The Case for Preferred Securities in an Institutional Asset Allocation

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Highlights

- Preferred securities are generally issued by noncyclical companies with stable business models in regulated industries—attractive attributes from a risk standpoint, yet they offer some of the highest income rates found within investment-grade fixed income.
- Preferreds have often provided stronger total returns compared with other fixed income investments.
- In addition, preferreds can provide diversification benefits and help manage interest-rate risk, given the large number of low-duration structures found in the asset class.
- For institutional investors seeking to expand beyond strict style box approaches, preferreds can be implemented either as an addition within an income-oriented solution or as a satellite allocation in a core/satellite model.

Many preferred securities offer yields of 5–6% or more, largely from investment-grade issuers, yet the complex and often misunderstood asset class is typically underutilized by institutional investors. We discuss how preferreds may improve income profiles and risk-adjusted returns within diversified portfolios due to their unique and complementary characteristics.

Finding Income in a Yield-Hungry World

Amid continued historically low absolute interest rates globally, institutional investors are facing challenges to generate income. Preferred securities, which historically have had significant yield advantages over other investment-grade classes, may provide desired income results. Moreover, because preferreds tend to have modest/low correlations with many asset classes, they may enhance income while also reducing portfolio volatility.

Overview of Preferred Securities

Preferreds play a unique role in capital markets. They are a form of equity for issuers, helping companies reach capitalization goals for regulatory and rating-agency purposes. Yet from an investor standpoint, preferreds act like bonds, not stocks, simply offering a fixed or floating rate of income. Issued at par like debt instruments, their market prices fluctuate with changes in interest rates or credit fundamentals, and hence preferreds can trade at premiums or discounts to par.

Preferred securities lie between common stock and senior debt in a company's capital structure. Preferred shareholders rank above common stockholders but below senior debtholders in the event of liquidation—presenting subordination risk that partly explains preferreds' higher income and wider credit spreads. It should be stressed that while preferred coupon payments are discretionary and subject to deferral or outright omission, such actions are extremely rare in practice, typically only occurring in cases of great corporate strain.

In light of this, it is no coincidence that the issuers of preferred securities are mainly large, highly regulated institutions and/or companies with high, stable and transparent cash flows—such as banks, insurance companies, utilities, telecommunication companies and real estate investment trusts (REITs). Given the discretionary nature of payments, investors generally demand high-quality, tested business models to provide an adequate comfort level that the expected income will be delivered.

Exhibit 1: Credit Class Rankings

Highest to Lowest		Possible Equity Treatment	Payment Format	Typical Term	Ratings Examples (Moody's/S&P) J.P. Morgan	Ratings Examples (Moody's/S&P) Bank of America
	Senior Debt	No, debt only	Non-deferrable interest	Short to long term	A2/A	A2/A-
	Subordinated Debt	No, debt only[a]	Non-deferrable interest	Medium to long term	A3/BBB+	Baa1/BBB+
	Hybrid Preferreds (Jr. Sub. Debt)	Limited[a]	Deferrable interest	Long term	Baa1/BBB-	Baa2/BBB-
	Traditional Preferreds	Yes	Dividend	Perpetual	Baa2/BBB-	Baa3/BBB-
	Common Equity	Yes	Dividend	Perpetual	N/A	N/A

At August 31, 2019.

(a) Other, more modest regulatory benefits may apply. The mention of specific securities is not a recommendation or solicitation to buy, sell or hold any particular security and should not be relied upon as investment advice.

Hybrid and traditional preferred securities are deeply subordinated instruments. They are above common equity in a company's capital structure, but subordinated to normal debt instruments. Deep subordination is a key reason why they pay high rates of income.

Because of these characteristics, preferreds can bring attractive diversification benefits when included in portfolios with corporate bond and high-yield allocations, due to varying sector exposures, as shown in Exhibit 2 below. High yield, for instance, has a significant energy sector component, whereas the preferreds market has almost no exposure to those typically cyclical and leveraged companies. At the same time, financial companies, in contrast to the corporate bond market, account for more than half of the preferreds universe (and have less-cyclical features).

Broad and Liquid Universe

The nearly $1 trillion global preferred securities universe is large and liquid. U.S. dollar preferreds account for roughly 64% of the market, including U.S. domestic issuers as well as many large foreign companies that issue in U.S. dollars. The remaining 36% is made up of foreign-currency-denominated securities.

