

The Case for Preferred Securities: Income, Tax Efficiency and Quality for a Higher-Rate Environment

Preferred and hybrid securities combine traits of debt and equity, offering elevated income in exchange for subordination and hybrid capital features. Whether accessed through exchange-traded funds (ETFs) or separately managed accounts (SMAs), preferred securities may offer a differentiated source of income within diversified portfolios.

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Why Preferreds Today?

Several factors underpin the case for preferred securities today:

HIGHER STARTING YIELDS. The repricing of interest rates has lifted preferred yields to multi-year highs, increasing the potential contribution of income to total returns.

AFTER-TAX INCOME ADVANTAGES. Many traditional US preferred securities generate Qualified Dividend Income (QDI), which may be taxed at long-term capital gains rates rather than ordinary income rates. For taxable investors, this can meaningfully enhance after-tax yield.

DIVERSIFICATION BENEFITS. Preferred securities have historically exhibited only moderate correlation to core investment-grade bonds, reflecting their hybrid nature and sensitivity to both interest rates and credit spreads.¹

Understanding Preferred Securities

Preferred securities are hybrid instruments that combine features of both debt and equity. Like traditional fixed income, they carry credit ratings, have a stated face value and typically pay a fixed coupon for an initial period. Like equities, issuers can defer or suspend payments, and the securities are perpetual or long-dated.

Preferred securities sit above common equity but below all forms of debt in a company's capital structure. Financial institutions represent the majority of issuance, reflecting regulatory requirements that incentivize the use of these securities. For US banking institutions, non-cumulative perpetual preferreds qualify as Additional Tier 1 capital, serving as a key component of regulatory capital.

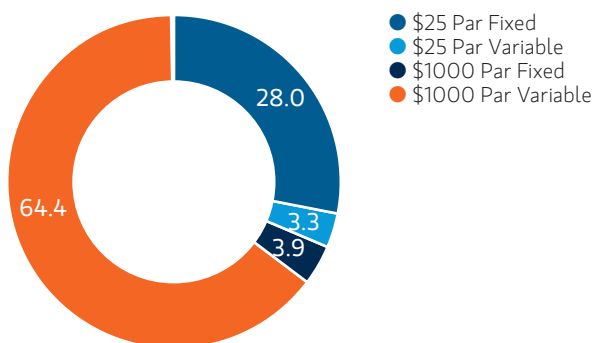
Nonfinancial issuers are primarily drawn from highly regulated and capital-intensive industries such as utilities, telecommunications and energy infrastructure. For corporate issuers, preferreds and hybrid debt can serve as a means of raising capital with limited impact to leverage ratios, due to the ratings agency treatment of hybrid securities.

Over 70% of the preferred securities market is rated investment grade. Rating agencies "notch" preferreds below an issuer's senior bonds to reflect subordination but evaluate them on the same ratings scale as other corporate credit instruments. Historically, credit performance among investment-grade preferred issuers has been broadly in line with similarly rated corporate bonds.

Due to their structural characteristics and subordination within the capital stack, preferreds have consistently offered among the highest yields in the investment-grade fixed income universe.

DISPLAY 1

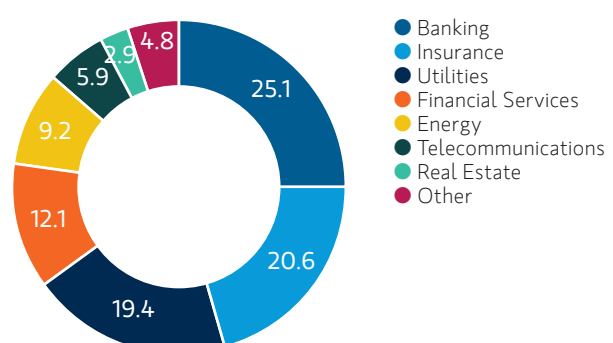
US preferred securities market



Source: Intercontinental Exchange, 02/18/2026.

DISPLAY 2

US preferred market by sector



Source: Intercontinental Exchange, 02/18/2026.

