Principal Asset Management℠

SPECTRUM SMA PREFERRED SECURITIES WITH CAPITAL SECURITIES

Quarterly commentary

2023 FOURTH QUARTER

Market environment

The fourth quarter was primarily a period of U.S. Treasury (UST) bond market capitulation in October and record reversal in November and December after fully pricing expectations for the Federal Reserve (Fed) policy to keep rates elevated for an extended period then suddenly reversing and pricing in six rate cuts next year. Indeed, Chairman Powell had convinced markets that there seemed to be a very long off ramp on inflation by saying, rates are restrictive and "there's a long way to go" on inflation. But in December, he said rates are "well into restrictive territory" and that the Fed had talked about rate cuts in the December meeting. UST ten-year yields dropped 68 basis points (bps) and UST 30-year yields dropped 65 bps by the end of the quarter. The change in market expectations on Fed policy further disinverted the yield curve by 20 bps, but the difference in yield between the UST ten-year note and the UST two-year note still closed the year inverted by -37 bps which foretells a slowing economy should still forthcoming. The overall market mood was jubilant and there appeared to be "buy at any cost" mentality as shorts were scrambling to cover and hybrid traders were buying just about anything to get long. Issuance surged in November, particularly in the CoCo sector, which saw deals price with coupons ranging between 9%-10%.

The ICE BofA All Capital Securities Index (I0CS) rose 6.46% in the fourth quarter compared to a decline of 0.19% during the last quarter -- the $1,000 par sector returned 6.82% and contributed 4.51% to the overall return, while the $25 par sector returned 6.82% and contributed 1.98% to the overall return. The ICE USD Contingent Capital Index (CDLR) rose 7.38% in the fourth quarter compared to 1.93% last quarter on the heels of an extraordinarily well-received two-part benchmark deal from UBS at 9.25%.

Valuation thoughts going into 1Q of 2024:

Spreads on the ICE BofA U.S. Investment Grade (IG) Index (CIPS) had a 50 basis point range this quarter and closed 16 bps tighter at an OAS of 243 bps. Spreads on the CDLR (CoCos) had a 75 basis point range and closed 51 bps tighter at an OAS of 316 bps. Spreads on the ICE BofA 5-10-year Investment Grade Corporate Index (C6C0) ended the quarter at 121 bps (30 bps tighter) and the ICE BofA U.S. High Yield (H0A0) ended the quarter at 339 bps (64 bps tighter). Compared to the IG Corporate Index, IG preferred securities (i.e., CIPS) offer a higher subordination premium of 2.01 times (i.e., 243/121) this

KEY TAKEAWAYS

- The UST market rallied significantly during the quarter after the Fed indicated it was likely done raising rates and that next year there may be a series of rate cuts.
- Expanding economic activity supported our sanguine credit expectations as junior subordinated credit performed very well by rallying roughly 100 bps lower in yield and tightening by about 20 bps in preferred securities and about 90 bps in CoCo securities.
- Performance between the institutional sectors and the retail sector was balanced as $1000 par preferred securities gained 6.38% and $25 par hybrids gained 6.42%; CoCo securities gained 7.38%.

SMA PROFILE

SMA with Capital Securities

$25 par preferred securities portfolio including an allocation to $1,000 par capital securities through inclusion of the Principal Funds Inc. Capital Securities Fund (PCSFX).

SMA Benchmark

ICE BofA Core Fixed Rate Preferred Securities Index (P0P2).

quarter than last quarter; CoCos also offer a higher subordination premium of 2.61 times (i.e., 316/121) this quarter. Also, from a duration standpoint institutional IG preferred securities have an average effective duration of 4.2 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 2.0 times the spread by going down the capital structure into preferred securities but take only about 2/3rds the duration risk which highlights the value proposition available in hybrids. Our Comprehensive Risk Estimates for preferred and capital securities range from 2.82% (NoCos) to 5.52% (CoCos), which implies that all 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 – despite the yield declines, hybrids are a better relative value this quarter than last quarter.

Changes in 4Q 2023	Core fixed rate $25 preferred (P0P4)	$1000 par IG preferred securities (CIPS)	Contingent capital securities (CDLR)
Govt OAS spreads	-5 bps	-16 bps	-51 bps
Price index change (%)	+3.95	+3.67	+5.76

Source: ICE Bank of America.

