Preferred and Capital Securities

What are preferred and capital securities?

These securities are typically issued by banks, insurance companies, and utilities

They are "hybrid" securities with characteristics of both stocks and bonds

Capital structure payment priority

- Senior debt
- Preferred and capital securities
- Common stock

Investors generally get paid after bondholders... but before stockholders

CHARACTERISTICS OF STOCKS

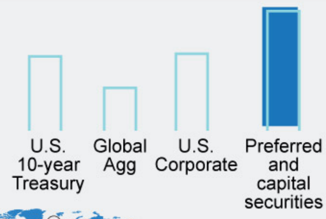
- Perpetual or long dated maturity
- Capital classification from regulators and credit rating agencies
- Dividend payment deferral options

CHARACTERISTICS OF BONDS

- Stated coupon payments
- Stated par value with definitive maturity date
- Assigned credit ratings

How can they add value to your portfolio now?

ADDITIONAL INCOME
More yield potential than other fixed income asset classes[1]



When one goes up, the other goes down

~~2.43%~~ 0.10%

DIVERSIFICATION BENEFITS
Moderate correlation to other asset classes, including emerging market bonds[2]

LOWER DEFAULT RISK
On average, the default rate was 0.10% versus 2.43% for high yield bonds[3]

HIGH-QUALITY SECTORS
Invested in highly-regulated and liquid developed markets

TAX EFFICIENCY FOR NON U.S. INVESTORS
Invests primarily in USD-denominated securities, but avoids those with U.S. dividend withholding tax requirements

As of 30 June 2023 unless noted otherwise.

1 Source: Spectrum Asset Management, Bloomberg, Barclays. The data shown is based on index returns. See disclosures for index definitions. Yields are represented by current yield.

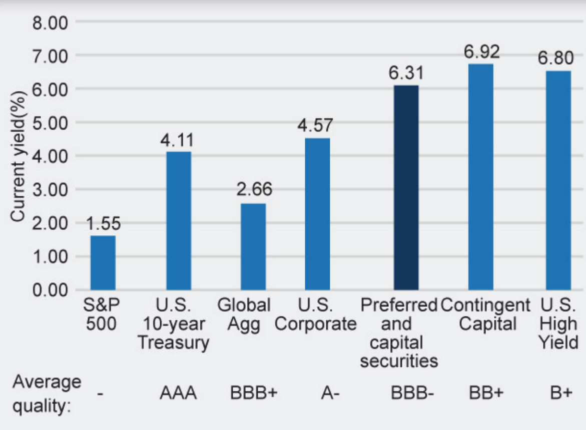
2 Source: Morningstar. Preferred and capital securities, represented by the ICE BofA U.S. All Capital Index, have a correlation of 0.84 against emerging market bonds, represented by the ICE BofA Emerging Markets Corporate Plus Index.

3 As of 31 December 2022. Source: Moody's Investors Service (investment-grade corporate bonds and high yield corporate bonds). Spectrum Asset Management, Inc. (preferred and capital securities). Average annual default rates from 2012-2022 shown. Investment-grade corporate bonds detailed 0.03% in the same period. Preferred and capital securities default rates include deferrals that may not constitute technical events of default. All default and deferral rates are volume weighted.

Attractive potential oncome opportunity

Unique security structures offer the potential for higher yields within an overall investment-grade portfolio. The largest increase in yield notably occurs when moving from corporates to preferred and capital securities while still maintaining an investment-grade rating.

Favorable Yield for Investment-Grade Quality



As of 30 September 2023. Source: Spectrum Asset Management, Bloomberg, Barclays. The data shown is based on index returns. See the second last section of the article for index definitions. Yields are represented by current yield except for S&P 500, which is represented by the dividend yield.

Attractive historical low default rates may be beneficial during market slowdowns

Preferred and capital securities have historically had default rates much closer to investment-grade corporate bonds than to high-yield corporate bonds.

Annual default rates (%) 2013-2022

	Investment grade corporate bonds	Preferred and capital securities
2013	0.04	0.00
2014	0.01	0.00
2015	0.00	0.06
2016	0.00	0.00
2017	0.00	0.13
2018	0.00	0.11
2019	0.22	0.44
2020	0.01	0.07
2021	0.00	0.09
2022	0.14	0.08
Average (2013-2022)	0.04	0.10

Source: Moody's Investors Service (investment grade corporate bonds); Spectrum Asset Management, Inc. (preferred and capital securities). Notes: Preferred and Capital Securities default rates include deferrals that may not constitute technical events of default. All default and deferral rates are volume weighted. Past performance is not an indication of future results.

Diversification

Historically, preferred and capital securities have correlated moderately to other asset classes, making them an attractive diversification tool for fixed income investors.

Five-year correlation to preferred and capital securities

As of 30 September 2023. Source: Bloomberg, Barclays, Spectrum Asset Management. The data shown is based on index returns. See the second last section of the article for index definitions.

