Morgan Stanley

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An Investor's Guide to Preferred Securities

SUMMARY

Preferred securities combine features of both fixed income and equity investments and are commonly referred to as hybrids. They may appeal to suitable individual investors because they have historically offered relatively attractive yields and low investment minimums (par values).

Preferreds generally fit into three categories:

- *Senior notes* — Also known as "baby bonds," these debt securities are senior, unsecured obligations of the issuer and pay regular interest income. Senior notes rank equally in a corporation's capital structure with traditional, $1,000 par senior unsecured bonds.
- *Trust preferred, enhanced trust preferred and junior subordinated debt securities* — These subordinate debt instruments have fixed, long-term maturities (30 years, 60 years or perpetual) and pay monthly, quarterly or semiannual interest that can be deferred. Most of these preferreds, however, require that missed payments accumulate and be paid before any dividends are distributed to equity shareholders.
- *Perpetual preferred stock* — This is traditional preferred stock that represents a nonvoting equity position in a corporation. Issued in perpetuity, traditional preferreds pay quarterly dividends that may be deferred without any obligation that the issuer make up missed payments (noncumulative). Real estate investment trust (REIT) preferreds, a subset of this category, is an exception because their dividends are cumulative.

TABLE OF CONTENTS

What Are Preferred Securities?

Preferred securities are financial instruments that possess both equity and fixed income characteristics, so they are commonly referred to as hybrid securities. The term preferred refers to the securities' senior position to common equity in the corporate capital structure. Preferred owners have a priority claim over common shareholders, but not bondholders, with respect to dividends / interest and any distribution resulting from liquidation.

There are many types of preferreds and it is important that investors understand the various levels of subordination and where each ranks in the capital structure.

Traditional Preferred Stock

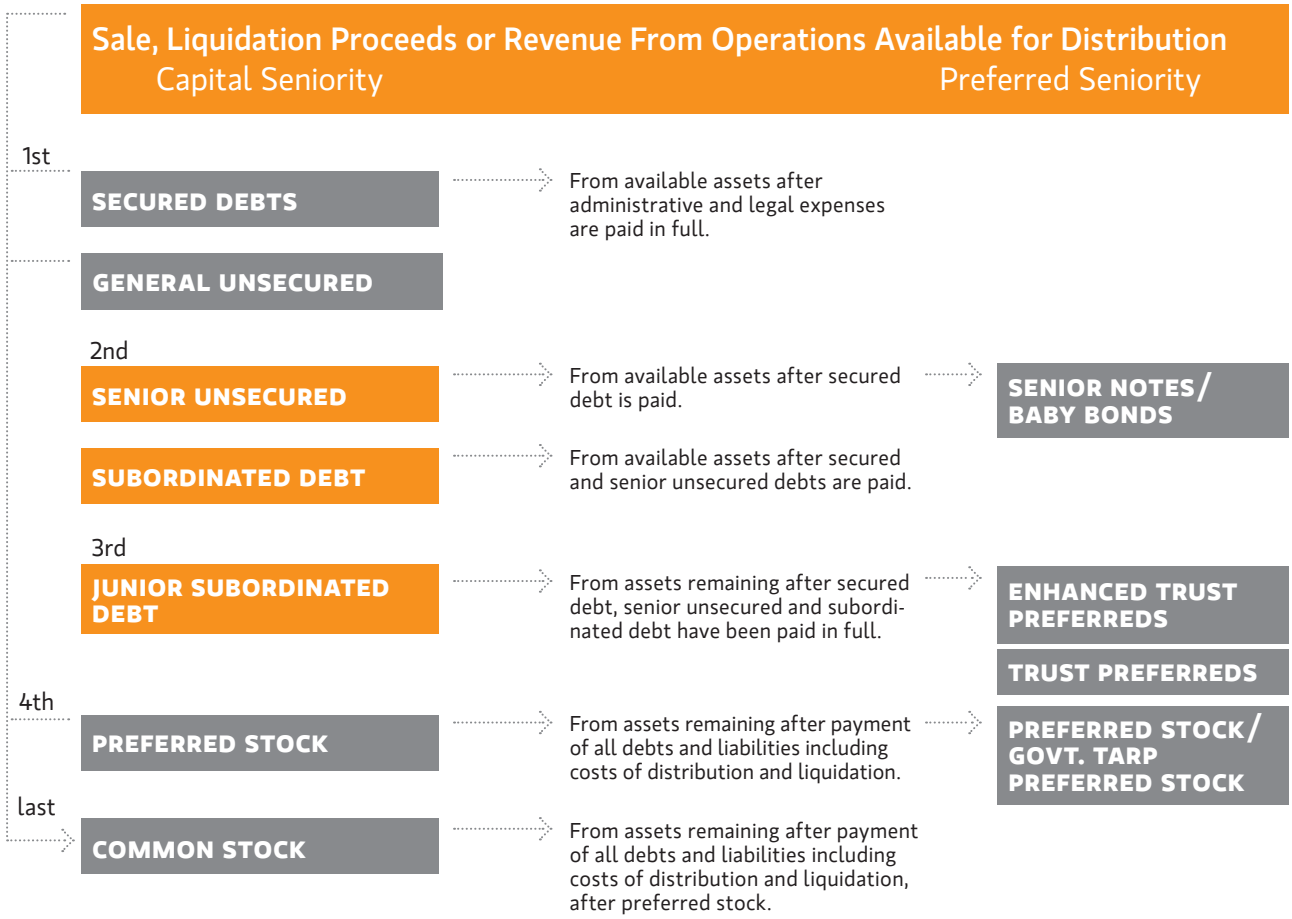
Traditional preferred stock (sometimes called perpetual "preferred" stock) represents a nonvoting equity position in the issuing company and has no set maturity date. Dividends are generally paid quarterly, are usually a fixed percentage of the face value (par) — or are set at a percentage spread to a benchmark rate — and may be deferred without any obligation that the issuer make up missed payments (noncumulative).

