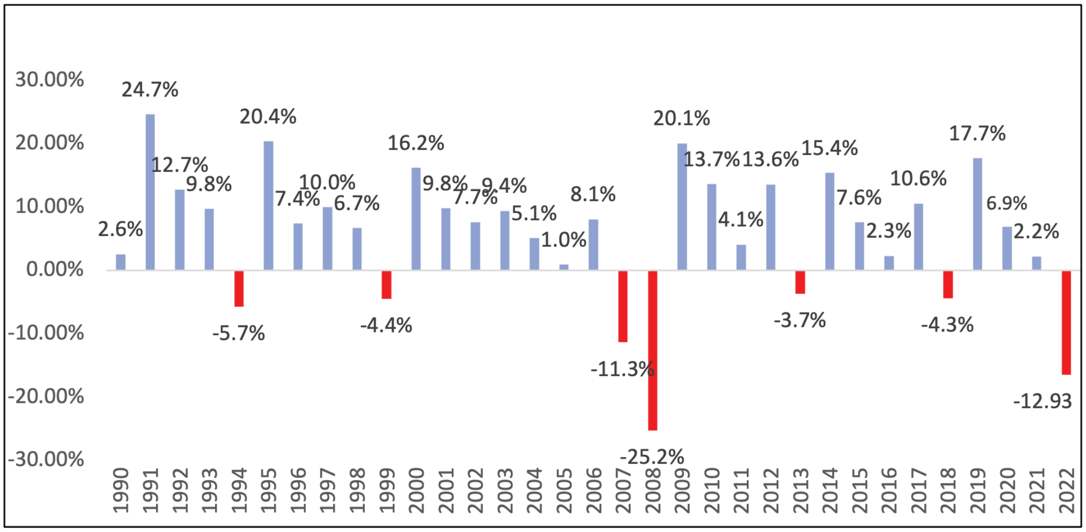
The Case for Preferred Securities

Authored by Edward "JR" Humphreys II, CFA, CAIA, Senior Portfolio Manager | January 3, 2023

When assessing the potential benefit of investing in preferred securities, there are a few strengths that emerge. One is that preferred equity has rarely had a year of negative performance and, when it has, the following year, it has tended to have very strong performance. In addition, looking ahead, inflation expectations look favorable and the Fed rate hikes are expected to end during the first quarter of 2023. Preferred yields also look attractive on both a relative, versus other fixed income assets, and on an absolute basis. Finally, a potential benefit of preferred securities is that strong bank capital may assist bank preferred investors.

Preferred Securities Calendar Year Total Return



Source: ICE BofA Fixed Rate Preferred Securities Index, 01/01/1990–11/30/2022
ICE BofA Fixed Rate Preferred Securities Index tracks the performance of fixed-rate U.S. dollar-denominated preferred securities issued in the U.S. domestic market.

Preferred equity has rarely had a year of negative performance and, when it has, the following years tended to have very strong performance. The exception was during the financial crisis of 2007-2008 when preferred equity performance had back-to-back negative years; this was due in part to banks and financial companies, who are the largest issuers of preferred securities, being at the center of the crisis. New regulations placed on financial institutions, such as the Dodd-Frank Act, require banks to increase their capital requirements and leverage ratios.

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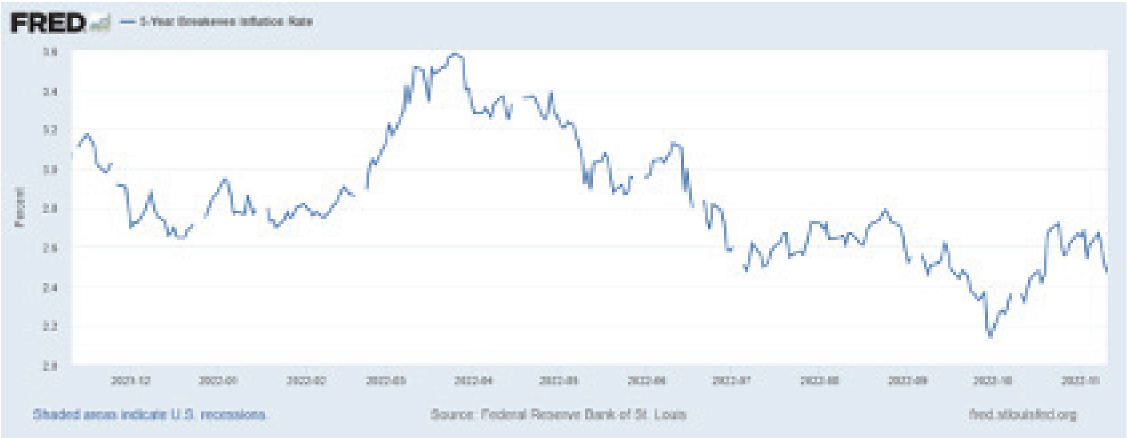
Forward Inflation Expectations Look Favorable

