Passive Management and Preferred Securities

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Not only was 1976 the 200th anniversary of the adoption of the Declaration of Independence by our Founding Fathers, it was also the year John Bogle's Vanguard Group launched the Vanguard 500 fund, the first index fund marketed to retail investors. John Bogle could be called the "Founding Father of Passive Investing."

Passive investing relies on the idea that it is difficult for investors to outperform the market due to several structural and behavioral factors. Structural factors include expenses such as trading fees, high management fees, and operating fees. Behavioral factors can be even more damaging to performance; these include trying to time the market or avoiding specific securities, holding on to losing positions and/or selling winning positions too early. There is a place for both active and passive investing in a portfolio—the trick for investors is knowing when passive investing works best and when active investing can give them an edge.

Could preferred securities be the right choice for active investing? Morningstar's December 31, 2022, Active/Passive Barometer gives us a historical look at active outperformance in various investment categories. A quick review of the 10-year active funds' success rate by category reveals some valuable information.

Active Funds' Success Rate by Category (%)

Category	1-Year	3-Year	5-Year	10-Year	15-Year	20-Year
U.S. Large Blend	54.1	38.1	30.1	13.1	9.3	8.7
U.S. Large Value	47.2	41.5	30.9	11.4	10.9	19.5
U.S. Large Growth	37.5	23.4	21.6	7.0	3.0	4.7
U.S. Mid Blend	50.5	46.5	31.6	18.1	10.6	12.7
U.S. Mid Value	39.6	50.5	31.5	4.6	17.2	–
U.S. Mid Growth	46.5	47.7	60.1	39.8	23.3	–
U.S. Small Blend	52.9	52.6	34.7	27.2	23.5	19.8
U.S. Small Value	61.0	44.2	43.8	32.7	15.8	22.1
U.S. Small Growth	56.9	50.3	57.6	46.4	26.6	–
Foreign Large Blend	36.8	43.6	31.5	29.9	24.1	18.9
Foreign Large Value	29.4	46.6	14.6	17.2	17.9	–
Foreign Small-Mid Blend	44.0	37.5	36.4	41.7	–	–
World Large-Blend	56.0	31.8	22.1	22.8	–	–
Diversified Emerging Markets	23.4	32.9	26.2	32.7	38.4	–
Europe Stock	25.0	47.1	25.0	38.1	40.9	15.7
U.S. Real Estate	42.9	74.2	62.7	52.3	25.7	23.6
Global Real Estate	20.0	69.8	63.8	56.9	–	–
Intermediate Core Bond	37.9	57.1	38.7	35.8	23.0	16.1
Corporate Bond	22.6	32.1	25.0	53.5	–	–
High-Yield Bond	27.2	42.6	47.4	49.4	–	–

Source: Morningstar data as of December 31, 2022

Note that active investing in the large cap asset class has a success rate of 13.1%, which tells us that this is a good space for passive investing. However, if you look at the corporate and high-yield bond spaces, you'll see that the success rate of active investing is 53.5% and 49.4% respectively, thereby justifying the case for active management. In simple terms, the more efficient the market, the stronger the case can be made for passive investing.

The efficient-market hypothesis in financial economics states that prices reflect all available information and that, therefore, it is impossible to outperform the market on a risk-adjusted basis. However, it is the degree of efficiency that is questionable, along with how investors react to the information available to them.

The U.S. large cap market is very efficient. Every day, thousands of very smart analysts and portfolio managers, aided with the latest software and data, analyze companies' financials, industries, and economic data looking for an edge. The market is very liquid, and it is easy to execute trades.

The preferred market is just the opposite. Smaller than the U.S. large cap market, the securities are not uniform in structure, and many tend to be less liquid. Data on preferred securities for the average investor is hard to come by. In addition, the indices used to model the passive ETFs have inefficiencies that can be capitalized by active management, such as:

> **Call Risk:** Numerous listed preferred securities are priced at a negative yield-to-call. The indices are indifferent to call risk and will continue to invest in preferred securities that will result in a negative return if held until called.
>
> **Credit Quality:** Similar to debt, credit quality influences the price of preferred securities. Indices are apathetic to credit quality.
>
> **Concentration Risk:** The largest issuers of preferred securities are financial institutions. This results in the indices concentrated in the financial sector, regardless of valuation.

Active Preferred ETFs vs. Passive Preferred ETFs

The preferred securities category is not broken out in the Active/Passive Barometer. However, using data from Morningstar, we looked at ETFs in the preferred stock category.

Using Morningstar's Return % Rank Category for the Morningstar Preferred Stock Category for the three passive index-based preferred ETFs, we reviewed their performance rank over 3, 5, and 10 years (as of 06/30/2023). We then looked at yearly returns for the years 2018 through 2022.

Morningstar Preferred Stock Category

The highest (or most favorable) percentile rank is 1 and the lowest (or least favorable) percentile rank is 100.

Name	Ticker	3 Yr Return% Rank Cat	5 Yr Return% Rank Cat	10 Yr Return% Rank Cat	2018 Return% Rank Cat	2019 Return% Rank Cat	2020 Return% Rank Cat	2021 Return% Rank Cat	2022 Return% Rank Cat
Invesco Preferred ETF	PGX	93	80	47	28	71	31	75	87
SPDR ICE Preferred Securities ETF	PSK	90	84	74	36	62	50	100	73
iShares Preferred & Income Securities ETF	PFF	36	58	63	53	84	12	22	70

Date as of 6/30/2023.

Invesco Preferred ETF (PGX) tracks the ICE BofAML Core Plus Fixed Rate Preferred Securities Index (P0P4).

iShares Preferred & Income Securities ETF (PFF) "Benchmark" reflects linked performance returns of both the ICE Exchange-Listed Fixed & Adjustable Rate Preferred Securities Index and the Wells Fargo Hybrid and Preferred Securities Aggregate Index. The index returns are reflective of the Wells Fargo Hybrid and Preferred Securities Aggregate Index from fund inception until 05/01/2021 and of the ICE Exchange-Listed Fixed & Adjustable Rate Preferred Securities Index effective 05/01/2021 to present.

SPDR ICE Preferred Securities ETF (PSK) tracks the ICE Exchange-Listed Fixed & Adjustable Rate Preferred Securities Index (PFAR).

If the preferred market was truly efficient then, at the minimum, their longer-term percentile rankings should be less than 50. PGX ranked 47 for the 10-year return percentile rank while PFF has a return percentile rank of 63. Neither, in my opinion, represents a strong case for an efficient market.

Summary

Passive investing works best for asset classes that are highly efficient, such as large cap U.S. equities where prices quickly reflect all available information and securities are uniform in structure and are easily traded. The preferred securities market is not large, the securities are not uniform, and information can be difficult to obtain. It is this type of environment that is best suited for active management.

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