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**CRITICAL INVESTING**

## Investors Rediscovering Preferred Shares

By IAN SALISBURY  
A DOW JONES NEWSWIRES COLUMN



NEW YORK -- Investors are rediscovering preferred shares, lured by eye-popping dividend yields.

These complex securities are often described as a hybrid between stocks and bonds and are largely issued by banks and other financial services firms. They offer the prospect of annual payouts amounting to 6%, 7% or even more at a time when investment-grade bonds typically yield about 5%.

They also are both risky and complicated, with unusual features that require extra homework.

What to consider: Preferred shares' attractive yields come at a price: The payouts are typically fixed at the time of issue, so unlike with common stock dividends, investors can't count on the issuer ever raising them. A key question is whether preferreds are "cumulative," that is, whether suspended dividends accumulate until they are paid out. Another is what kind of tax treatment preferred dividends are eligible for, since some are "qualified," taxed at a maximum of 15%, at least until Washington decides otherwise.

Like bonds, preferred-share issues carry credit ratings from agencies like Moody's Investors Service. They may also be callable and mature on a specific date. But preferred investors don't stand as high as bondholders do on the credit ladder, so if an issuer fails, they might receive pennies on the dollar or nothing at all. Fears of just such failures sent trading prices for many preferreds plunging deep below their typical \$25 par value during the financial crisis. Values have bounced back but investors shouldn't overlook the risks.

### Our Survey


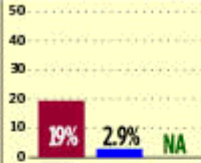
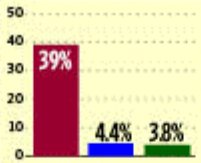
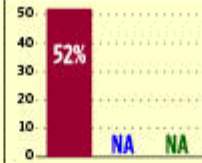
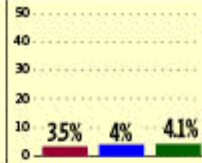
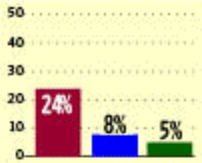
We asked three professional investors who are familiar with preferreds to examine five potential holdings picked to showcase the broad range of choices available to investors.

Among them: a closed-end fund from Flaherty & Crumrine Inc., a company with a long preferred-investing track record, and a newer index-tracking exchange-traded fund from iShares.

There were also three individual securities. Since banks' preferred shares represent about three-fifths of the \$365 billion preferred market we picked two. But one, Royal Bank of Scotland Group PLC's (RBS, RBS.LN) Series T shares, whose dividend was suspended earlier this year, seems to offer far greater risks and potential rewards than J.P. Morgan Chase & Co.'s (JPM) Series J, a tamer bet. Our final example, issued by Vornado Realty Trust (VNO), a real estate investment trust, represents one of the biggest groups of preferred-share issuers outside the financial services industry.



Our panelists: Daniel Forth, head of strategic indexing, Wells Fargo Securities; Robert Wasilewski, a financial adviser in Glenelg, Md.; and [Eric Weiss](#), a financial adviser in Miami.

 <b>CRITICAL INVESTING: PREFERRED SHARES</b>					
Investment (Symbol)	iShares S&P U.S. Preferred Stock Index Fund (PFF)	Flaherty & Crumrine/Claymore Preferred Securities Income Fund (FFC)	Royal Bank Of Scotland, 7.25% Non-Cumulative Dollar Preference Shares Series T (RBS.PRT)	JPMorgan Chase Capital X, 7% Capital Securities Series J (JPM.PRJ)	Vomado Realty Trust, 6.625% Series I Cumulative Redeemable Preferred Shares (VNO.PRI)
Inception Date/Initial Public Offering	2007	2003	2007	2002	2005
Trading Price (Premium/Discount)	\$39.55 (-0.4%)	\$16.87 (+3.79%)	\$16.80 (-33%)	\$25.38 (+1.5%)	\$24.61 (-1.6%)
Yield	7.2%	9%	N/A	6.9%	6.8%
Total Assets/IPO Size	\$5.6b	\$697m	\$1.45b	\$1b	\$175m
Call date	2012*	2022*	2012	2007	2010
Maturity Date	2048*	2051*	None	2032	None
Cumulative	50%*	69%*	No	Yes	Yes
Moody's Rating	~80% Investment Grade	~80% Investment Grade	B3	A2	Baa3
QDI Eligible **	50%*	27%*	Yes	No	No
Returns 1-Year 3-Year 5-Year					
Pros	Weiss sums up the case: "It's cheap. It's well diversified." The ETF's annual investment fee: 0.48%	"Leverage," or borrowed, money boosts the yield. Can hold institutional shares too illiquid for the ETF.	Big upside: Shares could rocket back to \$25 par value if RBS resumes dividend.	A big yield from a company that's seen as having relatively healthy credit.	A middling credit rating means more risk, possibly extra yield. Discount leaves room for appreciation
Cons	A drawback of diversification: Just half the ETF pay outs qualify for the 15% dividend tax rate.	Leverage cuts both ways, making this fund more volatile than the ETF. Its 2008 return: Negative 45%.	RBS, hit hard by the financial crisis, has suspended the dividend. Bulls hope to see it back soon. No Guarantees	Trading price above \$25 is not ideal. "We like to buy at \$2 or \$3 below par," says Wasilewski	This small issue could be hard to trade. "REIT and energy preferreds tend to be less liquid," says Forth.

Note: Returns and prices through 9/30 \*As reported by fund companies. Reflects average duration/maturity; proportion of portfolio that is cumulative/QDI eligible. \*\*Qualified Dividend Income is currently taxed at a maximum of 15%. The benefit may disappear or diminish soon, however, depending on action by Congress.

Source: Morningstar Inc./Issuers/QuantumOnline.com/FactSet

--(Ian Salisbury is a columnist who writes about personal finance; he covers topics including exchange-traded funds and separately managed accounts. He can be reached at 212-416-2241 or by email at [ian.salisbury@dowjones.com](mailto:ian.salisbury@dowjones.com).)

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