The Preferred Market: An Overview

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Chilton Trust Company CIO's Richard Chilton and Timothy Horan recommend that traditional municipal fixed income investors with the appropriate risk appetite should allocate between 15-35% of their fixed income asset allocation to the preferred (a.k.a. "hybrid") security market

Such an allocation may provide traditional fixed income investors the opportunity to capture additional yield. As with most financial instruments, preferred securities are typically negotiable and customizable by the issuer; accordingly, the characteristics exhibited in any one preferred security, even when issued from the same issuer, may vary from another preferred security, sometimes materially. This paper highlights a few salient features of preferred securities, our approach to security selection and the performance of the asset class in the context of a representative asset allocation decision. This overview is not intended to define the entire asset class or capture all of the potential advantages or risks in a preferred security allocation.

Asset Class Characteristics

A preferred security is a type of hybrid security which combines elements of debt and equity. The size of the US dollar-denominated preferred securities market can be estimated at approximately $228 billion[1], considerably smaller than the roughly $18 trillion S&P 500 equity market cap, $10 trillion U.S. Treasury market or the $6.6 trillion U.S. corporate bond market. Understanding preferred securities begins with the recognition that the legal framework of a typical preferred share potentially leaves the investor with a very different security pledge and position in the issuer's capital structure relative to traditional fixed-income instruments (Table 1).

Table 1: Preferred Shares Versus Traditional Debt and Equity*

	Maturity	Payment	Ability to Defer Payment	Voting Rights	Payment Rank
Debt	Fixed	Fixed Coupon	No	No	Senior or Subordinated
Preferred Shares	Perpetual	Fixed Dividend	Yes	No	Deeply Subordinated
Common Equity	Perpetual	Discretionary Dividend	Yes	Yes	Last

**Generalized characteristics shown for illustration purposes only. Variation exists within each asset class and may result in materially different information.*

[1]Represents combined market value of the Bank of America Merrill Lynch ("BAML") Fixed Rate Preferred Securities Index & Bank of America Merrill Lynch High Yield Fixed Rate Preferred Securities Index as of 3/30/2016. All references to the preferred securities market herein reflect these combined indices. Note that the BAML "fixed rate" indices actually include variable rate preferred securities. We exclude convertible preferred securities from our estimate.

Generally the obligation to pay a preferred dividend is discretionary, unlike bond coupon payments. In terms of both payment and bankruptcy priority, preferred shareholders often take precedence over common equity holders but rank behind bond holders. Given this capital structure positioning, preferred securities offer higher yields than unsecured corporate bonds. However, potential upside price return is lower than common equity given that the face value of a preferred security is generally fixed, unlike a share of common stock.

Pricing of preferred securities usually reflects this hybrid nature. Like a bond, the amount of the dividend is fixed in most cases, typically as a percentage of the face value or at a variable rate linked to a specific market index. However, with preferred shares often having no fixed maturity, these cash flows are discounted into perpetuity, like a common share. Therefore preferred securities are typically priced based on the present value of future dividend payments, discounted by a rate linked to the US Treasury yield curve.

From an issuer's perspective, preferred securities are attractive because they typically do not carry voting rights and do not dilute common equity[2]. In addition, most dividend payments in respect of preferred securities are made at the discretion of the issuer, unlike interest payments for bonds, for which non-payment may trigger an event-of-default. This flexibility represents one of the primary motivations for issuers to offer preferred securities. Financial industry issuers have dominated the market with issuance comprising 80% of the market. This is likely also due to the favorable capital treatment historically accorded preferred shares under regulatory requirements. For banks (but not industrial companies), this regulatory benefit can offset the traditional disincentive to preferred issuance -- namely that dividend payments are not tax deductible, unlike bond interest payments.

Security Selection

Our selection of preferred securities for investor portfolios focuses on the following factors:

- Credit quality
- Dividend type
- Maturity & Optionality
- Tax status
- Liquidity

Credit quality – preferred securities have much more limited recourse to an issuer's assets and cash flow compared to bond holders. This typically results in a credit rating several notches below the issuer's unsecured senior bonds and below every category of subordinated debt as well. The preferred market straddles the border of investment and speculative grade with approximately 50% of securities rated in the BBB category and 40% in the BB category. Similar to bonds, preferred securities are often issued with certain covenant protections though these are typically weaker than those enjoyed by bondholders. *For our clients, we generally focus on preferred securities determined to be of investment grade credit quality.*

