Principal Asset Management℠

SPECTRUM SMA PREFERRED SECURITIES

Quarterly commentary

2025 FIRST QUARTER

Market environment

The mood of the bond markets began to show concerns over the risks of rising inflation and corporate earnings disruptions from President Trump's notifications on tariffs. As a result, U.S. Treasury (UST) bond yields declined which shifted the term structure lower with the belly of the curve dipping a little more than longer maturities. The UST five-year note yield fell 43 basis points (bps) to 3.95% and the UST ten-year note fell 36 bps to 4.21%. The Federal Reserve (Fed) held policy rates steady this quarter but still left two rate cuts on the table. GDP growth was trimmed a bit and unemployment expectations rose, but Chairman Jerome Powell characterized any tariff impact on inflation as "transitory." Though leaving the policy rate unchanged, the Fed also slowed the pace of its balance sheet reductions to reduce the risk of a reserve shortage like in 2019. It said going "slower for longer" on reducing its holdings would build a "longer runway" for money markets to land more softly than its landing in the prior cycle. But the excessively eager tactics of the Trump administration is a surprise. Aggressive tariffs and retaliatory moves are repricing just about everything in capital markets. The administration's appetite for change appears to be voracious rather than gradual. Therefore, we believe that credit spreads have bottomed out in January and are now on a widening path to become higher than average. The volatility caused by policy challenges should create more interim buying opportunities. Importantly, the added growth policies of low taxation and less regulation can offset the drag from less fiscal spending; and more U.S. energy production can foster internal growth and disinflation. Global trade will eventually be renegotiated, and the rules will become clear. In the long run, these policies should foster a disinflationary economic environment that allows the Fed to cut its policy rates more and help to keep credit spreads tighter than average again.

Valuation thoughts going into 2Q of 2025:

- Everything moved wider this quarter due to the equity market volatility and a modest move lower in yields on the front end of the UST curve. The absolute spread score on retail paper widened by 0.73 standard deviations; the $25 par sector is a fair value with a spread score of 0.56 standard deviations above average.

KEY TAKEAWAYS

- The UST market rallied this quarter on concerns for tariffs and the drag they're apt to cause on global growth. The UST ten-year yield declined 36 bps to 4.21% after rising 79 bps last quarter. The Fed paused further rate cuts leaving the policy rate at 4.50-4.25%. The equity markets made new highs, but more chatter and concerns on tariffs cause share prices to trade down and volatility to rise, which widened credit spreads as USTs rallied.
- The retail preferred securities sector measured by P0P4 fell $2.69 and the rebalanced yield-to-worst rose 56 bps to 6.56% this quarter—spreads widened by 81 bps to an option adjusted spread of +136 bps (excluding call options, spreads to comparable treasuries are +217 bps).

SMA PROFILE

SMA Taxable
$25 par preferred securities portfolio

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)

Our Comprehensive Risk Estimates for preferred and capital securities range from +4.96% (NoCos) to +5.58% (CoCos), with retail paper ($25 par) in the middle at 5.51% which implies that all three hybrid sector yields are close to their average yields at the bottom or the three credit cycles because—hybrids are still an absolute value given their high yields despite generally tight spreads in not only hybrids, but in credit overall.

Changes in 1Q25 (Source: ICE Bond Indices)	Core fixed rate $25 preferred (P0P4)	$1,000 par IG preferred securities (IIPS)	Contingent capital securities (CDLR)
Govt OAS spreads	+81 bps	+28 bps	+29 bps
% Price change	-2.69	-0.08	+0.39

Source: ICE Bank of America.

$25 par market

The $25 par retail preferred securities sector had a volatile and negative quarter. ICE BofA Core Fixed Rate Preferred Securities Index (P0P2) had a total return of -1.23% for the quarter: +0.46%, +1.38%, and -3.02% for January, February, and March, respectively.

The $25 preferred market whipsawed in January as shown by the intra-month return between 1/3/2025 and 1/13/2025, which was -4.29%, and the final monthly return of +0.46%. Job data showing the labor market being resilient slashed the expectations for the Fed's rate cuts, putting pressure on the Treasury market. As a result, the $25 preferred market plunged as well only to recover sharply later toward the end of the month due to the release of a surprise slowdown of CPI data. More volatility came in late March when market focus shifted to the concerns around trade tariffs and the U.S. economy growth. As investors sought safe havens, the long-term Treasury yield declined, and spreads widened sharply.

