# Hybrid securities

*Fixed-income investments designed with equity features*

**Hybrid securities are also known as:**

- Fixed rate capital securities
- Preferreds
- $25 pars
- Senior notes/baby bonds
- Sub debt
- Trust preferreds (TRUPS)
- Enhanced trust preferreds (ETRUPS)
- Junior sub debt
- Preferred stock

*Hybrid securities are fixed income securities with attributes of equity and debt, typically ranking junior to other forms of debt and senior to common stock. They are investment vehicles with potential benefits for both income-oriented investors and issuers.*

In recent years, investors have used the term "preferred security" as a blanket term to describe any security that most commonly trades with a $25 par value (also trades in a $20, $50, or $100 par value), pays a fixed dividend or interest payment, and is exchange listed. But technically, preferred securities are a subset of hybrids. Due to market convention, the term preferreds and hybrids encompass anything from $25 par senior debt down to traditional preferred stock. Senior debt would NOT be considered hybrid capital or preferred, but market convention has been to call these $25 par preferred securities.

Like corporate bonds, hybrid/preferred securities have a stated maturity date and are senior to the common stock of the issuing corporation. Most preferred securities are issued with a $25 par value and are listed on one of the major securities exchanges. This piece will summarize the basics of $25 par "hybrid securities," their potential benefits to investors, the types of securities issued, the risk factors, and the tax implications.

## Types of hybrid securities

Hybrid securities encompass a variety of structures available to investors. This list should help you identify the basics of each of these types of issues, their features, and distribution schedules. The security types are listed in liquidation preference.

### $25 par senior notes

- Ranked equal to other senior debt.
- Non-deferrable interest payments. Non-payment of interest is default, therefore cumulative or non-cumulative is irrelevant.
- Non-callable generally for 5 or 10 years.
- Interest payments are fully taxable for the investor and tax deductible for the issuer.
- Typically a 30 or 40 year maturity.
- Recorded as debt on the issuer's balance sheet.

## At a glance

- **Par:** $25, $50, $100, and also $20
- **Listing:** NYSE, AMEX, or NASDAQ
- **Income:** Interest payments or dividends must be paid out before dividends to common stock holders.
- **Coupon rate:** Fixed for life, floating for life, or fixed to floating
- **Maturities:** 10 yr, 30 yr, 40 yr, 49 yr, 60 yr, 70 yr, or perpetual
- **Call:** Generally 5 or 10 years at par
- **Pays:** Quarterly or monthly
- **Voting rights:** None
- **Cumulative dividends:** If a company fails to make a dividend distribution to preferred shareholders with a cumulative dividend, they will be required to pay the deferred dividends in full before any other distributions can be made to common shareholders.
- **Non-cumulative dividends:** If a company chooses to omit the preferred dividend, they are under no obligation to make up the missed dividends prior to paying the common dividend. However, the issuer is still forced to stop dividends to common stock holders if they omit the preferred stock dividend.

### Trust preferreds

- A form of subordinated debt ranked junior to senior debt.
- Deferrable interest payments. Typically for a period of 5 to 10 years. Deferred interest accumulates. Investors may be responsible for a tax liability on payments deferred.
- Non-callable generally for 5 or 10 years.
- Interest payments are fully taxable for the investor and tax deductible for the issuer.
- Typically a 30 year maturity.
- Recorded as debt on the issuer's balance sheet but counts toward regulatory capital (Tier 1 capital) by the Federal Reserve and issuer receives some capital treatment by the ratings agencies.
- Originally issued by domestic banks but typically are no longer issued. Enhanced trust preferreds have taken their place.

### Enhanced trust preferreds, junior sub notes, etc

- Deeply subordinated in the capital structure but senior to "traditional" preferreds and equity.
- Deferrable interest payments. Typically for a period of 5 to 10 years. Deferred interest accumulates (cumulative).
- Non-callable generally for 5 or 10 years.
- Interest payments are fully taxable for the investor and tax deductible for the issuer.
- Maturities typically ranging from 40 to 60 years.
- Recorded as debt on the issuer's balance sheet but counts toward regulatory capital by the Federal Reserve and other governmental agencies. The issuer receives some capital treatment by the ratings agencies.
- Issued by domestic banks (Tier 1 capital), insurance companies, and utilities (all regulated entities).

