Portfolio Perspective from the Investment Advisory Group

Remain cautious on preferred securities

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Highlights

- Preferred securities (preferreds) are down nearly 11% from their highs in early February on concerns over the banking sector given the asset class has significant exposure to financials.
- Despite the more attractive yields, **we remain cautious on preferreds** given a more challenging environment including elevated recession risks, the overhang from the banking sector, and the prospect for more onerous regulations impacting issuer profitability.

What happened

Early in the year, preferred securities were outperforming most other non-core fixed income sectors. Their longer duration profile benefited from declining yields as investors anticipated the end of the Federal Reserve's (Fed) hiking cycle. However, with the failure of Silicon Valley Bank in March and expanding stress in the banking sector, the environment has become more challenging for preferred securities. They are particularly vulnerable given they are comprised mostly of financials.

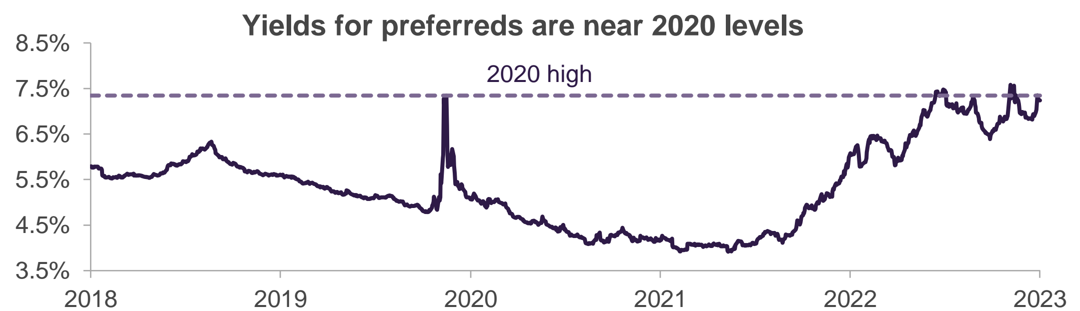
Also, there was the complete write-down of Credit Suisse Group's Additional Tier 1 bonds—a form of "contingent-convertible" bonds which are a hybrid of bank equity and debt—upon UBS Group's takeover of the bank. The decision to wipe out the bondholders while shareholders received some compensation sent a chill through investors in hybrid fixed income asset classes such as preferreds.

From its high in early February, the iShares Preferred & Income Securities ETF (PFF), holding both investment grade and below investment grade securities, has been negatively impacted by these events and is down nearly 11%. Given their hybrid nature, preferreds tend to have a higher correlation to equities, and their higher yields come with higher volatility.

Our take

At this time, we remain cautious on preferreds despite their more attractive valuations. We've maintained our cautious stance on non-core and below investment grade fixed income for most of the last year given the Fed's aggressive rate hiking cycle and its lagged effects on the economy. Therefore, we have been recommending an up-in-quality bias for fixed income portfolios, focusing on U.S. Treasuries.

Yields for preferreds are near 2020 levels



Data source: Truist IAG, FactSet. Yield shown is yield to maturity through May 9, 2023. Preferreds = ICE BofA Preferred Stock Fixed Rate Index. Past performance does not guarantee future results.

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Wealth

We continue to see elevated recession risks as the Fed's 500 basis points (5%) of rate hikes work their way through the system, along with tighter credit conditions, and the likelihood of a weakening jobs market weighing on growth.

Even more importantly, the stress and uncertainty in the banking sector are bound to be an overhang on the asset class for some time. There is the possibility that some issuers could suspend dividend payments on their preferred stock. We already witnessed that with First Republic Bank before it was taken over. Generally, dividend reductions and suspensions tend to be more likely during recessions as credit fundamentals deteriorate. However, larger market capitalization banks should fare better during periods of financial stress.

Plus, while the banking system as a whole remains on a stable footing as the Fed has mentioned, isolated issues may continue to arise—such as the three bank failures thus far—given the dynamics that have created this stress are still in place. For example, money market funds and U.S. Treasury bills offer more attractive yields than some banks' deposit rates. Additionally, some banks still have disproportionately large deposit accounts that exceed the federally insured limit. Therefore, these accounts remain more susceptible to client withdrawals at any sign of stress. There's also the poor sentiment surrounding the banking industry that will foster ongoing volatility in our view.

Even if we were to receive more clarity and a resolution on the backstopping of bank deposits by U.S. regulators, the supervisory and regulatory environment for banks is becoming more onerous and will negatively impact their financial outlook. This could create additional stress for some issuers.

Bottom line

Despite attractive valuations and yields, we remain cautious on preferred securities. For yield-seeking investors comfortable with the higher risk, we would recommend a selective approach with a strong emphasis on higher quality and liquidity. Thus, there may be opportunities on an individual name basis or among actively managed mutual funds, but we would expect the overall indices and broad-based (i.e., passive) exchange-traded funds to be more challenged.

Disclosures

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