Preferred Stocks and their Potential Pitfalls

REGIONS ASSET MANAGEMENT

Introduction

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Preferred securities are unique hybrid securities that combine features of both stocks and bonds. Given their attractive yields relative to traditional fixed income and lower volatility relative to equities, the asset class could be deemed appropriate for income-seeking portfolio managers and investors. However, preferred securities have different risk characteristics relative to traditional asset classes which must be accounted for. Before adding exposure to the asset class, investors need to understand three main questions:

1. Why have preferred securities historically offered a higher yield relative to most other fixed income sub-asset classes?
2. What are the risks associated with the asset class?
3. How should an investor properly measure potential future yields/returns in the asset class?

First, what is a preferred security?

Within a corporation's capital structure, preferred securities fall below senior debt and above common stocks. This means in a bankruptcy or liquidation scenario, investors in preferred securities will generally have a higher priority than common stock owners, hence the term "preferred", but a lower priority than holders of senior debt. Similar to bonds, preferred securities have stated par values, defined periodic payments, ratings from the major credit agencies, interest rate risk and no voting rights. However, given their lower priority in the capital structure, preferreds will have higher credit risk, higher yields and higher probability of default compared to senior bonds.

Preferred Market Overview

Preferred securities are structured in many different ways. Maturity dates can be a stated date or perpetual, meaning there is no maturity date no matter how long they are held. Payments of interest or dividends can be fixed, floating, fixed-to-variable, or fixed-floating. In addition, potential missed, or deferred payments can be accumulated or not accumulated depending on if a security is "cumulative" or "non-cumulative". The market's largest three segments are compared in Figure 1.

Figure 1: Characteristics of the Preferred Market

	$25 Par Preferred Securites	$1000 Par Preferred Securities	Contingent Convertible Securities (CoCo)
Typical Investor	Retail	Institutional	Institutional
Structure	Junior to Senior	Junior to Senior	Junior, non-cumulative perpetual, meaning coupons can be skipped at any time
Region of Issuance	Mostly United States	Mostly United States	Mostly Europe
Investment Grade	64.30%	76.10%	31.60%
High Yield	35.70%	23.90%	68.40%
Fixed Rate	77.30%	11.10%	5.20%
Non-Fixed Rate	22.70%	88.90%	94.80%
Current Yield	5.70%	5.50%	6.30%
Yield to Worst	1.90%	4.40%	4.60%
% Callable in next 12 months	30.60%	18.40%	11.80%

As of 9/30/2019; Source: Spectrum Asset Management & Bloomberg

Performance, Risks and Other Considerations

Issuance in the preferred market is heavily concentrated in the financial industry. Banks, insurance companies and other financial institutions represent 72.5% of total outstanding issuance in the preferred market. [1] Significant pressure on financial institutions, whether regulatory or market-related, could lead to volatility in the preferred market.

When evaluating performance and risks of preferred securities, there is potentially significant time period bias if the global financial crisis isn't accounted for. From February 2008 to February 2009, the ICE BofAML Fixed Rate Preferred Securities Index plummeted 53.3% while the S&P 500 Index fell 43.3%. This shocked investors as less than 10% of the preferred stock market was rated below investment grade in early 2008. While poor credit assessments of mortgage-related securities by the rating agencies dominated the headlines, preferred securities were also not accurately rated to account for potential risks. In the aftermath of the crisis, regulators placed stricter controls on financial institutions and the preferred market has evolved significantly, notably in the growth of the contingent convertible securities (CoCo) market. Today, credit agencies have the preferred market rated roughly 50% investment grade and 50% high yield with most of the investment grade exposure rated BBB. Figure 2 shows annualized returns, Sharpe ratios, standard deviations and correlations to the S&P 500 over the last 5-, 10- and 15-year periods (calculated using daily returns). The ICE BofAML Fixed Rate Preferred Securities Index tracks the performance of fixed-rate USD-denominated preferred securities issued in the U.S. domestic market.

Figure 2: Statistics of Fixed Income Indices

	Return			**Sharpe Ratio**			**Annual Std. Deviation**			**Correlation to S&P 500**		
	5 Yr	**10 Yr**	**15 Yr**	**5 Yr**	**10 Yr**	**15 Yr**	**5 Yr**	**10 Yr**	**15 Yr**	**5 Yr**	**10 Yr**	**15 Yr**
Bloomberg Barclays US Aggregate	3.05%	3.75%	4.15%	0.66	1.11	0.89	3.04	2.86	3.16	-0.30	-0.36	-0.29
Bloomberg Barclays US HY-Corporate	6.13%	7.57%	7.20%	0.97	1.21	0.56	5.24	5.78	9.04	0.46	0.42	0.31
ICE BofAML Fixed Rate Preffered Securities	6.51%	7.44%	3.92%	1.23	1.41	0.19	4.45	4.88	13.67	0.34	0.43	0.35

