Preferred securities: Resetting for a new cycle

Recent bank turbulence and the end of the Fed's rate-hiking cycle create what we believe may be an exceptional buying opportunity for preferreds

by **William Scapell, CFA** and **Elaine Zaharis-Nikas, CFA**

KEY TAKEAWAYS

Deep discounts and high yields represent uncommon value

Preferreds today are trading at discounts to par value not seen since the global financial crisis. High-quality preferreds also offer some of the highest yields in fixed income, with 6–9% income rates.

Regulatory tailwinds could be supportive of credit

Recent bank failures were idiosyncratic, not symptomatic of issues underlying the banking sector. Resulting tighter regulations are expected to benefit preferred shareholders in the long run.

End of the Fed's rate increases may be a powerful catalyst

Preferreds have historically generated significantly above-average total returns after market corrections and after the end of rate-hiking cycles.

Deep discounts represent uncommon value

The Federal Reserve's determined efforts to tame inflation have created what we believe is a rare opportunity in preferred securities. The steepest rise in short-term interest rates since the Volker era, coupled with recent bank failures connected to the rate cycle, has put heavy pressure on preferred prices. As a result, the securities are trading at deep discounts to par value (Exhibit 1).

Historically, preferreds have traded, on average, around par value and often at a premium. But rising rates and uncertainty about the health of the banking sector have tarred issuers of these securities—across various sectors—with the broad brush of fear. We believe concerns are mostly unwarranted, considering the healthy fundamentals of the companies.

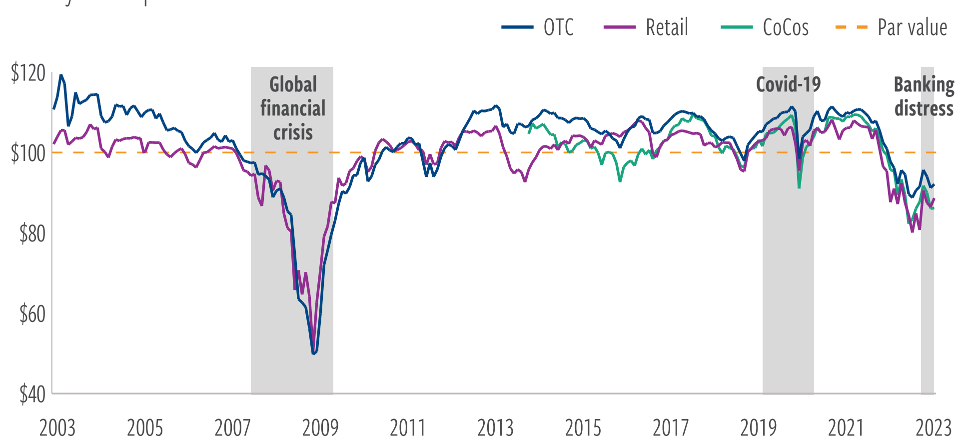
With segments of the preferreds market currently trading, on average, around 86 cents on the dollar—discounts not seen since the global financial crisis (GFC)—a substantial capital appreciation opportunity exists for investors, in our view. As we discuss in more detail below, catalysts include a calming of market fears around banks; a change in the interest rate cycle in coming months; and new, tougher bank regulation, which we think will supply a tailwind to bank credit in coming years.

EXHIBIT 1

Preferred securities offer deep discounts to par value

Historical average prices by preferreds market

January 2003–April 2023



	OTC	Retail	CoCos
Average price	$92.10	$88.63	$86.16
Discount to par value	(7.9%)	(11.4%)	(13.8%)
Historical average premium/discount to par[a]	2.4%	(0.9%)	1.7%

At April 30, 2023. Source: Bloomberg, Cohen & Steers.

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High-quality preferreds offer some of the highest yields in fixed income

The capital appreciation opportunity aside, preferreds offer yields superior to other fixed income categories (and currently higher than their historical averages). Yields were recently 7.65% for investment-grade OTC securities, about 8.65% for contingent capital (CoCo) issues (BB weighted-average rating), and 6.35% for the much smaller investment-grade retail market (Exhibit 2).

Given our view (shared by the market) that inflation will continue to trend lower, we believe preferred yields of 6–9% have great appeal for term fixed income allocations, representing equity-like long-term return potential—and made even more attractive by preferreds' position above equity in the capital structure.

