Citi Global Wealth
Investments

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CIO Strategy Bulletin

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Why We Prefer Preferreds

SUMMARY

- Of all the asset price movements driven by the banking panic in the past few weeks, one of the few notable pockets of value created in markets appears to be subordinated financial debt.
- A diversified basket of investment grade preferred equity securities now yields more than sub-investment grade bonds by the highest level in over a decade. Some of these shares and subordinated bonds yield near 8%. Less than half of the Investment Grade Capital Securities Index are banks.
- Regulators in the US and elsewhere acted quickly to reassure investors that the banking sector is sound and they continue to be proactive. In the US, among the 10 largest banks (plus one large brokerage services company) going back to the year 2000, only one bank didn’t pay a dividend for a period of time and it was during the depths of the Great Financial Crisis.
- When market volatility subsides, the relative value of preferreds may allow for appreciation potential. Other potential upside catalysts include a decline in inflation leading to Fed rate cuts over the next 12 months, stabilization in the banking sector as bank management focuses on improving liquidity and additional government measures.
- It is notable that despite all the volatility in IG-rated preferreds, they still have outperformed intermediate Treasuries since last summer on a total-return basis.

Why We Prefer Preferreds

Of all the asset price movements driven by the banking panic in the past few weeks, one of the few notable pockets of value created in markets appears to be subordinated financial debt. The decision of Swiss regulators to “bail out” common equity holders of Credit Suisse (to a limited extent) and “bail in” subordinated debt holders with a write-down to zero in CS’s Additional Tier-1 bonds (AT1s) caused a large repricing across the subordinated debt and preferred equity worlds.

A diversified basket of investment grade preferred equity securities now yields more than sub-investment grade bonds by the highest level in over a decade. Many of these shares and subordinated bonds yield near 8%. And the “preferred” sector is far from a pure play on banks. Less than half of the Investment Grade Capital Securities Index are banks.

For our positive view of this sector to be realized, we underscore our view that the events of 2023 are not a financial crisis akin to 2008-09 (see last week’s CIO Bulletin). Even looking back to the Global Financial Crisis, only one US bank suspended preferred dividend payments.

Our overweight in preferred equity is an additive part of our overall fixed income strategy. The 2% weighting for preferreds across medium-risk portfolios is designed to augment portfolio yield and complement our overweights in high quality bonds with underweights in junk. At today’s prices, we’d rather add to preferred holdings than cut. This can be an area for opportunistic investment, as well.

The Last Few Weeks: Fast Action to Support Banks and Banking

The unexpected events of the past month have focused investors on the risks to bank earnings and the financial sector’s equity and preferred securities’ values. We remain neutral on expected bank common equity performance and expect the sector to remain volatile, but we do not foresee another financial crisis and view this tail risk as small.

As we said in our March 13 CIO Briefing Note, regulators in the US and elsewhere acted quickly to reassure investors that the banking sector is sound and they continue to be proactive. The evening of the Silicon Valley Bank failure, for example, the Federal Reserve created a new program to provide liquidity to banks called the Bank Term Funding Program. This facility allows banks to pledge high quality Treasury and agency mortgage-backed securities (MBS) as collateral to the Fed for a period of up to one year, and in return receive cash up to the full “face value” of the pledged securities. As such, any negative mark to market of these securities from the rise in yields became less of an immediate concern for banks seeking to meet potential liquidity needs.

Other regulators, including the FDIC, have also provided tremendous support to sentiment in the banking system, guaranteeing uninsured deposits for SVB and Signature Bank. Treasury Secretary Janet Yellen has also indicated repeatedly that the government could provide emergency support again in the future if needed, stating: “We have used important tools to act quickly to prevent contagion. And they are tools we could use again. The strong actions we have taken ensure that Americans’ deposits are safe. Certainly, we would be prepared to take additional actions if warranted.”

Regulators in the UK, ECB, Canada and elsewhere are implementing policies similar to what US regulators have done. Their actions underscore the intrinsic health of the financial system. And, as a result, we have seen a marked reduction in overall volatility from its most extreme levels.

