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Fixed income perspective: preferred securities

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An often overlooked asset class, preferred securities can offer higher, tax-advantaged 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.

As the U.S. Federal Reserve has begun cutting interest rates, investors will continue to seek higher yielding fixed income asset classes. We believe preferred securities offer many additional benefits, including:

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

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.

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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.

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.[1] Since then, the preferred securities market has experienced significant growth and a change in issuer composition.

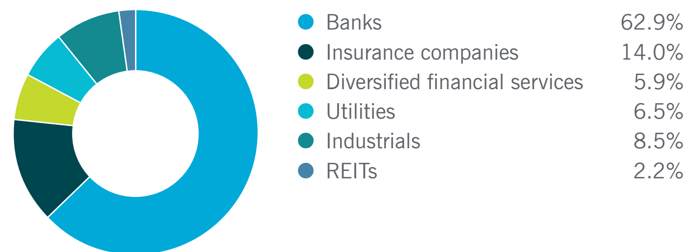
Financial institutions now make up most of the preferred universe (Figure 2). Since 2008, banks and brokerage firms (U.S. and international) have issued preferreds en masse to replenish capital depleted by housing and subprime losses during the financial crisis.

Figure 1: Preferred securities straddle debt and equity

	Class	Seniority
Debt	Secured debt	↓
	Unsecured debt	
	Unsecured subordinate debt	
	Hybrid securities & tier 2 securities	
Equity	**Preferred stocks & additional tier 1 securities**	
	Common stocks	

Source: Standard & Poor's.

Figure 2: Financial institutions dominate the market



Data source: Bank of America, Bloomberg L.P., 30 Sep 2024. Based on 60% ICE BofA U.S. All Capital Securities Index/40% ICE USD Contingent Capital 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	Hybrids	Traditional preferred stock*	Common stock
Character	Debt	Debt	Equity	Equity
Priority of claims	Senior to hybrids, preferreds and common equity	Senior to preferreds and common equities; junior to all other debt	Junior to all debt; senior to common equity	Junior to debt and preferred
Nature of payment	Interest	Interest	Dividend	Dividend
U.S. Tax advantage	None	Mostly non-QDI	DRD[2]/QDI[3]	DRD[2]/mostly QDI[3]
Term	Dated	Usually 60 years or longer	Perpetual	Perpetual
Payment deferral option	None	Yes, up to 10 years	Yes, indefinite	Yes, indefinite
Cumulative/ noncumulative	N/A (no deferral option)	Cumulative	Mostly noncumulative	Noncumulative

Data source: Preferred Securities Primer, BofA Global Research, 20 May 2024, Nuveen. *REIT preferreds have all the same characteristics with some exceptions. They are not DRD or QDI eligible (but they are eligible for a 20% deduction under 2017 tax reform) and they have cumulative dividends.

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. They have historically offered more income-generating power than equities and most fixed income asset classes on a taxable-equivalent basis.

Tax-advantaged income potential

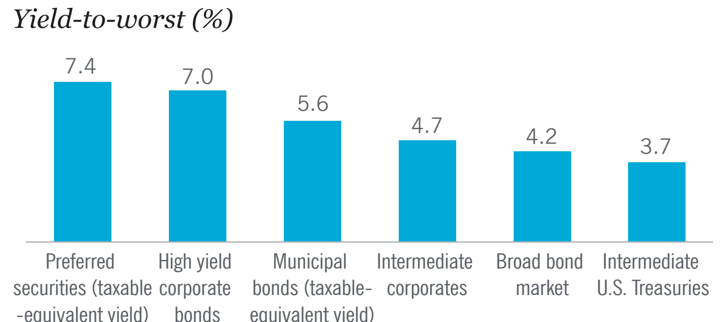
Since preferred securities are stock/bond hybrids, certain preferred securities generate qualified dividend income (QDI). This income is typically created by common stocks and taxed at the lower capital gains tax rate. In contrast, traditional fixed income investments create income subject to ordinary 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 2024. Qualified dividends are taxed at the long-term capital gains rate of 0%, 15% or 20% for the 2024 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.

As shown in Figure 4, QDI eligible preferreds offer higher taxable-equivalent yield than other fixed income sectors, including high yield corporate bonds.

