Stonebridge Preferred Securities Market Report

First Quarter, 2016

Market Recap

The preferred and hybrid securities markets continued their rally from the fourth quarter of 2015 with another quarter of positive performance to start off 2016. Despite market volatility in January and February, which caused credit spread widening in all risk assets, improving economic growth and receding fears regarding banks and credit markets allowed the quarter to end on a high note. Total return performance of the retail preferred securities market, as measured by the Bank of America Merrill Lynch Fixed Rate Preferred Securities Index, P0P1, in 1Q16 was 1.6%. Retail securities performed better than institutional securities in 1Q16 as measured by both the institutional hybrid index (C0CS) and the European-dominated contingent capital index (COCO). These indices generated total returns of 0.8% and -2.5%, respectively, during 1Q16 and mirrored the retail market volatility during the quarter by showing relatively weak performance early in the quarter followed by large positive returns in March.

The principal driver of weakness early in the quarter was negative headlines regarding profit fears in the banking system. We believe the selling pressure in the financial sector, and in the preferred and hybrid markets, in particular, were caused by:

1. **Lower interest rates driven by weak economic growth and quantitative easing in Europe and Japan.** This led to fears that U.S. rates would also remain low and put pressure on bank and insurance company profit margins.

2. **Weak earnings from Deutsche Bank in Germany and uncertainty surrounding regulatory capital rules in Europe.** This uncertainty was interpreted by the market as increasing coupon deferral risk for European bank AT1 Contingent Convertible Securities (Coco) securities and other Tier 1 issues. Mixed and sometimes contradictory comments by several European regulators and issuers initially increased investor concern but the market rallied in late February and March after regulators announced several potential changes which would improve investor protection in the Tier 1 and AT1 Coco market.

3. **Investor fear of losses and write-downs associated with bank exposure to low oil prices and energy related companies in their loan and securities portfolios.** While many of these concerns are legitimate, their effect is relatively minor relating to bank credit fundamentals which continue to look very stable.

*Effective duration– A measure of a fixed-income security's sensitivity to changes in interest rates reflecting the expected change in price given a 100 basis point rise in rates, including the impacts of embedded options.

Figure 1. Hybrid Preferred Total Return Performance Relative to Other Indices.

Index	TICKER	AVG. RATING	EFFECTIVE DURATION* 1Q2016	1Q2016 Total Return	FY2015 Total Return	4Q2015 Total Return
BAC-ML Preferred Stock Fixed Rate	**P0P1**	**BBB2**	**4.41**	1.60%	7.58%	3.46%
BAC-ML U.S. Capital Securities	**C0CS**	**BBB1**	**5.17**	0.75%	0.86%	0.23%
BAC-ML Contingent Capital Index - Hedged	COCO	**BB1**	**3.58**	-2.48%	6.93%	3.73%
BAC-ML Contingent Capital Index - Unhedged	COCO	**BB1**	**3.58**	-1.70%	3.62%	2.79%
BAC-ML US Corporate	C0A0	**A3**	**6.87**	3.92%	-0.63%	-0.56%
BAC-ML US Cash Pay High Yield	J0A0	**B1**	**4.25**	3.23%	-4.55%	-2.09%
BAC-ML US Current 10 Yr Treasury	GA10	**AAA**	**9.22**	4.78%	0.91%	-1.44%
BAC-ML US Current 30 Yr Treasury	GA30	**AAA**	**21.73**	8.94%	-3.20%	-2.09%
BAC-ML US Mortgage Backed Securities	M0A0	**AAA**	**3.76**	1.95%	1.46%	-0.06%
BAC-ML US Municipal Securities	U0A0	**AA3**	**6.65**	1.64%	3.55%	1.72%
S&P 500	SPX	**N/A**	**N/A**	1.35%	1.37%	7.03%

Source: Stonebridge Advisors LLC, BAC-ML Research

After raising short-term interest rates in December and signaling an intent to raise rates several more times in 2016, the U.S. Federal Reserve (Fed) shifted gears substantially in 1Q16 following increased macroeconomic instability in January and sharply weaker equity markets early in the quarter. The Fed is now signaling a more dovish posture on rates and the market expects at most 1-2 rate hikes in 2016 depending mostly upon factors outside of the United States. The 10yr and 30yr Treasuries rallied sharply during the quarter, with the 10yr Treasury yield ending the quarter 0.50% lower at 1.77% and the 30yr Treasury yield 0.41% lower at 3.0%. Treasury 10yr and 30yr yields have continued to rally into early April and are now close to retracing their recent low levels of early 2015 and February 2016.