Traditional preferred stock falls into three main categories:

- Dividends received deduction (DRD) eligible preferred securities
- Real estate investment trust (REIT) preferred securities
- Non-US preferred securities

DRD ELIGIBLE PREFERRED STOCK

Dividend Received Deduction (DRD) preferreds make up the largest portion of the traditional US preferred stock market. These securities are typically noncumulative and generally pay quarterly dividends that are tax-advantaged for corporations. Internal Revenue Service rules allow corporate income taxpaying US companies to exclude 70% of the dividend income they receive from their taxable income. In addition, these securities pay qualified dividend income (QDI), which is a favorable tax treatment on dividend income for individuals. (See page 7 for a discussion on QDI.) DRD eligible preferred stock is generally subject to US tax withholding for nonresident alien (NRA) clients.



REIT PREFERREDS

A real estate investment trust (REIT) is a trust or corporation that owns and manages income producing real estate. By law, REITs must distribute at least 90% of their net income to common shareholders in the form of dividends. Generally, REIT preferred stock is senior to common equity, is perpetual as well as cumulative and is generally ineligible for QDI tax treatment. Dividends are generally subject to US tax withholding for NRA clients.

NON-US PREFERREDS

Issued by foreign companies that raise capital in the United States, the majority of non-US preferreds are traded on US exchanges and are issued in $25 denominations.[1] Non-US preferreds are generally identical in structure to US-based, DRD eligible preferred stock and are not subject to foreign currency exchange risk because their securities are denominated in dollars. They may also qualify for QDI. (See page 7 for a discussion on QDI.) Non-US preferred stock is generally not subject to US tax withholding for NRA clients.

Traditional preferred stock may not be suitable for investors who are registered as US nonresident aliens, due to their tax withholding treatment by the IRS. Morgan Stanley does not provide tax advice. You should consult your tax advisor prior to making any tax related investment decisions.

Trust and Enhanced Trust Preferred Securities

These hybrid securities combine certain features of equity securities with many of the characteristics of interest-paying bonds (cumulative interest payments and no voting rights).

In 1996, the Federal Reserve determined that preferred securities could be used to meet banks' regulatory capital (known as Tier 1) requirements, and between 1996 and 2010, trust and enhanced trust preferreds proved to be a favorable alternative to traditional preferred stock and common equity. (See "Why Companies Issue Preferreds," page 4.)

The enhanced preferred structure was introduced in 2005, and these securities share many of the same characteristics as trust preferreds. Generally, enhanced trust preferred securities have longer stated maturity dates and interest deferral periods than trust preferreds, and they also pay cumulative interest payments. Both are generally not subject to US tax withholding for NRA clients.