Figure 4: Preferred securities can offer attractive, tax-advantaged income potential

Yield-to-worst (%)



Data source: Bloomberg L.P., 30 Sep 2024. **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; high yield corporate bonds: Bloomberg U.S. High Yield 2% Issuer Capped Index; municipal bonds: Bloomberg Municipal Bond Index; intermediate corporate bonds: Bloomberg Intermediate Corporate Index; broad bond market: Bloomberg U.S. Aggregate Bond Index; intermediate U.S. Treasuries: Bloomberg 7-10 Year U.S. Treasury Index. 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. For municipals, taxable-equivalent yield calculations use 37% federal income tax and 3.8% Medicare surtax rates. Preferred securities 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.

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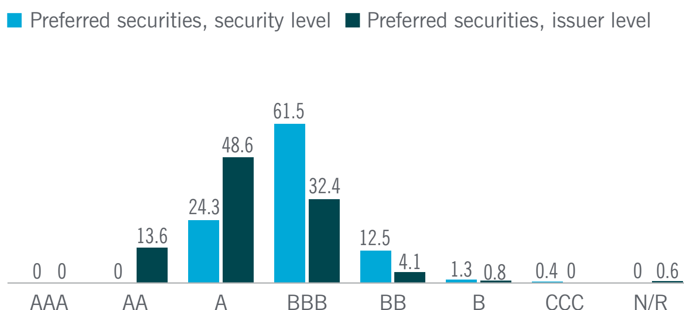
A high quality investment

Preferred securities are generally issued by high quality companies. Due to their subordinate capital structure position, preferreds may be rated 1 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 (%)



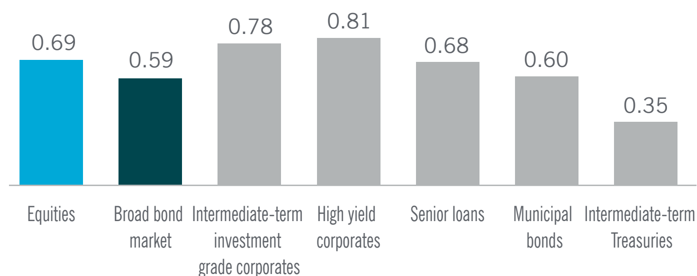
Data source: FactSet, Nuveen, 30 Sep 2024. **Performance data shown represents past performance and does not predict or guarantee future results.** Breakdown of the credit quality of the constituent components of the ICE BofA U.S. All Capital Securities Index; security and issuer level ratings based 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, the asset class exhibits relatively low correlation to both traditional fixed income and equity categories, as shown in Figure 6. In addition, there is little issuer overlap between preferred securities and high yield corporate bonds/senior loans. These two sectors have little exposure to banks and insurance companies, which are the largest issuers of preferred securities. Thus, an allocation to preferred securities could help diversify a portfolio with exposure to higher yielding credit sectors.

Figure 6: Preferreds may improve portfolio diversification

10-year correlation



Data source: Morningstar Direct, 01 Oct 2014 to 30 Sep 2024. **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; **senior loans:** Credit Suisse Leveraged Loan 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.

Moderate sensitivity to interest rate changes

Managing interest rate risk remains critical. For fixed rate coupon bonds, when interest rates increase, bond prices decrease, and vice versa, all else being equal. However, different types of bonds have varying sensitivities to changes in interest rates. Since most preferreds have longer-dated maturities (many are perpetual), it may seem counterintuitive that their effective durations, a measure of interest rate risk, tend to be more intermediate-term.

There are two main reasons for this: Most preferred securities are callable, which can significantly shorten their duration profile. And preferred securities are often issued with non-fixed-rate coupons that fluctuate with interest rate changes, making them less sensitive to rate changes, all else being equal. This factor can play an even greater role in reducing duration, all else being equal.

The modest duration profile allows investors to benefit from higher yields without necessarily

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assuming more interest rate risk than a typical core bond portfolio. In fact, $1000 par preferreds and contingent capital securities (CoCos) have lower duration on average than the broad bond market (Figure 7). Preferred securities may earn more income per unit of duration, also making their yield opportunity even more compelling on a risk-adjusted basis.

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.

