

Fixed Income Newsletter

Preferred Market Update

FIXED INCOME | FIXED INCOME MANAGED SOLUTIONS | MARKET INSIGHT | MARCH 2021

Preferreds declined in the month of February as investors reassessed allocations in light of rising rates. January preferred ETF outflows persisted into February, as 25 par securities, as represented by the ICE BofA Core Plus Fixed Rate Preferred Securities Index, dropped 1.55% in the month, taking year to date returns to -3.24%.¹ 1000 par preferreds weathered the rise in stronger condition, declining 47 basis points (bps) to -0.69% for the year. After the reset in valuations, yields for 25 par exceed 1000 par for the first time since last summer.

Interest rates have dominated the conversation for investors this year, triggering rebalancing across equities and producing negative total returns for traditional fixed income classes such as investment grade bonds and municipals. For preferreds, the key difference is the larger credit spread, the yield above the risk free rate. The economic forces that propel rates higher can also tighten spreads, offsetting the impact, and securities such as preferreds can have a lower correlation to interest rates.

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The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Disclosure section for index definitions.

¹ Source Bloomberg as of February 28, 2021

Basis point. One basis point = 0.01%

Specific to preferreds, the 25 par market is a majority fixed for life structure, which can have greater sensitivity to rates moves as securities “extend” in a selloff and trade to perpetuity rather than to call. The 1000 par market consists predominantly of fixed-to-floating rate structures, which allow the “back end” to move higher with rising rates, mitigating the extension risk. During the month, we witnessed some impact from these structural differences with 25 par underperforming 1000 and 25 par fixed for life underperforming 25 par fixed to floating rate.

Refinancing activity and fund flows have had an impact as well. At year end, nearly 15% of the P0P1 Index, ICE BofA Fixed Rate Preferred Securities Index, was trading at a negative yield to call. On our calculations, over 11 billion of preferreds have had announced calls since the start of the year as issuers refinance coupons at lower levels. Fund flows, measured by the largest preferred ETFs, have turned negative for this year after increasing over five billion in 2020.

After the reset however, valuations are at historical norms for 25 par and 1000, measured by the option adjusted spread (OAS) and, we believe, are increasingly attractive to alternatives such as BB-rated high yield.

While new issuance slowed at the end of the month, \$7.6 billion of new issue preferred supply priced in February, a 33% increase from last year.² Leading the way were the money center banks, issuing lower coupon securities to refinance newly callable securities following Q4 results at the end of January. We only anticipate more activity based on the calendar for securities hitting first call this year.

In terms of structure, we note our research shows that every new fixed to floating preferred has a Treasury-

DISPLAY 1

Returns

INDEX	MTD	QTD	YTD	2020
25 Par Preferreds	-1.55	-3.24	-3.24	7.38
1000 Par IG	-0.47	-0.69	-0.69	8.22
1000 Par HY	-0.03	0.45	0.45	6.03
USD CoCo	0.64	0.82	0.82	7.54
US High Yield	0.30	0.67	0.67	6.17
US Corporate	-1.98	-3.19	-3.19	9.81
5-10yr. Financials	-1.57	-2.25	-2.25	10.69

Source: Bloomberg data as of 2/26/21

Metrics

INDEX	CY	YTW	YTM	OAS	EFF. DUR.
25 Par Preferreds	5.56	3.49	5.22	281	5.74
1000 Par IG	4.97	3.18	3.78	226	4.49
1000 Par HY	5.45	3.89	4.29	288	4.51
USD CoCo	6.14	3.70	4.88	294	3.43
US High Yield	5.70	4.36	4.93	357	4.01
US Corporate	3.40	2.11	2.17	95	8.19
5-10yr. Financials	3.31	2.02	2.07	90	6.37

Source: Bloomberg data as of 2/26/21

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based reset this year. Issuers and the marketplace are recognizing the value, especially in light of recent rate moves, and we largely agree.

