STONEBRIDGE
Advisors LLC

An Introduction to Preferred Securities –
Market Primer, Overview and Outlook

Introduction

Stonebridge Advisors LLC, an affiliate of First Trust Portfolios L.P., has created this *Introduction to Preferred Securities* to help our clients and prospective clients better understand preferred securities (preferreds) and their fundamental characteristics. It is our hope that this primer will help you decide what role preferred securities should play in your investment portfolios.

Who should consider owning preferred securities?

In our opinion, investors seeking a fixed income product with above-average yields, relatively stable income, ratings averaging investment grade, and portfolio diversification benefits should consider preferreds as a core part of their investment portfolio. The low correlation of preferreds to other asset classes can potentially reduce portfolio volatility. It is important to note that diversification does not guarantee a profit or protect against a loss.

What are preferred securities?

Preferreds are a commonly overlooked asset class within the investment universe. Investors often refer to this asset class as hybrid securities (hybrids), as these securities offer a hybrid mix of debt and equity characteristics. Debt characteristics include scheduled coupon payments, defined par amounts and credit ratings. Equity characteristics include perpetual or long-dated terms, lower priority in the capital structure and discretionary or deferrable dividend/interest payments.

Securities that fall under the preferreds category include traditional preferred stock, trust preferreds, subordinated and junior subordinated hybrid securities, and contingent convertible (CoCo) securities. Additionally, there are senior debt securities, known as baby bonds, issued in the $25 par retail form. Despite not sharing the traditional features of preferred and hybrid securities, baby bonds are considered part of the preferred securities market because of their $25 par structure.

Who issues preferred securities and why?

Companies typically issue preferreds for either regulatory or rating agency equity capital credit. Banks account for roughly 50% of the preferred market, as global bank regulatory capital standards allow preferreds to comprise a portion of Tier 1 capital, which represents the highest quality of bank capital. Insurers, financial service companies, real estate investment trusts (REITs) and utilities are common issuers of preferreds as well.

A deeper look at preferreds – features and varieties

While preferreds exhibit hybrid characteristics of debt and equity, they are best defined as a fixed income credit product (like a corporate bond) with equity-like features. To qualify as regulatory or rating agency equity capital, a security must address three main regulatory/rating agency concerns: permanence of capital, loss-absorption and coupon/dividend discretion.

Permanence of capital

Preferred terms can range from 30 years to perpetual. Long terms reflect more permanence within the issuer's capital structure. To maintain this permanence, regulators and rating agencies may remove capital treatment within a certain number of years of maturity.

This paper was prepared by Stonebridge Advisors LLC and reflects the current opinion of the authors. It is based on sources and data believed to be accurate and reliable. Opinions and forward looking statements are subject to change without notice.

Loss absorption

Loss absorption increases the lower a security resides in the capital structure. The lower position in the capital structure reflects a subordinated priority of creditor claim in bankruptcy or regulatory resolution. Subordinated capital provides some protection for creditors higher in the capital structure. Common equity represents the lowest part of the capital structure, and provides maximum loss absorption for the benefit of all other creditors. Preferreds typically sit between common equity and senior debt in the capital structure and thus represent subordinated capital that can receive favorable regulatory and rating agency capital treatment.

Coupon/dividend discretion

Flexibility in paying coupons/dividends is another important equity-like feature that distinguishes preferreds. Regulators and rating agencies will look for issuer discretion in paying coupons/dividends, and this will typically mean that the issuer can defer the payment of coupons/dividends without defaulting. Cumulative coupons/dividends will accumulate while issuers defer payment, and would thus be eventually paid retroactively if/when the issuer reinstates payments. Non-cumulative dividend/interest payments that are deferred will not be paid retroactively if/when the issuer reinstates payments. Historically, deferral of coupons/dividends has been a rare occurrence in the preferreds market.

Bank issuers – preferred stock vs. CoCos

Issuers generally have various options to address the primary regulatory/rating agency concerns when structuring a preferred security. However, banks are fairly restricted, as security structures are prescribed by bank regulation. As mentioned above, global bank regulatory capital standards allow preferreds to comprise a portion of Tier 1 capital. U.S. banks are limited to Dividend Received Deduction (DRD)/Qualified Dividend Income (QDI) preferred stock, while non-U.S. banks are limited to CoCos. Preferred stock and CoCos are both perpetual with non-cumulative, deferrable dividends and coupons, thereby addressing permanence and dividend/coupon discretion similarly.

