# Saturday, November 15, 2008

## Gentlemen Prefer Bonds

Stocks and bonds are the instruments of equity and debt, both of which represent claims against a company's assets. The truth of the matter, however, is that common stocks are at the bottom of the food chain with respect to those claims. Further, it has been said that *"the value of a stock is a function of its capacity and propensity to return cash to its owner" - [Josh Peters, The Ultimate Dividend Playbook]*. Well guess what, boys and girls? 99% of stocks have done a lousy job of performing that function.

Notwithstanding any market rallies that occur subsequent to this post, stocks [as measured by the S&P 500] have been essentially flat for the last 10 years. Their paltry 1% dividends have done little to mitigate that dismal performance. Bonds, on the other hand [by the way, the bond market is nearly 3 times the size of the stock market] continue to deliver consistent predictable returns day in and day out. Another fact propping up the bond vs. stock argument is that bondholders are two steps ahead of common stocks when it comes to distribution of assets in bankruptcy or other liquidation.

Now having made somewhat of a case for the preference of bonds over stocks, there is even a better option in todays markets. That option is Preferred Stocks. I would have titled this post "Gentlemen Prefer Preferreds" but it wouldn't sound as sexy. Anyway, preferred stocks are essentially a hybrid product of stocks and bonds.

While there are some variations, preferred stocks are usually issued at a par value of $25.00 and typically have a call date of 5 years. The call date represents the date that the issuing company can exercise an option to call in or buy back the preferred stock at stated par value. When issued, a fixed dividend is declared and will remain in place until the stock is repurchased by the issuing company. For the most part, these dividends qualify for the 15% dividend tax rate compared to interest which is taxed as ordinary income. And the main reason they are called *Preferred* is that the dividend payments and claims against assets come in front of those given to Common stock.

Now here's the best part. The recent stock market slide has depressed the market prices of Preferred issues as well. All of those initial coupon rates of 4% - 5% when issued are now yielding 8% - 10% and more for investment grade Preferreds. Besides the handsome dividend payments, there is also the prospect of future capital gains as they begin to ascend back to their par values of $25.00, which would boost total returns well into double digits.

So if you believe that in fact markets will eventually recover during your lifetime, why not get paid an excellent return while you wait?