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Use Preferred Stocks To Increase Yield And Reduce Risk

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Summary

- High-yielding preferred stocks are overlooked by ordinary investors.
- The market for common stocks is over sold to common investors.
- Investors should focus on investments that pay a strong premium over inflation.

Preferred stocks are hybrid equities that occupy the space between common stocks and corporate bonds. They are technically equities that pay a predetermined dividend similar to a bond coupon. Like a bond, they often are credit rated, they have a maturity and some have convertibility to common shares. Because of these features this equity tends to trade like debt securities.

Stronger Dividends and Less Appreciation

Unlike a common issue, preferred shareholders are entitled to their dividends. These dividends have preference over the common dividends. If the company is unable to pay the dividend, many preferreds are cumulative, and the unpaid dividends accumulate and must be paid in full before the common dividend can be paid.

Preferred stocks are typically owned by investors who are more interested in the dividend and less interested in capital appreciation. Most preferreds are callable. They can be called by the issuer at par value. As compensation to the investor, preferreds pay several percentage points over the common shares. Currently, most rated preferred shares tend to have medium to low investment grade credit ratings.

Unloved and Unappreciated

Preferreds are disliked by many bond investors because of the call risk and dividend structure and by stock investors because of limited capital gains potential. Preferreds are also poorly promoted by much of the stock selling community because there is no exciting story to sell. They are more like a lift-truck than a sports car, useful but boring to discuss.

They are also shunned by the institutional bond and mutual fund community, because the issues are relatively small and less liquid - the lack of quantity prevents executing the big orders needed for their large portfolios. Despite these drawbacks there is a place for an allocation to preferreds in a individual investor portfolios.

Protection in Rising Rate Environments

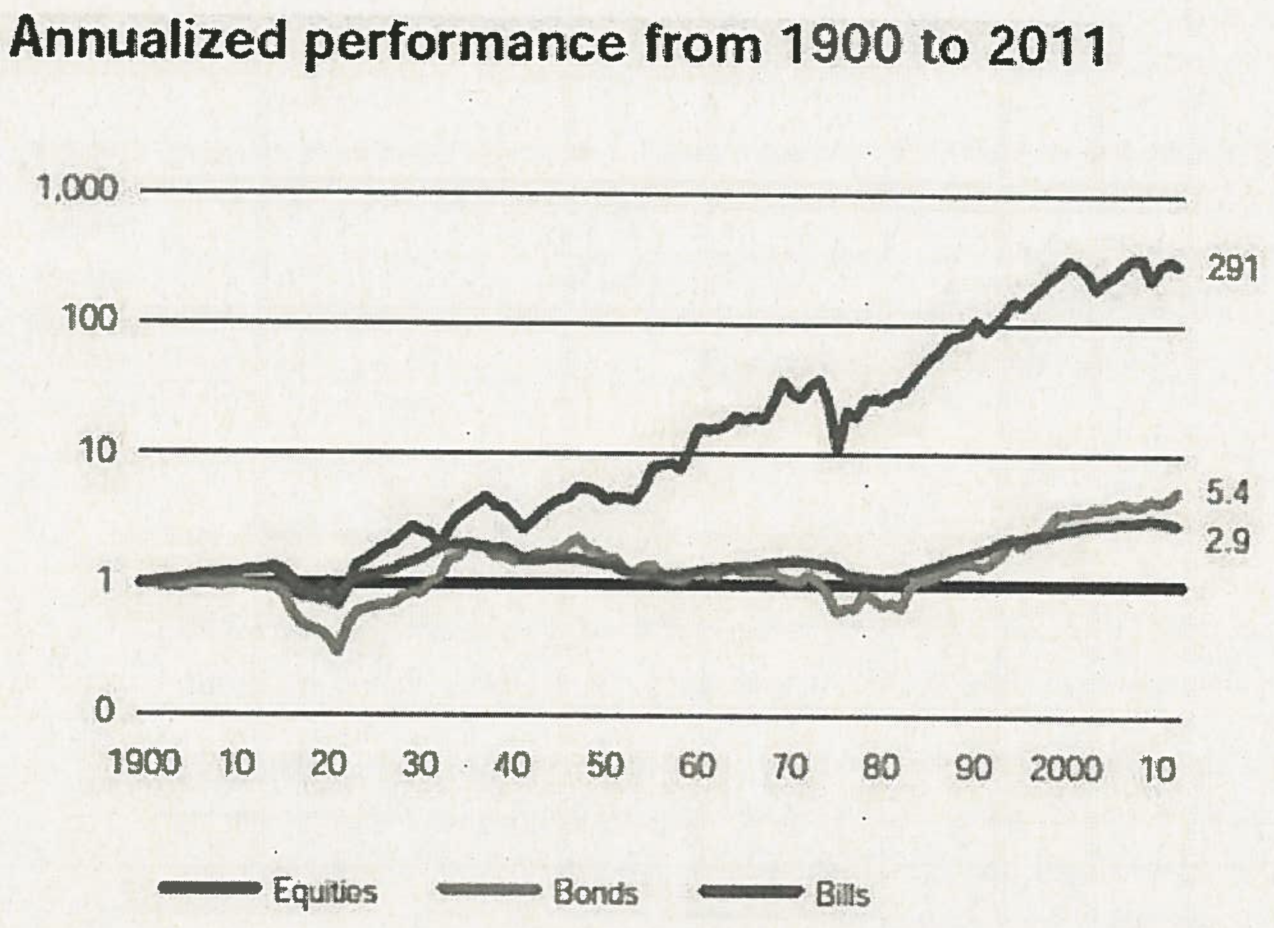
Additionally, For individual investors, preferred stocks are less sensitive to rising interest rates and can provide protection is a rising rate environment.

