Preferred Shares: An income investment you may have overlooked

Investors seeking income often limit their selection to bonds and give little or no consideration to preferred shares. They usually ignore preferreds simply because they don't know much about them.

Perhaps the easiest way to think of preferred shares is that they are shares which behave like a bond. A preferred share represents an ownership interest in a corporation, just as common stock does. But it also produces a reliable stream of income -- in the form of a pre-set dividend -- very much like the interest paid on a bond. The price of a preferred moves with interest rates, like a bond's price. When interest rates rise, the price of the preferred falls, and when rates fall, the price rises.

The same independent services that rate bonds, namely, Canadian Bond Rating Service Inc. and Dominion Bond Rating Service Inc., rate many preferred issues -- from highest quality (P-1 or PFD-1) to speculative (P-5 or PFD-5). And, like bonds, most preferred shares can be "called," or retired, by the issuer. In most cases, the call price is above the par value (price at which shares are originally issued).

Preferreds are well-suited to relatively conservative investors. They are also useful for more aggressive investors who want to balance a portfolio heavily weighted towards growth stocks. The income from preferreds can boost the current yield on shares of companies that usually reinvest their earnings in their fast-growing businesses rather than pay dividends.

Preferred shares offer the following attractions:

- <u>High Yield</u> Preferred shares typically yield one to three percentage points more in dividends than common stock issued by the same company. Since dividends are paid quarterly, many investors purchase three or more preferred issues with different payment dates to assure themselves a monthly dividend cheque.

- <u>Liquidity</u> Many preferred issues are listed on the major stock exchanges, making them easy to buy and sell. Most preferred shares are issued at par values of $25, putting them well within the reach of individual investors. Older issues trade above or below their par value depending on interest rates and other market conditions.

- <u>Safety</u> Preferred shares rank senior to common shares -- that is, preferred shareholders' claims for dividends and corporate assets (in the event the company is liquidated) come before common shareholders' claims. If a company runs into serious financial problems, the board of directors may vote to reduce or skip the preferred dividend without placing the company in default. But most preferred stock is "cumulative," so missed dividends accumulate and must be paid to preferred shareholders before any dividends are paid to common shareholders. (Keep in mind, though, that preferred stock is junior to all the company's debt. Bond interest payments take priority over preferred dividends and bondholders would get paid off first if the company were dissolved.)

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The dividend on some preferred issues can be increased by the board if the company does especially well and the common stock dividend rises to a certain level. Such issues are called "participating" preferreds and usually command a premium price. Most preferreds are "non-participating"; their dividends never change, regardless of how high the common stock dividends rise.

Retractable preferreds have a fixed term which means the investor has the right to sell the shares back to the issuing corporation at a certain price on predetermined dates. The investor is, therefore, guaranteed a selling price. These shares are most attractive to investors who require a steady income and are concerned about the preservation of capital.

Convertible preferred shares offer income-oriented investors a chance at capital appreciation, too. These are preferred shares that can be exchanged for a specified number of common shares. The trade-off is that prices of convertible preferreds typically fluctuate more than those of non-convertible issues. They are probably not for investors who value a relatively stable share price.

One major advantage of investing in preferred shares is the dividend tax credit which eases the tax burden on dividend income. Essentially, all dividends collected on Canadian companies are eligible for this tax credit.

With this in mind, quite often preferred issues are an excellent alternative for producing income as compared to other interest-bearing investments which are fully taxed.

If you think preferred shares may have a place in your portfolio, check with your ScotiaMcLeod advisor. Because of all the variables associated with these securities, expert advice is essential to choose both the right type of preferred share and the right issue.

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