Bank preferred stock and CoCos differ with respect to loss absorption in distressed situations. In the event of a bank failure and resolution, regulators have the ability to impose principal losses in a similar fashion on both instruments in order to recapitalize the bank. However, CoCos may suffer principal losses prior to bank failure if a bank's capital level drops below a specified trigger level, thus triggering the "contingent conversion" into either equity or some degree of principal write-down. Although preferred stock will not contain such explicit triggers, there is an implicit risk of regulatory intervention in preferred stock should a U.S. bank's capital level drop below typical CoCo capital trigger levels. As a result, investors may view regulatory treatment as more clear and explicit in CoCos relative to preferred stock.

Banks and regulators seek to limit the risk of conversions and regulatory intervention by holding/requiring capital levels significantly above trigger levels. As a result, conversion and regulatory intervention is generally a remote risk across the majority of bank issuers in the preferred market and historically the risk of a write-down or default has been very low.

Non-bank issuers

Non-bank issuers have relatively more flexibility in issuing preferreds with various features, as they are typically seeking a certain degree of rating agency equity capital credit. Different mixes of features (i.e. perpetual vs. dated maturities, cumulative vs. non-cumulative, subordinated vs. deeply subordinated) can yield varying percentages of equity capital credit from the rating agencies. As a result, we tend to see a wider variety of hybrid structures from non-bank issuers.

We also note that certain insurers operating within the European Union (EU) may also seek regulatory treatment for Tier 1 or Tier 2 capital within the EU insurance solvency regime (i.e. Solvency II), so we tend to see a wider variety of hybrid structures from this group as well.

U.S. tax treatment of dividends

Dividends that are paid out of after-tax income may be eligible as QDI for individual investors, and thus may provide tax advantages for investors. Those paid by U.S. issuers are also eligible for the DRD for corporations. All securities that pay DRD-eligible dividends are QDI eligible; however, not all QDI-eligible dividends are DRD-eligible.

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Figure 1. Types of Preferred Securities

	Hybrid	Contingent Convertible (CoCo)	DRD/QDI Preferred	Retail Baby Bonds	REIT Preferred	Trust Preferred
Typical Capital Structure Position	Subordinated, Junior Subordinated	Junior Subordinated	Preferred Stock	Senior	Preferred Stock	Junior Subordinated
Market Type	$25 or $1000 Par	$1000 Par	$25 or $1000 Par	$25 Par	Typically $25 Par	$25 or $1000 Par
Payment Dividend / Interest	Interest	Interest	Dividend	Interest	Dividend	Typically Interest
US Tax Treatment	Some DRD/QDI	Generally Fully Taxable, Some QDI	DRD/QDI	Fully Taxable	Fully Taxable	Typically Fully Taxable
Payment Deferral Option	Yes	Yes	Yes	No	Yes	Yes
Cumulative / Non–Cumulative	Cumulative or Non-Cumulative	Non-Cumulative	Mostly Non-Cumulative	N/A	Cumulative	Cumulative
Term	Final Maturity	Perpetual	Perpetual	Final Maturity	Perpetual	Final Maturity

Source: Stonebridge Advisors LLC

The importance of coupons and call structures

Coupon type and call options are notable terms that can differentiate preferred security structures and provide investors opportunities to adjust effective duration and manage extension risk within their portfolios.

Coupon type

Historically, fixed-rate, or more commonly referred to as “fixed-for-life”, coupon structures dominated the preferreds universe. All else equal, these securities tend to exhibit greater interest rate risk than alternative coupon structures. Over time, adjustable-rate and variable-rate coupons have gained in prominence within the preferreds market. Adjustable-rate securities, or “floaters,” offer coupon rates that adjust periodically and are tied to a specific index rate. Typically, floaters carry a margin, or spread, over the three-month London Interbank Offered Rate (LIBOR) or a comparable short-term benchmark rate, and can be used as a hedge against rising interest rates.

Today, a more common coupon structure is the <u>variable-rate coupon</u>, which is most prevalent in the $1000 par institutional market.

- Variable-rate coupons carry a fixed interest rate for a specified time period, typically 5 to 10 years until the first call date.
- After the initial fixed rate period, if the security is not redeemed, the coupon will reset periodically at a predefined spread (reset spread) over a specified benchmark rate (usually 5-year U.S. Treasuries or interest rate swaps) for the remaining life of the security.

