Rocaton

INSIGHTS

The Case for Preferred Securities

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EXECUTIVE SUMMARY

- We believe preferred securities are overlooked by most institutional and high net worth investors despite offering some attractive benefits.
- Preferreds are a fixed income asset class and currently offer relatively high levels of income along with interest rate duration similar to the broad fixed income market.
- In our opinion, there is the potential for credit risk to decrease over the next few years in the preferreds market as financial sector reform could be a tailwind for the banking and insurance sectors, the largest issuers of preferreds.
- We suggest investors consider how allocations to preferreds could help meet their investment objectives, potentially reallocating capital from high yield fixed income to preferreds.
- Investors should be aware of some of the challenges of the asset class, including a limited universe of high quality investment manager strategies, sector concentration and duration extension risk.
- For taxable investors, both individuals and corporations, preferreds are often taxed at a lower income tax rate than conventional interest paying fixed income.

Introduction

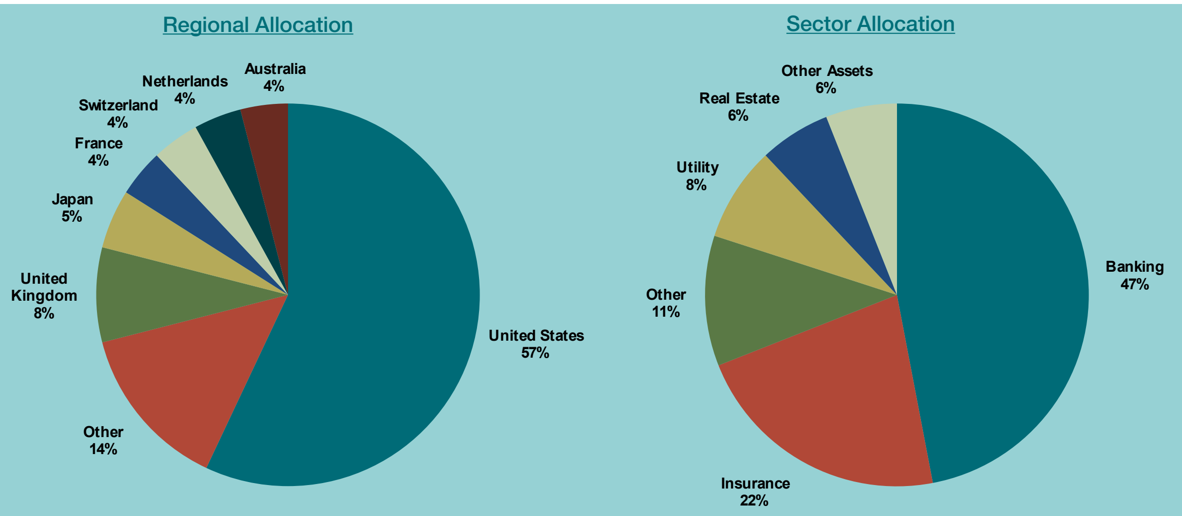
Preferred securities ("preferreds") are often overlooked by investors. We believe preferred securities can play a role in most investors' portfolios as the asset class provides a relatively high level of income. Further, we believe the fundamentals of the underlying issuers are stable to improving, depending on the sector, resulting in the potential for spread tightening. Preferreds have greater credit risk (average credit quality BBB/BB) and volatility than core fixed income and should be considered alongside high yield, bank loans, convertibles, and emerging market debt. While there are some investment challenges with the asset class, which we outline in greater detail below, we believe preferreds are a compelling investment idea in today's low yielding environment.

Preferred Securities Overview

Preferred securities are a class of stock or hybrid debt entitling the investor to certain preferential treatment relative to common stock investors. Preferred investors have priority claims to payment of dividends and, in the liquidation of company assets, priority over the issuer's common shareholders. It should be noted, however, that preferreds are subordinate to corporate bond holders and other creditors. Credit ratings reflect this subordination and are typically two-to-four credit notches below issuers' senior debt. There are a number of different structures including fixed rate, floating rate, and fixed-to-floating rate. Floating rate securities typically have a quarterly coupon reset based on changes in LIBOR. Fixed-to-floating rate securities typically pay a fixed coupon for a finite period of time at which point the security may be called or have the coupon reset to a floating rate. Broadly speaking, preferred securities are often perpetual but typically include call features. Further, some securities may allow issuers to skip (non-cumulative) or defer (cumulative) dividend payments without invoking default. There are also hybrid preferred securities and contingent convertible securities ("CoCos") which are part of the opportunity set.

Figure 1:

Preferred Securities Sector and Regional Allocations



Source: FactSet. As of December 31, 2016 Based on theBofA Merrill Lynch Preferred Fixed Rate index.

Broadly defined, the market size is approximately $900 billion based on par values of preferred securities outstanding. Approximately 80% of this market is traded over-the-counter while the remaining 20% is exchange traded. More than half of the market is comprised of U.S. issuers and there is meaningful sector concentration in the asset class, primarily across banks, insurance companies, REITS, and utilities (see Figure 1). Approximately 56% of the preferred universe is rated investment grade, 28% is rated below investment grade and 16% is not rated. There are a number of preferred securities benchmarks which may be appropriate (depending on the mandate) including the BofA Merrill Lynch Fixed Rate and Perpetual Preferred Indexes, among others.