Over the coming weeks, the next catalyst for primary market activity should be a decision from the Fed on the Supplementary Leverage Ratio (SLR). As liquidity has flooded the financial system, deposits are flowing into the largest banks and growing the asset base

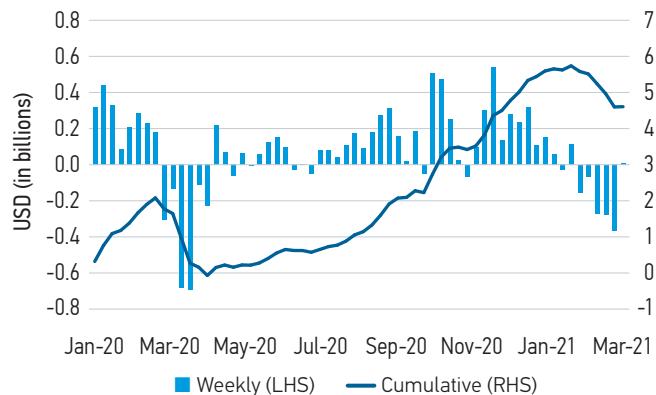
more quickly than capital. For banks that hold excess on deposit at the Fed or invest in Treasuries, the Fed implemented an exclusion last March for these assets from the SLR calculation, which is scheduled to expire at month end. We're watching developments closely as it could have implications for bank capital as well as Treasury liquidity if dealers need to cut balance sheets quickly.

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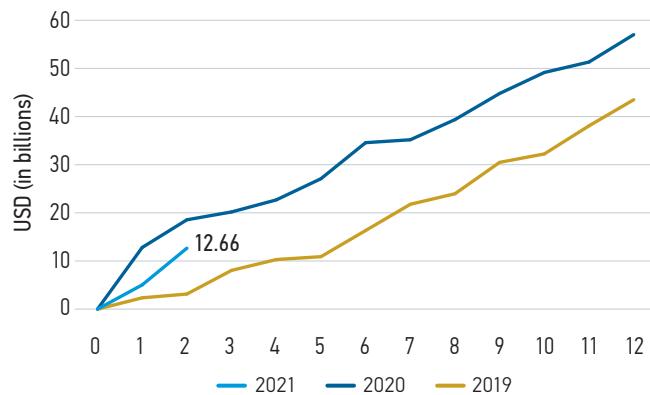
² Source: Bloomberg, MSIM as of February 26, 2021

DISPLAY 2

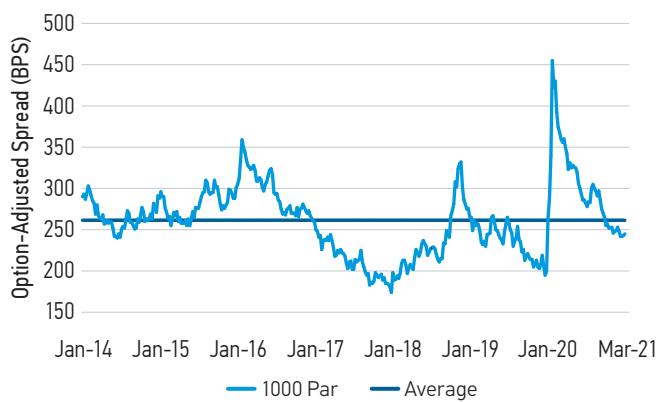
Preferred ETF Flows



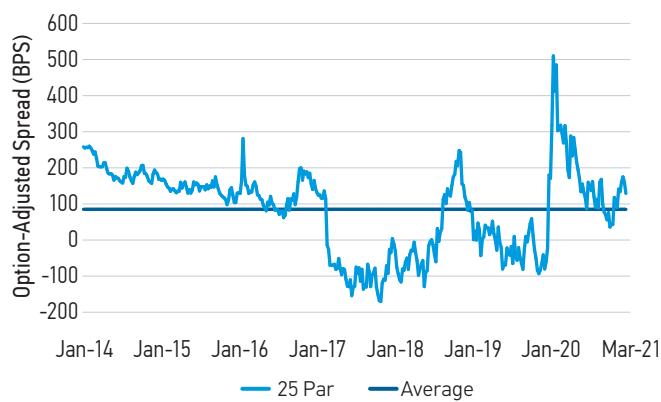
Cumulative U.S. Preferred Issuance



1000 Par OAS



25 Par OAS



Ratio of 1000 Par to BB High Yield OAS



Ratio of 1000 Par to Senior Financial OAS



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Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks.

Fixed-income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes.