Figure 2. Performance by Duration Band.

	P0P1		C0CS	
Duration Bands	**Weighting**	**1Q 2016 TR**	**Weighting**	**1Q 2016 TR**
Eff Dur[0 - 3]	33.16%	1.02%	28.65%	-0.91%
Eff Dur[3 - 5]	18.83%	1.56%	11.00%	3.69%
Eff Dur[5 - 8]	37.52%	1.76%	41.38%	2.24%
Eff Dur[8 - 12]	10.26%	2.54%	18.51%	-2.10%
Eff Dur[>=12]	0.23%	7.74%	0.47%	1.28%
Grand Total	100.00%	1.60%	100.00%	0.75%

Source: Stonebridge Advisors LLC , BAC-ML Research

In This Issue:

In 1Q16, strength in longer-duration Treasuries was accompanied by outperformance of longer-duration preferred securities, particularly in the retail market. In contrast, intermediate-duration securities performed the best during the quarter in the institutional preferred market. In our opinion, credit spread movements were a much larger factor affecting performance of institutional securities given the higher weighting of non-US banks in the institutional index. Overall, the retail preferred market outperformed the institutional preferred market by 85 basis points (bps) during 1Q16, which was partly driven by another quarter of strong growth in retail preferred ETFs[1] assets of $1.1bn or 7.6% growth during 1Q16.

Figure 3. AUM Growth of Leading Preferred ETFs in Q1 2016.

	Growth (Millions)
FPE	$ 182.435
PFF	$ 274.644
VRP	$ 66.554
PGX	$ 547.852
PGF	$ (79.969)
PSK	$ 144.008

Source:Bloomberg

The financial sector, composed mostly of banks and insurance issuers, has the largest weighting in the preferred and hybrid market and has benefited from a stable to improving credit profile for most issuers. Despite credit-related volatility, this stable fundamental picture for financials has not changed. Moderate new issue volumes and large security redemptions in the preferred market also helped support technical demand as prices rallied in March. Credit spreads in the retail preferred market widened during 1Q16 to +428bps, compared to +368bps over the 10yr. U.S. Treasury at the start of the quarter, but most of this was driven by the 50bps yield rally in the 10yr. U.S. Treasury.

New Issuance Recap

New issuance volumes of USD preferred and hybrid securities totaled $25.1 billion for 1Q16, which is about $2 billion higher than 4Q15. Unlike past quarters, weakness in European bank credit sentiment led to diminished issuance of institutional fixed-to-floating rate hybrid structures. Approximately 64%, or $16.3 billion, of issuance in 1Q16 were institutionally targeted fixed-to-floating rate structures. Retail issuance was $8.8bn during the quarter, a figure which is nearly 3x the amount issued in Q4. Redemptions totaled approximately $18.6 billion in the 1st quarter, almost the same as 4Q15, but roughly $5bn in both of these quarters is accounted for by a General Electric preferred exchange done in December and again in January. This quarter was the first time for well over a year that new retail issues outpaced redemptions in the $25 par market. Low rates, particularly in Europe, continued to drive strong European and Asian investor participation in USD deals, driven by absolute yield differentials and the relatively strong U.S. dollar. A number of new issues, mostly from Asian issuers, were specifically targeted toward non-US investors and were unavailable for sale in the U.S.

[1]Includes iShares U.S. Preferred Stock ETF (PFF), PowerShares Financial Preferred Portfolio (PGF), PowerShares Preferred Portfolio (PGX), PowerShares Variable Rate Preferred Portfolio (VRP), SPDR Wells Fargo Preferred Stock ETF (PSK) and First Trust Preferred Securities and Income ETF (FPE).

Figure 4. Top 10 Retail and Institutional USD New Issues for 1Q 2016 (by $ AMT).

