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Spectrum Asset Management

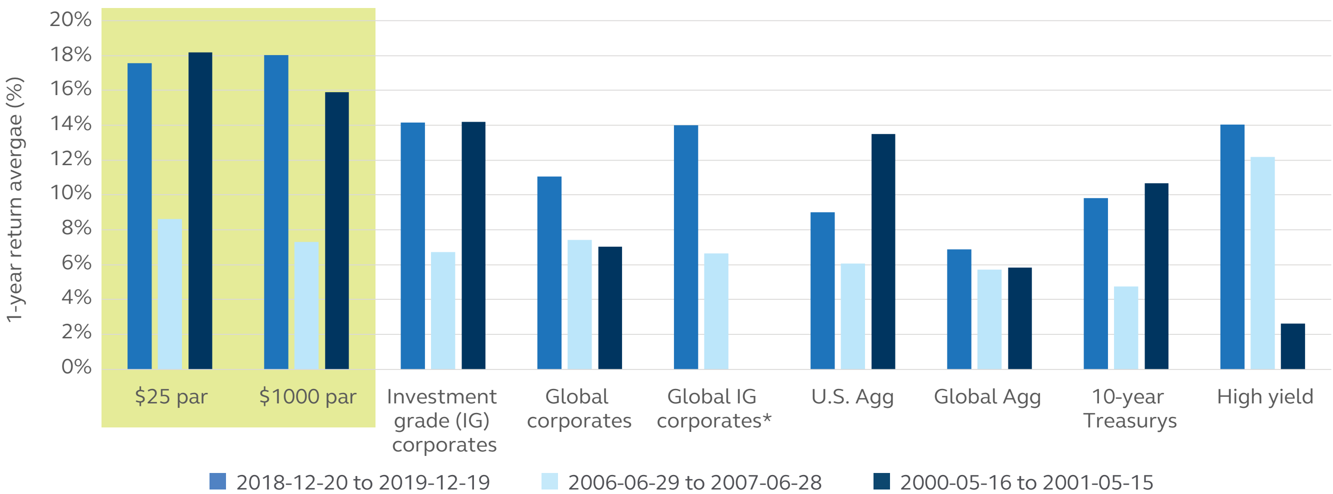
Principal Asset Management℠

Preferred and capital securities in today's environment

The Federal Reserve (Fed) has continued to keep rates flat for the time being and, according to Chairman Jerome Powell, it is likely that rates will be cut at some point this year. We believe an allocation to preferred and capital securities during this market environment can be beneficial for investors. Their performance in previous flat and declining rate environments have been attractive and the discounted prices of the asset class may help provide increased total return potential.

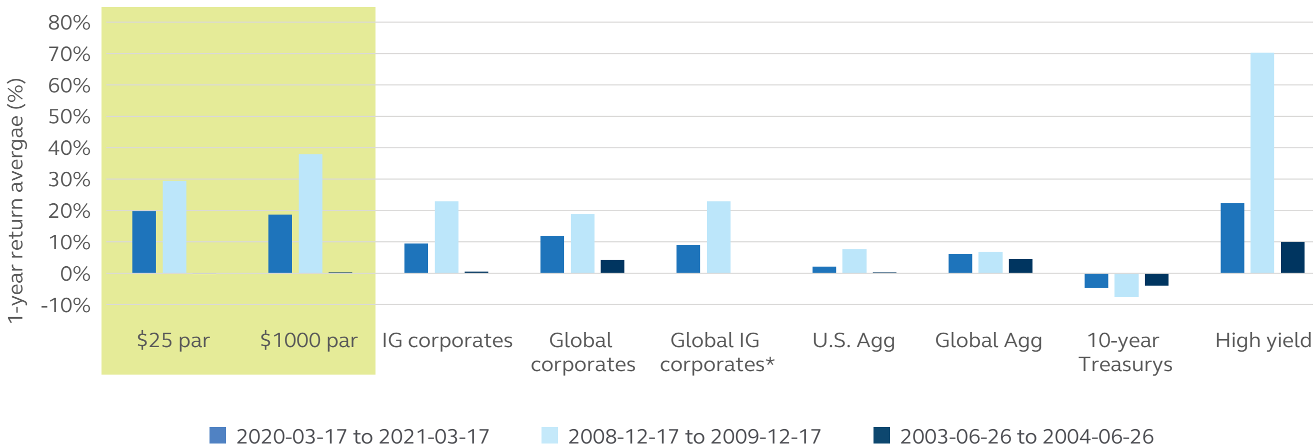
Historical performance in flat and declining rate environments

EXHIBIT 1: Fixed income sectors following previous flat rate environments.



