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# Fixed income perspective: preferred securities



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*Preferred securities can offer higher income potential compared to other fixed income sectors. Primarily investment grade securities, their low correlation to other fixed income sectors and equities may also strengthen portfolio construction in an uncertain environment. Market inefficiencies may also provide opportunities to add alpha in actively managed strategies, and certain structures may have tax advantages.*

2023 was an undeniably challenging environment for the bank-dominated preferred sector, but we believe the worst is behind us. Risks within the U.S. regional bank space may remain elevated, but we believe they will be limited to price and spread volatility versus the threat of additional insolvencies. Historically attractive yields may help cushion total return from price volatility. With the U.S. Federal Reserve near the end of its hiking cycle, preferreds may also benefit from future declines in rates.

With high relative yields, preferreds have become even more attractive following the increase in interest rates over the past year. We believe preferred securities offer many additional benefits, including:

- Tax-advantaged income potential, since many preferred security structures pay qualified dividend income (QDI)
- Reduced interest rate sensitivity through non-fixed-rate coupon structures
- Predominantly investment grade securities to help manage credit risk
- Inefficiencies may create alpha opportunities for active managers
- Strong and improving fundamentals of the banking sector, the largest segment of the preferred universe

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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## WHAT IS A PREFERRED SECURITY?

Preferred securities don't fit neatly into a traditional asset allocation category, as they contain features of both stocks and bonds. A preferred security can be classified as either debt or equity on the balance sheet, depending on its features. The easiest way to identify preferred securities is by their placement within the corporate capital structure.

Figure 1 illustrates how preferreds typically reside on the boundary between debt and equity. In a bankruptcy or liquidation, preferred security owners have a higher priority than common stock owners, but a lower priority than senior debt holders. They will be paid only if there is money left after senior creditors have been made whole.

**Figure 1: Preferred securities straddle debt and equity**

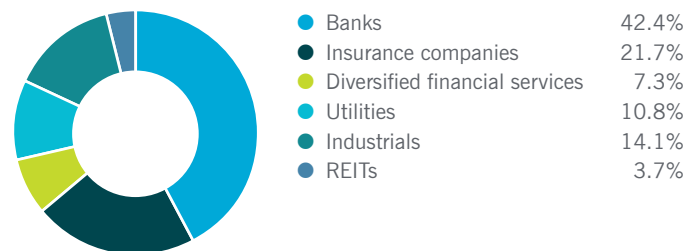
	Class	Seniority
Debt	Secured debt	↓
	Unsecured debt	
	Unsecured subordinate debt	
<b>Hybrid securities &amp; tier 2 securities</b>		
Equity	<b>Preferred stocks &amp; additional tier 1 securities</b>	
	Common stocks	

Source: Standard & Poor's.

Preferred securities trace back to the 16th century in England and the 1850s in the United States. However, in the 1980s the asset class evolved from a financing tool for highly regulated utilities to an important financing vehicle and capital instrument for financial institutions.<sup>1</sup> Since then, the preferred securities market has experienced significant growth and a change in issuer composition.

Financial institutions now make up most of the preferred universe (Figure 2). Since 2008, banks and brokerage firms (U.S. and international) have issued preferreds en masse to replenish capital depleted by housing and subprime losses during the financial crisis.

**Figure 2: Financial institutions dominate the market**



Data source: Bank of America, Bloomberg L.P., 30 Sep 2023. Based on the ICE BofA U.S. All Capital Securities Index.

## TYPES OF PREFERRED SECURITIES

A preferred security's combination of features will classify it as either an equity or a fixed income security, but most preferred securities have elements of each. For example, some preferred securities generate income in the form of interest, while others generate income in the form of dividends. Other common features are shown in Figure 3.

Contingent capital securities (CoCos) are hybrid securities created by regulators after the Global Financial Crisis as a way to help undercapitalized banks. CoCos are primarily issued by European financial institutions to help fulfill their capital requirements, while U.S. banks issue preferred stock. Because CoCos and preferred stock play nearly identical roles and rank similarly within an issuer's capital structure, CoCos are commonly held in strategies that invest in preferred securities.

