Overlooked by many investors, some preferred stock pays eye-catching quarterly dividends that should appeal to yield-hungry buyers. But do your homework.

Preferreds at 6% Yields

By Eric Uhlfelder

OVER THE PAST SEVERAL YEARS, THE private-equity firm **KKR** has been issuing securities paying dividends that are currently yielding up to 6.5%, which must be paid before common shareholders get theirs.

Junk-size yields from one of the world's leading buyout shops?

Yes. In the case of KKR (ticker: KKR Pfd A), the firm has been offering preferred shares, one of the least-well-known asset classes and one of the best sources of income.

Preferred stock has been around since the early 19th century. Like common stock, it offers an ownership stake to shareholders, but it has priority if the company has to be liquidated. It has a lesser repayment priority than most debt, though its dividends similarly provide a steady source of income to investors.

Preferred comes in several forms and is generally callable after five or 10 years. It can also be perpetual, which means it has no set maturity or buyout date, though it can be bought back.

Cohen & Steers, a $58.5 billion global asset manager, estimates the global preferred market totaled nearly $1 trillion at the end of March, two-thirds of which trades in dollars. Primary issuers include banks, insurers, financial-services companies, utilities, and real-estate firms. Among them are **Morgan Stanley** (MS) and **JPMorgan Chase**. (A comprehensive listing of preferred stocks appears on page M22).

The average current yield of investment-grade preferreds is an attractive 5.8%, according to the money manager. Equivalently rated corporate bonds pay 4%, municipal bonds 4.4%, and 10-year Treasuries almost 3%. Only junk bonds yield more than preferreds: 6.4%. Kevin Conery, preferred trading-desk analyst at Piper Jaffray, notes preferreds hold another potential attraction because their prices are less than half correlated with common stocks'. Should stocks fall, preferred shares might enjoy more support.

A key reason why preferreds pay handsome quarterly dividends is that they appeal to a limited audience that isn't bothered by the lack of a firm maturity date or by the possibility of an early call that redeems the securities at an inopportune time for the shareholder. The main dynamic affecting preferreds' yields is the shifting 10-year Treasury yields, which provide the benchmark for preferred pricing terms. Other factors include changing corporate and industry credit conditions.

From the middle of 2016 through April 2018, 10-year Treasury rates have risen from 1.4% to 3%, which is their trading range over the past seven years. Given those relatively narrow parameters, preferred values have held up over this time.

With the Federal Reserve removing liquidity from the market and the U.S. government spending aggressively, however, long rates could break out of that range. William Scapell, manager of the $7.5 billion **Cohen & Steers Preferred Securi-**

Quality Income Plays

These six preferred-stock issues offer high yields and strong protections.

Company / Ticker	Coupon	Current Price	Current Yield	Call Date	Yield-to-Call
Aegon / AEB pfd	4.00*	$24.67	4.05%	Dec. '10	*
JPMorgan Chase / JPM Pfd H	6.15%	26.11	5.88	Sept. '20	4.54%
Morgan Stanley / MS Pfd E	7.125**	28.21	6.31	Oct. '23	4.51
KKR / KKR Pfd A	6.75	25.85	6.52	June '21	5.83
Apollo Global Mgmt / APO Pfd A	6.375	24.24	6.57	March '22	7.51
Seaspan / SSW Pfd E	8.25	24.29	8.49	Feb. '19	9.20

Data through April 27. *AEB's dividend will be the higher of 4% or 3-month U.S. Libor + 0.875% and it can be called in any month at $25 **After Oct. 2023, the dividend becomes a floating rate equal to 3-month U.S. Libor + 4.32%.

Sources: UBS; Bloomberg

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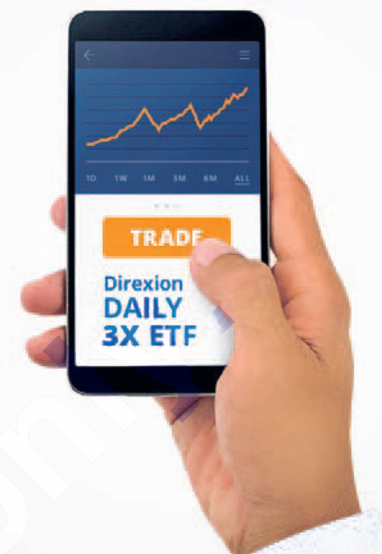

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ties and Income fund (CPXAX), believes that over the next year, these developments could push rates to about 3.25%.

On the advisory side, Guy LeBas, chief fixed-income strategist at Janney Montgomery Scott, is even more sanguine about rates. "We may be nearing the peak of rising long-term interest rates," says LeBas, "as we seem to be approaching the end of the economic-growth cycle." He believes investors may become more concerned about an economic downturn in 2019 and 2020, which could mean that 10-year Treasury yields decline.