There is a wide misperception that the preferreds market consists mostly of long-dated securities that trade on an exchange. Yet globally, only about 15% of the preferreds market trades on an exchange, predominately the New York Stock Exchange. Far larger is the institutionally traded over-the-counter (OTC) market, at around $830 billion across currencies. Further, the OTC market is growing more rapidly, driven by foreign issuers and the development of new types of preferred securities—such as contingent capital securities (CoCos), which are issued almost exclusively in the OTC market to institutional investors.

Exhibit 2: Low Sector Overlap With Other Fixed Income Classes

Sector	Index Weights: Preferred Securities[a]	Index Weights: High-Yield Bonds[b]	Index Weights: Corporate Bonds[c]
Banking	**55%**	**2%**	**22%**
Insurance	**25%**	**1%**	**4%**
Utilities	7%	2%	8%
Real Estate	2%	2%	2%
Energy	**4%**	**13%**	**11%**
Telecommunications	**1%**	11%	4%
Media	0%	10%	3%
Basic Industry & Capital Goods	0%	17%	9%

At August 31, 2019. Only key sectors are shown. Sector allocations may vary over time.

(a) 60% ICE BofAML U.S. IG Institutional Capital Securities Index, 20% ICE BofAML Core Fixed Rate Preferred Securities Index and 20% Bloomberg Barclays USD Developed Market Contingent Capital Index. (b) ICE BofAML High-Yield Master Bond Index. (c) ICE BofAML Corporate Master Index.

Financial Reform Tailwinds

Considering that banks account for about half of the global market for preferreds, the financial crisis of 2008/09 has had a profound impact on the preferred securities market. Stricter banking regulations have put pressure on corporate profits but have been positive for bondholders and owners of preferred securities. Balance sheets of many of the largest issuers of preferred securities have strengthened significantly, making preferred securities a safer investment, in our view, even as these issuers have maintained a competitive yield advantage.

Reforms are also inducing companies to redeem many preferred securities whose structures no longer meet regulatory capital requirements, and to issue new ones that do. Many of these new securities feature innovative structures that have the potential to provide value opportunities for active managers.

How Preferred Securities Can Enhance Institutional Portfolios

In our view, preferred securities can add value as a dedicated, long-term investment in a well-rounded institutional fixed income portfolio based on important potential benefits, including:

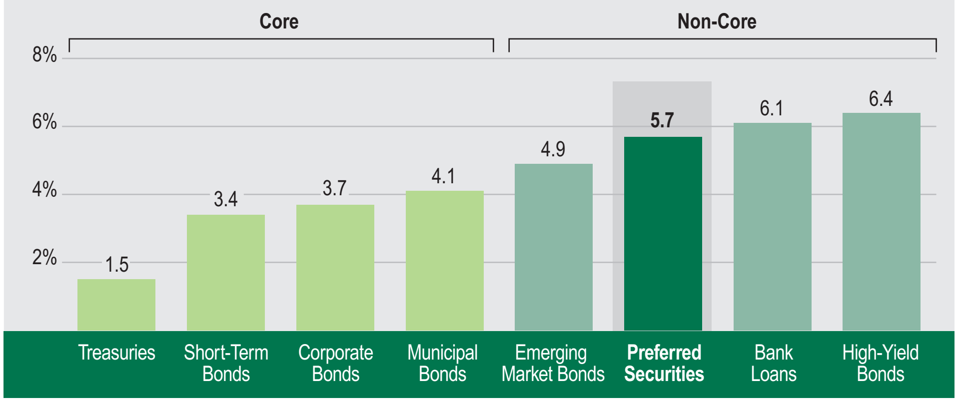
- Attractive income component
- Strong total returns
- Low correlations with many other fixed income classes
- Low-duration structures that can help manage interest-rate risk
- Opportunity for improved risk-adjusted returns
- Tax-advantaged income for taxable institutions

Higher Income Levels Than Most Fixed Income Classes

Investment-grade preferred securities typically offer some of the highest income rates in high-grade fixed income markets. As shown in Exhibit 3, as of August 31, 2019, preferreds had higher yields than all the main "core" categories and were competitive with the selected non-core groups. This above-average income component has contributed to attractive total returns over time while often providing a cushion in down markets.

