Preferred Securities Q&A

By Carl Pappo, CFA, CIO US Fixed Income, Allianz Global Investors

Summary

- Preferred securities (preferreds) generally pay a higher level of income when compared to most other fixed income classes.
- Within the range of various structures, preferred securities offer different coupon structures which could be leveraged to manage different interest rate environments.
- Where preferred securities sit in the issuer's capital structure, their history of low defaults and the dominance of the banking sector across the preferred universe give us confidence that preferred securities would continue to provide high quality income.
- Preferred securities could provide portfolio diversification benefits given limited correlation with other asset classes.

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Q: Why might preferred securities be a good alternative to traditional high yielding instruments, such as high yield bonds and emerging market debt? What are the differences between these securities in terms of yield and risk profile?

A: More so than high yield and emerging market securities, preferred securities predominately carry investment grade ratings. For investors looking to reduce overall portfolio risk while still achieving high quality income goals, preferred securities offer an attractive alternative. The overall quality of our preferred portfolio is higher than typical high yield and emerging market debt funds. This is evidenced by the quality of the companies we are investing in (investment grade ratings) and the historical and expected defaults of investment grade debt vs. that of high yield and emerging market bonds.

Preferred securities are predominately rated BBB (investment grade, IG), while high yield is predominately BB/B (non-IG) and emerging market indices can be as much as one third below investment grade rated. Historically it is proven that investment grade companies will experience lower defaults. Preferred securities generally pay a higher

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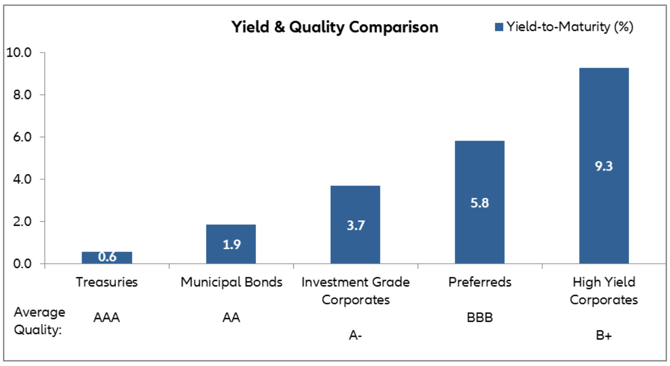
level of income when compared to most other fixed income classes. In comparison to high yield and emerging markets, preferreds still offer very competitive yield levels at significantly less risk of default.



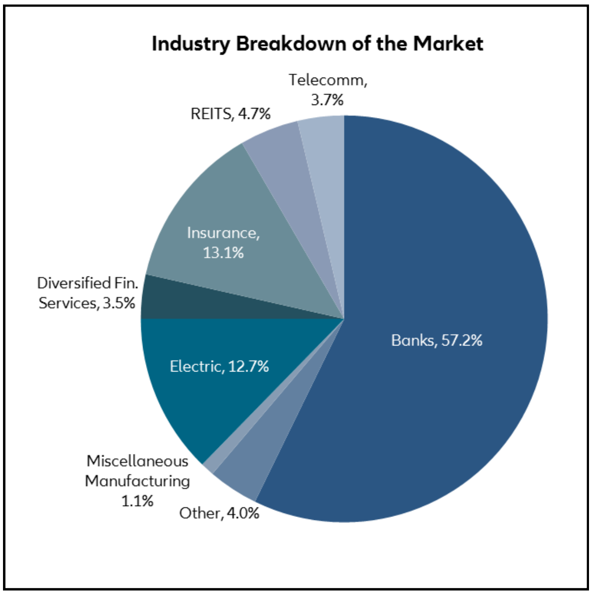
Source: As of 31 March 2020. Allianz Global Investors, Bloomberg, ICE BofA Merrill Lynch. Yield to maturity as of 31 March 2020 of ICE BofAML Fixed Rate Preferred Securities Index, ICE BofAML ICE BofAML 3-7 Year US Municipal Securities Index, ICE BofAML US Corporate Index, ICE BofAML US High Yield Index

Q: Faced with the possibility of ultra-low or even negative yields, it is becoming quite challenging for investors to manage interest rate risk in developed markets. Could you describe the interest rate risks associated with preferreds?

A: Managing interest rate risk can actually be a positive for preferred investors. Multiple structures exist in the preferred market place to help issuers satisfy the various constraints applied to them by regulators, credit ratings agencies, and investors. Within the range of various structures, preferred securities offer different coupon structures which can be leveraged to manage different interest rate environments. The abundance of fixed-to-floating rate structures and fixed for life coupon payments available across preferreds support our active management approach to managing interest-rate risk. Preferreds can also leverage the banking sector in the form of higher earnings during a rising interest rate environment, to further offset interest rate risk.

Q: The global economy has suffered as the public health crisis rolls on. This raises the risk for dividend cuts in the equity space going forward. Why might preferreds offer high quality income? Does their placement in the capital structure generate advantages for preferred securities?

A: The coronavirus outbreak caused considerable dislocation across both fixed income and equity markets in the first quarter of 2020. Risk assets repriced quickly in direct response to business shutdowns and stay at home measures placed across the globe. In response, governments and central banks across the world took unprecedented actions to minimize the impact to the global economy and most certainly attempt to limit bankruptcies and defaults. As can be seen in the following chart, the financial sector is well-represented in the preferred universe. Where preferred securities sit in the issuer's capital structure, their history of low defaults and the dominance of the banking sector across the preferred universe give us confidence that preferred securities will continue to provide high quality income. Preferred securities sit above common equity in the capital structure so they are better insulated against loss absorption.