The reason this attractive asset class flies beneath most investors' and advisors' radar is due to limited brokerage and media coverage. Few folks know preferreds' prices, yields, and benefits. But as many seasoned investors will attest, there's more opportunity in less-crowded trades.

A preferred issuer is highly unlikely to stop paying dividends, just as a proven bond issuer is unlikely to stop paying interest.

U.S. preferred investors can get an after-tax boost because many issues pay qualified dividends eligible for a 15%-to-20% tax rate—much less than personal tax rates that still top out at 37%.

C-corporations, which are entities that are taxed separately from their owners, can also get a large break from so-called dividends received deduction preferreds, which allow them to deduct half the dividend from their own income.

A preferred offering both tax benefits is JPMorgan Chase's series H (JPM Pfd H), which sector strategist Frank Sileo at UBS calls "Attractive." It's trading at $26.11 and currently yields nearly 5.9%. It's callable in September 2020 at $25. If that happens, investors will still have earned 4.5% a year and can take a tax loss, which adds further value.

Some issuers offer variable-rate preferreds with a guaranteed floor rate, while others start off with a fixed rate that then shifts to a floating rate after a certain date to maintain the attractiveness as rates change. The floating rate is typically the three-month U.S. London interbank offered rate (currently 2.35%), or Libor, plus a kicker.

The global Dutch-based insurer **Aegon** has a variable-rate preferred (AEB Pfd) with a floor of 4% (based on its $25 par price) or Libor plus 0.875%, whichever is higher. It's currently trading below par at $24.67, yielding 4.05%. This provides call protection to investors, meaning they won't lose money if the company decides to call the security, which it can do on quarterly notice. The dividend is taxable at the low qualified rate.

A riskier junk-rated play for yield-hungry investors that's also on UBS's Attractive list is Morgan Stanley's 7.125% series E. It's selling well over par at $28.21, but its current yield is 6.3%. It's callable in October 2023, and if that happens, you would still earn 4.5%. But if it isn't called, the variable rate kicks in, earning investors Libor plus 4.32%. And its dividend is also tax-qualified.

Some dividends are cumulative. This means if they ever are suspended—which they can be without the issuing company being in default—the issuer must repay all missed preferred payments before restarting its common dividend. As a result, a cumulative preferred issuer is likely to suspend its stock dividend to keep paying the preferred-stock dividend.

A large container-ship leasing company, Vancouver-based **Seaspan**, has issued cumulative preferred. The issue (SSW Pfd E) carries an 8.25% coupon and the dividend is tax-qualified. Shares are selling slightly below their initial call price, which can be paid anytime after February of next year.

With half its leases to Chinese shippers supported by a global recovery, this preferred should deliver attractive total returns over the near term—and probably longer.

Following a period of significant turmoil for Seaspan and the container-ship industry, Deutsche Bank shipping analyst Amit Mehrotra has upgraded his recommendation on common Seaspan shares from Hold to Buy. He sees the stock potentially doubling over the next year. "We now forecast a much brighter horizon for Seaspan," says Mehrotra, "underpinned by a more prudent leverage profile, inflecting cash flows, and long-term chartering arrangements with good returns over cost of capital."

If Mehrotra is right, preferred investors should be treated to a rich dividend for 10 months with the prospect of a call keeping the price near par. One risk: a trade war that disrupts shipping and global growth.

Actively managed funds may seem like a prudent way to protect oneself if rates do rise. But practical options are limited for investors looking for short-term exposure. Sales and management fees are substantial. Two open-end examples: **Nuveen Preferred Securities & Income** (NPSAX) charges sales fees of 4.75% and an annual fee of 1.04%; **Pimco Preferred and Capital Securities** (PFANX) has a sales charge of 3.75% and an annual fee of 1.15%.

Closed-end funds employ leverage that will make returns more volatile, and their discounts could expand from the underlying net asset values. The only reasonable fund alternative is an institutional class of open-end funds, which has no sales fees and lower expenses. But they typically require a minimum $100,000 commitment.

So if an investor isn't looking for long-term exposure, the most practical way to invest is through an experienced advisor or by doing it yourself.

Some investors may be turned off by preferreds because they are lower down the capital structure than debt. But if a company misses a preferred dividend payment, it will drive up its cost of capital. "Firms will tap every possible resource to avoid that miss," explains Conery of Piper Jaffray.

Preferred shareholders don't enjoy the defensive covenants bondholders do. However, except in extreme circumstances, if preferred is issued by a well-established company, it's similar to a bond. The issuer is highly unlikely to stop paying dividends, just as a proven bond issuer is unlikely to stop paying interest.

But there are no free lunches. Make sure you understand the issuer's business, credit, and profitability. And while there's sufficient liquidity to get into and out of preferreds, it's much less than common shares. Use limit orders on both sides of the trade. This won't only ensure precise execution, but it can get you bargains. And be mindful of the ex-dividend and call dates before buying. ■

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