

Preferred Stocks Explained - Part 2

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Summary

- In Part 1, we covered the basics of preferred stocks. Now we get a little more advanced.
- In this article we cover the concepts of stripped price, stripped yield, and building on the concept of yield-to-call which we discussed in Part 1.
- Also, we look at the various types of preferred stocks.
- Last, we cover the risks in owning preferred stocks.
- This idea was discussed in more depth with members of my private investing community, High Dividend Opportunities.

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Produced with HDO's preferred stock expert "Preferred Stock Trader" and the HDO Team.

Introduction

This is the final part of a two-part article on preferred stocks. If you have come upon this article, we suggest that you first read [Preferred Stocks Explained - Part 1](#), so that you have a basic understanding of preferred stocks. In this article, we build on Part 1 with other important topics relating to preferred stocks.

How To Calculate Yield-To-Call and Current Yield

Yield-to-call (YTC) was discussed in Part 1, so we assume you have read that. In Part 2, we're going to discuss the concepts of "stripped price" and "stripped yield." These concepts are important in calculating current yield and yield-to-call. They adjust current yield and YTC based on where you are in the dividend payment cycle.

For example, you would certainly rather buy 8% yielding preferred stock "X" at \$25.50 the day before it goes ex-dividend 50 cents than pay \$25.50 for "X" the day after it goes ex-dividend. The "stripped price" adjusts for that. The "stripped price" is basically the current price of a preferred stock minus the accrued dividends. So in this example, on the day before "X" goes ex-dividend 50 cents, you have accrued 50 cents in dividends. Thus, if you buy "X" the day before it goes ex-dividend, the "stripped price" would be \$25.00 (\$25.50 less 50 cents in accrued dividends). If you pay \$25.50 the day after "X" goes ex-dividend, the stripped price will be \$25.50 since you have not accrued any dividends yet towards the next dividend which is three months away. But the current yield you see from Yahoo Finance or your broker will not take into account accrued dividends and so is not completely accurate.

In this example, "X" pays 50 cents every three months. Thus, if 1.5 months have passed since the last time it went ex-dividend, the accrued dividends would be 25 cents or half of a quarter's dividend. Thus, if the current price is \$25.50, the "stripped price" will be \$25.25.

The reason that understanding "stripped price" is important is that "stripped price" should be used when calculating YTC or current yield. Here's a [yield-to-call calculator](#) you can use. But when you enter the current price into this calculator, you need to enter the current "stripped price" if you want to get the most accurate result.

"Stripped price" is very important when calculating YTC when the call date is near. Let's say you have a call date that is 1 month away on "X." If you buy it at \$25.50 the day before it goes ex-dividend 50 cents, your effective price or "stripped price" is \$25.00. Thus, your YTC is 8%, the same as the current yield at \$25.00. But if you pay \$25.50 the day after it goes ex-dividend, your stripped price is \$25.50. If it can be called in one month, you will only accrue 17 cents of dividends during that month and will have a negative YTC. You will lose 33 cents per share if "X" is called on its call date. So if you don't use stripped price when doing this calculation, you can get completely distorted results. That is, if you entered \$25.50 into the YTC calculator the day before the ex-dividend date, it would tell you that your YTC is negative when actually it is 8% - obviously a huge difference.

"Stripped Current Yield" or "Stripped YTC" is simply the yield or YTC using the "stripped price" to do your calculation rather than the current price. Your broker will not give you "stripped current yield" but only current yield without adjusting for accrued dividends.

Types of Preferred Stocks

1. Fixed-Rate Preferred Stocks

As it sounds, a fixed-rate preferred stock always will pay the same dividend amount every year. The current yield may vary as the price of the preferred stock moves up or down from par, but the size of the dividend will never change unless dividends are suspended. Fixed-rate preferred stocks do not provide interest rate protection since the dividend will not adjust in a higher or lower interest rate environment.

