Manulife Investment Management

Preferred securities essential

Issued by large enterprises

Utilities

Regulated utilities provide stable and predictable stream of earnings that are secured by a lack of competition and low sensitivity from commodity prices and the economic cycle.

In the US, the industry is highly regulated, companies have very clean balance sheets and have an average rating of investment grade at BBB-, illustrating the higher quality nature.

Average returns of preferred securities in the past three years: **6.2%**

Communications

The communications industry includes cable, satellite, media and entertainment businesses. With the advent of the 5G era, the entire industry chain is expected to be upgraded concurrently, while expanding the scope of their applications at the same time.

This sector, like the utilities industry, is also regulated by the government and their business are less affected by global trade.

Average returns of preferred securities in the past three years: **10.2%**

Banks

Banks are the main issuers of the preferred securities market. The balance sheet of the banking industry stands at its strongest level in 50 years while their Tier 1 common capital ratio remains stable.

Despite the low rate environment may weigh on the net interest margin of the banking industry, low interest rates coupled with continuous economic growth will benefit loan growth and support the overall revenue of the banking industry.

Average returns of preferred securities in the past three years: **7.0%**

Insurance

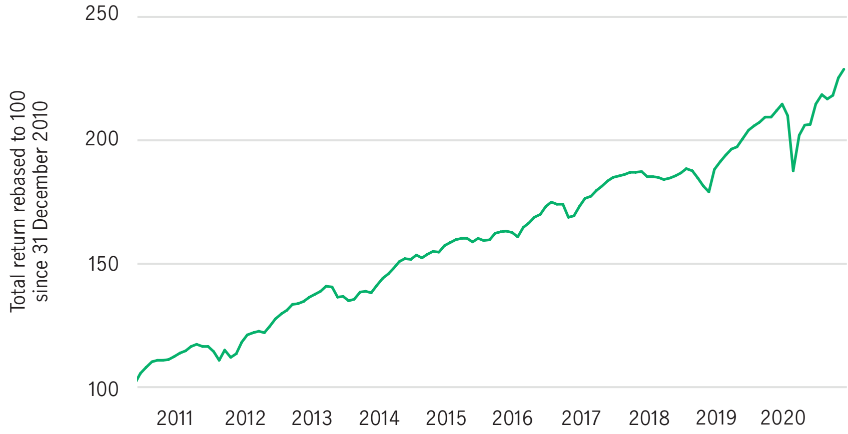
With similarities to the banking sector, the insurance company balance sheets are very strong. The insurance sector is regulated by regulators and have strict guidelines for how much risk-based capital a company should have. Property and Casualty (P&C) are relatively attractive among insurers as they are seen as less sensitive to declining interest rates and their earnings will likely improve as they are better positioned to increase pricing after recent natural catastrophes.

Average returns of preferred securities in the past three years: **7.5%**

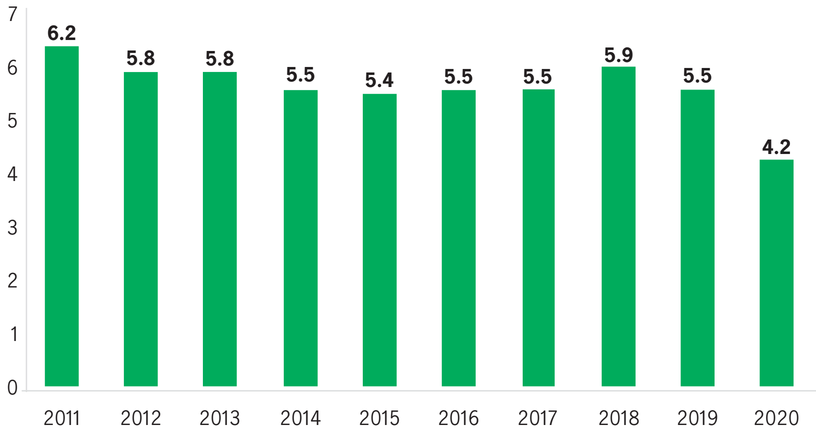
Source: Bloomberg, as of 31 December 2020. Preferred securities markets measured by ICE BofAML US All Capital Securities Index (IOCS). Industry breakdown follows Bloomberg Barclays Level 2-3 Class classification. Performance information is for information only.

