A "Preferred" Yield for Trusts? Balancing the Beneficiaries' Needs

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Stuck choosing between riskier stocks or safer bonds which provide little income in today's market environment? Have you considered an allocation to Preferred securities for your trust portfolio?

Trustees are like financial physicians in a way. They follow the rule of *first do no harm*. No harm to the principal, that is. The issue: How does one maintain and grow assets for the remainder beneficiary while at the same time provide a sufficient income stream to the income beneficiary?

Traditionally, a 3% to 5% distribution of income to the current beneficiary while preserving the trust for the remainder beneficiary was not particularly hard to do with a 70/30 stock-bond mix. In today's low interest rate market, neither investment grade bonds nor common stocks are offering an average 3% to 5% yield which many income beneficiaries were used to receiving. As of the third quarter of 2016, the average yield for single A rated 10 year corporate bonds is 2.75% and the S&P 500 is about 2.15% (Source: Bloomberg). This leaves trustees searching for a way to find more income.

Generally, dividend stocks offer income and more growth potential, but at a higher risk than bonds. Investment grade bonds are generally considered safer, but have limited growth potential. If trustees attempt to chase yield with riskier investments, they may be harming the remainder beneficiaries.

So choosing how trust assets are invested to meet the needs of both the income and remainder beneficiaries can seem like a never-ending balancing act.

Hence, the idea of considering a hybrid investment such as Preferred securities, which generally provide higher yields than investment grade bonds and have less volatility than common stocks. In August, the average yield on Preferred securities was 4.08% (Source: BofA Merrill Lynch).

Preferred securities carry more risk than most bonds but less risk than common stocks. In general, higher yields are associated with lower quality issuers. In order for Preferred securities to provide you with higher yields, they tend to have lower credit ratings than bonds from the same issuer. However, this does not necessarily mean that all Preferred securities suffer from poor credit quality. Trustees can find investment grade rated Preferred securities, which have better credit quality than "high yield" bonds. Additionally, many Preferred securities are issued by financial companies and banks, which are highly regulated.

Like bonds, many Preferred securities offer steady and reliable income through fixed distributions. These distributions can be deferred, but the Preferred shareholder will receive a dividend before a common stockholder whose dividend is not guaranteed. During bankruptcy, a Preferred shareholder is often in line for payment after the bondholder but before the common stockholder.

Some Preferred securities offer preferential tax treatment and may save beneficiaries some money when their tax bill arrives. Like common stocks, certain Preferred securities are taxed at a qualified dividend rate, which may be between 15% - 20%. Often, this is lower than the ordinary income tax rate on bonds.

Even with Preferred securities in the mix of investments, there is still a chance that the trustee may not be able to meet the demands of both the income and remainder beneficiaries.

Fortunately, trustees have another tool which has been blessed by the Florida statutes. The Florida Principal and Income Act is an aide for trustees to balance the needs of the income and remainder beneficiaries. It provides trustees direction to invest the trust for total return and blurs the lines as to what is considered income and principal. Florida law provides trustees with two options. They can elect the unitrust conversion which is an annual payout set between 3% and 5%. Or, they can exercise the power to adjust and allocate funds between income and principal.

The above is a glance at some of the characteristics of Preferred securities. They come in many forms with different levels of opportunity and risk, residing somewhere between stocks and bonds.

Due to the various types of Preferred securities available, it is important to discuss with an advisor whether an allocation to Preferred securities is appropriate for your trust.

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