Why Some Advisors Have a Preference for Preferred Stock

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Lance McGray of Advisors Asset Management and Brandon Opre of TrustTree Financial

A successful preferred investment involves getting two things right: the future of the underlying company and the future of interest rates.

Preferred stock may be a unique asset class, falling somewhere between common stock and bonds. But a number of advisors aren't holding its hybrid nature against it, especially with Federal Reserve rate cuts on the horizon.

Preferred shares are known for their reliable dividend payments, which result from their elevated positions in corporate capital structures. Put plainly, in the case of a company liquidation, preferred shareholders rank behind bondholders in order of payment, but are senior to common equity holders.

But a higher place in the creditor line is not all that preferred stockholders are entitled to. Preferred stock also pays a higher yield, currently in the range of 6 percent to 9 percent, a feature that offers pleasant protection should markets – both stock and bond – prove volatile, as they did in 2022.

"I think preferreds complement and help diversify from some of the stocks or bonds in a traditional portfolio," said Brandon Opre, financial advisor at TrustTree Financial. "We don't expect growth from them, but we do like the stability and yield they provide."

THE GOOD, THE BAD, THE PREFERRED

It's worth noting that there are some downsides to owning preferred shares that many advisors find off-putting, and not just their lack of voting rights.

First of all, banks make up a sizable percentage of the preferred market's issuers, so there could be overlap in a portfolio if a client is already overweight financials. Along those lines, second- or third-tier banks might not be the best credit risks right now following the demise of Silicon Valley Bank last year.

Furthermore, preferred securities can also be "called," which means that the issuer can buy out shareholders at par value, creating additional portfolio management headaches.

Finally, many advisors quibble with the tax treatment of preferred stock. Dividends on preferred shares are taxable income, but the tax rate you pay depends on whether the IRS considers the dividends to be qualified.

Rest easy on that last note, says Lance McGray, head of ETF product at Advisors Asset Management. In his view, the majority of the income that is distributed from these securities clears the qualified bar.

"That's really important because these distributions are taxed at a long-term capital gains rate instead of as ordinary income," McGray said.

McGray adds that the current market is ripe for preferred stock buyers not just because the amount of income that preferred shares generate, but also because of the discounts that can be found in the market as a result of the worries surrounding the banking sector.

"If you look at the preferred stock market right now coming out of the regional banking crisis, we have preferreds that are trading at 10 percent to 15 percent discounts from where they generally trade," he said. "This means you are getting a tremendous amount of income, but you're also getting the potential for capital appreciation, which would be very similar to a traditional equity portfolio."

McGray's firm introduced the AAM Low Duration Preferred and Income Securities ETF (PFLD) in late 2019. The PFLD, currently at $238 million in assets and yielding slightly above 7 percent, focuses on low-duration securities.

'PREFERRED' FOR SPECIAL SITUATIONS

Rick Wedell, chief investment officer at RFG Advisory, views preferred stock as a "relatively esoteric asset class" and says it's best employed in special situations and almost always in combination with other income-focused investments like high-yield bonds, leveraged loans and REITs.

"Preferred stock is what we call an asymmetric downside risk asset class," Wedell said. "Your upside is capped, your downside is potentially 100% of your investment. As a result, diversification is your friend, which is why we use preferred ETFs or mutual funds to get broad exposure to the space without single-name risk."

Similarly, David La Pointe, registered principal at La Pointe Wealth Advisors, part of LPL Financial, refers to preferreds as a "junk-bond hybrid," and only uses them as a contrarian play, and rarely for a full business cycle.

"They can be quite volatile and illiquid when the proverbial crud hits the oscillator. We consider them for our portfolios when times are tough and no one really wants them," La Pointe said.

Timing is also everything when it comes to preferreds for Richard Alt, CEO of Carnegie Investment Counsel. He says the ideal preferred stock is backed by a company with strengthening financials and heading into a period when interest rates are falling.

"A successful preferred investment is getting two decisions correct, the future of the underlying company and the future of interest rates," Alt said. "If you can get those two decisions right, you will have a nice stream of steady income for clients that need yield."

Similarly, Todd Stankiewicz, president of Sykon Capital, says variable-rate preferred stocks emerge as an appealing option in the current market landscape because they feature coupons that adjust in tandem with interest rates. Therefore, they offer reduced duration, or interest-rate sensitivity, compared to their fixed-rate counterparts.

"Once the FOMC does initiate a rate cutting cycle, fixed rate preferred stocks may offer a dual advantage in a declining rate environment: a potentially more consistent, fixed dividend yield that becomes increasingly attractive as alternative fixed-income yields decline, and the potential for capital appreciation as the market recalibrates the value of these higher-yielding assets upwards," Stankiewicz said.

Meanwhile, Janet Fox, president of ACH Investment Group, also part of LPL Financial, is more client-specific when it comes to this particular investment tool. She recommends preferred stocks to clients who are seeking higher dividends than are available from their common share counterparts. Fox is also particular about the type of preferreds she picks, especially callable securities and convertible issues that convert into common shares.

"Cumulative preferred stock are dividends that accumulate, and any missed dividend payments are paid out first to these shareholders if for any reason the dividend has been missed," said Fox. "Non-cumulative preferred stock dividends do not accumulate and therefore missed dividend payments are not paid to the shareholders."

All that said, there are some flat-out naysayers when it comes to preferreds, including Jonathan Swanburg, president of TSA Wealth Management, who would rather opt for common stock or senior debt if given the choice.

"There are certainly occasions where a preferred may be attractively priced, but as an asset class, they have all the risk of a 50-plus-year maturity bond with a BBB or below credit rating, and without the upside in the event rates drop or credit quality improves, since preferreds can generally be called," Swanburg said.