## POTENTIAL BENEFITS OF PREFERRED SECURITIES

Preferred securities potentially offer relatively attractive yields. They may also provide less sensitivity to interest rate changes, portfolio diversification and tax-advantaged income. This combination has created significant interest in the asset class.

**Figure 3: Multiple structures exist in the preferred market**

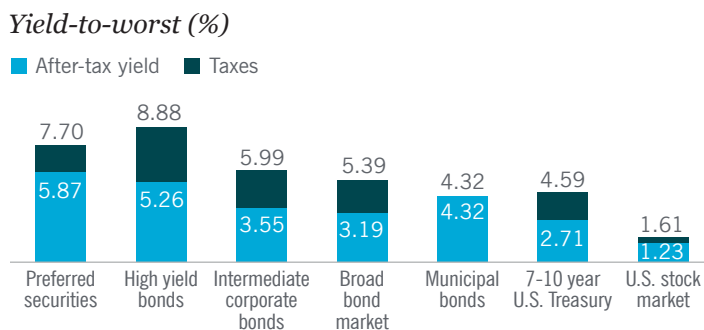
Feature	Senior notes	Trust preferred	Hybrids	Traditional preferred stock	Common stock
Character	Debt	Debt	Debt	Equity	Equity
Priority of claims	Senior to trust preferred, hybrids, preferreds and common equity	Senior to hybrids, preferreds and common equity; junior to senior and subordinate debt	Senior to all equity; junior to senior debt, subordinated debt and trust preferreds	Junior to all debt; senior to common equity	Junior to debt and preferred
Nature of payment	Interest	Interest	Interest	Dividend	Dividend
U.S. Tax advantage	None	Typically none	Typically none	DRD <sup>2</sup> /QDI <sup>3</sup>	DRD <sup>2</sup> / QDI <sup>3</sup>
Term	Dated	Typically 30 – 40 years	Typically 30 – 60 years	Typically perpetual	Perpetual
Payment deferral option	None	Yes, typically 5 – 10 years	Yes, typically up to 10 years	Yes, typically indefinite	Yes, indefinite
Cumulative/noncumulative	N/A	Typically cumulative	Typically cumulative	Mostly noncumulative	Noncumulative

Sources: Preferred Securities Quarterly Guide, Bank of America, 02 Feb 2018; Nuveen.

### Attractive relative yields

Because they are lower in the capital structure and thus carry more subordination risk, preferred securities generally contain wider credit spreads and pay a higher level of income than their more senior debt counterparts. As shown in Figure 4, preferred securities have had attractive yields relative to other asset classes. They have offered more income-generating power than equities and most fixed income asset classes, with the exception of high yield bonds.

**Figure 4: Preferred securities have offered attractive income**



Data source: Bloomberg, L.P., ICE BofA, FactSet, 30 Sep 2023. **Performance data shown represents past performance and does not predict or guarantee future results.** The tax treatment of dividends is subject to change based on changes in tax rules and regulations. Chart shows yield-to-worst adjusted for applicable tax rates. After-tax calculations shown use 37% federal income tax and 3.8% Medicare surtax rates for high yield bonds, intermediate corporate, broad bond market, and 7-10 year U.S. Treasuries. For preferred securities and U.S. stock market, after-tax calculations assume all income is QDI-eligible and is taxed at the 20% QDI rate plus 3.8% Medicare surtax rate. Municipal bond income is not subject to federal income taxes or Medicare taxes. **Representative indexes: preferred securities:** ICE BofA U.S. All Capital Securities Index; **intermediate corporate bonds:** Bloomberg Intermediate Corporate Index; **municipal bonds:** Bloomberg Municipal Bond Index; **broad bond market:** Bloomberg U.S. Aggregate Bond Index; **7-10 year Treasuries:** Bloomberg 7-10 year U.S. Treasury Index; **U.S. stock market:** S&P 500 Index; **high yield corporate bonds:** Bloomberg U.S. High Yield 2% Issuer Capped Index.

### Tax-advantaged income potential

Since preferred securities are stock/bond hybrids, certain preferred securities generate qualified dividend income (QDI). This income is typically created by common stocks and taxed at the lower capital gains tax rate. In contrast, traditional fixed income investments create income subject to ordinary income tax rates.