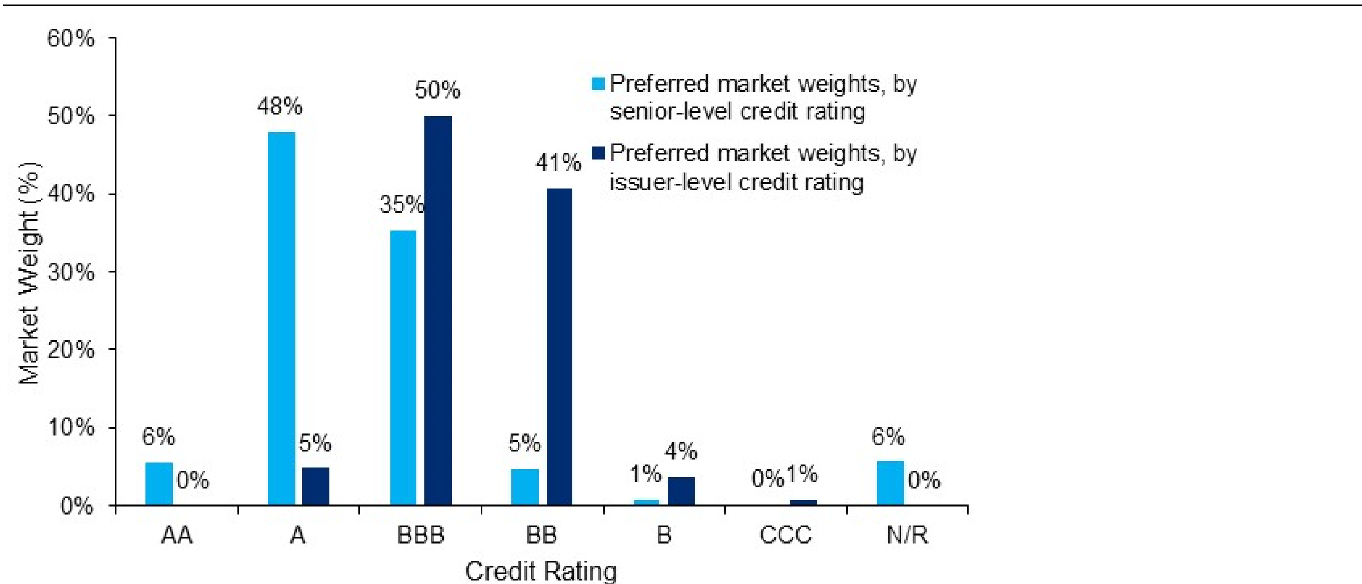
Bank Preferreds

There are many different types and structures of preferreds, and their terms differ depending on issuer and jurisdiction. In this discussion, we are only referencing what are commonly known as "institutional preferreds," which carry $1,000 par denominations. This type of security typically is structured with a variable-rate coupon for a period of years (usually five years) after which the issuer has the right to "call" the security and pay back the full principal. If the issuer doesn't call the security on this call date, the coupon is reset and remains outstanding.

US bank preferreds are generally understood to rank junior to all the debt of the bank issuer. A key consideration for preferred valuation within this capital structure context is that dividends cannot be paid on a bank's equity unless the bank first pays the coupon (or dividend) on its preferred security. If there's any dividend payment at all, the full amount owed on the preferred must be paid. Notably in the US, among the 10 largest banks (plus one large brokerage services company) going back to the year 2000, only one bank didn't pay a dividend for a period of time and it was during the depths of the Great Financial Crisis (GFC). Bank preferreds – regardless of rating of the actual security – are generally issued by investment-grade rated issuers. Preferred securities are rated lower because they're structurally subordinate in the payment waterfall to actual debt issuance (**Figure 1**). This is an important feature of assessing preferred credit risk, as it's in many ways similar to analyzing the equity values of the issuer from a solvency and dividend-paying standpoint. Note also that most bank preferreds don't have maturity dates, meaning they're "perpetual" unless called by the issuer. Therefore, "extension risk" exists when a preferred security doesn't get called on its initial call date.

As part of CGWI's Global Investment Committee portfolio allocation, we hold a small overweight (2%) to investment grade preferreds on an index basis, but the concepts we discuss here can also apply to high yield preferreds issued both in the US and globally. (In Europe, many bank preferreds are high yield rated and are referred to as AT1s, or "CoCos" for Contingent Capital.)

