WELLS FARGO Advisors

A guide to investing in hybrid securities

Before you make an investment decision, it is important to review your financial situation, investment objectives, risk tolerance, time horizon, diversification needs, and liquidity objectives with your financial advisor. This guide summarizes the basics of $25 par "hybrid securities," their potential benefits to investors, the types of securities issued, their risk factors, and their tax implications to help you better understand the features and costs associated with hybrid securities, as well as how your financial advisor and Wells Fargo Advisors are compensated when you invest in these products.

What are hybrid securities?

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 sometimes known as Fixed Rate Capital Securities, Preferreds, $25 par's, Senior Notes/Baby Bonds, Subordinated Debt, Trust Preferreds (TRUPs), Junior Subordinated Debt, and Preferred Stock.

Technically, preferred securities are a subset of hybrids. However, in recent years, investors have used the term "preferred security" as a blanket term to describe a range of different securities, many with similar characteristics. Preferreds can be categorized in different ways but many investors are familiar with the typical $25 par, fixed-for-life coupon, which trades on the NYSE. Recently, issuers have begun issuing $1,000 par securities with more frequency. These securities typically have a coupon that is fixed for a set time period (5 or 10 years) and then, if not called, floats at a spread over libor, and trades over the counter. The $1,000 par securities have mainly been distributed to institutional accounts while $25 par have been distributed to retail investors. The $25 par and exchange listing provide greater liquidity in smaller sizes for the retail investor.

Structurally, many people consider the terms "preferreds" and "hybrids" to encompass anything from $25 par senior debt down to traditional preferred stock. Although $25 senior debt (Baby Bonds) would NOT be considered hybrid capital or preferred by regulators and rating agencies, investors have historically called these securities preferreds.

Hybrid securities are investment vehicles with potential benefits for both income-oriented investors and issuers. Typically, hybrid securities are longer dated (maturities between 30 and 50 years) or perpetual instruments and are senior to the common stock of the issuing corporation. They do not have voting rights, and generally are callable at par value 5 or 10 years after issuance. Coupons can be structured as fixed for life, floating for life, or fixed to floating rates.

We have a responsibility to consider reasonably available alternatives in making a recommendation. We do not need to evaluate every possible alternative either within our products or outside the firm in making a recommendation. We are not required to offer the "best" or lowest cost product. While cost is a factor that we take into consideration in making a recommendation, it is not the only factor.

You should consider factors such as those below prior to accepting a recommendation:

- The potential risks, rewards, and costs in purchasing and in the future selling of a security.
- Your age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, and risk tolerance.
- The security's investment objectives, characteristics (including any special or unusual features), liquidity, volatility, and likely performance in a variety of market and economic conditions.
- For complex products, you should consider whether less complex or costly products achieve the same objectives.

By accepting a recommendation, you acknowledge that you have considered the above factors to your satisfaction.

Types of coupons

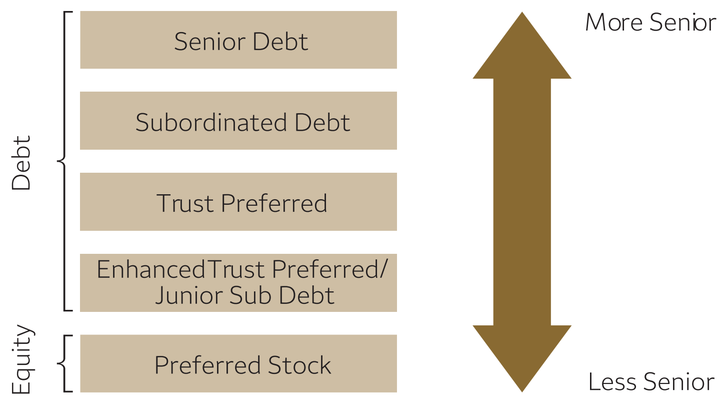
There are three main types of coupons on hybrid securities, but by far the most common type is a fixed-for-life coupon. Below is the description and typical attributes of each in order of amount outstanding.