Most dividends are classified as either ordinary (unqualified) or qualified, with the primary difference being the rate at which the dividends are taxed. Ordinary dividends, like interest income, are taxed at an investor’s federal income tax rate, which ranges from 10% to 37% for 2023. Qualified dividends are taxed at the long-term capital gains rate of 0%, 15% or 20% for the 2023 tax year, depending on the investor’s tax bracket. Therefore, investors may see a significant tax savings and higher after-tax return with qualified dividends versus ordinary dividends or interest income, regardless of their income tax bracket.

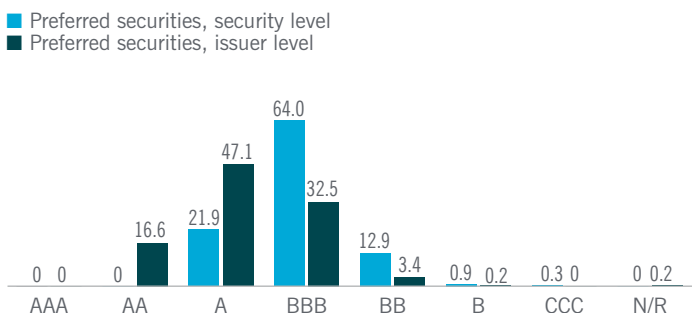
### A high quality investment

Preferred securities are generally issued by high quality companies. Due to their subordinate capital structure position, preferreds may be rated 3 to 5 quality notches lower than the senior debt of the same issuer. For instance, an entity issuing a preferred security rated BB would typically have investment grade senior unsecured debt rated BBB or higher. Although preferred securities are lower

in the capital structure than traditional bonds, many are investment grade in nature. They may produce a higher yield than investment grade corporate bonds without the credit risk of a below-investment-grade, high yield bond.

Figure 5 shows how the quality of the company issuing the preferred securities is typically much higher than the rating of the individual securities. For example, most individual preferred securities are rated BBB, but most companies issuing preferred securities are A rated.

**Figure 5: Preferreds are predominantly from high quality issuers and rated investment grade (%)**



Data source: FactSet, Nuveen, 30 Sep 2023. Performance data shown represents past performance and does not predict or guarantee future results. Breakdown of the credit quality of the constituent components of the ICE BofA U.S. All Capital Securities Index; security and issuer level ratings based on the highest rating of Standard & Poor's, Moody's, Fitch, A.M. Best or DBRS Morningstar (security level only). AAA, AA, A and BBB are investment grade ratings; BB, B, CCC/CC/C and D are below-investment-grade ratings.

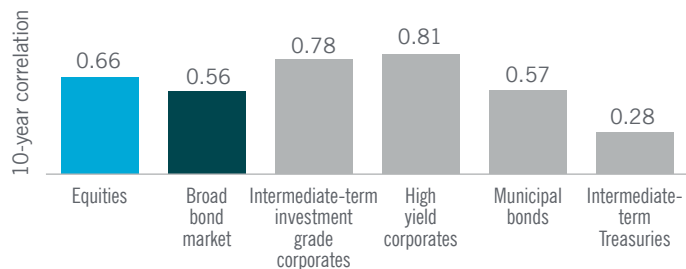
### Increased diversification

Since preferred securities include features of both bonds and stocks, it is not surprising that the asset class exhibits relatively low correlation to both traditional fixed income and equity categories, as shown in Figure 6. This means that adding a slice of preferred securities to a portfolio may improve overall portfolio diversification.

### Less sensitivity to interest rate changes

Managing interest rate risk remains critical for fixed income portfolios. When interest rates are low and remain low for long periods of time, the bigger risk to portfolios can be sudden, unexpected increases in rates. Indeed, when interest rates go up, bond prices go down, but different types of bonds have varying sensitivities to changes in interest rates.