¹ Diversification does not eliminate the risk of loss.

Income and the Importance of After-Tax Yield

For taxable investors, one of the most compelling attributes of preferreds is their potential to generate Qualified Dividend Income (QDI). Most preferred securities pay dividends that qualify as QDI, which is generally taxed at long-term capital gains rates rather than ordinary income rates.

For investors in higher tax brackets, this distinction can meaningfully enhance after-tax income.

Consider a preferred security yielding 6.5%:

- If taxed at a combined 40.8% ordinary income rate, the after-tax yield is approximately 3.85%.
- If taxed at a combined 23.8% QDI rate, the after-tax yield is approximately 4.95%.

The difference—over 100 basis points in this example—may materially alter relative value comparisons versus taxable corporate bonds.

Not all preferreds qualify for QDI treatment. REIT preferreds and many hybrid debt structures may be taxed as ordinary income. Corporate investors may benefit from the Dividends Received Deduction (DRD) on certain securities. For many investors, evaluating preferred securities on a taxable-equivalent yield basis provides a more accurate framework for comparison with traditional bonds.

Structure and Interest Rate Sensitivity

The \$350 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, these segments of the market can vary meaningfully in their interest rate sensitivity.

There are two common structural types:

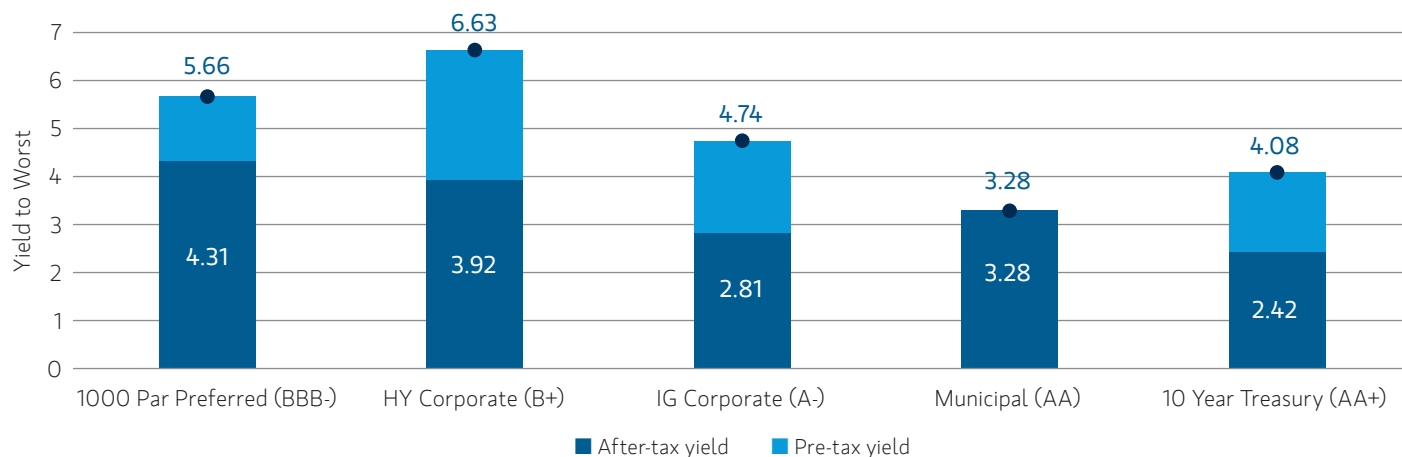
- **FIXED-FOR-LIFE PREFERREDS** pay a static coupon indefinitely and are more prevalent in the exchange-traded \$25 par market.
- **FIXED-TO-RESET PREFERREDS** pay a fixed coupon until a specified date and then reset periodically at a spread over a benchmark, such as the 5-year Constant Maturity Treasury (CMT) rate or the Secured Overnight Financing Rate (SOFR). This structure is common in the \$1,000 par institutional market.

Interest rate sensitivity is generally measured using **effective duration**, which estimates how much price may change for a 1% move in interest rates.

