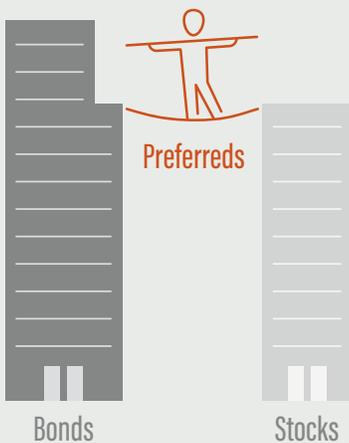


## Primer on Preferred Stocks



Within the vast spectrum of financial instruments, preferred stocks (or “preferreds”) occupy a unique place. Because of their characteristics, they straddle the line between stocks and bonds. Technically, they are equity securities, but they share many characteristics with debt instruments. Some even refer to preferred stocks as hybrid securities.

## Why Preferreds?

A company may choose to issue preferreds for a couple of reasons:

- ▶ **Flexibility of payments.** Preferred dividends may be suspended in case of corporate cash problems.
- ▶ **Potentially easier to market.** The majority of preferred stock is bought and held by institutional investors, which may make it easier to market at the initial public offering.

Institutions tend to invest in preferred stock because IRS rules allow U.S. corporations that pay corporate income taxes to generally exclude 70% of the dividend income they receive from their taxable income. This is known as the dividend received deduction, and it is one of the main reasons why investors in preferreds are primarily institutions.

The fact that individuals are not eligible for such favorable tax treatment should not automatically exclude preferreds from consideration, however.

## Types of Preferred Stocks

Although the possibilities are nearly endless, these are some of the basic types of preferred stocks:



**Cumulative.** Most preferred stock is cumulative, meaning that if the company withholds part, or all, of the expected dividends, these are considered dividends in arrears and must be paid before any other dividends. Preferred stock that does not carry the cumulative feature is called a straight or noncumulative preferred.



**Callable.** The majority of preferred shares are redeemable, giving the issuer the right to redeem the stock at a date and price specified in the prospectus.



**Convertible.** The timing for conversion to a fixed number of common shares and the conversion price specific to the individual issue will be laid out in the preferred stock's prospectus.



**Participating.** Preferred stock has a fixed dividend rate. If the company issues participating preferreds, those stocks gain the potential to earn more than their stated rate. The exact formula for participation will be found in the prospectus. Most preferreds are non-participating stocks.



**Adjustable-Rate Preferred Stock (ARPS).** These preferreds pay dividends based on several factors stipulated by the company. Dividends for ARPS are keyed to yields on a benchmark, typically on U.S. government issues, providing the investor limited protection against adverse interest rate markets.

## Bonds and Preferreds

Because so much of the commentary about preferred shares compares them to bonds and other debt instruments, let us first look at the similarities between preferreds and bonds.

### Similarities



**Interest Rate Sensitivity.** Preferreds are issued with a fixed par value and pay dividends based on a percentage of that par, usually at a fixed rate. Just like bonds, which also make fixed payments, the market value of preferred shares is sensitive to changes in interest rates. If interest rates rise, the value of the preferred shares falls. If rates decline, the opposite should hold true. However, the relative move of preferred yields is usually less dramatic than that of bonds.



**Callability.** Preferreds technically have an unlimited life because they have no fixed maturity date, but they may be called by the issuer after a certain date. The motivation for the redemption is generally the same as for bonds: a company calls in securities that pay higher rates than what the market is currently offering. Also, as is the case with bonds, the redemption price may be at a premium to par to enhance the preferred's initial marketability.



**Senior Securities.** Like bonds, preferreds are senior to common stock. However, bonds have more seniority than preferreds. The seniority of preferreds applies to both the distribution of corporate earnings (as dividends) and the liquidation of proceeds in case of bankruptcy. With preferreds, the investor is standing closer to the front of the line for payment than common shareholders, although not by much.



**Convertibility.** As with convertible bonds, preferreds can often be converted into the common stock of the issuing company. This feature may give investors flexibility, allowing them to lock in the fixed return from the preferred dividends and, potentially, to participate in the capital appreciation of the common stock.



**Ratings.** Like bonds, preferred stocks are rated by the major credit rating companies, such as Standard & Poor's and Moody's. The rating for preferreds is generally one or two tiers below that of the same company's bonds because preferred dividends do not carry the same guarantees as interest payments from bonds and they are junior to all creditors.

## Differences

Now, let us look at the differences between preferreds and bonds.



**Type of Security.** As observed earlier, preferred stock is equity; bonds are debt. Most debt instruments, along with most creditors, are senior to any equity.



**Payments.** Preferreds pay dividends. These are fixed dividends, normally for the life of the stock, but they must be declared by the company's board of directors. As such, there is not the same array of guarantees that are afforded to bondholders. With preferreds, if a company has a need for cash, the board of directors can decide to withhold preferred dividends; the trust indenture prevents companies from taking the same action on their corporate bonds.