**Figure 6: Preferreds may improve portfolio diversification**



Data source: Morningstar Direct, 01 Oct 2013 to 30 Sep 2023. Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: preferred securities: ICE BofA U.S. All Capital Securities Index; equities: S&P 500 Index; broad bond market: Bloomberg U.S. Aggregate Bond Index; intermediate-term investment grade corporates: Bloomberg Intermediate Investment Grade Corporate Index; high yield corporates: Bloomberg U.S. High Yield Corporate Bond Index; municipal bonds: Bloomberg Municipal Bond Index; intermediate-term Treasuries: Bloomberg 7-10 Year U.S. Treasury Index. Correlation ranges between -1 and +1. A correlation coefficient of +1 implies that as one security moves, either up or down, the other security will move in the same direction. A correlation coefficient of -1 means that if one security moves in either direction the other security will move in the opposite direction. Correlation of 0 means the movements of the securities are completely random.

Since most preferreds have longer-dated maturities (many are perpetual), it may seem counterintuitive for them to perform in a rising rate environment. Longer-maturity securities are generally more sensitive to rising rates. As active managers, we use several features of the preferred universe to help us reduce the impact of changing interest rates on our portfolios.

**Higher coupon rates.** The higher average coupon rate of preferred securities can make them less sensitive to changes in interest rates because the income of the bond remains constant as rates change, reducing the impact.

**Credit spread sensitivity.** Due to their lower position in the capital structure, preferred securities are often more sensitive to changes in credit spreads than other types of bonds. On a relative basis, they may perform well during periods of gradually increasing interest rates, as credit spreads often tighten during periods of rising rates.

**Different available coupon structures.** Preferred securities are issued with a number of different coupon structures that active managers can use to help adjust the portfolio for changing rate environments.

*Fixed rate coupons* generally pay a specified coupon rate for life. These structures can be beneficial when rates are expected to decline, as the coupon will remain more valuable and provide constant income during low rate periods.

*Fixed-to-floating rate coupons* pay a fixed coupon for a preset number of years (commonly 5 or 10), then convert to a floating rate coupon for the remaining life of the security or until it is called. The floating rate coupon is based on a benchmark rate, such as 3-month LIBOR, plus a predetermined spread set when the security is issued. Once it converts to a floating rate structure, the coupon will generally reset every three months.

*Fixed-to-fixed rate coupons* also pay a fixed coupon for a preset number of years, then reset at regular intervals (typically five years) to another fixed rate. The reset rate is based on a market rate plus a margin. For example, a Goldman Sachs preferred security was issued in 2019 with a fixed coupon of 5.5% until 2024, when it resets to the 5-year Treasury rate plus 3.6%.

Compared to fixed-rate coupon structures, fixed-to-floating and fixed-to-fixed rate coupon structures typically experience less duration extension when rates rise. This feature makes them less sensitive

to rate changes in a rising rate environment. They usually experience better relative price performance (Figure 7), since the prices of lower duration bonds are less affected by rising rates. Lastly, the floating and resetting rate nature of the coupons allows the securities to capture increases in interest rates, because the coupon should increase with interest rates.

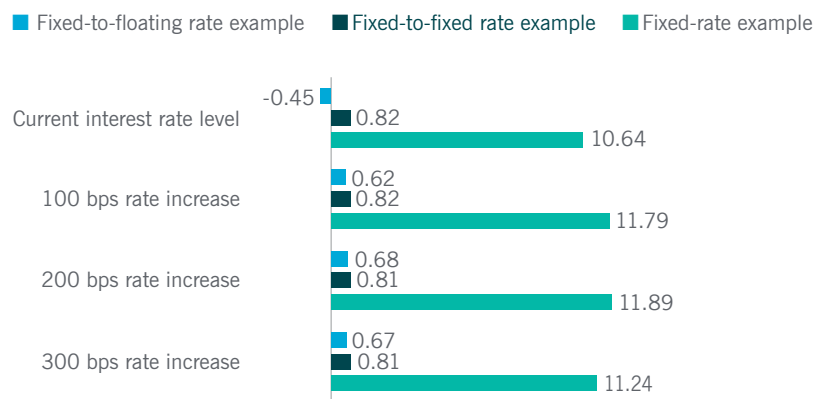
**Industry composition.** Banks represent about 63% of the issuer base and insurance companies another 14%.<sup>4</sup>

*The banking sector* has generally benefited in a rising rate environment. Bank profit margins will likely improve as interest rates rise and banks can earn more on loans and investments. A higher interest rate environment generally means the economy is improving, which can increase demand for loans and decrease the percentage of nonperforming loans. In a declining rate environment where bank profits are squeezed, active managers can rotate into other industries with less rate sensitivity.

