

Preferred Securities

As of 30 Sep 2021

Bond market overview

U.S. economic growth slowed in the third quarter, reflecting both a natural deceleration toward normal conditions after the reopening boom earlier this year and lingering headwinds. Global COVID case counts continued to rise over the summer before peaking in August. Supply chain disruptions crimped activity and drove up prices. Also, a wide variety of industries faced labor shortages as a record number of job openings proved hard to fill. While these headwinds kept growth from reaching its full potential, strong balance sheets and healthy demand likely helped U.S. gross domestic product (GDP) to expand at a quarter-on-quarter annualized rate of about 5%. In Europe, where the summer COVID wave was less severe, third quarter growth may come in around 9%. China's strict lockdowns probably limited its growth to roughly 3%.

On the economic policy front, the Federal Reserve (Fed) moved closer to initiating the withdrawal of monetary accommodation, using its September meeting to signal a likely tapering of monthly asset purchases beginning in the fourth quarter. The Fed's summary of economic projections reflected lower growth for 2021, while inflation and unemployment projections moved higher as the effects from COVID are lasting longer than anticipated. Policymakers also indicated that the first rate hike could come toward the end of 2022. Fiscal policy remained supportive during the quarter and Congress continued to wrangle over a large fiscal package that will likely pass later this year. The European Central Bank (ECB) also announced plans to begin unwinding its Pandemic Emergency Purchase Programme (PEPP), reflecting a eurozone economy on stronger footing.

This backdrop resulted in a fairly stable quarter for the fixed income markets. After declining 21 basis points in July, the 10-year Treasury yield rose 28 basis points throughout July and August, ending the period 7 basis points higher at 1.52%.

The asset class, represented by the Custom Blended Index* (which encompasses the preferred securities and contingent capital securities (CoCo) markets), had a third quarter

return of 0.54%, which outperformed financial senior debt but underperformed financial equities. A comparable senior corporate bond index, the Bloomberg US Credit-Financial Institutions Index, posted a quarterly return of 0.11%, while the S&P 500 Financials Sector Index gained 2.74%. That being said, the asset class did post mixed results across its three broad categories. The \$1000 par preferred securities market posted the highest quarterly return at 1.15%, followed by U.S. dollar-denominated (USD) CoCo securities with a return of 0.44%, and then the \$25 par preferred market, which posted a negative return of -0.32%. In our opinion, the outperformance of \$1000 par preferreds versus \$25 par preferreds during the quarter was not too surprising. First, compared to \$25 par preferreds, \$1000 par preferreds have appeared cheaper for some time. At the beginning of the quarter, the average option adjusted spread (OAS) for \$1000 par preferreds was 214 basis points, 190 basis points above the average OAS of 24 basis points for \$25 par preferred securities. At the end of the period, this difference had narrowed to just 124 basis points. The convergence was due to \$1000 par OAS having declined 6 basis points to 208 basis points, while \$25 par preferred OAS increased 60 basis points to finish at 84 basis points. We believe the outperformance of \$1000 par preferreds was partly due to market participants reacting to the relative value opportunity between the two categories. Second, interest rates generally increased during the quarter. The average duration of \$25 par preferred securities at quarter end was 5.7 years, which was decently higher than the average duration of 4.3 years for \$1000 par preferreds. Therefore, in addition to spreads moving higher in the third quarter for \$25 par preferred securities during a time when \$1000 par preferreds average OAS actually declined, the \$25 par preferred segment's longer duration also contributed to relative underperformance.

Portfolio performance

The Preferred Securities SMA strategy posted a positive total return for the quarter, and outperformed its benchmark, as the ICE BofA Core Plus Fixed Rate Preferred Securities Index posted a negative total return. The primary drivers of outperformance were duration positioning, coupon structure allocation and to a lesser degree, security

*The Custom Blended Index consists of 60% ICE BofA U.S. All Capital Securities Index and 40% ICE BofA Contingent Capital Index USD Hedged.

This report contains no recommendation to buy or sell any specific security and should not be considered investment advice of any kind.

Past performance is no guarantee of future results. Please see last page for additional disclosures integral to this report.

NOT FDIC INSURED NO BANK GUARANTEE MAY LOSE VALUE

Preferred Securities

As of 30 Sep 2021

selection. First, as of September 30, the strategy's effective duration was 3.76 years, almost 1.25 years shorter than that of its benchmark, the ICE BAML Core Plus Fixed Rate Preferred Securities Index. Overall, rates rose slightly during the quarter which benefited the strategy given its shorter duration profile. Second, the strategy's coupon structure positioning was also a performance contributor. Securities with coupon reset features materially outperformed their fixed-rate coupon counterpart over the three month period. Consternation over the potential of Fed tapering likely drove this performance difference. Securities with coupon reset features are more defensive against rising rates. The primary reason for this is because they have minimal duration past their initial coupon reset date (which is typically their first call date). On the other hand, lower coupon fixed-rate coupon structures typically experience an increase (extension) in duration as rates rise because issuers are less likely to redeem them at their first call date. As their duration extends, they become increasingly sensitive to further rate movements which increases the magnitude of changes in valuations. This is the reason why we currently favor securities with coupon reset features and higher-coupon fixed-rate structures. Lastly, security selection within the insurance sector was a smaller contributor. There were several insurance positions held in the ICE BAML Core Plus Fixed Rate Preferred Securities Index that underperformed the broader index. These securities were not held in the strategy and avoiding them contributed to this quarter's outperformance.