5 Year Break-Even Inflation Rate

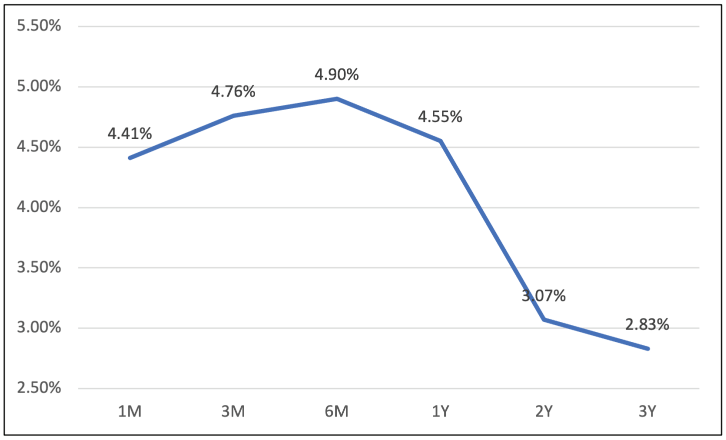


The latest value (~2.5) implies what market participants expect inflation to be in the next 5 years, on average.

Stable prices are one of the Federal Open Market Committee (FOMC) mandates. The rapid increase in the Fed Fund rate from 0.25% to 4.00% has helped to lower the 5-year break-even inflation rate to approximately 2.5% (2.5% is what market participants expect inflation to be in the next 5 years, on average).

Fed Rate Hikes Are Expected to End During the Early Second Quarter of 2023

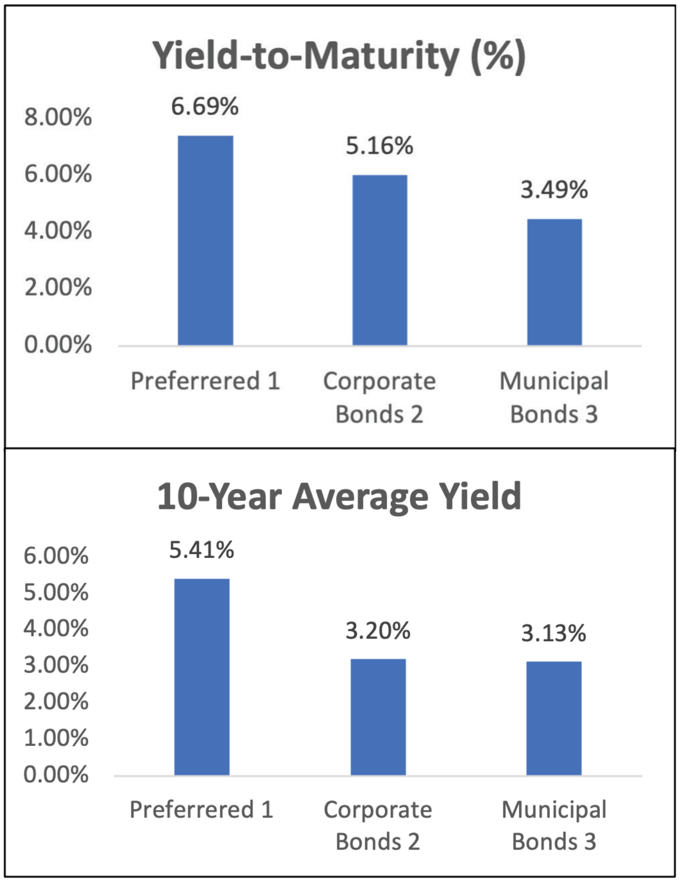
Market Implied Policy Curve as of 12/15/2022



The overnight implied policy rate peaks six months from 12/15/2022 at 4.94%. Source: Bloomberg

The Fed is close to the end of hiking the Fed funds rate. The market implied policy curve shows Fed Funds peaking around 5% late first quarter or early second quarter of 2023, then declining in early 2024.

Preferred Yields Look Attractive on Both Relative and Absolute Basis



As of 12/15/2022; Source: Bloomberg. Dividends on preferred shares are taxable income, with most considered Qualified. The tax rate you pay depends on whether the IRS considers the dividends to be "Qualified." Qualified dividends are taxed at lower rates than ordinary income.

The 60/40 equity/fixed income portfolio may be back. After years of zero interest rates and "TINA" (There Is No Alternative to equities) income in back in fixed income. Preferred securities look attractive on an absolute basis and relative to other fixed income investments. Preferred security yields are now above their 10-year average.