ISSUER	SECURITY DESCRIPTION	ID	COUPON	COUPON TYPE	PAR AMOUNT	DEAL SIZE ($MM)
RETAIL						
BANK OF AMERICA CORP	BAC 6.2	BAC/PC	6.2	FIXED	25	1,100
CITIGROUP INC	C 6.3	C/PS	6.3	FIXED	25	1,035
WELLS FARGO & COMPANY	WFC 5.7	WFC/PW	5.7	FIXED	25	1,000
EBAY INC	EBAY 6	EBAYL	6	FIXED	25	750
CHARLES SCHWAB CORP	SCHW 5.95	SCHW/PD	5.95	FIXED	25	750
GOLDMAN SACHS GROUP INC	GS 6.3	GS/PN	6.3	FIXED	25	675
BB&T CORPORATION	BBT 5 5/8	BBT/PH	5.625	FIXED	25	465
HUNTINGTON BANCSHARES	HBAN 6 1/4	HBANO	6.25	FIXED	25	400
KKR & CO LP	KKR 6 3/4	KKR/PA	6.75	FIXED	25	345
SCE TRUST V	EIX 5.45	SCE/PK	5.45	VARIABLE	25	300
INSTITUTIONAL						
GENERAL ELECTRIC CO	GE 5 12/29/49	369604BQ5	5	VARIABLE	1000	5,694
BNP PARIBAS	BNP 7 5/8 12/29/49	05565AAQ6	7.625	VARIABLE	1000	1,500
NIPPON LIFE INSURANCE	NIPLIF 4.7 01/20/46	654579AE1	4.7	VARIABLE	1000	1,500
UBS GROUP AG	UBS 6 7/8 12/29/49	JK4458820	6.875	VARIABLE	1000	1,500
CREDIT AGRICOLE SA	ACAFP 8 1/8 12/29/49	225313AJ4	8.125	VARIABLE	1000	1,250
OVPH LTD	CKINF 5 7/8 12/29/49	JK2151823	5.875	FIXED	1000	1,200
BANK OF AMERICA CORP	BAC 6.3 12/29/49	060505EU4	6.3	VARIABLE	1000	1,000
CLOVERIE PLC ZURICH INS	ZURNVX 5 5/8 06/24/46	JK5179706	5.625	VARIABLE	1000	1,000
FRANSHION BRILLIANT LTD	CHJMAO 6 12/29/49	JV8917041	6	VARIABLE	1000	500
HUANENG HK CAPITAL LTD	HUANEN 4.3 12/29/49	JV6800579	4.3	VARIABLE	1000	500

Source: Stonebridge Advisors LLC, Bloomberg

Comparing the Drivers of Financial Equity Market vs Preferred/Hybrid Market Performance

During 1Q16, weakness in the equity prices of global financials helped lead to generic weakness in prices of bank preferred and hybrid securities. The equity market weakness was driven by investor concerns about potentially weak bank earnings growth and their ability to grow dividends, repurchase stock and increase earnings per share in an environment of low interest rates, heavy regulation and slow economic growth. We believe that these concerns are substantially more negative for equity investors than debt or preferred investors where returns are primarily driven by interest or dividend income. The equity market is very heavily driven by forward earnings expectations while factors such as capital strength, balance sheet/funding liquidity, and asset quality (all relatively positive compared to the past) should be more important factors when analyzing a credit investment such as a preferred or hybrid security.

Our view is that bank earnings will be structurally lower than in the past, especially on an return on equity basis, due to margin pressure from low rates, larger minimum capital requirements, more limited trading business opportunities, and higher costs from regulation. We also believe that investment banking/wholesale focused banks are likely to see more pres-

sure from these factors than more traditional deposit taking banks dominated by retail/consumer/small business lending franchises. We generally prefer the latter type of banks in our investment strategies, especially where we find well-structured preferred securities that should protect us in most market scenarios with lower volatility. While we would love for banks to earn more in the future, we don't really want them to lever up and take on substantially more risk to do that! Having banks earn "utility"-like returns while remaining relatively low risk with less volatility is not so bad if you own their preferred stock or other capital securities, in our opinion.

The banks that are adapting best to this new world are those that have already shrunk their cost structures and narrowed their risk and business focus to those businesses where they have good market share or other types of competitive advantages. The laggards have been reluctant to restructure in the past and we believe may experience a period of very weak earnings while they cut costs and reorganize in the current environment. Ultimately most will succeed, but are likely to see above-average spread volatility and underperform in the near term, in our opinion. U.S. banks are generally ahead of the curve fundamentally compared to many of the European banks, but many of the hybrid structures we see from the European banks are more attractive than what we find in the U.S.