While the incredibly bullish sentiment of earlier this year has subsided modestly, the economic expansion continues. At this time, we still expect above-trend U.S. and global growth through year-end 2022. That being said, there have been grumblings recently regarding the risk of stagflation, which we believe is unlikely. With respect to "stag", and as noted above, our outlook is for above-trend growth through the end of 2022. With respect to "flation", our outlook is for inflation to moderate somewhere between 2.25% and 2.5% by the end of next year. Our conviction in both of these forecasts is quite high; however, we do recognize that there are risks to both outlooks. As such, we will continue to closely monitor future economic data, and if necessary, adjust our outlook and positioning accordingly.

We continue to field questions regarding the impact on preferred qualified dividend income (QDI) if tax rates moved higher as part of a broader tax overhaul here in the U.S. Recent information leaked to the press suggests that House Democrats will propose an increase on capital

gains and QDI tax rates from the current rate of 20% up to 25%, or up to 28.8% when adding in the Medicare surtax. However, in years past, QDI tax-related headlines have had no measureable impact on the valuations of preferred securities, which we believe is because of several reasons. First, it appears the preferred securities market is still primarily viewed as a taxable fixed income investment. Despite the beneficial tax treatment afforded QDI distributions, we still frequently observe investors allocating preferred exposure to qualified accounts. Second, the increased adoption of preferred securities over the past several years by institutional investors has likely reduced its sensitivity to changes in QDI tax rates even further. In our conversations with institutional investors, their participation in the preferred market is driven primarily by what they perceive as attractive risk-adjusted credit spreads relative to other areas of fixed income. Admittedly, many of these institutions could take advantage of the dividends received deduction (DRD) afforded to some preferred securities structures. However, we have fielded very few requests for DRD-focused mandates. This leads us to believe that DRD is not a driving force behind the increase in institutional interest. One last point concerns investor flows into the asset class, which have been strong year-to-date despite discussions of higher QDI rates since the Biden administration took office. This further supports our thesis that a change in QDI tax rates is unlikely to have a measureable impact on preferred securities and CoCo valuations.

Despite strong performance year to date, our outlook still remains constructive for the preferred securities market. Barring any unforeseen developments, we anticipate maintaining most of the strategy's current positioning relative to the index. We believe that economic fundamentals, U.S. Treasury supply and Fed tapering will eventually push rates higher and the yield curve steeper versus quarter-end levels. In addition to the strategy's outright shorter duration positioning, an overweight to securities that have coupons with reset features helps it keep a lower duration profile, while also positioning the portfolio to potentially outperform in a steeper yield curve environment. We also plan on keeping an underweight to short-call securities because most trade with very low - or even negative - yields. Last, an overweight to the financial sector and underweight to industrials is defensive in nature. The financial sector as a whole is comprised of highly regulated industries. Banks and insurance companies, which make up the majority of this sector, are subject to strict financial regulation, plus most banks are required to

Gross of fee performance may not include the deduction of trading commissions and other transaction costs and does not include fees. Net of fee performance will be lower than the gross of fee performance and may or may not have outperformed the index referenced. This report contains no recommendation to buy or sell any specific security and should not be considered investment advice of any kind. Past performance is no guarantee of future results. Please see last page for additional disclosures integral to this report.

Preferred Securities

As of 30 Sep 2021

regularly participate in fairly rigorous stress tests. For these reasons we continue to favor highly regulated industries over those with less government oversight.

This material is not intended to be a recommendation or investment advice, does not constitute a solicitation to buy, sell or hold a security or investment strategy, and is not provided in a fiduciary capacity. The information provided does not take into account the specific objectives or circumstances of any particular investor, or suggest any specific course of action. Investment decisions should be made based on an investor's objectives and circumstances and in consultation with his or her financial professionals.

Glossary

The Bloomberg Barclays Aggregate Index tracks the performance of U.S. investment-grade bonds. The **Bloomberg Barclays 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. The **ICE BofA Core Plus Fixed Rate Preferred Index** tracks the performance of fixed rate U.S. dollar denominated preferred securities issued in the U.S. domestic market. Qualifying securities must be rated at least B3 and must have an investment grade rated country of risk. **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 professionals regarding unknown financial terms and concepts.

The views and opinions expressed are for informational and educational purposes only as of the date of production/writing and may change without notice at any time based on numerous factors, such as market or other conditions, legal and regulatory developments, additional risks and uncertainties and may not come to pass. This material may contain "forward-looking" information that is not purely historical in nature. Such information may include, among other things, projections, forecasts, estimates of market returns, and proposed or expected portfolio composition. Any changes to assumptions that may have been made in preparing this material could have a material impact on the information presented herein by way of example. **Past**

performance is no guarantee of future results. All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such. This information does not constitute investment research as defined under MiFID.

A word on risk

All investments carry a certain degree of risk and it is important to review investment objectives, risk tolerance, tax liability and liquidity needs before choosing an investment style or manager. Investing in fixed income securities entails risk including the possible loss of principal. 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. 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. Preferred securities are subordinate to bonds and other debt instruments in a company's capital structure and therefore are subject to greater credit risk. Certain types of preferred, hybrid or debt securities with special loss absorption provisions, such as contingent capital securities (CoCos), may be or become so subordinated that they present risks equivalent to, or in some cases even greater than, the same company's common stock. 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.

Nuveen Asset Management, LLC is a registered investment adviser and an affiliate of Nuveen, LLC.