

Preferred Securities

Marketing communication | As of 30 Sep 2024

- **During the third quarter, the Preferred Securities strategy underperformed its benchmark on a gross and net of fees basis.**
- **The underweight to lower rated securities and duration positioning were the primary detractors from performance.**
- **Curve positioning was the primary contributor to performance.**

Market review

U.S. and global economies continued to expand during the quarter, although more signs of a slowdown emerged. Monthly U.S. job creation moderated significantly versus the first half of the year, causing unemployment to rise above 4%; however, layoffs and outright job losses remained rare. At the same time, U.S. consumption continued to expand at a healthy pace as illustrated by robust retail sales, while the housing market showed early signs of rebounding. In Europe, overall growth continued to improve versus 2023's sluggishness, with consumption and net exports improving modestly. China's government unleashed a broad package of stimulus measures to kickstart the country's deteriorating economy and ward off deflation.

Amid further signs of moderating U.S. inflation and the weakening labor market, Federal Reserve (Fed) policymakers made a supersized 50-basis-point rate cut in September, while asserting that a more aggressive pace shouldn't be expected going forward. Moderating inflation also allowed the European Central Bank (ECB) to cut rates for a second time this cycle, while the Bank of England made its first 25-basis-point cut in August. The Bank of Japan (BoJ) was the outlier with a surprise increase to the country's key interest rate to help curb the yen's fall versus the dollar.

The quarter was relatively void of headlines specific to the preferred securities market. For the bank sector, the largest issuer of preferred securities, most news was positive. Banks released second-quarter 2024 earnings that generally exceeded expectations, a trend that has now spanned several quarters. While banks continued to report stress 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, drawn-out situation that more likely impacts banks' stock valuations, given the potential to weigh on earnings, but are less of a concern for credit investors. In the current environment, most banks will be able to outearn and reserve enough to cover future losses. At the end of June, the Fed released annual stress test results, with all 31 participating 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.



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During the quarter, the preferred securities market was more affected by geopolitical headlines and a continual guessing game as to the future direction of rates and Fed policy. The Fed's arguably larger-than-expected cut in September represented the first time it had lowered the fed funds rate since early 2020. With the Fed cutting rates, the U.S. economy continuing to hum along, and inflation still above the long-term 2% target, the Treasury yield curve steepened quite meaningfully during the quarter. The bellwether 10-year Treasury yield ended the quarter 55 basis points lower at 3.81%, while two-year rates fell by nearly twice as much. As a result, the two-to-10-year segment of the yield curve returned to an upward slope following an extended period of inversion.

The \$25 par preferred segment of the market surged during the quarter, outperforming both \$1000 par preferreds and U.S. dollar-denominated contingent capital securities (USD CoCos). The drivers of the outperformance were twofold. First, at the start of the quarter, the \$25 par preferred segment of the market had an average duration of roughly 7.6 years, more than twice the average duration of \$1000 par preferreds and USD CoCos. In a declining rate environment, longer duration securities generally outperform. Second, all three market segments continued to see significant redemption activity during the quarter. But while new issue activity was relatively healthy across the \$1000 par preferred and USD CoCo segments, the \$25 par preferred market experienced a dearth of meaningful new issue supply. As investors in \$25 par preferreds recycled cash from redemptions back into the segment, the resulting supply/demand imbalance drove option adjusted spreads (OAS) disproportionately lower by -50 basis points during the quarter, compared to changes of 0 basis points and -17 basis points for the \$1000 par preferred and USD segments, respectively. At quarter-end, the average OAS for the \$1000 par preferred and USD CoCo segments was 196 basis points and 255 basis points, respectively, compared to only 25 basis points for \$25 par preferreds. While the OAS for \$25 par preferreds may appear rich at quarter end, it was actually higher than its lowest level of -44 basis points recorded mid-September. Given the combination of the segment's higher average duration and significant decline in OAS, \$25 par preferreds posted a whopping 8.31% return for the quarter, the best quarterly return for the segment in more than four years.

