The Case for Preferred Securities

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Preferred securities are a large and growing asset class that can offer valuable benefits for investors and issuers alike. Regulatory changes implemented following the global financial crisis helped increase the size and fundamental strength of this market. In this paper we explore how these hybrid securities can offer high after-tax income and portfolio diversification for investors.

Key takeaways

- » Preferred securities can deliver a high level of potentially tax-advantaged income for investors.
- » The majority of securities are rated investment grade and are issued by companies in highly regulated industries such as financial institutions and utilities.
- » The unique structure of preferreds, with features such as fixed-to-variable rate coupons, can result in a lower correlation to traditional fixed income.
- » An active manager can potentially take advantage of the inefficiencies inherent in this market.

Parametric

Overview

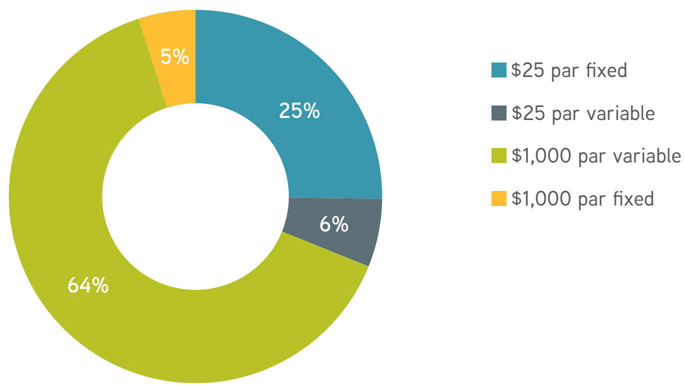
Preferreds are fixed income securities with both debt- and equity-like characteristics. They may trade on exchanges, like ETFs, or over the counter, like traditional bonds. As with debt, preferreds have a set face value, credit rating, and predetermined recurring coupon. As with equities, issuers can defer or suspend payments, and the instruments typically carry perpetual or long-dated maturities.

For these features, preferreds have historically paid among the highest yields in the investment-grade (IG) fixed income universe. Many preferred securities also pay qualified dividend income (QDI), which can provide an after-tax advantage to alternatives in fixed income such as corporate bonds and high yield.

The US preferred market

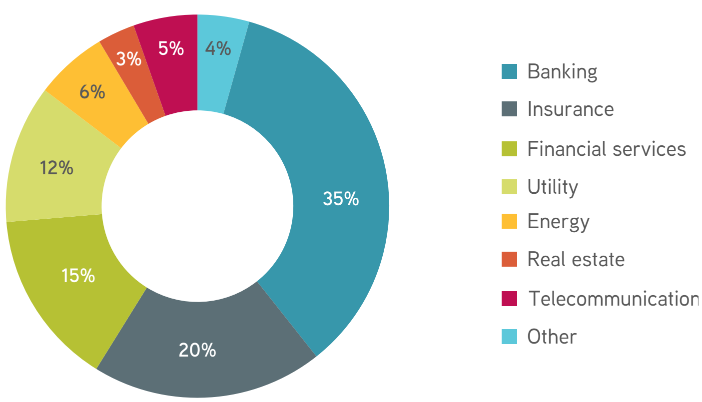
The $300 billion+ US preferred market spans exchange-traded $25 par securities as well as $1,000 par securities, which trade like corporate debt. Beyond differences in trading conventions, the $1,000 par institutional class is primarily fixed to variable rate, while the majority of the $25 par retail market is fixed for life. Fixed-to-variable rate securities carry a fixed coupon until the first call date, after which they pay a coupon based on an underlying index, such as the secured overnight financing rate (SOFR) or the five-year Treasury rate, plus a fixed spread.

FIGURE 1: US PREFERRED SECURITIES MARKET



Source: Intercontinental Exchange, 6/30/2023. For illustrative purposes only. Not a recommendation to buy or sell any security. It is not possible to invest directly in an index. Indexes are unmanaged and do not reflect the deduction of fees or expenses. Past performance is no guarantee of future results.

FIGURE 2: US PREFERRED MARKET BY SECTOR



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Credit ratings

Preferreds are subordinated securities that rank below senior debt and just above common equity. Credit rating agencies notch preferreds and hybrid debt lower than senior debt due to their higher credit risk and features such as deferrable coupon or dividend payments. Despite their additional risk, over 70% of preferred and hybrid securities are rated investment grade.

Preferred issuers

Financial institutions are the primary issuers of preferred securities, with banks, financial services companies, and insurers representing more than 70% of preferred indexes. Nonfinancial issuers are mainly those from highly regulated industries such as utilities, telecommunications, and pipeline companies. For corporate issuers, preferreds and hybrid debt can be a means to raise capital with limited impact to leverage ratios due to the ratings agency treatment of hybrid securities.

