Preferred Securities Belong in Fixed-Income Portfolios

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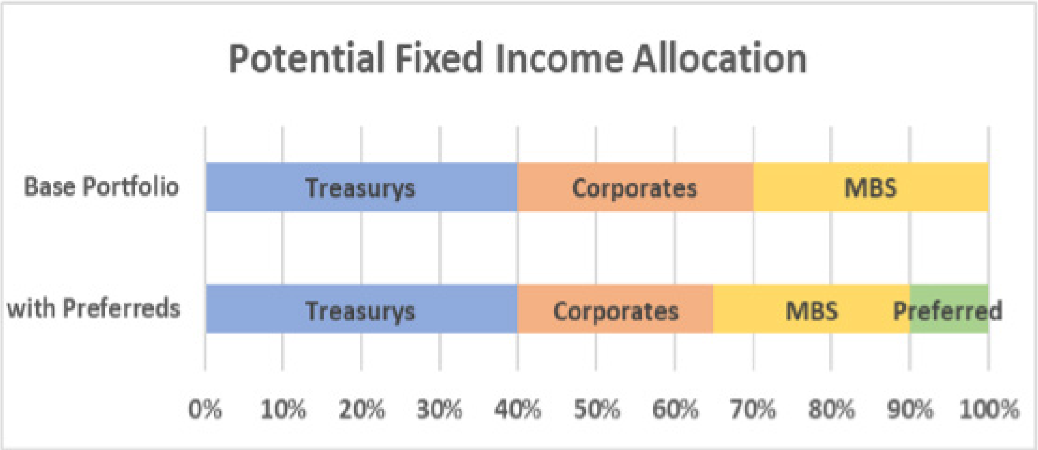
Investors have many different approaches and options to build a fixed-income portfolio. Wall Street is really good at coming up with different ideas and sales pitches. One asset class that is often overlooked is preferred equities, a hybrid security sitting between traditional bonds and common stock. Companies may issue preferreds to help with capital requirements, credit metrics, manage maturity schedules, or optimize the cost of capital without diluting earnings per share.

What is the appeal for investors? As the security is subordinate to traditional bonds, investors receive a higher yield for the same company. So, investors can get more income without chasing lower credit quality issuers. A bonus advantage for U.S. individuals, preferred equity payments can be qualified dividends rather than ordinary income like interest payments. Lastly, these securities often have lower correlations to other asset classes, providing a nice diversification benefit.

A fixed income allocation to preferred equities has historically provided higher returns without materially altering the risk profile over the long term. A Base fixed-income portfolio could be inspired by the Bloomberg U.S. Aggregate Bond Index[1] and result in a 40% allocation to U.S. Treasurys[2] and 30% to each Mortgage-Backed Securities (MBS)[3] and US Corporates.[4] An alternative portfolio would take 5% from MBS and Corporates and allocate it to Preferreds.[5]



Indexes

1 – Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market in the United States, including Treasuries, government related and corporate securities, mortgage-backed securities, asset-backed securities and CMBS (agency and non-agency). **2 – Bloomberg US Treasury Total Return Unhedged USD** measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. **3 – Bloomberg US MBS Index Total Return Value Unhedged USD** tracks fixed-rate agency mortgage backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). **4 – Bloomberg US Corporate Bond Index** measures the USD-denominated, investment grade, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Baa3/BBB-/BBB- or higher. **5 – S&P U.S. Preferred Stock Index** is designed to serve the investment community's need for an investable benchmark representing the U.S. preferred stock market. Preferred stocks are a class of capital stock that pays dividends at a specified rate and has a preference over common stock in the payment of dividends and the liquidation of assets.

See disclosures on page 3.

Testing these two portfolios over the last 20 years demonstrates the advantages of including Preferreds in the portfolio. To complete the analysis, indexes were utilized to represent the asset classes and then rebalanced annually at year-end. The portfolio with Preferreds outperforms the Base portfolio across all trailing increments. Additionally, the addition of Preferreds provides alpha without materially changing risk (standard deviation) when compared to the Base Portfolio. It also captures more upside and less downside than the Base Portfolio.

