SPECTRUM SMA TAX ADVANTAGED PREFERRED SECURITIES

Quarterly commentary

2024 FIRST QUARTER

Market environment

The U.S. Treasury (UST) bond market questioned its exuberance over rate cuts this quarter and began pricing out the six-rate cut expectation to three-rate cut expectations as inflation stayed elevated over the Federal Reserve's (Fed) objective. Chairman Powell put emphasis on being "confident" on inflation but said that the committee was "not there yet" and that "March is not the base case." The tone of the January meeting was to push back on the bond market's aggression because the risks to inflation were noted to still be concerning and harmful to a vast number of households unable to absorb it. Ultimately, most Fed members were wary of cutting too soon. As the quarter progressed, so too did the U.S. economy which has led the Fed to strengthen its economic outlook noting that there are baseline biases this summer that could elevate inflation rather than temper it lower. Indeed, the good economic news impelled the equity markets higher and commensurately cut volatility which combined to have a very favorable impact on junior subordinated credit spreads. Consequently, the new issue market for hybrids was vibrant, particularly in the institutional sectors, and was well received by investors helping to tighten spreads as prices went up, even though U.S. treasuries went down.

The ICE BofA All Capital Securities Index (I0CS) rose 4.54% in the first quarter compared to a rise of 6.46% during the last quarter. The $1,000 par sector contributed 2.65% to the overall return while the $25 par sector contributed 1.91% – both preferred stock segments did particularly well as qualified dividend income was in demand. The ICE USD Contingent Capital Index (CDLR) rose 3.12% in the first quarter compared to 7.38% last quarter.

Valuation thoughts going into 2Q of 2024:

Spreads on the ICE BofA U.S. Investment Grade Index (CIPS) had a 68 basis point range this quarter and closed 59 basis points (bps) tighter at an OAS of 184 bps. Spreads on the CDLR (CoCos) had a 57 basis point range and closed 41 bps tighter at an OAS of 275 bps. Spreads on the ICE BofA 5-10-year Investment Grade Corporate Index (C6C0) ended the quarter at 112 bps (9 bps tighter) and the ICE BofA U.S. High Yield (H0A0) ended the quarter at 315 bps (24 bps tighter). Therefore, relative to the IG Corporate Index (C6C0), IG preferred securities (i.e., CIPS) offer a slightly lower subordination premium of 1.64 times (i.e., 184/112) this quarter and

KEY TAKEAWAYS

- The UST market declined this quarter due to the U.S. Federal Reserve's resolve to keep its policy rate high for longer than expected to gain confidence that inflation is under control.
- Solidly expanding economic activity supported constructive credit expectations as hybrid credit performed exceptionally well despite the UST bond market's 30-37 basis point rise in yields.
- Performance in the institutional sectors and the retail sector was strong with prices going up despite declining UST prices. Spreads tightened 68 bps in NoCos, 41 bps in CoCos, and 65 bps in retail paper.

SMA PROFILE

SMA Tax Advantaged

$25 par preferred securities portfolio emphasizing qualified dividend income-eligible securities

SMA Benchmark

ICE BofA Core Fixed Rate Preferred Securities Index (P0P2)

CoCos offer marginally higher subordination premium of 2.46 times (i.e., 275/112). Also, from a duration standpoint institutional IG preferred securities have an average effective duration of 3.9 years relative to 6.1 years on the IG Corporate Index, which implies less term structure risk for preferred securities. The implication is that within the IG umbrella, investors can pick up over 1.6 times the spread by going down the capital structure into preferred securities but take only about 64% the duration risk, which highlights the value proposition available in hybrids. Our Comprehensive Risk Estimates for preferred and capital securities range from 2.6% (NoCos) to 5.3% (CoCos), which implies that both sectors are discounted enough on price, yield, and spread to suggest positive total return outcomes based on a return to the average yield at the bottom of the last three credit cycles – hybrids are still an absolute value given their high yields.

Changes in 1Q24 (Source: ICE Bond Indices)	Core fixed rate $25 preferred (P0P4)	$1,000 par IG preferred securities (CIPS)	Contingent capital securities (CDLR)
Govt OAS spreads	-65 bps	-59 bps	-41 bps
% Price change	+3.53	+2.28	+1.45

Source: ICE Bank of America.