Dividend type – fixed rate dividends represent ~60% of the market while variable rate securities comprise ~40%. As mentioned previously, in most cases, dividends are payable solely at the discretion of the issuer. Approximately 66% of preferred securities are "non-cumulative", meaning the issuer is under no legal obligation to make up missed dividends at a later date. Notably, the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 has incentivized financial companies to issue increased amounts of non-cumulative securities at the expense of those securities with cumulative dividends. *We prefer securities for which dividend deferrals are cumulative, providing the issuer with greater incentive to remain current on payments.*

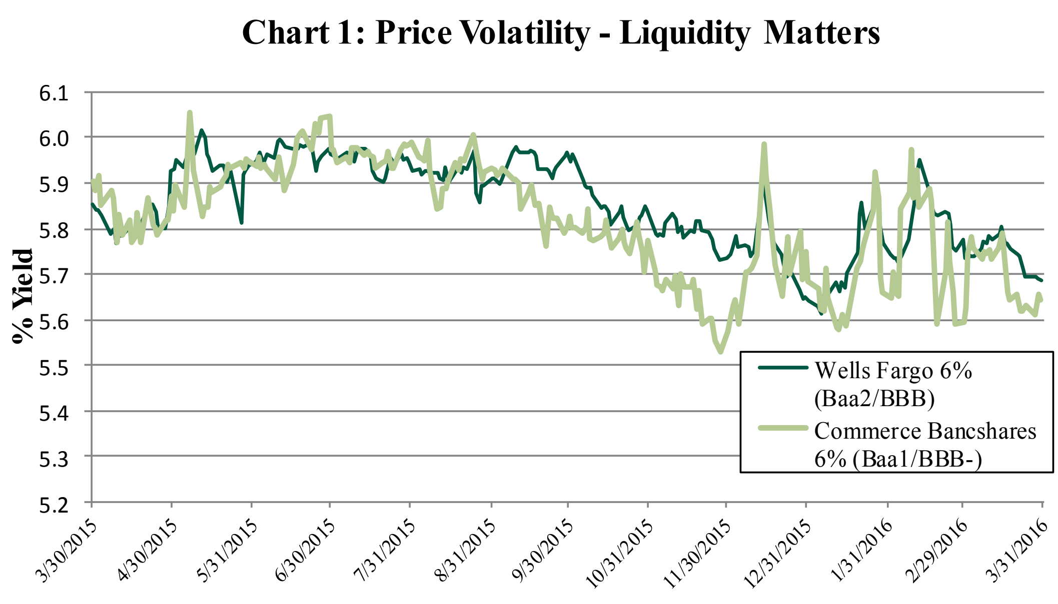
[2]Over 90% of preferred securities in the BAML U.S. Preferred Index do not grant voting rights. Note that this index does not include convertible preferred securities. Occasionally, voting rights can be granted in the event a dividend payment is deferred for a certain length of time.

Maturity & Optionality - over 80% of the market is comprised of "perpetual" securities which have no fixed maturity date, introducing interest rate risk. This price volatility is somewhat mitigated by the presence of call options, a very common feature of these securities. This translates into in an effective duration for the preferred security market of 4.5 years, in line with the 4.4 year effective duration for the intermediate investment grade corporate bond market and the 4.1 year duration for the intermediate municipal market[3]. Please note that while a portion of the market consists of preferred securities that are convertible into common equity, *we focus solely on non-convertible securities which usually exhibit lower price volatility.*

Tax status – preferred dividends often enjoy Qualified Dividend Income (QDI) status, resulting in income being taxed at the long term capital gains tax rate (between 15-20% depending on tax bracket) versus the ordinary income rate for bond interest income. Tax law also allows corporations to deduct a portion of dividends received, referred to as the Dividends Received Deduction (DRD). While this deduction does not benefit individuals, DRD-eligible securities enjoy a relatively broader buyer base. *Given the tax-sensitive nature of our typical client mandate, we focus on those securities which enjoy QDI status.*

Liquidity – similar to bonds, liquidity is often driven by issuer, industry and issue size. However preferred securities are typically issued in $25,000 lot sizes, much smaller than most bond issues. An intangible factor supportive of liquidity is the fact that the majority of preferred issuance is represented by financial institutions which could reasonably be expected to provide liquidity on their own securities under most circumstances. *In order to increase flexibility, we generally seek larger issues from more recognized issuers.*

To demonstrate the liquidity dynamic of these securities, we highlight below the variation in pricing evident in two comparable securities, issued by Wells Fargo and Commerce Bank, which share comparable credit quality, call structure and tax status. The Wells Fargo issue has an $800 million face value while the Commerce Bank issue is less, at a $150 million face value. Unsurprisingly, volatility is considerably greater for the Commerce Bank issue as shown in Chart 1.