1. Preferred securities: ICE BofA Fixed Rate Preferred Securities Index tracks the performance of fixed-rate U.S. dollar-denominated preferred securities issued in the U.S. domestic market. 2. Corporate bonds: ICE BofA Corporate Master Index (Credit quality: A-) tracks the performance of U.S. dollar-denominated investment-grade corporate debt publicly issued in the U.S. domestic market. 3. Municipal bonds: ICE BofA Municipal Master Index (Credit quality: AA-) tracks the performance of U.S. dollar-denominated investment-grade tax-exempt debt publicly issued by U.S. states and territories, and their political subdivisions, in the U.S. domestic market.

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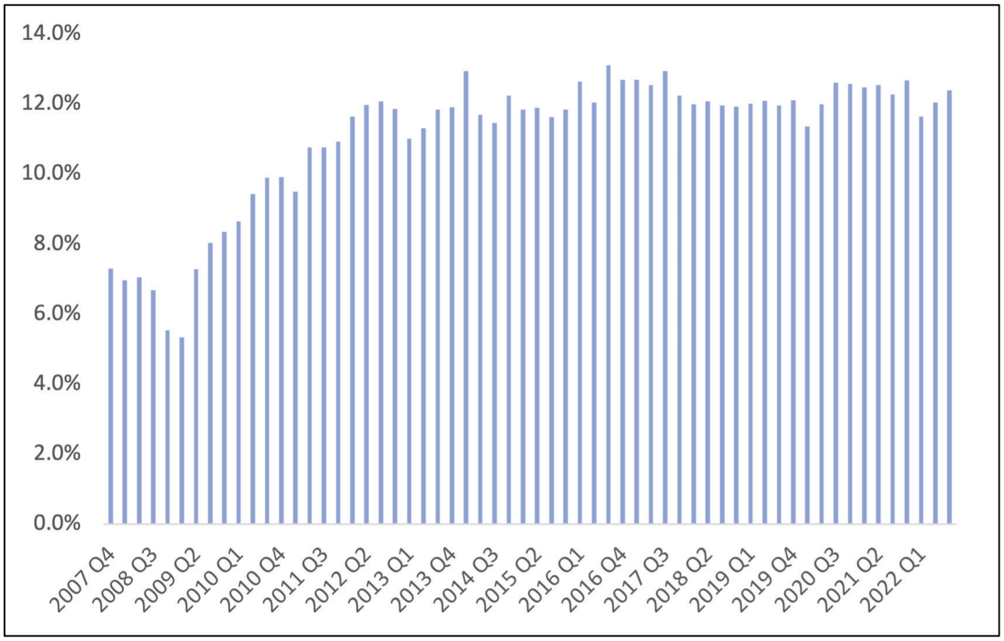
Strong Bank Capital Levels May Assist Bank Preferred Investors

Tier 1 Common Capital Ratio of Major Banks



As of 10/31/22; Source: Bloomberg. The Tier 1 common capital ratio is a measurement of a bank's core equity capital, compared with its total risk-weighted assets, and signifies a bank's financial strength. The Tier 1 common capital ratio is utilized by regulators and investors because it shows how well a bank can withstand financial stress and remain solvent. Banks used in this calculation include Bank of America, Citigroup Inc, Goldman Sachs, JPMorgan Chase, Morgan Stanley, and Well Fargo & Co.

One concern is the possibility of a severe recession. The back-to-back negative returns from preferred equity in 2007 and 2008 were during the Great Recession of 2007. During this period, banks (the largest issuer of preferred equity) suffered greatly and many required government interventions to prevent widespread bankruptcies. As a result, the government increased regulation and increased capital ratios to prevent another financial meltdown. On average, banks today are approximately twice as strong compared to 2008.

Preferred equity security valuations are very attractive. The Fed's aggressive rate hikes are having the desired impact on inflation at the detriment of fixed income performance. Preferred securities now offer a yield investors have not seen in years and may be a true alternative to equities. These higher yields will help to minimize the impact that further rate increases have on their value. We are starting to see a shift from investors focusing on the Fed's aggressive hiking to the eventual pause, then cutting, of rates. Timing the bottom is difficult and I feel that, in a year, preferred investors will be well rewarded. If you believe that the Fed is starting to win the battle with inflation and will not wreck the economy, then this might be the time for preferred securities to shine.

Summary

1. Preferred equity has rarely had a year of negative performance and, when it has, the following year tended to have very strong performance.
2. Forward inflation expectations look favorable.
3. Fed rate hikes are expected to end during the early second quarter of 2023.
4. Preferred yields look attractive on both a relative, versus other fixed income assets, and on an absolute basis.
5. Strong bank capital may assist bank preferred investors.

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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. In this commentary

We make comparisons of preferred securities to corporate bonds and municipal bonds. It is important to note that corporate bonds sit higher in the capital structure than preferred securities and therefore, in the event of bankruptcy, will be senior to the preferred securities. Municipal bonds are issued and backed by state and local governments and their agencies, and the interest from municipal securities is often free from both state and local income taxes.

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