Figure 1: **Preferred market by issuer and issue credit ratings**



Source: Bloomberg as of December 2022. Credit ratings are by S&P. Bonds are affected by a number of risks, including fluctuations in interest rates, credit risk and prepayment risk. In general, as prevailing interest rates rise, fixed income securities prices will fall. Bonds face credit risk if a decline in an issuer's credit rating, or creditworthiness, causes a

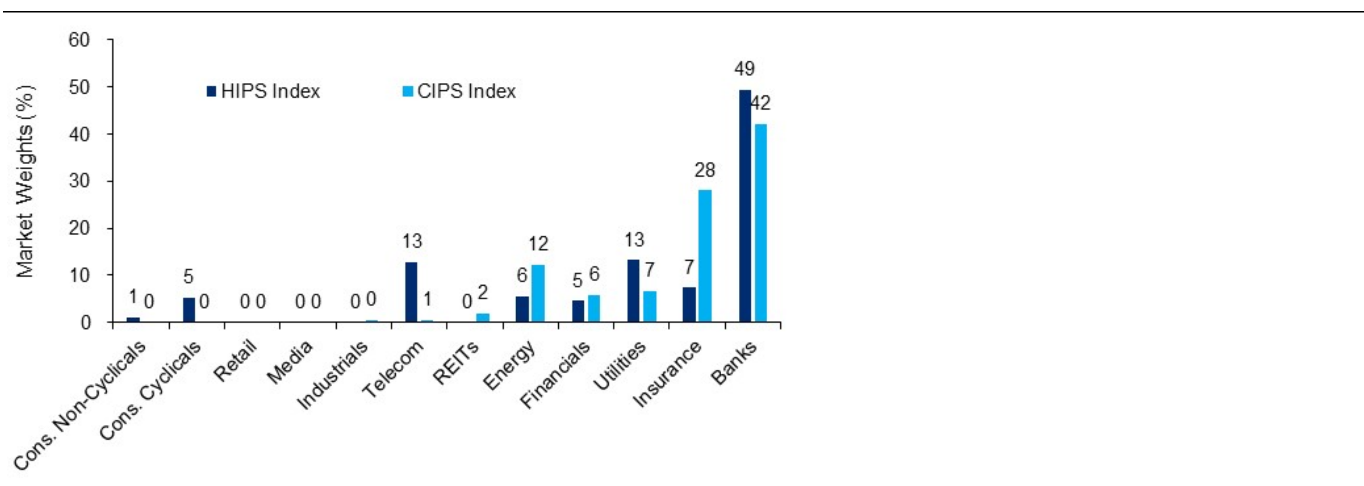
bond's price to decline. High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues. Finally, bonds can be subject to prepayment risk. When interest rates fall, an issuer may choose to borrow money at a lower interest rate, while paying off its previously issued bonds. As a consequence, underlying bonds will lose the interest payments from the investment and will be forced to reinvest in a market where prevailing interest rates are lower than when the initial investment was made

More Than Banks

The Investment Grade Capital Securities Index isn't entirely composed of banks (**Figure 2**). About 48% of the index is issued by financials (banks and brokerage services). Of that 48%, most are issued by the top 11 issuers. Several of those banks are considered regional banks, but they're the largest regionals by total assets in the US. Short of a systemic financial event akin to the Great Financial Crisis, it's unlikely for bank earnings to become so stressed that these banks can't make dividend payments on their equity – meaning preferred payment performance on coupons is likely to continue.

The other 52% are issued by insurance companies, utilities and other non-bank entities. While insurance companies are "financials," this sector won't likely be affected by banking stress and, therefore, may offer diversification within the overall preferred opportunity.

Figure 2: **US IG vs HY preferred index, by sector weights**



Source: Bloomberg as of March 30, 2023. The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results.