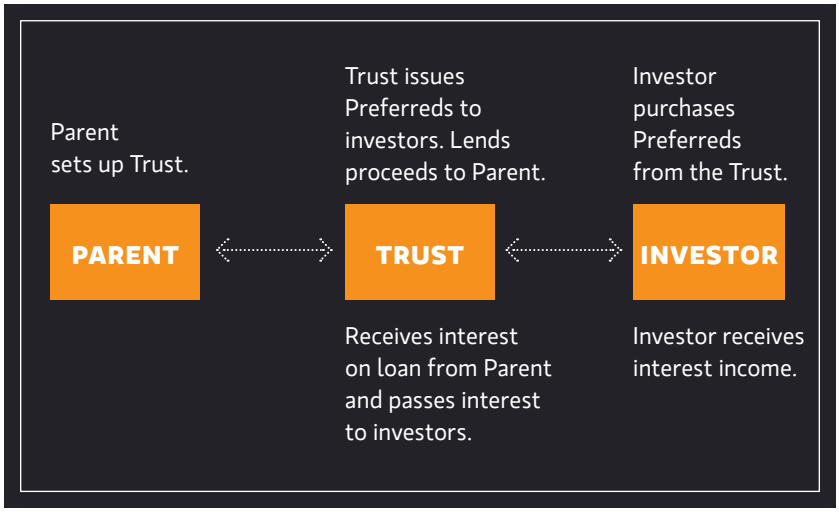
SENIOR NOTES

Senior notes, often referred to as baby bonds, are $25 par debt instruments that pay regular interest income, usually monthly or quarterly. These exchange-listed preferreds rank equally with other unsecured and unsubordinated debt of the issuer and generally receive credit ratings equivalent to the senior long-term debt rating of the issuer.

JUNIOR SUBORDINATED DEBT

These long-term, callable debt securities are senior to common and traditional perpetual preferred stock and typically pay a fixed or fixed-to-floating rate of interest, which can be deferred but is cumulative (between 5 and 10 years). Junior subordinated debt securities are not QDI-eligible because their payments are considered interest instead of dividends.

Creating a Trust Preferred



Additional Preferred Structures

MANDATORY CONVERTIBLE PREFERREDS

A small segment of the market, mandatory convertible preferred securities have a stated maturity (typically three years), at which point they automatically convert into the common shares of the issuer. The amount of stock received in a mandatory convertible preferreds transaction varies because conversion is dependent on the stock's price at the time of conversion. As a result, the investor is exposed to the risk of falling stock prices.

THIRD-PARTY PREFERREDS

Third-party preferreds are repackaged securities offered in $25 par amounts. Broker-dealer or investment banks create them by depositing traditional or trust/enhanced trust preferreds, junior subordinated or senior debt of a selected issuer in a grantor trust and issuing new securities representing ownership interests in the new vehicle.

Overview of Investment Features

Preferred stock and trust preferred have obvious structural differences, but they also share several common characteristics.

PAR VALUES

Historically, the preferred market offered $25 minimum denominations (par value), making them an accessible choice for many individual investors. The expansion of the market led to the introduction of different par values, and investors now have a choice of securities with face amounts of $25, $50, $100 and $1,000.

INCOME

Traditional and trust/enhanced trust, preferred, junior subordinated debt and

WHY COMPANIES ISSUE PREFERREDS

In a textbook capital structure, companies raise funds by borrowing (issuing bonds) or by selling ownership interests, via a common stock offering. In reality, a corporation's optimal capital structure — one that allows it to raise capital at the lowest possible cost — will likely include different varieties of equity, debt and preferreds.

Companies issue preferred securities to fund their business, diversify their capital sources, meet regulatory capital ratio requirements and satisfy rating agency credit criteria. Issuing traditional preferreds can provide an attractive source of equity capital that is nondilutive to common shareholders, generally less costly than common stock and, in the case of trust preferreds, allows interest payments to be deducted for corporate tax purposes.

Since the late 1990s, banks have been one of the largest issuers of preferreds. Regulators require lenders to have adequate capital to support their activities. As trust preferred securities generally qualified as a form of regulatory capital (Tier 1), and were typically less expensive to issue than equity, banks used them to help meet their capital obligations.