Banks use preferreds to satisfy regulatory requirements covering capital and leverage ratios. As regulations increased following the global financial crisis, so did the size and strength of the preferreds market. In the US, preferreds representing up to 1.5% of a bank's risk-weighted assets can count toward additional tier 1 capital. For these capital securities, preferreds need to include a few features:

- No stated maturity (perpetual)
- Equity accounting treatment with subordination to all debt
- Deferrable and non-cumulative dividend payment
- First call date at least five years from the date of issuance

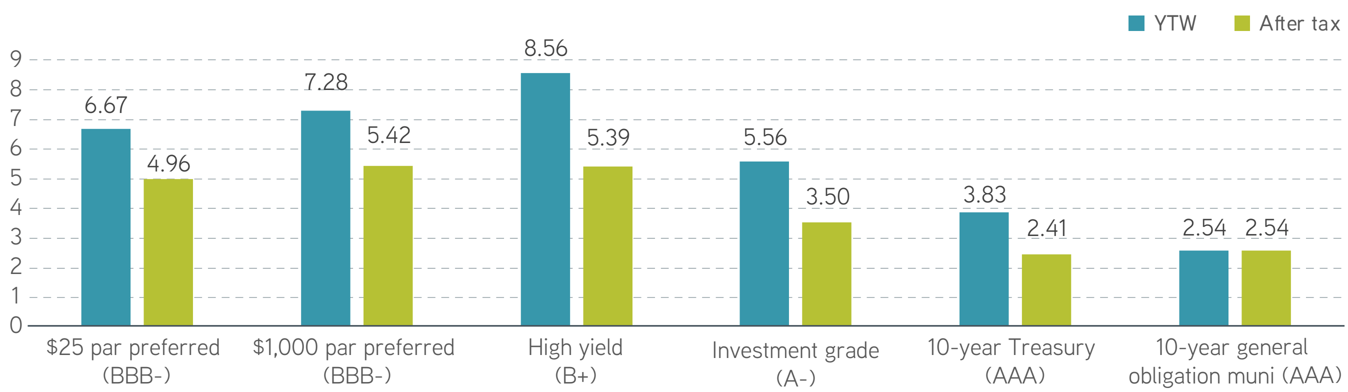
Outside the US, regulators following the financial crisis adopted a structure for banks' additional tier 1 capital known as contingent capital securities, or CoCos. Similar to US preferreds in many ways, CoCos differ in that they have an explicit trigger where the securities can be written down based on their ratio of common equity to risk assets, known as CET1, or if regulators determine the bank is nonviable.

FIGURE 3: TYPICAL CAPITAL STRUCTURE AND SAMPLE CREDIT RATING

	Security rank	Income type	Credit rating
	Senior debt (operating company level)	Nondeferrable interest	A-
	Senior debt (holding company level)	Nondeferrable interest	BBB+
	Subordinated debt (tier 2)	Nondeferrable interest	BBB
Preferred and hybrid securities	Junior subordinated debt	Deferrable interest (non-QDI)	BBB-
	Preferred equity	Deferrable dividend (QDI)	BB+
	Common equity	Deferrable dividend	N/A

Source: Parametric, 6/30/2023. For illustrative purposes only. Not a recommendation to buy or sell any security.

FIGURE 4: FIXED INCOME ASSET CLASS YIELDS



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Tax-advantaged yield for fixed income securities

For US taxpayers, attractive after-tax yields are an important benefit of preferred securities. The majority of preferreds pay qualified dividend income (QDI), which is taxed at the long-term capital gains rate for US taxpayers. For individuals in the highest tax bracket, this translates to a federal tax rate of 20% plus the 3.8% Medicare surcharge, compared with a 40.8% combined rate for ordinary income. For corporations, the dividend received deduction (DRD) can lower the effective corporate tax rate on income from qualifying securities to 10.5%.

Non-QDI preferreds are generally hybrid bonds, such as those issued by nonfinancials for the ratings benefit. One key determinant is whether the security is a dividend-paying equity or coupon-paying debt instrument from an accounting standpoint. Hybrid bonds carry equity-like features, such as deep subordination, deferrable coupons, and long—if not perpetual—maturities, which accounts for the equity credit from ratings agencies. But if the securities are debt instruments, the IRS generally doesn't treat interest payments as QDI. For this same reason, nonresident clients may be eligible to own the securities and avoid withholding tax.

How preferreds fit in

High after-tax income and low correlation to traditional fixed income can make preferreds an attractive complement to fixed income portfolios. Even before considering the impact of tax, historical returns for preferreds have been comparable to those of US junk bonds, despite their considerably higher credit ratings. During the 10-year period ending June 30, 2023, preferred total return and volatility was similar to that of high-yield bonds while exceeding those of municipal bonds and US IG corporates.

The unique structure of preferreds, with features such as fixed-to-variable rate coupons, can result in a lower correlation to traditional fixed income. Based on index returns over the last 10 years, the correlation of preferreds to the Barclays Aggregate was only 51%, while the correlation to the S&P 500® was lower than that of high-yield bonds at 62%. Figure 4 shows the correlation of preferred securities (proxied by the ICE BofA Fixed Rate Preferred Securities Index) to equities (proxied by the S&P 500®) and corporate high-yield, municipal, and aggregate fixed income (proxied by the Bloomberg US Corporate High Yield Index, the Bloomberg Municipal Bond Index, and the Bloomberg Barclays US Aggregate Bond Index, respectively).