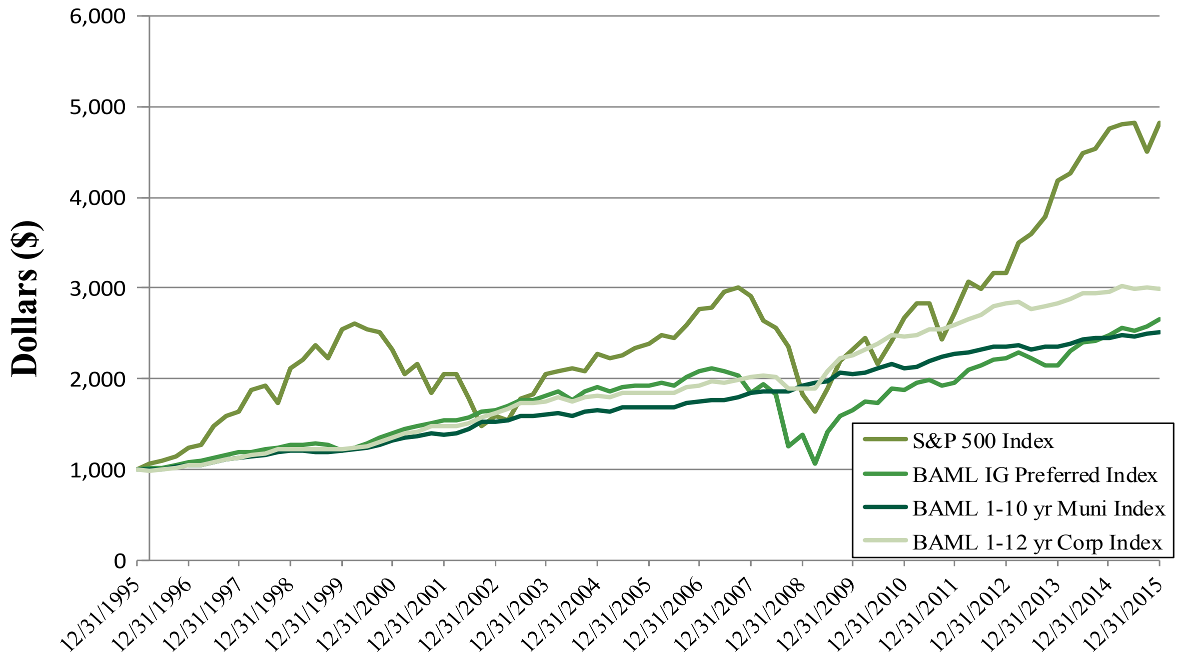
(Source: Bloomberg LP)

[3]Duration figures referenced from BAML Fixed Rate Preferred Securities Index, BAML 1-10 Year U.S. Corporate Index & BAML 1-12 Year Municipal Securities Index, as of 3/31/16.

Portfolio Application

As seen in Chart 2 below, an investment in the preferred market made in 1996 would have yielded cumulative total returns below that of the stock market and in line with traditional fixed income. However, this performance is disproportionately influenced by the financial crisis of 2008-2009, an event we believe is unlikely to reoccur in the medium term.

Chart 2: Comparative Asset Class Returns, 1996-2015*



**Reflects the cumulative value of 1,000 invested on 1/1/1996*
(Source: Bank of America Merrill Lynch)

In the analysis displayed in Table 2 below, we examine the investment performance of various asset classes over the past 20 years. Pricing volatility (as reflected in standard deviation of returns) has been quite high for preferred securities over the past 20 years, approaching the volatility of the stock market. However, we believe that the magnitude of this volatility was disproportionately impacted by the financial crisis. While it is possible that such an episode could reoccur in the future, our performance analysis has excluded the financial crisis based on the presumption that the financial sector – which represents 80% of the preferred market – has benefited from heightened regulatory oversight. We believe this has translated into certain structural improvements that have materially reduced the likelihood of another 2008-2009-like financial crisis in the medium term. Importantly, after making this adjustment, our analysis shows that preferred securities exhibit a volatility profile which remains higher than fixed income but more appropriately placed relative to the equity market.