Preferreds offer an average **5.5%** yield in the past decade

The preferred market recorded positive returns in nine of the past ten years



Preferreds offer an average 5.5% yield in the past decade

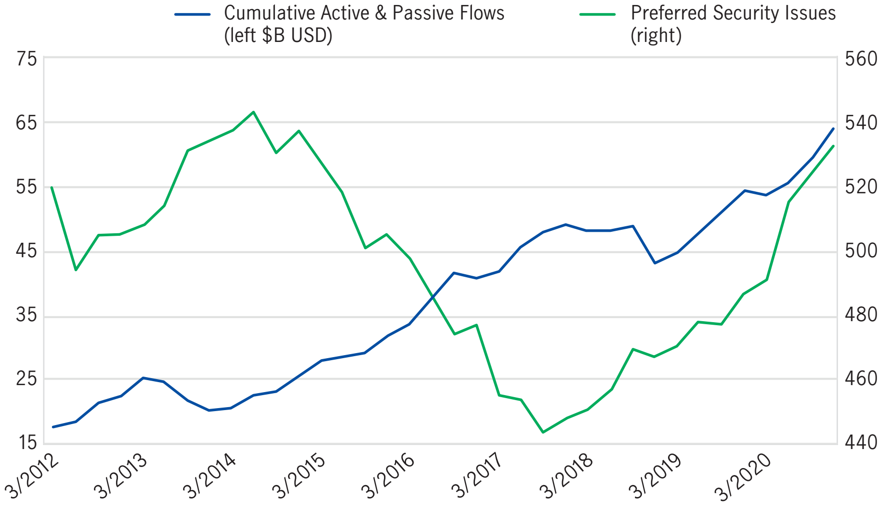


Source: Bloomberg, as of 31 December 2020. Performance of preferred securities markets from 2011 to 2012 is measured by 50% ICE BofAML Fixed Interest Preferred Securities Index (P0P1) + 50% ICE BofAML US Capital Securities Index (C0CS). Performance of preferred securities markets since 2013 measured by ICE BofAML US All Capital Securities Index (I0CS). Yield refers to yield of maturity.

Quality supply has bottomed out and rebounded

Since preferred securities can be regarded as equities in balance sheets without carrying voting rights, preferred issuance will not increase debt levels or dilute ownership. Therefore, companies are often willing to issue preferred securities with higher coupons for financing purposes.

In the past decade, the banking industry has once issued large amounts of preferred securities to fulfill the capital adequacy requirement by regulators. With the stress test showing the banks having fully compliant capital ratio and solid fiscal status, the banks' issuance of preferred securities has gradually decreased. Meanwhile, non-financial companies (such as utilities and communication ones) started to issue preferred securities amidst global economic recovery and low interest rate environment. Many of their issues offer high credit quality with compelling yields. On the other hand, investors' demand of quality assets with higher yield is expected to remain strong amid low rates environment.



For example, the US utilities sector has experienced an increase in regulation since 2008, which benefits investors. In the meantime, many companies have upgraded their production capacity, invested in sustainable energy production technologies and looked for M&A opportunities. Therefore, utility's companies turned to the preferred securities market for their financing needs to raise funds for future developments.

Dominion Energy, a US-listed major energy service company with a BBB+ (investment grade) credit rating, provides electricity or natural gas to 7.5 million customers in 18 states. It has launched a series of business plans in recent years. Apart from having reduced its carbon intensity by 50% from 2000 through 2017, the company also announced a further 50% reduction in carbon emissions and a 50% reduction in methane emissions from its gas assets by 2030. In 2018, the company announced several M&A deals and started a variety of renewable energy projects, including solar and wind energy. The company issued bonds and preferred securities during the period to raise funds for business development.[1]

Example: Various types of securities issued by Dominion Energy[2]

	Coupon rate	Maturity date (dd/mm/yy)	Security ratings
Senior bond	2.45%	15/01/23	BBB
Preferred security	7.25%	01/06/22	BBB-
Common stock	4.68% (dividend yield)	N/A	N/A

[1] Source: Company website.
[2] Source: Bloomberg, as of 31 December 2020. Credit rating by Standard and Poor.

