- JOURNAL REPORTS: FUNDS & ETFS

Preferred Stocks Beckon If Interest Rates Behave

Preferred shares from many companies are offering attractive dividends, but as interest rates rise, there's risk

Shipping-related preferred stocks are an attractive option for some investors. Shown, a Seaspan shipyard in North Vancouver. DARRYL DYCK/BLOOMBERG

By Eric Uhlfelder

A buying opportunity may be shaping up in the $750 billion market of U.S. preferred shares.

This relatively obscure asset class has taken a hit during the second half of the year, with individual preferreds correcting 10% to 20%. Industry observers felt these securities—hybrids between stocks and bonds that are prized for their income—were due for a reckoning of sorts after having held up too well while the Federal Reserve raised rates over the past several years. Like all fixed-income securities, when interest rates rise, preferred prices tend to fall.

A key reason why preferreds sold off during the second half of the year was the spike in 10-year Treasury yields. This is the benchmark rate that most directly affects preferred pricing, says Barry McAlinden, a senior credit strategist in UBS's Chief Investment Office.

"We don't think this yield will move meaningfully above its 2018 peak of 3.2% over the next year," says Mr. McAlinden, "which should bode well for preferreds."

This is generally in the ballpark with most near-term calls for 10-Year Treasury yields. Several years out could be a different story, with Jeffrey Gundlach, chief executive officer of DoubleLine Capital, being one of the most bearish, calling for a sharp rise in 10-year yields to 6%. That would not be good news for existing fixed-rate preferreds.

However, over the past two months, the yield of the 10-Year Treasury has sharply declined from 3.23% to 2.85%. Meanwhile, preferred prices continue to fall and their yields continue to rise.

For investors who feel interest-rate rises will be contained for a while and the greater fear is more of a slowing rather than an overheating economy, then preferred shares may be a good source of income. For investors who fear interest rates will continue to rise across the board, then they should stay away from most preferred stocks.

Preferred shares are a kind of cross between exchange-traded stocks (that you can easily buy online) and bonds whose prices fluctuate with interest rates and credit risk. Investors buy preferreds for their income, rarely for capital gains.

Though they've been around for decades, this asset class is underresearched and not well understood.

A key benefit many preferreds have over bonds is their yield is typically higher than bonds, and the dividends they pay are taxed at a much lower rate than debt. Bonds pay interest, which is taxed at a higher rate.

An example of such a preferred, which UBS recommends, is State Street STT -1.31% Capital's preferred E shares. It has held up better than most preferreds, currently yielding 6% after its price declined from $26.55 in July to $25.07 in early December. The dividend of this investment-grade preferred is taxed at the low qualified-dividend-income rate of 15% to 20%. It can be initially called (bought back) by State Street in December 2019 at $25. But investors would still net a 5.6% return and a small tax loss.

Preferential Treatment

A look at select preferred shares

SECURITY	TICKER	PRICE	CURRENT YIELD	CREDIT RATING	CALL DATE	YIELD TO CALL
State Street Capital Preferred E	STT-PRE	$25.07	5.98%	BBB	Dec-19	5.60%
Public Storage Preferred E	PSA-PRE*	20.84	5.88	BBB+	Nov-21	12.35
Seaspan Preferred G	SSW-PRG*	24.04	8.53	NR	Jun-21	10.37
Morgan Stanley Preferred E	MS-PRE	26.76	6.70	BB+	Oct-23	5.55
KKR Preferred B	KKR-PRB	25.20	6.45	BBB+	Sep-21	6.13
BB&T Preferred E	BBT-PRE	22.15	5.87	BBB-	Aug-17	14.36†

* Dividend is cumulative, which means if the dividend is ever suspended, all missed dividends must first be repaid on this preferred before Seaspan can pay a common dividend. † This is an absolute return if called on the next earliest date in February 2019.

Another point to keep in mind: Preferred prices don't move in lockstep with stocks—in Wall Street parlance, they are less than half "correlated" with common stocks, according to Kevin Conery, analyst on the preferred trading desk at Piper Jaffray. This means if the market continues to tumble and rate increases are constrained (which is more likely if stocks continue to fall), preferreds might be a better store of value than stocks.

