

Preferred Securities Select

Marketing communication | As of 31 Dec 2024

- **During the fourth quarter, the Preferred Securities Select strategy outperformed its benchmark on a gross and net of fees basis.**
- **There were no major detractors from performance**
- **Duration positioning and coupon structure allocation were the primary contributors to performance.**

Market review

U.S. and global economies remained healthy through the end of 2024. In the U.S., the pace of job creation picked up slightly, supporting continued resilience in consumption spending. Survey measures of business activity generally improved as well, with one gauge of services-sector activity hitting its highest level since mid-2022. Overseas, manufacturing activity in China rebounded a bit, with the country's official Purchasing Managers' Index (PMI) number reaching its highest level since April. Conditions in Europe remained tepid, with softening business surveys, although the consumer showed signs of renewed strength. On the inflation front, U.S. core prices continued to rise around 2.8% year-on-year, but the housing subindex showed further signs of moderating.

The Federal Reserve (Fed) cut interest rates by 25 basis points at both of its meetings during the fourth quarter, bringing the policy rate range to 4.25%-4.50%. However, the Fed's updated rate forecasts in December surprised markets with only 50 basis points of cuts slated for 2025, down from 100 basis points projected previously. The European Central Bank (ECB) also reduced rates twice during the quarter, while the Bank of England (BoE) cut once. Separately, the Republican party swept the U.S. elections, winning control of the White House and both chambers of Congress. As consumers remained resilient, progress on the inflation front slowed, and election results pointed to potential pricing pressures down the road, U.S. Treasury yields rose sharply during the quarter and the yield curve steepened. The 10-year Treasury yield ended the quarter 77 basis points higher at 4.58%.

The quarter was relatively void of headlines specific to the preferred securities market. For the bank sector, the largest issuer of preferred securities, news was generally positive. Banks released third-quarter 2024 earnings that, on average, exceeded expectations, a trend that has now spanned several quarters. At the end of June, the Fed released annual stress test results, with all 31 participating banks yet again passing this year's exam. Based on this year's exam, the 31 banks tested currently hold almost \$600 billion of excess capital. While the incoming Trump administration has stated a desire to scale back regulations governing the bank sector, we don't believe the changes will be meaningful enough to alter the underlying fundamental story of the bank sector for two reasons. First, from a political standpoint, the perception of going soft on the bank sector would likely not resonate well with the constituents of either political party. Second, from a fundamental standpoint, bank sector profitability has



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remained at historically high levels under the current regulatory regime, while still supporting the broader economy with adequate credit and liquidity.

With the backdrop of materially higher interest rates, the \$25 par preferred segment underperformed during the quarter. This represented a meaningful reversal of absolute and relative performance for the segment versus the previous quarter when a combination of lower rates and a dearth of \$25 par preferred new issue supply drove valuations to relatively lofty levels. During the fourth quarter, the longer average duration of the \$25 par preferred segment versus the \$1000 par preferred and U.S. dollar-denominated contingent capital securities (USD CoCos) markets put it at a relative disadvantage. At quarter-end, the average duration of \$25 par preferreds stood at 8.1 years, well above the average durations of 3.8 years and 3.2 years for the \$1000 par preferred and USD CoCo segments, respectively. Compounding the underperformance of \$25 par preferreds, the segment's option-adjusted spread (OAS) moved higher during the quarter, while the OAS for the other two market segments moved lower. During the quarter, the average OAS for \$25 par preferreds increased by 32 basis points, while the OAS for \$1000 par preferreds and USD CoCos declined by 16 and 15 basis points, respectively. Despite the underperformance, \$25 par preferreds still looked rich versus the other two segments. At quarter end, the average OAS for \$25 par preferreds was 55 basis points, well below \$1000 par preferreds and USD CoCos at 181 basis points and 244 basis points, respectively. For the quarter, the total return for \$25 par preferreds was -4.93%, well below the slightly positive returns of 0.13% and 0.22% for the \$1000 par and USD CoCo segments, respectively.

