

The Alphabet Soup of Preferred Stock

Have the recent shifts in the economy caused your income to drop? Many investors have used preferred stocks because of their potential for high, steady quarterly dividends and growth of principal. But even these have been affected by the economic downturn. Over the past 10 years, however, some new versions of preferred stocks have emerged that may provide you with higher income in this historically low interest rate environment.

Fixed-rate capital securities have a whole group of acronyms, depending on the stock's underwriter. For instance:

- Quarterly Income Preferred Securities (QUIPS) pay quarterly dividends
- Monthly Income Preferred Securities (MIPS) pay monthly dividends
- Trust Originated Preferred Securities (TOPrS) use a trust instead of a limited partnership structure

These new securities are unique in that the dividends are paid with pretax corporate dollars instead of after-tax dollars as is the case with traditional preferred stock dividends. Therefore, investors have been paid higher returns. The issuing company sets up a partnership that sells the new preferred securities. The partnership lends money to the company and receives a long-term bond. The company then makes tax-deductible interest payments to the partnership, and the partnership distributes the dividends to investors without paying income tax. Investors have to report the income on their K-1 tax form instead of a 1099.

Compared to corporate bonds¹ that are sold in \$1,000 units, fixed-rate capital securities generally sell for \$25 each. Maturities range from 30 to 49 years (although you may sell them whenever you please and a profit or loss may result). The price of these securities fluctuates up and down, inversely to changes in interest rates.

Just as with regular preferred stocks and bonds, fixed-rate capital securities can be called. So if interest rates were to decline, your higher dividend yielding shares might get redeemed, but there is usually a 5 to 10 year call protection period.

If by chance the issuing company gets in financial trouble, they cannot suspend your dividends by any more than five years. And it can only be done after the dividends on common and other preferred stocks are stopped. Whereas conventional preferred stock dividends can stop indefinitely.

Who is suitable for these securities? An investor desiring to earn 6% to 8% fixed rates² who does not need the fund for instant liquidity (although they can be sold at any time). These securities are typically appropriate for retirees who should focus on higher rated issues. If you'd like to receive a list of attractive opportunities, please check off and return the enclosed coupon.

1 Corporate bonds have a fixed maturity date while preferred stocks do not. In liquidation, bond holders have a priority claim on company assets before preferred shareholders. Bonds may be less volatile because of this preference. Issuers do not have the option to cease bond payments but may suspend preferred stock dividends. Bonds typically pay interest twice annually while preferred shares typically pay dividends quarterly.

2 <http://www.kiplinger.com/columns/balance/archive/2002/balance0311.html>