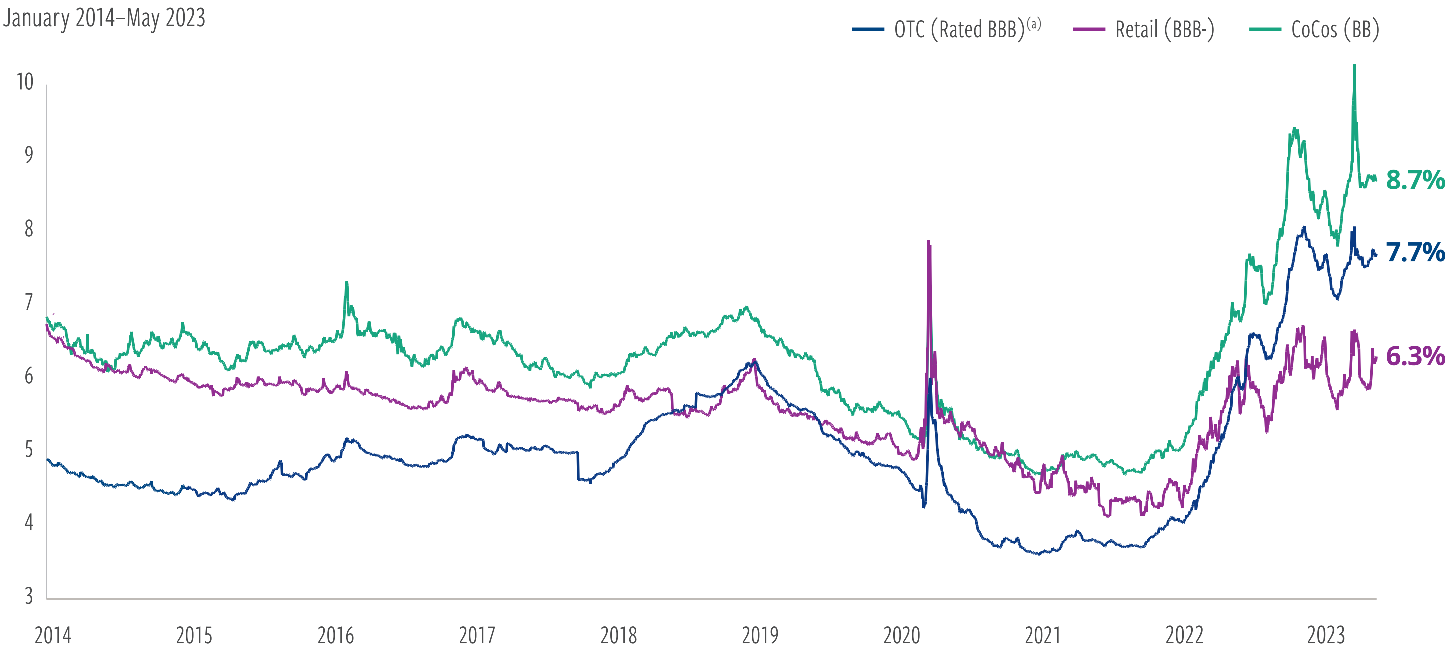
Income has traditionally been the most significant driver of bond returns, and quality preferred securities have historically out-earned investment-grade debt, leading to material outperformance for long-term investors. Unlike with high-yield bonds, preferreds' high income potential does not come at the expense of quality (as most issuers are investment-grade companies).

EXHIBIT 2

High income represents term value

Yield to maturity (%)

January 2014–May 2023



At May 15, 2023. Source: Bloomberg.

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How we got here: Particular circumstances of failed banks are not likely to be repeated

Despite what have often been dire headlines, we do not believe we are witnessing anything akin to the global financial crisis—far from it. Recent failures at a small number of specialized U.S. banks stemmed from poor management of quantitative easing excesses, which were exposed by the rapid change to quantitative tightening as central banks grappled with inflation. In contrast to the GFC, broad credit excesses are not an issue; nor is bank capital, which is far above historical averages and in keeping with the much higher regulatory requirements implemented following the GFC.

Silicon Valley Bank (SVB), Signature Bank and First Republic Bank, which failed recently, shared certain characteristics. Notably, they experienced extreme deposit growth during the Fed's quantitative easing phase—over 75% since 2020—and had highly concentrated depositor bases. In addition, they invested their substantial deposit flows into longer-term securities when rates were low. As a result, although the securities purchased were high quality, the holdings fell in value when the rate cycle ferociously turned, creating an asset/liability mismatch and (unrealized) capital weakness.