$25 par market

The $25 par retail preferred securities sector had a positive quarter. This is the first quarter with three consecutive positive months since 2Q 2021. ICE BofA Core Fixed Rate Preferred Securities Index (P0P2) had a total return of 4.6% for the quarter; +3.2%, +1.1%, and +0.3% for January, February, and March, respectively. While long-term Treasury yields crept up moderately throughout the period, the $25 par preferred market remained resilient as spreads tightened over the quarter. Market technicals are the main reason for spreads grinding tighter as the ongoing trend of supply shortage from the primary market due to redemptions continues.

In February, Moody's published the new equity credit rating methodology confirming deferable junior subordinated debt will receive the same equity credit as perpetual preferreds. This has bolstered redemptions of perpetual issues, which include AIG 5.85% (AIG.A), Citigroup floater (C.J), NiSource 6.5% (NI.B), State Street Corp 5.9% (STT.D), and Wells Fargo 6.625% (WFC.R). There were some new deals such as Synchrony Financial 8.25% ($500 million), Athene Holding 7.25% ($575 million), and Affiliated Managers Group 6.75% ($450 million), but there was no issuance from major banks in the $25 par preferred space during the quarter.

News around New York Community Bancorp's surprise loss and dividend cut made the headlines during the quarter. Their preferred (NYCB.A) plunged about 40% to $14.31, but it somewhat recovered from the bottom and ended the quarter at $17.42.

The sector closed the quarter yielding 5.56% (22 bps lower than the last quarter's end). The spread (OAS) over comparable UST securities was -2 bps (61 bps tighter).

After having some outflows earlier in the quarter, $25 par preferred specific ETFs had better inflows for the rest of the period. The total inflow for the quarter was approximately $900 million. This increase in demand with shrinking supply was also an underlying reason for spread tightening.

SMA portfolio characteristics and performance review

	SMA portfolio	SMA benchmark
	SMA Tax Advantaged	P0P2
Average dollar price ($)	89.40	90.72
Average coupon (%)[3]	5.22	5.32
Current yield (%)[3]	5.67	5.86
Yield to worst (%)[3]	5.03	5.56
Modified duration (years)	14.28	13.50
Quality	BBB2	BBB2

Source: Spectrum Asset Management, Bloomberg. As of 03/31/2024. ICE BofA Core Fixed Rate Preferred Securities Index (P0P2).

[3] Yields and yield related characteristics shown are only one component of performance or expected performance and are not and should not be viewed as a statement of the current or future performance of the strategy. See the gross and net performance of the strategy.

	Total returns (%)					
	3-month	Year-to-date	1-year	3-year	5-year	10-year
SMA Tax Advantaged (gross)	5.06	5.06	9.38	0.06	3.08	4.75
SMA Tax Advantaged (net)[1]	4.48	4.48	6.96	-2.17	0.79	2.42
Performance benchmark[2]	4.57	4.57	9.90	-1.13	1.82	4.19
P0P2	4.57	4.57	9.90	-1.13	1.82	4.19

Past performance is not indicative of future returns.

Source: Principal Global Investors. As of 03/31/2024.

[1] Net fees are 2.25%

[2] The performance benchmark is composed of the ICE BofA Fixed Rate Preferred Securities Index (P0P1) through December 31, 2013 and the ICE BofA Core Fixed Rate Preferred Securities Index (P0P2) subsequently.

Portfolio update

Contributors

- **Huntington Bancshares** 4.5% HBANP
- **Charles Schwab Corp** 4.45% SCHWprJ
- **Citizens Financial Group** 5% CFGprE
- **Wells Fargo & Company** 4.75% WFCprZ
- **Capital One Financial Co** 5% COFprI

Detractors

- **NY Community Bancorp Inc** 6.375% NYCBprA
- **M&T Bank Corporation** 5.625% MTBprH
- **Berkley (WR) Corporation** 4.25% WRBprG
- **Berkley (WR) Corporation** 5.1% WRBprF
- **Berkley (WR) Corporation** 4.125% WRBprH