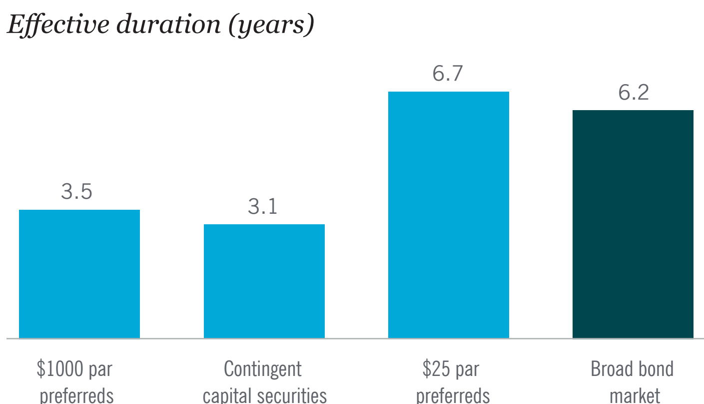
Fixed-to-floating rate coupons pay a fixed coupon for a preset number of years (commonly 5 or 10), then convert to a floating rate coupon for the remaining life of the security or until it is called. The floating rate coupon is based on a benchmark rate, such as 3-month SOFR, plus a predetermined spread 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 Citigroup preferred security was issued in 2023 with a fixed coupon of 7.625% until 2028, when it resets to the 5-year Treasury rate plus 3.2%.

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 8), 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.

Figure 7: The universe is intermediate-term in nature

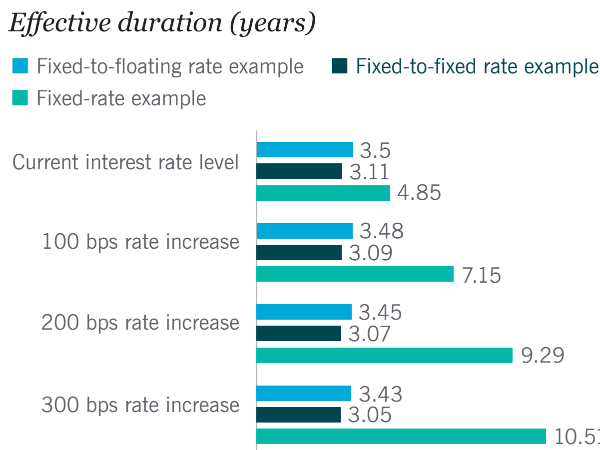
Effective duration (years)



Data source: Morningstar Direct, 30 Sep 2024. **Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: $1000 par preferred:** ICE BofA U.S. Institutional Capital Securities Index; **contingent capital securities:** ICE USD Contingent Capital Index; **$25 par preferred:** ICE BofA Core Plus Fixed Rate Preferred Index; **broad bond market:** Bloomberg U.S. Aggregate Index.

Figure 8: Securities with adjustable rate coupons remain less sensitive to interest rate changes

Effective duration (years)



Data source: FactSet, 30 Sep 2024. Assumes immediate parallel shift of the 30 Sep 2024 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.

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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:[4]

- $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 9 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. In 2021, retail investor demand drove down the yield of the retail version of the security, while the institutional yield remained relatively steady. Although yields in the two markets subsequently grew more similar, institutional $1000 par securities have historically offered greater yield than $25 par securities.

Figure 9: Retail and institutional investors value preferred securities from the same company differently

Issue Type	Retail	Institutional
Par	$25	$1000
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.

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.

A few years ago, 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 10.

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 10: 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 45% of the U.S.-dollar-denominated market.[5] 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 SECURITIES OUTLOOK

We see ample opportunities for investors to deploy capital, given our expectations for the U.S. economy to continue steadily slowing and for the Fed to respond with gradual rate cuts. We think preferred securities can continue to deliver attractive risk-adjusted, after-tax returns given their solid underlying credit fundamentals, relatively muted supply and steadfast investor demand for such investments.

Fundamentals

We remain constructive on 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. Third quarter 2024 earnings generally exceeded expectations, a trend that has now spanned several quarters.