Investment Outlook

With recent economic data in the U.S. showing modest strength and low inflation while the rest of the world continues to show weak growth, we expect that interest rates in the U.S. will remain historically low despite several very gradual and tepid moves by the Fed to increase front-end rates. Since its December 2015 increase in the Fed Funds rate by 0.25%, the Fed has increasingly tempered its timetable for interest rate increases which is now dependent upon factors outside of the U.S. where rates are generally much lower. In this environment, we continue to see attractive yields on preferreds and hybrids relative to other parts of the fixed-income market. Part of this view is also driven by increased market and credit risk in competing sectors such as energy, commodities, and emerging markets debt. In contrast to those sectors, credit fundamentals in the financial sector should continue to support the preferred and hybrid market over the next year. Volatility in preferred and hybrids in 1Q16 was due mostly to regulatory uncertainty surrounding European Coco structures and coupon risk. However, in our opinion, the relatively brief sell-off in February is likely to change those regulations, which should prove supportive to hybrid investors. We expect that banks and insurance companies will continue to strengthen their capital ratios and reduce balance sheet risk in 2016. Yield spreads of preferred and hybrid securities relative to both U.S. Treasuries and other credit spread products remain wider than historical averages, which, in our opinion, should help drive positive performance in the asset class (Figures 5 & 6).

Figure 5. Comparison of Preferred Securities to Other Fixed-Income Asset Classes as of 3/31/16.

Index	TICKER	AVG. RATING	CURRENT YIELD (%)	OAS**	EFFECTIVE DURATION
BAC-ML Preferred Stock Fixed Rate	**P0P1**	BBB	5.93	177	4.41
BAC-ML Preferred Stock Adjustable Rate	**P0A0**	BBB+	4.73	N/A	N/A
BAC-ML U.S. Capital Securities	**C0CS**	BBB	6.16	307	5.17
BAC-ML Contingent Capital Index	**COCO**	BB+	7.05	539	3.58
BAC-ML US Corporate	C0A0	A-	3.98	170	6.87
BAC-ML US Cash Pay High Yield	J0A0	B+	7.19	693	4.24
BAC-ML US Current 10 Yr Treasury	GA10	AAA	1.65	N/A	9.22
BAC-ML US Current 30 Yr Treasury	GA30	AAA	2.56	N/A	21.73
BAC-ML US Mortgage Backed Securities	M0A0	AAA	3.49	28	3.76
BAC-ML US Municipal Securities	U0A0	AA-	4.28	7	6.65

Source: Stonebridge Advisors LLC, BAC-ML Research
**OAS – Option Adjusted Spread. A measure of the spread compensation a fixed-income investor receives - including the impacts of embedded options - for risks other than interest-rate risk, including credit risk and liquidity risk.

While the market has largely priced in the risk of modestly rising rates in 2016, this environment has created an investor preference for fixed-to-floating rate structures with less duration and convexity risk. One benefit of wider credit spreads is that the back-end reset spreads on new fixed-to-floating issues are more attractive and should limit potential extension risk. For this reason, most new issuance has been met with strong demand as buyers have been mostly long-term investors in search of yield and attractive structures, and many of the new issues offer a component of rate protection. The weakness and volatility in the high-yield bond market has also led to increasing demand from conservative, yield-oriented investors attracted to higher-rated and more stable hybrid securities from financial issuers. In all of our strategies, we focus on owning those issues with the best structures, including high back-end reset spread protection.

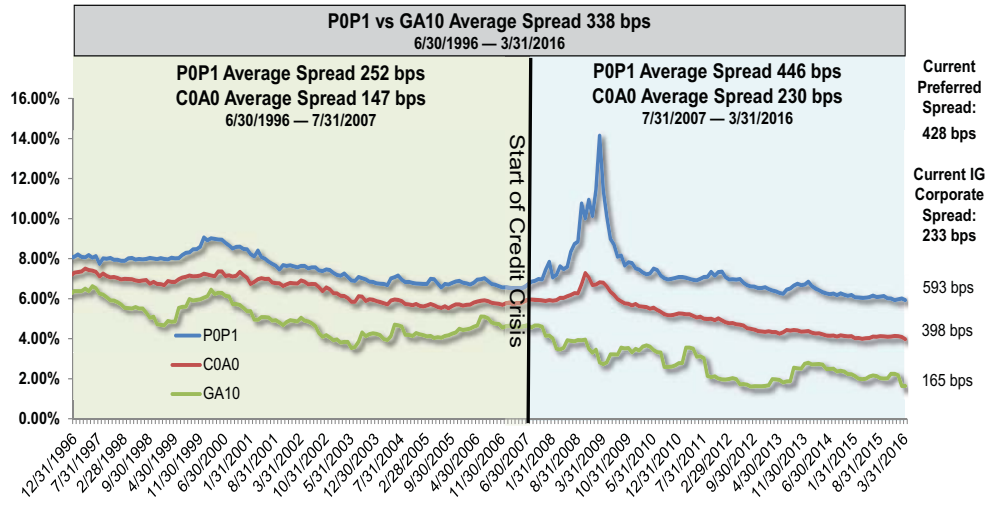
For the remainder of 2016, we expect a larger portion of new issues to be generated by non-U.S. issuers, particularly European banks issuing Cocos to meet AT1 regulatory capital requirements. The recent volatility in European names should modestly reduce the supply pressure and ensure the new issues are likely to be attractively structured in terms of back-end reset spreads. Much of this new AT1 Coco supply from Europe will be used to redeem older hybrid issues by the same issuers that no longer count as regulatory capital, so net new issuance should be modest. New preferred issuance by the largest U.S. Banks, which have been very active since 2013, is likely to drop by as much as 50% given that most banks have limited need for additional AT1 capital. Away from banks, we expect a larger number of smaller issuers and issues to target both the institutional and retail preferred markets for senior, subordinated and preferred level structures. In the $25 par retail market, we expect to see a modest uptick in issuance versus low levels in the past as rates remain low on an absolute basis. While increasing interest rates have generally been negative for the fixed-for-life dominated retail preferred market, the technical support provided by good investor demand, high redemptions and limited issuance is a strong offsetting factor.

