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Preferred-stock investments paying off

By Andrew Leckey

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Preferred stock represents an upper notch in the investor pecking order and receives the most notoriety when economic times turn bad.

A preferred stockholder has priority over holders of common stock in dividend payments, as well as in the distribution of assets if a firm is liquidated in bankruptcy. Even if a company stops paying a preferred dividend for a time, it must repay all the money it would have sent to preferred shareholders before it can again pay a dividend to common shareholders.

The stock-bond hybrid that commits a company to pay a set amount of interest has trading characteristics more like a bond than a common stock. As a result, it usually has greater price stability but typically has less upside. Because its guaranteed dividends are higher than those of common stocks or bonds, it attracts income investors.

Last fall, Warren Buffett put preferred shares back in the headlines when he bought preferred stock worth \$5 billion in Goldman Sachs Group Inc. and \$3 billion in General Electric Co., each featuring a 10 percent dividend yield.

"It's no big surprise that Warren Buffett chose to buy the preferred shares, which sent the message that dividends matter," said Kenneth Winans, president of the Winans International money-management firm in Novato, Calif., and author of the book "Preferreds: Wall Street's Best-Kept Income Secret."

Although generally more stable than common stocks, preferred stocks often are thinly traded and can experience the short-term volatility inherent with any type of stock that has a small market.

Preferreds come in different types, including some that give the right to convert into common stock at a prearranged price. Although preferred stock suits investor emphasis on capital preservation, it does not match bonds in all respects.

"An investor must first understand that while preferred stockholders are ahead of the common stockholders, they are behind bondholders," said Tim Anderson, chief fixed-income strategist with Riverfront Investment Group in Richmond, Va.

Among exchange-traded funds that hold preferred shares, PowerShares Financial Preferred ETF has a portfolio consisting of half U.S. banks and insurance companies and half foreign banks and insurance companies, Burns said. Meanwhile, iShares S&P U.S. Preferred Stock Index is three-quarters financial stocks, he said. Both of those ETFs are down by more than half over the past year.

"We think the common stocks of the banks will get wiped out, but the preferred stock will be kept whole," said Scott Burns, director of exchange-traded-fund analysis for Morningstar Inc. in Chicago. He said a market-basket ETF approach removes worry about making one bad bet.

Because bank balance sheets are what Anderson calls a "black hole," this is a difficult time to pick a winning preferred bank stock.

For example, Bank of America's preferred stock recently was lowered to below investment level by Fitch Ratings Service. BofA has \$100 billion in preferred stock, equal to more than \$5 billion in annual costs, which means a "potential" for the bank to skip or defer dividend payments, Fitch said.

"If there's a BofA investor choice between common stock, knowing it will probably have a few more cycles of dividend cuts, or stepping into preferred shares, I'd purchase the preferred," said Winans, who recommends that preferred stock be used in moderation in personal portfolios. "And if BofA ever went into bankruptcy, the preferred shareholder is in a better position to get something over the common shareholder."

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