Variable rate securities with coupon structures that reset periodically (typically every 3 months) to a short term benchmark rate are commonly referred to as fixed-to-float securities, while variable rate coupon structures that reset to another fixed rate period (typically 5 or 10 years) are referred to as fixed-to-fixed securities. The diagram below provides an example of a 5-year U.S. Treasury (UST) fixed-to-fixed variable-rate coupon structure:

Figure 2. Variable Rate Coupon Example – 5-Year Coupon Reset with a 5-Year U.S. Treasury Benchmark

<u>New Deal Pricing</u>	⇨	<u>Year 5 (if NOT called)</u>	⇨	<u>Year 10 (if NOT called)</u>
Initial Coupon = 6.00%		UST 5yr = 3.00%		UST 5yr = 2.50%
UST 5yr = 2.75%		Reset Spread = 3.25%		Reset Spread = 3.25%
Reset Spread = 3.25%		**New Coupon = 6.25%**		**New Coupon = 5.75%**

Variable-rate structures can be advantageous for managing interest rate risk, as the rate duration is limited to the initial fixed-rate period and the periods between coupon resets. Most securities in the preferred and hybrid securities market are redeemed at or around their first call dates and only around 7.5% of the market is currently floating, as of 3/31/22.

Call options

The majority of preferreds have an issuer par call feature within 5 to 10 years of the issuance date. Call options, particularly when combined with adjustable-rate coupons, also allow investors opportunities to adjust duration within their portfolios. The par call feature typically shortens effective duration, providing investors a variety of effective duration choices within the preferreds market.

Extension risk

Extension risk is the risk that a security is not called on its first call date. This risk varies for different coupon structures. For fixed-for-life securities, market interest rate risk will often play a more influential role on extension risk. In contrast, extension risk in variable-rate securities tends to reflect the credit spread differential between where the issuer can refinance in the market and the reset spread on the existing security after the fixed coupon period ends. Put another way, if the issuer cannot refinance with a credit spread near or tighter than the reset spread on the existing issue, then extension risk increases.

Extension beyond the initial call date may have a negative impact on the price if the coupon is materially lower than current market coupon rates.

Coupon type, call options and extension risk represent a number of structural factors that affect preferreds valuations, and thus require diligent review of security documents to fully understand preferred structures and the implications of changing interest rates.

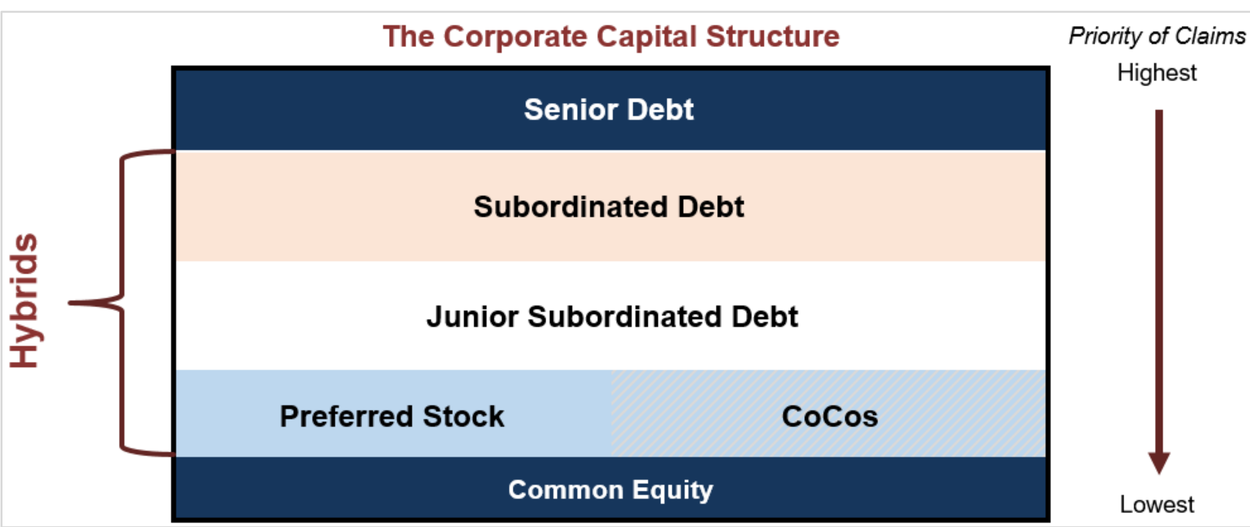
During periods of declining interest rates, longer duration and fixed-for-life securities historically outperform the overall preferreds market. In contrast, in a rising interest rate environment, variable-rate securities with lower duration historically outperform the overall preferreds market.