*Insurance companies* can more easily achieve their investment return targets when rates rise, using higher quality investments. This can reduce the amount of assets they are required to hold,

**Figure 7: Securities with adjustable rate coupons remain less sensitive to interest rate changes**

*Effective duration (years)*



Data source: FactSet, 30 Sep 2023. Assumes immediate parallel shift of the 30 Sep 2023 yield curve with OAS (option-adjusted spread) and volatility held constant. Performance data shown represents past performance and does not predict or guarantee future results. Hypothetical scenarios are for informational purposes only. Scenario data is provided by a third-party source believed to be reliable. Securities mentioned are used as examples for educational/informational purposes only; inclusion does not constitute a recommendation to buy or sell or imply inclusion in any Nuveen investment vehicle.



**Figure 8: Retail and institutional investors value preferred securities from the same company differently**

Issue Type	Retail		Institutional	
Par	\$25		\$1,000	
Coupon	5.85%		5.90%	
Call date	Sep 2023		Jun 2024	
Payments	Noncumulative		Noncumulative	
Maturity	Perpetual		Perpetual	
Rating	Baa2/BB+		Baa2/BB+	

Year-end	Yield	Price (% par)	Yield	Price (% par)
2020	3.10%	106.85	3.98%	106.13
2021	1.75%	106.61	3.53%	105.51
2022	8.60%	91.54	8.75%	89.56

Data source: Bloomberg, L.P., 31 Dec 2022. Performance data shown represents past performance and does not predict or guarantee future results. Yields represent yield-to-worst. Securities mentioned are used as examples for educational/informational purposes only; inclusion here does not constitute a recommendation to buy or sell or imply inclusion in any Nuveen investment vehicle.

diminish the risk they will not meet their return targets and improve their overall profitability. Rising rates also mean an increase in the discount rate, making the present value of insurance companies' liabilities decline. This means they do not have to hold as much in reserves.

### MARKET INEFFICIENCIES MAY CREATE ALPHA OPPORTUNITIES

In addition to the various structures detailed in Figure 3, the more than \$500 billion U.S. preferred securities market is primarily composed of two types of issues:<sup>5</sup>

- \$25 par value securities that trade on the major stock exchanges and target retail investors.
- \$1000 par value securities that trade over the counter and target institutional investors.

These distinct market segments offer opportunities for a professional asset manager to add alpha by managing portfolios between these denominations.

### Mispricing between issues

Two preferred markets means pricing discrepancies can and do often occur. For example, a company may issue both \$25 and \$1000 par value securities

with the same credit and structural risk. A professional manager can compare the difference in economics for essentially the same security, selling what they believe to be the overpriced security and buying the underpriced security. In some cases, the difference in valuations between the two markets can be substantial.

Figure 8 is a historical example that shows two securities that were nearly identical: one \$25 par and one \$1000 par. Retail investors often focus on coupon rate when valuing securities, which can drive \$25 par securities to relatively rich levels in their search for income. Institutional investors tend to value securities based on yield spreads to U.S. Treasuries or senior debt. The result can be an extreme difference in valuations between the two securities. Although yields in the two markets have recently been more similar, institutional \$1,000 par securities have historically offered greater yield than \$25 par securities.

### Active management of scheduled call risk

Most of the preferred security universe has explicitly stated call provisions. Most preferred issuers will call securities when they can be refinanced at cheaper levels. This is usually in response to lower interest rates and/or tighter credit spreads, or when the issuer already has excess capital on its balance sheet. Scheduled calls of preferred securities trading at premiums may lead to investor loss, especially when investors are not actively managing yields to call.

Recently, valuations for retail \$25 par preferred securities became so rich that a significant population of securities traded at negative yields-to-worst/yields-to-call. This illustrates some of the vast pricing differences between the retail and institutional markets.

In 2021, for example, four fairly large preferred deals were called, all trading at negative yields to call. This resulted in substantial investor losses, as shown in Figure 9.

Managing call risk should be a high priority for preferred investors. A professional asset manager has the experience and resources to understand and position portfolios for these extreme pricing scenarios.