There is a rich supply of preferred securities combined with strong credit ratings and compelling yield

Types of preferred securities

Preferred debt (including subordinated debt and junior subordinated debt)	✓ Normally with regular payouts ✓ Mostly with a maturity date ✓ Non-US investors are not subject to any withholding tax
Traditional preferred stock	✓ Senior to common stocks in the capital structure; no voting rights ✓ With a maturity date or perpetual in nature ✓ For dividend: Non-US investors are subject to a withholding tax of about 30% while US investors enjoy a tax advantage
CoCos	✓ Must be a perpetual bond ✓ Coupon payments that can be omitted or cancelled at the issuer's discretion ✓ Subject to bond covenants, part or all of the CoCos will be converted to common shares or even cancelled in the event that: 1) An issuer's capital ratio falls below the required level; 2) Regulators believe that the bank's capital ratio is too low

Glossary of preferred securities

Floating rate and fixed-to-float rate	• The coupon of a floating rate security is tied to a short-term benchmark rate plus a premium, such as the 3-month interbank rate plus 400 basis points. • A fixed-to-float rate security pays a fixed coupon for a stated number of years, and then floats. Some reset the coupon rate according every quarterly or semi-annually, for example, 3-month interbank rate plus 300-450 basis points. • This feature has broader appeal for institutional investors given a lower duration and some protection from rising rates.
Cumulative/non-cumulative	• "Cumulative" means that any deferred coupons continue to accrue as a liability to the issuer. Generally speaking, the holders of cumulative preferred securities are entitled to the coupon prior to common shareholders. • For "non-cumulative" securities, the issuer has the right to cancel the coupon due without being in default. • Cumulative preferred securities are senior to non-cumulative preferred securities in the capital structure.
AT1/T2	• Under the Basel III regulations, a bank's capital ratio is composed of three types: Additional Tier 1 Capital (AT1), Tier 2 Capital (T2), and Core Equity Tier 1. • In the capital structure, a Tier 2 bond has the highest priority of claim on an issuer's assets, followed by an AT1 bond and then a common share. In other words, the holders of a Tier 2 bond can receive the proceeds of liquidated assets first, followed by the holders of an AT1 bond and common share respectively. • CoCos, if they fulfill the related requirements, could qualify as either AT1 or AT2 capital of a bank under Basel III.
Callable	• The issuer can redeem the security prior to its maturity. • Callable terms are favourable to issuers as they can redeem and reissue new bonds with a lower coupon in a rate cut environment.
Convertible bond	• Under certain conditions, the issuer can convert the security into common shares.
Perpetual bond	• A bond with no maturity date or a long maturity period. • Most perpetual bonds include early redemption terms. The issuer, for instance, can redeem the bond five years following the issuance with 30 days' notice.
Effective duration	• A bond price is affected by interest rate changes while duration reflects the sensitivity of a bond price to the movement of interest rates. The longer the duration of a bond, the greater its price decline when interest rates increase. • While a traditional bond has one maturity date, some preferred securities have long maturity periods with early redemption terms. These conditions will be reflected in the calculation of "effective duration" to obtain an accurate and effective indicator.

Manulife's investment expertise

26 years+
Investment experience by the US based lead managers

140+
Global fixed income investment experts[1]

US$5.3billion
AUM in preferred securities[2], and one of the key players in the market

[1] Total is comprised of investment professionals of Manulife Investment Management, Manulife-TEDA Fund Management Co. Ltd., a 49% joint venture is a joint venture between Manulife Financial and Northern International Trust, part of the Tianjin TEDA Investment Holding Co. Ltd. (TEDA), and Mahindra Manulife Investment Management Private Limited, a 49% joint venture of Manulife and Mahindra AMC. As of 30 September 2020.

[2] Source: Manulife Investment Management, as of 31 December 2020.

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