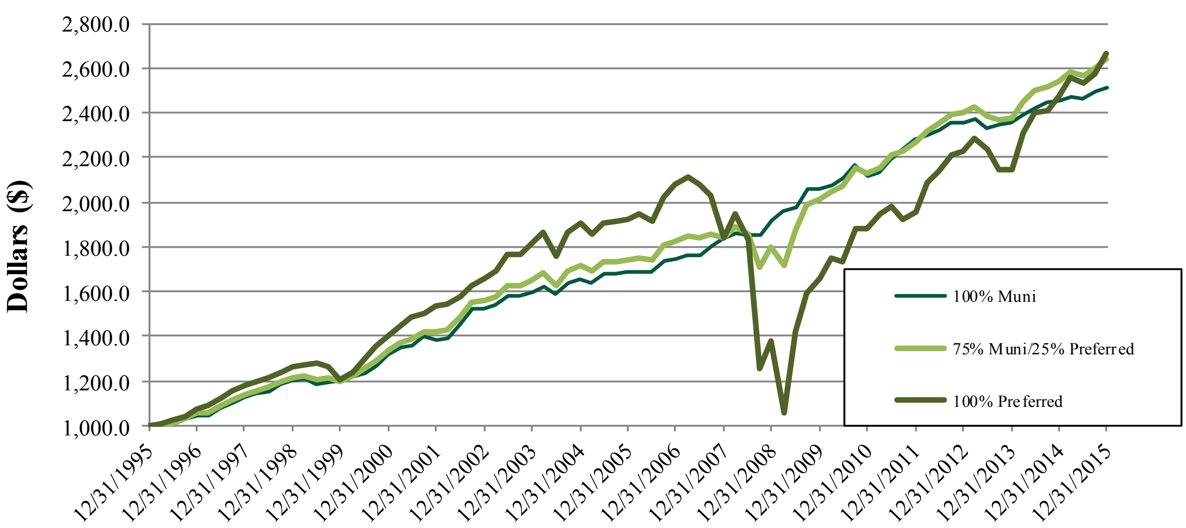
Table 2: Comparative Risk / Return Analysis, 1996-2015 (ex. 2008-2009)

	Preferred Security Index[4]	S&P 500 Equity Index[5]	Corporate Investment Grade Index[6]	Municipal Bond Index[7]
Yield to Worst/ Dividend Yield	4.4%	2.2%	2.7%	1.4%
Quarterly Annualized Return	6.2%	10.5%	5.6%	4.6%
Standard Deviation (Annualized)	5.8%	15.3%	3.3%	2.7%
Correlation with Preferred Security Index	100.0%	16.0%	57.0%	41.0%

[4]BAML Fixed Rate Preferred Securities Index, 3/31/16
[5]S&P 500 Index, 3/31/2016
[6]BAML 1-10 Year US Corporate Index, 3/31/16
[7]BAML 1-12 Year Municipal Securities Index, 3/31/16

In terms of investment performance, preferred securities demonstrate a superior return to investment grade corporate and municipal fixed income. This outperformance is due in large part to the high proportion of total return attributable to the income component of preferred securities, which offers materially higher yields than investment grade corporate and municipal bonds. Importantly, the asset class also provides diversification benefits with returns only 16% correlated with the stock market, 41% correlated with municipal bonds and 57% correlated with investment grade corporate bonds. This diversification benefit becomes especially important when examining the past 20 years, inclusive of the financial crisis. Specifically, a blended portfolio of municipal bonds and preferred securities would have achieved cumulative total returns in line with preferred securities but with much lower volatility (see Chart 3). And total returns are incrementally higher relative to a pure municipal allocation with only a modest increase in volatility.

Chart 3: Value of $1,000 Invested Over 20 Years



(Source: Bank of America Merril Lynch)

Portfolio	**Average Return**
100% Muni	4.72%
75% Muni 25% Preferred	4.79%
100% Preferred	5.02%

Summary

We believe that preferred securities represent an appealing long term investment option for clients seeking higher yields. Our outlook for the asset class is in large part driven by our outlook for the financial sector, which represents the predominance of preferred issuance. Investors should consider an allocation to preferred securities in the context of their overall exposure to the financial sector. With stable conditions expected to predominate in the sector over the medium term, we believe traditional fixed income investors seeking additional yield should strongly consider an allocation to preferred securities. Additional advantages include favorable tax-treatment of dividend income as well as reducing overall portfolio volatility given the favorable diversification benefits.