FIGURE 5: FIXED INCOME INDEX 10-YEAR RETURNS

Index	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013	10-year ann. returns	10-year ann. volatility
ICE BofA Fixed Rate Preferred	-14.60	2.24	6.95	17.71	-4.34	10.58	2.32	7.58	15.44	-3.65	4.20%	7.45%
Bloomberg US Corporate High Yield	-11.22	5.36	6.17	14.41	-2.27	7.48	17.49	-4.64	2.50	7.42	4.18%	7.50%
ICE BofA US Corporate	-15.44	-0.95	9.81	14.23	-2.25	6.48	5.96	-0.63	7.51	-1.46	2.62%	6.16%
Bloomberg Muni	-8.01	1.56	5.00	7.21	1.04	5.42	0.44	3.55	9.78	-2.89	2.87%	4.37%

Source: Intercontinental Exchange, 6/30/2023. For illustrative purposes only. Not a recommendation to buy or sell any security. It is not possible to invest directly in an index. Indexes are unmanaged and do not reflect the deduction of fees or expenses. Past performance is no guarantee of future results.

FIGURE 6: CORRELATIONS OF PREFERRED SECURITIES TO OTHER ASSET CLASSES

Index	ICE BofA Fixed Rate Preferred	S&P 500®	Bloomberg US Corporate HY	Bloomberg Muni	Barclays US Aggregate
ICE BofA Fixed Rate Preferred	100%	62%	79%	73%	61%
S&P 500®	62%	100%	75%	36%	13%
Bloomberg US Corporate HY	79%	75%	100%	57%	37%
Bloomberg Muni	73%	36%	57%	100%	67%
Barclays US Aggregate	51%	13%	37%	67%	100%

Sources: Intercontinental Exchange, S&P Global, 6/30/2023. For illustrative purposes only. Not a recommendation to buy or sell any security. It is not possible to invest directly in an index. Indexes are unmanaged and do not reflect the deduction of fees or expenses. Past performance is no guarantee of future results.

While preferred securities are primarily perpetual, rate reset structures can lower interest rate sensitivity. After the first call date, dividend payments reset at a fixed spread plus the rate on a reference index, such as the five-year constant-maturity Treasury or SOFR. By resetting quarterly or every five years, these securities may perform better in a period of rising rates.

Coupon rates can affect interest-rate sensitivity as well. An economically rational issuer should refinance a higher coupon security for a cheaper option when the opportunity arises. High-coupon securities have a lower likelihood of extending beyond the call date, all else equal. This shorter expected lifespan can reduce the impact of higher rates relative to lower coupon securities.

Parametric's approach to managing preferred securities

The high yields of preferreds come with additional risk, but the nuances of this market can create opportunities for an active manager. Fund flows from large ETFs can distort prices on underlying securities, and heavy retail ownership can lead to inefficiencies in the preferred market. As the $25 par index hit all-time highs in the summer of 2021, more than 15% of the underlying securities traded at a negative yield. Credit selection is also critical in preferreds, which regional bank stress in the spring of 2023 made clear.

Subordinated securities have a higher risk of principal loss, and issuers can suspend or cancel coupon payments. Backed by a team of dedicated IG research analysts, the portfolio managers at Parametric can build portfolios from the bottom up to capture idiosyncratic opportunities and avoid missteps.

Combining the advantages of a separately managed account (SMA) with portfolios that can offer 100% QDI-paying securities, Parametric's preferred strategies offer investors customized portfolios with lower fees and greater tax efficiency than a fund or ETF. By leveraging proprietary technology, the trading team at Parametric is able to execute efficiently while providing tax-loss harvesting at scale.

Conclusion

In the IG fixed income universe, few alternatives can match the high potential after-tax yields of preferreds. With their unique structure and lower correlation, preferreds are an attractive complement to traditional fixed income, and an active manager can capitalize on inefficiencies inherent in this asset class. Parametric now offers three preferred SMA options, with strategies focusing on the $25 par market, the $1,000 par market, and securities for nonresident clients. We believe these securities deserve a place in investors' fixed income portfolios.

FIGURE 7: $1,000 PAR HISTORICAL YIELD TO WORST

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As interest rates rise, the value of a client portfolio invested primarily in fixed income securities or similar instruments is likely to decline. Conversely, when interest rates decline, the value of such a client portfolio is likely to rise. Securities with longer maturities are more sensitive to changes in interest rates than securities with shorter maturities, making them more volatile. A rising interest rate environment may extend the average life of mortgages or other asset-backed receivables underlying mortgage-backed or asset-backed securities. This extension increases the risk of depreciation due to future increases in market interest rates. In a declining interest rate environment, prepayment of certain types of securities may increase. In such circumstances, the portfolio manager may have to reinvest the prepayment proceeds at lower yields. A strategy that is managed toward an income objective may hold securities with longer maturities and therefore be more exposed to interest rate risk than a strategy focused on total return.

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