Understanding credit risk and security ranking

Issuer credit fundamentals and security ranking are critical considerations when investing in preferreds. The majority of preferreds are assigned a credit rating by one or more of the major rating agencies. Credit ratings from AAA down to BBB- are considered "investment grade" (IG). Credit ratings below BBB- are considered non-investment grade. Higher credit ratings imply a relatively lower probability of default and deferral of dividend/interest payments. However, a glance at credit ratings alone may not adequately paint the picture of an issuer's financial condition. A deeper credit analysis is often required to fully understand issuer credit risk.

When analyzing credit risk, the ranking of a security in the capital structure, as illustrated in Figure 3, is important in terms of claims on principal and interest payments. As discussed in the loss absorption section herein, a lower position in the capital structure reflects a subordinated priority of creditor claim in bankruptcy or regulatory resolution.

Figure 3. Typical Capital Structure



Source: Stonebridge Advisors LLC

Retail vs. institutional securities

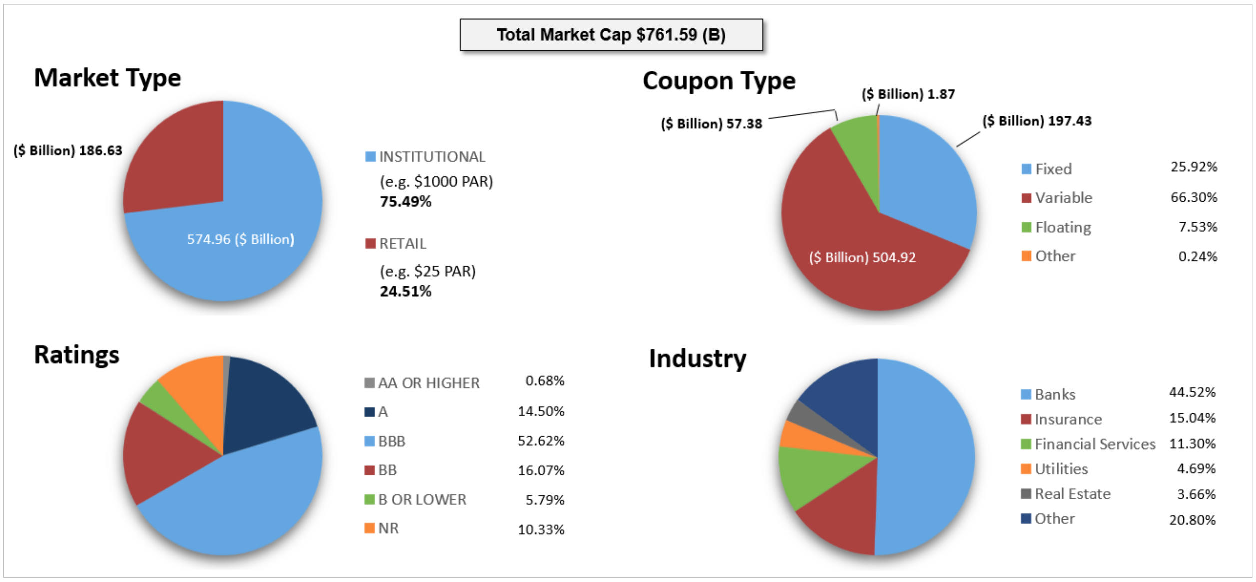
Preferred securities in USD are issued to both retail investors directly and to institutional investors. Traditionally, retail securities are issued in $25 par formats, list on a stock exchange and trade on a per share basis. In contrast, institutionally targeted securities usually have $1,000 par formats, are traded over-the-counter rather than via an exchange and often have larger minimum holding sizes between $1,000 and $200,000.

The $25 par retail market is mostly characterized by fixed-for-life perpetual or long maturity structures. In contrast, the $1,000 par institutional market is dominated by variable-rate structures. For issuers, the institutional market can often be more appealing due to lower issuance costs and larger deal sizes, but issuers may pivot from one market to the other depending on the relative attractiveness.