First, because many can be called they tend to trade near their par value when the prevailing interest rates are below the dividend rate. So as interest rates decrease below their dividends, they tend to not appropriate because they can be called back by the issuer. Many issues are paying over six percent despite near zero short-term interest rates. The callable issues tend to stick near their par value, usually 25 dollars.

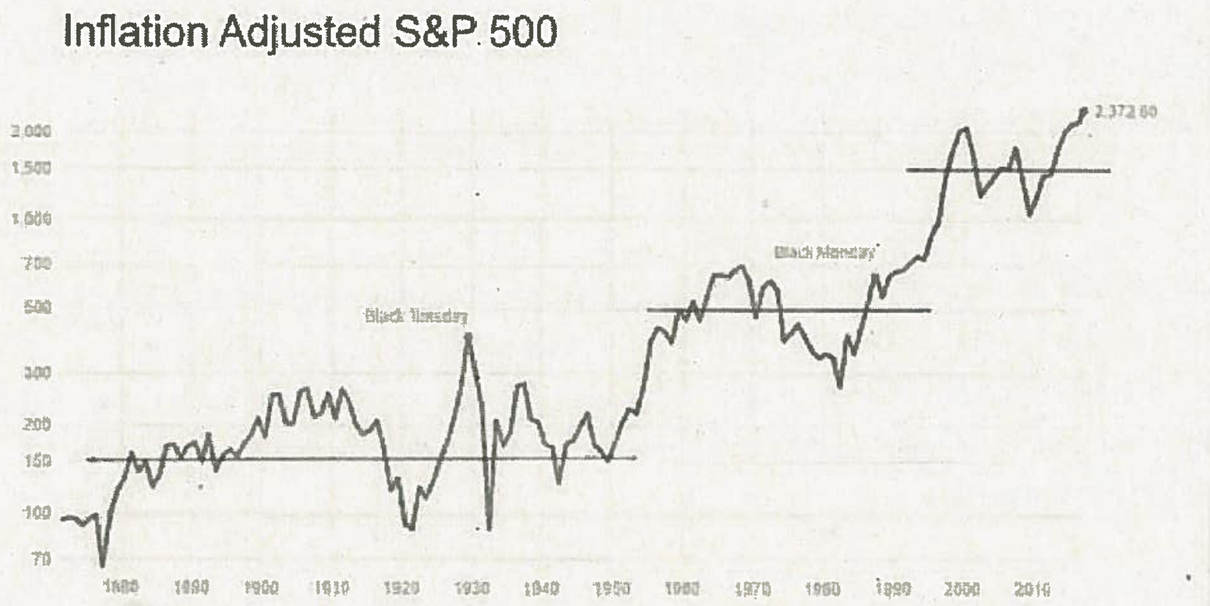
Their second protective feature is they tend to have higher dividend payments, many above six percent. This high dividend provides a cushion in a rising rate environment. To understand this, imagine two bonds: one pays two percent and the other pays six percent. A quarter point rise in short-term interest rates represents 12.5 percent of two percent bond coupon, but only four percent of the six percent bond. All else equal, this lower percentage change causes less price movement in the security and limits potential downside risk.

