Our Preferred Fixed Income Risk is in Preferreds

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EXECUTIVE SUMMARY

- The LPL Research Strategic and Tactical Asset Allocation Committee (STAAC) recently upgraded its tactical view on preferreds given attractive valuations relative to history.
- Preferreds are issued primarily by financial institutions with the largest issuers being banks and insurance companies.
- There are three primary segments of the preferred market—each with potentially different characteristics—with total issuance over $1 trillion.
- While there are a number of options available for investment, our preferred expression within the sector is though active management due to the different markets with different characteristics.

AN INTRO TO THE PREFERRED SECURITIES MARKET

Preferred securities (preferreds) are often referred to as “hybrid” securities as they have both bond and equity characteristics. This hybrid nature results in preferred securities being senior to common stock but subordinated, or junior, to bonds within a company’s capital stack. Similar to bonds, preferred securities offer a stated yield (from dividends, not a coupon) and a par value, which limits potential losses while not participating in potential price appreciation of a company’s common stock. While there are many types of preferred securities, dividends are generally guaranteed, but may be deferred based on company management’s discretion. Preferred securities, then, tend to offer higher yield compared to bonds issued by a company to attract investors.

There are three primary segments of the preferred market – 1) retail (known as $25 par), 2) institutional (known as $1000 par), and 3) Contingent Convertible (known as CoCo). In total, the preferred market is over $1 trillion, with the retail, institutional, and CoCo segments representing roughly 25%, 35%, and 40% of the market as of December 2022. As shown in **Figure 1**, the retail market (ICE Core Plus Fixed Rate Index) is an exchange-traded market where the securities generally have longer durations and lower yields, whereas the institutional market (ICE US Capital Securities Index) is an over-the-counter traded market where the securities pay dividends semi-annually. The CoCo market is primarily composed of European financial issuers (ICE USD Contingent Capital Index) with different characteristics and different risk premiums. CoCos came into existence following the global financial crisis (GFC), with regulators creating CoCos as a means to provide an additional layer (known as Additional Tier 1 or AT1) of capital to absorb losses in the event of a bank default.

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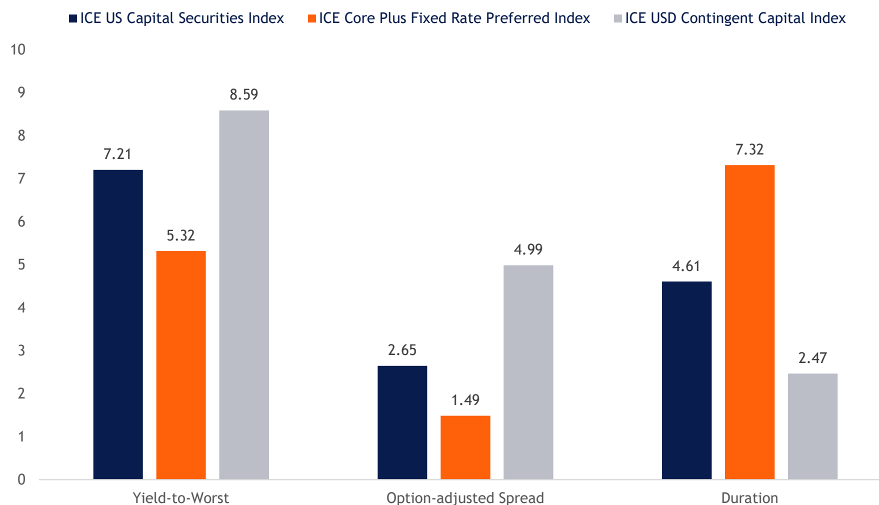
There are three primary segments of the preferred market with total issuance over $1 trillion. Each market has unique characteristics.

1 Preferreds Trade in Multiple Markets



Source: LPL Research, Bloomberg. Data as of 4/14/23.
Indexes are unmanaged statistical composites and cannot be invested into directly.

Preferreds are issued primarily by financial institutions with the largest issuers being banks and insurance companies (Figure 2). REITs, utilities and other financial institutions also issue preferreds. Preferred securities count toward regulatory capital requirements, so banks issue preferreds to help them maintain their required capital ratio. Preferred securities are highly correlated with the health of the financial system and a shock to the financial system would adversely impact these securities. Preferreds tend to be BBB- or BB-rated, meaning they carry higher levels of credit and default risks than the senior debt issued by the same issuer. However, since the issuers of preferred securities tend to be higher quality companies and rated investment-grade, default rates have been lower than similarly rated non-financial corporate bonds. Additionally, it isn't uncommon to have companies issue securities across the three markets.

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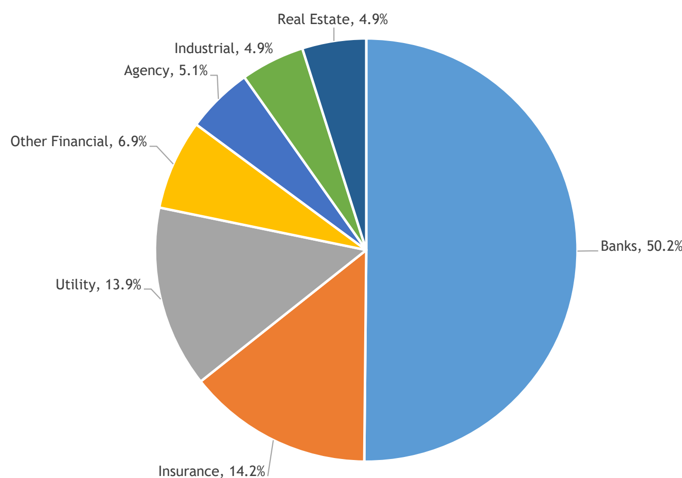
2 Financial Institutions are the Largest Issuers of Preferreds



Source: LPL Research, Bloomberg. Data as of 12/31/23

WHAT CAUSED RECENT PREFERRED SECURITY VOLATILITY

The preferred market, particularly the European CoCo / AT1 market, made headlines in March as Credit Suisse was eventually bought by rival UBS as the bank reeled from deposit outflows. As part of this acquisition, the Swiss Government provided substantial financial support and in a statement note that the transaction “will trigger a complete write-down of the nominal value of all AT1 shares of Credit Suisse” in the amount of $17 billion without a negative impact to equity holders.

