

SPECTRUM SMA PREFERRED 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 (IOCS) 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,

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 Taxable

\$25 par preferred securities portfolio

SMA Tax Advantaged

\$25 par preferred securities portfolio emphasizing qualified dividend income-eligible securities

SMA Non-Resident Alien

\$25 par preferred securities portfolio excluding securities subject to backup withholding taxes for non-U.S. taxpayers

SMA Benchmark

ICE BofA Core Fixed Rate Preferred Securities Index (POP2)

IG preferred securities (i.e., CIPS) offer a higher subordination premium of 2.01 times (i.e., 243/121) this 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 4Q23 (Source: ICE Bond Indices)	Core fixed rate \$25 preferred (POP4)	\$1,000 par IG preferred securities (CIPS)	Contingent capital securities (CDLR)
Govt OAS spreads	-5 bps	-16 bps	-51 bps
% Price 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 (POP2) 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.

SMA portfolio characteristics and performance review

	SMA portfolio			SMA benchmark
	SMA Taxable	SMA Tax Advantaged	SMA Non-Resident Alien	POP2
Average dollar price (\$)	87.48	87.04	90.20	87.99
Average coupon (%)	5.28	5.31	5.46	5.31
Current yield (%)	5.95	5.94	5.82	6.03
Yield to worst (%)	5.24	5.32	5.14	5.78
Modified duration (years)	14.27	13.80	14.22	13.02
Quality	BBB2	BBB2	BBB1	BBB2

Source: Spectrum Asset Management, Bloomberg. As of 12/31/2023. ICE BofA Core Fixed Rate Preferred Securities Index (POP2).

	SMA Taxable total returns (%)					
	3-month	Year-to-date	1-year	3-year	5-year	10-year
SMA Taxable (gross)	5.95	9.83	9.83	-1.89	3.69	4.99
SMA Taxable (net) ¹	5.37	7.40	7.40	-4.08	1.39	2.66
Performance benchmark ²	6.87	10.79	10.79	-3.08	2.54	4.57
POP2	6.87	10.79	10.79	-3.08	2.54	4.57

	SMA Tax Advantaged total returns (%)					
	3-month	Year-to-date	1-year	3-year	5-year	10-year
SMA Tax Advantaged (gross)	5.93	9.79	9.79	-1.94	3.71	5.04
SMA Tax Advantaged (net) ¹	5.35	7.36	7.36	-4.12	1.41	2.71
Performance benchmark ²	6.87	10.79	10.79	-3.08	2.54	4.57
POP2	6.87	10.79	10.79	-3.08	2.54	4.57

	SMA Non-Resident Alien total returns (%)					
	3-month	Year-to-date	1-year	3-year	5-year	10-year
SMA Non-Resident Alien (gross)	5.17	11.54	11.54	-0.54	4.41	5.03
SMA Non-Resident Alien (net) ¹	4.59	9.08	9.08	-2.76	2.09	2.70
Performance benchmark ²	6.87	10.79	10.79	-3.08	2.54	4.57
POP2	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 (POP1) through December 31, 2013 and the ICE BofA Core Fixed Rate Preferred Securities Index (POP2) 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)	69.45	4.31
25parHybrid (\$25 par junior- subordinated bond)	15.55	1.15
BabyBond (\$25 par senior debt)	2.68	0.04
REIT Pfd (\$25 par cumulative REIT preferred securities)	6.37	0.52
Total return gross	94.06	6.01
Total return net	—	5.37

Portfolio sector attribution

Top contributors	Weight (%)	Contribution to return (%)	Top detractors	Weight (%)	Contribution to return (%)
Banking	43.04	2.63	Utility - Foreign	0.44	0.00
REIT - Preferred	6.37	0.52	Reinsurance	0.49	0.01
Reinsurance - Foreign	3.77	0.51	Financial	1.27	0.15

Portfolio allocation

Top 5 issuers	Weight (%)	Top 5 industries	Weight (%)	Top 5 countries	Weight (%)
Morgan Stanley	4.86	Banking	43.04	United States	92.84
Bank of America Corp	4.83	Utility	10.97	Bermuda	0.78
JPMorgan Chase & Co	4.57	Brokerage	10.24	Canada	0.44
Public Storage	4.41	Insurance - Life	7.86	—	—
U.S. Bancorp	4.24	REIT - Preferred	6.37	—	—

Portfolio update

Contributors

- **Arch Capital Group Ltd** 4.55% ACGLN
- **Truist Financial Corp** 4.75% TFCprR
- **U.S. Bancorp** 4% USBprR
- **Berkley (WR) Corporation** 4.125% WRBprH
- **Fifth Third Bancorp** 4.95% FITBO

Detractors

- **Georgia Power Co** 5% GPJA
- **Keycorp** 6.125% KEYprl
- **Stifel Financial Corp** 5.2% SFB
- **Voya Financial Inc** 5.35% VOYAprB
- **Entergy Louisiana LLC** 4.875% ELC

New additions

- **Goldman Sachs Group Inc** 6.30069% GSprD

Closeout

- **Citigroup Inc** 6.875% CprK – called

Increased positions

- **Charles Schwab Corp** 4.45% SCHWprJ
- **Duke Energy Corp** 5.625% DUKB
- **Citizens Financial Group** 5% CFGprE
- **Wells Fargo & Company** 4.7% WFCprA
- **Southern Co** 4.2% SOJE
- **American Intl Group** 5.85% AIGprA
- **Nextera Energy Capital** 5.65% NEEprN
- **Wells Fargo & Company** 4.75% WFCprZ

- **Bank Of America Corp** 4.25% BACprQ
- **Arch Capital Group Ltd** 4.55% ACGLN
- **CMS Energy Corp** 5.875% CMSD
- **Truist Financial Corp** 4.75% TFCprR
- **Metlife Inc** 4.75% METprF
- **Morgan Stanley** 4.25% MSprO
- **Fifth Third Bancorp** 4.95% FITBO
- **Huntington Bancshares** 4.5% HBANP

Decreased positions

- **Citigroup Inc** 9.63176000000001% CprJ

Calculations exclude cash and derivatives, where applicable.