- Fixed-for-Life coupon
  - » As the name implies, the coupon is fixed for the life of the instrument
  - » Has a longer duration than other coupon structures
  - » Yields tend to be higher than fixed-to-float and floating rate structures
  - » $25 par and listed on a major exchange
  - » Pays quarterly
- Fixed-to-Float coupon
  - » Coupon is fixed for 5 or 10 years, then floats at a set spread over libor after the fixed period (if not called)
  - » Has a shorter duration than fixed-for-life securities
  - » Yields are lower than fixed-for-life coupons
  - » $1,000 par and trade over-the-counter (some $25 par)
  - » Pays semi-annual during fixed coupon period and quarter during floating rate period
- Floating Rate coupon
  - » Coupon floats (or resets) quarterly at a spread over 3 month libor
  - » Yields are lower due to reset over short term index
  - » Duration shorter than fixed-for-life and fixed-to-float securities
  - » Pays quarterly

Types of preferred securities

Preferred 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; the order investors would be paid through liquidation of a company's assets if it became insolvent.

Hybrid Securities in Order of Liquidation Preference



$25 Par senior notes—$25 par senior notes are ranked equal to other senior debt of the issuer—many times called "baby bonds" due to par amount. They typically have a 30- or 60-year maturity, and are generally non-callable for 5 or 10 years after issuance. Interest payments are non-deferrable and non-payment of interest is considered default by the issuer. Interest payments are fully taxable for the investor, tax deductible for the issuer, and recorded as debt on the issuer's balance sheet.

$25 Par subordinated debt—$25 par "sub" debt is junior to senior debt and senior to trust preferred and preferreds. Maturities range from 30 to 60 years with non-call periods of 5 years. Interest payments are non-deferrable however non-payment of interest is NOT considered default by the issuer. Interest payments are fully taxable for the investor, tax deductible for the issuer, and recorded as debt on the issuer's balance sheet.

Junior Sub Debt, Trust Preferreds, and Enhanced Trust Preferreds—Each security is a form of "deferrable subordinated debt" ranking junior to senior debt and ordinary subordinated debt but senior to preferred and equity. Maturity profiles range from 30 – 60 years and are generally non-callable for 5 or 10 years from issuance. They allow for the deferral of interest payments (typically for a period of 5 to 10 years), however deferred interest will accumulate. Interest payments are fully taxable for the investor and tax deductible for the issuer. It's important to note that investors may be responsible for a tax liability on deferred interest payments.

Preferreds, preference shares, and depositary shares—These preferred securities rank only above common shares in liquidation preference. They have a perpetual maturity (meaning no fixed maturity date) and are generally non-callable for 5 to 10 years from issuance. Dividends can be cumulative or non-cumulative and can be deferred indefinitely. Dividend payments are typically taxed at a reduced rate for individuals (Qualified Dividend Income or “QDI” benefit) and C-Corporations (Dividends Received Deduction or “DRD” benefit)—the exception being tax shelter entities (i.e., REITs, MLPs, and BDCs).

Companies issue preferred stock in order to receive regulatory capital treatment, strengthen their balance sheets (rating agency benefit), and improve their debt-to-equity ratio (rating agency benefit).

Typically issued by banks, insurance companies, utilities, and Real Estate Investment Trusts (REITs), these securities are recorded as equity on the issuer’s balance sheet, although investors typically view preferred stock as a form of debt. 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.

Non-rated hybrids

Non-rated hybrids are fixed-income securities with issuers that have not received a credit rating from one or more of the major credit rating agencies. These securities are not required to have a credit rating. A non-rated hybrid is not necessarily a weaker credit, but they cannot be deemed investment grade as they have not been rated by an outside agency.

