Preferred Securities Select

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 Benchmark 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 Select SMA Strategy portfolio outperformed the benchmark index, the ICE BofA US All Capital Securities Index, during the third quarter on a gross-of-fees basis. While the strategy's performance slightly edged out that of its benchmark, there were several factors which brought about that result. Denomination allocation ($25 par versus $1000 par) coupled with coupon structure and term structure positioning, were the two primary contributors to outperformance, while sector allocation was a slight detractor.

As previously mentioned, the $25 par side of the market underperformed its $1000 par counterpart during the quarter. As the majority of $25 par securities have fixed-rate coupon structures, their underperformance coincided with fixed-rate

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coupon structures underperforming those with coupon reset features across the entire preferred market. Consternation over rising rates given the potential of Fed tapering, as well as headlines regarding inflation, likely drove this performance difference. Demand for fixed-rate coupon structures seemingly waned as these structures typically experience duration extension as rates rise. On the other hand, securities with coupon reset features are more defensive against rising rates because the help to as they mitigate duration extension risk. For that reason the strategy has been positioned accordingly, with an overweight to both securities with coupon reset features and $1000 par securities, and corresponding underweights to both fixed-rate coupon structures and $25 par denominated securities. This positioning benefited the strategy during the quarter as fixed-rate coupon structures and $25 par securities underperformed the broader market. Beyond that, term structure contributed to outperformance during the marking period. The strategy had an overall shorter duration profile than that of its benchmark, which was beneficial as – overall - rates slightly rose during the quarter. Lastly, sector allocation was a minor detractor. The energy sector outperformed the broader index and the strategy's underweight to the sector slightly offset some of 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.

As a reminder, the U.S. bank sectors is the largest issuers of preferred. The bank sector successfully navigated through the trough of the COVID crisis, and prospered on the heels of the recovery. U.S. and bank earnings for full-year 2020 exceeded expectations and earnings for the first half of 2021, on average, were also ahead of consensus. Further, U.S. banks once again performed well during their respective 2021 stress tests. Today, the U.S. bank and insurance sectors operate with record high levels of regulatory and statutory capital. In aggregate, this is testament to the strength of the fundamental credit story underlying the preferred securities market.

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 valuations.

Despite strong performance year to date, our outlook still remains constructive for the preferred security market for the above-mentioned reasons. 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. The strategy's overweight to securities that have coupons with reset features helps it keep a lower duration profile, while also positioning the strategy to potentially outperform in a steeper yield curve environment. Also, the meaningful OAS differential between $1000 par preferred and $25 par preferred securities still supports our overweight to the former versus the latter. As of 9/30/2021

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the strategy's model portfolio had and effective duration of 3.6 years, about 0.9 year shorter than the index. However, average call protection for securities in the strategy was roughly the same at 4.1 years, suggesting less reinvestment risk than one might assume given the strategy's duration.

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GLOSSARY

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** are debt or capital securities of primarily non-U.S. issuers with loss absorption contingency mechanisms built into the terms of the security. The **Custom Benchmark Index** consists of 60% ICE BofA U.S. All Capital Securities Index and 40% ICE BofA Contingent Capital Index USD Hedged. **ICE BofA U.S. All Capital Securities Index** is a subset of the ICE BofA U.S. Corporate and U.S. High Yield Index including all fixed-to-floating rate, perpetual callable and capital securities, and fixed rate preferred securities. **ICE BofA Contingent Capital Securities USD Hedged Index** tracks the performance of all contingent capital debt publicly issued in the major domestic and Eurobond markets, including investment grade and sub-investment-grade issues. **Option Adjusted Spread** 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. 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. **It is not possible to invest directly in an index.**

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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.

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