

Preferred Stocks Explained

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Summary

- This article is part one of a two-part series on preferred stocks hopefully answering most questions that people may have.
- This article includes topics like what is a preferred stock, what are term-preferred stocks, yield-to-call, cumulative versus non-cumulative preferred stocks, etc...
- Part two should be published sometime next week and will be a bit more advanced covering preferred taxation, stripped price/yield, fixed and floating rate preferreds, and more.
- This idea was discussed in more depth with members of my private investing community, High Dividend Opportunities.

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Preferred Stocks Explained (Part 1)

Produced with: HDO's preferred stock expert "Preferred Stock Trader"

The Difference Between Preferred Stock and Common Stock

Like common stocks, preferred stocks are considered to be equity. They're not considered debt – although they're like debt from the point of view of the common stockholder because they're higher in the capital structure than common stock. In other words, in a bankruptcy preferred stockholders have a higher claim to the assets of the company than do common stockholders. Theoretically, preferred stockholders should be made whole before common stockholders get anything, but in reality that isn't completely true. You may see situations where, for example, the preferred stockholders receive 80% of the money remaining after bondholders are paid while common stockholders get 20%. This is to help smooth the bankruptcy process. And preferred stockholders may get money despite bondholders, with a higher claim, also not being made completely whole.

Another difference is that only common stockholders get to vote on company issues while preferred stockholders have no voting power. There are certain circumstances where preferred stockholders might get a vote but that is a rare occurrence and not worth going into.

A third difference is that the prospectus of the preferred stock sets out what the dividend will be on a preferred stock, while the company is free to pay whatever dividend they choose to common stockholders. While common stock dividends can be lowered or even cut to zero, preferred dividends cannot be lowered. They are either paid in full or suspended completely.

If preferred dividends are suspended (cut to zero), common stockholders cannot receive any dividends until preferred stockholders are made completely whole for all missed dividends (if dividends are cumulative). But the company must continue to pay debt holders their interest payments or they will be forced into bankruptcy. The company can skip paying preferred dividend payments forever but can still operate outside of bankruptcy as long as they are paying their lenders and suppliers.

Cumulative Versus Non-Cumulative Preferred Stocks

If a preferred stock is "cumulative," all missed dividend payments during a dividend suspension period must be paid to preferred stockholders before any dividends can be paid to common stockholders.

One important point to make here is that when the company is ready to pay the back dividends that they missed during the suspension period, they're paid to whoever owns the preferred stock currently. Those who owned the preferred stock during suspension will get nothing if they do not still own the preferred stock.

If a dividend is suspended on a non-cumulative preferred stock, the company does not have to pay back any missed dividends. To be able to start offering common stock dividends again, all the company has to do is to start paying preferred stock dividends also. There's no reimbursement for any missed dividend payments.

Many people fear non-cumulative preferred stocks as some people believe that companies are more likely to suspend preferred dividends if they never have to pay back missed dividends. In my experience, this fear is way overblown, and whether payments are suspended on a preferred is almost 100% related to the company's ability to pay and not whether their preferred is cumulative or non-cumulative.

Companies that issue non-cumulative dividends don't do so because they plan to stiff their preferred stockholders at a future date. I don't know the law, but it seems that banks and insurance companies must (or have a strong regulatory incentive to) issue non-cumulative preferred stock.

And in my experience, non-cumulative preferreds are often of much higher quality and I have seen many more cumulative preferred stocks suspend their dividends than non-cumulative stocks. I also have seen many more companies with cumulative preferred stocks go bankrupt than with non-cumulative preferred stocks. So, personally, I pay very little attention to whether a preferred stock is cumulative or non-cumulative and much more attention to the balance sheet of a company and its operating performance. I suggest you also do the same.

Preferred Stocks Have No Maturity Date

Besides the fact that preferred stocks are lower than bonds in the capital structure of a company, and can have dividends suspended outside of bankruptcy, preferred stocks are also riskier than bonds because they have no maturity date. Whereas with a bond, you know that you will get par value returned to you at maturity, no matter what interest rates do, preferred stocks are perpetual and may never be redeemed/called. If we go into a very long cycle of higher interest rates, preferred stock prices can fall way below par and stay there for years or decades.

Term-Preferred Stocks and Preferred Stocks with a "Failure to Redeem Clause"

Term-preferred stocks are preferred stocks that have a redemption date. Preferred stocks with "failure to redeem clauses" also have a redemption date. And both of these forms of preferred stock tend to have cumulative dividends. Preferred redemption dates are similar to bond maturity dates but weaker in force. A company can still opt to not redeem these preferreds on the redemption date without going into bankruptcy. The penalty for not redeeming is generally a significant hike in the dividend they must pay each quarter after the redemption date is passed.

