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Stocks In Bonds' Clothing And The "Yield Rally"

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Summary

- Along with common stocks, preferred shares were pushed down in the corona-triggered market decline. Yet their dividend yields increased, and dividend income is the main reason to buy them.
- Preferred shares are a much-overlooked fixed-income alternative for stock-skiddish investors piling into bonds paying paltry, declining yields.
- Individual investors should be aware of pitfalls, including the potential downsides of callable shares.

Contrary to the situation with common stocks, the decline in the value of preferred shares amid the corona correction really hasn't been a bad thing. As preferred shares are lumped in with common shares, the market decline pushed them down with common shares, triggering what fixed-income professional jokingly call a "yield rally."

The past 15 months have been a great time for preferred shares. The S&P Preferred Stock index was up 17.64% in 2019. This year, the index rose 2.25% before the late February market decline took its toll on asset value. From Feb. 14 through Thursday, Feb. 27, the preferred index fell 3.65%, hitting minus 3.2% at market close Feb. 28.

As preferred dividends are fixed, the lower share price increased dividend yields--the ratio of the annual dividend to the share price, meaning that new investors would pay less to get the same dividend. And while it's nice to get asset appreciation, the dividend is the main reason to buy preferred shares.

For example, on Feb. 11, preferred shares of Prudential (PRU) were trading at $27.80, with a dividend of $1.40 per share, so the dividend yield was 5%. By Feb. 28, the share price had gone down to $26.02, increasing the dividend yield to 5.38%.

This an object lesson in the dynamics of preferred shares, which enable investors to actually benefit in the short term from share price *decreases*--anathema to the common-stock mentality. In the long term, of course, investors also want to be able to sell their preferred shares for a profit after years of collecting income.

Though the correction is being attributed largely or entirely to corona virus pandemic, this was only the trigger. The market was overbought and was long overdue statistically for a correction. And this is, after all, an election year: There has been a correction in every election year since 1960.

So, amid strong fundamentals that will continue—or resume post-corona--the market drop was a predictable and necessary short-term dip for common shares and a yield rally for preferred shares.

A strange hybrid of stocks and bonds that's largely unfamiliar to many individual investors, preferred shares are structured differently than common shares to meet different financial goals for issuing companies. They trade as stocks but pay dividends with bond-like reliability. Technically classified as category. They are one place where you can still get decent income, relative to inflation, in return for tying your money up for a few years. Their volatility is right between that of bonds and common stocks.

For skittish common stock investors, preferred shares offer security. Despite a rocking market in most of 2019 and early this year, investors worried about the impacts of Brexit, trade tensions and a potential recession herded into bonds with historically low yields. After dwindling below 2%, the 10-year Treasury bond rate dipped below 1% on March 3 for the first time in three years, to .999%, and ended the week at market close March 6 at .754.

For many investors, some portfolio allocation to preferred shares would be a better alternative, as they pose less risk than common stocks but pay far superior yields in the form of dividends, many issues in the 5-6% range.

Preferred stocks are issued primarily by banks and financial institutions (70% of the universe), but also by utilities, real estate investment trusts (REITs), healthcare, energy, industrials and consumer staples. The concentration of preferred stocks in the financial sector might normally be viewed as posing industry risk, but regulations that came from the financial crisis of 2008 have made these institutions safer from default risk than they've been in decades. And, as they do with bonds, investors can manage risk by choosing companies with high credit ratings.

Other advantages of preferred shares include: more insulation from interest-rate risk than is offered by bonds; far lower risk than with common stocks and a low correlation with them; and priority over common shareholders (but below that of bondholders) in the event of default. This last feature results in somewhat lower credit ratings than those for the same company's bonds.

Another advantage: While taxable-bonds (non-municipal bond) yields are generally taxed at the painful federal ordinary income rate, many preferred share dividends are qualified, meaning the long-term capital gains rate of 15% for most people and about 20% for the upper bracket.

Yet, as in all things investing, there are downsides pitfalls. A key downside for individual investors is that preferred stocks are considerably more complicated than bonds and common stocks. There are several different varieties, each with different rules: Some can be converted into common stock and some can't; some have a set maturity (as with bonds) and some don't; rates may be floating or fixed; and some pay missed dividends retroactively while others don't.

One type of preferred shares that can easily trip up individual investors is callable shares. When issuing these shares, companies reserve the right to buy them back from the purchaser at a set price whenever they choose, in keeping with set rules. (This can happen when the market becomes advantageous for selling lower-yielding bonds.) Owners of callable preferred shares may not have time before calls to get enough income from the shares to justify the purchase price, relative to the pre-set call price, resulting in a negative yield-to-call scenario.

Information on which preferred share issues have negative yield-to-call characteristics can be difficult for individual investors to come by, and passively managed funds tend to include negative yield-to-call shares. So investors are usually better off investing through actively managed funds, many of which have handily outperformed passive funds over the past decade.

Despite the clear advantages of preferred shares to bonds, few individual investors have taken advantage; there's only about $31 billion invested in preferred-share ETFs.

Preferred shares are the redheaded stepchildren of the fixed income world that many individual investors should consider adopting— if not as a replacement for bonds, then at least as an alternative asset to diversity their portfolios. This way, they can get some measure of both asset preservation and actual income in this low-rate environment.