Preferreds stand out from a yield perspective.

Exhibit 3: Yield by Asset Class



At August 31, 2019. Source: BofAML, Barclays, Powershares, Cohen & Steers.

Strong Historical Total Returns Over Full Market Cycles

Preferred securities have historically provided strong total returns over a full market cycle. On a calendar year basis, returns for preferred securities were often well balanced with returns in other classes, and, in some cases, outperformed the peer group as a whole. For the trailing nine-year period through 2018 (post the global financial crisis, and as banks greatly improved their capital strength), preferred securities were among the top-performing fixed income sectors on average.

Exhibit 4: Total Returns by Asset Class
2006–2018

		Total Return											
		Post-Crisis									*Crisis and Pre-Crisis*		
	Average Return 2010–2018	**2018**	**2017**	**2016**	**2015**	**2014**	**2013**	**2012**	**2011**	**2010**	**2009**	**2008**	**2007**
Preferred Securities Ranking Within Fixed Income	**2**	**5**	**1**	**4**	**1**	**1**	**3**	**2**	**4**	**1**	**3**	**4**	**5**
Fixed Income													
Preferred Securities	6.9%	-3.9%	10.1%	3.8%	4.2%	12.1%	0.6%	17.4%	2.3%	15.6%	33.2%	-28.0%	-6.6%
U.S. Bank Loans	4.9%	1.1%	4.2%	9.9%	-0.4%	2.1%	6.2%	9.4%	1.8%	10.0%	44.9%	-28.8%	1.9%
U.S. High-Yield bonds	7.0%	-2.3%	7.5%	17.5%	-4.6%	2.5%	7.4%	15.6%	4.4%	15.2%	57.5%	-26.4%	2.2%
Emerging Market Debt	6.3%	-1.7%	9.3%	10.2%	1.2%	5.5%	-6.6%	18.5%	8.5%	12.0%	28.2%	-10.9%	6.3%
Traditional Fixed Income	3.2%	0.0%	3.5%	2.6%	0.5%	6.0%	-2.0%	4.2%	7.8%	6.5%	5.9%	5.2%	7.0%
Non-Fixed Income													
Global Equities	8.2%	-8.7%	22.4%	7.5%	-0.9%	4.9%	26.7%	15.8%	-5.5%	11.8%	30.0%	-40.7%	9.0%

At August 31, 2019. Source: Morningstar, Cohen & Steers.

Data quoted represents past performance, which is no guarantee of future results. Preferreds: Blend 50% ICE BofAML Cap Sec 50% ICE BofAML Fixed Rate; Global Equities: MSCI World NR USD; U.S. Bank Loans: Credit Suisse Leveraged Loan USD TR USD; U.S. High-Yield Bonds: ICE BofAML U.S. HY Master II TR USD; Emerging Market Debt: JPM EMBI Global TR USD; Traditional Fixed Income: Barclays U.S. Agg Bond TR USD.

Low Correlations With Equity Markets and Other Fixed Income Asset Classes

Preferred securities have had diversifying correlation with equities and other non-traditional asset classes. This is partly because banks and insurance companies, the largest issuers of preferred securities, are typically not well represented in other fixed income strategies, like high-yield bonds. Exhibit 5 shows the five-year correlation of the selected investment strategies with one another. Low correlations with other asset classes provide strong evidence for preferred securities as a portfolio diversifier.

Preferreds have generally had modest-to-low correlations with other asset classes.

Exhibit 5: Correlations of Monthly Returns
8/2014–8/2019

	Preferred Securities	**Global Equities**	**U.S. Bank Loans**	**U.S. High-Yield Bonds**	**Emerging Market Debt**	**Traditional Fixed Income**
Preferred Securities	**1.00**					
Global Equities	0.56	**1.00**				
U.S. Bank Loans	0.54	0.67	**1.00**			
U.S. High-Yield Bonds	0.70	0.78	0.82	**1.00**		
Emerging Market Debt	0.67	0.55	0.50	0.79	**1.00**	
Traditional Fixed Income	0.48	-0.10	-0.16	0.13	0.43	**1.00**

At August 31, 2019. Source: Morningstar.