There were a couple of notable new issues in the primary market—Southern Co 6.5% ($565 million) Jr. Subordinated Debt and Bank of NY Mellon Corp 6.15% ($500 million) Preferred. There were no redemption announcements of note. Even with some new issuance, the ongoing trend of supply shortage from the primary market continued, which provided support to the market from a technical standpoint.

The sector closed the quarter yielding 6.23% (62 bps higher than last quarter's end). The spread (OAS) over comparable U.S. Treasury securities was +94 bps (86 bps wider).

The direction of cashflows for $25 par preferred securities specific ETFs was mixed but mostly positive. PGX had a relatively big cash outflow, erasing the increase in share counts from last quarter. For the quarter, the total inflow for the ETFs was approximately $500 million.

SMA portfolio characteristics and performance review

	SMA portfolio		SMA benchmark
	SMA Taxable	SMA Tax Advantaged	P0P2
Average dollar price ($)	83.14	83.25	84.68
Average coupon (%)[1]	5.15	5.15	5.38
Current yield (%)[1]	6.15	6.12	6.35
Yield to worst (%)[1]	5.90	5.89	6.23
Modified duration (years)	13.86	13.54	12.87
Quality	BBB2	BBB2	BBB2

Source: Spectrum Asset Management, Bloomberg. As of 03/31/2025. ICE BofA Core Fixed Rate Preferred Securities Index (P0P2).

[1] 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.

	SMA Taxable total returns (%)				
	3-month	1-year	3-year	5-year	10-year
SMA Taxable (gross)	-0.87	-1.79	0.54	2.87	3.31
SMA Taxable (net)[2]	-1.43	-3.98	-1.70	0.59	1.01
Performance benchmark[3]	-1.23	-1.44	0.25	1.83	2.85
P0P2	-1.23	-1.44	0.25	1.83	2.85

	SMA Tax Advantaged total returns (%)				
	3-month	1-year	3-year	5-year	10-year
SMA Tax Advantaged (gross)	-0.86	-1.58	0.70	3.10	3.39
SMA Tax Advantaged (net)[2]	-1.42	-3.77	-1.54	0.81	1.09
Performance benchmark[3]	-1.23	-1.44	0.25	1.83	2.85
P0P2	-1.23	-1.44	0.25	1.83	2.85

Past performance is not indicative of future returns.

Source: Principal Global Investors. As of 03/31/2025.

[2] Net fees are 2.25%.

[3] 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.

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. Performance results shown reflects the composite for each strategy listed.

SMA Taxable

SMA Taxable major security sector components	Weight (%)	Contribution to return (%)
25parPFD ($25 par preferred stock)	72.42	-0.62
25parHybrid ($25 par junior- subordinated bond)	16.58	-0.09
BabyBond ($25 par senior debt)	1.83	-0.06
REIT Pfd ($25 par cumulative REIT preferred securities)	6.29	-0.10
Total weight	97.12	—
Total return gross	—	-0.87
Total return net	—	-1.43

Portfolio sector attribution

Top contributors	Weight (%)	Contribution to return (%)	Top detractors	Weight (%)	Contribution to return (%)
Reinsurance	0.47	0.00	Banking	46.99	-0.36
Financial	1.16	-0.02	REIT - Preferred	6.29	-0.10
Insurance - Life	9.03	-0.04	Insurance - Multi Line	3.10	-0.07

Portfolio allocation

Top 5 issuers	Weight (%)	Top 5 industries	Weight (%)	Top 5 countries	Weight (%)
Bank of America Corp	7.80	Banking	46.99	United States	96.25
Morgan Stanley	6.72	Utility	11.14	Bermuda	0.87
Wells Fargo & Co	5.34	Brokerage	11.12	—	—
JPMorgan Chase & Co	5.10	Insurance - Life	9.03	—	—
U.S. Bancorp	4.69	REIT - Preferred	6.29	—	—

Portfolio update

Contributors

- **Fifth Third Bancorp** 4.95% FITBO
- **Truist Financial Corp** 4.75% TFCprR
- **Truist Financial Corp** 5.25% TFCprO
- **Voya Financial Inc** 5.35% VOYAprB
- **Citizens Financial Group** 5% CFGprE

Detractors

- **U.S. Bancorp** 4% USBprR
- **MetLife Inc** 4.75% METprF
- **CMS Energy Corp** 4.2% CMSprC
- **Bank of America Corp** 4.375% BACprO
- **Prudential Financial Inc** 4.125% PFH