Market composition

The size of the USD preferred and hybrid securities market is approximately $762 billion as of March 31, 2022, split roughly 75% institutional and 25% retail (see figure 4). The majority of issues have variable-rate structures, and over two-thirds of the market is rated investment grade. As discussed above, financials comprise the largest proportion of the market by industry (~80%), with banks alone accounting for half of all preferreds and hybrids. Historically, U.S. banks dominated the preferred securities market. However, there has been an increasing amount of issuance by non-U.S. banks (mostly European) in USD in recent years, driven by increasing global regulatory capital needs.

Figure 4. Preferred Securities Market Characteristics – US$ denominated issues



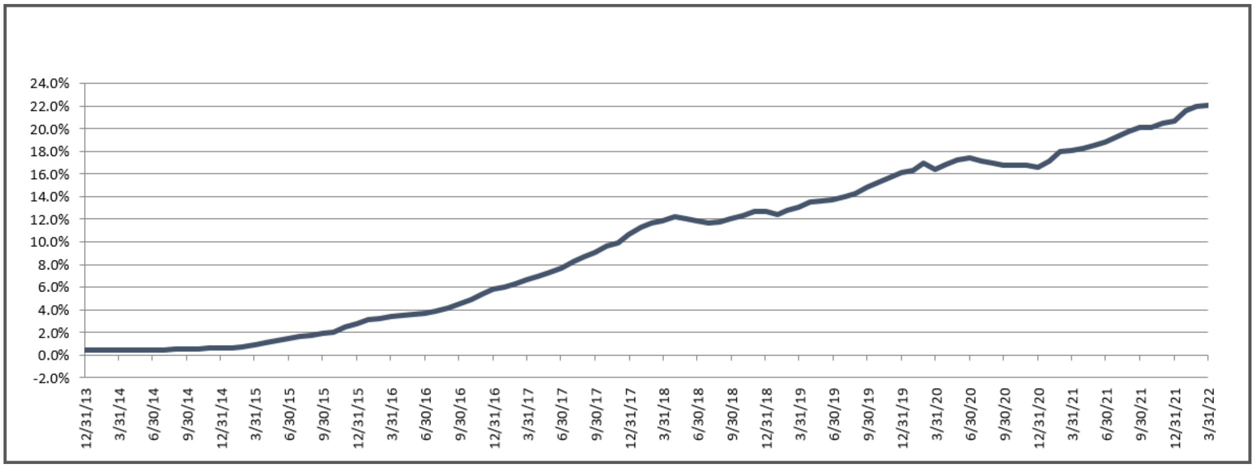
Source: Bloomberg and Stonebridge Advisors LLC as of 03/31/2022. Includes all USD Preferreds, Hybrid Securities, and other securities reported on Bloomberg or otherwise known to Stonebridge, that have an initial market capitalization of at least $25 million and trade on the preferred and hybrid securities desks on Wall Street. Ratings are based on the highest rating available from eligible NRSROs.

The increasing role of ETFs

Passively managed exchange-traded funds (ETFs) that focus on the $25 par retail preferred securities market have grown substantially in recent years. In some cases, these ETFs can own large proportions of individual retail issues. As these passive ETFs experience inflows and outflows, their trading activity in individual issues can create dislocations in pricing and relative value to comparative securities.

Additionally, actively managed preferred securities ETFs have grown in popularity, which allow the fund managers to attempt to take advantage of alpha-generating investments, such as pricing dislocations, as well as out of benchmark opportunities.

Figure 5. Active ETFs % of Total Preferred and Hybrid Securities ETF Market



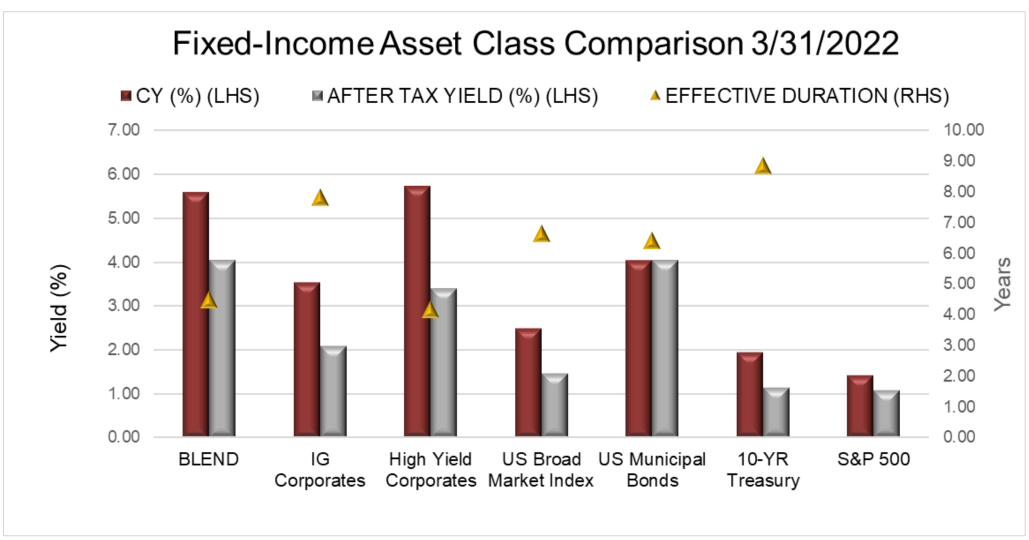
Source: Bloomberg and Stonebridge Advisors LLC as of 3/31/2022

