For public distribution in the U.S. For institutional, professional, and/or wholesale investor use only in other permitted jurisdictions as defined by local law and regulations.

Principal Asset Management℠

Spectrum Asset Management

The "pull toward par"

OCTOBER 2023

It's no longer your grandmother's preferred stock market of fixed-rate perpetuals in utilities and railroads. The "hybrid" market has evolved and grown over the years into a $460 billion market of preferred stock, junior subordinated debt, and contingent convertible capital securities. Roughly 77% of the hybrid market is structured as an adjustable-rate security rather than a fixed rate (for life) security.[1] The most common type of adjustable-rate capital security is the five-year fixed-to-refixed structure. The terms of these fixed-to-refixed securities are typically:

MATURITY	• Perpetual or 40 years
COUPON	• Fixed rate and originally priced at a spread (e.g., +325bps) off the five-year U.S. Treasury note
CALL OR REDEMPTION	• Non-call for five years • If not called, the coupon resets at the then current five-year U.S. Treasury rate plus the initial spread (e.g., +325bps) for another five-year term (let's call this the "backend spread") • Some are callable every payment date while others are not callable until the next reset five years later

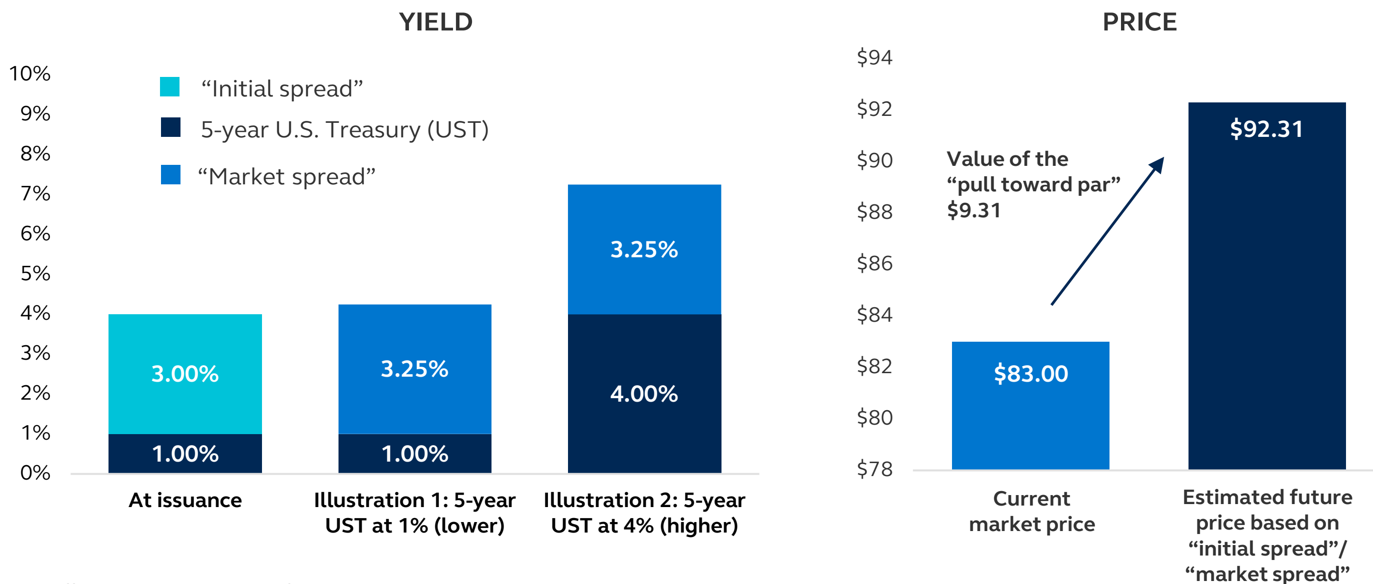
The paper basically trades to where the market *thinks* a new issue with the same fixed-to-refixed structure would come, though there are indeed inefficiencies that benefit active management. Issuers of hybrids are capital intensive (e.g., banks, insurance, utilities, and industrials) so there are issuance cycles or waves that play through, depending on variable capital needs. The issuance wave of 2020-2021 (a period when the Federal Reserve (Fed) was making "easy" money with quantitative easing and keeping the federal funds at zero) saw hybrid issuance come at low coupons (e.g., 4%) with generous spreads (e.g., +300-325 basis points (bps)) which would reset five years later. This type of issuance is now trading at 10–15-point discounts because the Fed has raised the federal funds rate by over 500bps in just 18 months, raising the U.S. Treasury yield curve significantly, and negatively impacting credit prices. If the backend reset spreads are wide enough, the expected new coupon (estimated to be reset off today's five-year U.S. Treasury yield) can act like a quasi-maturity because the paper would be expected to be redeemed at par with a more economic (i.e., lower) current market spread. If the backend spread is below the current market (e.g., +300bps), then the coupon could reset higher, but the paper would not be redeemed because the initial issuance spread is economic for the issuer to leave outstanding.