### Preferreds, preference shares, and depositary shares

- Ranked only above common shares in the capital structure
- Deferrable dividend payments. Typically not cumulative. Dividends can be deferred indefinitely.
- Non-callable generally for 5 or 10 years.
- Dividend payments are typically taxed at a reduced rate for individuals (QDI benefit for payments through December 31, 2010) and C-Corporations (DRD benefit for ongoing payments).
- Perpetual maturity.
- Recorded as equity on the issuer's balance sheet. Issuers received greater equity credit from regulatory bodies, banks, and rating agencies.
- Issued by banks (in the US considered unrestricted Tier 1 capital), utilities, and REITs.

# The basics of hybrid securities

### Why do corporations issue junior sub notes, enhanced trust preferreds?

Unlike common and "traditional" preferred stock dividends, the distributions made on enhanced trust preferreds and junior sub notes are tax-deductible for the issuer and are considered interest payments. (Remember that distributions are fully taxable for the investor.) Because of the deeply subordinated nature of these securities and the deferral feature, rating agencies have taken a positive view of this financial tool for the issuer and given them some equity credit for these securities. However, as with preferred stock, such deferrals can only occur if the parent company stops all other stock dividend payments.

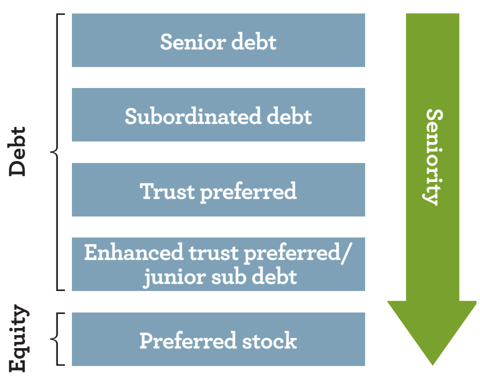
### Why do corporations issue preferred stock?

Companies issue preferred stock in order to strengthen their balance sheets and improve their debt to equity ratio. Preferred stock is recorded as equity on an issuer's balance sheet although investors typically view preferred stock as a form of debt. Preferred securities are typically given more "equity" credit by the rating agencies and regulatory bodies than Junior Sub Notes or Enhanced Trust Preferreds. Even though preferred stock is recorded as equity on an issuer's balance sheet, the issuance of preferred stock does not dilute the ownership interest of the common shareholders. Distributions made on preferred stock are fully taxable for the issuer, but taxed at a reduced rate for the investor (QDI for individuals on payments through December 31, 2010 & DRD for C-Corporations for ongoing payments).

### Who buys preferred securities?

Preferred securities are designed to offer current income, so they appeal to income-oriented investors. These securities also appeal to institutional investors such as money managers and corporations.

## Hybrid securities in order of liquidation preference




# Potential benefits

- **Competitive yields.** As distributions from hybrid securities are typically deferrable and most have maturities greater than 30 years, hybrids typically pay higher yields than traditional debt securities.
- **Stable income payments.** Hybrid securities offer a regular source of income generally paying coupons quarterly or monthly. This helps investors plan for income needs. An issuer can defer payments under certain circumstances. See deferral risks under risk factors.
- **Low minimum investment.** Most hybrids are issued with a $25 par value, offering investors a fairly low-cost way to purchase a fixed income security.
- **Liquidity.** The majority of preferred offerings are listed on a major stock exchange (NYSE, AMEX, NASDAQ) and have a large and active secondary market.
- **Correlation to other investments.** In 2009, most of the Hybrid/Preferred securities market has been highly correlated with equities. Historically, Hybrid/Preferred securities have had volatility and returns that have had low correlations with common stock returns. This can make them a good complement to a diversified portfolio.

