

How Institutional Investors Can Benefit From Preferred Securities

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Many preferred securities (also known as capital securities or hybrids) 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.

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.
- Institutional investors may implement a preferreds allocation as an addition within an income-oriented solution or as a satellite allocation in a core/satellite model.

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	Bank of America
Senior Debt	No, debt only	Non-deferrable interest	Short to long term	A3/A	A3/A-
Subordinated Debt	No, debt only ^(a)	Non-deferrable interest	Medium to long term	Baa1/A-	Baa2/BBB+
Hybrid Preferreds (Jr. Sub. Debt)	Limited ^(a)	Deferrable interest	Long term	Baa2/BBB-	Baa3/BBB-
Traditional Preferreds	Yes	Dividend	Perpetual	Baa3/BBB-	Ba1/BBB-
Common Equity	Yes	Dividend	Perpetual	N/A	N/A

At June 30, 2018.

(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 20% 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 \$800 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)	High-Yield Bonds ^(b)	Corporate Bonds ^(c)
Banking	49%	3%	23%
Insurance	26%	1%	4%
Utilities	8%	2%	8%
Real Estate	4%	1%	2%
Energy	3%	16%	11%
Telecommunications	1%	9%	4%
Media	0%	11%	3%
Basic Industry & Capital Goods	0%	17%	9%

At June 30, 2018. Only key sectors are shown. Sector allocations may vary over time.

(a) 60% ICE BofAML U.S. IG Institutional Capital Securities Index, 30% ICE BofAML Core Fixed Rate Preferred Securities Index and 10% 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

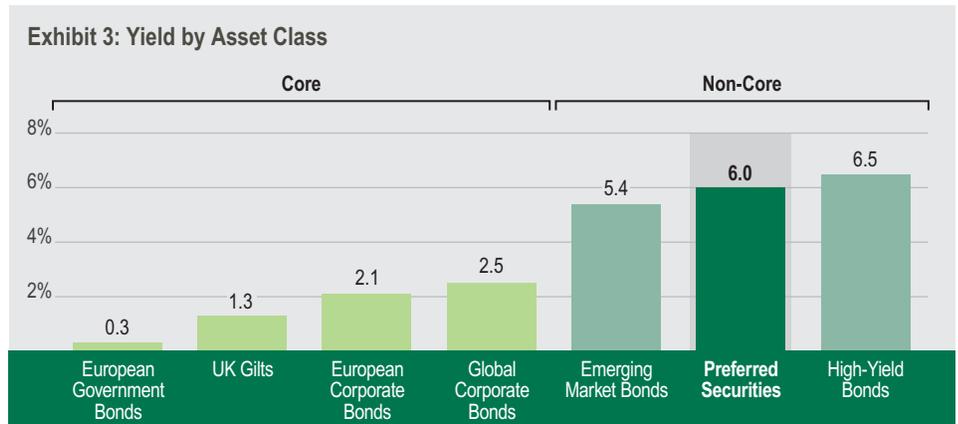
In our view, preferred securities can add value as a dedicated, long-term investment in a well-rounded institutional fixed income portfolio based on important potential benefits, including:

- 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

Higher Income Levels Than Nearly All Other Fixed Income Classes

Investment-grade preferred securities typically offer some of the highest income rates in high-grade fixed income markets, with yields that have recently been competitive with high-yield bonds. As shown in Exhibit 3, as of June 30, 2018, preferreds had higher yields than all the main “core” categories and all the selected non-core groups except high-yield bonds. 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.



At June 30, 2018. Source: BofAML, Barclays, Cohen & Steers.

Data quoted represents past performance, which is no guarantee of future results. European Government Bonds: GECU10YR Index TR USD; UK Gilts: GUKG10 Index TR USD; European Corporate Bonds: ICE BofAML EMU Corp Index TR USD; Global Corporate Bonds: Barclays Global Aggregate Corporates Index; Emerging Market Bonds: Barclays EM USD Aggregate TR; Preferreds: Blend: 50% ICE BofAML Cap Sec 50% ICE BofAML Fixed Rate TR USD; High Yield Bonds: ICE BofAML US HY Master II TR USD.