**Figure 9: Sample scheduled call losses**

Ticker	Call date	Price prior to call	Realized yield-to-call	Size of deal (\$MM)
JPM H	30 Apr 2021	25.32	-17.4%	1,150
JPM G	30 Apr 2021	25.30	-16.3%	1,425
FHN A	13 May 2021	25.36	-4.0%	100
KKR A	04 May 2021	25.61	-6.8%	345

Data source: Bloomberg, L.P. Performance data shown represents past performance and does not predict or guarantee future results. Prices and yield-to-call are as of the day before each security's call date announcement. Realized yield-to-call is annualized. Securities mentioned are used as examples for educational/informational purposes only; inclusion here does not constitute a recommendation to buy or sell or imply inclusion in any Nuveen investment vehicle.

### Larger block sizes and greater liquidity

The institutional side of the market typically trades in larger block sizes, while the average retail investor typically does not have large enough positions to efficiently access this market.

### Access to the international market

Securities issued by non-U.S. entities in U.S. dollars constitute 44% of the U.S.-dollar-denominated market.<sup>6</sup> This market tends to be dominated by institutional \$1000 par value securities. Retail investors typically ignore this market, and research departments provide less coverage. Adding these securities to a portfolio may increase issuer diversification and reduce correlation with U.S. asset classes.

## PREFERRED AND COCO MARKETS CONTINUE TO RECOVER

The preferred and CoCo securities markets continue to recover following a selloff caused by the bank mini-crisis in early 2023.

Since then, favorable U.S. bank earnings have eased fears of further turmoil. Notably, during the second quarter, banks reported stabilized deposit levels reflecting typical attrition levels for this stage in the cycle. During the third quarter, many banks – including several regional banks – reported increased deposit levels quarter-over-quarter. Investors are now increasingly focused on the direction of interest rates, economic data, U.S. Federal Reserve policy, U.S. and global growth, and geopolitical risks.

In Europe, the USD Additional Tier 1 (AT1) CoCo market continued to recover from Credit Suisse-related headlines. Investors, including Nuveen, believe the write-down of Credit Suisse AT1 CoCos was an isolated event specific to a Swiss bank, the Swiss regulator (FINMA) and the Swiss government. Following the incident, the European Central Bank (ECB) and Bank of England (BOE) issued press releases supporting the AT1 hierarchy within a bank's capital stack, helping to reestablish confidence in the broader Western European AT1 CoCo market outside of Switzerland.

The overwhelming rebuke from investors over how FINMA and the Swiss government forced the write-down of the Credit Suisse AT1 CoCos gives us confidence that the probability is very low of another similar scenario.

## INCREASED BANK REGULATION SHOULD BE POSITIVE FOR CREDIT INVESTORS

We expect the level of regulatory oversight to increase for all banks, including maintaining greater liquidity and higher levels of capital. The Fed has already proposed significantly higher capital standards for U.S. banks with assets exceeding \$100 billion. In addition, regulators will expand the annual stress tests to include more banks, as well as specifically testing variables that led to the bank crisis (duration risk and liquidity risk). Another proposal will require banks with assets exceeding \$100 billion to use a standardized risk-weighted asset model.

These requirements should further strengthen bank credit profiles and the soundness of the sector, which is good for credit investors.

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*Favorable U.S. bank earnings have eased fears of further turmoil.*

However, what benefits credit investors – including preferred securities and AT1 CoCo investors – may not support the common shareholder. Holding higher levels of capital should dilute banks’ return on capital via lower dividends and decreased share buybacks. If the standardized model leads to higher risk-weighted assets, it could require banks to hold more capital going forward or exit higher risk positions on the balance sheet.

Unfortunately for the common shareholder, those higher risk positions are likely more profitable. Scaling back on risk could impact earnings, which would affect equity valuations, all else equal. None of this is positive for equity valuations, which makes it important to understand the regulatory impact on the layers of the capital stack.

## PREFERRED SECURITIES OUTLOOK

Although we remain generally constructive on U.S. bank sector fundamentals, our U.S. economic outlook has turned cautious. Our base case calls for a soft or no landing, but recession risk would affect all sectors, not just banks. If negative U.S. bank sector headlines reemerge, we believe the previous steps taken by the Fed, FDIC and U.S. Treasury should materially cushion their severity and impact.

