Portfolio Considerations: Preferred Securities Edition

Summary:

- Preferreds as an asset class are forecasted to still do well, due to the fact that it's still believed to represent some of the best relative value in all of fixed income today.
- Preferred securities warrant some consideration for investors seeking to have a steady tax-efficient income stream from their portfolio.
- The spread between high-yield bonds and investment-grade preferred securities is narrower today than historically, which is reflected in the market, as we see investors allocate to preferreds at the expense of their high-yield allocation.

The Closed-End Fund Association (CEFA) spoke with Brian Cordes, Senior Vice President, Head of Portfolio Specialists at Cohen & Steers. Here, we speak with Brian about preferred securities and two of Cohen & Steers closed-end funds.

Brian Cordes

Libby Hastert

The following Q&A recaps the conversation that originally took place as part of CEFA's podcast series on November 20, 2017, which can be heard on CEFA.com.

Speaker: **Welcome, and thanks for joining the Closed-End Fund Association for another discussion. Today we will hear from an industry expert who shares insight on a timely issue affecting the Closed-End Fund space.**

LH: **Hello. I'm Libby Hastert, Content Specialist at the Closed-End Fund Association. Today we're speaking with Brian, Senior Vice President, Head of Portfolio Specialists at Cohen & Steers.**
Cohen & Steers is a global investment manager specializing in liquid and real assets, including real estate securities, listed infrastructure, commodities and natural resource equities, as well as preferred securities and other income solutions.

With investors' increasing appetite for income-generating investment vehicles, we're going to talk with Brian about preferred securities and two of Cohen & Steers closed-end funds, Select Preferred and Income, symbol PSF, and Limited Duration Preferred and Income, symbol LDP. Brian, it seems that preferred securities are an underutilized asset class among institutional investors. Why do you think this is the case? More, how do you see preferred securities being positioned in an institutional portfolio. Brian?

BC: I think you're right. In a lot of ways I think it's just about investor misconceptions, and with this asset class in particular it really comes down to two things, number one, the size of the preferred universe. Most think that it's a very small market. Then also the structure or the make-up of the universe, as well. On the first point, when you think about the preferred universe as a whole, it's actually 940 billion dollars in size, so it is a very large market, and that catches many by surprise. On top of that, initially when investors think of preferred they typically think of the $25 par preferreds that trade on the New York Stock Exchange, they're fix rate perpetual securities, and they offer investors five years of call protection. With a structure like that, you have a very long duration, and that's what investors believe make up the entire preferred universe, when in reality, that only represents about 20% of that 940 billion dollar market, it's what we refer to as the retail preferred market or the exchange traded market.

The remaining 80% of that 940 billion dollar universe is in what we refer to as the institutional, or the over-the-counter preferred market, and it's in this market that institutional investors demand a fixed float structure, because they don't want to take on the duration or the interest rate risk that is prevalent in that retail preferred market. With that, when you look at the preferred universe as a whole, roughly two-thirds of that universe has a duration of five years or less. Once again, proving that one of those misconceptions is actually inaccurate. Now, I will say some of those misconceptions of investors are starting to go away, and that we continue to see more and more adopt preferreds as a part of their fixed income allocation, especially in the institutional market. We've seen a big pickup and interest there over the last couple of years, and typically when someone allocates to preferreds they're normally doing so and making a 10 to 15% of their overall fixed income allocation.

LH: The name of your funds, Selected Preferred Unlimited Duration, imply active management of the portfolio. How important is this in the preferred asset class?

BC: It's very important. In fact, when you look at preferreds as a whole, not only are they, is it more of a complex market, it's a market that's going under a lot of regulatory changes over the last several years of which will continue as well. Then you also have the needs to manage interest rate risk throughout times as well. If you look at the preferred market today, and you look at some of the exchange traded funds, some of those passive options that are available to investors, if you look at the largest exchange traded funds in this space, they only are able to access that $25 market, that retail market. Not only are they accessing these fixed rate perpetuals, which will be more interest rate sensitive, but that market is also shrinking.

As you would imagine, over time the ETFs have grown in size, especially given the demand for income from investors, and with that, it just makes the performance in that market very susceptible to the flows in and out of the ETFs. From an active manager's standpoint, our viewpoint, we have access to that entire 940 billion dollar universe, which can be very helpful. If you were to just take one point in time, look back during the taper tantrum of 2013, we were able to post positive total of returns during that period, while the retail market actually lost about 4.6% and the institutional market gained 4.8. You could just see the dispersion of returns between the various preferred markets, and thus the importance to have an active manager that can go in between and really identify the markets for the very best value.

LH: Currently the old spreads between the high-yield bonds and investment-grade preferred securities are narrow relative to the historical average. Does this create a relative value opportunity for investors in the preferred securities, and in a rising interest rate environment? What would your expectations be for preferred securities as compared to high-yield bonds?

