INVESTOR'S BUSINESS DAILY

Mutual Funds & Personal Finance

Preferred Stocks Hit By Credit Crunch

BY JESSE EMSPAK
INVESTOR'S BUSINESS DAILY

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The market for preferred stock has grown sharply in the past 15 years. But some money managers doubt the market can keep up that growth.

Preferreds are yet another victim, those managers say, of the overall market's current credit crunch. They also are being hurt by uncertainty about how long it may take the Federal Reserve to trim interest rates.

Investors are growing more skittish about preferreds because of fallout from the boom in leveraged buyouts in recent years.

With companies having taken on so much debt to finance takeovers, investors now wonder about the ability of those companies to keep paying debts like dividends on their preferred shares and bond interest.

Until recently, preferreds grew at a sprint. The value of all preferreds was only $50 billion in 1992. The total market capitalization of preferreds zoomed to $214 billion through the end of June 2007, according to Standard & Poor's.

Preferred shares are issued to investors as equity. One drawback is that their voting rights are generally weaker than ordinary shares. They are less liquid than common stock. But they make up for that by paying dividends that are steadier than ordinary shares' dividends. It is harder for a business to cut the payout on its preferreds.

Preferred stock doesn't count toward a firm's debt-to-equity ratio.

Some preferreds also are convertible to ordinary shares.

Ken Winans, president of Winans International, an investment management and research firm, says daily prices of preferreds started to dip toward their 200-day moving averages in late 2006 for the first time in years, in part because of bond market turmoil. That downturn got worse in recent weeks.

Investors give up some price appreciation for steady income with preferreds. So any dip in price takes a big bite out of its total return.

Fixed-Income Favorites

Preferred stock tends to show up in fixed-income funds. Principal's Preferred Security Institutional Fund has one of the larger allocations of any fund: $641 million, or 63.82% of assets as of July 30.

The fund lost 4.10% year to date, going into Wednesday. It returned 6.9% in 2006.

One of its biggest holdings is Deutsche Bank Contingent Capital Trust, which made up 2.27% of assets as of June 30. It has been on a steady slide since July 23, when it closed at 24.60. It now trades at about 23, where it yields 7.01%.

Lord Abbett Bond-Debenture holds $247.6 million of its $4.6 billion in preferreds.

The fund lost 2.8% over the past three months. Its year-to-date gain was 2.44%.

Winans' firm publishes its International Preferred Stock Index, which shows a steady rise from 1981 into 2005. Then price changes grew more erratic.

In 2006 the index fell to its 200-day average. In April 2007 it dipped below it.

Standard & Poor's preferred index has been basically flat since Dec. 31.

Usually, the index returns a yearly average of 6% to 7%, S&P analyst Srikant Dash says.

But in the past few years returns got more volatile. Many of the same companies that used preferreds to raise cheap capital became highly leveraged, Winans says. Preferred dividends usually can't be cut like ordinary dividends, only deferred.

So if earnings don't rise faster than the amount owed, any company that delayed dividends on its preferred faces a growing obligation. There's no upswing of companies in arrears yet, but the growing debt many companies have could mean trouble down the road.

John Miller, lead manager of $40 million Nuveen Preferred Securities says price changes in the past few weeks are due to investors seeking issuers with better credit.

The big impact will be on whether corporations can sell new preferred stock issues. Firms will have to offer bigger dividends on anything that goes out, relative to the share price.

Miller has moved to higher quality preferreds and shorter duration fixed-income securities to cut income risk. He doesn't see a crisis yet.

Winans says when looking at preferreds, two key metrics are the action of the common stock in conjunction with a firm's bonds.

If both are advancing, its preferreds tend to be a better buy.

Motorola's Corporate Backed Treasury Certificates are one of Winans' holdings. It's more appealing to him than many preferreds now because of its stability, he says.

Motorola (MOT) common stock is off 20% so far this year. But its preferred shares are down just 1%. Its yield is 8%.

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