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Spectrum Asset Management

Principal Asset Management℠

Guide to preferred securities

What are preferred securities?

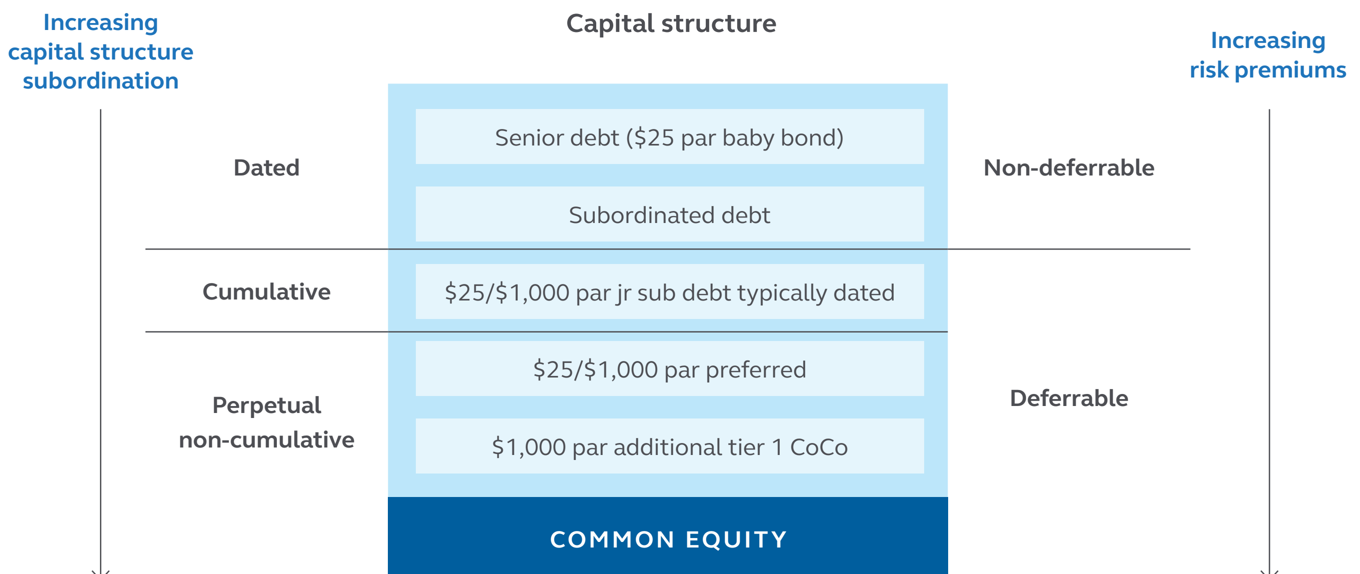
Preferred securities have been an attractive fixed income sector for investors around the world for many years, but they are still not widely understood. The purpose of this guide is to provide a better understanding of these instruments and their market, as well as why preferred securities may be a compelling investment choice for some investors.

Preferred securities, often known as "preferreds" or "hybrids," are similar to, but not exactly the same as, the more traditional preferred or preference shares markets. Preference shares were first issued in the United Kingdom and United States (U.S.) in the 19th century by railway companies. Investors demanded "preference," or priority, in the payment of dividends over common/ordinary shares. In the 1970s and 1980s, the preferred share market evolved to finance the construction cycle for U.S. utilities. In the early 1990s, the preferred share market restored capital to the U.S. banking industry after the savings and loan crisis. The hybrid preferred securities market evolved as a new generation of preferreds.

Preferred securities and other capital securities are deeply subordinated in the capital structure and can typically defer or skip payments without creating an event of default. Preferred securities are issued mainly by large banks and insurance companies for regulatory and rating agency capital purposes. Similar to other fixed income investments, the performance of preferred securities can be affected by interest rates and credit risks.

Preferred securities have several characteristics that investors find attractive:

- Fixed income diversification
- Yield enhancement
- Stable credit quality
- Low default and deferral history



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Hybrid features

Preferred securities are sometimes referred to as "hybrids" due to their combined debt and equity attributes. Debt-like features may include stated coupon payments, a definitive maturity date, and a stated par value. Equity-like features typically include a long-dated maturity or a perpetuity, capital credit from regulators and credit rating agencies, and payment deferral options. In a distressed situation, distributions of cumulative preferred issues can be deferred for up to 10 years, and those of non-cumulative issues can be passed indefinitely, without the threat of investors being able to force the issuer into bankruptcy. This is in stark contrast to a standard corporate bond, where a bondholder can force an issuer into bankruptcy after one missed coupon payment. Preferred security investors generally have preference over common equity investors, whereby all payments must be made before any dividend payments are distributed on common equity. While there are companies that have failed to pay on their preferreds, most have done so only when they have filed for bankruptcy and also defaulted on their senior bonds and loans.