Preferred securities offer the potential for an attractive source of income

The incremental yield potential offered by preferreds over investment-grade securities is significant (See Figure 6). The preferred and hybrid investment universe is represented by The Preferred Full Market Blend Index (BLEND), this is a custom index comprised of a combination of indices from ICE Data Services, including 30% P0P4 (IG and non-IG $25 par retail securities), 30% CIPS (IG $1000 par institutional securities), 30% CDLR (IG and non-IG non-US bank CoCos), and 10% HIPS (non-IG $1000 par institutional securities). This breakdown roughly matches the proportional market cap of each market segment within the preferred and hybrid universe.

The BLEND Index carries an average credit rating of BBB3 and has achieved an annualized return of 4.06% for the past 5 years through March 31, 2022. Investment-grade corporates with an A3 average credit rating, as represented by the ICE BofA Corporate Master index (C0A0), are the next closest investment-grade product with an annualized return of 2.1% over the same time period. On an after-tax basis, for an individual investor in the highest Federal tax bracket, preferreds remain attractive, providing nearly 2.0% excess yield versus IG corporates.

Figure 6. Yield Comparison of Various Fixed-Income Asset Classes



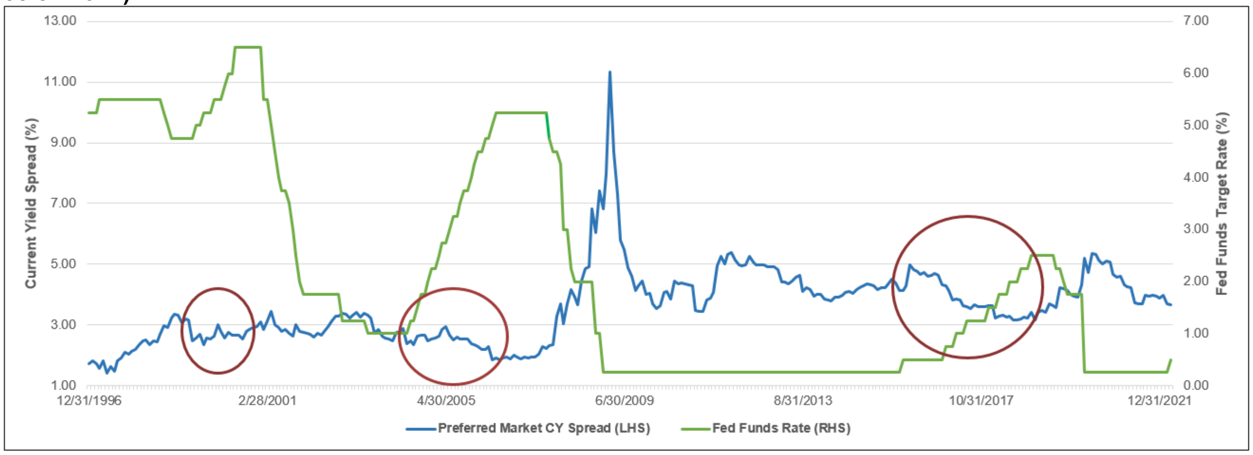
Source: ICE Data Services, Stonebridge Advisors and Bloomberg

* Preferred Securities are represented by a custom index containing 30% P0P4, 30% CIPS, 30% CDLR & 10% HIPS.

Assumes 40.8% Federal Tax Rate, no state tax. QDI eligible securities are determined by Bloomberg and Stonebridge. See the Glossary for index definitions at end of primer. Index statistics are based on the "new" index holdings after the 03/31/2022 rebalance**. Past performance is not a guarantee of future results.** For illustrative purposes only and not indicative of any investment.