Despite the redemption not being absolutely obligatory, I don't know that I have ever seen a term preferred or preferred with a "failure to redeem" clause ever not be redeemed timely. Thus, I really favor these preferred stocks with redemption dates as they pretty much remove interest rate risk that traditional preferred stocks carry. Most preferred stocks do not offer redemption dates, but the ones that do should certainly be strongly considered for purchase if the company is reasonably solid and the yield is relatively competitive.

For preferred stocks with redemption dates, calculating yield-to-redemption is a very useful measure to see your expected return.

Yield-To-Call

With the exception of convertible preferred stocks and a few non-callable preferred stocks, preferred stocks generally have a call date (or often referred to as an optional redemption). On the call date, or any time after that, the company can opt to redeem the preferred stock at a price that's specified in the prospectus. Generally, the call price is the liquidation price and most preferred stocks have a \$25 liquidation value. However, there are some preferred stocks that have liquidation values other than \$25.

Some people confuse a call date with a redemption or maturity date. That's a big mistake. Whereas with a maturity or redemption date, the company has a strong motive to redeem the preferred stock or bond on its redemption date, but with a call date, the company will only call/redeem the preferred stock if they feel it is in their interest to do so, and a company can theoretically not call a preferred stock for decades.

Generally, preferred stocks are called if the yield on the preferred stock is relatively high in relation to the interest rate the company can now borrow at or relative to the yield on any new preferred stock they might decide to issue. Many companies will issue a new preferred stock at a lower yield than their current preferred stock and use the money they receive from selling the new preferred stock to redeem the older and higher-yielding preferred stock.

If your preferred stock is selling significantly above par, it's likely to be called, and therefore calculating the yield-to-call (YTC) is much more important than looking at the current yield to determine the return you can expect to make by buying or holding a preferred stock at its current price. YTC also is important to calculate when a stock is approaching its call date, even if it's not significantly over par, as it still may be a very likely call.

To determine the likelihood of a call, you can look at the current yield on the preferred stock to see if it's higher than the other preferred stocks that the same company has issued or whether it's higher than other preferred stocks issued by similar companies with similar risk or other preferred stocks with the same credit rating.

If your stock is selling below par, YTC is not useful. You may see some very high yield numbers if you calculate YTC for a preferred selling below par, but don't let that fool you. Since the company is under no obligation to call a preferred stock, it's unlikely that a company will call a preferred stock that is selling below par (although it does happen on rare occasions).

Many preferred stocks also have a clause that if there's a change of control at the company (generally the company is bought by another company), the company can opt to call the preferred stock before its call date. And sometimes the preferred stockholder may have the right to force the company to buy the preferred stock at par on a buyout. Some preferreds also offer an option to convert the preferred stock into some number of common shares on a buyout.

Stock Symbols by Broker

Unlike baby bonds and common stocks, where brokers all use the same symbols, each broker generally has its own format for preferred stock symbols. You should get to know how your broker creates preferred stock symbols if you don't know already. Here's a list of preferred stock symbols for a typical preferred stock from some major brokers – using the common stock symbol NLY and its series "G" preferred stock. Some brokers use more than one symbol, depending on which part of their site or trading platform you're using. Anyone investing in preferred stocks and baby bonds needs to be acquainted with and bookmark [QuantumOnline](#). They have a whole page dedicated to this [discussion](#) including a helpful chart to identify other variations of ticker symbols. Here are a few examples:

TD Ameritrade, HDO, QuantumOnline, IEX, Google Finance NLY-G

Merrill Lynch NLYPRG or NLY.PR

Interactive Brokers NLY PRG (note the space)

Fidelity NLYPRG or NLY/PG or NLY PRG

Etrade NLY.PR.G

Yahoo Finance NLY-PG

Seeking Alpha, Nasdaq NLY.PG

Schwab NLY/PRG or NLYpG

Preferred Stocks Explained - Part 2

In part 2, we plan to cover concepts like interest rate risk, credit risk, credit ratings, preferred stock taxation, stripped price/yield, buying preferred stocks over par, and the difference between fixed-rate preferred stocks and those that start out as fixed-rate but then have their dividend payments float or reset later on.

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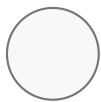
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