

Preferred Securities

Preferred securities combine elements of both stocks and bonds, and while holders of preferred securities are higher in the capital structure than common shareholders, they do not generally have the right to vote in a company's affairs. The main types of preferred securities are Traditional Preferred Stock, Trust Preferred Securities, Notes/Senior Notes and Adjustable Rate Preferreds.

PREFERRED STOCK

Originally, most preferred stock purchasers were corporations, which enjoy special tax advantages as they are allowed to exclude a percentage of preferred dividends from income. Recently, however, more individual investors have begun purchasing preferred stocks to earn the higher dividends paid compared to common stock, as well as to benefit from recent changes in federal tax laws.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 introduced a new category of qualified dividend income taxable at federal rates of 15% (or 5% for taxpayers in the two lowest tax brackets). These securities are often referred to as offering Qualified Dividend Income (QDI)*.

Preferred Stock Features

- Ranks senior to common stock, but junior to debt in a company's capital structure.
- Pays dividends at a stated rate, either as a percent of par value or a specific dollar amount.
- Preferred stock is perpetual, meaning it does not have a maturity date.
- Dividends are either cumulative (any dividends not paid accumulate and must be paid before

dividends are paid on common stock) or non-cumulative.

- Preferred stockholders do not typically have voting rights except under certain circumstances.
- Preferred shareholders do not have the same rights as debt holders and cannot initiate legal action against the issuer in case of a failure to pay (defer) dividends.
- Par value on preferreds is generally \$25.
- Preferreds feature a degree of price stability compared to common stock as a result of the fixed dividend payment.

Because these issues do have a fixed dividend, most feature a call date, which allows the issuer to retire the preferred shares when interest rates decline.

TRUST PREFERRED

In the early 1990's, financial institutions began to issue a variation of preferred stock that rapidly became popular with retail investors. Recognition that these securities all share common features led to a generic label to cover them all: Trust Preferred Securities (TruPS).

These securities have been attractive to income-oriented investors, while also creating a cost-efficient source of capital for issuers. An important advantage for the issuer is that periodic payments on Trust Preferreds are tax deductible, just like interest payments on debt securities.

Trust Preferreds are considered subordinated junior debentures, senior to common and preferred stock in payment priority, but behind other debt. Trust Preferreds are not bonds; they fall between a stock



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Preferred Securities, continued

and a bond in terms of right to payment. In other words, interest on bonds must be paid before the interest is paid to Trust Preferred holders, which must be paid before dividends are paid to common stockholders. To the individual investor, they are attractive because they offer higher coupon rates, since the issuer can pass on cost savings to investors. Trust Preferreds do not qualify for the Dividends Received Deduction (DRD), which is a dividend exclusion feature available to corporate investors, or QDI for individual investors.

The Dodd-Frank Wall Street Reform and Consumer Protection Act passed in 2010 eliminated the inclusion of trust preferreds from Tier 1 capital for banks with total assets greater than \$15 billion. The Tier 1 treatment will begin to be phased out in 2013, and will be phased out by the end of 2018. As a result, banks could call their hybrid and Trust Preferreds at some point during that time-frame.

Trust Preferred Features

- Usually issued in \$25 face amounts and typically pay a fixed coupon rate. Ranks senior to common stock, but junior to debt in a company's capital structure.
- Trust Preferreds are issued in maturities of 30 to 60 years. Some give the issuer the right to extend or shorten the maturity, although this could not occur during any payment deferral period.
- Usually offer 5-year call protection when first issued.
- They pay quarterly and are generally cumulative. Most include a provision which would allow the issuer to defer payments for up to 10 years (only after payments are suspended on common stock and preferred stock).

- Investors should review an issuer's credit quality, giving more weight to the deferral option for lower-rated companies. If the issuer uses the deferral option, the investor is responsible for the taxes on interest earned but not received. Later, if the issuing company pays all of the deferred interest, the security holder would not owe any additional taxes on the deferred payments received.
- Most Trust Preferreds feature a "special event" redemption option. This feature allows the issuer to redeem the securities at par plus accrued interest in the event of a tax law change, which would prohibit deductibility of the interest payments.
- They are easily bought and sold since they are traditionally listed on the major stock exchanges.

NOTES/SENIOR NOTES

Some issuers prefer to issue \$25 par Notes or Senior Notes which pay quarterly interest and rank above Trust Preferreds. These issues would rank equally with their bond counterparts in the capital structure.

ADJUSTABLE RATE PREFERRED

This preferred structure pays a variable rate dividend, usually on a quarterly basis. The dividend rate tracks the movement of a defined Treasury security benchmark or LIBOR. Adjustable rate preferred stock was designed to minimize price fluctuations in response to changes in interest rates. Adjustable rate preferreds are issued as traditional preferred stock or as Trust Preferred securities.

** Currently in effect until 12/31/2012.*

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