MEKKY MEDIA RELATIONS

U.S. News
Date: July 25th, 2019
Online UMV: 23,921,839

Yahoo!
Date: July 25th, 2019
Online UMV: 1,834,222

WTOP
Date: July 25th, 2019
Online UMV: 3,507,506

U.S.News & WORLD REPORT

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# 7 Tips to Know When Buying Preferred Stocks

These hybrid vehicles can offer equity investors more yields.

By **Debbie Carlson**, Contributor July 25, 2019, at 4:18 p.m.

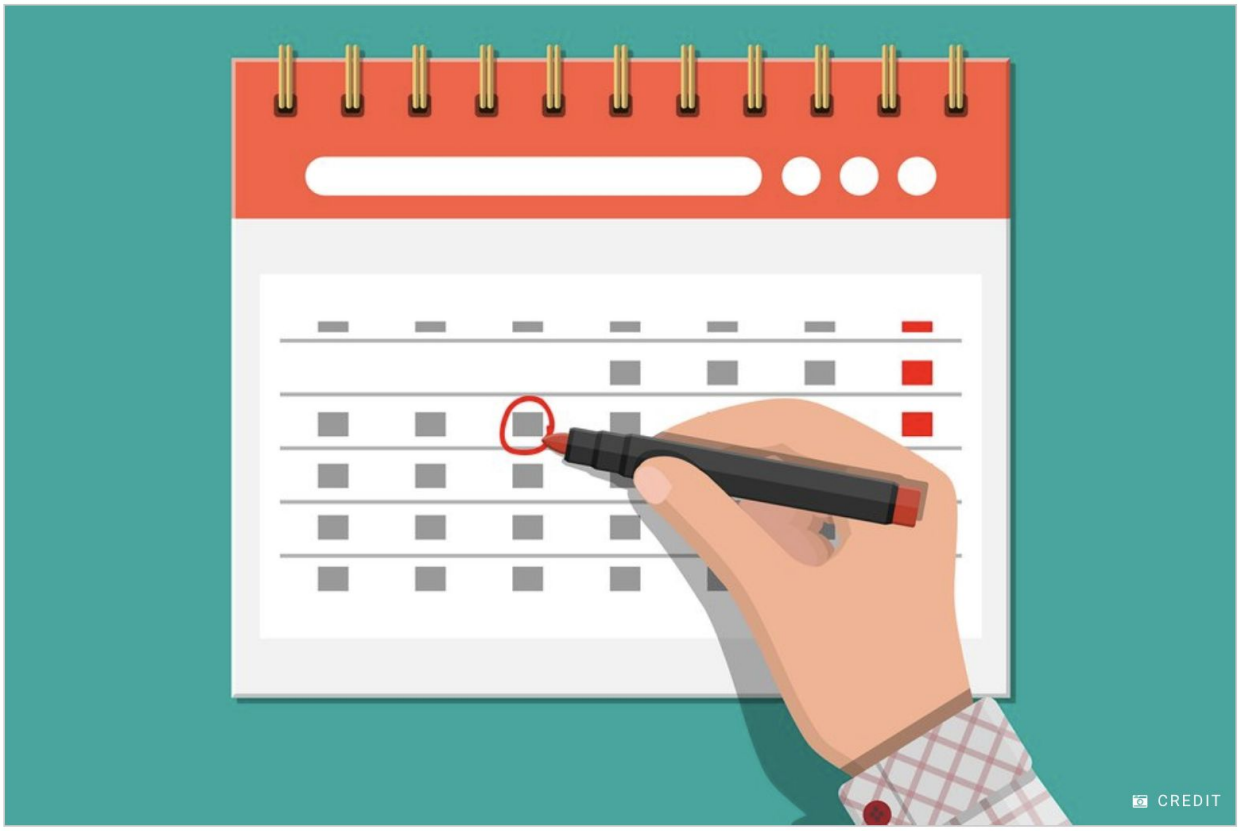

**Preferred shareholders claim priority over common stockholders.**

The recent drop in interest rates as the Federal Reserve looks set to cut rates may make preferred stocks attractive again. "It always seems that these low-yielding environments get investors interested in some alternatives to fixed income," says Jim Barnes, director of fixed income at Bryn Mawr Trust's wealth management division. People can buy preferred stocks the same way they buy common stock— directly from the company, an online broker or a financial advisor. Most financial advisors prefer individual preferred stocks, but there are preferred stock mutual funds and exchange-traded funds such as Salient Select Income Fund (ticker: KIFAX) and Invesco Preferred ETF (PGX). Here are seven tips to know when buying preferred stocks.