New additions

- **Bank Of NY Mellon Corp** 6.15% BKprK
- **Southern Co** 6.5% SOJF

Closeout

- None for this period

Increased positions

- **Bank of America Corp** 4.25% BACprQ
- **JPMorgan Chase & Co** 4.2% JPMprM
- **Wells Fargo & Company** 4.25% WFCprD
- **Wells Fargo & Company** 4.75% WFCprZ
- **JPMorgan Chase & Co** 4.55% JPMprK
- **Wells Fargo & Company** 4.375% WFCprC
- **Public Storage** 3.875% PSAprN
- **AT&T Inc** 4.75% TprC

Decreased positions

- **Morgan Stanley** 6.875% MSprF
- **JPMorgan Chase & Co** 6% JPMprC

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SMA Tax Advantaged

SMA Tax Advantaged major security sector components	Weight (%)	Contribution to return (%)
25parPFD ($25 par preferred stock)	79.13	-0.62
25parHybrid ($25 par junior- subordinated bond)	11.70	-0.10
BabyBond ($25 par senior debt)	1.48	-0.06
REIT Pfd ($25 par cumulative REIT preferred securities)	4.79	-0.07
Total weight	97.11	—
Total return gross	—	-0.86
Total return net	—	-1.42

Portfolio sector attribution

Top contributors	Weight (%)	Contribution to return (%)	Top detractors	Weight (%)	Contribution to return (%)
Reinsurance	0.47	0.00	Banking	50.38	-0.30
Financial	0.71	-0.01	Utility	8.00	-0.10
Insurance - Life	8.85	-0.01	Brokerage	11.89	-0.10

Portfolio allocation

Top 5 issuers	Weight (%)	Top 5 industries	Weight (%)	Top 5 countries	Weight (%)
Bank of America Corp	7.92	Banking	50.38	United States	96.23
Morgan Stanley	6.67	Brokerage	11.89	Bermuda	0.88
JPMorgan Chase & Co	5.82	Insurance - Life	8.85	—	—
Wells Fargo & Co	5.81	Utility	8.00	—	—
U.S. Bancorp	4.80	REIT - Preferred	4.79	—	—

Portfolio update

Contributors

- **Fifth Third Bancorp** 4.95% FITBO
- **Truist Financial Corp** 4.75% TFCprR
- **Webster Financial Corp** 5.25% WBSprF
- **Voya Financial Inc** 5.35% VOYAprB
- **Truist Financial Corp** 5.25% TFCprO

Detractors

- **CMS Energy Corp** 4.2% CMSprC
- **U.S. Bancorp** 4% USBprR
- **MetLife Inc** 4.75% METprF
- **U.S. Bancorp** 4.5% USBprS
- **Bank of America Corp** 4.375% BACprO

New additions

- **Bank of NY Mellon Corp** 6.15% BKprK
- **Southern Co** 6.5% SOJF

Decreased positions

- **JPMorgan Chase & Co** 6% JPMprC
- **Morgan Stanley** 6.875% MSprF

Increased positions

- **JPMorgan Chase & Co** 4.2% JPMprM
- **Bank of America Corp** 4.375% BACprO
- **JPMorgan Chase & Co** 4.55% JPMprK
- **Wells Fargo & Company** 4.375% WFCprC
- **Wells Fargo & Company** 4.75% WFCprZ
- **Bank of America Corp** 4.25% BACprQ

Closeout

- None for this period

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Market outlook

- The excessively eager tactics of the Trump administration is a surprise. Aggressive tariffs and retaliatory moves have repriced just about everything in capital markets. The administration's appetite for change appears to be voracious rather than gradual. Therefore, we believe that credit spreads have bottomed out in January and are now on a widening path to become higher than average.
- The volatility caused by policy challenges should create more interim buying opportunities (like now). Hybrids have positive absolute Estimated Risk Adjusted RORs for maximum credit valuation risk compared to IG corporates and high yield bonds, which are negative over the one-year period.
- Importantly, the added growth policies of low taxation and less regulation can offset the drag from less fiscal spending; and more U.S. energy production can foster internal growth and disinflation.
- Global trade will eventually be renegotiated, and the rules will become clear. In the long run, these policies should foster a disinflationary economic environment that allows the Fed to cut its policy rates more and help to keep credit spreads tighter than average again.
- We recommend holding existing hybrid positions (adding more on weakness) and switching from high yield bonds and intermediate IG corporate bonds into hybrids—especially given the relative safety of hybrid concentrations in banks, insurance, and utilities.

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