Despite our expectation that rates remain fairly low by historical standards, we have maintained our conservative stance on interest-rate risk by continuing to increase our exposure to less interest-rate sensitive securities. We believe it is prudent to maintain durations shorter than the benchmark, particularly if we can do so while paying income comparable to the benchmark yield. We recognize, however, that as the preferred and hybrid market has appreciated, the benchmark duration has trended down to be closer to the duration on Stonebridge managed products. We believe the quality of our managed products and stability of duration is better than the benchmark given our lower exposure to negatively convex securities (such as securities trading at negative yield to calls and low coupon fixed-rate structures). As a result, we believe our portfolios should show more resilience in a market downturn and potentially outperform in a rising rate environment.

As a result, we continue to favor structures with good rate protection and high current yields. In the institutional market, we favor non-callable 5-year and 10-year fixed-to-floats with high reset margins. High reset margins are important because they potentially limit extension risk past the first call date and also ensure better price performance should a security extend and price off the reset margin. Fixed-rate securities with high current yields that we believe the issuer could refinance at a substantially lower cost of capital and that have attractive yield–to-calls (varies depending on the call date) are also attractive. We also like legacy Tier 1 regulatory capital securities issued by U.S. and European banks that are likely to be called in the next few years that have high current yields and also attractive yield to calls relative to senior debt securities in the same credits. Between 2016 and 2020, we expect to see many of these older Tier 1 securities get called and replaced with AT1 fixed-to-floating rate Coco securities, which are not issued in the $25 par retail market. In the institutional AT1 Coco market, we have been very selective and own issues with high back-end reset protection issued by banks with stable to positive credit profiles.

In terms of geographic exposure, we see U.S. bank names as safe havens but continue to see European bank and insurance names as attractive given their wider yields and attractive hybrid structures. In Europe, we remain selective in terms of issuers, and we favor banks and insurers with good credit and business fundamentals which are located in the stronger European markets such as the UK, Netherlands, France, Germany, Spain and Switzerland. We continue to have very little exposure to emerging markets issuers and are selective with respect to European banks with large emerging markets businesses. We also expect increased hybrid issuance by insurance companies who desire to boost their regulatory and rating agency capital ratios. Many insurance issues have attractive fixed-to-floating structures with good reset spreads and are often more senior in the capital structure than preferred stock. Despite the uncertainty around the outlook for U.S. rates, we believe that a slowly growing U.S. economy, stable to improving corporate credit, and limited supply continue to be supportive of the preferred and hybrid markets.

Figure 6. Historical Spread of Preferred Securities vs High Grade Corporate Bonds and the 10-year Treasury.



Preferred Securities are represented by the BofA Merrill Lynch Fixed-Rate Preferred Securities Index (P0P1) which tracks the performance of fixed-rate U.S. dollar-denominated preferred securities issued in the U.S. domestic market.

Investment Grade Corporate Securities are represented by the BofA Merrill Lynch US Corporate Index which tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market.

10-Year Treasuries are represented by the BofA Merrill Lynch Current 10-Year U.S. Treasury Index (GA10) which is comprised of the most recently issued 10-year U.S. Treasury note.

Source: Merrill Lynch, Bloomberg, Stonebridge Advisors LLC

Past performance is not indicative of future results and there can be no guarantee historical attractive spreads will continue into the future.

The first quarter performance for the Taxable Preferred Composite and the Tax-Advantaged QDI Preferred Composite are available upon request by contacting Stonebridge Advisors LLC at 203-762-0004.