Increased positions

- **Berkley (Wr) Corporation** 5.1% WRBprF
- **Wells Fargo & Company** 4.75% WFCprZ
- **Prudential Financial Inc** 4.125% PFH
- **Bank Of America Corp** 4.375% BACprO
- **M&T Bank Corporation** 5.625% MTBprH
- **Metlife Inc** 4.75% METprF
- **Bank Of America Corp** 4.25% BACprQ
- **State Street Corp** 5.35% STTprG

Decreased positions

- None for this period

New additions

- **Bank Of America Corp** 6.24942% BMLprH
- **Public Storage** 3.875% PSAprN
- **Assurant Inc** 5.25% AIZN

Closeout

- **American Intl Group** 5.85% AIGprA - *called*
- **Wells Fargo & Company** 10.315% WFCprR - *called*
- **State Street Corp** 9.008% STTprD - *called*
- **NY Community Bancorp Inc** 6.375% NYCBprA - *credit*
- **Algonquin Pwr & Utility** 6.2% AQNB - *credit*

Calculations exclude cash and derivatives, where applicable.

SMA portfolio characteristics shown are representative accounts that are selected on non-performance-based criteria that may include institutional, model or sponsor portfolio that is most representative of the SMA strategy and is shown for illustrative purposes. Actual client portfolios holdings may differ because of account size, client-imposed investment restrictions, the timing of client investments and market, economic and individual company consideration. Quarterly new additions and closeouts represent all new purchases and full liquidations of securities for the previous quarter of the representative portfolio. Performance results shown reflects the composite for each strategy listed.

SMA Tax Advantaged

SMA Tax Advantaged major security sector components	Weight (%)	Contribution to return (%)
25parPFD ($25 par preferred stock)	73.31	4.43
25parHybrid ($25 par junior- subordinated bond)	10.82	0.43
BabyBond ($25 par senior debt)	1.48	0.12
REIT Pfd ($25 par cumulative REIT preferred securities)	4.78	0.10
Total return gross	90.39	5.07
Total return net	—	4.48

Portfolio sector attribution

Top contributors	Weight (%)	Contribution to return (%)	Top detractors	Weight (%)	Contribution to return (%)
Banking	44.74	2.98	Insurance - P&C	2.04	-0.02
Brokerage	10.64	0.60	Reinsurance	0.46	0.00
Insurance - Life	8.56	0.42	Utility - Foreign	0.00	0.01

Portfolio allocation

Top 5 issuers	Weight (%)	Top 5 industries	Weight (%)	Top 5 countries	Weight (%)
Bank of America Corp	6.11	Banking	44.74	United States	89.38
U.S. Bancorp	4.75	Brokerage	10.64	Bermuda	1.01
Morgan Stanley	4.71	Insurance - Life	8.56	—	—
JPMorgan Chase & Co	4.62	Utility	7.60	—	—
MetLife Inc	3.90	REIT - Preferred	4.78	—	—

Market outlook

- There should be ample opportunities to buy attractive hybrid yields this year because the UST market is in a confirmation mode and cannot run more than what the Fed ultimately does which, the more the year progresses, appears will be less than the bond market had originally discounted – so, a longer term UST rally (i.e., the UST ten-year) for this year has largely already been played out by last year's move, hence the backup so far this year.
- We expect capital returns this year to be largely related to tightening spreads.
- Maintain a defensive orientation by positioning fixed-to-refixed structures and barbelling these discounts with current coupon new issuance which embeds a "pull toward par" backstory to preserve capital and offer the potential for income growth.
- Hybrids offer the most positive real yield opportunity in corporate credit, net of default.
- The Fed should cut rates by 50-75 bps later this year, though elevated real yields in U.S. treasurys will likely persist because of a higher terminal rate (i.e., "r-star") being necessary in the new paradigms de-globalization, de-carbonization, and fiscal excess (all inflationary).
- The structural "pull toward par" discounts should reward hybrid investors who take advantage of today's lower prices and fair value spreads. Indeed, large sectors of the hybrid markets are not "fixed income", but rather "fixed-to-refixed income", which means if rates do stay higher than they have in the past coming out of this rates cycle, income in hybrid portfolios can rise.

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