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We believe this write-down of Credit Suisse AT1 securities is an outlier event, and do not expect AT1 securities absorbing losses before equity investors to become the norm in Europe. Financial regulators in Europe have issued statements to reassure markets that the events at Credit Suisse were extraordinary. Various financial authorities across Europe (Single Resolution Board, European Banking Authority, Bank of England, and European Central Bank) said that their actions in future circumstances will be guided by an established framework in which “common equity instruments are the first ones to absorb losses, and only after their full use would Additional Tier One (AT1) be required to be written down.”

As expected, this wipe out of a portion of Credit Suisse’s preferred securities sent shock waves throughout the institutional preferred markets. Broadly, CoCo valuations dropped, with the ICE USD Contingent Capital Index declining roughly 14% in March. However, as the dust has settled across the banking industry and preferred market, CoCo returns have stabilized, with the index return 1% over the course of April.

WHY INVEST IN PREFERREDS

The LPL Research Strategic and Tactical Asset Allocation Committee (STAAC) recently upgraded its tactical view on preferreds given attractive valuations relative to history. Given the hybrid nature of preferred securities, there are diversification benefits to adding preferreds to a portfolio. While these securities tend to “act” like equity and high-yield fixed income securities across a full market cycle, since the financial crisis in 2009, these securities have generally held up better than both asset classes during equity market sell-offs (as measured by the S&P 500 Index). Additionally,the majority of preferred dividends are taxed at qualified dividend income rates, which may be less than ordinary income tax rates (top federal rate of 37%). This means that for U.S. investors, preferred stocks may provide a compelling after-tax yield relative to other asset classes.

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Even with the volatility in European CoCo markets in March, preferreds are one of the best performing asset classes this year, with the ICE Core Plus Fixed Rate Index up over 6% year-to-date (through 04/17/23). Moreover, index yields remain elevated relative to history (**Figure 3**), so these securities could be an attractive option for income oriented investors. In general, preferreds offer generous yields, both absolute and after-tax, with their high income stream serving as a total return buffer against future spread volatility. As such, preferred securities can be higher yielding alternatives to traditional core fixed income options.

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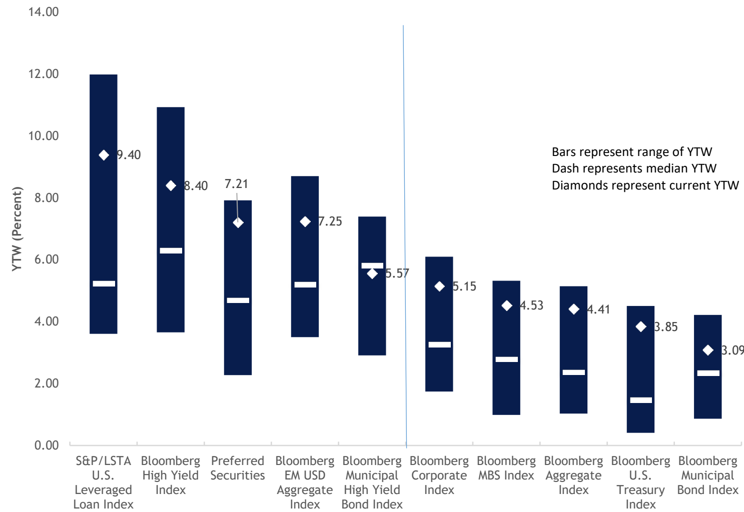
3 **Preferred Yields Are Above Historical Averages**



Source: LPL Research, Bloomberg. Data as of 04/14/23.
Indexes cannot be invested into directly.
Past Performance is no guarantee of future results.

As noted above, preferreds are concentrated in the financial sector, but since the GFC, many financial institutions have emerged with stronger balance sheets, which should limit downgrades and defaults, in our view. Despite the lower earnings environment for financials this year and bank stress from domestic regional banks and Credit Suisse in Europe, the fundamental health of the financial system remains intact. These financial institutions can likely weather any potential recessionary storm while continuing to pay dividends on their preferred securities.

OPTIONS AVAILABLE

While we still recommend the majority of fixed income exposure to be allocated to core bonds, for those income-oriented investors willing to take on some additional credit risk, preferred securities may be an attractive investment to consider. And while there are a number of options available for investment, our preferred expression within the sector is though active management due to the different markets with different characteristics (see above). Most active managers are able to take advantage of the relative value opportunities across markets (many issuers issue in all markets) whereas many ETFs (not all though) tends to invest only in the more liquid retail market. Nonetheless, we think a small allocation to preferreds may make sense as part of a diversified asset allocation plan.

IMPORTANT DISCLOSURES

This material is for general information only and is not intended to provide specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors or will yield positive outcomes. Investing involves risks including possible loss of principal. Any economic forecasts set forth may not develop as predicted and are subject to change.

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The Standard & Poor’s 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Please read the full Outlook 2021: Powering Forward publication for additional description and disclosure.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

Preferred stock dividends are paid at the discretion of the issuing company. Preferred stocks are subject to interest rate and credit risk. As interest rates rise, the price of the preferred falls (and vice versa). They may be subject to a call feature with changing interest rates or credit ratings.

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