Preferreds are also attractive when compared to traditional high-yield investments. The ICE BofA U.S. Cash Pay High Yield Index (J0A0) carries an average credit rating of B1. J0A0's current yield is slightly higher than the BLEND at 5.74%, but on an after-tax basis it is approximately 0.66% lower for an individual investor in the highest Federal tax bracket, and is composed of substantially lower-rated securities. As shown in Figure 7, preferred securities current yield (CY) spreads over 10-year Treasuries have tightened by an average of 34 basis points during the last three Federal Reserve (Fed) tightening cycles. This spread tightening along with the high income offered by preferreds can help cushion total returns from rate and market volatility.

Figure 7. Historical spread of preferreds vs. 10-year Treasuries during Fed tightening cycles (12/31/1996 – 03/31/2022)



Source: ICE Data Services and Stonebridge Advisors LLC.
Preferred securities are represented by a blend of ICE indices (30% P0P4 / 30% CIPS / 30% CDLR / 10% HIPS). Please see the Glossary for index definitions at the end of the primer. Investment Grade Corporate Securities are represented by the ICE BofA US Corporate Index (C0A0). 10-Year Treasuries are represented by the ICE BofA Current 10-Year U.S. Treasury Index (GA10). **Past performance is not a guarantee of future results**. For illustrative purposes only and not indicative of any investment.

Correlation of preferred securities to other asset classes

Preferreds may provide added balance to an asset allocation strategy. The historical correlation between preferreds and many other asset classes is relatively low, as illustrated by Figure 8.

Figure 8. Correlation of Preferred Securities to Other Asset Classes (03/31/2002 – 03/31/2022)

INDEX	ICE BofA Fixed-Rate Pfd Securities	ICE BofA U.S. IG Institutional Capital Securities	ICE BofA U.S. Municipal Securities	ICE BofA U.S. Corporate	ICE BofA U.S. Cash Pay High Yield	ICE BofA Current 10-yr U.S. Treasury	S&P 500	ICE BofA U.S. Convertible Bond
ICE BofA Fixed-Rate Preferred Securities	1.00							
ICE BofA U.S. Investment Grade Institutional Capital Securities	0.65	1.00						
ICE BofA U.S. Municipal Securities	0.33	0.38	1.00					
ICE BofA U.S. Corporate	0.50	0.72	0.66	1.00				
ICE BofA U.S. Cash Pay High Yield	0.49	0.68	0.34	0.63	1.00			
ICE BofA Current 10-yr U.S. Treasury	0.09	0.10	0.53	0.53	-0.17	1.00		
S&P 500	0.42	0.48	0.02	0.31	0.70	-0.33	1.00	
ICE BofA U.S. Convertible Bond	0.37	0.52	0.18	0.46	0.78	-0.25	0.83	1.00

Source: Stonebridge Advisors LLC, ICE Data Services. See the Glossary for index definitions at the end of this primer.

The value of investing with Stonebridge Advisors LLC

Investment team

Stonebridge is one of only a few firms that truly specialize in preferred and hybrid securities. The investment team has an average level of experience of 20 years, with the CEO having specialized in preferred securities for the majority of his 40-year career and the CIO spending the majority of his 22-year career dedicated to the asset class. This experience has allowed Stonebridge to navigate through various market cycles and deal with the many nuances specific to the preferred securities market. In order to manage preferred securities with consistent success, it is our belief that there should be a singular focus on the preferreds market.

Key members of the investment team are:

Scott Fleming, *Founder, President, Chief Executive Officer*
Robert Wolf, *Executive Vice President, Chief Investment Officer*
Eric Weaver, *Executive Vice President, Chief Strategist, Portfolio Manager*
Angelo Graci, *CFA, Executive Vice President, Head of Credit Research, Portfolio Manager*
Allen Shepard, *PhD, Vice President, Senior Risk and Portfolio Analyst*
Connor Fleming, *CFA, CIPM, Vice President, Senior Analyst*
Scott Hubbell, *CFA, Vice President, Senior Analyst*
Jeff Vinca, *Vice President, Senior Trader*
Marie-Belle Mikue, *Senior Analyst and Trader*
Celeste Guerrero, *SMA Trader*

Investment philosophy

The Stonebridge investment philosophy is rooted in our commitment to our clients and attention to risk management. We add value through comprehensive analysis of financial markets and individual investment opportunities. In addition to thorough fundamental analysis, we draw upon our experience and understanding of the asset class and its unique structures to take advantage of market inefficiencies using an active management approach. Although past performance is never a guarantee of future performance, adhering to our conservative and disciplined principles has resulted in consistent and superior investment returns for our clients.