Source: As of 31 March 2020. Allianz Global Investors, ICE BofAML Fixed Rate Preferred Securities Index. The information above is provided for illustrative purposes only, it should not be considered a recommendation to purchase or sell any particular security or strategy or an investment advice.

Q: What are the correlation characteristics of preferred securities in comparison with traditional asset classes? Do they offer any diversification benefits?

A: Preferred securities can provide portfolio diversification benefits given limited correlation with other asset classes. With both bond and equity-like characteristics, preferred securities have historically demonstrated a relatively low correlation compared to both traditional fixed income sectors and equity segments. Please see illustration below.

	Preferreds	High Yield	S&P 500	Levered loans	10-YR Treasury	Municipals	Corporates	3-7 YR Munis
Preferreds	1.00							
High Yield	0.70	1.00						
S&P 500	0.50	0.76	1.00					
Levered loans	0.56	0.84	0.61	1.00				
10-YR Treasury	0.08	(0.25)	(0.49)	(0.38)	1.00			
Municipals	0.49	0.24	(0.03)	0.19	0.64	1.00		
Corporates	0.68	0.65	0.27	0.53	0.46	0.74	1.00	
3-7 YR Munis	0.50	0.28	(0.01)	0.20	0.61	0.89	0.72	1.00

Source: Allianz Global Investors, Bloomberg, ICE BofA Merrill Lynch (BofAML). Correlation of returns 31 March 2010 to 31 March 2020 of ICE BofAML Fixed Rate Preferred Securities Index, ICE BofAML Current 10YR Index ICE BofAML 3-7 Year US Municipal Securities Index, ICE BofAML US Corporate Index, ICE BofAML US High Yield Master Index.

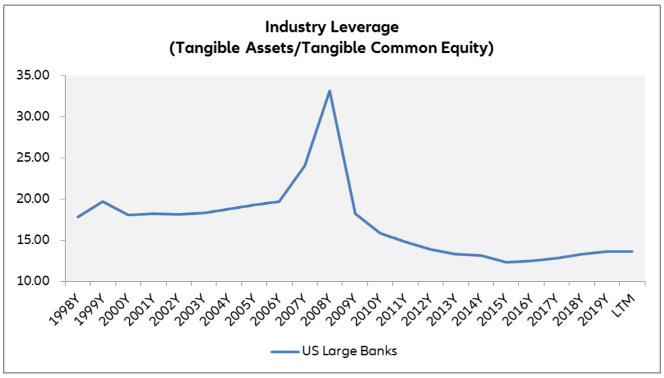
Q: Fixed income investors often avoid equity markets due in part to concerns about the degree of volatility. How does this asset class perform when equity market volatility spikes?

A: Market volatility creates opportunity, and this is certainly the case with preferred securities. We have seen in other periods of stress where preferred securities have traded down harder than other asset classes in the short term, but have rebounded and more importantly avoided defaults. We feel that preferred securities have been oversold during this sell-off; some US banks are good examples of this. Corporate spreads widened to levels that offered extremely attractive risk-reward in the first quarter of 2020, and some investors used this opportunity to become overweight credit in general and continue to find nice opportunities in preferreds. Furthermore, focusing on financially sound companies with businesses that can be modeled with a high degree of certainty over the next 12-18 months, improves the outcomes of preferred investing.

Q: What's your view on the financial sector? What are the benefits and risks of this sector?

A: We continue to favor most financial sectors. The quality of the US banking system is excellent and they have already taken actions to insulate themselves, as well as benefiting from a number of Fed (Federal Reserve Board) actions. Within the preferred securities sector, we have seen a significant jump in yields. Prior to the COVID -19 crisis many high quality banks preferred securities were trading close to 4.00%, today these same high quality banks are offering yields around 6.00%.

Emerging from the financial crisis of 2008, the US banking system is stronger than ever. The US banking system is the only industry that has been "stress tested" in recent years, and it is benefiting from this scrutiny during the current situation. As can be seen in the below chart, post-crisis deleveraging has nearly doubled the common equity buffer in the financial system.



Source: As of 31 March 31 2020. Allianz Global Investors. FDIC QBP Time Series, SNL. US Large banks consist of JPM, BAC, C, BK, STT, WFC, USB, PNC, BBT, MTB, CMA, KEY, HBAN, FITB, STI, RF, SNV[1]

[1] Federal Deposit Insurance Corporation's Quarterly Banking Profile (FDIC QBP); SNL Financial Limited (SNL); JP Morgan Chase (JPM); Bank of America Corporation (BAC); Citigroup, Inc (C); The Bank of New York Mellon Co. (BK); State Street Corporation (STT); Wells Fargo & Company (WFC); U.S. Bancorp (USB); PNC Financial Services Group (PNC); Branch Banking and Trust Company (BBT); Manufacturers Bank & Trust Company (MTB); Comerica Incorporated (CMA); KeyBank (KEY); Huntington Bancshares Incorporated (HBAN); Fifth Third Bancorp (FITB); SunTrust Banks, Inc. (STI); Regions Financial Corp (RF); Synovus Bank (SNV).

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