Municipal securities are subject to early redemption risk and sensitive to tax, legislative and political changes. **Taxability Risk.**

Changes in tax laws or adverse determinations by the Internal Revenue Service ("IRS") may make the income from some municipal obligations taxable. By investing in investment company securities, the portfolio is subject to the underlying risks of that investment company's portfolio securities. In addition to the Portfolio's fees and expenses, the Portfolio generally would bear its share of the investment company's fees and expenses. **Preferred securities** are subject to interest rate risk and generally decreases in value if interest rates rise and increase in value if interest rates fall. High yield securities ("junk bonds") are lower rated securities that may have a higher degree of credit and liquidity risk.

INDEX DEFINITIONS

The indexes shown in this report are not meant to depict the performance of any specific investment, and the indexes shown do not include any expenses, fees or sales charges, which would lower performance. The indexes shown are unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

The **Bloomberg Barclays U.S. Corporate 1-3 Year Index** measures the investment grade, fixed-rate, taxable corporate bond market with 1-3 year maturities.

The **Bloomberg Barclays U.S. Municipal Bond Index** is an index that covers the USD-denominated long-term, tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds. It is composed of approximately 1,100 bonds.

The **CIPS/Markit UK Manufacturing Purchasing Managers' Index (PMI)** is a composite index based on five of the individual indexes with the following weights: New Orders - 0.3, Output - 0.25, Employment - 0.2, Suppliers' Delivery Times - 0.15, Stock of Items Purchased - 0.1, with the Delivery Times Index inverted so that it moves in a comparable direction.

The **Citigroup Economic Surprise Indices** are objective and quantitative measures of economic news. They are defined as weighted historical standard deviations of data surprises (actual releases vs. Bloomberg survey median). A positive reading of the Economic Surprise Index suggests that economic releases have on balance been beating consensus.

The **ICE BofAML Core Plus Fixed Rate Preferred Securities Index** tracks the performance of fixed-rate US dollar-denominated preferred, U.S.-domiciled securities.

The **ICE BofAML U.S. All Capital Securities Index** is a subset of the ICE BofAML Merrill Lynch U.S. Corporate Index including all fixed-to-floating rate, perpetual callable and capital securities.

The **ICE BofAML U.S. High Yield Master II Constrained Index (ICE BofAML US High Yield)** is a market-value-weighted index of all domestic and Yankee high-yield bonds, including deferred interest bonds and payment-in-kind securities. Its securities have maturities of one year or more and a credit rating lower than BBB-/Baa3, but are not in default.

The **ICE BofAML U.S. Corporate Index (COAO)** tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market.

The **ICE BofAML US Corporate BB Index** is a subset of the ICE BofAML US High Yield Master II Index tracking the performance of US dollar

denominated below investment grade rated corporate debt publicly issued in the US domestic market. This subset includes all securities with a given investment grade rating BB.

The **ICE BofAML US Corporate B Index** is a subset of the ICE BofAML US High Yield Master II Index tracking the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market. This subset includes all securities with a given investment grade rating B.

The **ICE BofAML US Corporate C Index** is a subset of the ICE BofAML US High Yield Master II Index tracking the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market. This subset includes all securities with a given investment grade rating CCC or below.

The **ICE BofAML Eurodollar Banking Index (EOBA)** is a subset of ICE BofAML Eurodollar Index including all securities of Bank Issuers and tracks the performance of US dollar denominated investment grade quasi-government, corporate, securitized and collateralized debt publicly issued in the eurobond markets.

The **ICE BofAML Fixed Rate Preferred Securities Index** tracks the performance of fixed rate, U.S. dollar denominated, investment-grade preferred securities in the U.S. domestic market.

The **ICE BofAML US Investment Grade Institutional Capital Securities Index (CIPS)** tracks the performance of US dollar denominated investment grade hybrid capital corporate and preferred securities publicly issued in the US domestic market.

The **ICE BofAML U.S. High Yield Institutional Capital Securities Index (HIPS)** tracks the performance of US dollar denominated investment grade hybrid capital corporate and preferred securities publicly issued in the US domestic market.

The **ICE BofAML Contingent Capital Index (CDLR)** tracks the performance of investment grade and below investment grade contingent capital debt publicly issued in the major domestic and Eurobond markets.

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