2. Fixed-To-Floating Rate Preferred Stocks

These preferred stocks start out as fixed-rate preferred stocks, but on their call dates, if they're not called, their dividend payments become variable. After the call date has passed, the rate will generally be the current three-month LIBOR rate plus some floor rate. In the example of NYMTM ([NYMTM](#)), the rate will be set to the three-month LIBOR yield plus 6.429% if NYMTM is not called on 1/15/2025. This floating rate is set in the prospectus. Thus, once the call date has passed, the actual dividends paid out can rise and fall depending on changes in the three-month LIBOR rate.

Since LIBOR is going to go away, some new rate will be substituted for LIBOR, maybe SOFR. We have already seen a fixed-to-floating rate preferred ([OTCPK:NYMTL](#)) issued recently using SOFR instead of LIBOR.

Since LIBOR/SOFR are short-term rates that generally correlate to the Fed Funds rate, dividend payments on these preferred stocks will rise and fall with changes in LIBOR/SOFR. Thus, you do have protection against short-term hikes in interest rates, but because preferred stocks are perpetual (have no maturity date), they correlate more to long-term interest rates.

So if the 10-year Treasury bond rises significantly in yield, but the Fed keeps short-term interest unchanged, the protection against higher rates will not actually be realized.

3. Reset-Rate Preferred Stocks

In response to LIBOR's eventual disappearance, several reset-rate preferreds have been issued. The symbols for some of these are ARGO-A ([ARGO.PA](#)), SPNT-B ([SPNT.PB](#)), WCC-A ([WCC.PA](#)), and FTAI-C ([FTAI.PC](#)).

Reset-rate preferreds are similar to fixed-to-floating rate preferreds in that they offer a fixed rate until they reach their call dates. At that point, if the preferred stock is not called, the dividend is reset to the U.S. five-year Treasury note plus some floor interest rate. In the case of ARGO-A, if it is not called on 9/15/2025, the dividend will then be set to the yield of the five-year T-note plus 6.712%. After the call date, the dividend will only be reset every five years.

The reset rates on these types of preferred stocks have been very generous. These seem to provide better protection against higher interest rates than LIBOR fixed-to-floaters in that these preferreds have been issued with higher floors than the LIBOR fixed-to-floaters, and the five-year T-note interest rate is more set by the market than by the Fed. Historically and currently, the five-year note has a higher yield than LIBOR or SOFR.

4. Convertible Preferred Stocks

These preferred stocks are generally fixed-rate preferred stocks but allow the owner the option to convert their preferred shares into a certain number of the company's common shares. Thus, if the common stock goes up enough in price, it also will pull the price of the preferred stock higher. Convertible preferred stocks can generally move higher in price than traditional preferred stocks because they generally don't have a call date.

Although generally convertible preferred stocks do not have a call date, they do have a date after which the company can force convertible preferred stockholders to convert their shares to common shares. But this can only happen if the common shares rise to a particular price and a forced conversion will be profitable for those who purchased their convertible shares at par.

Convertible preferred stocks can get complicated, so we will not go into more detail here. But here is an [article](#) that does go into more detail.

5. Busted Convertible Preferred Stocks

These are convertible preferred stocks in which conversion to common stock is very unlikely due to the fact that the common stock price is nowhere near high enough to allow the company to force conversion. And the common stock price also is nowhere near high enough to induce owners of the convertible preferred to want to convert their shares to common stock. This makes them relatively simple.

These preferred shares can be very attractive because they have no call date and therefore there is no limit to how high they can go in price. Two of our favorite busted convertible preferred stocks are RLJ-A ([RLJ.PA](#)) and CEQP- ([CEQPPR](#)). We believe these are the best preferred stock values in their sectors (hotels and midstream energy). It seems that investors either don't know that these securities can't be called or don't appreciate the value of not having a call date.

Preferred Stock Risk

Preferred stocks carry four types of possible risks.