> "Preferred securities rank junior to senior debt, but are senior to common equity."

Junior ranking in capital structure

Preferred securities rank junior to senior debt, but are senior to common equity. For example, if a company has filed for bankruptcy and the assets of the company are liquidated to pay off creditors, the most senior investors would expect to receive more than those lower (e.g., preferred security investors) in the capital structure. This "recovery rate" is expressed as the amount recovered as a percentage of the par amount of the investment.

Distributions

Preferred securities pay distributions to their holders in the form of interest or dividend payments, either on a quarterly or semi-annual basis. The tax characteristics of preferreds can vary depending on the jurisdiction of the issuer and investor, and specific security structure. Dividend payments are not tax deductible to the issuer but may be tax beneficial to the investor. Interest payments are tax deductible to the issuer and potentially fully taxable to the investor.

Callable

Most preferred securities are callable or redeemable prior to maturity by the issuer. This right allows the issuing company the option to buy back the securities from the investor at the stated par value before the maturity date. This is valuable to the issuer because, if interest rates decline after the securities have been issued, the issuer can "call back" the securities and re-issue new securities at a lower interest rate, thereby locking in a cheaper cost of capital. To make the securities more attractive to investors, the issuer provides some guarantee that it will not call the security for a specific period of time. This "call protection" is generally five years for $25 par securities and 10 years for $1,000 par capital securities. This embedded call option feature in the security has value to the issuer and creates reinvestment risk[1] for the investor. The value of this option will change as the probability of the security being called increases or declines. For example, a security that is trading at a significant premium to par, implying that interest rates have fallen since issuance, is likely to get called at the first available call date. Alternatively, a security trading at a deep discount to par implies that interest rates have risen since issuance, meaning the security is unlikely to be called soon.

[1] Reinvestment risk is the risk that future coupon payments will not be reinvested at the interest rate from the initial purchase of the bond.

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Structures

There are several types of preferred and capital securities in the market.

> "Most of the preferred securities market comprises large global financial services issuers."

Baby bonds

Senior debt structured and issued as $25 par instruments, meaning that each bond has a stated, par value of $25, with a specific, dated maturity. Baby bonds appeal to retail investors who ordinarily cannot participate in the institutionally-traded senior debt and $1,000 capital security markets. Baby bonds are usually listed on a securities exchange, such as the New York Stock Exchange (NYSE).

Subordinated debt

Junior to senior debt, and frequently plays some role in meeting regulatory capital requirements for insurance companies. Subordinated debt usually has a specific, stated maturity, and coupons are typically not deferrable.

Cumulative junior-subordinated debt and non-cumulative preferred securities

Comprising a majority of the preferred and capital securities market, these rank junior to baby bonds and subordinated debt, and have coupons that can be deferred. The most senior of these securities are $25 par and $1,000 par junior-subordinated debt instruments (typically bonds with long-dated maturities or perpetuities) having cumulative coupons. These are generally issued by insurers, utilities, and industrial companies. "Cumulative" means that any deferred coupons continue to accrue as a liability to the issuer. Non-cumulative perpetual preferreds are subordinated to cumulative preferreds. Non-cumulative perpetual preferreds include both $25 par and $1,000 par dividend-paying preferreds, largely additional tier 1 ("AT1") securities of U.S. banks.

AT1 contingent convertible (CoCos) capital securities

A recent form of capital issued by non-U.S. (mostly European) banks as part of newer regulation following the global financial crisis. CoCos are structured as junior, non-cumulative perpetual securities whose coupons can be skipped at any time. In addition, if the issuer's regulatory common equity capital drops below certain pre-set levels, the CoCo will be either written down in par value (sometimes with the ability to be written back up later if the issuer's capital improves), written off completely, or converted into common stock, depending on the terms of the structure. U.S. banks do not currently issue CoCos due to different tax laws in the United States.

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The preferred securities market

The hybrid securities market can be divided into a retail $25 par sector and an institutional $1,000 par capital securities sector. This market began in the early 1990s, largely driven by regulatory rules for financial institutions. Until then, most preferreds were issued by railways, utilities, and industrial firms.

