VANDERBILT Ave.
ASSET MANAGEMENT

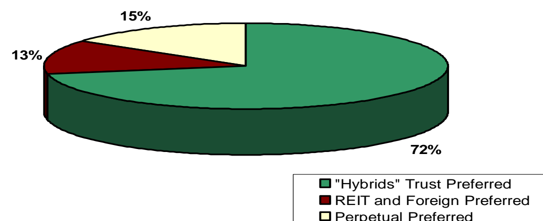
Emad A. Zikry, President and Chief Executive Officer

Time to Prefer Preferred

We humans are generally orderly beasts. We like crisp categorizations of people, places and things. It makes things easier to deal with as it allows for neater storage of our ideas and concepts. Perhaps it is a result of this group tendency that opportunities in investing very often present themselves in between these pigeonholes. An example of this in today's market is the opportunity that presents itself in preferred securities.

Preferred securities have a preference over common shares in the payment of dividends, and also hold a higher position in the capital structure of a corporation. That is they are senior to common equity, although they are junior to any debt securities of the issuer. Preferred securities pay a stipulated dividend, usually a fixed amount, but sometimes an adjustable rate based upon a formula such as a certain percentage above Treasury bills or another money market rate. It should be noted, however, that preferred dividend payments are not legally required, as is the case with interest payments on debt, and may be stopped by the issuer's board of directors. This happens very infrequently, as non-payment of a preferred dividend is tantamount to declaring bankruptcy. Because of the ability to suspend dividends, there is another feature of preferred issues that is important, and that is whether the issue is cumulative or non-cumulative. In the case of a cumulative issue, before any dividend can be paid on common equity, any and all arrears in dividend payments to the preferred securities must be made up.

While the asset class itself is not easily categorized, its market is. As is illustrated in the chart below, the market for preferred securities is composed of three main types of issues.



The type of preferred that one should own is particularly important with the recent change in the laws regarding the taxation of dividends. This is because only dividends paid out of income that has already been taxed are considered tax-exempt. "Hybrids" such as **trust preferreds** make up the

majority of the market and they are, in effect, bonds restructured via a trust into preferred stock. Because of this restructuring, the payouts of these securities are still legally defined as interest, not dividends. Since this allows companies to deduct the payments they make on these securities, they would remain a taxable item for the holder even under the new rules. Another class of preferreds, those issued by real estate investment trusts (REIT's) and foreign issuers will also not benefit from the removal of the double taxation. This is because **REITs** pass through virtually all their income to shareholders without paying taxes and most foreign entities do not pay U.S. taxes. The remainder of the preferred universe is made up of the so-called **"perpetual"** preferreds. These issues pay dividends that are 70% non-taxable for corporations under a provision called the Dividend Received Deduction. Since they are paid out of after tax income, their dividends are affected by the new rules. Naturally, the distinctions in tax treatment between the different types of preferreds have less impact on tax-exempt than taxable investors, but the relationship between the various types are impacted and this must not be overlooked when accessing relative value.

Like bonds, the price of preferred securities is driven by two primary variables: interest rates and credit quality. Because, as mentioned above, most preferreds pay a fixed dividend, when interest rates go up and investors can find better yields in newly issued securities, prices of existing preferreds decline. The inverse is true if interest rates go down. Creditworthiness also has a major impact on price. If the credit quality of the issuing entity improves it means the certainty of receiving payments is greater. This in turn means that the risk premium necessary to attract investors is less and the price of the stock will then rise. The converse is also true here, that is deteriorating credit requires a higher risk premium and a thus a lower price.

Because preferred issues are really "bonds in mufti", the process we at Vanderbilt use to identify value amongst them is the same rigorous and disciplined one that we apply in the selection of corporate bonds. We focus on cash flow and the ratio of short-term to long-term debt, and require that both be above average in comparison to an issuers peer group. We also look particularly carefully at earnings surprises, using a significant negative earnings surprise as a sell signal, and at a significant positive surprise as a factor to consider towards a possible purchase.

From a relative value perspective preferreds look quite attractive with yields currently in the range of 5 – 7%. This compares very favorably to 5-year Treasuries that currently yield about 2.5 %, or even 10-year Treasuries that yield about 3.5 %.

For all the reasons listed above, we believe the time is ripe to take advantage of the opportunities that exist in this asset class.

Vanderbilt Research Team