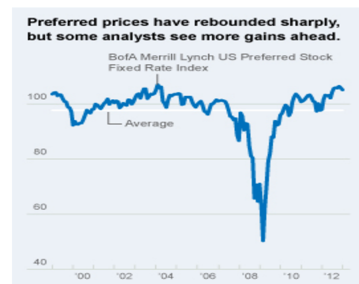
A preferred way to earn up to 7%

BY DAREN FONDA, FIDELITY INTERACTIVE CONTENT SERVICES — 01/08/13

Preferred stocks may be pricey, but some money managers see upside ahead.

Most stocks and bonds don't yield anywhere close to 5% in today's low-rate world.

But one corner of the market still beats that threshold: preferred stocks. And while the niche surged in 2012, some money managers see a bit more upside ahead. Preferred stocks, known as preferreds for short, typically pay dividends at a fixed rate that's usually higher than the yield on a company's common stock. Most are issued at $25 a share and trade around their "par" value. Moreover, preferred shareholders get paid before common stockholders, and some preferreds are "cumulative," meaning if a company misses a payment, it's still on the hook to pay the full amount later.



SOURCE: Fidelity Investments

But preferreds are sensitive to changes in interest rates, and they have other risks too. They're mainly issued by banks and other financial companies with less than top-notch credit ratings. And their dividends can be cut or suspended without warning. If the preferred is "non-cumulative," investors may never see a missed payment.

Like other risky assets, preferreds plunged during the financial crisis. The benchmark Bank of America Merrill Lynch U.S. Preferred Stock Fixed Rate Index fell to 50 cents on the dollar in March 2009, as big names in the index such as AIG, Lehman Brothers and Fannie Mae traded for pennies on the dollar.

Another drawback: Many preferreds can be "called," or redeemed by their issuers, after a few years. That can be a positive if the stock is trading under par. But if it's trading at a premium, investors may take a loss. The risk is especially high when interest rates are declining because companies often call in their preferreds to issue new securities at lower rates. Moreover, many banks are now phasing out some preferred stock to meet stricter capital requirements, a trend that could continue for some time.

Healthier balance sheets

While the market has risks, the companies backing preferreds are generally in stronger financial shape than they were four years ago, says Adam Kramer, a Fidelity Investments portfolio manager who covers preferred stocks in the Fidelity Strategic Dividend & Income Fund (FSDIX). The Merrill Lynch preferred index, yielding around 6.6% recently, is now more diversified among a broader set of financial companies, he points out, and many have stronger balance sheets, higher levels of capital and improving earnings.

"There's still risk in these names," he says, "but they've done remarkable things with their balance sheets. It's a dramatic difference from 2008."

Kramer doesn't think preferreds look as promising as they did a year ago. The market returned nearly 14% in 2012 and the Merrill Lynch index trades around 105 cents on the dollar — making another year of double-digit gains unlikely.

Still, Kramer maintains that preferreds look attractive compared to investment-grade bonds. Preferred coupon rates are generally higher, he says, and total returns this year could be in the low single digits.

Some advisers also use preferreds to diversify a portfolio. Preferreds aren't closely correlated to Treasurys or high-grade corporate bonds, according to Greg Zandlo, president of North East Asset Management in Minneapolis. If interest rates rise because the economy is improving, bonds could take a hit, notes Kramer. Yet preferreds may hold up better because banks' financial positions would likely be getting healthier and the higher coupons in preferreds would help offset declines in principal.

If you're considering investing, the first step is to see how preferreds fit with your other investments, says Zandlo. If you own lots of junk bonds or financial stocks, adding preferreds may be too risky. Zandlo generally recommends holding 10% to 15% of a total portfolio in preferreds and suggests investing over a period of weeks or months to lower your average cost in case the market takes a hit.

How to invest

Given the complexity of preferreds, most advisers recommend investing through an ETF or fund. These investments hold baskets of preferreds, providing automatic diversification, and they offer broad exposure to the market, says George Kiraly, an adviser with LodeStar Advisory Group in Short Hills, N.J.

One way to dip in is with a mutual fund that holds some preferreds along with other income-oriented investments.

Fidelity Strategic Dividend & Income Fund (FSDIX) takes that approach, investing around 20% of its assets in preferreds, along with dividend-paying common stocks, REITs and convertible bonds. While the preferred market looks a bit frothy, co-manager Kramer sees good opportunity now in "floating rate" preferreds, which should do well if interest rates start to rise. Overall, the fund beat the S&P 500 with an 11.8% annualized return over the last three years. Its yield is relatively low, however, at 2.5%.

Another top performer is Nuveen Preferred Securities Fund (NPSCX). It holds almost all its assets in preferreds and yields around 4.8%. Its 14% annualized return over the last three years beat 85% of flexible income funds, according to Lipper. One caveat: The fund's expense ratio is high at 1.85%. There's also a $75 transaction fee to buy shares on the Fidelity platform.