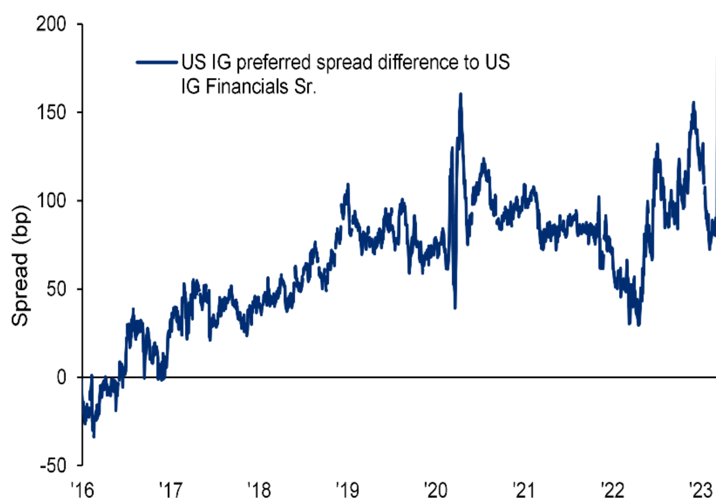
What Happened in the Preferred Market

In US markets, investment-grade-rated preferred index yields had soared 100bp following the Silicon Valley Bank failure to 7.9%, exceeding levels reached last November. While even the large money center banks saw certain preferred yields rise above 8.0%, the underperformance was largely led by regional bank issuers. Yields now are approximately 7.35%. Cautious investor sentiment also fueled a meaningful flight to quality into US Treasury debt. In turn, the yield premium (or spread) offered in the IG preferred market pushed significantly wider. Index spreads in IG-rated preferreds are now roughly 355bp, the widest levels since the peak Covid selloff.

Preferreds have increased their relative value across bank capital structures. For example, preferreds have meaningfully cheapened relative to senior debt. The spread “pick-up” in IG-rated preferreds over senior unsecured bank debt is now 180bp. The historical relationship over the last 20 years is closer to 90bp (**Figure 3**). In addition, IG-rated preferreds now offer more yield (almost 40bps) than they have in many years versus US high yield BB-rated corporate bonds (**Figures 4 and 5**), even though high yield corporate bonds would be more susceptible to default in a recession.

When market volatility subsides, this relative value will likely be a catalyst for the outperformance of preferreds, in our view. Other potential upside catalysts include a decline in inflation leading to Fed rate cuts over the next 12 months, stabilization in the banking sector as bank management focuses on improving liquidity, and possibly additional government measures that enhance the size and scope of deposit insurance (among other potential system-enhancing measures). It’s also notable that despite all the volatility in IG-rated preferreds, they have still outperformed intermediate Treasuries since last summer on a total-return basis (**Figure 6**).

Figure 3: US IG preferreds spread difference to senior bank debt



Source: Bloomberg USD IG Bank Senior Bond Index spread vs ICE BofA US IG Capital Securities index (CIPS) spread, as of March 30, 2023. The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results.

Figure 4: **Yield on US investment grade preferreds vs yield on BB-rated bonds**

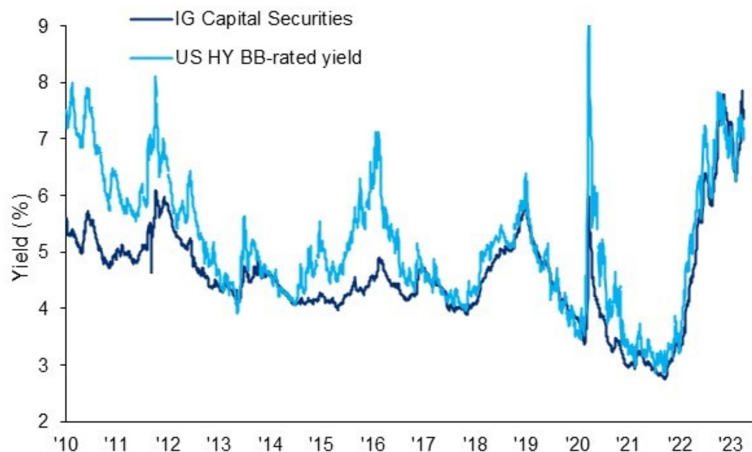


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Figure 5: **Yield on US investment grade preferreds minus yield on BB-rated bonds**

Source: Bloomberg as of March 30, 2023. The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results.

Figure 6: **Total return of US preferreds vs US Treasuries since July 2022** ***(when GIC added to overweight)***

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European "Preferreds"