Fixed-for-life preferreds generally exhibit higher effective duration because their income stream does not adjust when rates move. Fixed-to-reset structures typically exhibit lower effective duration, particularly as reset dates approach, since their coupons can adjust upward if short-term rates remain elevated.

DISPLAY 3

Fixed income asset class yields

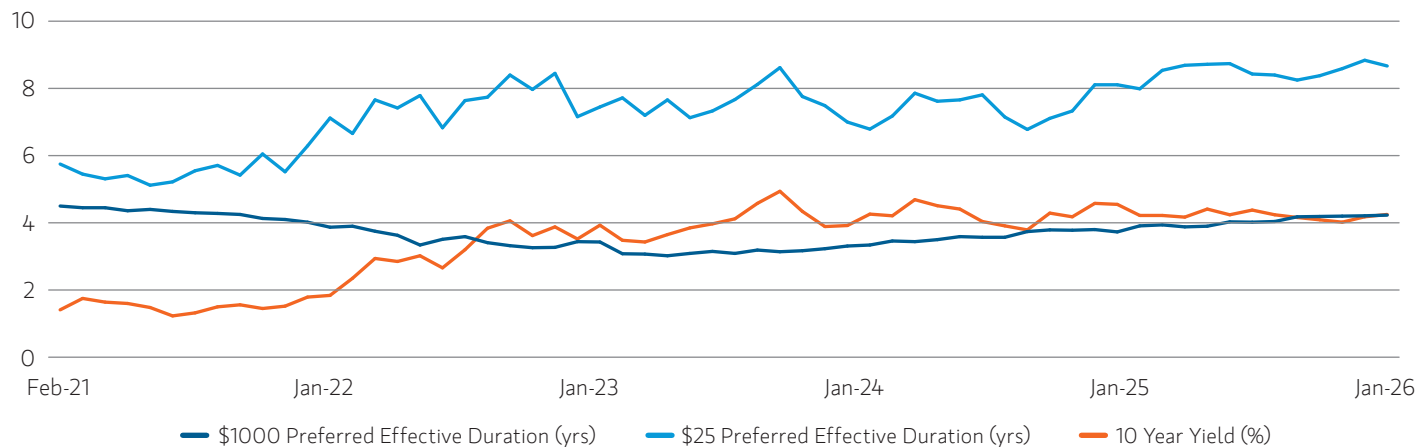


Past performance is no guarantee of future results.

Source: Bloomberg, 02/18/2026. 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. Assumes a 37% ordinary income tax rate and a 20% long-term gains tax rate, with 67% of each preferred index made up of QDI securities. State and local taxes are not reflected unless provided by the client.

DISPLAY 4

Effective duration of fixed-for-life and fixed-to-reset preferreds



Past performance is no guarantee of future results.

Sources: Intercontinental Exchange, 02/28/2021 to 01/31/2026. 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.

Coupon rates can affect interest rate sensitivity as well. An economically rational issuer is more likely to refinance a higher coupon security if market conditions permit. High coupon securities therefore tend to have a lower likelihood of extending beyond the call date, all else equal. This shorter expected lifespan can reduce rate sensitivity relative to lower coupon securities.

In today’s higher-rate environment, reset structures can moderate interest rate sensitivity while maintaining attractive income characteristics.

Corporate Hybrids

In addition to traditional preferred equity, the broader preferred universe includes corporate hybrid securities.

These are typically long-dated or perpetual subordinated bonds that incorporate equity-like features.

Corporate hybrids rank junior to senior and subordinated debt, permit optional coupon deferral without triggering default, receive partial “equity credit” from credit rating agencies and include call features and replacement capital provisions.

From an investor’s perspective, hybrids are subordinated income instruments that can offer elevated yields relative to senior debt. Corporate hybrids are typically issued by capital-intensive sectors such as utilities, telecommunications, infrastructure and energy to satisfy strategic capital management objectives.