1. Credit Risk

Credit risk or operational risk is one kind of risk. This is no different than the risk you face when buying bonds or even common stocks. The risk here is that the company's business will start to do poorly which puts the company's ability to continue to pay preferred stock dividends at risk. Even if the company continues to pay the preferred dividends, fear of future dividend suspensions could cause the price of the preferred stock to drop – possibly dramatically.

Credit risk generally is more likely to hit:

- Companies that operate in cyclical or economically sensitive industries,
- Those companies that may be dependent on one product or one large customer,
- Technology companies where the product can become obsolete with the development of better technologies by their competitors, and,

- Probably most importantly, those companies with a lot of debt/leverage or companies whose cash flows are not currently covering the preferred stock dividend.

Companies with higher credit risk generally offer higher yields to compensate for this risk. On the other hand, preferred stocks from a company like Public Storage (PSA) offer very low yields because they have extremely little debt/leverage and operate in a very recession-resistant business.

2. Interest Rate Risk

Unlike credit risk, interest rate risk does not put your dividends in jeopardy. What's in jeopardy, if interest rates rise, is the price of your preferred stock. Because preferred stocks have no maturity dates, a higher interest rate environment can cause their prices to fall dramatically and stay low if interest rates do not fall back to their previously lower levels.

Interest rate risk applies much more to high quality (low credit risk) preferreds. Their yields tend to correlate with Treasury yields. If a PSA preferred stock generally trades at 2% above the 30-year bond yield, if the yield on the 30-year bond goes from 2% to 3%, then investors will now want a 5% yield on PSA preferred stocks rather than the current 4%. This will cause a PSA preferred with a \$1.00 per year dividend to fall in price from \$25.00 to \$20.00.

Companies with high yields due to credit risk are less affected by rises in Treasury rates. First of all, if the preferred stock is currently yielding 8%, a 1% rise would not affect the stock price as much in percentage terms as a 1% rise would to a 4% yielder. But additionally, a higher interest rate environment may well be caused by a very strong economy. A strong economy reduces operational risk for companies and therefore credit risk is reduced. Thus, investors might be happy with a 7.5% yield rather than the current 8% yield if the company is now perceived as safer. So high-yield preferred stocks may not be affected at all by a rise in rates depending on the reason for the interest rate rise.

We have seen this recently. Although long-term Treasury rates have risen from their post-COVID lows, high yield preferreds have gone way up in price due to much higher confidence in the economy and in the companies which have higher credit risk. So there has been a negative correlation between high yield preferred stock prices and bond prices.

3. Call Risk

Call risk is the risk that your preferred stock will be called at par (usually \$25). If your preferred stock is selling over par, you should always check your YTC to see if you are satisfied with the return you will get if your preferred stock is called. If the call date is nearing, or the call date has passed, then you must assess the risk of a loss on a call and consider the likelihood of whether that company will call the preferred stock.

Assessing whether a preferred stock will be called is too complex of a discussion to go into here, but if you see that there are other preferred stocks issued by the same company with lower yields than the one you own, or similar companies are issuing lower-yielding preferred stocks, then that should be a warning sign that a call may happen.

4. Buyout Risk

Buyout risk can take two forms. One is that the company buying out your company may be a weaker company with more credit risk. This could cause your preferred stock to fall in price. Unfortunately, there's no way to know in advance when this might happen.

The second form is when your preferred stock is selling way over par and the prospectus on your preferred stock allows the company to call your preferred shares at par on a "change of control." This will likely cause your preferred stock to drop to a price near par. Again, this situation is hard to predict, but you can look at the prospectus of your preferred stock and see what will happen to your preferred stock on a change of control. Also, old large-cap companies are less likely to be bought than smaller companies. For example, PSA is the largest company in its sector and has been around for decades. A buyout there is highly unlikely.

Quantumonline.com provides a link to the prospectus of each preferred stock in its database. That is the easiest way to find and read a preferred stock prospectus.

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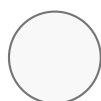
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