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 eight-year period through December 31, 2017 (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–Q218

	Total Return YTD 2018	Average Return 2010–2017	Total Return											
			Post-Crisis								Crisis and Pre-Crisis			
			2017	2016	2015	2014	2013	2012	2011	2010	2009	2008	2007	2006
Preferred Securities Ranking Within Fixed Income	2	2	4	7	1	1	5	4	6	1	4	7	8	7
Fixed Income														
Preferred Securities	-1.3%	8.3%	10.1%	3.8%	4.2%	12.1%	0.6%	17.4%	2.3%	15.6%	33.2%	-28.0%	-6.6%	6.5%
Emerging Market Debt	-5.2%	7.3%	9.3%	10.2%	1.2%	5.5%	-6.6%	18.5%	8.5%	12.0%	28.2%	-10.9%	6.3%	9.9%
Global High-Yield Bonds	-2.5%	8.4%	10.4%	14.3%	-2.7%	0.0%	7.3%	19.6%	3.1%	14.8%	59.4%	-26.9%	3.2%	13.7%
European High-Yield Bonds	-4.4%	7.0%	21.5%	5.9%	-9.5%	-7.4%	15.0%	29.2%	-5.6%	6.8%	80.5%	-37.5%	8.4%	24.2%
U.S. High-Yield Bonds	0.1%	8.2%	7.5%	17.5%	-4.6%	2.5%	7.4%	15.6%	4.4%	15.2%	57.5%	-26.4%	2.2%	11.8%
European IG Corporates	-3.4%	2.7%	16.6%	1.7%	-10.7%	-4.8%	7.0%	15.4%	-1.8%	-2.1%	19.4%	-8.5%	10.9%	12.4%
Global IG Corporates	-3.2%	4.3%	9.1%	4.3%	-3.6%	3.2%	0.4%	11.2%	4.3%	5.8%	19.2%	-8.7%	6.7%	7.2%
U.S. IG Corporates	-3.3%	5.6%	6.4%	6.1%	-0.7%	7.4%	-1.5%	9.9%	8.0%	9.0%	18.5%	-4.9%	4.6%	4.3%
Non-Fixed Income														
Global Equities	0.4%	10.3%	22.4%	7.5%	-0.9%	4.9%	26.7%	15.8%	-5.5%	11.8%	30.0%	-40.7%	9.0%	20.1%

At June 30, 2018. 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; Emerging Market Debt: JPM EMBI Global TR; Global High-Yield Bonds: BBgBarc Global High Yield TR USD; European High-Yield Bonds: ICE BofAML Euro Hi-Yld TR; U.S. High Yield Bonds: ICE BofAML US HY Master II TR; European IG Corporates: BBgBarc Euro Agg Corps TR; Global IG Corporates: BBgBarc Gbl Agg Corp TR USD; U.S. IG Corporates: BBgBarc US Corp IG TR USD; Global Equities: MSCI World NR.

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

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.

Exhibit 5: Correlations of Monthly Returns
7/1/2013–6/30/2018

	Preferred Securities	U.S. High-Yield Bonds	European High-Yield Bonds	Emerging Market Debt	European IG Corporates	Global Equities	Global IG Corporates	Global High-Yield Bonds	U.S. IG Corporates
Preferred Securities	1.00								
U.S. High-Yield Bonds	0.58	1.00							
European High-Yield Bonds	0.35	0.61	1.00						
Emerging Market Debt	0.69	0.68	0.56	1.00					
European IG Corporates	0.31	0.45	0.95	0.53	1.00				
Global Equities	0.38	0.73	0.64	0.54	0.51	1.00			
Global IG Corporates	0.66	0.63	0.76	0.77	0.79	0.52	1.00		
Global High-Yield Bonds	0.57	0.93	0.82	0.78	0.69	0.77	0.75	1.00	
U.S. IG Corporates	0.75	0.49	0.26	0.67	0.28	0.23	0.80	0.45	1.00

At June 30, 2018. Source: Morningstar.