Portfolio review

During the fourth quarter, the Preferred Securities Select SMA Strategy outperformed the Index, the ICE BofA US All Capital Securities Index, on a gross and net of fees basis. On an absolute basis, spread tightening and coupon income both contributed to this quarter's total return, while duration was a slight detractor. On a relative basis, the strategy's outperformance primarily came from duration positioning versus its benchmark, while security structure allocation was also a large contributor. There were no major detractors from performance.

At the beginning of the quarter the strategy's duration was 2.9 years, considerably less than that of its benchmark. Most of this positioning comes about naturally as a result of an overweight to securities with coupon reset features, along

with a corresponding underweight to securities with fixed-rate coupons. We continue to favor securities with coupon reset features. They have minimal duration extension risk compared to their fixed-rate counterparts, plus in the current rate environment those nearing their conversion to a floating rate have the additional potential for coupon increases. This quarter, the lower duration profile of the strategy relative to the Index was the main performance contributor, given the aforementioned rise in rates. For context, yield on the US Treasury 10-year note increased roughly 77 basis points as of quarter-end.

Coupon structure allocation also contributed to relative performance this past quarter. We favor and overweight securities with coupon reset features versus their fixed-rate counterpart, which we remain underweight. Nearly all fixed-rate coupon structures are issued in \$25 par format, while most \$1,000 par securities are issued with coupon reset features. As coupon structure mostly goes hand-in-hand with security structure, the strategy has an underweight to both fixed-rate and \$25 par securities, and has a corresponding overweight to both securities with coupon reset features and \$1,000 par structures. The \$25 par market materially underperformed its \$1000 par counterpart, as evidenced by the ICE BofA Core Plus Fixed Rate Preferred Securities Index (\$25 par) posting a -4.93% return for the quarter, while the ICE US Institutional Capital Securities Index (\$1000 par) posted a positive +0.13% return for the same timeframe. Therefore, the strategy's underweight to \$25 par and fixed rate securities performance contributed to relative performance.

Sector allocation offset an extremely small portion of this quarter's relative outperformance. On an option adjusted spread (OAS) basis, both the communications and energy sectors outperformed the broader index. The strategy has an underweight to both of these sectors, which slightly detracted from relative performance.

During the quarter, trading was slightly more muted than in recent quarters. The most notable strategy trades were executed in November, as the strategy exited both Markel Group and American National Group, while it established new positions in Dominion Energy, Sempra, and Corebridge Financial Inc.

Outlook

We remain constructive regarding the fundamentals underlying the U.S. bank sector, the largest sector within our market, particularly considering the favorable results of the 2024 bank stress tests and recent bank earnings. We are

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also constructive on the insurance sector, the second largest issuer of securities in our index, because of historically high risk-based capital levels, the added protection from regulatory oversight, an inherent benefit from higher interest rates, and historically high sales of annuity products for consecutive years. We are also reassured by the fact that over the past several years, most property and casualty insurance providers have exited certain geographies and lines of business that are high risk, leaving those obligations up to various state and/or federal government insurance programs.

Our outlook regarding valuations across the preferred securities market is moderately constructive. While OAS levels are below longer-term medians, current levels are still above historic all-time lows. Given solid underlying fundamentals of the asset class's largest sectors, strong demand for fixed income securities at current absolute yield levels, and investor demand for tax-efficient income solutions, we believe that OAS levels should remain supported at current levels. We like the dynamic of owning securities with coupons that could reset higher than current coupon levels. For most of the securities in our portfolio, if the coupons were to reset today, the new coupons would be higher than the coupons currently being paid by the same security.

While the Fed and other central banks have made measurable progress at slowing the pace of inflation, the U.S. economy and consumer have remained relatively resilient. The current strength of the U.S. economy, coupled with a potentially inflationary agenda from the incoming administration, increases the risk that inflation remains elevated and that the Fed both slows the speed and decreases the number of future interest rate cuts. Fortunately, in the U.S., corporations and the consumer remain on stable footing, with neither showing signs of distress yet. U.S. employment statistics continue to be solid, while consumer spending and confidence has remained firm. Employment and spending remain incredibly important as the U.S. economy is roughly 70% consumption based. While it is tough to see the U.S. economy stalling without a deterioration in the job market, which we have yet to see, the implications of a pullback in the labor market

would be concerning. That said, our base case is that the U.S. economy remains resilient, and that inflation does grind lower over time, but at a slower pace than we previously expected.

