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Spectrum Asset Management

Principal Asset Management℠

There's still time to participate in the preferred and capital securities rally

KEY TAKEAWAYS

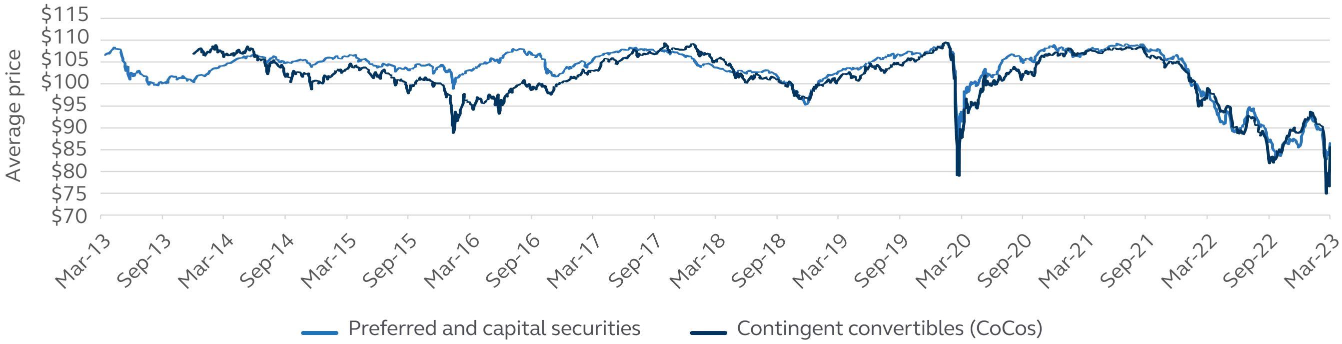
- Prices for preferred and capital securities are discounted to previous crisis levels, providing a potential opportunity for investors looking for income.
- The asset class has historically offered attractive performance following rate hikes.
- The fixed-to-refixed reset structures of preferred and capital securities may help preserve capital as their coupons can participate as rates rise.
- Credit quality can be crucial to a fixed income portfolio, especially with defaults likely to increase among lower-quality investments in 2023, so potential investors should look to Spectrum Asset Management, a quality-defensive active manager.

The Federal Reserve (Fed) has been raising rates for over a year and the U.S. Treasury market had been behaving like the Fed was nearly done and a policy pivot was nearby. Though the pivot may not be immediate, it may still be on the radar. Inflation is stubborn, and we will have to wait and see if the Fed will continue to raise rates. Given the correction in rates and credit markets after a strong start this year, we expect there to be considerable opportunities to buy the dips in preferred and capital securities as this rate hike cycle matures and markets reprice a persistent and determined Fed. We have seen this happen during prior rate cycles as yields rise and spreads tighten in anticipation of renewed economic growth and an easier Fed.

Discounted prices and higher yields set the stage for high income potential

During times of elevated inflation, preferred and capital securities can offer higher quality income with manageable interest rate risk when compared to core investment grade bonds. In addition to yields being at a 10-year high, attractive prices and discounts to par are also evident. With current prices at or below previous crisis levels, an allocation to preferred and capital securities may be beneficial to those looking for higher yield and/or potential capital appreciation as terms age to their coupon reset dates over the next few years.

Current prices for the preferred and capital securities universe are at or below previous lows



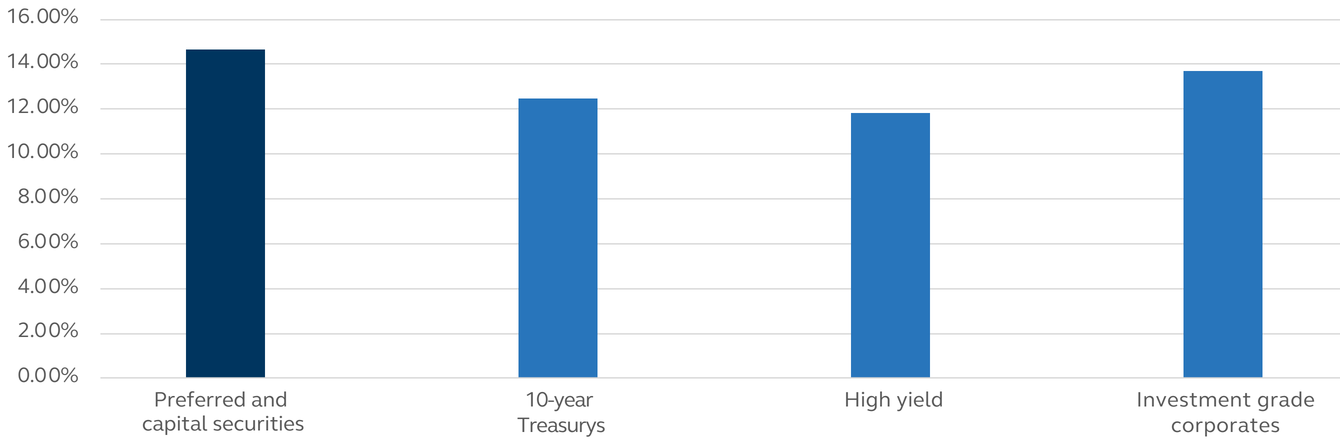
As of March 31, 2023. Source: Bloomberg, Spectrum Asset Management. Preferred and capital securities represents the ICE BofA U.S. All Capital Securities Index; Contingent convertibles represents the ICE BofA Contingent Capital Index. See disclosures for index definitions.