Companies primarily issue hybrids to improve credit metrics—rating agencies often treat a portion of hybrid

DISPLAY 5

Typical capital structure and sample credit rating

	SECURITY RANK	INCOME TYPE	CREDIT RATING
Preferred and hybrid securities	Senior debt (operating company level)	Nondeferrable interest	A-
	Senior debt (holding company level)	Nondeferrable interest	BBB+
	Subordinated debt (tier 2)	Nondeferrable interest	BBB
	Junior subordinated debt	Deferrable interest (non-QD)	BBB-
	Preferred equity	Deferrable dividend (QD)	BB+
	Common equity	Deferrable dividend	N/A

Source: Parametric, 02/18/2026. For illustrative purposes only. Not a recommendation to buy or sell any security.

issuance as equity—and to avoid shareholder dilution that would result from issuing common stock. As with traditional preferreds, corporate hybrids represent a middle ground between debt and equity, providing issuers with structural flexibility and investors with enhanced income in exchange for subordination and complexity.

Contingent Convertibles

The non-US equivalent to US bank preferred securities are called Contingent Convertibles, or CoCos. While CoCos share many similarities with US preferreds—including their role as Additional Tier 1 regulatory capital—they differ in important structural respects.

CoCos typically contain explicit loss-absorption triggers tied to a bank’s capital ratios, such as its Common Equity Tier 1 (CET1) ratio. If those thresholds are breached, or if regulators determine that the institution is no longer viable, CoCos may be written down or converted into equity.

In contrast, traditional US bank preferreds generally don’t contain automatic principal write-down mechanisms linked to capital ratio triggers. US preferred structures also typically include a dividend stopper, requiring suspension of common dividends before preferred dividends can be deferred. CoCo distributions, by comparison, are fully discretionary. These structural distinctions, along with differences in regulatory discretion across jurisdictions, can influence how subordinated capital instruments behave during periods of banking stress.

Relative Value and Diversification

Preferred securities have historically offered yields above investment-grade corporate bonds, reflecting subordination

and structural complexity. When combined with potential QDI treatment, preferreds may compare favorably with many taxable bond sectors on an after-tax basis.

Beyond yield, preferreds may also provide diversification to complement traditional fixed income allocations. Historically, preferred returns have exhibited only moderate correlation to core bond benchmarks such as the Bloomberg US Aggregate Bond Index. Their hybrid nature—driven by both rate movements and credit spreads—means they have not consistently moved in lockstep with duration-heavy government bonds.

While correlations can rise during systemic stress, over longer periods preferreds have provided a differentiated source of income and risk exposure within diversified fixed income portfolios.

Active Management and Portfolio Implementation

The preferred and hybrid market exhibits unique attributes that may provide opportunities for active managers. Independent supply and demand characteristics across segments of the market, as well as differences in tax treatment, reset mechanics and call provisions, may create dispersion that rewards careful analysis. High sector concentration further underscores the importance of rigorous issuer-level credit research.

ETFs can offer efficient and transparent exposure to a broad range of preferred and hybrid securities, often with lower minimum investment thresholds than SMAs. SMAs can provide greater flexibility and customization. Portfolios may emphasize QDI-eligible securities, manage issuer concentration and incorporate tax loss harvesting strategies.

DISPLAY 6
Correlations of preferred securities to other asset classes, 10 years through January 31

SECURITY RANK	PREFERRED INDEX	S&P 500® INDEX	HIGH YIELD INDEX	MUNICIPAL INDEX	US AGGREGATE INDEX
Preferred Index	100%	63%	81%	70%	52%
S&P 500® Index	63%	100%	76%	37%	19%
High Yield Index	81%	76%	100%	62%	44%
Municipal Index	70%	37%	62%	100%	67%
US Aggregate Index	52%	19%	44%	67%	100%

Past performance is no guarantee of future results.

Sources: Intercontinental Exchange, S&P Global, Bloomberg, 01/31/2026. 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.

The choice of vehicle depends on the investor's objectives, tax profile and desired degree of customization.

