

Preferred stock:

Not really preferred or stock

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Preferred stocks' regular dividend payments can provide attractive income over time. However, they are very sensitive to changes in interest rates and more volatile than other fixed-income investments.

In addition, their value depends primarily on the company's ability to pay preferred dividends over time. As a result, most preferred stocks are considered aggressive-income investments and may not be appropriate for your portfolio. Instead, we recommend quality individual bonds or bond funds that offer a better balance between risks and benefits.

What is preferred stock?

Preferred stock is an equity security that has characteristics of bonds and common stocks.

Preferred stock is similar to bonds in that it generally provides regular, fixed payments to its shareholders and typically has a credit rating like a bond. The equity characteristic of preferred stock is its regular, fixed payment in the form of a dividend and not an interest payment, like with a traditional bond. Also, its claim on company assets is subordinate to all company debt.

We would generally consider preferred stock to be a fixed-income investment. Its value is affected primarily by changes in interest rates and the credit outlook of the company but without the upside appreciation potential of common stock.

Potential benefits of preferred stock

Attractive yield

The income provided by preferred stocks can be attractive and is likely the biggest draw for investors. While the dividends preferred stocks generate are attractive for investors seeking income, the yield for preferreds is generally higher because of the potentially greater risk.

Tax considerations

Preferred stock typically pays qualified dividends as opposed to interest payments. This means preferred stock may be eligible for the 20%

maximum tax on qualified dividend income. (Trust-preferred securities are excluded from this. See the sidebar on Page 4 for more information.) This may be a benefit over interest income, which is taxable at the investor's income tax rate.

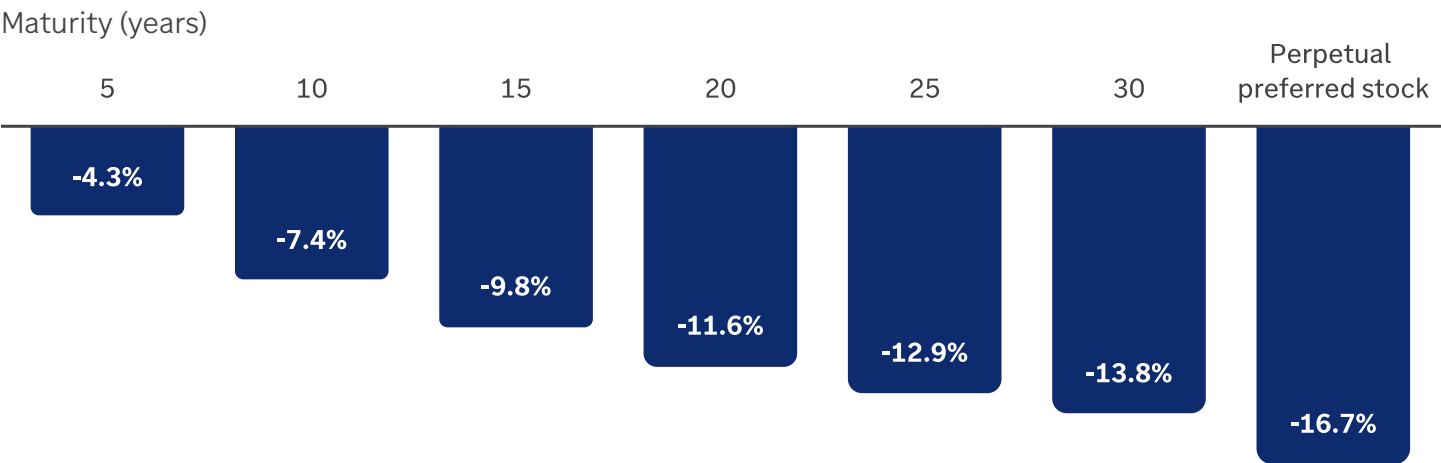
Also, preferred stock issued after 1942 is eligible for the 70% dividend received deduction (DRD) for C corporations. While individuals cannot take advantage of the DRD, this is a benefit for certain corporations. Please see a tax professional for specific tax considerations for preferred stock.