While banks acknowledge continued challenges within commercial real estate (CRE) exposure, levels remained manageable with several banks stating that office CRE valuations seem to be at, or near, trough levels. We believe the risks surrounding CRE exposure will be a long-term situation that more likely impacts banks' stock valuations, given the potential effect on earnings. In the current environment, we believe most banks will be able to outearn and reserve enough to cover future losses. With respect to the consumer, delinquency rates have trended higher recently. That being said, the pace of the increase has slowed, and overall delinquency rates are still well below pre-pandemic levels.

At the end of June, the Fed released annual stress test results, with all 31 participating U.S. banks yet again passing this year's exam. All in, the banks were able to absorb $685 billion of combined losses and still maintain capital levels well above regulatory minimum requirements. Based on this year's exam, the 31 banks tested currently hold almost $600 billion of excess capital.[6]

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If additional U.S. bank sector headlines re-emerge, we believe previous steps taken by the Fed, FDIC and U.S. Treasury in response to the mini bank crisis of 2023 would cushion the severity and impact. Recent stress within the U.S. bank sector had more to do with mismanagement of interest rate risk than credit-related or macro events.

We believe managing duration is relatively straightforward, best monitored by regulators and managed by banks. Also, with the Fed encouraging banks to utilize the Fed window for liquidity during times of market distress, the likelihood is very low of a bank becoming insolvent due to a sudden need for liquidity.

Technicals

We expect net new issue supply to be relatively muted within the bank sector, given that most banks maintain sufficiently high capital levels to create a comfortable cushion above regulatory requirements.

We anticipate modestly positive net new hybrid issuance across the other corporate sectors. With Moody's changing the equity content treatment of hybrid securities in early 2023, we expect many issuers to refinance perpetual preferred stock structures with hybrid securities. From an issuer's perspective, a hybrid security is now less expensive than a perpetual preferred stock, all else being equal. The former pays investors interest like a bond that is tax deductible for the issuer, while the latter pays investors a dividend paid for by the issuer with after-tax dollars.

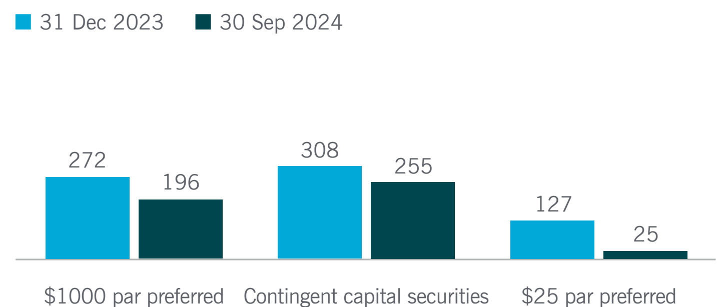
Also, the recent increase in demand for power from AI has ramped up capex plans within the utility sector. Hybrid supply has already increased to fund these projects and is likely to remain elevated. Many of these utility hybrid securities will be investment grade and high yield credit index eligible, which creates broader investor demand and provides preferred securities investors an opportunity to diversify away from the financial services sector. We expect this additional supply will be readily absorbed.

Valuations

We are marginally constructive regarding valuations across the preferred and CoCos markets. Credit spreads have decreased significantly, including preferred securities (Figure 11). However, given preferreds' strong underlying fundamental and technical stories, we feel current valuations should remain supported.

But not all preferreds are created equal. We favor $1000 par preferreds and CoCos over $25 par preferreds on an option-adjusted spread (OAS) basis. And since the average effective durations for $1000 par preferreds and CoCos are around half that of $25 par preferreds, we favor $1000 par preferreds and CoCos even more on a risk-adjusted basis.

Figure 11: $1000 par preferreds and CoCos offer more attractive spreads



Data source: Bloomberg, L.P. **Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: $1000 par preferred:** ICE BofA U.S. Institutional Capital Securities Index; **$25 par preferred:** ICE BofA Core Plus Fixed Rate Preferred Index; **contingent capital (CoCo):** ICE USD Contingent Capital Index.

For more information, visit us at 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: Nuveen, 30 Sep 2024. $50 and $100 par securities exist, but they are much less common. **5** Data source: Based on ICE BofA U.S. All Capital Securities Index and ICE USD Contingent Capital Index as of 30 Sep 2024, Nuveen. **6** Data source: https://www.federalreserve.gov/publications/files/2024-dfast-results-20240626.pdf.

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