Weakened bank supervision notably contributed to the banks' failures, as GFC-era enhanced supervisory procedures were relaxed by Congress in 2018 for all but the largest banks. Among the many material changes that followed, securities market-to-market rules were relaxed, allowing unrealized capital drawdowns to form even in available-for-sale books. In the case of the failed banks, those drawdowns were very large, materially impacting capital and leaving these institutions vulnerable.

Broad credit excesses are not an issue in the banking sector; nor is capital, which is far above historical averages.

We believe these particular characteristics of the failed banks are not widely shared in the U.S. banking system. For one, most banks experienced far smaller deposit growth in recent years, generally in the single- to low double-digits. Just as important, most banks did not invest heavily in longer-dated securities when overnight rates were low. Consequently, they are well capitalized even net of securities marks.

As a general matter, deposits and overall funding across the broader banking industry are much more diversified than in the failed banks, with more stable deposit bases characterized by generally longer-term depositor relationships. With their first-quarter results, the majority of banks (including regionals) reported somewhat unremarkable deposit trends (1–3% increases or decreases)—nothing like the deposit outflows at the banks that failed. As well, other funding sources appear ample relative to uninsured deposits for most banks.

Credit Suisse was also an outlier

Turning to non-U.S. banking turmoil, we believe that Credit Suisse (CS) was also an outlier, but for somewhat different reasons. Unlike other large European banks, CS struggled in recent years with very weak profitability following large credit losses and litigation issues in 2021. With the unrelated failures of the U.S. banks further unnerving CS clients and investors, funding and franchise erosion became critical. Swiss authorities facilitated the merger of CS with UBS and took the unusual step of ordering a complete and permanent write-down of CS's contingent capital securities. This raised investor concerns regarding CoCos generally.

We do not view other large European banks as having anywhere near CS's level of vulnerability. In fact, capital and funding in Europe's largest banks are superior to those of many U.S. institutions. Whereas U.S. regulations were weakened in recent years, European banks were forced to maintain strong balance sheets; they continued to mark available-for-sale securities to market, prudently managing assets and liabilities. Also, unlike the U.S. banks that failed, European banks generally experienced only very modest deposit growth in recent years. Hence, they have not suffered from the excesses of quantitative easing, as the failed U.S. banks did.

Risk to bank earnings, but not to viability

While investor concerns are elevated, we believe the risks for most banks relate mainly to earnings, not viability. Hence, we believe the recent pressure on bank stocks seems more warranted than that on their preferreds.

We note three bank earnings pinch points:

- **Funding costs are likely to rise.** Given heightened concerns, some depositors may move money out of deposits and into money market funds and other investments. Banks might switch some funding to costlier sources, such as bonds and CDs. So far, there has been only modest deposit loss; however, deposit "beta" has been rising—i.e., banks generally have had to pay more to retain their deposit levels.
- **The FDIC estimates a $16 billion cost associated with the recent bank failures.** To replenish the insurance fund, banks will have to pay higher assessments to the FDIC. These costs are quite meaningful, though they are likely to be spread out over several years.
- **Regulation is expected to become more demanding.** New rules will likely involve the marking-to-market of securities portfolios as well as improvements to various facets of funding (discussed in more detail below). Stronger regulation will be more costly, forcing the banks to hold more capital and/or accept higher-cost (and more stable) funding sources.

In the near term, pressure on bank earnings is bad for equity and preferred holders alike. However, strong bank regulation is typically very good for preferred holders and other creditors over time, as it improves the quality and stability of the organizations. Consider the years of beneficial "credit tailwinds" from strengthening bank regulation following the GFC. We expect a similar dynamic from this episode, and the probability of bank failures, particularly for large banks, appears highly remote.

New bank rules will likely result in higher capital and liquidity requirements, which could provide a powerful tailwind for preferred shareholders over time.

An attractive entry point—and why details matter

As discussed above, we believe the failed banks had unusual characteristics that led to depositor panic (and ultimately their failures). Notably, they had both capital and funding weaknesses that played on each other, resulting in a confidence spiral. Michael Barr, Vice Chair for Supervision at the Federal Reserve, wrote in his report on the failure of SVB: "This experience has emphasized why strong bank capital matters. While the proximate cause of SVB's failure was a liquidity run, the underlying issue was concern about its solvency."

Most publicly listed banks, including regionals, are well-capitalized (even net of securities marks) and more conservatively funded. Accordingly, we believe broader fears will fade over time rather than worsening. Of course, we cannot discount the potential for further negative news flow, as a small number of regional banks share some of the characteristics we saw in the failed banks.