$25 par market

The retail $25 par preferred securities sector had a positive quarter. ICE BofA Core Fixed Rate Preferred Securities Index (P0P2) had a total return of 6.87% for the quarter; -4.3%, +8.9%, and +2.5% for October, November, and December, respectively. While the market was concerned that the Fed would maintain elevated interest rates ("higher for longer") earlier in the quarter, the focus shifted more to rate cuts when both the labor market and the services showed signs of cooling in early November. Long-term Treasury yields dropped significantly during the period, which bolstered the $25 par preferred market performance as well. The government option adjusted spread tightened significantly with the rate cut optimism, fluctuating towards the end of the year as the market tried to balance the expectation of rate cuts against the risk of economic downturn.

The ongoing trend of supply shortage from the primary market and redemptions continued, which exacerbated supply imbalance of the $25 preferred market. There were some senior debt deals with relatively small sizes such as $345 million deal from F&G Annuities & Life (FG), but there was no issuance from major banks. Citigroup called two issues totaling $1.9 billion during the quarter: CpK full call and CpJ with a partial redemption.

The sector closed the quarter yielding 5.78% (51 bps lower than the last quarter's end). The spread (OAS) over comparable U.S. Treasury securities was 59 bps (6 bps tighter).

$25 par preferred specific ETFs had big outflows totaling over $200 million in October but underwent a complete reversal in November cancelling out the previous outflows. The total inflow for the quarter was approximately $630 million.

$1,000 par market

- There were $-60 million of net (out)flows during the period; AUM closed at $1.04 billion
- Added $7 million Limited Recourse Capital Notes (LRCN)
- Added $8 million Insurance Hybrids
- Cut $2 million Utility Hybrids
- Cut $5 million $1000 par Pfd (U.S. bank AT1)
- Cut $23 million CoCos
- Cut $10 million Floating Rate Legacy Hybrids
- The average rating of the portfolio was little changed -- using the middle of three NRSO ratings the score went from 8.85 (BBB-) to 8.82 (BBB-); the amount of below investment grade paper (using middle three NRSOs) went from 30.9% to 31.5%
- The portfolio is 96.1% variable rate with a modified duration of 2.9 years

SMA portfolio characteristics and performance review

	SMA portfolio	SMA benchmark
	SMA with Capital Securities	P0P2
Average dollar price ($)	88.50	87.99
Average coupon (%)	5.43	5.31
Current yield (%)	5.93	6.03
Yield to worst (%)	6.03	5.78
Modified duration (years)	8.95	13.02
Quality	BBB2	BBB2

Source: Spectrum Asset Management, Bloomberg. As of 12/31/2023. ICE BofA Core Fixed Rate Preferred Securities Index (P0P2).

	Total returns (%)					
	3-month	Year-to-date	1-year	3-year	5-year	10-year
SMA with Capital Securities (gross)	6.06	8.44	8.44	-1.44	3.71	5.00
SMA with Capital Securities (net)[1]	5.48	6.04	6.04	-3.64	1.40	2.67
Performance benchmark[2]	6.87	10.79	10.79	-3.08	2.54	4.57
P0P2	6.87	10.79	10.79	-3.08	2.54	4.57

Past performance is not indicative of future returns.

Source: Principal Global Investors. As of 12/31/2023.

[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

$25 par contributors

- **Berkley (WR) Corporation** 4.125% WRBprH
- **Truist Financial Corp** 4.75% TFCprR
- **U.S. Bancorp** 4.5% USBprS
- **Arch Capital Group Ltd** 4.55% ACGLN
- **Bank Of America Corp** 4.25% BACprQ

$25 par detractors

- **Entergy Louisiana Llc** 4.875% ELC
- **Georgia Power Co** 5% GPJA
- **Keycorp** 6.125% KEYprI
- **Entergy Arkansas Llc** 4.875% EAI
- **Morgan Stanley** 7.125% MSprE

$1,000 par contributors

- AT1 CoCos returned 6.75% and contributed 1.71% to the Fund’s return.
- $1000 par Preferred Stocks returned 6.21% and contributed 2.69% to the Fund’s return.
- Insurance hybrids returned 4.98% and contributed 0.64% to the Fund’s return.

$1,000 par detractors

- The 22.4% underweight in the $25 par Preferred Stock sector detracted 1.59% from the return relative to the All Capital Securities Index (I0CS).
- The 6.9% underweight in the $25 par hybrid sector detracted 0.49% from the return relative to the All Capital Securities Index (I0CS).
- The 2.6% underweight in the $25 par REIT sector detracted 0.13% from the return relative to the All Capital Securities Index (I0CS).

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. Past performance does not guarantee future return.