Potential negatives of preferred stock

- **Very sensitive to interest rates** — Bond prices generally decline when interest rates rise and then rise when interest rates fall. Similarly, preferred stock prices decline when interest rates rise and vice versa. Perpetual preferred stock prices tend to decline more than long-term bond prices of the same issuer because they don't mature.

For example: If all interest rates rise by 1%, the price of a 10-year bond yielding 5% will decline about 7.4%. The price of a perpetual preferred stock that yields 5% will decline approximately 16.7%. The lack of a specified maturity for the repayment of the principal amount makes preferred shares more sensitive to changes in interest rates.

Price decline for a 1% rise in interest rates for a 5% coupon bond or preferred stock



Source: Edward Jones calculations. This example is for illustration only and does not represent any currently available investments.



Potential negatives of preferred stock (*continued*)

- **No maturity date** — The vast majority of preferred stocks are perpetual and, therefore, lack a maturity date. This is significant because if interest rates rise, the value of preferred stocks and bonds would decline.

However, as the bond approaches maturity, the price begins to move toward par value, but the preferred stock does not move, because it lacks a maturity date. This could leave preferred stocks trading below par value if interest rates rise and remain elevated, with no opportunity to recover a decline in principal.
- **Noncumulative dividends** — Some preferred stocks have a noncumulative dividend. This means that if the issuer were to temporarily suspend its dividends, the missed dividend payments would not be made up in the future.

The combination of a noncumulative feature and a perpetual maturity means an issuer could stop making dividend payments and the preferred stock would never mature, so investors would lose most or all of their investment.
- **Deep subordination** — Subordination refers to the order of priorities in claims for ownership in a company. Preferred stock ranks lower than all other forms of investment except for common stock. In a bankruptcy, preferred stock shareholders would be very low on the priority list of claims and would likely lose much, if not all, of their investment.

Preferred stock = higher risks

Preferred stock is not stock in the traditional sense, in that it doesn't generally participate in the upside as a company's earnings grow. Also, preferred stock is not really preferred at all: It is subordinate to all other company issues except common stock.

So, if it's not preferred, and it's not really stock, then what is it? It's basically the least senior form of debt financing for a company, with some potential tax benefits to owners.

While we acknowledge the potential income preferred stocks generate for investors, in most cases, we believe the increased risk is greater than the increased income these investments produce.

At Edward Jones, we discourage owning individual bonds that are rated below investment grade. With the majority of preferred stocks rated below investment grade, we believe most are likely not appropriate for your portfolio.

Alternative investment ideas

We generally believe investors seeking income should look toward highly rated individual bonds or bond funds. These investments offer higher-quality income and do not have the negative impact of being deeply subordinated. Investors who are interested in potential price appreciation and some current income should consider rising-income stocks.

Many preferred stocks can be classified as aggressive income. Edward Jones generally recommends investors seeking aggressive income consider high-yield bond funds or exchange-traded funds (ETFs), with no more than 10% of a portfolio allocated to aggressive income, depending on your portfolio objective. If you're above this threshold, talk with your financial advisor about whether reducing your aggressive-income exposure may be appropriate for your portfolio.

Trust-preferred securities

Trust-preferred securities combine some of the characteristics of corporate bonds and traditional preferred stocks. They are also referred to as fixed-rate capital securities or by their "brand" names (TOPrS, QUICS, MIPS, etc.).

These securities usually:

- Pay regular, fixed dividends
- Have a stated maturity date
- Possess a \$25 par value

Most trust-preferred securities allow the issuer to defer dividends for up to five years, after it first suspends all common and preferred stock dividends. Should the issuer defer dividends, investors will still pay income taxes on the deferred income as it accrues.

Edward Jones believes there are better alternatives for investors seeking regular income. Due to the risk of dividend suspension, these securities should be considered aggressive-income investments.