The \$1000 par preferred and USD CoCo segments trailed with quarterly returns of 4.81% and 5.42%, respectively. Usually, preferred market returns of that magnitude would be quite noteworthy but were overshadowed by the \$25 par

preferred market. Because the durations of both segments were less than half that of the \$25 par preferred market, they not surprisingly underperformed in the declining rate environment. The performance differential was exacerbated by the unchanged OAS for \$1000 par preferreds and modest decline in OAS for USD CoCos, which paled in comparison to the 50-basis-point drop in average OAS for \$25 par preferred securities. While USD CoCos still have the highest average OAS of the three segments, the difference in its OAS versus \$1000 par preferreds remained at the narrow end of the historical range.

Portfolio review

The Preferred Securities strategy underperformed its benchmark, the ICE BofA Core Plus Fixed Rate Preferred Securities index, on both a gross and net of fees basis. On an absolute basis, duration, spread tightening and coupon income all drove positive performance. On a relative basis, the strategy's underperformance came from an underweight to lower rated securities and spread duration positioning, as well as from its duration positioning.

Third quarter performance for the \$25 par segment of the market was certainly impressive. From a credit ratings perspective, all ratings "buckets" experienced positive performance, but the magnitude across the buckets of the performance was not uniform. Below investment grade (BIG) securities handily outperformed investment grade (IG) securities. The Preferred Securities strategy is positioned more conservatively and is restricted from investing in BIG securities. As such, the strategy has very little exposure as the only BIG positions the strategy has allocated to are names that have fallen from IG to BIG. A large portion of the benchmark, however, is comprised of below investment grade securities. These securities typically have higher yields and higher corresponding OAS that also often move in greater magnitude than the market as a whole. These high-beta securities that are essentially not found in the strategy massively outperformed the IG segment of the \$25 par market and thus, was a large detractor from relative performance.

At the beginning of the quarter, the strategy's duration was 5.1 years, about 1.6 years 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

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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 detracted from performance, given the aforementioned drop in rates. However, curve positioning offset some of this underperformance. The strategy was overweight the shorter end of the curve and underweight the longer end of the curve which contributed to performance as the short end declined by the most.

Trading across the strategy was relatively muted this quarter. Issuance was again very light, but we did participate in two new issues that came to market in July from Morgan Stanley and Regions Financial.

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. If additional headlines specific to the U.S. bank sector were to re-emerge, we believe that 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 any sort of credit-related or macro events. We believe duration management is a relatively straightforward process that will be better monitored by regulators and better managed by banks going forward. Also, with the Fed forcing banks to utilize the Fed window for liquidity during times of market distress, the likelihood of a bank becoming insolvent due to a sudden need for liquidity is very low. Finally, the Fed recently released revised capital proposals for U.S. banks, which will further bolster a bank system that many feel is already adequately capitalized to withstand severe economic conditions.

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. In addition, with expectations for limited net supply and continued investor demand for tax-advantaged income, we think that current 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 we own, if the coupons were to reset today, the new coupons would be higher than the coupons currently being paid, which should bode well should these securities extend through their first call date and the coupons reset.

We believe the Fed is likely to cut rates further in 2024 but recent economic data might limit the cuts to 25-basis-point increments in November and December. Given the strength of recent economic data and the fact that the market has priced in a significant number of rate cuts, we will likely maintain the strategy's slightly shorter duration profile versus the index in the near term. While not our base case today, there is still the risk that the Fed is behind the curve with rate cuts and drives the U.S. economy into recession, or cuts rates too aggressively and too early, spurring another leg higher in inflation.

Barring any unforeseen developments, we anticipate maintaining most of the strategy's current positioning relative to its benchmark. We continue to maintain an overweight to the financial sector and underweight to industrials, which 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 regularly participate in fairly rigorous stress tests. For these reasons we continue to favor highly regulated industries over those with less government oversight.

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For more information contact: 800.752.8700 or visit nuveen.com

Minimum investment is \$100,000.

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 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 GLCS®/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 professional regarding unknown financial terms and concepts.

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