New additions

- **Wells Fargo & Company** 4.75% WFCprZ

Increased positions

- **Bank Of America Corp** 4.25% BACprQ
- **JPMorgan Chase & Co** 4.75% JPMprJ
- **Southern Co** 4.95% SOJD
- **American Intl Group** 5.85% AIGprA
- **Truist Financial Corp** 4.75% TFCprR
- **CMS Energy Corp** 5.875% CMSD
- **Capital One Financial Co** 4.8% COFprJ
- **Charles Schwab Corp** 4.45% SCHWprJ
- **Arch Capital Group Ltd** 4.55% ACGLN
- **Fifth Third Bancorp** 4.95% FITBO
- **AT&T Inc** 5% TprA
- **Metlife Inc** 4.75% METprF
- **DTE Energy Co** 4.375% DTG

Decreased positions

- **Citigroup Inc** 9.63176% CprJ *(partial call)*

Closeouts

- **Citigroup Inc** 6.875% CprK *(called)*

SMA with Capital Securities

SMA with Capital Securities major security sector components	Weight (%)	Contribution to return (%)
InsuranceHyb ($1,000 par junior subordinated debt - insurance)	5.51	0.27
AT1 ($1,000 par non-U.S. bank contingent convertible securities)	9.67	0.72
1000parDRD ($1,000 par U.S. bank AT1 preferred stock)	0.00	0.00
1000CapitalSecFloater ($1,000 par floating rate U.S. bank trust preferred securities)	0.00	0.00
BankingHyb ($1,000 par non-U.S. banks trust preferred securities)	0.94	0.07
DRDPfd ($1,000 par non-cumulative preferred stock)	0.00	0.00
CorporateHyb ($1,000 par junior subordinated debt - corporates)	1.67	0.10
UtilityHyb ($1,000 par junior subordinated debt - utilities)	0.86	0.03
SubDebt ($1,000 par subordinated debt)	0.16	0.01
T2Coco ($1,000 par tier2 contingent convertible securities)	0.00	0.00
MasterLPs ($1,000 par junior subordinated debt - MLP and energy)	2.04	0.13
25parPfd ($25 par preferred stock)	38.28	2.44
REITPfd ($25 par cumulative REIT preferred securities)	4.12	0.32
1000parPfd	18.04	1.12
U.S. Treasury	0.00	0.00
TRUPFloater	0.79	0.02
PfdStock	0.04	0.00
RT1	0.16	0.02
PreferredETF	0.06	0.00
NVCC_RT1	0.00	0.00
BankNVCC_AT1	0.92	0.05
Limited Recourse Capital Notes	0.95	0.07
25parDRD	0.00	0.00
25parHybrid	8.72	0.76
BabyBond	1.63	0.00
Cash	5.43	0.01
Total return gross	100.00	6.14
Total return net	—	5.48

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Portfolio sector attribution

Top contributors	Weight (%)	Contribution to return (%)	Top detractors	Weight (%)	Contribution to return (%)
Banking	37.95	2.40	Insurance Brokerage	0.04	0.00
Banking - Foreign	12.46	0.91	Utility - Foreign	0.22	0.00
Brokerage	9.20	0.42	Preferred ETF	0.06	0.00

Portfolio allocation

Top 5 issuers	Weight (%)	Top 5 industries	Weight (%)	Top 5 countries	Weight (%)
Bank of America Corp	3.87	Banking	37.95	United States	75.65
U.S. Bancorp	3.77	Banking - Foreign	12.46	Britain	4.67
Wells Fargo & Co	3.53	Brokerage	9.20	Canada	3.70
Morgan Stanley	3.51	Utility	7.96	Switzerland	2.80
Huntington Bancshares Inc/OH	3.15	Insurance - Life	4.92	France	1.55

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Market outlook

- As spreads were tighter and yields moved lower, our absolute return expectations are trimmed somewhat, but the spreads in junior subordination compared to more senior financials are improved – especially when considering better spreads per unit of duration for hybrids and CoCos.
- There are attractive yields available in hybrid preferred securities which offer significant yield advantages to corporate bonds.
- The UST market appears overbought in pricing in six rate cuts when the Fed seems generous in suggesting three rate cuts despite inflation still being above 3% and trending sideways.
- Ongoing equity complacency has turned to exuberance as real rates have zoomed lower and the Fed is posturing for rates cuts—a steeper UST yield curve and its constructive implications for the U.S. economy bode well for spread performance expectations.
- There is still good value in the junior subordinated fixed-to-refixed sectors based on discounted prices and still generous assumed coupons on a refixing which keeps the “pull toward par” story in play, regardless of the direction for intermediate rates.
- Today’s high hybrid yields are attractive based on our Comprehensive Risk profiles which compels us to be bullish on buying junior subordination in quality financials despite money market yields being high as well, though money market yields are expected to decline this year. By the time short rates do finally come down, prices on term spread product should have already made a good move higher (as they proved this quarter) in anticipation of lower rates playing through the back end of this rate cycle.

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