

Preferred securities essential





A higher quality investment with **more attractive yield**



Mispricing in preferred securities offers opportunities for professional investment managers to add alpha for their portfolios

Amidst an ever-changing global economy coupled with a lower-for-longer interest rate environment, investors are seeking **higher quality investments with more attractive yields**.

Preferred securities: A US\$1 trillion market

The global preferred securities market is valued at over US\$1 trillion, close to that of US high yield bonds.

Over 90% of preferred issuers are rated as investment grade. With yield levels similar to global high yield bonds, preferred securities offer higher credit quality¹.

	Average credit rating	Yield to maturity	2020 return
Preferred securities market	BBB- (Investment grade)	4.98%	+7.6%
Global high yield bond market	B+ (Non-investment grade)	4.25%	+6.2%

Source: Bloomberg, as of 31 December 2020. Past performance is not indicative of future results.

The difference between \$25 par and \$1,000 par markets

The preferred securities market is primarily comprised of two types of issues: \$25 par value securities targeted at retail investors and \$1,000 par value securities targeted at institutional investors. \$25 par securities are traded on the major stock exchanges, and the denomination of \$25 par securities in small sizes enables a retail investor to buy 100 shares for around \$2,500. In contrast, \$1,000 par securities are traded over-the-counter and are mainly purchased by institutional investors. Its higher denomination also acts as a hurdle for most retail investors.

The domination of retail investors and passive exchange-traded funds (ETFs) for \$25 par securities, may lead to higher volatility driven by sentiment and capital flows, which may also create pricing distortions among \$25 and \$1,000 par securities in the secondary market prices, even if they are from the same issuer with similar terms. The mispricing in preferred securities offers opportunities for professional investment managers to add alpha for their portfolios.

¹ Preferred securities market represented by ICE BofAML US All Capital Securities Index (IOCS), Global high yield bonds represented by ICE BofAML Global High Yield Index (HW00). For illustration purposes only. Past performance is not indicative of future results.

Issued by large enterprises



Utilities

Regulated utilities provide a 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 utilities industry is highly regulated, and companies also have very clean balance sheets and an average investment grade rating of BBB-, illustrating the higher quality nature.

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



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 its Tier 1 common capital ratio remains stable.

Despite the low rate environment weighing on the net interest margin of the banking industry, these low interest rates, coupled with continuous economic growth, can benefit loan and overall revenue growth of the banking industry.

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

Source: Bloomberg, as of 31 December 2020. Preferred securities market is measured by ICE BofAML US All Capital Securities Index (IOCS). Industry breakdown follows Bloomberg Barclays Level 2-3 Class classification. Average returns shown are for information only and are not indicative of future performance.



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 is less affected by global trade conditions.

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



Insurance

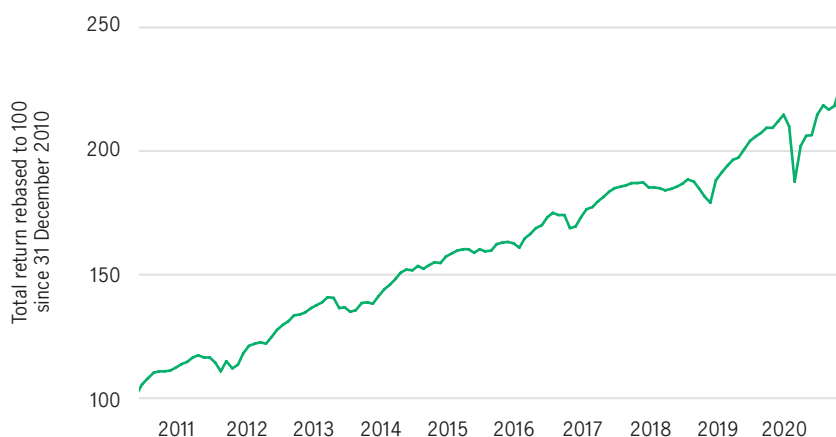
Similar to the banking sector, the insurance sector's balance sheet is very healthy. The sector is highly regulated by regulators and has strict guidelines on the level of risk-based capital a company should have. Property and Casualty (P&C) insurance is relatively attractive among insurers, as they are seen as being 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%**