**Preferred stocks are a hybrid.**

Preferred stocks are a hybrid between common stocks and bonds. These stocks are for investors who can't stomach the volatility of common equity, but have enough risk appetite that they want to get additional yield, Barnes says. The dividend is often stated

as a percentage of the stock's par value. Preferred stock dividends are usually higher than the common stock dividend, but the par value generally won't change even if the common equity price does. "If an investor has the stomach for say, high-yield bonds or emerging market debt, a preferred stock might make a nice diversifier in there as well," he says.




**Pay attention if the stock is callable.**

Craig Bolanos, CEO of Wealth Management Group, says investors should check if the stock is callable, meaning the issuer can "call in" or redeem the stock at a certain price at a certain date. Experts say look at the date when the company can start to redeem the stock and if they will offer any call premium – the dollar amount over the stock's par value. A company may perform a call-in for preferred shares if they realize they can offer lower dividends. "People really need to take that into consideration when

purchasing any preferred stock that has a call provision, because you'd hate to have your favorite preferred stock called away from you," he says.


**Consider cumulative preferred stocks.**

If a preferred stock is designated as a cumulative stock, it means if the company ever stops paying its dividends, preferred shareholders will receive catch-up payments on all missed dividends before it starts repaying dividends to common shareholders, Bolanos says. Companies that omit the dividend on a cumulative preferred stock are considered in arrears and that should be noted in the financial statements. Noncumulative preferred stocks don't have this option. "Cumulative preferred stock is a very conservative way to access preferred stock. I don't want to call it protected, but in essence, you're kind of protected," he says.


## Check to see if shares are convertible.

A convertible preferred stock pays the holder dividends, but shares can be converted into common stock of the issuing company at a future date and price, Bolanos says. That can be attractive to people who think the company may grow. Bolanos says it can be a lower-risk play into a growth company as the holders are higher in the capital structure, meaning they will be paid back before common stockholders if things go bad. "But if things turn out to go really well, then I have my preferred turned into a nice equity play," he says. But that's not a straight income investment, it's more about total return – dividends plus share appreciation, he adds.


## Watch the company's credit profile.

Because of preferred stock's hybrid status, a company's credit rating takes on heightened importance, says Damon Southward, chief market strategist at Briefing.com. He looks at a company's coverage ratio, which is the income the firm generates above its fixed-interest payments. He prefers coverage ratios at two times income overpayments. Southward also looks for companies with a market share that's at least 10 times the outstanding preferred shares. That lets a company issue a secondary offering of common stock if they're going through a rough patch – bringing in extra cash so it doesn't have to suspend its dividends. He also looks at ratings from credit agencies like Moody's (MCO) and Standard & Poor's.


## Compare yields properly.

For comparing yields, Southward looks at companies in the same industry to understand what's standard in the sector; he also looks at the U.S. 10-year Treasury's yield for an overall baseline. Companies with higher credit ratings generate lower yields, while companies with lower credit ratings offer higher yields. The energy sector, he says, offers some of the best preferred stocks with high dividends. These firms pay higher dividends to attract investors who shied away after the crude oil market collapse a few years ago. "Energy companies have cleaned up their balance sheets and generally aren't overspending their cash flow," he says. "It's very different from where things were a few years ago."


**Keep an eye on the common stock.**

Preferred stockholders should watch the common stock for clues on a company's health and as an early warning sign to sell if needed. Pay closer attention if a company's common stock moves significantly, even if the preferred issues don't budge, Southward says. Those could be underlying signs of trouble, he says. He also likes to own firms that issue common dividends and see how the company treats those payments if they're struggling. "If a company is cutting its common share distribution, that's a meaningful sign of trouble," he says. "And if they have suspended or eliminated it, then I'm completely out of the preferred stock."


## Consider these tips on preferred stocks.

- Preferred stocks are a hybrid.
- Pay attention if the stock is callable.
- Consider cumulative preferred stocks.
- Check to see if shares are convertible.
- Watch the company's credit profile.
- Compare yields properly.
- Keep an eye on the common stock.