BC: Yeah, so it's a good question. When you look today at yield spreads, if you look at the preferred market, it's currently yielding 5.3%. Okay, now that's based off of an average credit quality of a triple B. If you were to look at the high-yield market, the single B plus market today, it's yielding 6%. All right, so right now that has high yield with an income advantage of 70 basis points over the preferred market. However, if you look back historically, going all the way back to 1997, which is as far back as the data will allow, over that period, high yield is historically averaged a spread of 229 basis points over preferreds. That spread is far more narrow today than what we've seen historically, and that's why we continue to see many investors allocate to preferreds at the expense of their high-yield allocation, not moving out of high yield altogether, but just rebalancing a bit, so to speak, between the two markets.

Because if you look at the high-yield market, you need to drop down four or five credit notches from that triple B credit of preferreds just to pick up an added 70 basis points in the way of income, and investors are recognizing the better relative value in preferreds today. On top of that, there's also some good diversification benefits when you look at the two asset classes together. In the preferred market, it's primarily, the issuers there are primarily are banks and insurance companies, whereas in the high-yield market, you have a more cyclically oriented issuers, commodities, energy, and you don't have as many bank and insurance issuance. It also provides good diversification benefits to fixed income investors, just from an issuer standpoint, as well. Historically, both have fared pretty well in rising interest rate environments.

LH: With companies in the financial sector as the primary issuers of preferred securities, should a rising interest rate environment benefit the preferred asset class as a result?

BC: Sure. Sure. When you think about banks and insurance companies, of course they're really the industries that benefit most from a rising interest rate environment. Banks benefit from a stronger net interest margin, insurance companies will receive better returns on their investment portfolios. When you think about yield spreads, the yield on a preferred over that of let's just say a 10 year treasury, those yield spreads are all about credit risks.

To the extent that, let's just say a bank for example, to the extent that their credit risk becomes diminished in a rising interest rate environment, because of the items that we've already discussed, it's possible you could see spreads continue to narrow. It doesn't mean that you wouldn't see the yield on preferreds move higher, it's just that you wouldn't have to see it move in a one for one relationship. If the 10-year treasury were to rise a 100 basis points, it doesn't necessarily mean you would see preferreds increase 100 basis points as well, meaning that spread would compress a bit.

LH: Income-oriented investors are often focused on being tax efficient, which leads us to municipal bonds. Do preferred securities warrant some consideration for those investors seeking to have a steady tax-efficient income stream from their portfolio?

BC: I think they do, and this also catches many investors by surprise. Just thinking about that preferred market again yielding 5.3% today, what many don't realize is that a good portion of that income will be treated as qualified dividend income. By way of example, if you took a conservative point of view that only 50% of the income generated by preferreds would be treated as qualified dividend income, even for those making less than 400,000 and those making more 415,000, you would still see them with an after tax yield advantage over muni's.

In fact, for those making more than 415,000, their after tax yields would be 3.5%, whereas if you look at the municipal bond market today it's 3.1%. Again this is another area of preferreds where you can add some diversification to your portfolio, but also pickup an income advantage, not only before, but after taxes as well.

LH: What's the outlook for Cohen & Steers Limited Duration Preferred and Income Fund, Inc., LDP and Cohen & Steers Select Preferred and Income Fund, Inc., ticker PSF?

BC: With preferreds in general, the preferred market, like many areas, the fixed income has had a good year. We think when you look forward for preferreds, the asset class can still do well, and a lot of that is due to the fact that we think it's still represents some of the best relative value in all of fixed income today for a few reasons. Number one, are simply those income levels, and with everyone looking for income and not much are readily available, preferreds still offer it. Again, right now the asset class is yielding 5.3%, and we just talked about the fact that a lot of that income there's tax advantages as well. You also continue to have good yield spreads, we discussed the yield spread in the high-yield market, but if you were to look at even yield spreads over the 10 year treasury today, right now preferreds have a yield spread of 300 basis points over the 10 year treasury, which puts it pretty much right in line with where it's been over the last, going back to 1997 as well.

Not many asset classes can say that right now, so from a yield spread standpoint valuation, still appear good as well, and then also you have the continued improving quality of the issuers. Again, with the majority of those asset class coming from banks and insurance companies, we all know the regulatory environment they've been operating under since the financial crisis, and as such whether you look at major US banks, or major European banks for that matter, their capital levels have nearly doubled. More importantly, what that does is it really allows them to withstand to a better degree any type of stress to the financial market, like you saw in 2007, 2008. The feds stress tests that are conducted on an annual basis are a good barometer of how strong the banks have become. Then also you have those diversification benefits, very low correlation of both equities and bonds for that matter. Overall, taking all of that into account, we do believe preferreds, the outlook is still positive, given the relative value advantages that we see in this space today.

