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INVESTMENT MANAGEMENT

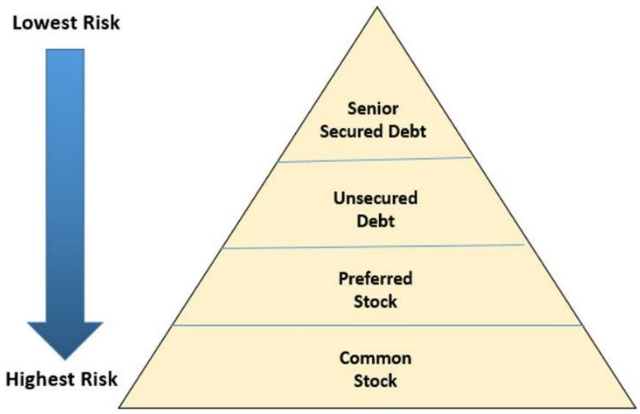
Preferred Stocks

28 August 2020

The first half of 2020 has asset managers looking across regions and asset classes for untapped sources of return. Some seem to be quite thematic – should it be gold? Pharmaceutical stocks? Bitcoin? In a market where returns are more uncertain than usual, and protection assets yield less than single-digit income, the search for yield, especially for investors dependent on investment income, becomes paramount. Preferred stock (known as preference shares in South Africa), while not one of the more popular asset classes for the everyday investor, provides some benefits for a manager disappointed by fixed income and wary of equity.

Fixed Income or Equity?

Preferred stock is a hybrid of equity and bonds – higher in the corporate capital structure than common equity (CE), but without the voting rights that CE shareholders enjoy. The 'waterfall' of the corporate capital structure outlines not only the orientation of risk as investors move away from pure debt but the right to income (dividends) as well, with common equity given the lowest prioritization. If a firm experiencing financial trouble decides to cut dividends to shore up its balance sheet, CE dividends will be the first to be cut, and only once those dividends go to 0 can the firm cut preferred stock dividends. Likewise, once the firm can pay dividends again, all preferred stockholders must receive their full dividend before CE shareholders are eligible for a dividend payment once again. Cumulative preferred stock is a subset that requires missed dividend payments to be paid retroactively until all current and past dividend payments have been met - only then will common shareholders see any income.



Source: IG Group

Historical Characteristics and Performance

As a 'hybrid', the statistical analysis of preferred stock falls somewhere between fixed income and equity. For it's similarities to common stock, preferreds have historically had higher standard deviation than bonds, but lower than equity. Over the long-term preferreds' total returns have eclipsed fixed income returns, though because of its equity-like characteristics preferreds are more exposed to volatility and have much more exposure to market swings. For example, the historical correlation between the US preferreds market index pre-COVID sat at a moderate 0.54 to the US equity market – the US bond index correlation was -0.22 over the same period. With the massive market downturn in the first half of the year, the year-to-date correlation between the preferred index and the US equity market spiked to 0.96 – the US bond index correlation likewise spiked to

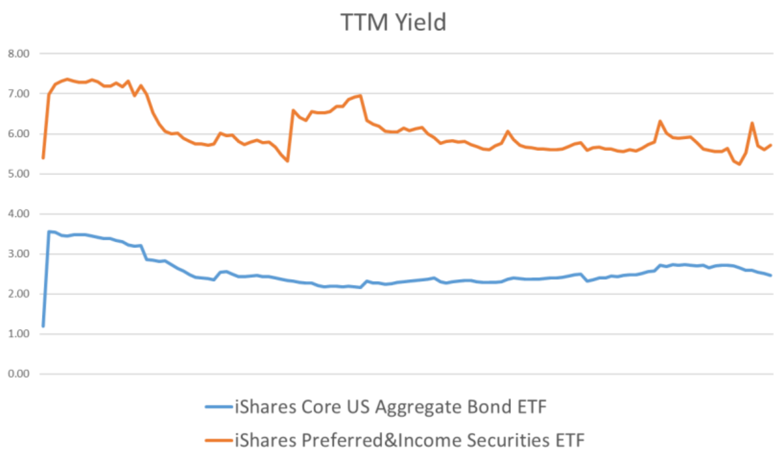
0.46 over the same period. Preferreds then look like the poster child for the bear market adage: "Correlations go to 1".

With the higher levels of volatility and exposure to market movements, preferreds are not then necessarily the answer for investors focused on the preservation of capital but rather for the preservation of income. For investors living off the income their portfolio provides and concerned about cash flow levels during bouts of market volatility, preferreds can act as a bridge for portfolios waiting for the return of a bull market.

Preferreds Among COVID Assets

As with any rational asset allocation decision, managers must consider preferreds against other available asset classes, and in a COVID world, preferreds offer advantages.

One of the benefits of preferreds is the level of income they provide. The rates on preferred equity are generally higher as a trade-off for buying a riskier asset class than bonds, and at no time is that more critical than in the fixed income environment in which we find ourselves. With many central bank rates at negative or very low yielding levels, matching previous levels of portfolio income is near impossible without dipping into portfolio capital or taking a chance on stock dividends. In contrast, preferreds have maintained a healthy spread over their structurally senior counterparts. For an investor principally concerned with maintaining a certain level of income, preferreds can help patch the gap in income.



Source: Morningstar Data

Investors looking for income yields above the paltry amounts offered by fixed income right now might find themselves likewise disappointed by equity's handouts. Preferred dividends enjoy higher protection from the capital structure than common equity, and CE dividends have certainly taken a massive hit this year. Among declining profit margins and facing uncertain earnings, many companies have cut or even cancelled dividends in 2020, seeing total shareholder payouts decline by over 22% worldwide – the worst quarterly fall since 2009.[1] Even developed markets are seeing their dividend payouts take a nosedive – in France, payments dropped by almost two-thirds, and in the UK – by half.[1] It's probable that some of the dividend cuts also affected preferred stock, but CE dividends are, by design, the first on the cutting block.

Another vital aspect to highlight about preferred stock and dividends is the issuers. Banks "constitute over half of the preferred securities universe", and unlike the last crisis, the financial sector has held up quite well.[2] With higher liquidity levels, more robust balance sheets, and more

[1] Financial Times (2020). 'Global dividends suffer worst quarterly fall since 2009'
[2] Martin, Bill (2020). MarketWatch, "Preferred securities: staying the course amid COVID-19"

stringent regulation, banks have managed to weather the market downturn much better than they did ten years ago. That extra capital cushion also helps banks maintain their dividend payments, and as the significant sector making up preferred stock issuers, that is good news for preferred dividend recipients.

All asset classes should be considered in the context of both a portfolio and a macroeconomic environment, and the low-income setting in which we find ourselves is the epitome of a rock and a hard place. Where fixed income provides protection but not income, and equity has lost the confidence to provide the latter, preferred stock can act as an efficient stop-gap until yields, and returns revert to more normal levels.

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