The market for U.S. dollar-denominated preferreds, totaling over US$500 billion, trades on the U.S. listed exchanges or over-the -counter.

$25 par securities

When Texaco issued the first $25 par security in 1993, it was not only structured more like a bond, but it also targeted the retail market. Texaco listed the securities on the NYSE, a market where retail investors were comfortable because of their equity investing experience. Like with the Texaco issuance, denominating $25 par securities in small sizes enables a retail investor to buy 100 shares for around $2,500. This differs from the corporate bond market which trades over the counter (OTC) in large lot sizes and is not as easily accessible to retail investors. Today, $25 par preferred securities are still dominated by retail rather than institutional investors.

$1,000 par capital securities

Also known as capital securities, these preferred securities are designed to have similar trading characteristics to corporate bonds. Accounting for a majority of the U.S. dollar-denominated preferred market, capital securities trade OTC with accrued interest in large, institutional lot sizes. The first hybrid $1,000 par preferred security was issued in 1996 by First Bank System, a regional U.S. bank. The issuance was driven by a decision from the U.S. Federal Reserve that allowed U.S. banks to treat qualifying trust preferred securities as part of their regulatory capital. This decision established the U.S. banks on par with European and other foreign banks. Capital security issuance to institutional investors became a cheap option (versus equity issuance) for a bank raising regulatory capital.

Credit quality of preferreds

The stable credit quality of preferreds reflects the resiliency of large banks and insurers, which represent the major issuers. Post global financial crisis, the banking and insurance industries have evolved into two of the most attractive industry sectors due to strengthened credit fundamentals. This improvement has been driven by regulatory changes implemented in the United States through the Dodd-Frank Act, globally through the Basel III agreement for banks, and in Europe through Solvency II for insurers. Unlike before the global financial crisis, banks are now more “utility-like,” characterized by steadier profits, higher capital levels, lower leverage, tighter regulation, and simplified, better managed business models. Today, the insurance industry exhibits even stronger capital and liquidity, supported by sound risk management and enhanced regulatory initiatives. Following the global financial crisis, the fundamental health of the financial industry has resulted in a reduction in global systemic risk.

Most preferred securities are rated by the large credit rating agencies such as Standard & Poor’s, Moody’s and/or Fitch. It has become an industry standard that preferreds are formulaically rated several notches below the rating of the senior debt of the same issuer. Nearly 90% of the senior debt of preferred issuers is investment grade, making preferreds reasonably comparable to high grade rather than below investment-grade fixed income due to better underlying credit fundamentals. Historically, the default characteristics of preferreds have been markedly lower than those of below investment-grade bonds. Moreover, similar to investment-grade debt, preferred securities have experienced little to no defaults over the past several years.

Approximately half of the preferred securities market today is rated investment grade, which is significantly lower than in 2007 when the market was mostly investment grade. After the global financial crisis, the major rating agencies adjusted their preferred security rating methodologies—principally for banks—under the rationale that preferred ratings should no longer benefit from government support (i.e., a bailout). This resulted in preferred ratings being lowered by three notches to an average rating of BBB-, compared with a rating of A- pre-global financial crisis. The rating agencies have reduced their government support assumptions for senior and subordinated debt as well, which has led to some ratings compression between debt and preferreds.

Companies issue preferreds for a variety of reasons

Most of the preferred securities market comprises large global financial services issuers. Among the many benefits are:

Regulatory capital credit

Global banking regulation categorizes certain preferred stock and contingent capital as AT1 capital. Notably, preferreds serve as an important source of regulatory capital providing support for bondholders and other senior creditors.

Structural benefits

Due to deferrable income features, non-payment of interest or dividends does not create an event of default for the issuer. Embedded call options can also add value.

Rating agency equity credit

The major credit rating agencies can award some equity credit to preferred securities when analyzing a company's enterprise credit rating. Consequently, the issuance of a preferred security could have less of an impact on an issuer's financial leverage (compared with that of a straight bond), while supporting the issuer's senior debt rating.

Lower capital cost

Due to greater risks in common stock ownership, equity investors require a higher return than that demanded from preferred investors. As a result, preferreds can present a lower cost option to the issuer and provide some equity credit. Importantly, preferred issuance is non-dilutive to shareholders.