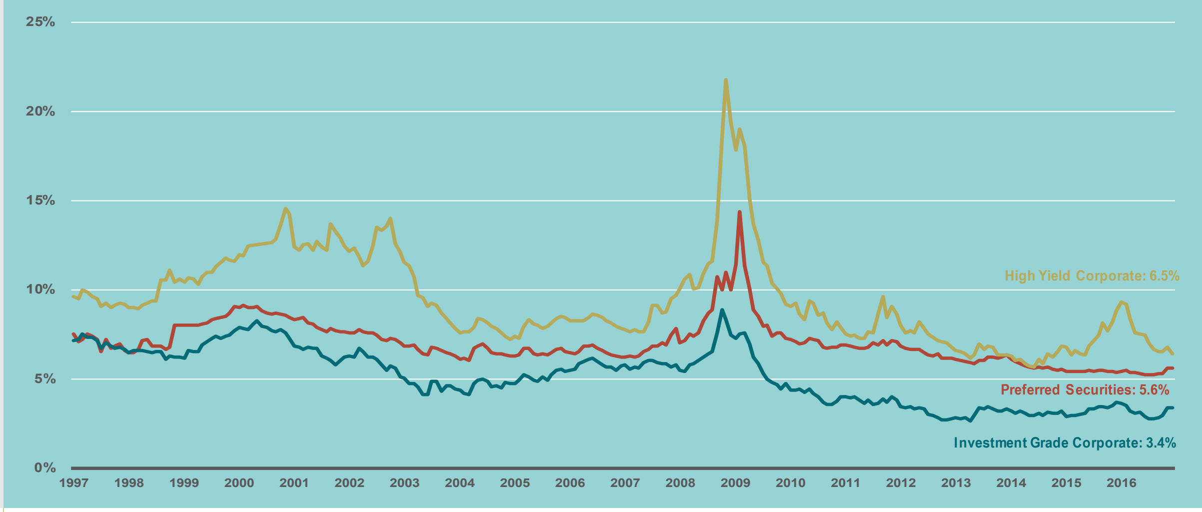
The case for allocating to preferred securities today

As stated, preferreds provide relatively high levels of current income and offer some of the highest yields in the investment grade and near-investment grade fixed income universe (see Figure 2). Further, floating-rate and fixed-to-floating rate securities can provide lower interest rate duration exposure than other traditional fixed income assets[1]. Beyond the income potential, we believe there is the potential for improvement in the financial sector which would favorably impact preferred securities. Higher interest rates, a steepening yield curve, and potential changes to regulation may be favorable for the financial sector's profitability and market capitalization. Post-financial crisis, regulatory changes, including Dodd-Frank, forced many banks to improve their balance sheets and exit riskier but potentially more profitable business lines. In Europe, new Basel III standards were developed in 2013 and European banks have until 2019 to fully comply with these new standards. This has resulted in banks which have levels of capital 2-3x greater than what they were in 2006. While investors likely remember the challenging environment for financials during the 2008 market downturn, balance sheets for many of the banks are in far better shape today and a meaningful deterioration in credit quality seems unlikely in our opinion. Preferred securities, which have significant allocations to the financial sector, should benefit from general improvements in the finance and banking sectors.

[1]Since the financial crisis, a meaningful part of new issuance has been fixed-to-floating rate paper. Most of this issuance had interest rate reset dates 10 years from issuance and, therefore, over the next 5-10 years, much of the preferred security opportunity set will be called or converted to floating rate with large spreads typically above 5-year swaps. As such, over the next few years, the preferreds marketplace may witness a gradual reduction in interest rate risk.

Figure 2:

Yield Comparison - Preferred Securities vs. High Yield and Investment Grade Corporate Bonds



Source: FactSet. Data Through December 31, 2016 Based on the Bloomberg Barclays Corporate, Bloomberg Barclays High Yield and BofA Merrill Lynch Preferred Fixed Rate indicies.

While we believe the beta opportunity in preferreds is compelling, there is the potential for active managers to create a portfolio with a yield advantage and downside protection relative to a broad index. We suggest investors consider active approaches in preferred securities which can create downside protection through bottom-up and top-down fundamental research, security selection, structure analysis and broad diversification. Investors should understand that active approaches may have reasonably high tracking error in pursuit of attractive returns and to avoid issuer concentration.