Either way though, the price should rise or be **"pulled toward par"** as the coupon reset date approaches because the coupon will reset based off the five-year U.S. Treasury rate at that time.

[1]Source: Spectrum Asset Management and ICE Data Services. Data as of 9/20/2023.

From the price perspective, it doesn't matter whether Treasury yields go up or down. Discounted securities in different environments will function the same, moving upward as the market reprices the new coupon rate.

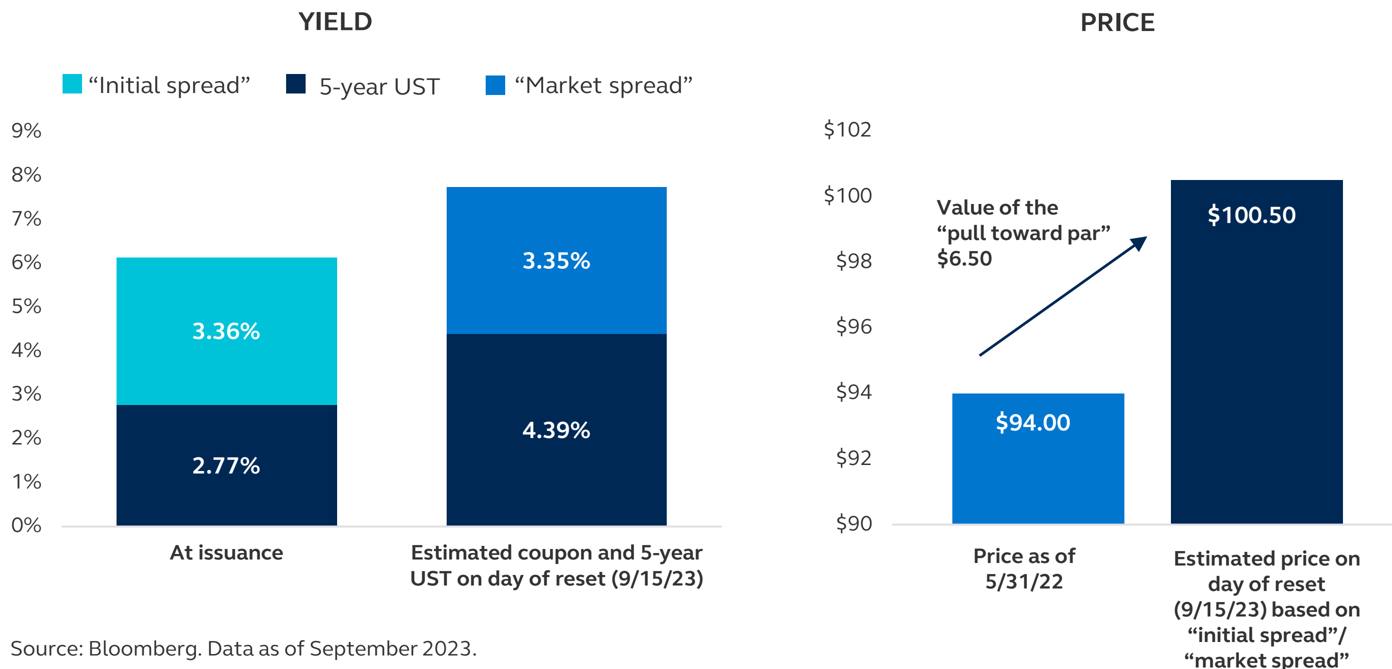
ESTIMATING THE "PULL TOWARD PAR" IN DIFFERENT MARKET ENVIRONMENTS



For illustrative purposes only.

This is occurring in today's market with forecasted yields. Prices are moving upward as the market reprices the security and new future yield.

AN ACTUAL "PULL TOWARD PAR" EXAMPLE



Source: Bloomberg. Data as of September 2023.

The "pull toward par" is a function of time aging to the coupon reset date and "market spread" for the issuer at the time of coupon reset.

So, if spreads widen significantly then the “pull” may not transpire as originally expected, which is why credit choice and structure choice are critical when selecting perpetual capital securities. Notwithstanding, if credit spreads stay reasonably stable, the “pull toward par” can be expected with some degree of confidence because the reset mechanism updates relative to the benchmark five-year Treasury yield. Indeed, when U.S. Treasury yields rise like they have (and may stay high for longer), investors may receive not only the price benefit of a “pull toward par” as the paper ages to the reset date, but also a potential significant income pickup because market yields on five-year Treasuries may have risen significantly since the time of issuance too.