Our fundamental investment philosophy in managing tax-advantaged and taxable preferred securities is to obtain an attractive total return while preserving capital. Stonebridge purchases diversified portfolios of high-quality preferred securities and seeks to manage duration through active portfolio management and/or by employing a cross hedge (depending on mandates in a client's investment guidelines). All securities that Stonebridge purchases must first be evaluated based on relative value analysis, credit fundamentals, and market technical analysis.

Stonebridge advantages

Experience – Stonebridge's experienced investment team has successfully navigated through a variety of market conditions:

- Rising interest rates
- Credit events
- Overload of demand or supply of new issues
- Tax law changes
- Changes in regulatory capital treatment of preferreds

Style – Stonebridge employs a conservative investment style that has achieved consistently strong results for clients in various market types. Our repeatable and disciplined investment process is hinged on a bottom-up security selection process that includes credit fundamental, relative value and market technical analysis.

Performance – Past performance is no guarantee of future performance. Stonebridge has been able to perform for clients in both bull and bear markets, achieving relative strong outperformance as demonstrated by our performance track record.

Glossary

Qualified Dividend Income (QDI) – For individuals, dividends from U.S. corporations and qualified foreign corporations on securities held for a minimum of 91 days, during the 120-day period beginning 60 days before the ex-dividend payment, receive favorable tax treatment and are considered Qualified Dividend Income (QDI). The maximum QDI tax rate is 23.8% (20% Qualified Dividend Tax and 3.8% Unearned Income Medicare Contribution Tax).

Dividend Received Deduction (DRD) – For corporations, Dividend Received Deduction (DRD) currently allows corporations to deduct 50% of the dividend income from taxation as long as shares are held for a minimum of 46 days.

Effective Duration – Effective Duration gives a measure of the percentage change in the price of a security resulting from a given shift in interest rates. It is distinguished from other similar measures such as Modified Duration in that it can be applied to securities with variable cash flows such as a bond with an embedded option.

Index Definitions

Custom Preferred Full Market Blend (BLEND) – ICE BofA Custom Blend Index – 30% P0P4 / 30% CDLR / 30% CIPS / 10% HIPS

ICE BofA Fixed-Rate Preferred Securities Index (P0P1) – tracks the performance of investment-grade only, fixed-rate U.S. dollar-denominated preferred securities issued in the U.S. domestic market.

ICE BofA Core Plus Fixed-Rate Preferred Securities Index (P0P4) – tracks the performance of fixed-rate U.S. dollar-denominated preferred securities issued in the U.S. domestic market.

ICE BofA USD Contingent Capital Index (CDLR) – a subset of the ICE BofA Contingent Capital Index (COCO), focusing on all securities denominated in US dollars. COCO tracks the performance of contingent capital securities that are investment grade and below investment grade publicly issued in the major domestic and eurobond markets.

ICE BofA U.S. Cash Pay High Yield Index (J0A0) – tracks the performance of U.S. dollar-denominated below investment-grade corporate debt, currently in a coupon-paying period, that is publicly issued in the U.S. domestic market.

ICE BofA U.S. Municipal Securities Index (U0A0) – tracks the performance of U.S. dollar-denominated investment-grade tax-exempt debt publicly issued by U.S. states and territories, and their political subdivisions, in the U.S. domestic market.

ICE BofA U.S. Corporate Index (C0A0) – tracks the performance of U.S. dollar-denominated investment-grade corporate debt publicly issued in the U.S. domestic market.

ICE BofA U.S. Investment Grade Institutional Capital Securities Index (CIPS) – tracks the performance of U.S. dollar-denominated investment grade hybrid capital corporate and preferred securities issued in the U.S. domestic market.

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

ICE BofA U.S. Mortgage-Backed Securities Index (M0A0) – tracks the performance of U.S. dollar-denominated fixed rate and hybrid residential mortgage pass-through securities publicly issued by U.S. agencies in the U.S. domestic market.

ICE BofA Current 10-Year U.S. Treasury Index (GA10) – a one-security index comprised of the most recently issued 10-year U.S. Treasury note.

S&P 500 Index (SPX) – a stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or Nasdaq.

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