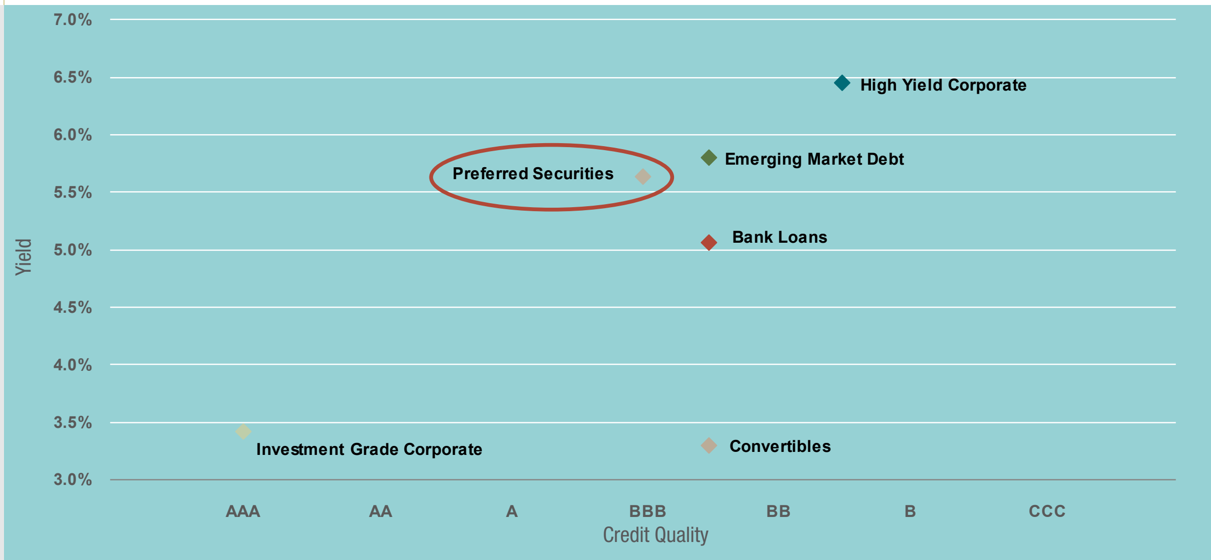
Where do preferred securities fit in a portfolio?

As mentioned earlier, we believe preferreds fit best alongside of or in place of allocations to high yield, bank loans, convertibles or emerging markets debt. We are also supportive of core and core plus fixed income mandates which include allocations to preferred securities, however, in our view, dedicated preferred mandates are more desirable. Today, it may be more advantageous for investors to consider selling high yield fixed income in favor of preferreds. High yield fixed income generated a 17% return in 2016 as spreads tightened materially. As a result, we believe the return potential for high yield is diminished. Preferreds offer a similar yield to high yield and, broadly speaking, possess a higher credit quality. Lastly, as we have already discussed, we believe the underlying fundamentals of preferred issuers may be more attractive than those of high yield issuers. For example, the issuers of preferreds are typically rated investment grade at the senior debt level. In the capital structure, preferreds are often rated low investment grade or just below investment grade given the subordination. As shown in Figure 3, the preferred securities index has an investment grade rating and offers a yield which is similar or better than other low-investment grade or below investment grade asset classes. We believe that the near-term return potential for preferred securities is better than high yield, but similar to bank loans, emerging market debt and convertibles. As such, we suggest reducing high yield exposures today in favor of preferreds.

Although we believe preferred securities can be a strategic investment in portfolios, we also suggest that investors maintain flexibility within their allocations to preferreds, high yield, bank loans, convertibles and EMD. Overvalued asset classes within this group which have generated strong returns should be exited in favor of more attractively priced exposures. We suggest investors maintain a target allocation to the asset class group in total and be willing to modify underlying allocations based on market opportunities.

Figure 3:

Fixed Income Credit Quality vs. Yield



Source: FactSet. Data Through December 31, 2016

Considerations

While we feel strongly that investors should contemplate an allocation to preferred securities, there are some considerations which investors should be aware of before making an allocation. To start, despite the investment grade rating, subordination in the capital structure can create periods of volatility in excess of core fixed income. For example, the broad fixed rate preferred securities index declined 25% in 2008 before generating a 20% return in 2009. Given the junior position in the capital structure, downside protection can disappear quickly. Additionally, since an issuer's corporate bonds sit higher in the capital structure than its preferred securities, the corporate bonds would be senior to the preferred securities in the event of bankruptcy. We have also discussed the sector concentration issues as banking and insurance represent ≈70% of the preferred universe. While we believe there is the potential for regulatory reform in the financial sector, there is still a high level of uncertainty as to the timing and type of reforms that might be enacted. Lastly, there are implementation challenges as there are a limited number of high quality active managers in the space. Further, comparisons across active preferred managers are difficult given the heterogeneity of investment strategies and objectives. It should also be noted that while there are a few passive strategies available, we generally believe that investors should avoid the limited passive strategies that do exist. For example, passive ETFs tracking preferred securities indexes can be heavily influenced by retail investors.

Conclusion

We believe preferred securities should not be overlooked by institutional and high net worth investors. We would suggest investors consider a strategic allocation to the asset class and consider reducing high yield to fund the allocation. The potential for strong performance from the financial sector may be a tailwind to preferred securities. Additionally, preferreds provide some of the highest yields among investment grade fixed income asset classes and floating rate or fixed-to-floating rate exposures can limit interest rate exposures over time.

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