An Abundance of Low-Duration Structures Can Mitigate Interest-Rate Risk

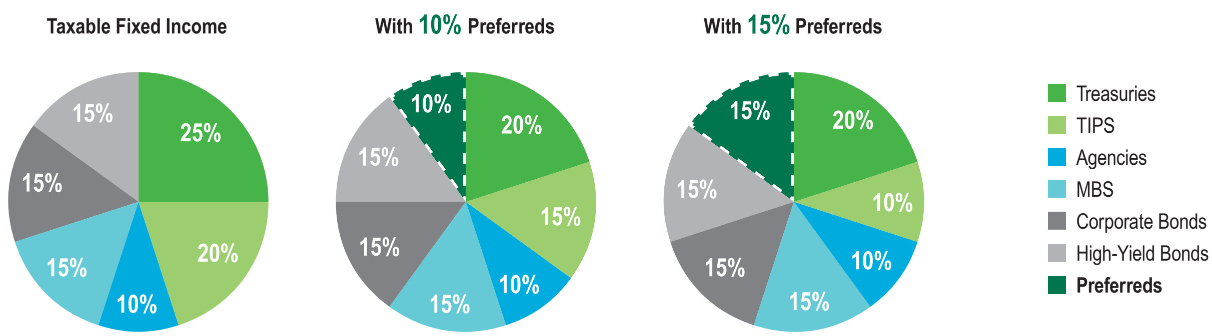
In addition to offering traditional pure fixed-rate securities, the preferreds universe contains other structures, including fixed-to-float securities that dominate the OTC market (and are available on a more limited basis in the exchange-traded market). As their name implies, these instruments pay a fixed coupon rate for a specified period, after which the coupon may reset based on movements in an interest-rate benchmark. Such lower-duration securities have proven to help cushion the impact of a rising-interest-rate environment (as coupons adjust upward), and active investors can choose from a wide variety of liquid structures to help manage rate risk.

Opportunity for Improved Risk-Adjusted Returns

Preferred securities can cushion the impact of a rising-interest-rate environment.

Since the correlations of preferreds with other fixed income and equity assets have been somewhat modest historically, they may have the potential to improve the risk-adjusted returns of diversified portfolios. To illustrate this potential, the exhibit below shows that adding preferred securities to a diversified fixed income allocation improved overall total returns over the five-year holding horizon while helping to contain portfolio volatility: in other words, better portfolio efficiency. Notably, preferreds modestly outperformed high-yield bonds in this period, but with a significantly lower standard deviation of returns compared with high yield.

Exhibit 6: Sample Fixed Income Asset Allocation Portfolio Over Five Years



Return	**3.1%**	**3.4%**	**3.6%**
Risk[(a)]	2.8%	2.7%	2.7%

At August 31, 2019. Source: Cohen & Steers, Morningstar.

Data quoted represents past performance, which is no guarantee of future results. The information presented above does not reflect the performance of any fund or other account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above. This chart is for illustrative purposes only and is not intended to represent the returns of any specific security. Performance information for any Cohen & Steers fund is available at cohenandsteers.com.

(a) Risk is measured by standard deviation which shows how much variation or dispersion exists from the average.

Treasuries are represented by the ICE BofAML US Treasury Index. TIPS represented by Merrill Lynch US Inflation-Linked Treasury Index. Agencies are represented by the ICE BofAML US Composite Agency Index. MBS (Mortgage Backed Securities) are represented by the Barclays US MBS Index. Corporate Bonds are represented by the ICE BofAML Corporate Master Index. High-Yield Bonds are represented by the ICE BofAML High Yield Master Bond Index. Preferred Securities are represented by 50% ICE BofAML Fixed Rate Preferred Securities Index and 50% ICE BofAML Capital Securities Index through December 31, 2016, 60% ICE BofAML US IG Institutional Capital Securities Index, 30% ICE BofAML Core Fixed Rate Preferred Securities Index and 10% Bloomberg Barclays Developed Market USD Contingent Capital Index through 12/31/2018, and 60% ICE BofAML US IG Institutional Capital Securities Index, 20% ICE BofAML Core Fixed Rate Preferred Securities Index and 20% Bloomberg Barclays Developed Market USD Contingent Capital Index for periods thereafter.

For eligible investors, already attractive yields on preferred securities can be even more competitive on a tax-adjusted basis.