Historical strong performance

The hybrid nature of the preferred and capital securities asset class, with both equity and fixed-income characteristics, may provide diversification benefits to an investment portfolio. Historically, when markets rallied, preferred and capital securities often outperformed fixed income, while in flat-to-down markets, they often outperformed global equities.

2015	2016	2017	2018	2019	2020	2021	2022
Preferred and capital securities 5.43%	U.S. equities 11.96%	EM equities 37.28%	Global IG Corp -2.24%	U.S. equities 31.49%	U.S. equities 18.40%	U.S. REITs 41.30%	DM equities -14.45%
U.S. REITs 2.83%	EM equities 11.19%	DM equities 25.03%	Global HY Corp -3.91%	U.S. REITs 28.66%	EM equities 18.31%	U.S. equities 28.71%	Preferred and capital securities -14.85%
U.S. equities 1.38%	U.S. REITs 8.63%	U.S. equities 21.83%	U.S. REITs -4.04%	DM equities 22.01%	Global IG Corp 9.68%	DM equities 11.26%	Global IG Corp -15.28%
Global IG Corp -0.42%	Global HY Corp 8.11%	Global HY Corp 11.16%	U.S. equities -4.38%	EM equities 18.42%	Global HY Corp 9.40%	Preferred and capital securities 3.42%	Global HY Corp -15.37%
DM equities -0.81%	Global IG Corp 5.95%	Preferred and capital securities 10.55%	Preferred and capital securities -4.45%	Preferred and capital securities 18.39%	DM equities 7.82%	Global IG Corp -0.89%	U.S. equities -18.11%
Global HY Corp -3.09%	Preferred and capital securities 3.81%	U.S. REITs 8.67%	DM equities -13.79%	Global IG Corp 14.06%	Preferred and capital securities 7.63%	Global HY Corp -1.84 %	EM equities -20.09%
EM equities -14.92%	DM equities 1.00%	Global IG Corp 6.32%	EM equities -14.57%	Global HY Corp 12.31%	U.S. REITs -5.12%	EM equities -2.54%	U.S. REITs -24.95%

Best

Worst

As of 31 December 2022. Source: Morningstar. Past performance is not an indication of future results. See the second last section of the article for index definitions.

Index descriptions

1. Bloomberg Global Aggregate Index (Global Agg) provides a broad-based measure of the global investment-grade fixed income markets.
2. S&P 500 Index (S&P 500) is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies.
3. ICE BofA U.S. All Capital Securities Index (Preferred and capital securities) tracks the performance of fixed rate, U.S. dollar denominated hybrid corporate and preferred securities publicly issued in the U.S. domestic market.
4. ICE BofA Contingent Capital Index (Contingent Capital) tracks the performance of investment grade and below investment grade contingent capital debt publicly issued in the major domestic and eurobond markets.
5. ICE BofA U.S. High Yield Index (U.S. High Yield) tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.
6. ICE BofA U.S. Corporate Index (U.S. Corporate) tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market.
7. ICE BofA Current 10-Year U.S. Treasury Index (U.S. 10-year Treasury) is a one-security index comprised of the most recently issued 10-year U.S. Treasury note.
8. The MSCI EAFE Index (DM equities) captures large and mid-capitalization equities across 21 Developed Markets countries around the world, excluding the U.S. and Canada. It serves as a performance benchmark for the major international equity markets as represented by 21 major MSCI indices from Europe, Australasia, and the Middle East.
9. MSCI Emerging Markets Index (EM equities) is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.
10. FTSE Nareit All Equity REITs Index (U.S. REITs) is a free-float adjusted, market capitalization-weighted index of U.S. equity REITs. Constituents of the index include all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets other than mortgages secured by real property.
11. Bloomberg Global High Yield Index (Global HY) is a multi-currency flagship measure of the global high yield debt market. The index represents the union of the U.S. High Yield, the Pan-European High Yield, and Emerging Markets (EM) Hard Currency High Yield Indices. The high yield and emerging markets sub-components are mutually exclusive.

Risk considerations

Past performance is no guarantee of future results. Investing involves risk, including possible loss of principal. Fixed-income investment options are subject to interest rate risk, and their value will decline as interest rates rise. Risks of preferred securities differ from risks inherent in other investments. In particular, in a bankruptcy preferred securities are senior to common stock but subordinate to other corporate debt. Contingent Capital Securities carry greater risk compared to other securities in times of credit stress. An issuer or regulator's decision to write down, write off or convert a CoCo may result in complete loss on an investment.

The market value of debt securities is affected by changes in prevailing interest rates and the Fund may be exposed to credit risk by investing in debt securities.

Default risk and liquidity risk associated with investment in below investment grade securities. Contingent Convertible Securities risk is due by the substantially greater risk that these instruments may have compared to other forms of securities in times of credit stress and may result in a material loss to the Fund. Currency hedging may reduce but will not remove risk. Hedging will incur more transaction costs and fees which will affect overall return.