Source: Bloomberg, Spectrum Asset Management. Past performance does not guarantee future results. *Bloomberg does not have daily data for this index prior to September 14, 2004. Please see disclosures for index descriptions.

EXHIBIT 2: Fixed income sectors following previous declining rate environments.



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Income and return

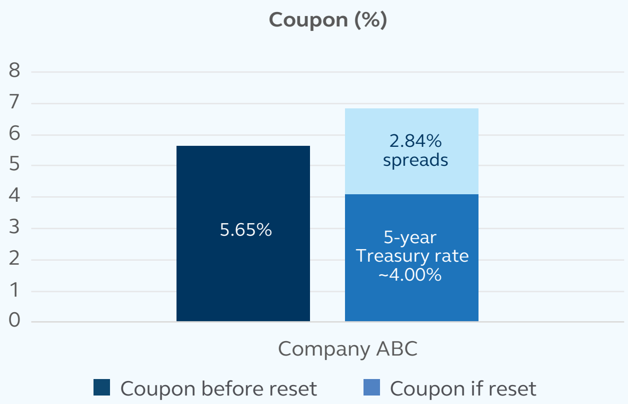
Not only historically has the asset class held up well but newer structures with discounted prices could also provide an attractive opportunity for preferred and capital securities.

Due to the stress of the current market environment, one structure in particular—the fixed-to-variable securities—has been discounted. These structures typically have their yield set for a number of years and then reset to a market rate plus a back end spread.

Many of these securities were issued (back-end) when rates were lower. As rates and the Treasury markets have risen, the fixed-to-variable securities present an attractive opportunity. Issuers can make the economic decision to let the coupon reset at a higher rate, which may mean accepting an increased cost, or call the security at par, thus, providing an entry point for investors looking for higher income potential as coupons reset or attractive total returns as the structures "pull towards par".

EXHIBIT 3: A case study of a security issued at a discount

Security ABC was trading as low as $90 in the last eight months with a coupon of 5.65%. It was scheduled to reset on June 15, 2023, at the 5-year Treasury (roughly 4%) plus a spread of 2.84%. If the company had let the coupon reset, the new coupon would have roughly been 6.84%.



For illustrative purposes only. Not specific to any securities.

On the other hand, if—instead of letting the coupon reset—the company called the preferred at 100, one could have received a double-digit equity-like return from this individual fixed income security in less than a year.

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Looking at stated coupons and back-end reset rates is only one of many things to review when investing in the preferred and capital securities asset class. As securities have evolved, newer coupon structures have become available that may help clients in various rate environments. We believe there is good value in fixed-to-variable reset structures based on discounted prices and potentially elevated coupons with unique total return opportunities, as securities pull price toward par over the intermediate term.

Spectrum Asset Management

As one of the largest specialized managers of preferred and capital securities in the U.S., Spectrum Asset Management manages US $19.0 billion in assets under management as of December 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 Core Fixed Rate Preferred Securities Index ($25 par) tracks the performance of fixed rate U.S. dollar denominated investment grade preferred securities issued in the U.S. domestic market.
- ICE BofA U.S. Investment Grade Institutional Capital Securities Index ($1000 par) tracks the performance of U.S. dollar denominated investment grade hybrid capital corporate and preferred securities publicly issued in the U.S. domestic market.
- ICE BofA U.S. Corporate Index (Investment grade corporates) tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market.
- ICE BofA Global Corporate Index (Global corporates) tracks the performance of investment grade corporate debt publicly issued in the major domestic and eurobond markets.
- Bloomberg Global Aggregate Corporate USD Total Return Index Value (Global investment grade corporates) is a flagship measure of USD denominated global investment grade debt, fixed-rate corporate debt.
- Bloomberg U.S. Aggregate Index (U.S. Agg) provides a broad-based measure of the U.S. investment-grade fixed income markets.
- Bloomberg Global Aggregate Total Return Index Value (Global Agg) is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.
- ICE BofA Current 10-Year U.S. Treasury Index (10-year Treasurys) is a one-security index comprised of the most recently issued 10-year U.S. Treasury note.
- ICE BofA U.S. High Yield Index (High yield) tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

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.

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