## Fundamentals

After a rocky spring, the 2023 U.S. bank stress test results showed strong balance sheets in the face of dire economic conditions, with exams using commercial real estate as a primary area of stress.

Like the second quarter, bank earnings on average during the third quarter were better than expected. Many banks now must pay higher interest rates to attract and/or retain deposits, somewhat eroding net interest margins. However, this is to be expected at this point in the cycle and is more concerning for equity investors, as profitability directly affects equity valuations.

As fixed income investors, assuming the banks remain profitable, we are more focused on balance sheet metrics such as capital and liquidity. We believe heightened regulations are net positive

for credit investors, including preferred and AT1 CoCo investors, as they should improve the overall soundness of the banking system.

## Technicals

For several years, most preferred issuance has been related to refinancing, limiting the overall growth of the asset class. 2023 net issuance (new issue less redemptions) has been net negative, creating a supportive supply technical not found elsewhere in fixed income.

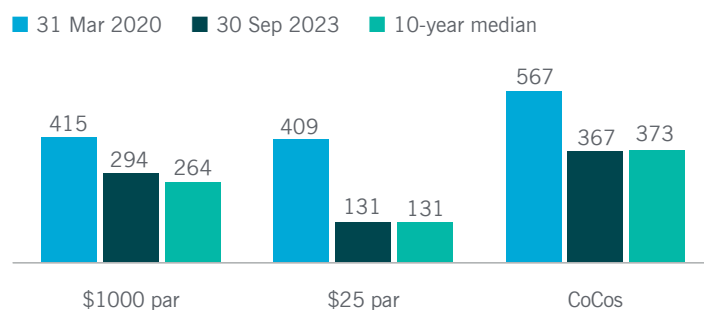
Issuance has slightly increased recently in attractive structures with high initial coupons. Use of proceeds for existing deals has been used to repay near-term/currently callable preferreds, so these new issues do not materially change the supportive supply environment.

## Valuations

Our valuation outlook is mildly constructive. Option-adjusted spreads (OAS) look fair to modestly attractive versus longer-term median levels (Figure 10).

**Figure 10: Preferred spreads remain attractive**

*Option-adjusted spread to Treasuries (bps)*



Data source: Bank of America, Nuveen, 30 Sep 2023. Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: \$1000 par preferred: market capitalization-weighted blend of the ICE BofA U.S. Investment Grade Institutional Capital Securities Index and the ICE BofA U.S. High Yield Institutional Capital Securities Index; \$25 par preferred: ICE BofA Core Plus Fixed Rate Preferred Index; contingent capital (CoCo): ICE BofA Contingent Capital Index.

In addition, many securities across all three segments are trading at significant discounts to par. For example, the average dollar price on our blended index intended to represent the preferred and CoCo universe was just \$89 as of 30 Sep 2023.



In an environment where interest rates may remain elevated, we like owning discounted, dollar-priced securities with coupons that could reset higher than current levels. Also, if these issuers opt not to pay the higher coupons, they can call the securities at par, offering the opportunity to reap capital appreciation between today's discount price and par.

## We believe the worst is behind us

Overall, we still like the preferred and CoCo space. We expect interest rates will eventually decline as the Fed concludes its hiking cycle. In the meantime, historically attractive yields can help cushion total return from price spread and volatility.

**For more information, visit us at [nuveen.com](https://www.nuveen.com).**

### Endnotes

#### Sources

1 "Hybrid Capital," J.P. Morgan, 14 Oct 2014. 2 Dividend Received Deduction allows corporations to deduct 70% of the income received from federal taxable income. Please consult a qualified tax advisor for details on your particular situation. 3 Qualified Dividend Income is taxed at the capital gains rate. 4 Data source: Custom blend of 60% ICE BofA U.S. All Capital Securities Index and 40% ICE BofA Contingent Capital USD Hedged Index, as of 30 Sep 2023, Nuveen. 5 Data source: Nuveen, 30 Sep 2023. \$50 and \$100 par securities exist, but they are much less common. 6 Data source: Based on ICE BofA U.S. All Capital Securities Index and ICE USD Contingent Capital Index as of 30 Sep 2023, Nuveen.

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