HOW MIGHT PREFERRED STOCK FIT IN A PORTFOLIO?

SENSITIVITY OF PREFERRED STOCK RETURN TO EQUITY-LIKE DEFAULT RISK IS MOST SIMILAR TO HIGH YIELD.

September 2020

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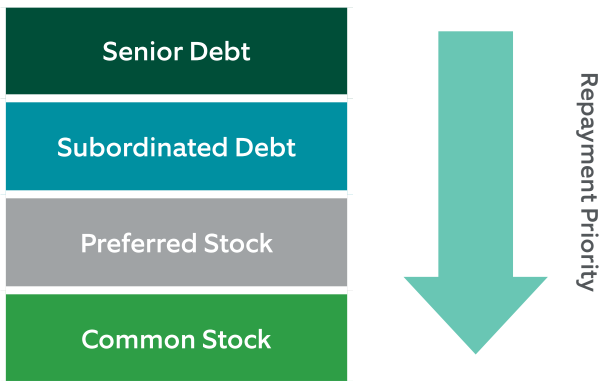
With low interest rates expected for the foreseeable future, some investors are seeking higher yields from assets other than traditional fixed income. Our 2018 research article Don't Undermine Diversification by Reaching for Yield warns investors to be careful when reaching for yield, as elevated credit risk can undermine the diversification benefits of high-grade bonds. This is why high-yield bonds are part of the risk-asset allocation. More recently, some wealth management investors have begun looking closer at niche securities like preferred stock, historically dominated by institutional investors.

Within a firm's capital structure, preferred stock is an intermediate position that is junior to bondholders but senior to common stockholders. Preferred stocks share many key characteristics with bonds. Like bonds, preferred stocks are issued with a fixed par value and pay a fixed or floating rate of income off the par value. If interest rates rise, the value of preferred shares falls.

But unlike a bond's coupon, a preferred stock's dividend can be deferred or omitted by company management in periods of stress. Preferred stock also has a deep subordination of claims to company assets in the event of bankruptcy (Exhibit 1). These features expose investors to material credit risk. Credit agencies commonly rate preferred stock a few notches below an issuer's senior debt.

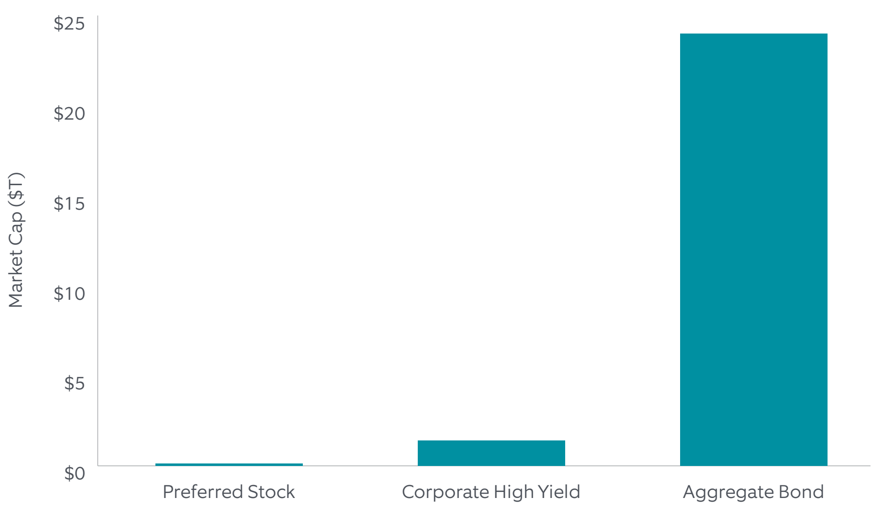
EXHIBIT 1 – CAPITAL STRUCTURE



Meanwhile, investors expect to earn a higher dividend from preferred stock than either common stock or the bond's coupon, particularly after tax. Corporations benefit from IRS rules on deducting dividends received and personal investors benefit from qualified dividend treatment of most (but not all) preferred stocks being taxed at the long-term capital gains rate.

