Financial Decision Partners
Financial Planning & Investment Management

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Preferred Stock: A Hybrid Investment

With interest rates on government bonds and highly rated corporate bonds barely keeping up with inflation, investors are searching far and wide for better returns. One alternative is preferred stock.

Preferred stock is often called a stock-bond hybrid. While technically an equity investment, shares of preferred stock pay a dividend, usually on a quarterly basis. The yields typically range from 4% to 8%, but some issues generate 10% or more.

Preferred stock generally does not have the same volatility as common stock -- shares usually have a par value of $25 (although some shares have a par value of $50 or $100) and can trade for a premium or a discount. They have low correlations with both common stock and bond returns. Preferred stocks do not have maturities. They remain in the market until they are called by the issuer, usually with only 30 days' notice.

Understanding Preferred Stock

Preferred stock can be bought just like common stock, but it has many variables. You can get key information on the type of preferred stock being issued by reading its prospectus, which will tell you the following:

- **Cumulative vs. noncumulative --** Most preferred issues are cumulative, which means that the dividends will accrue even if they are not paid each quarter.
- **Convertible vs. nonconvertible --** Convertible preferred stock can be exchanged for common stock, usually after a set date at a certain price. This allows the shareholder to lock in the dividend income and potentially profit from a rise in the common stock while seeking protection from a fall.
- **Voting vs. nonvoting --** Shares of preferred stock may or may not give the owners voting rights. Most do not, but in some cases, preferred shareholders will receive voting rights if dividends have not been paid for a stipulated length of time.
- **Participating vs. nonparticipating --** Participating shares may receive additional dividends. These can be based on a stipulated percentage of either the net income or the dividend paid to the common stockholders.
- **Adjustable vs. fixed --** Most preferred stock is fixed rate. In the case of adjustable rate, shareholders receive a dividend that differs based on any number of factors stipulated by the company at the issue's initial offering.

Risks of Preferred Stock

Investors in preferred stock face a number of risks.

- **Default risk --** In the event of a bankruptcy, preferred stockholders are paid before common stockholders, but after creditors and bondholders.
- **Interest rate risk --** If interest rates decline, the issuer may decide to buy back the existing preferred shares in order to issue new ones at a lower rate. If rates go up, the holder of the preferred shares might be left holding a security that pays less than the market rate for many years or in perpetuity, effectively reducing the value of the holding.

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- **Lack of price appreciation --** Unlike common shares, which might appreciate as company earnings rise, any company growth has minimal effect on the preferred share price. However, if the company goes into a tailspin, that preferred stock dividend could be threatened, hurting its share price.
- **Early callbacks --** Companies that issue preferred stock hold a call option, which allows them to redeem the securities at face value after a certain period, usually five years. Doing so can deprive investors holding those shares of additional years of guaranteed income they thought they'd locked in, not to mention any price appreciation on the shares, which issuers could buy back at par value.
- **Liquidity risk --** Some preferred stocks are not widely followed and are lightly traded. Those stocks can be risky because the lack of trading volume makes it difficult to move in or out of a position at a reasonable price.

Seeking Income? Consider Dividend-Paying Stocks

As continued uncertainty at home and abroad roils the financial markets, income-minded investors seeking protection from the bumpy road ahead may find that dividend-paying stocks offer an attractive mix of features and warrant a place in their equity portfolios.

The appeal is simple: Dividend-paying stocks can provide investors with tangible returns on a regular basis regardless of market conditions. Note that dividends can be increased, decreased, and/or eliminated at any time without prior notice.

The Potential Benefits of Dividend-Paying Stocks

If you own stock in a company that has announced it will be issuing a dividend, or if you are proactively considering adding an allocation to dividend-paying stocks, history provides compelling evidence of the potential long-term benefits of dividends and their reinvestment.

- **A sign of corporate financial health.** Dividend payouts are often seen as a sign of a company's financial health and management's confidence in future cash flow. Dividends also communicate a positive message to investors who perceive a long-term dividend as a sign of corporate maturity and strength.
- **A key driver of total return.** There are several factors that may contribute to the superior total return of dividend-paying stocks over the long term. One of them is dividend reinvestment. The longer the period in which dividends are reinvested, the greater the spread between price return and dividend reinvested total return.
- **Potentially stronger returns, lower volatility.** Dividends may help to mitigate portfolio losses when stock prices decline, and over long time horizons, stocks with a history of increasing their dividend each year have also produced higher returns with considerably less risk than non-dividend-paying stocks. Since 1990, the S&P 500 Dividend Aristocrats -- those stocks within the S&P 500 that have increased their dividends each year for at least 25 consecutive years -- produced annualized returns of 11.29% vs. 8.55% for the S&P 500 overall, with less volatility (13.91% vs. 15.04%, respectively).[1]

If you are considering adding dividend-paying stocks to your investment mix, keep the following thoughts in mind.

- **Dividend-paying stocks may help diversify an income-generating portfolio.** Income-oriented investors may want to diversify potential sources of income within their portfolios. Given current realities present in the bond market, stocks with above-average dividend yields may compare favorably with bonds and may act as a buffer should conditions turn negative within the bond market.

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- **Dividends benefit from continued favorable tax treatment.** The American Taxpayer Relief Act extended the Bush-era tax cuts, which are capped at a maximum of 15% on qualifying dividends for most taxpayers. The rate rises to 20% for those who earn over $450,000.