While most banks are in good shape, clearly some are stronger than others. Differences among issuers are why details matter greatly. While we recognize that risks have risen, we believe very attractive entry points exist in depressed securities from many stronger banks. What is more, preferreds issued by insurance companies, utilities and other non-financials have also been pressured along with the broader market. This presents an attractive investment opportunity across the asset class, in our view.

U.S. banking system reforms likely to be supportive of credit

We expect many measures to be taken to strengthen bank regulation and bolster the resiliency of the financial system. New rules will likely impose higher capital and liquidity requirements. Although bank stocks have come under pressure on the prospect (as reforms may weigh on profitability), we believe the remedies will be supportive of credit over the long term. Recall that coming out of the global financial crisis tighter regulations benefited creditors for many years, particularly preferred holders.

Possible new measures to be instituted include:

Stringent standards applied to a broader set of banks

- The Fed could reevaluate the tailoring framework and expand rules for banks with $100+ billion of assets

Increased capital requirements

- Reduced reliance on internal bank models, more scrutiny of trading and operational risks
- A broader set of firms will be required to deduct certain unrealized losses from capital
- Greater frequency of stress tests and additional stressed scenarios

Enhanced liquidity risk and interest rate risk management

- Standardized liquidity rules will likely apply to a broader set of firms
- The Fed will likely reevaluate the stability of uninsured deposits and all securities in liquidity stress tests

More long-term debt for certain regional banks

- Expanding the standard for loss-absorbing unsecured debt would improve funding profiles and protect depositors

End of Fed rate increases may serve as a powerful catalyst

Though the recent volatility in preferreds has been unsettling, we believe a great deal of negative information is priced into the market. And while it can be difficult to identify troughs, we believe investors should remain grounded and focused on fundamentals.

As we outlined earlier, bank issuer fundamentals are generally solid. However, some issuers may still be vulnerable, underscoring the importance of both selectivity in securities and diversification across sectors.

History shows that preferred market corrections are typically followed by strong returns. For perspective, in the six market corrections going back to the global financial crisis, preferred securities meaningfully outperformed U.S. bonds in subsequent months, typically generating equity-like returns in the process (Exhibit 3).

EXHIBIT 3

Preferreds' performance has been strong following market corrections

Significant corrections and their aftermath

				Returns 3 months after trough			Returns 6 months after trough		
Cause of the correction	Peak	Trough	Preferreds drawdown	U.S. bonds	U.S. equities	Preferreds	U.S. bonds	U.S. equities	Preferreds
Global financial crisis	5/8/2007	3/9/2009	**-57.5%**	1.2%	40.2%	**68.8%**	5.9%	54.6%	**87.5%**
European sovereign debt crisis	5/17/2011	10/4/2011	**-7.8%**	0.6%	14.3%	**5.6%**	1.0%	25.9%	**12.7%**
Taper tantrum	5/8/2013	8/19/2013	**-6.9%**	2.2%	9.2%	**3.1%**	3.1%	12.3%	**6.7%**
Period of rising interest rates	1/8/2018	12/27/2018	**-4.9%**	3.4%	13.3%	**7.9%**	6.4%	18.7%	**12.3%**
Covid-19 pandemic	2/20/2020	3/23/2020	**-22.0%**	4.8%	40.7%	**24.1%**	5.8%	46.0%	**29.3%**
High inflation and high rates	9/16/2021	10/21/2022	**-17.4%**	7.5%	6.3%	**11.2%**	7.3%	11.1%	**6.2%**
Banking distress	2/2/2023	3/20/2023	**-11.6%**			**?**			**?**
Average			**-18.3%**	**3.3%**	**20.7%**	**20.1%**	**4.9%**	**28.1%**	**25.8%**
Average excluding GFC			**-11.8%**	**3.7%**	**16.8%**	**10.4%**	**4.7%**	**22.8%**	**13.4%**

At April 30, 2023. Source: Morningstar Direct, Cohen & Steers.

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Fixed income rallies have followed the end of rate hikes

After 10 rate hikes in a little more than a year, the Federal Reserve has signaled that the current aggressive tightening cycle is near an end. Investors have widely anticipated the decision amid moderating inflation and signs of slowing growth. Historically, whenever the Fed reaches the terminal rate, the long end of the maturity spectrum rallies materially, resulting in strong performance for fixed income—especially preferred securities (Exhibit 4).