Another difference is that preferred dividends are paid from the company's after-tax profits, while bond interest is paid before taxes. This factor makes it typically more expensive for a company to issue and pay dividends on preferred stocks.



**Yields.** Computing current yields on preferreds is similar to the calculation on bonds: the annual dividend is divided by the price.

$$\frac{\$1.75 \text{ ANNUALIZED DIVIDEND}}{\$25 \text{ CURRENT MARKET VALUE}} = .07 \text{ or } 7\% \text{ CURRENT YIELD}$$

*Hypothetical example shown for illustrative purposes only.*

For example, if a preferred stock is paying an annualized dividend of \$1.75 and is currently trading in the market at \$25, the current yield is:  $\$1.75 \div \$25 = .07$ , or 7%. In the market, however, yields on preferreds are typically higher than those of bonds from the same issuer, reflecting the higher risk the preferreds present for investors.



**Volatility.** While preferreds are interest rate sensitive, they are typically not as price sensitive to interest rate fluctuations as bonds. However, their prices do reflect the general market factors that affect their issuers to a greater degree than the same issuer's bonds.



**Accessibility.** Information about a company's preferred shares is usually easier to obtain than information about the company's bonds, making preferreds, in a general sense, easier to trade (and perhaps more liquid). The low par values of the preferred shares also make investing easier, because bonds, with par values around \$1,000, often have minimum purchase requirements.

## Common and Preferred Stocks

### Similarities



**Payments.** Both are equity instruments. Their dividends come from the company's after-tax profits, and are taxable to the shareholder (unless held in a tax-advantaged account).

### Differences



**Payments.** Preferreds have fixed dividends and, although they are never guaranteed, the issuer has a greater obligation to pay them. Common stock dividends, if they exist at all, are paid after the company's obligations to all preferred stockholders have been satisfied.



**Appreciation.** This is where preferreds lose their luster for many investors. If, for example, a pharmaceutical research company discovers an effective cure for the flu, its common stock will soar, while the preferreds might only increase by a few points. The lower volatility of preferred stocks may look attractive, but it cuts both ways: preferreds are not as sensitive to a company's losses, but they will not share in a company's success to the same degree as common stock.



**Voting.** Whereas common stock is often called voting equity, preferred stocks usually have no voting rights.

Preferreds are not as sensitive to a company's losses, but they will not share in a company's success to the same degree as common stock.



### Preferred Stock Pros

- ▶ Higher fixed-income payments than bonds or common stock
- ▶ Lower investment per share compared to bonds
- ▶ Priority over common stocks for dividend payments and liquidation proceeds
- ▶ Greater price stability than common stocks
- ▶ Greater liquidity than corporate bonds of similar quality



### Preferred Stock Cons

- ▶ Callability
- ▶ Lack of specific maturity date makes recovery of invested principal uncertain
- ▶ Limited appreciation potential
- ▶ Interest rate sensitivity
- ▶ Lack of voting rights

## Conclusion

An individual investor reviewing preferred stocks should carefully examine both their advantages and their drawbacks. There are a number of strong companies in stable industries that issue preferred stocks that pay dividends above investment-grade bonds. The starting point for research on a specific preferred is the stock's prospectus, which you can find online or through your Financial Advisor. If you are looking for a potentially relatively safer investment, you should not overlook the preferred stock market.

Contact your financial advisor to learn more about INVESTMENT ESSENTIALS or please visit [amgfunds.com/essentials](http://amgfunds.com/essentials) for more information.

## About AMG Funds



The largest network of institutional quality boutique investment solutions through a single point of access



Unrivaled access to insights of over 30 independent and autonomous investment managers



More than 100 actively managed products covering the risk spectrum for investors searching beyond the index

The opinions expressed are not intended to be a forecast of future events, a guarantee of future results or investment advice.

An issuer of a security may be unwilling or unable to pay income on a security. Stocks do not assure dividend payments and are paid only when declared by an issuer's board of directors.

AMG Funds does not provide legal or tax advice. Always consult an attorney or tax professional regarding your specific financial or tax situation.

Investing involves risk, including possible loss of principal.

Preferred stocks have characteristics of both stocks and bonds, and therefore may be subject to the risks of both the equity and bond markets.

Companies that issue convertible securities are often small to medium size, and they may be subject to lower credit ratings. High yield, lower-rated securities involve greater risk than higher-rated securities. Small and mid cap companies are also subject to increased risks such as greater price volatility, lower trading volume, and less liquidity than the stocks of larger, more established companies.

Preferred stocks may also be subject to credit and interest rate risk. Changing interest rates may adversely affect the value of an investment. An increase in interest rates typically causes the value of preferred securities to fall.

AMG Distributors, Inc., is a member of FINRA/SIPC.