As shown in the chart on the previous page, 2022 into 2023 looks a lot like 2018 into 2019, which means the bond market – expecting a recession – can keep on rallying in advance of, and during, the time when the Fed pivots and moves sideways. The market has sold off to previous crisis levels, making preferred and capital securities look cheap on yield and price with solid credit fundamentals from issuers. Their yields remain higher than the last three credit cycle bottoms, so income should more than offset potential capital risks of some spread widening from a recession.

Attractive performance has historically followed rate hike cycles

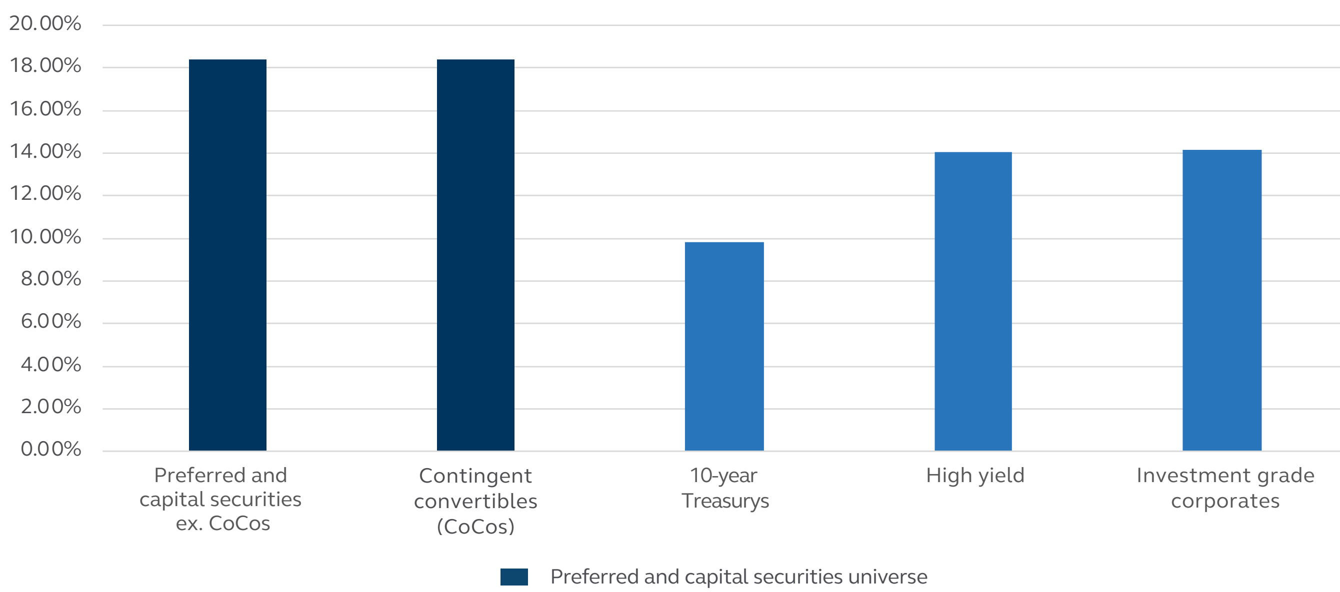
Due to their high level of income, preferred and capital securities tend to outperform coming out of Fed hiking cycles. Income can overcome waning duration risk, with average one-year performance on preferred and capital securities outpacing high yield, investment grade corporates, and 10-year Treasurys over the previous rate hike cycles.