Conclusion

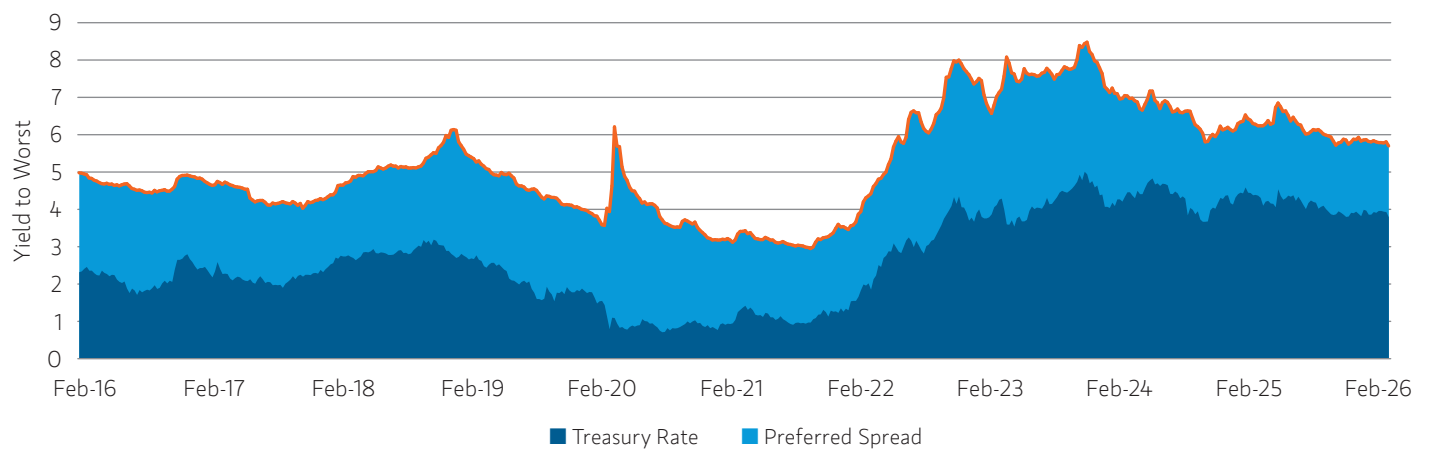
Within the investment-grade fixed income universe, few alternatives can match the high potential after-tax yields of preferreds. With their unique structure and moderate

correlation to traditional fixed income, preferreds may serve as an attractive complement to core bond allocations.

Supported by strengthened capital frameworks, elevated starting yields and potential after-tax advantages through QDI, preferred and hybrid securities may offer a compelling fixed income opportunity in today's higher-rate environment.

DISPLAY 7

\$1,000 par historical yield to worst



Past performance is no guarantee of future results.

Source: Intercontinental Exchange, 02/19/2016 to 02/13/2026. ICE BofA US Institutional Capital Securities Index tracks the performance of US dollar-denominated institutional capital securities, including traditional preferred stock and hybrid capital instruments issued in the U.S. market. 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.

Index Definitions

The ICE BofA Contingent Capital Securities Index is designed to track the performance of investment-grade and below-investment-grade contingent capital debt.

The ICE BofA BB High Yield Index is a financial index that tracks the performance of US dollar-denominated, below-investment-grade corporate debt publicly issued in the US domestic market.

The ICE BofA US Institutional Capital Securities Index is a capitalization-weighted index that tracks the performance of fixed-rate US-dollar-denominated preferred securities issued in the US domestic market.

The ICE BofA US Corporate Index is a comprehensive index that tracks the performance of US dollar-denominated investment-grade corporate debt publicly issued in the US domestic market.

The ICE BofA Fixed Rate Preferred Securities Index is an unmanaged index of fixed-rate, preferred securities issued in the U.S.

The ICE BofA Core Plus Fixed Rate Preferred Securities Index is a capitalization-weighted index that tracks the performance of fixed-rate US dollar-denominated preferred securities issued in the US domestic market.

The ICE US Broad Municipal Index measures the performance of US dollar-denominated, tax-exempt municipal bonds issued in the US market.

The Bloomberg US Generic Government 10 Year Index represents the yield of the current on-the-run 10-year US Treasury note.

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