In the aftermath of the 2008 financial crisis, Congress included the Collins Amendment in the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, which phases out trust and enhanced trust preferreds as Tier 1 capital.

As a result, US banks redeemed $43.2 billion of trust preferreds in 2012 and issued new, noncumulative perpetual preferred stock, which qualifies as Tier 1 capital. Trust and Enhanced Trust Preferred securities generally have provisions where the issuer can call the issue prior to the stated call date provided a capital treatment, tax or regulatory event occurs, and if regulatory approval is received.

$25 par senior notes can be structured as either fixed-to-float or variable-rate securities. Preferred stock typically distributes quarterly dividend income, while trust/enhanced trust, junior subordinated and senior notes typically pay quarterly interest income. You should be aware that dividend income and interest income receive different tax treatment from the Internal Revenue Service (IRS). Preferred stock dividends are taxed as QDI, while trust/enhanced preferred, junior subordinated and senior note interest income is taxed as ordinary income. (See "Taxation of Preferred Securities" on page 7 for a discussion on the tax treatment of preferreds.) Morgan Stanley does not provide tax advice. You should consult your tax advisor prior to making any tax-related investment decisions.

PAYMENT DEFERRAL OPTION

Preferred securities are generally issued with an interest or dividend payment deferment feature. In certain cases the issuer can choose to defer income payments on preferred securities without forcing a default. The deferral can be for a maximum period of time or indefinite, depending on the structure of the particular security. Details about payment deferral can be found in the individual security's offering documents.

Deferred payment can be cumulative (missed payments accumulate and are payable later) or noncumulative (missed payments do not accumulate). If interest payments are cumulative, the company typically must meet the entire outstanding obligation before making dividend payments to holders of securities that are lower in the capital structure. In most cases, a dividend stopper prevents the issuer from paying dividends to common shareholders while the deferral is in place.

You should be aware that deferred interest payments will be treated as income for tax purposes (phantom income), and preferred holders will be liable for income tax, even though the cash payments won't be received until the end of the deferral period. (See page 7 for a more complete explanation of phantom income.)

MARKET ACCESS

Once issued, the majority of $25 par securities trade on the New York Stock Exchange (NYSE), although some may trade in the over-the-counter (OTC) market. Although publicly traded, liquidity (the ease of converting an asset to cash) is not guaranteed and preferreds' market value may fluctuate. If you sell prior to maturity, the price you receive may be more or less than the original cost or par value, depending on market conditions.

Deferment Options

TYPE	DEFERMENT TIME FRAME	PHANTOM TAX	PAYMENT
Traditional Preferred Stock	Defer Perpetually	No Phantom Tax	Noncumulative
Trust Preferred	Defer for 5 Years	Phantom Tax	Cumulative
Enhanced Trust Preferred	Defer for 10 Years	Phantom Tax	Cumulative

Understanding Preferred Securities' Credit Ratings

Credit ratings are one measure of an issuer's ability to make timely payments of interest and principal. Depending on their credit ratings, preferred securities are either investment grade or below investment grade. To be above investment grade, a security must be rated at least Baa3 / BBB– / BBB, respectively, by Moody's, Standard & Poor's and / or Fitch Ratings, the three major ratings agencies. Investment grade securities generally have the least probability of default. As such, they are generally considered suitable for most conservative to moderate investors. Securities rated below investment grade are recommended for aggressive investors only.

Investment Considerations

CREDIT RISK

The possibility that the issuer might be unable to pay interest and / or principal on a timely basis is known as credit risk. Widely recognized rating agencies, such as Moody's, Standard & Poor's and Fitch Ratings evaluate quantitative and qualitative factors to come up with a credit rating, which is a measure of an issuer's creditworthiness.