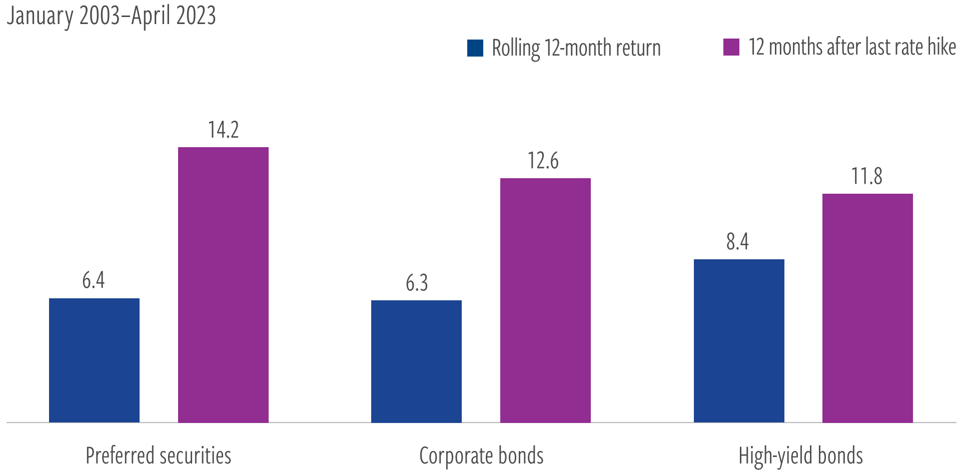
It's worth noting, once again, that these securities constitute a high-quality market, mainly composed of investment-grade issues. We believe that in its battle to bring down inflation, the Fed may go too far with tightening credit, and we see there is a strong possibility for a modest-to-average recession. Given this outlook, we believe it makes sense to stick to quality.

EXHIBIT 4

Returns are particularly strong following rate-hiking cycles

Rolling 12-month returns and 12-month returns after the end of rate hikes (%)

January 2003–April 2023



At April 30, 2023. Source: ICE BofA, Cohen & Steers.

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Historically, the end of rate-hiking cycles has seen yields in the bond market move materially lower relatively quickly, as central bankers respond to slowing economic conditions.

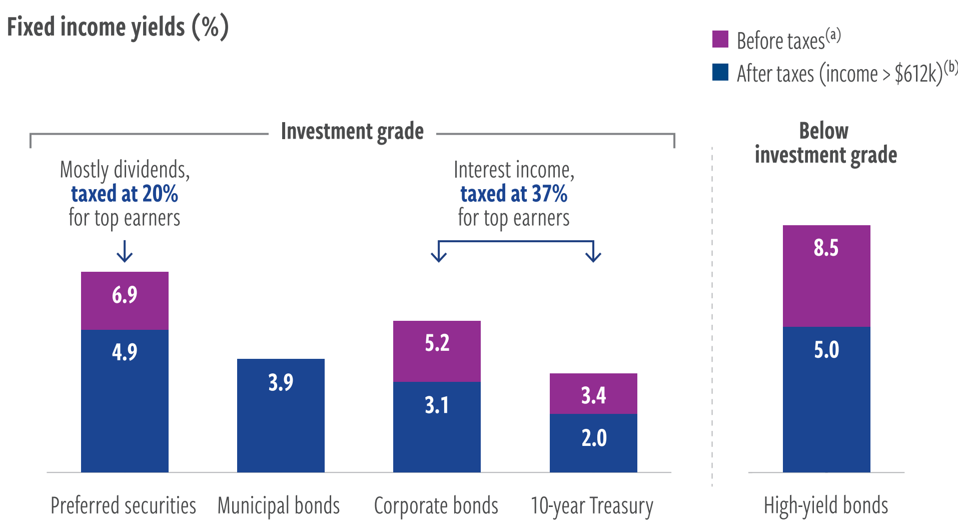
Tax-advantaged income for U.S. investors

For U.S. investors, the attractiveness of preferred securities is enhanced by favorable tax treatment. Many preferred securities pay qualified dividend income (QDI), which is taxed at just 20% for top U.S. earners (compared with 37% for interest income). For someone in the top tax bracket, a QDI-qualified investment-grade preferred yielding 6.9% would have an after-tax yield of 4.9%, whereas an interest-bearing 8.5% high-yield bond would have an after-tax yield of just 5.0%. In order to earn a higher after-tax yield than investment-grade preferreds, investors need to go down five notches in credit quality to bonds rated "highly speculative."

