholders	Equity

- Similar to bonds, preferred securities are issued at a par amount, which refers to the face or dollar value for an issue. For those preferreds listed on an exchange, par is usually $25, whereas OTC preferreds usually are issued at $1,000 par.
- Preferreds generally trade in a relatively narrow band around their par amount and often fluctuate in price based on the direction of interest rates, much like bonds.
- As with a bond's coupons, the dividends on fixed rate preferred stocks are set from the time they are issued.

How are preferred securities unique?

While preferred securities do share many attributes with common stocks and bonds, they possess a variety of features unique to their hybrid asset class structure.

- Usually the dividends preferred securities pay are taxed as normal income. However, the dividends on some preferreds are "qualified". These qualified dividends are taxed at the preferential capital gains rate, which may increase the after-tax yield of the investment.
- A troubled company may decide to skip a preferred security's dividend payment, or only pay it partially. Some preferreds, called cumulative preferreds, have a measure of protection against this risk and owners of these securities are entitled to receive this missed dividend at a later point in time.
- Most preferred securities that trade on an exchange are fixed rate, meaning their dividend amounts do not change. However, the majority of the preferred market is traded OTC, which is characterized by two variable rate structures:
    - Floating rate preferreds have a dividend rate that adjusts up or down ("floats") based on an underlying index (usually LIBOR).
    - Fixed-to-float preferreds have a fixed dividend which switches to a floating rate after a set period of time. These types of preferred securities may be advantageous in a rising rate environment.

What type of market environment is right to invest in preferred securities?

We believe it is best to make investment decisions based on overall financial goals, rather than the whims of the market. Generally speaking, preferred securities tend to perform best when changes in interest rates are steady and at a measured pace - not entirely dissimilar to our current interest rate environment. But if interest rates rise sharply and suddenly, preferred securities may be negatively impacted.

In periods of persistently low interest rates, such as we have been in, preferred securities can be appealing based on their ability to provide higher income. For investors seeking to balance income and capital preservation, a long-term allocation to preferred securities may be worth considering.

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