Spectrum Asset Management

Spectrum is one of the largest specialized managers of preferred and capital securities in the U.S. Through the implementation of its fundamental credit-based investment philosophy, and leveraging its experience in capital structure analysis, Spectrum has successfully managed preferred and capital securities through a variety of credit, interest rate, evolving regulatory, and market conditions since its inception in 1987.

This material is provided by and reflects the current views and opinions of Spectrum Asset Management, Inc., an affiliate of Principal Global Investors.

Risk considerations

Past performance is no guarantee of future results. Investing involves risk, including possible loss of principal. Fixed Income investments are subject to interest rate risk; when interest rates rise, the price of debt typically declines. Risks of preferred securities differ from risks inherent in other investments. In particular, in a bankruptcy, preferred securities are senior to common stock but subordinate to other corporate debt.

Important information

This material covers general information only and does not take account of any investor's investment objectives or financial situation and should not be construed as specific investment advice, a recommendation, or be relied on in any way as a guarantee, promise, forecast or prediction of future events regarding an investment or the markets in general. The opinions and predictions expressed are subject to change without prior notice. The information presented has been derived from sources believed to be accurate; however, we do not independently verify or guarantee its accuracy or validity. Any reference to a specific investment or security does not constitute a recommendation to buy, sell, or hold such investment or security, nor an indication that the investment manager or its affiliates has recommended a specific security for any client account. Subject to any contrary provisions of applicable law, the investment manager and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in the information or data provided.

This material may contain 'forward-looking' information that is not purely historical in nature and may include, among other things, projections, and forecasts. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader.

This document is intended for use in: • The United States by Principal Global Investors, LLC, which is regulated by the U.S. Securities and Exchange Commission. • Europe by Principal Global Investors (Ireland) Limited, 70 Sir John Rogerson's Quay, Dublin 2, D02 R296, Ireland. Principal Global Investors (Ireland) Limited is regulated by the Central Bank of Ireland. Clients that do not directly contract with Principal Global Investors (Europe) Limited ("PGIE") or Principal Global Investors (Ireland) Limited ("PGII") will not benefit from the protections offered by the rules and regulations of the Financial Conduct Authority or the Central Bank of Ireland, including those enacted under MiFID II. Further, where clients do contract with PGIE or PGII, PGIE or PGII may delegate management authority to affiliates that are not authorized and regulated within Europe and in any such case, the client may not benefit from all protections offered by the rules and regulations of the Financial Conduct Authority, or the Central Bank of Ireland. In Europe, this document is directed exclusively at Professional Clients and Eligible Counterparties and should not be relied upon by Retail Clients (all as defined by the MiFID). • United Kingdom by Principal Global Investors (Europe) Limited, Level 1, 1 Wood Street, London, EC2V 7 JB, registered in England, No. 03819986, which is authorized and regulated by the Financial Conduct Authority ("FCA"). • This document is marketing material and is issued in Switzerland by Principal Global Investors (Switzerland) GmbH. • United Arab Emirates by Principal Global Investors LLC, a branch registered in the Dubai International Financial Centre and authorized by the Dubai Financial Services Authority as a representative office and is delivered on an individual basis to the recipient and should not be passed on or otherwise distributed by the recipient to any other person or organisation. • Singapore by Principal Global Investors (Singapore)Limited (ACRA Reg.No.199603735H), which is regulated by the Monetary Authority of Singapore and is directed exclusively at institutional investors as defined by the Securities and Futures Act 2001. This advertisement or publication has not been reviewed by the Monetary Authority of Singapore. • Australia by Principal Global Investors (Australia) Limited (ABN 45 102 488 068, AFS Licence No. 225385), which is regulated by the Australian Securities and Investments Commission and is only directed at wholesale clients as defined under Corporations Act 2001. • Hong Kong SAR (China) by Principal Asset Management Company (Asia) Limited, which is regulated by the Securities and Futures Commission. This document has not been reviewed by the Securities and Futures Commission.• Other APAC Countries/Jurisdictions, this material is issued for institutional investors only (or professional/sophisticated/qualified investors, as such term may apply in local jurisdictions) and is delivered on an individual basis to the recipient and should not be passed on, used by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

Principal Funds are distributed by Principal Funds Distributor, Inc.

Principal Asset Management℠ is a trade name of Principal Global Investors, LLC.

©2023 Principal Financial Services, Inc. Principal®, Principal Financial Group®, Principal Asset Management, and Principal and the logomark design are registered trademarks and service marks of Principal Financial Services, Inc., a Principal Financial Group company, in various countries around the world and may be used only with the permission of Principal Financial Services, Inc.

MM13695 | 10/2023 | 3139228-10/2024