Understanding preferreds

Where corporate bonds pay interest twice yearly, preferreds pay quarterly dividends. And according to Cohen & Steers, a $58.5 billion asset manager, investment-grade preferreds offer the highest pretax average yields (6.0%) of any income asset class, save for junk bonds (6.7%). Municipal bonds are yielding 4.4%, investment-grade corporate bonds are paying 4.2%, and 10-year Treasurys are delivering 3.0%.

Preferred dividends must be paid before those of common shares, but their credit ratings are several notches below senior unsecured debt.

Preferreds come in many different shades. Many come with fixed coupons, others with floating rates, and then there are those with yields that will shift from fixed to a floating rate. Some offer preferential tax income treatment for individuals and corporations. The majority never mature (called perpetuals), but all can be called by their issuers five to 10 years after they come to market, and at any point thereafter.

Preferred yields are higher than those on bonds because, among other things, most preferreds don't mature, thus not guaranteeing repayment at par like bonds do, and their dividends can be missed without triggering a default.

But when dealing with financially solvent companies, Mr. Conery says, "firms will tap every possible resource to avoid that dividend miss." The reason: Missing dividend payments will drive up the cost of capital due to the perception that the issuer is suffering from mounting financial worries.

A small portion of preferreds do offer some protection against missed dividends. These are called cumulative shares, which means a company cannot restart payment of a common dividend until it repays all missed dividends of its preferreds.

Public Storage , PSA -0.97% the real-estate investment trust that builds storage facilities across the country, issued a bunch of such preferreds. Its Series E, whose dividends aren't eligible for the lower QDI rate, fell sharply since September from $24.59 to $20.84, yielding 5.88%. Though callable in November 2021, investors would enjoy an annualized return of 12.35% if it's called at $25, because capital gains get factored into the return.

What moves prices

In addition to 10-year Treasury yields, pricing is determined by the spread over these yields, which varies based on demand for preferreds and a long view of interest rates. Credit risk also moves prices.

Shipping-related preferreds typically are considered higher-than-average credit risk plays because of uncertain, volatile charter rates they're able to charge clients. But they offer very high yields for investors who believe in the long-term underlying buoyancy of a shipping company, despite growing global trade tensions that are directly impacting shipping.

Such a play could be Seaspan , SSW 0.85% which leases container ships it owns. Seaspan securities aren't rated because the firm has been able to raise capital without a credit rating. Its series G preferreds are currently yielding 8.53% after their price fell from nearly $26 in early September to $24.04. The dividend is both tax qualified and cumulative. It's callable in 2.5 years. So if the firm can refinance at a cheaper rate than its 8.2% coupon—currently the highest on the firm's books—then this preferred would likely be the first one the firm would call, also creating a capital gain for a new investor. While he figures 10-year Treasury yields will not likely exceed 3.5% over the next year, William Scapell, manager of the $7.5 billion Cohen & Steers Preferred Securities & Income Fund (CPXAX), favors quality fixed-to-floating rate (three-month Libor plus 4 percentage points) issues that can provide longer-term interest-rate protection.

One such security on UBS's attractive list, despite a credit rating just below investment grade, is Morgan Stanley MS -3.03% Series E preferred. It has slipped $2 since August to $26.76, currently yielding 6.70%. And if it's not called in October 2023, its variable rate

could yield more than 7% based on current three-month Libor plus its 4.32 percentage-point spread. If it's called, investors will still walk away with an annual return of over 5.5%.

Like all investing, buying preferreds requires substantial understanding of a company's finances and risks. Because preferreds are less liquid than common shares, investors should use limit orders when buying and selling, always mindful of ex-dividend and call dates. A good, free place to start researching preferreds is Quantumonline.com.

Cohen & Steers, Invesco, Nuveen and Principal have large, seasoned preferred funds that have generated annualized yields between 5% and 6% over the past five years. But funds with sales charges will negate this edge over the near term. Closed-end funds' use of leverage, which increases yield, makes their prices more volatile.

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