Average one-year return following end of previous Fed hiking cycles (1995-2006)



Preferred and capital securities represents the ICE BofA Fixed Rate Preferred Securities Index; 10-year Treasurys represents the ICE BofA Current 10-Year U.S. Treasury Index; High yield represents the ICE BofA U.S. High Yield Index; Investment grade corporate represents the ICE BofA U.S. Corporate Index. See disclosures for index definitions.

One-year return following end of the most recent Fed hiking cycle (2018-2019)



Preferred and capital securities represents the ICE BofA U.S. All Capital Securities Index; Contingent convertibles represents the ICE BofA Contingent Capital Index; 10-year Treasurys represents the ICE BofA Current 10-Year U.S. Treasury Index; High yield represents the ICE BofA U.S. High Yield Index; Investment grade corporate represents the ICE BofA U.S. Corporate Index. See disclosures for index definitions.

Source: Bloomberg, Spectrum Asset Management. The rising rate cycles shown here portray the Fed rate hike cycles ending in February 1995, May 2000, June 2006, and December 2018. For historical purposes, we show the Preferred and capital securities market as the ICE BofA Fixed Rate Preferred Securities Index, which has the longest track record and was representative of the markets historically. For the most recent rate hike cycle, we show the preferred and capital securities universe as the ICE BofA U.S. All Capital Securities Index and the ICE BofA Contingent Capital Index to provide a more current view of the markets. See disclosures for definitions.

Play defense in your portfolio with preferred and capital securities

Now may also be the time to preserve capital in your portfolio by playing defense. Preferred and capital securities can be capital defensive as predominant fixed-to-refixed types may reset coupons from the 4% area up to within a 7-8% range just a few years from now if rates stay high, elevating prices from today's deep discounts. Higher coupons can provide a cushion to absorb potential losses from rising rates to help mitigate some risk in a fixed income portfolio.

Further, preferred and capital securities are positioned to have significantly lower default rates when compared to high yield while maintaining higher income relative to investment grade corporate bonds. If central banks become too aggressive in fighting inflation, credit quality will likely become an issue. However, Spectrum Asset Management focuses on investment-grade, higher credit quality issuers (primarily banks, financials, and insurance companies), which can help minimize default risks during recessions.

Attractive historical low default rates may be beneficial during market slowdowns

Annual default rates (%) 2013-2022											
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Average (2013-2022)
Investment grade corporate bonds	0.04	0.01	0.00	0.00	0.00	0.00	0.22	0.01	0.00	0.14	0.04
Preferred and capital securities	0.00	0.00	0.06	0.00	0.13	0.11	0.44	0.07	0.09	0.08	0.10
High yield corporate bonds	1.09	1.74	3.48	3.27	1.82	1.92	2.82	6.26	0.31	1.55	2.43

Source: Moody's Investors Service (investment grade corporate bonds and high yield corporate bonds); Spectrum Asset Management, Inc. (preferred and capital securities). Note: Preferred and Capital Securities default rates include deferrals that may not constitute technical events of default. All default and deferral rates are volume weighted. Past performance is not an indication of future results.

Spectrum Asset Management

As one of the largest specialized managers of preferred and capital securities in the U.S., Spectrum manages US $21.13 billion in assets as of March 31, 2023. Through the implementation of its fundamental credit-based investment philosophy, and leveraging its expertise 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.

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Index descriptions

- ICE BofA Fixed Rate Preferred Securities Index tracks the performance of investment-grade exchange-traded preferred securities ($25 par) with outstanding market values of at least $100 million.
- ICE BofA U.S. All Capital Securities Index tracks the performance of fixed rate, U.S. dollar denominated hybrid corporate and preferred securities publicly issued in the U.S. domestic market.
- ICE BofA Contingent Capital Index tracks the performance of investment grade and below investment grade contingent capital debt publicly issued in the major domestic and eurobond markets.
- ICE BofA U.S. High Yield Index tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.
- ICE BofA U.S. Corporate Index tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market.
- ICE BofA Current 10-Year U.S. Treasury Index is a one-security index comprised of the most recently issued 10-year U.S. Treasury note.

Risk considerations

Past performance is no guarantee of future results. Investing involves risk, including possible loss of principal. Fixed-income investment options are subject to interest rate risk, and their value will decline as interest rates rise. 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. Contingent Capital Securities carry greater risk compared to other securities in times of credit stress. An issuer or regulator's decision to write down, write off or convert a CoCo may result in complete loss on an investment.

Important information

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All figures shown in this document are in U.S. dollars unless otherwise noted.

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