Stocks are not the money machine you've been told (or sold) they are.

To appreciate preferred stocks, we need to review the historical performance of common shares. Stock sellers like to boast of the out-performance of common stocks over bonds and cash. We have all seen this chart.



But much of the growth in the stock market is just inflation. Adjusted for inflation the market has been flat for long periods. Periods that are often longer than the average investor's time horizon. For example, adjusted for inflation the market was flat from Jan 1, 1881 when it was 159.57 until Jan 1, 1949 when it was 155.42. That's 78 years - that's a lifetime.



It declined slightly during a 27-year period from Jan 1, 1955 (323.79) until Jan 1, 1982 (302.07) and a 16-year period from Jan 1, 2000 (2,050.88) until Jan 1, 2016 (1,966.57). Investors have had to tolerate long periods of volatile but flat real performance to gain from two major growth spurts from 1949-1955 and 1982-2000. Overall the compounded rate of return from 1871 until 2017 was 2.5% over inflation with 121 years out of 145, 83% of the time, flat or slightly declining.

Focus on the return above inflation.

So if investors get the average 2.5 percent growth plus the current US. inflation rate of 2.5 percent then they can expect a five percent total return from stocks - a little more if inflation picks up. Given that inflation is low, stocks are trading at a high P/E ratio, and corporate profits are at record highs, the actual returns will be less than five percent if the PE and profit levels mean revert.

Unless you are confident that profits, stock valuations, and inflation will soar, you should look to other solutions for part of your portfolio. Instead, of risking your money to get a potential five percent long-term gain, consider allocating some of your portfolio into preferred stocks. Look for preferreds that pay at least 2.5 percent above your inflation estimate. For example a preferred that pays 6 percent will yield 3.5 percent over inflation and one percent over the historical equity growth of 2.5 percent.

Where to start.

In later articles I'll cover some individual preferred stocks, but for small allocations investors can look at the preferred ETFS like the iShares U.S. Preferred Stock ETF (NYSEARCA:PFF), currently yielding 5.78 percent, or the PowerShares Preferred Portfolio ETF (NYSEARCA:PGX), with a yield of 5.86 percent. There are also many closed-end preferred funds, many that are levered and trade at a discount; Nuveen Preferred Income Opportunities Fund (NYSE:JPC) trades at a seven percent discount and yields 7.92 percent with 30 percent leverage. Both of these structures pose more risk and more expenses than individual issues. The best way to invest is to buy individual issues. But these funds can offer some convenience for smaller allocations.

Risks

Preferreds in general are less risky than common shares, but they are not risk-free. They contain price risk and liquidity risk - many of these shares were hard hit in 2008 crash - and interest rate risk. Because of these risks it is important to manage your allocation size and diversify among many issues. It is important to do your own analysis or hire an advisor familiar with preferreds.