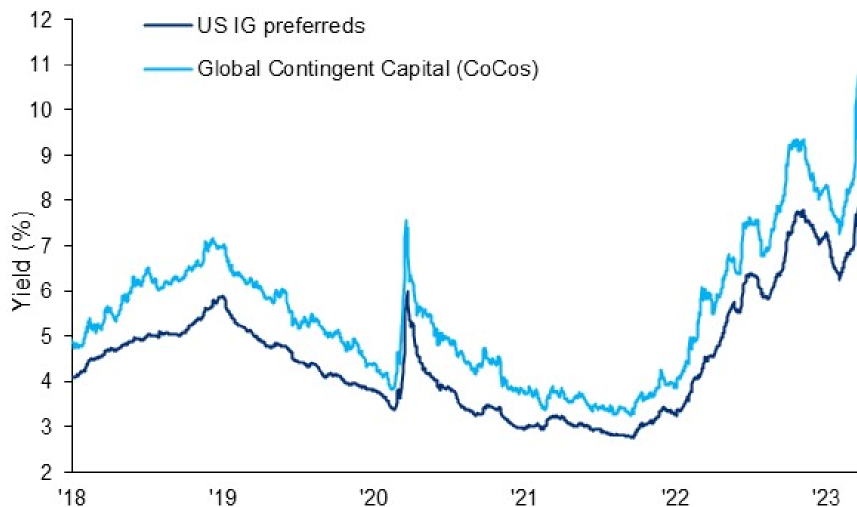
In Europe, the fallout from the Swiss government eliminating any value for Credit Suisse AT1 holders threw the entire European AT1 market into question. AT1s are almost all high yield rated. Index yields for AT1s spiked 200bp to 10.25%, an all-time high. After regulators around the world supported the proper hierarchy of AT1 holders being senior to common shareholders, the market calmed, and buyers are returning. However, index yields are still around 8.60%, which is well above levels seen during the 2011 European debt crisis.

Investors will likely need time to price in a proper spread premium for European AT1s versus US preferreds given their structural differences (**Figure 7**). At the same time, there will also likely be wider dispersion in valuations between banks across the continent. That said, we believe European banks are generally well-capitalized and are in excess of their liquidity requirements. Europe also doesn't have the regional bank presence seen in the US. While a higher degree of selectivity will be required, we believe the AT1 market may offer an interesting risk/reward opportunity for investors who properly understand the risks of the instrument and issuer.

Where to Look

For investors interested in taking a closer look at institutional bank preferreds, there are options. Numerous funds are dedicated to this asset class, and there are other types of funds that offer preferreds as part of a larger fixed income allocation. Preferreds may also be purchased directly depending on investor suitability. We continue to suggest investors consider a small allocation to preferreds to enhance their overall core fixed income yields.

Figure 7: **Global Contingent Convertible bonds (CoCos) vs US preferred yields**



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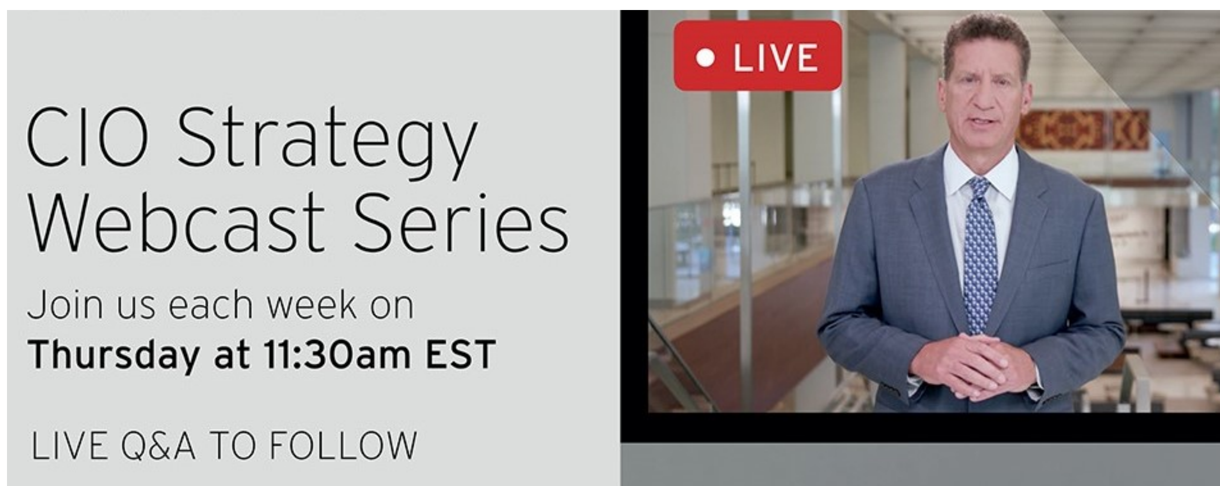

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Alpha and/or numeric symbols used to give indications of relative credit quality. In the municipal market, these designations are published by the rating services. Internal ratings are also used by other market participants to indicate credit quality.

Bond credit quality ratings		Rating agencies	
Credit risk	**Moody's[1]**	**Standard and Poor's[2]**	**Fitch Ratings[2]**
Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

1 The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2, or 3 to show relative standing within the category.
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