LH: **Thanks for joining us today, Brian. We appreciate that outlook as we look into 2018, and hope you'll join us again for another discussion.**

Speaker: **Thank you for joining us. We hope you will stop by again for news on this ever changing space. Until next time, connect with us on Twitter at @CEFAssociation, or by searching for the Closed-End Fund Association on LinkedIn and YouTube.**

Please consider the investment objectives, risks, charges and expenses of any Cohen & Steers U.S. registered open-end fund carefully before investing. A summary prospectus and prospectus containing this and other information may be obtained, free of charge, by visiting cohenandsteers.com or by calling 800 330 7348. Please read the summary prospectus and prospectus carefully before investing.

Data quoted represents past performance, which is no guarantee of future results. The information presented does not reflect the performance of any fund or account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected.

This podcast is for informational purposes, and reflects prevailing conditions and our judgment as of the date of this material, which are subject to change. We consider the information in this article to be accurate, but we do not represent that it is complete or should be relied upon as the sole source of suitability for investment. There is no guarantee that any market forecast set forth in this article will be realized. There is no guarantee that any historical trend illustrated in this presentation will be repeated in the future, and there is no way to predict precisely when such a trend will begin. The mention of specific securities is not a recommendation or solicitation to buy, sell or hold any particular security and should not be relied upon as investment advice.

This material represents an assessment of the market environment at a specific point in time and should not be relied upon as investment advice, does not constitute a recommendation to buy or sell a security or other investment and is not intended to predict or depict performance of any investment. This material is not being provided in a fiduciary capacity and is not intended to recommend any investment policy or investment strategy or take into account the specific objectives or circumstances of any investor. Please consult with your investment, tax or legal adviser regarding your individual circumstances prior to investing.

Risks of Investing in Preferred Securities

Investing in any market exposes investors to risks. In general, the risks of investing in preferred securities are similar to those of investing in bonds, including credit risk and interest-rate risk. As nearly all preferred securities have issuer call options, call risk and reinvestment risk are also important considerations. In addition, investors face equity-like risks, such as deferral or omission of distributions, subordination to bonds and other more senior debt, and higher corporate governance risks with limited voting rights. The fund is classified as a "non-diversified" fund under the federal securities laws because it can invest in fewer individual companies than a diversified fund. However, the fund must meet certain diversification requirements under the U.S. tax laws.

Risks associated with preferred securities differ from risks inherent with other investments. In particular, in the event of bankruptcy, a company's preferred securities are senior to common stock but subordinated to all other types of corporate debt. Throughout this presentation we will make comparisons of preferred securities to corporate bonds, municipal bonds and 10-Year Treasury bonds. It is important to note that corporate bonds sit higher in the capital structure than preferred securities, and therefore in the event of bankruptcy will be senior to the preferred securities. Municipal bonds are issued and backed by state and local governments and their agencies, and the interest from municipal securities is often free from both state and local income taxes. 10-Year Treasury bonds are issued by the U.S. government and are generally considered the safest of all bonds since they're backed by the full faith and credit of the U.S. government as to timely payment of principal and interest.
Preferred Funds may invest in below investment-grade securities. Below investment-grade securities or equivalent unrated securities generally involve greater volatility of price and risk of loss of income and principal, and may be more susceptible to real or perceived adverse economic and competitive industry conditions than higher grade securities. No representation or warranty is made as to the efficacy of any particular strategy or fund or the actual returns that may be achieved.

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.

Risks of Investing in Closed-End Funds
Risks associated with investing in closed-end end funds generally include market risk, leverage risk, risk of anti-takeover provisions and non-diversification. In addition, shares of many closed-end funds frequently trade at a discount from their net asset value.

Cohen & Steers Capital Management, Inc. (Cohen & Steers) is a registered investment advisory firm that provides investment management services to corporate retirement, public and union retirement plans, endowments, foundations and mutual funds.

Cohen & Steers U.S. registered open-end funds are distributed by Cohen & Steers Securities, LLC., and funds are only available to U.S. residents.

Cohen & Steers UK Limited is authorized and regulated by the Financial Conduct Authority (FRN 458459).

Cohen & Steers Japan, LLC, is a registered financial instruments operator (investment advisory and agency business with the Financial Services Agency of Japan and the Kanto Local Finance Bureau No. 2857) and is a member of the Japan Investment Advisers Association.

Disclosure
Closed-end funds trade on exchanges at prices that may be more or less than their NAVs. There is no guarantee that an investor can sell shares at a price greater than or equal to the purchase price, or that a CEF's discount will narrow or be eliminated. CEFs often use leverage, which increases a fund's risk or volatility. The actual amount of distributions may vary with fund performance and market conditions. Past performance is no guarantee for future results.