Another way to invest is through ETFs and closed-end funds that focus on preferreds. Closed-end funds, which hold baskets of securities and trade on the open market like a stock, tend to yield a bit more than mutual funds, but they're riskier since they often use leverage to boost returns. Their share prices usually trade at a discount or premium to the funds' net asset value, adding another element of complexity and volatility.

As always, the following picks are suggestions, based on our research and interviews with analysts and money managers. You should do your own research or consult an adviser before investing.

iShares S&P U.S. Preferred Stock Index Fund

- **Ticker: PFF**
- **30-day SEC yield:** 5.6%
- **Expense ratio:** 0.48%

For broad exposure to preferreds, Kiraly recommends the iShares S&P U.S. Preferred Stock Index Fund ETF (PFF), which tracks the S&P U.S. Preferred Stock Index. With $10.7 billion in assets, it's the largest preferred ETF on the market. It holds 267 preferreds, with none accounting for more than 3% of the fund.

One potential drawback: 85% of the fund's assets are in banks and other financial firms, including European companies such as HSBC (HBC) and ING Group (ING). Many large banks are now calling in their preferreds, which could pressure prices for the index, says Morningstar analyst Abby Woodham.

Market Vectors Preferred Securities ex Financials ETF

- **Ticker: PFXF**
- **30-day SEC yield:** 6.2%
- **Expense ratio:** 0.4%

This ETF avoids financials entirely. About a third of its assets are in preferreds issued by real-estate investment trusts; 24% of the fund is in utilities and 13% is in auto manufacturers, including 11.3% in General Motors (GM) preferreds alone. The upside of the ETF is that it yields a bit more. Changes in bank capital requirements aren't an issue for investors, and it's broadly diversified across industries.

The downside: Many non-financial preferreds trade at a premium, according to Fidelity fund manager Kramer. Moreover, the ETF's 11% position in GM preferred stock looks top-heavy, says Morningstar's Woodham. If GM's financial position weakens, it could drag down the ETF's returns. "A 10% position in one company is larger than what you'd see in some other funds," she says.

Nuveen Quality Preferred Income Fund 3

- **Ticker: JHP**
- **Distribution rate:** 7%
- **Expense ratio:** 1.86%

Nuveen Quality Preferred Fund (JHP) is a closed-end fund that holds 96% of its assets in preferreds, concentrated

mainly in insurance, commercial banks and other financial companies. The fund returned 21.9% last year, beating 76% of peers, according to Morningstar. About 80% of the fund is now invested in “quality” or investment-grade preferreds — though it can hold up to 20% in junk-rated preferreds — and lead manager Phil Jacoby has avoided bank preferreds that are susceptible to being called due to provisions stemming from the Dodd/Frank financial reform law.

The fund trades at a 4% discount to its net asset value, slightly steeper than its 3.3% average discount over the last three years, according to Morningstar. That’s a decent discount compared to other preferred closed-end funds, says Cecilia Gondor, chief investment officer of Thomas J. Herzfeld Advisors, an investment firm in Miami that specializes in closed-end funds.

One potential red flag: Several top holdings were issued by European financial firms such as Deutsche Bank (DB), Aegon (AEG) and ING Group. If Europe’s financial crisis flares up, these holdings could take a hit. Jacoby says these names are some of the “biggest and best capitalized” in Europe, however, and that financial positions have improved with new bank capital requirements.

John Hancock Premium Dividend Fund

- **Ticker: PDT**
- **Distribution rate:** 6.7%
- **Expense ratio:** 1.98%

Less of a preferred pure-play, this closed-end fund holds 66% of its assets in preferreds with the remainder in common shares. Nearly half the portfolio is in utilities, which hurt returns in 2012 as utilities trailed the market, leaving the fund with a 7.8% total return, according to Morningstar.

Longer term, however, the fund’s performance has been strong. Its 6.7% annualized return over the past five years, adjusted for risk, compared a 0.6% loss for the average preferred closed-end fund, according to Morningstar. The managers have a value-oriented style, producing strong and stable performance, notes Morningstar analyst Cara Esser. The fund recently traded at a 4% discount to its net asset value, in line with its average discount the last three years.

The downside: The fund’s expense ratio is high. And the fund is 34% leveraged, which could elevate losses in the event of a market downturn, says Gondor. If the utilities sector continues to underperform, moreover, the fund could fall behind.

Daren Fonda is Senior Writer and Investing Columnist with Fidelity Interactive Content Services. He does not own any of the securities mentioned in this article.

© 2008-2013 Fidelity Interactive Content Services LLC. All rights reserved.