## Risk Factors

Hybrid securities have certain risks in common with other fixed-income securities. These risks affect the market price of the securities, which in turn affects their yield. In general, investors demand higher yields to compensate for higher risks.

- **Interest-rate or market risk.** As with bonds, the prices of hybrids will move inversely with interest rates. When rates rise, prices fall; when rates fall, prices rise. If an investor has to sell a hybrid security before maturity, it may be worth more or less than its purchase price.
- **Credit risk.** Credit risk is the risk that an issuer will be unable to meet its obligations to investors because of financial difficulty within the company. Credit ratings by independent rating agencies help investors judge the credit risk. Issuers with lower credit ratings will tend to pay higher interest rates to compensate investors for the additional credit risk. Any change in an issuer's credit rating or in the marketplace's perception of an issuer's business outlook can have a profound impact on the value of any outstanding securities.
- **Deferral risk.** The issuer of a hybrid security can typically defer payment of distributions in case of financial difficulties. The company can defer income distributions only if the parent company stops all other stock dividend payments or any payments to securities junior to the hybrid. During the period of deferral of dated (with a maturity date) securities, the investor will incur a tax liability on the deferred income —which continues to accrue, typically at a stated rate, even though it is not actually paid. Investors can avoid this tax obligation by holding these securities in a tax-deferred retirement account. At the end of the deferral period, the issuer is required to pay all deferred distributions, if cumulative, before the company makes any payment on common stock.
- **Call or reinvestment risk.** Many preferred securities are issued with call features that allow the issuer to redeem or "call" the security at a stated date before maturity. Downward trends in interest rates make the issuer more likely to use the call feature (so as to issue new debt at lower interest rates). When this happens, investors may have to reinvest their principal at lower interest rates — reducing their income stream.
- **Distributions.** Distributions from hybrid securities are fully taxable for all investors. If an issuer suspends distributions, the investor is liable for income tax on those distributions that accrued — even though they were not being received — for a period typically up to 60 months. Distributions from preferred stock are typically taxed at a reduced rate for most investors. Individual investors receive "qualified dividend income" which is currently taxed at a maximum rate of 15%. Under the "dividend receives deduction" allowance, only 30% of distributions made from preferred stock and paid to C-Corporations are currently taxed at the company's ordinary income tax rate. The "dividend receives deduction" allowance does not apply to individuals. If an issuer suspends distributions, the investor is liable for income tax on those distributions that accrued — even though they were not being received — the length of the period could be indefinite, since preferred stock is perpetual.

- **Capital gains and losses.** If a preferred security is sold before the security is redeemed by the issuer, the investor may realize a capital gain or loss. Although a gain or loss on the sale of a security is generally considered to be capital, special rules apply to shares of securities purchased at "market discount" (for an amount less than the original-issue price plus accrued original issue discount). In such a case, a portion of any gain up to the amount of accrued market discount is taxed as ordinary income, unless the seller has elected to include accrued market discount in income on a current basis.

## Summary

Hybrid securities can be a valuable addition to your fixed-income portfolio. They typically provide higher yields, good liquidity, and accurate pricing. Your Wells Fargo Financial Advisor can help you determine whether these securities fit your investment objectives and risk tolerance and which types may best suit your investment needs. For more information on preferred securities and your portfolio, consult your Wells Fargo Financial Advisor today.

*Dividends are not guaranteed and are subject to change and elimination.*

*Wells Fargo Advisors is not a legal or tax advisor. However, its Financial Advisors will be glad to work with you, your accountant, tax advisor and or lawyer to help you meet your financial goals.*

*Under a "Sunset" provision, the changes to tax law under The Economic Growth and Tax Relief Reconciliation Act of 2001 are scheduled to expire on December 31, 2010, and do not apply for tax years after this date unless action is taken by Congress. Therefore it is important to confer with your tax advisor as to the potential impact of the sunset provision on your tax decision.*