Issuers generally have two main reasons for issuing non-rated securities. First, some issuers are considered creditworthy borrowers, but the rating is foregone because the size or placement of the issue is such that the cost of being reviewed by a rating agency outweighs the benefit. A non-rated issue will generally offer a yield higher than a comparable rated issue, so if the cost of receiving a rating is higher than this additional cost of borrowing, an issuer may opt for issuing non-rated securities. Second, an issuer may feel their securities would not meet the rating criteria of the rating agencies, or, if rated, would be classified below investment grade. This issuer may be working towards getting a rating by issuing preferred stock.

Because non-rated offerings tend to be smaller issues, these securities may have less liquidity than rated offerings that have a larger float (the total number of securities publicly owned and available for trading). Smaller issues can mean fewer securities to change hands between investors. Additionally, investors are more likely to incorporate a buy and hold strategy, thus minimizing the available market in these securities.

Features and characteristics

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 in the form of interest payments or dividends, generally paying quarterly or monthly. This helps investors plan for income needs. An issuer can defer payments under certain circumstances (see deferral risk under section titled Risks), however these payments must be made before any dividends can be paid to common stock holders. This is called a dividend stopper. Dividends must be stopped on the common stock if dividends are deferred on preferreds.

Cumulative vs. non-cumulative payments—Hybrid securities that have a stated maturity are cumulative, meaning that if a company fails to make a dividend distribution to the hybrid shareholders, they will be required to pay the accumulated deferred dividends in full before any other distributions can be made to common shareholders. Traditional Preferred Stock can be cumulative or non-cumulative.

Preferred stock that doesn't carry the cumulative feature is called a non-cumulative preferred. 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 choose to omit the preferred stock dividend.

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.

Fixed rate vs. fixed-to-floating rate coupon/dividend payments—A fixed rate security pays a fixed payment for the life of the security, while a fixed-to-floating rate security pays a fixed rate for a specific period of time, then a floating rate until the security is called by the issuer. If the fixed-to-floating security is not called at the end of the initial fixed rate period, then the new coupon would float at a pre-defined rate over a floating-rate benchmark (typically 3-month LIBOR). Fixed-to-floating rate securities have a shorter duration than fixed rate securities and are thereby less sensitive to interest rate movements.

Correlation* to other investments—While in 2009 most of the hybrid/preferred securities market was 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 an approprpriate complement to a diversified portfolio.

**Correlation is the tendency for the returns of two assets to move together relative to their average. The measurement can range from –1 (perfect negative correlation, one goes up while the other goes down) to 1 (perfect positive correlation, both moving in the same direction). A correlation of 0 means no relationship can be found between the movements in the assets' performance.*

Risks

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—There is no guarantee as to the market prices of hybrid securities; therefore investors may suffer a loss. 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 sells 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.

Default risk—Defaults occur when a company fails to pay an interest or principal payment to a debt holder as scheduled and as specified in the legal agreements, i.e., the indenture. Factors such as business cycle volatility, excessive leverage, or threats of competitive takeovers may lead to default. In a corporate bankruptcy or dissolution, an investor may lose some or all of their investment. Hybrid securities investors would be paid only after all payments are made to senior debt holders. Although secured bondholders and holders of senior debt issues may receive some distribution of corporate assets, it is rarely enough to "make whole" the total investment. Companies in default tend to trade at very low prices, if they trade at all, and liquidity may be nonexistent

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. Deferral may have adverse tax consequences (for hybrids with maturities) and could adversely affect the trading price of a hybrid security. During 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. If an issuer ends 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, so investors should not rely on distributions through their maturity dates. Downward trends in interest rates make the issuer more likely to use the call feature (so as to issue new securities at lower interest rates). When this happens, investors may have to reinvest their principal at lower interest rates — reducing their income stream.

Event risk—Encompasses a variety of pitfalls that can affect a company's ability to repay its debt obligations on time. These include poor management, changes in management, failure to anticipate shifts in the company's markets, rising costs of raw materials, regulations, and new competition.