Credit Ratings

	RATING	MOODY'S	S&P	FITCH RATINGS
Investment Grade	Best Quality	Aaa	AAA	AAA
	High Quality	Aa1, Aa2, Aa3	AA+, A, A–	A
	Upper Medium Grade	A1, A2, A3	A+, A, A–	A
	Medium Grade	Baa1, Baa2, Baa3	BBB+, BBB, BBB	BBB
Below Investment Grade	Speculative Grade	Ba1, B1 Ba2, B2 Ba3, B3	AA+, A, A–	BB, B
	Highly Speculative Grade	Caa1, Caa2, Caa3, Ca	CCC+, CCC– CCC, CC C	CCC, CC, D
	Default	C	D	D

CALL RISK

The majority of preferred securities are callable, allowing the issuer to redeem them prior to maturity. If the security is called, the investor bears the risk of reinvesting the proceeds at a potentially lower rate of return. To compensate investors for this potential early redemption, callable preferred securities typically offer the following: higher yields than their noncallable counterparts; a call protection period (usually five years from issuance) during which time the issuer cannot redeem the securities; and, in certain cases, a call premium, which pays the holder of a called security a price greater than their par value.

Trust and enhanced trust preferred securities generally have call provisions allowing the issuer to redeem them prior to their stated call date, provided a capital treatment, tax or regulatory event occurs, and if regulatory approval is received.

INTEREST RATE AND DURATION RISK

The possibility that the market value of securities might rise or fall due to changes in prevailing interest rates is known as interest rate risk. Generally, all fixed income securities are susceptible to fluctuations in interest rates; all else being equal, if interest rates rise, preferred prices will generally fall, and vice versa. Duration measures a bond's price sensitivity to changes in interest rates. The longer the bond's duration, the more sensitive its market value is to changes in interest rates. Your Financial Advisor can provide you with the duration risk of your fixed income investments.

SECONDARY MARKET RISK

Most preferreds are listed on securities exchanges, which may provide a degree of liquidity. However, there is no guarantee that an active or liquid secondary market will exist for any individual issue. If a security is sold in the secondary market prior to maturity (or call date), the price received may be more or less than the face value or the original purchase price, depending on market conditions at the time of the sale. Prices can be volatile during periods of market turbulence, and some preferred issues will be more liquid than others.

Taxation of Preferred Securities

QUALIFIED DIVIDEND INCOME (QDI)

Dividend income on some perpetual preferred stock will be eligible for preferential tax treatment. The tax rate on these dividends, known as qualifying dividend income or QDI, is at the more favorable 20% tax rate (plus an additional 3.8% Medicare surcharge) for investors in the 39.6% tax bracket and 15% (plus an additional 3.8% Medicare surcharge for certain income limits) for those in all other classifications.

In order to be eligible for the preferential tax treatment, the qualifying preferred securities must be held by an investor for more than 90 days during the 181-day period, beginning 90 days before the ex-dividend date.

Some preferreds issued by foreign companies may also qualify for the reduced QDI tax rate, if one of these requirements is met: the foreign company is incorporated in a jurisdiction that has a comprehensive income tax treaty with the United States, or the preferred stock trades on a US exchange.

By comparison, trust preferred securities are ineligible for QDI treatment because they pay interest income instead of dividends. The interest received will be taxed as ordinary income (federal, state and local taxes) if the securities are held in a regular brokerage account. Given their tax status, trust and enhanced trust preferreds may be an appropriate choice for qualified retirement accounts, including individual retirement accounts (IRAs) and 401(k) plans.

Trust and enhanced trust preferred investors will be liable for income tax on phantom income, which are interest payments that have been deferred but are treated as income for tax purposes.

Preferred Securities at Morgan Stanley

As a Morgan Stanley client, you have the opportunity to participate in the new issue preferred market[2] with one of Wall Street's leading underwriters.[3] Your Morgan Stanley Financial Advisor can provide you with additional information on preferred securities, including a selection of current offerings, and will assist you in structuring a portfolio that is best suited to your own investment goals and risk tolerance.

LEARN MORE ABOUT PREFERREDS

Preferred stocks' position in a company's capital structures places them in a lower priority of payment than bonds but in a senior position to stocks. As such, their dividend payments are generally higher than the interest income from investment grade bonds. Preferreds also usually pay higher dividends than common stocks because investors won't have the opportunity to participate in the company's growth. Your Morgan Stanley Financial Advisor can work with you to assess your income and growth needs and help you identify appropriate opportunities in the preferred securities market.

[1] Investing in foreign and emerging markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. International investing should comprise only a limited portion of a balanced portfolio.

[2] New-issue offerings of preferred securities are offered by prospectus, which contains complete information, including risk factors, and should be read carefully before investing.

[3] Source: Bloomberg, July 2013

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