Institutions that file taxes as C-corporations in the U.S. may also garner tax benefits from preferred securities investments. Dividends issued directly from one tax-paying C-corp to another are generally eligible for the dividends received deduction (DRD) for the dividend recipient. This would include a taxable institution that owns the preferred securities of (and hence has an ownership stake in) a taxable C-corp. Eligible buyers normally receive the minimum deduction of 50% of the dividend. For a corporate investor with a 21% tax rate, the effective tax on preferred income may fall to just 10.5%—so a DRD-eligible preferred paying 6.9% would have a taxable-equivalent yield of 7.7%.

EXHIBIT 5

Preferreds can offer tax-advantaged income to U.S. investors



At April 30, 2023. Source: ICE BofA, Cohen & Steers.
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Conclusion

Preferred securities' income, coupled with discounts to par value not seen since the global financial crisis, presents what we believe is an attractive total return opportunity for investors. The end of the Fed's rate increases and more robust bank regulation may be powerful catalysts for the new cycle. But diversification and active management remain key in volatile markets. Active managers can potentially maximize returns by investing across sectors; looking deeper into fundamentals, valuation metrics and risks; and taking action as valuation opportunities present themselves.

Attributes of preferred securities

High income rates

Generally the **highest income rates** available from investment-grade fixed income securities.

Value opportunities

Value opportunities in below-investment-grade and non-rated issues

Multi-sector approach

Allows for a multi-sector approach, including obligations of banks, insurance companies, REITs and infrastructure companies

Wide yield spreads

Preferred securities' wide yield spreads to other areas within fixed income indicate potential value

Low correlations

Historically **low correlations** to stocks and bonds

Low interest rate risk

Many structures have **modest or low interest rate risk**

Quality issuers

Issuers of preferreds tend to be in **highly regulated** and/or **stable-cash flow** industries

Tax advantage

Potential **tax advantages** for U.S. investors (individuals and C-corporations) through lower tax rates on dividend income

About the authors

William Scapell, CFA, Executive Vice President, is Head of Fixed Income and Preferred Securities and a senior portfolio manager for the firm's preferred securities portfolios. He has 31 years of investment experience. Prior to joining Cohen & Steers in 2003, Mr. Scapell worked in the fixed income research department at Merrill Lynch, where he was their chief strategist for preferred securities for three years and a vice president in the corporate finance and treasury department for two years. Previously, he held bank supervision and monetary policy roles at the Federal Reserve Bank of New York for six years. Mr. Scapell holds a BA from Vassar College and an MA from Columbia University's School of International and Public Affairs. He is based in New York.

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Index definitions and important disclosures

An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes.

Preferred securities: OTC: ICE BofA U.S. IG Institutional Capital Securities Index tracks the performance of USD-denominated investment-grade hybrid capital corporate and preferred securities publicly issued in the U.S. domestic market. Retail: ICE BofA Core Fixed Rate Preferred Securities Index (Credit quality: BBB-) tracks the performance of fixed-rate U.S. dollar-denominated preferred securities issued in the U.S. domestic market. CoCos: The Bloomberg Developed Market Contingent Capital Index (Credit quality: BB) includes hybrid capital securities in developed markets with explicit equity conversion or write-down loss absorption mechanisms that are based on an issuer's regulatory capital ratio or other explicit solvency-based triggers. **Investment-grade bonds:** ICE BofA Corporate Master Index (Credit quality: A-) tracks the performance of U.S. dollar-denominated investment-grade corporate debt publicly issued in the U.S. domestic market. **High-yield bonds:** ICE BofA High Yield Master Index (Credit quality: B+) tracks the performance of U.S. dollar-denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market. **Municipal bonds:** ICE BofA Municipal Master Index (Credit quality: AA-) 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. **U.S. Treasuries:** ICE BofA U.S. Treasury Index tracks the performance of U.S. dollar denominated sovereign debt publicly issued by the U.S. government in its domestic market.

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Duration Risk. Duration is a mathematical calculation of the average life of a fixed-income or preferred security that serves as a measure of the security's price risk to changes in interest rates (or yields). Securities with longer durations tend to be more sensitive to interest-rate (or yield) changes than securities with shorter durations. Duration differs from maturity in that it considers potential changes to interest rates, and a security's coupon payments, yield, price and par value and call features, in addition to the amount of time until the security matures. Various techniques may be used to shorten or lengthen the Fund's duration. The duration of a security will be expected to change over time with changes in market factors and time to maturity.

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