General tax treatment

Distributions—Distributions from hybrid securities with maturities are fully taxable for all investors. If an issuer defers 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 (excluding REIT and MLP preferreds) are typically taxed at a reduced rate for most investors. Individual investors receive "qualified dividend income" (QDI) which is currently taxed at a maximum rate of 20% for individuals in the 39.6% tax bracket and 15% for individuals in the 25% – 35% tax brackets. 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.

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." 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.

Wells Fargo Advisors is not a legal or tax advisor. Please consult with your tax advisor before engaging in any transaction that may have tax consequences.

Investor characteristics

Purchasers of hybrid securities are generally income investors seeking to earn a stated interest rate. These securities also may appeal to institutional investors such as money managers and corporations. Further, you should not purchase hybrid securities unless you are able to understand and bear the associated market and yield risks. Hybrid securities investors should have the financial status, knowledge, and experience in financial and business matters to evaluate the merits and risks in light of their particular circumstances.

Diversification—Wells Fargo Advisors believes that investors should diversify their investments. It is recommended that investors observe an asset-allocation strategy and not overweight their overall portfolio in any one class of securities. Although asset allocation can be an effective investment strategy, it cannot eliminate the risk of fluctuating prices and uncertain returns.

Costs of investing in hybrid securities

Hybrid securities are generally sold on an exchange or bought and sold between dealers and investors much like other fixed-income instruments. Dealers trade the securities at a net cost, which includes their own spread, or profit, on the transaction. Upon purchase and sale of a hybrid security, you will generally incur a commission or markup in processing the transaction.

Hybrid securities purchased during the Initial Public Offering (IPO) period have a sales concession built into the purchase price, and a portion is paid to your financial advisor for those transactions.

Additional information

To learn more about hybrid securities, ask your financial advisor or visit the following websites:

Wells Fargo Advisors Private Client Group and Wells Fargo Advisors Financial Network
wellsfargoadvisors.com

For additional investor information:
Financial Industry Regulatory Authority
finra.org

U.S. Securities and Exchange Commission
sec.gov

Securities Industry and Financial Markets Association
sifma.org

How are your financial advisor and Wells Fargo Advisors compensated on hybrid securities?

For helping you invest in the most appropriate hybrid securities, Wells Fargo Advisors and your financial advisor are compensated in ways that vary depending on the selected security. If the purchase is made during the IPO period, a financial advisor may be paid a sales concession. This sales concession is built into the share price and is passed by the issuer along to the financial advisor.

Your financial advisor will receive compensation in the form of a commission or markup from most transactions made in the secondary market. For most purchases, this compensation is based on the dollar amount purchased or sold in the hybrid security transaction.

In certain advisory accounts, a financial advisor's compensation may be based on a percentage of assets in the account rather than on the commission, as mentioned above. The compensation formula that determines the amount of payment to your financial advisor is generally the same for all hybrid securities.

In addition to receiving compensation, your financial advisor may receive internal credits in the syndicate allocation process for sales in hybrid securities and other products. For securities their clients have indicated an interest in purchasing, financial advisors may receive allocations of new equity syndicate deals based on the number of internal credits accumulated. For example, a financial advisor accumulating a large number of internal credits may receive a greater allocation of a new equity syndicate issue than a financial advisor with fewer credits.

Wells Fargo Securities, LLC may receive compensation for making a market or keeping an inventory on select offerings. Wells Fargo Securities may have an investment banking relationship with hybrid/preferred issuers. Disclosures of any such conflicts are noted on research reports.

Within the division that operates in Wells Fargo financial centers and some Wells Fargo branches, a Licensed Banker may refer you to a financial advisor, as they generally work as a team. In this case, the Licensed Banker will be compensated through a referral arrangement with the financial advisor.

Talk with your financial advisor

Hybrid/preferred securities can be a valuable addition to your fixed-income portfolio when appropriate. Your 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 hybrid securities and your portfolio, consult your financial advisor today.

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