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SMA Tax Advantaged

SMA Tax Advantaged major security sector components	Weight (%)	Contribution to return (%)
25parPFD (\$25 par preferred stock)	77.50	4.77
25parHybrid (\$25 par junior- subordinated bond)	10.11	0.82
BabyBond (\$25 par senior debt)	1.46	-0.02
REIT Pfd (\$25 par cumulative REIT preferred securities)	4.48	0.35
Total return gross	93.55	5.91
Total return net	—	5.35

Portfolio sector attribution

Top contributors	Weight (%)	Contribution to return (%)	Top detractors	Weight (%)	Contribution to return (%)
Banking	46.60	2.91	Utility - Foreign	0.22	0.00
Insurance - Multi Line	5.95	0.57	Reinsurance	0.49	0.01
Reinsurance - Foreign	4.00	0.54	Financial	0.78	0.11

Portfolio allocation

Top 5 issuers	Weight (%)	Top 5 industries	Weight (%)	Top 5 countries	Weight (%)
Bank of America Corp	4.94	Banking	46.60	United States	92.33
Morgan Stanley	4.83	Brokerage	10.75	Bermuda	1.00
JPMorgan Chase & Co	4.74	Insurance - Life	8.04	Canada	0.22
U.S. Bancorp	4.69	Utility	7.77	—	—
Wells Fargo & Co	4.45	Insurance - Multi Line	5.95	—	—

Portfolio update

Contributors

- Arch Capital Group Ltd 4.55% ACGLN
- Truist Financial Corp 4.75% TFCprR
- Fifth Third Bancorp 4.95% FITBO
- American Intl Group 5.85% AIGprA
- Allstate Corp 5.1% ALLprH

Detractors

- Georgia Power Co 5% GPJA
- Voya Financial Inc 5.35% VOYAprB
- Keycorp 6.125% KEYprI
- Entergy Louisiana LLC 4.875% ELC
- Morgan Stanley 7.125% MSprE

New additions

- None for this period

Increased positions

- Charles Schwab Corp 4.45% SCHWprJ
- Wells Fargo & Company 4.75% WFCprZ
- Wells Fargo & Company 4.7% WFCprA
- Goldman Sachs Group Inc 6.30069% GSprD
- Citizens Financial Group 5% CFGprE
- Southern Co 4.2% SOJE
- CMS Energy Corp 5.875% CMSD
- Fifth Third Bancorp 4.95% FITBO
- Arch Capital Group Ltd 4.55% ACGLN
- American Intl Group 5.85% AIGprA
- Morgan Stanley 4.25% MSprO
- Metlife Inc 4.75% METprF
- Duke Energy Corp 5.75% DUKprA
- Huntington Bancshares 4.5% HBANP
- Bank Of America Corp 4.25% BACprQ

Decreased positions

- Citigroup Inc 9.63176000000001% CprJ

Closeout

- Citigroup Inc 6.875% CprK – called

Calculations exclude cash and derivatives, where applicable.

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SMA-Non-Resident Alien

SMA Non-Resident Alien major security sector components	Weight (%)	Contribution to return (%)
25parPFD (\$25 par preferred stock)	9.59	1.29
25parHybrid (\$25 par junior- subordinated bond)	57.47	3.30
BabyBond (\$25 par senior debt)	12.85	0.33
REIT Pfd (\$25 par cumulative REIT preferred securities)	0.00	0.00
Total return gross	79.91	4.92
Total return net	—	4.59

Portfolio sector attribution

Top contributors	Weight (%)	Contribution to return (%)	Top detractors	Weight (%)	Contribution to return (%)
Reinsurance - Foreign	9.59	1.29	Brokerage	4.30	-0.14
Insurance - P&C	9.68	1.16	Utility - Foreign	1.81	0.00
Utility	25.28	1.00	Reinsurance	1.92	0.03

Portfolio allocation

Top 5 issuers	Weight (%)	Top 5 industries	Weight (%)	Top 5 countries	Weight (%)
WR Berkley Corp	5.44	Utility	25.28	United States	73.42
Arch Capital Group Ltd	4.91	Insurance - P&C	9.68	Bermuda	4.68
CMS Energy Corp	4.82	Reinsurance - Foreign	9.59	Canada	1.81
DTE Energy Co	4.74	Insurance - Multi Line	9.26	—	—
RenaissanceRe Holdings Ltd	4.68	Insurance - Life	9.07	—	—

Portfolio update

Contributors

- Berkley (WR) Corporation 5.1% WRBprF
- Renaissance Holdings L 5.75% RNRprF
- Berkley (WR) Corporation 4.25% WRBprG
- Arch Capital Group Ltd 4.55% ACGLN
- Arch Capital Group Ltd 5.45% ACGLO

Detractors

- Stifel Financial Corp 5.2% SFB
- Georgia Power Co 5% GPJA
- Duke Energy Corp 5.625% DUKB
- Entergy Louisiana LLC 4.875% ELC
- Allstate Corp 8.82048% ALLprB

New additions

- None for this period

Increased positions

- None for this period

Decreased positions

- None for this period

Closeout

- Algonquin Pwr & Utility 9.34144% AQNA - called

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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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