Tax-Advantaged for Taxable Institutions

Institutions that file taxes as C corporations in the U.S. may garner tax benefits to U.S. investors from preferred securities investments. Dividends issued directly from one tax-paying C corporation to another are generally eligible for the Dividends Received (tax) Deduction (DRD) for the dividend recipient. This would include a taxable institution that owns the preferred securities of (and hence has an ownership stake in) a taxable C corporation. The DRD is intended to offset triple taxation of dividends.

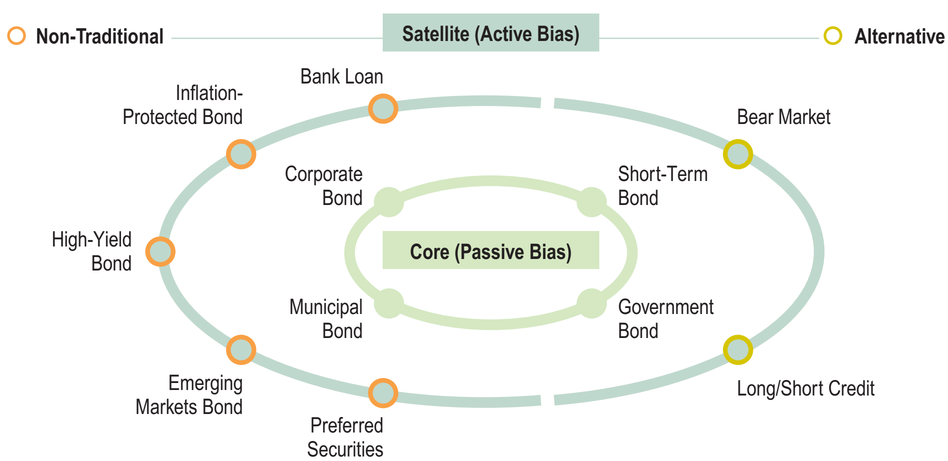
The extent of the tax deduction depends on the ownership stake, with a minimum of a 50% deduction of dividends received and a maximum of 100% if the corporation owns more than 80% of the dividend-paying company.

The DRD benefit can be powerful. By owning preferred securities, eligible buyers will normally receive the minimum deduction—meaning that 50% of the dividend will be exempt from taxation. For a corporate investor with a 21% tax rate, the effective tax on preferred income may fall to just 10.5% ((1–0.5) * 0.21). This means a DRD-eligible preferred paying 6.0% would have a taxable-equivalent yield of approximately 6.8%.

Implementing a Preferred Securities Allocation

We are increasingly seeing institutions move beyond a strict style box and benchmark focus toward outcome-focused solutions, and we believe preferreds offer attractive advantages for these allocations. One approach is to add alternative income-oriented classes to a designated income bucket. Another approach is core/satellite investing, consisting of a core portfolio of diversified investments complemented by satellite positions in specialty asset classes.

Exhibit 7: Fixed Income Investing—Segmenting the Asset Classes



Source: Cerulli Associates.

The core/satellite approach typically combines core allocations to passive strategies in markets that are highly efficient, and satellite allocations using actively managed strategies in sectors where managers have greater potential for outperformance. Specifically, core strategies are often used for beta exposure (a desired risk/return and income profile), while satellite strategies are generally used to generate alpha (returns in excess of a benchmark).

The combination of core and satellite strategies allows investors to manage fees and pursue more attractive risk-adjusted performance. Exhibit 7 highlights how a fixed income portfolio can be segmented using a core/satellite portfolio construction approach.

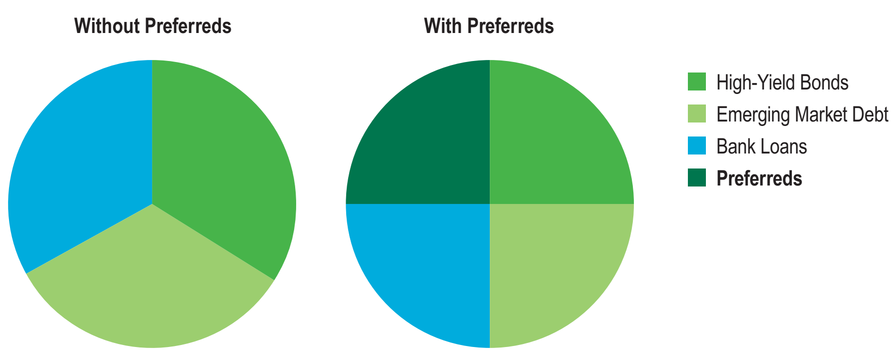
Individual fixed income strategies can be volatile, as the various bond market sectors, structures and maturities tend to respond differently to changing market environments. By diversifying fixed income strategies, investors may reduce portfolio volatility and mitigate interest-rate and credit risks. We believe the logic of augmenting core holdings with non-core asset classes is being increasingly accepted among institutional investors. Institutional flows to non-traditional fixed income asset classes have been impressive over the past five years, totaling more than $100 billion.(1)

Institutions are increasingly adding non-traditional classes to core fixed income holdings.