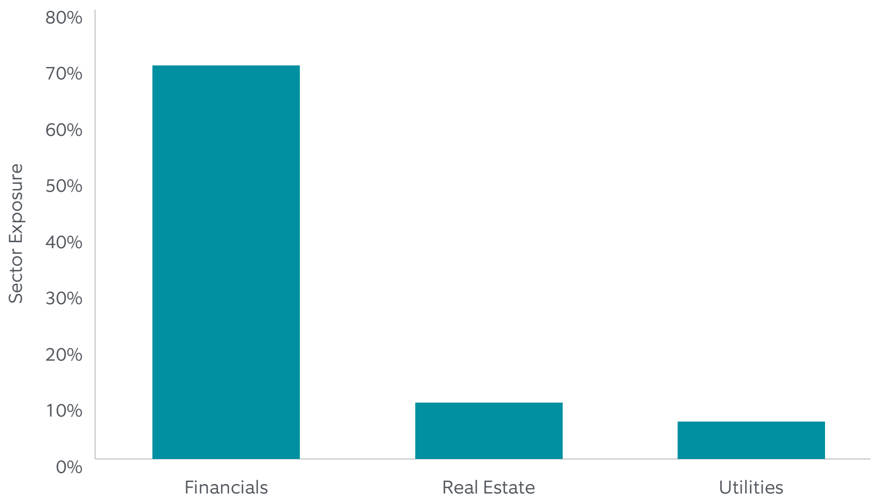
Despite bond-like attributes, preferred stock is not part of common fixed income benchmarks like the Bloomberg Barclays Aggregate Bond Index or Corporate High Yield Index and the market value of exchange-traded U.S. preferred stocks is relatively minimal (Exhibit 2).

EXHIBIT 2 – MARKET VALUES



Given the payment optionality of preferred stock dividends, investors seek issuers with high-quality, stable business models and transparent cash flows. More recently, this has manifested in sector concentrations within regulated institutions like banks, REITs, and utilities (Exhibit 3).

EXHIBIT 3 – SECTOR CONCENTRATION



Corporate balance sheets benefit from credit agency and regulator treatment of preferred stock. Since the Global Financial Crisis, in particular, the Federal Reserve has focused on leverage ratios in assessing capital adequacy and preferred stock is considered Tier 1 capital. Preferred stock also tends to be a cheaper source of capital than common stock.

The return behaviors of preferred stock are critical to understanding how the asset might fit within a total portfolio. We compare the S&P Preferred Stock Index to the Aggregate Bond Index and Corporate High Yield Index since common inception of September 2003 through June 2020 (Exhibit 4).

EXHIBIT 4 – RETURN AND RISK

Index	Return	Risk	Term Beta	Default Beta
Aggregate Bond	4.4%	3.2%	0.94	0.16
Corporate High Yield	7.2%	9.3%	1.00	1.00
Preferred Stock	5.1%	15.7%	1.53	1.05

The Aggregate Bond Index returned 4.4% (annualized) with a standard deviation of 3.2%. In comparison, the Corporate High Yield Index had a meaningfully higher return of 7.2% with an elevated standard deviation of 9.3%. Preferred Stock had a modestly higher return of 5.1% with a much higher standard deviation of 15.7%.

Term and default factors are well documented sources of return and risk in bond markets. Term represents maturity-related interest rate risk. Default represents equity-like default or credit risk. The Aggregate Bond Index has a much smaller default beta than the Corporate High Yield Index, as the Aggregate's return behaviors are largely driven by diversifying term risk. The difference in default betas largely explains the difference in standard deviations.

In comparison, the Preferred Stock Index has an elevated term beta due to its lack of fixed maturity. More importantly, it has a high default beta similar to high-yield bonds. Additionally, the majority of preferred stock risk is uncompensated, idiosyncratic risk. The high default beta and idiosyncratic risk together explain its high standard deviation.

Preferred stock shows high sensitivity to equity-like default risk, which makes the return behaviors more like high-yield bonds. For investors with continued desire to own preferred stock in a diversified portfolio, best practice would be to fulfill it as part of the high-yield allocation within risk assets.