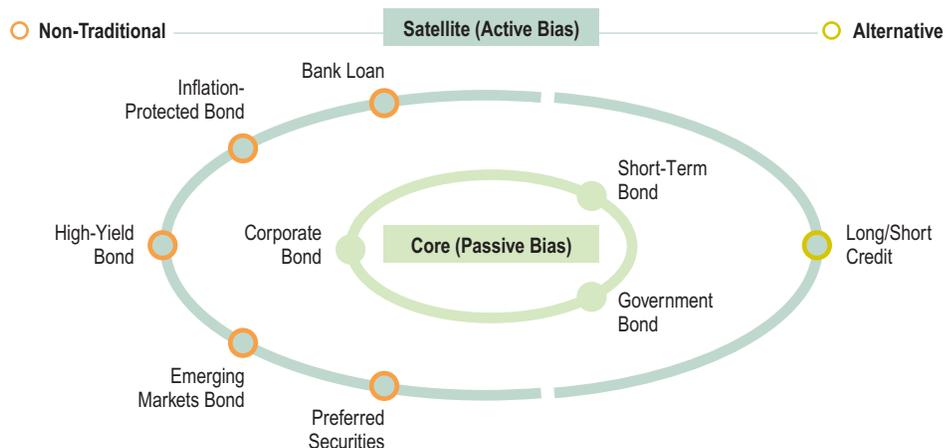
An Abundance of Low-Duration Structures Can Mitigate Interest-Rate Risk

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.

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 6: Fixed Income Investing—Segmenting the Asset Classes



Source: Cohen & Steers, 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 6 highlights how a fixed income portfolio can be segmented using a core/satellite portfolio construction approach.

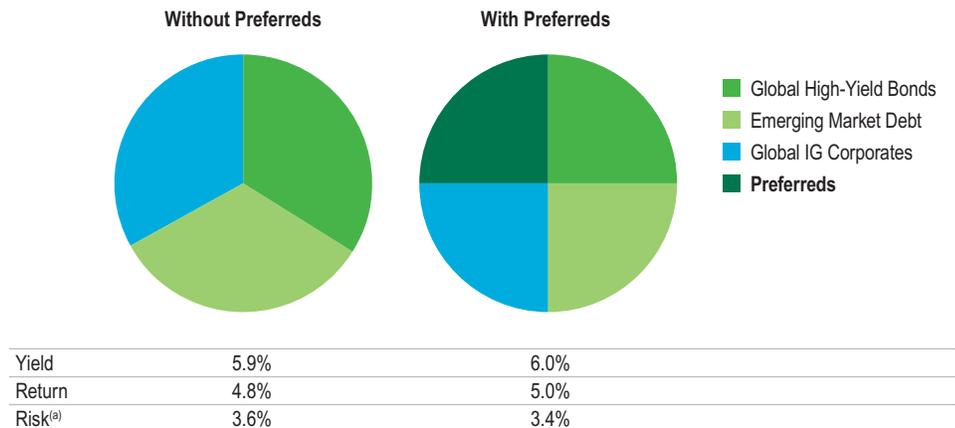
Individual fixed income strategies can be volatile, as the various bond market sectors, structures and maturities tend to respond differently to changing market environments. By diversifying fixed income strategies, investors may reduce portfolio volatility and mitigate interest-rate and credit risks. 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 \$70 billion globally.⁽¹⁾

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 global high-yield bonds, emerging market debt and global investment-grade corporates, which generated an annualized return of 4.8% and had a 5.9% yield. The equal-weight portfolio on the right, which was expanded to include preferreds, had better returns and a 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.

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

Exhibit 7: Sample Fixed Income Asset Allocation Portfolio Over Five Years



At June 30, 2018. Source: BofAML, Barclays, Cohen & Steers.

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(a) Risk is measured by standard deviation which shows how much variation or dispersion exists from the average. Global High-Yield Bonds are represented by the BBgBarc Global High Yield TR USD. Emerging market debt is represented by JPM EMBI Global TR. Global IG Corporates are represented by the BBgBarc Gbl Agg Corp TR USD. Preferred Securities are represented by 50% ICE BofAML Cap Sec 50% ICE BofAML Fixed Rate.

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

(1) Source: eVestment.

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

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.

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

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