Principal Asset Management[SM]

SPECTRUM SMA PREFERRED SECURITIES WITH CAPITAL 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 CoCos offer marginally higher subordination premium of 2.46 times (i.e., 275/112). Also, from a duration standpoint

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 with Capital Securities

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

SMA Benchmark

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

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 1Q 2024	Core fixed rate $25 preferred (P0P4)	$1000 par IG preferred securities (CIPS)	Contingent capital securities (CDLR)
Govt OAS spreads	-65 bps	-59 bps	-41 bps
Price index change (%)	+3.53	+2.28	+1.45

Source: ICE Bank of America.

$25 par

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.

$1,000 par

- Added 0.96% to Cash
- Added 0.65% to $1000 par Preferred Stock
- Added 0.33% to Limited Recourse Capital Notes
- Cut 1.00% from Corporate Hybrids
- Cut 0.38% from Insurance Hybrids
- Cut 0.21% from Subordinated Debt
- The average rating of the portfolio improved – using the middle of three NRSO ratings the score was little changed moving from 8.82 (BBB-) to 8.85 (BBB-), excluding cash; the amount of below investment grade paper on average went from 31.5% to 31.7%
- The portfolio is 96.2% variable rate with a modified duration of 2.78 years

SMA portfolio characteristics and performance review

	SMA portfolio	SMA benchmark
	SMA with Capital Securities	P0P2
Average dollar price ($)	90.79	90.72
Average coupon (%)[3]	5.37	5.32
Current yield (%)[3]	5.72	5.86
Yield to worst (%)[3]	5.62	5.56
Modified duration (years)	8.95	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 with Capital Securities (gross)	4.49	4.49	11.43	0.24	3.17	4.66
SMA with Capital Securities (net)[1]	3.91	3.91	8.97	-1.99	0.88	2.34
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

$25 par contributors

- **Keycorp** 6.125% KEYprI
- **U.S. Bancorp** 4.5% USBprS
- **Capital One Financial Co** 5% COFprI
- **Truist Financial Corp** 4.75% TFCprR
- **Huntington Bancshares** 6.875% HBANL

$25 par detractors

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

$1,000 par contributors

- The $1000 par preferred stock sector contributed 2.40% to the portfolio.
- The CoCo AT1 sector contributed 0.67% to the portfolio.
- The insurance hybrid sector contributed 0.47% to the portfolio.

$1,000 par detractors

- The preferred stock sector underperformed and contributed 0.00% to the portfolio.
- The subordinated debt sector underperformed and contributed 0.00% to the portfolio.
- The passive preferred ETF sector contributed 0.01% to the portfolio.

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

- **Bank of America Corp** 6.24942% BMLprH
- **Assurant Inc** 5.25% AIZN

Increased positions

- **Bank of America Corp** 4.375% BACprO
- **Wells Fargo & Company** 4.75% WFCprZ
- **Berkley (WR) Corporation** 5.1% WRBprF
- **MetLife Inc** 4.75% METprF
- **Public Storage** 4.75% PSAprK
- **M&T Bank Corporation** 5.625% MTBprH

Decreased positions

- None for this period

Closeouts

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

SMA with Capital Securities

SMA with Capital Securities major security sector components	Weight (%)	Contribution to return (%)
InsuranceHyb ($1,000 par junior subordinated debt - insurance)	5.28	0.19
AT1 ($1,000 par non-U.S. bank contingent convertible securities)	9.51	0.27
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)	0.86	0.02
DRDPfd ($1,000 par non-cumulative preferred stock)	0.00	0.00
CorporateHyb ($1,000 par junior subordinated debt - corporates)	1.23	0.04
UtilityHyb ($1,000 par junior subordinated debt - utilities)	0.90	0.06
SubDebt ($1,000 par subordinated debt)	0.07	0.00
T2Coco ($1,000 par tier2 contingent convertible securities)	0.00	0.00
PipelineHyb ($1,000 par junior subordinated debt - MLP and energy)	2.04	0.12
25parPfd ($25 par preferred stock)	37.24	2.16
REITPfd ($25 par cumulative REIT preferred securities)	4.21	0.08
1000parPfd	18.07	0.98
U.S. Treasury	0.00	0.00
TRUPFloater	0.74	0.03
PfdStock	0.00	0.00
RT1	0.15	0.01
PreferredETF	0.05	0.00
NVCC_RT1	0.00	0.00
BankNVCC_AT1	0.86	0.04
Limited Recourse Capital Notes	1.07	0.03
25parDRD	0.00	0.00
25parHybrid	8.91	0.27
BabyBond	1.63	0.10
Cash	7.15	0.01
Total return gross	100.00	4.42
Total return net	—	3.91

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Portfolio sector attribution

Top contributors	Weight (%)	Contribution to return (%)	Top detractors	Weight (%)	Contribution to return (%)
Banking	37.15	2.28	**Insurance Brokerage**	0.00	0.00
Brokerage	8.96	0.39	**Food**	0.24	0.00
Banking - Foreign	12.21	0.36	**Preferred ETF**	0.05	0.00

Portfolio allocation

Top 5 issuers	Weight (%)	Top 5 industries	Weight (%)	Top 5 countries	Weight (%)
Bank of America Corp	5.06	**Banking**	37.15	**United States**	75.06
U.S. Bancorp	3.84	**Banking - Foreign**	12.21	**Britain**	4.08
Morgan Stanley	3.41	**Brokerage**	8.96	**Canada**	3.59
Public Storage	3.27	**Utility**	7.91	**Switzerland**	2.96
Huntington Bancshares Inc/OH	3.08	**Insurance - Life**	5.28	**France**	1.44

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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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