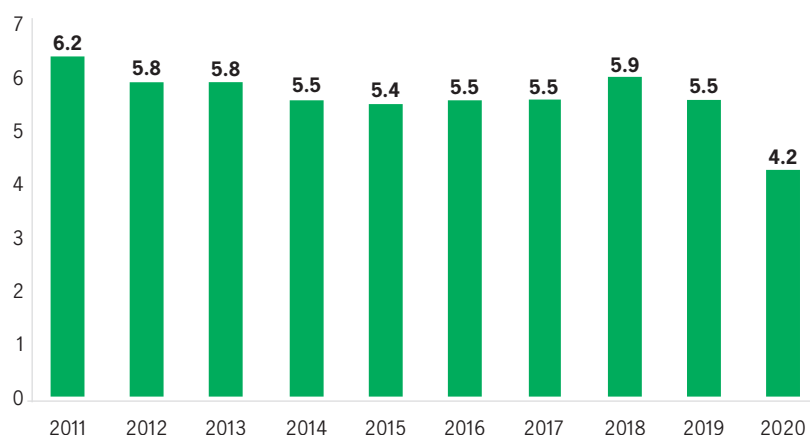


Preferreds offered
an average **5.5%**
yield in the past
decade

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



Preferreds offered an average 5.5% yield in the past decade

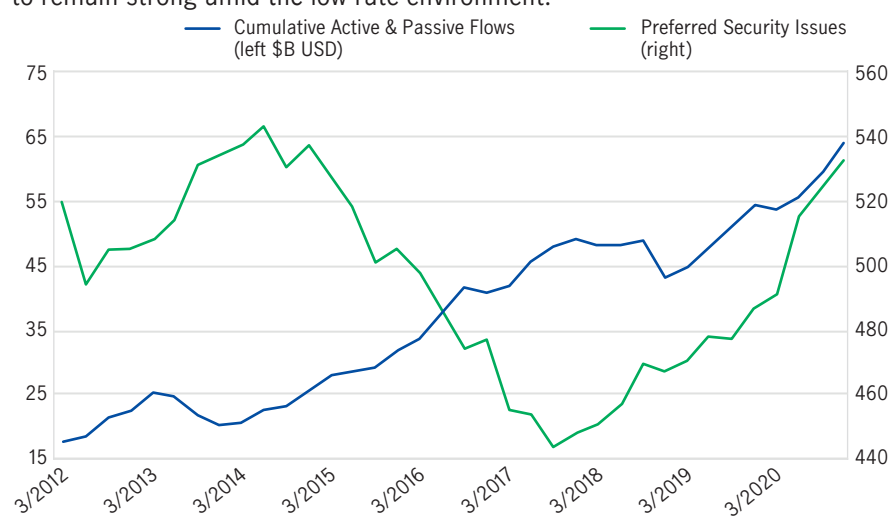


Source: Bloomberg, as of 31 December 2020. Performance of preferred securities market from 2011 to 2012 is measured by 50% ICE BofAML Fixed Interest Preferred Securities Index (POP1) + 50% ICE BofAML US Capital Securities Index (COCS). Performance of preferred securities markets since 2013 measured by ICE BofAML US All Capital Securities Index (IOCS). Yield refers to yield to 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 had issued large amounts of preferred securities to fulfill the capital adequacy requirement by regulators. With stress tests showing the banks having fully compliant capital ratios and solid fiscal statuses, banks' issuance of preferred securities has gradually decreased. Meanwhile, non-financial companies (such as utilities and communication names) have started to issue more preferred securities amidst the 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 for quality assets with higher yield is expected to remain strong amid the low rate 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 searched for M&A opportunities. Therefore, utility 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 Energy²

	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. For illustration purposes only. This is not a recommendation to buy or sell any security.

² Source: Bloomberg, as of 31 December 2020. Credit rating by Standard and Poor's.



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

Types of preferred securities

Preferred debt (including subordinated debt and junior subordinated debt)	<ul style="list-style-type: none"> ✓ Normally with regular payouts ✓ Mostly with a maturity date ✓ Non-US investors are not subject to any withholding tax
Traditional preferred stock	<ul style="list-style-type: none"> ✓ Senior to common stock in the capital structure; no voting rights ✓ With a maturity date or perpetual in nature ✓ For dividends: Non-US investors are subject to a withholding tax of about 30% while US investors enjoy a tax advantage
Contingent Convertibles (CoCos)	<ul style="list-style-type: none"> ✓ 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	<ul style="list-style-type: none"> • 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	<ul style="list-style-type: none"> • "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	<ul style="list-style-type: none"> • 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	<ul style="list-style-type: none"> • 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	<ul style="list-style-type: none"> • Under certain conditions, the issuer can convert the security into common shares.
Perpetual bond	<ul style="list-style-type: none"> • 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	<ul style="list-style-type: none"> • 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 experts¹

US\$5.3billion

AUM in preferred securities², 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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