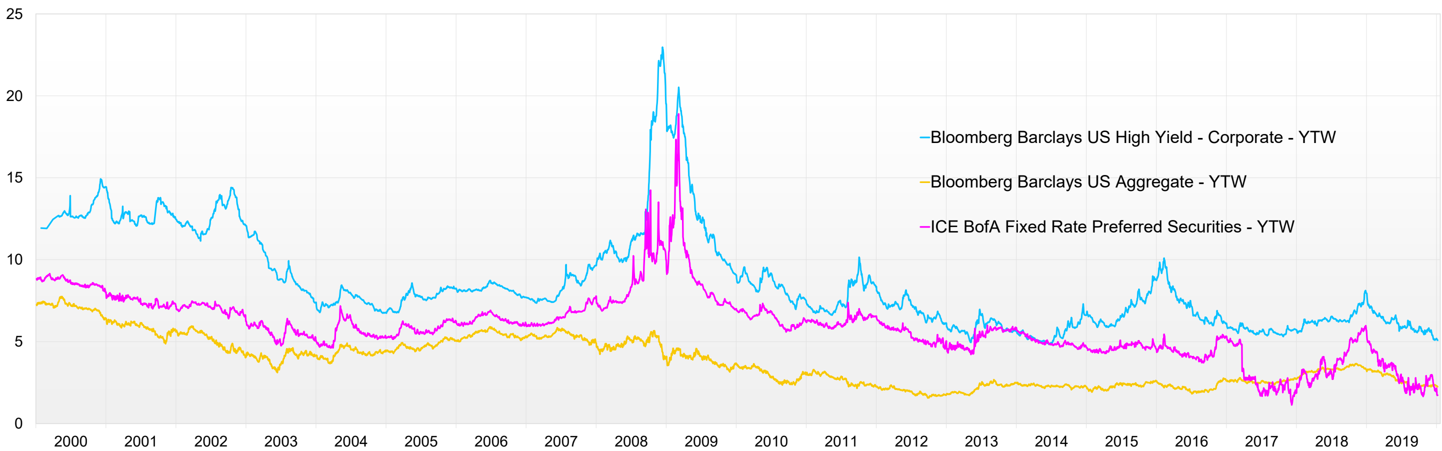
As of 12/31/2019; Source: FactSet

Interest Rate Risk/ Call Risk

Like traditional fixed income securities, preferred securities are subject to interest rate risk. The effective duration of the ICE BofAML Fixed Rate Preferred Securities Index has ranged from 2.7 to 9.7 years within the last 20 years. While some traditional bonds have call features, they are more prevalent in preferred securities. A callable option on a bond allows the issuing company to purchase back the security at a certain stated price. Companies use this call feature when rates fall and they're able to replace outstanding debt at lower yields. When a security is called, it forces investors to reinvest back into the market at an inopportune time. It's important to note that corporations won't necessarily call their bonds immediately if prices fall below the stated call price as transaction costs and other corporate financial considerations may delay or prevent the security from being called.

There are many different calculations for yield in fixed income. One of the most commonly quoted calculation is the trailing twelve month (TTM) yield which as its name states is the yield over the past twelve months. While the calculation may be useful, it is backward looking and doesn't account for current interest rate levels. Yield-to-worst (YTW) is a more commonly quoted yield for preferred securities as it factors in the current interest rate environment and call risk. Yield-to-worst accounts for these factors and is defined as the lowest potential yield for a bond assuming the bond doesn't default. Figure 3 shows the yield-to-worst (YTW) for preferreds and other fixed income indices over time. With declining interest rates in 2019, the YTW for the Preferred Securities index has dropped more drastically compared to other fixed income indices due to the significant call risk associated with preferreds.

Figure 3: Yield-to-Worst Over Time



Source: FactSet

Conclusion

For traditional fixed income asset classes, the two most prevalent risks are interest rate risk and credit risk. In addition to these traditional risks, preferreds are structured in various ways and have unique risks which must be accounted for. Given current low interest rates, call risk is especially important. As an example, within the $25 Par market, 30.6% of bonds are callable within the next twelve months which leads that segment of the market to have a yield-to-worst of just 1.9% as of September 30, 2019. [1] Preferred securities may be suitable as a portion of a diversified portfolio for income-oriented investors with a long-term time horizon; however, understanding potential risks and drivers of potential return is necessary before allocating to the space.

Sources

1: Spectrum Asset Management as of 9/30/2019

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