Enhanced Risk/Return/Income Potential With Preferreds

The exhibit below, which focuses on non-core classes, illustrates the potential of a preferred allocation to enhance the return and risk profile of a fixed income bucket, while helping to maintain an attractive income stream. On the left is an equally divided mix of high-yield bonds, emerging market debt and bank loans, which generated an annualized return of 4.5% and had a 5.7% yield. The equal-weight portfolio on the right, which was expanded to include preferreds, had better returns and a slightly higher yield, yet with lower risk. Whether as an addition to an income bucket as seen here, or as a satellite added to a core allocation, we believe preferreds are an attractive alternative.

Exhibit 8: Sample Fixed Income Asset Allocation Portfolio Over Five Years



Yield	5.7%	5.8%
Return	4.5%	4.8%
Risk[a]	4.2%	3.9%

At August 31, 2019. Source: BofAML, Barclays, Credit Suisse, Cohen & Steers.

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(a) Risk is measured by standard deviation which shows how much variation or dispersion exists from the average.

High-Yield Bonds are represented by the ICE BofAML U.S. High Yield Master II Index. Emerging market debt is represented by the ICE BofAML Emerging Markets Diversified Corporate Index. Bank loans are represented by the Credit Suisse Leveraged Loan Index. Preferred Securities are represented by 50% ICE BofAML Fixed Rate Preferred Securities Index and 50% ICE BofAML Capital Securities Index through December 31, 2016, 60% ICE BofAML US IG Institutional Capital Securities Index, 30% ICE BofAML Core Fixed Rate Preferred Securities Index and 10% Bloomberg Barclays Developed Market USD Contingent Capital Index through 12/31/2018, and 60% ICE BofAML US IG Institutional Capital Securities Index, 20% ICE BofAML Core Fixed Rate Preferred Securities Index and 20% Bloomberg Barclays Developed Market USD Contingent Capital Index for periods thereafter.

(1) Source: eVestment.

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Investing in Preferreds: The Low-Duration Option

Demand for low-duration fixed income has been growing as investors increasingly anticipate an end to years of near-zero interest rates. One often overlooked category in the low-duration universe is preferred securities. These securities pay relatively high income rates—often in the 4–5% range—while also mitigating investors' exposure to changes in interest rates. Another important consideration is that low-duration preferreds can represent different sectors compared with what investors get from other low-duration fixed income, therefore helping to diversify investors' portfolios.

Depending on an investor's objectives, we believe a low-duration preferred strategy may offer an attractive option for those concerned about the potential inflationary effects as new policies take hold post the U.S. 2016 election. At the same time, we believe the broad preferred securities market is generally well positioned to deliver attractive income, while offering characteristics that can help to defend against rising interest rates.

Conclusion

A dedicated preferreds manager can help investors navigate complex markets and achieve desired total returns and yield objectives.

Preferred securities offer a number of unique features and benefits when included in an institutional investor's fixed income allocation. Given that preferreds can complement, diversify and significantly improve the risk-return profile of a fixed income allocation while providing attractive income, they warrant a dedicated allocation in institutional portfolios, in which they are typically underrepresented at present.

While the asset class is complex, investors who choose to work with a dedicated specialist manager, well versed in navigating preferred markets, can achieve rewarding results. For an already complicated market that is undergoing massive changes, it is our view that research-driven active management, together with a global reach, is the best formula for pursuing desired results.

About Cohen & Steers

Cohen & Steers is a global investment manager specializing in liquid real assets, including real estate securities, listed infrastructure and natural resource equities, as well as preferred securities and other income solutions. Founded in 1986, the firm is headquartered in New York City, with offices in London, Hong Kong and Tokyo.