Please note that past dividends are not a guarantee of future dividends. Stock markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Different parts of the market can react differently to these developments. The value of an individual security or particular type of security can be more volatile than, and can perform differently from, the market as a whole.
The information in this communication is not intended to be tax advice and should not be treated as such. Each individual's tax situation is different. You should contact your financial or tax professional to discuss your personal situation.

Source/Disclaimer:
[1]Source: Standard & Poor's. Volatility is measured by standard deviation. Past performance is no guarantee of future results. Indexes are unmanaged, statistical composites, and investors cannot invest directly in any index. The returns shown do not reflect payment of any sales charges or fees an investor would pay to purchase the securities they represent. The imposition of these fees and charges would cause the actual performance to be lower than the performance shown.

Why You Need a Health Care Proxy

You may someday face a sudden health crisis due to an accident or serious illness that leaves you unable to make your own medical decisions. Fortunately, there is a means to address this potential future concern -- it's called a health care proxy.

A health care proxy allows you to legally designate someone -- a proxy -- to make medical decisions for you. Keep in mind that in some states you may even be able to combine a health care proxy and living will into a single document.

Hospitals and nursing homes are required to ask about the existence of any advance directive when you are admitted. In most states, a health care proxy does not take effect until you can no longer make medical decisions for yourself; until then, only you can legally consent to any treatment. In addition, you can always change or cancel the document as long as you are mentally alert. If you decide to make changes to any of these documents, be sure to do so in writing.

Know the Potential Drawbacks
Though it is a legal document, a health care proxy cannot handle every medical situation. Here are some key points to consider before you designate a proxy.

- **Some caregivers could override your document.** Most states permit a doctor or health care facility to reject any advance directive for reasons of conscience. In these cases, the doctor or facility must tell you or your health care proxy about this when you are admitted to care and must offer to help transfer you to another party or facility that will comply with your wishes or the health care proxy.
- **The advance directive may not be followed by emergency medical services (EMS).** If EMS is summoned to treat you in case of a life-threatening situation, they are usually required to resuscitate and stabilize you until you reach the hospital, regardless of an existing advance directive.

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- **Know state laws.** Though all states accept health care proxies as legal, each varies considerably in what is required of these documents. Also, if a health care proxy is written to your state's specification but you undergo medical treatment when visiting another state, the rules regulating health care proxies in the state in which treatment takes place will usually prevail.
- **Do not use a health care proxy unless you fully trust the person you have named.** If you don't have a health care proxy, many states will appoint a person to make medical decisions on your behalf. Usually, this person is your closest relative, whose values may or may not coincide with your intentions.

The information in this communication is not intended to be legal advice and should not be treated as such. Each individual's situation is different. You should contact your legal professional to discuss your personal situation.

The Estate Planning Benefits of Life Insurance

Life insurance is typically a critical element of a family's estate plan -- it may enhance the amount of wealth you can bequeath to your heirs and provide a ready source of cash for post-death financial obligations. If the value of your estate exceeds the federal estate tax threshold (for 2013, this amount is $5.25 million), this source of liquidity may reduce the likelihood that your heirs will be forced to sell assets to pay estate taxes.

When you designate an individual as beneficiary, life insurance proceeds are paid directly to the beneficiary and are not subject to probate proceedings. The beneficiary has quick access to a source of funds that may be used for costs, such as lawyer's fees, associated with settling your estate. If the policy is payable to your estate instead, the proceeds are subject to probate the same as any other asset. Because the probate process for a complicated estate may take as long as a year, your heirs may have to wait longer before accessing the proceeds.

Proceeds from life insurance that are received by the beneficiaries upon the death of the insured are generally income tax free, except when:

- The insured has died within three years of transferring ownership.
- The proceeds of the policy are paid to the executor of the insured's estate.
- The insured owned or partially owned the policy.

Transferring Your Policy

Transferring ownership of a life insurance policy entails a trade-off between control and taxes. Once you transfer ownership to another person, you relinquish control of the policy. If, for example, the new owner cashes in the policy before your death, you have no recourse. Although the new owner is obligated to pay premiums that may be due following the transfer, you can periodically gift funds to be used as premium payments.

Another technique for transferring ownership is creating an irrevocable life insurance trust (ILIT) that holds the policy. A trust enables you to stipulate that the policy be kept in effect for as long as you live. You designate a trustee who, upon your death, distributes the insurance proceeds to your heirs. An ILIT excludes life insurance proceeds from the estate of the first spouse to die and from the estate of the surviving spouse. The spouse may be the life insurance beneficiary, but may not have any right to or power over trust principal except per the discretion of the trustees.

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Business Value of Life Insurance

Many families also use life insurance proceeds as a tool for managing an estate that includes ownership of a business. For example, an entrepreneur may find himself in the situation of planning an estate in which his two adult children -- one who works in his business and one who does not -- are his heirs. Many entrepreneurs in this situation will bequeath the business to the son or daughter who works there and designate the other as beneficiary of a life insurance policy whose value equals that of the business.

Many business owners rely on life insurance proceeds as part of a business continuation agreement that enables business partners to acquire the ownership interest of a deceased owner's heirs. In this instance, the surviving owners use insurance proceeds to purchase the interest of heirs who have no intention of managing the business.

Estate and insurance planning are complex areas that require assistance from experienced professionals.

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