Tax advantages

The tax characteristics of preferred securities can vary by jurisdiction, and can be attractive to both the issuer and the investor. Interest payments are generally tax deductible to the issuer and may be fully taxable to the investor. Dividend payments are not tax deductible to the issuer and may be tax beneficial to the investor. From a U.S. investor's perspective, dividend payments made by a U.S. issuer can qualify for favorable tax treatment.

Meeting investor demand

The development of the $25 par retail-oriented preferred securities market tapped a new investor base for issuers. The yields demanded by retail investors may differ from institutional investors depending on market conditions. From a capital raising perspective, an issuer has the benefit of choosing the market with the best demand and pricing dynamics.

What makes preferreds attractive to investors?

Yield

Historically, preferred securities are one of the highest yielding sectors of the fixed income market. Preferreds typically trade at an attractive spread over the same issuer's senior debt. As such, when the enterprise rating of a particular issuer is stable to improving, investment in a junior-subordinated instrument (e.g. a preferred security) gives the potential for a greater yield and return than debt issued higher in the capital structure. This is known as investing "down the capital structure."

Regular income frequency

$25 par preferred securities pay quarterly distribution payments, similar to common stock payments. $1,000 par capital securities pay semi-annual coupons, similar to corporate bond frequencies. Coupon payments are dependent upon an issuer's ability to service their debts.

Quality

The majority of preferred securities are issued by well-known and widely-researched companies which generally have investment-grade-rated senior debt. Historically, most of the additional return generated by preferred securities is attributable to the junior-subordination premium and the value of the call option. Defaults in the preferred securities market are somewhat greater than those found in the investment grade corporate bond market, yet significantly below those found in the below-investment-grade corporate bond market.

Diversification

Historically, preferred securities have moderately positive correlations with the general bond market. Preferreds, therefore, have the potential to offer an attractive diversification tool for fixed income investors by helping to rebalance expected risk-adjusted returns of a broad fixed income portfolio.

Liquidity

Most preferred securities markets can be categorized as "liquid," whereby individual constituents can be expected to be sold within seven calendar days or fewer.

Market inefficiency

While there is not ongoing dispersion between the markets, the predominance of retail investors in the $25 par market and institutional investors in the $1,000 par preferred securities market can potentially create pricing inefficiencies and trading opportunities for investors willing and able to access and trade both markets.

Yields and spreads

Preferred securities, like other fixed income securities, are typically valued on a yield basis, and spread basis versus U.S. Treasurys. Spread relationships to senior debt are a key value consideration as well.

Current yield

This is calculated by dividing the annual coupon payment by the current market price of the security.

Yield to maturity

This is the yield if the bond is held to final maturity and dividends are reinvested at the yield-to-maturity rate, taking into account the income earned and any capital gain or loss that will be made. For example, an investor has to consider redemption at a lower price if a bond is bought at a premium and held to maturity, as the holder will only receive the par or nominal value at maturity.

Yield to call

This is the realized yield if a security is held until the first call date, assuming all dividends are reinvested at the call rate and taking into account any income and capital gains or losses.

Yield to worst

This is the lower of the yield to maturity and the yield to call. Generally, if the bond is trading at a premium to par, the yield to call will be lower and the bond is more likely to be called. However, if it is trading at or below par, the yield to maturity will be lower and it is more likely not to be called.

Interest rates can change during any holding period. Importantly, an investor should monitor reinvestment rates, and the risk that a fixed coupon may switch to a floating rate (or variable re-fixed rate) over the life of the issue.

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The scope of our investor base spans over 70 markets

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Spectrum Asset Management

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Spectrum has a long track record of implementing its fundamental credit-based investment philosophy, leveraging its expertise in capital structure analysis and employing and retaining its experienced team of investment professionals.

Spectrum manages portfolios of preferred securities for an international universe of corporate, pension fund, insurance and endowment clients, open-end and closed-end mutual funds domiciled in the United States, Ireland and Japan, and separately managed account programs for high-net-worth individual investors sponsored by a variety of broker-dealers. Spectrum's capabilities can be accessed via the locally registered Principal Global Investors entity.

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Risk warning

Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results. Fixed-income investment options are subject to interest rate risk; as interest rates rise their values will decline Risks of preferred securities differ from risks inherent in other investments. In a bankruptcy, preferred securities are senior to common stock but subordinate to other corporate debt (Preferred securities rank junior to senior debt). When interest rates rise, the price of debt and preferred securities typically declines. Contingent capital securities (CoCos) may have substantially greater risk than other securities in times of financial stress. An issuer or regulators decision to write down, write off or convert a CoCo may result in complete loss on an investment.

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