Consumption: A key driver of economic growth

Consumption is a key pillar of the global economy. Investors continue to focus on how consumers spend their time and money, adopting a bottom-up, fundamental approach to seeking out high-quality brands with an innate focus on sustainability to capture this exciting theme.

Key points

- The impact of higher interest rates on the consumer, the likelihood of a soft landing, and the outlook for China remain key considerations.
- Investors continue to invest in how consumers spend their time and money, focusing on companies with strong brands and pricing power, which gives them the resilience required for a more uncertain environment.
- Longer-term consumption trends persist and offer up opportunities for companies, including a greater focus on leisure and wellbeing, rising demand for high-end products with resale value, and less wasteful consumption.

What is the investment outlook for sustainable consumer brands in 2024, given the prevailing macro environment (slowing global growth, geopolitical, higher rates)?

Consumption is the fundamental pillar of global GDP and will continue to be an essential driver of economic growth in 2024. While markets are expected to remain volatile in the near term, requiring a selective approach, it now appears that inflationary pressures are easing, and that consumer spending has held up reasonably well in many markets despite cost-of-living pressures. This is particularly true in markets like the US, where government subsidies and a healthy job market have supported disposable incomes. At the same time, consumers have been substantially deleveraging since the global financial crisis.

The pandemic and cost-of-living pressures mean consumers have faced considerable uncertainty in recent years. While this has impacted consumer sentiment indicators, the ability and willingness of consumers to spend is still there. Moreover, a bit of a "carpe diem" attitude is seen that has driven demand for travel and experiences – and should continue to do so into 2024. All this contributes to a more positive outlook for the consumer. However, there remains significant variation across regions, with, for example, still visible weakness in the Chinese consumer market.

The high-quality names investors look for are those with proven execution that have demonstrated an ability to grow through the cycle. Investors try to take a step back and look at the trends that will drive these companies over the long term – and continue to think that those companies with strong brands and excellent pricing power will do well in a weaker macroeconomic environment.

What do you think could surprise markets in 2024, positively or negatively?

In recent times, equity markets have faced two difficult options: a recession or continued inflationary pressures, which pose headwinds to the outlook for consumers and companies. However, as investors have seen, a soft landing is also possible. Corporate earnings have been relatively resilient in 2023, and investors are reasonably positive as they look into 2024. Although many companies sound cautious about the 2024 outlook, investors think the demand outlook is improving. Many developed economies have strong labour markets, and as people continue to earn good wages and inflationary pressures abate, consumers are likely to continue to spend. Given high interest rates, many consumers might have decided not to buy a new house or car, leaving more disposable income for discretionary spending.

In a market where monetary policy and the pace of the recovery in China have been key determinants of market direction, any indications of a soft landing or a recovery in consumer confidence in China are likely to be a significant positive "surprise" for markets. Despite the level of uncertainty, investors see good upside in many areas – especially given that many high-quality stocks have substantially derated over the past few years and are now trading on very attractive valuations.

What themes, sectors, or regions would offer opportunities and potential risks?

Despite market volatility and short-term oscillations in sentiment, the long-term consumption trends investors focus on persist. These include a greater emphasis among consumers on leisure and well-being, the tendency of Generation Z to favor high-end, quality products with resale value, and the growing desire for less wasteful consumption. Many high-quality companies have derated significantly, and investors continue to look to capture these valuation opportunities, adding to companies where long-term fundamentals are improving, even if the immediate outlook is challenging.

One current area of interest is the healthcare sector, where investors see several companies taking ownership of their brands and coming to the market with high-quality products, while becoming increasingly consumer-focused in nature. Investors also favor stocks that benefit from rising middle-class wealth in developing countries. India is a particular area of interest following a research trip in 2023, and opportunities are seen to gain exposure to both domestic players and global brands selling into the market that stand to benefit from the under-penetration of goods and services in the country.

Conclusion

All in all, investors prefer businesses exhibiting a strong brand with a demonstrated consumer moat reflected in superior pricing power. Importance is placed on the quality of the management team and their track record, as it's believed a clear vision on brand and coherent execution are essential. In addition, sustainable investing is core to a quality-focused and fundamentals-driven investment process. It's believed that strong sustainability practices will lead to a lower cost of capital and higher returns for a company versus competitors with weaker practices, reflecting in an enhanced brand leadership and market share over time.

The COVID-19 crisis has resulted in a shift in consumers' daily activities to online platforms (e-commerce, digital entertainment, and education), increased awareness about health and fitness, enhanced focus on sustainability and the acceleration of the premiumization trend. Investors are well-positioned to capitalize on these trends. The textiles, apparel, and luxury goods sub-sector will continue to overweight, with a preference towards global brands with greater pricing power. Investors also favor the broadline retail sub-sector.