Given the concentration of financials in the preferred sector, the portfolio underperformed during the Financial Crisis years of 2007-2008. Despite the banking turmoil in early 2023, Preferreds were one of the better performing fixed income asset classes due to the higher yields and presence of some floating rate securities. Since Preferreds are generally perpetual, they carry higher duration, which hurts when rates rise materially but could outperform when rates decline.

10 Year Correlations (ending 12/31/2023)

	US Treasurys	US MBS	US Corporates
Preferred Stock	0.231	0.415	0.677

*Bloomberg calculations based on weekly returns.

Annualized Returns (ending 12/31/2023)

	Base Portfolio	with Preferreds
1 Year	5.69%	6.21%
3 Year	-3.36%	-3.41%
5 Years	1.10%	1.39%
10 Years	1.82%	2.08%
20 Years	3.28%	3.43%

10-Year Risk Metrics (ending 12/31/2023)

	Base Portfolio	with Preferreds
Jensen's Alpha	-	0.24
Beta	1.00	1.01
Annualized Standard Deviation	4.88	4.99
Sharpe Ratio	0.12	0.16
Downside Capture	100.00	99.21
Upside Capture	100.00	103.89
Capture Ratio	1.00	1.05

*FactSet calculations with Base as Benchmark

Summary

Preferred Equities should be included in fixed income portfolios. They can provide higher yield, nice diversification benefits, and a small allocation shouldn't materially alter the risk profile.

See disclosures on page 3.

Disclosure

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Definitions

Jensen Alpha: A measure of performance on a risk-adjusted basis. Alpha takes the volatility (price risk) of a fund and compares its risk-adjusted performance to a benchmark index. The excess return of the fund relative to the return of the benchmark is a fund's alpha.
Beta: Beta measures the sensitivity of an investment to the movement of its benchmark. A beta higher than 1.0 indicates the investment has been more volatile than the benchmark and a beta of less than 1.0 indicates that the investment has been less volatile than the benchmark.
Capture Ratio: measures the performance of an investment during upward and downward market trends with respect to its benchmark index.
Correlation: a statistical measure of how two securities move in relation to each other.
Downside Capture Ratio: Calculated by taking the fund's monthly return during the periods of negative benchmark performance and dividing it by the benchmark return. (or) Down Market Capture - Measure of a manager's performance in down markets relative to the market.
Sharpe Ratio: A measure that uses standard deviation and excess return to determine reward per unit of risk. The greater a fund's Sharpe ratio, the better its risk-adjusted performance has been.
Standard Deviation: Standard deviation of returns measures the average a return series deviates from its mean. It is often used as a measure of risk. When a fund has a high standard deviation, the predicted range of performance implies greater volatility.
Upside Capture Ratio: Calculated by taking the fund's monthly return during months when the benchmark had a positive return and dividing it by the benchmark return during that same month.

Risks of Investing in Preferred Securities

Investing in any market exposes investors to risks. In general, the risks of investing in preferred securities are similar to those of investing in bonds, including credit risk and interest-rate risk. As nearly all preferred securities have issuer call options, call risk and reinvestment risk are also important considerations. In addition, investors face equity-like risks, such as deferral or omission of distributions, subordination to bonds and other more senior debt, and higher corporate governance risks with limited voting rights. Risks associated with preferred securities differ from risks inherent with other investments. In particular, in the event of bankruptcy, a company's preferred securities are senior to common stock but subordinated to all other types of corporate debt.

Preferred funds may invest in below-investment-grade securities and unrated securities judged to be below investment grade by the Advisor. Below investment-grade securities or equivalent unrated securities generally involve greater volatility of price and risk of loss of income and principal and may be more susceptible to real or perceived adverse economic and competitive industry conditions than higher-grade securities.

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