From a technical perspective, we have changed our outlook regarding net supply within the preferred securities market. We expect net supply to be modestly positive for the foreseeable future. With Moody's officially changing its methodology for assigning equity credit to hybrid securities in early 2024, a move that aligned its methodology closer to S&P and Fitch, we anticipate more corporate hybrid supply as issuers take advantage of garnering the 50% equity content treatment for hybrid structures from each of the Big 3 rating agencies. In addition, capital expenditures are likely to meaningfully increase in the utility sector, with those issuers needing to manage leverage levels and protect their ratings. As a result of these overarching two factors, we anticipate corporate hybrid supply to be net positive \$20 - \$25 billion in 2025. Given much of this new hybrid issuance will be eligible for investment grade or high yield corporate bond indices, investor interest will likely be broad based and this new supply should be easily absorbed. This wave of index-eligible hybrid supply may also spur more investor interest in the preferred securities asset class, which could further support current valuations.

Barring any unforeseen developments, we anticipate maintaining most of the strategy's current positioning relative to its index. Given the strength of recent economic data, the potential for inflationary policies with the new administration, and the Fed's guidance for a slower pace of rate cuts, we will likely maintain a shorter duration profile versus the index in the near term. We believe underweighting \$25 par preferreds and fixed-rate coupon structures versus overweighting securities with coupon reset features and \$1000 par preferreds is warranted. Also, the \$25 par preferred segment tends to be more volatile and less liquid than the other two segments, making the relative value opportunity on a risk-adjusted basis even less appealing.

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For more information contact: 800.752.8700 or visit nuveen.com

Minimum investment is \$400,000.

Important information on risk

All investments carry a certain degree of risk, including possible loss of principal, and there is no assurance that an investment will provide positive performance over any period of time. The preferred securities strategy entails certain risks, including preferred security risk, interest rate risk, income risk, credit risk, non-US securities risk and concentration/non-diversification risk, among others. There are specific risks associated with investing in preferred securities, including generally an absence of voting rights with respect to the issuing company unless certain events occur. The issuer of preferred securities may redeem the securities prior to a specified date. As with all call provisions, a redemption by the issuer may negatively impact the return of the security held by an account. Investing internationally presents certain risks not associated with investing solely in the U.S., such as currency fluctuation, political and economic change, social unrest, changes in government relations, differences in accounting and the lesser degree of accurate public information available, foreign company risk, market risk and correlation risk. Preferred security investments are generally invested in a high percentage of the securities of companies principally engaged in the financial services sector, which makes these investments more susceptible to adverse economic or regulatory occurrences affecting that sector.

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Glossary

The **Custom Benchmark Index** consists of 60% ICE BofA U.S. All Capital Securities Index and 40% ICE USD Contingent Capital Index. The **Bloomberg U.S. Credit - Financial Institutions Index** measures the performance of U.S. dollar denominated publicly-issued investment-grade corporate bonds in the financial sector. **Contingent Capital Securities (CoCos)** are debt or capital securities of primarily non-U.S. issuers with loss absorption contingency mechanisms built into the terms of the security. The **S&P 500® Financials Index** comprises those companies included in the S&P 500® that are classified as members of the GICS® financials sector. Contingent Capital Securities (CoCos) are debt or capital securities of primarily non-U.S. issuers with loss absorption contingency mechanisms built into the terms of the security. The **ICE BofA Capital Securities Index** tracks the performance of U.S. dollar-denominated investment-grade corporate debt publicly issued in the U.S. domestic market, consisting of fixed-to-floating-rate, perpetual callable and capital securities. **Option adjusted spread (OAS)** is the constant spread that when added to all discount rates from the treasury curve on the binomial interest rate tree model (used by the indices) will make the theoretical value of the future cash flows equal to the market price of the instrument. **It is not possible to invest directly in an index.** Clients should consult their financial professional regarding unknown financial terms and concepts.

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