



Amid a persistent low-yield environment with the post-COVID economic development, preferred securities can offer a compelling opportunity that will continue into 2021: with careful issuer selection, investors may achieve potentially higher yields without the need to sacrifice quality. This makes them a valuable fit for today's income portfolios.

## Maximising yield potential in an investment-grade asset class

While preferred securities were affected by the global pandemic fallout, their trajectory throughout 2020 has shown this to be a resilient asset class.

### Preferred securities' 2020 trajectory – A resilient recovery

After the volatility witnessed in the first quarter of 2020, preferred securities also benefited from the Federal Reserve's (Fed's) supportive actions, recovering 16.27% in the second and third quarter of 2020, surpassing that of US high-yield bonds, which rebounded by 15.49% over the same period. Year-to-date, preferred securities posted 5.98% return while US high-yield bonds gained 4.18%<sup>1</sup>.

With potential yield-spread tightening and a lower-for-longer interest-rate environment, we are positive that preferred securities, as an investment-grade asset class, can potentially help investors navigate the low-yield landscape that will persist into the new year.

### Positive macro trends

The economic environment should continue to improve in 2021. As multiple global vaccines come into play, we anticipate broad-based spread tightening – a positive catalyst for preferred

securities. The average yield spread of preferred securities versus the 10-year Treasury is still above the historical average yield spread – meaning there is potential for further spread tightening. Furthermore, this is expected to occur across sectors: consumer cyclicals and telecommunications, in particular, have the potential for greater spread tightening as the economy improves.

We also believe that the previously mentioned lower-for-longer interest-rate environment will persist in 2021. There are three reasons to support our view. First, growth and inflation expectations are expected to be muted. GDP expansion, particularly in the US, may also be hampered by demographic pressures, as the over-65 age group is set to increase by more than 50% in the next three decades<sup>2</sup>.

Secondly, the looming prospect of a smaller fiscal stimulus stemming from a divided US government may temper inflation expectations. Thirdly, there is now a record USD 17.17 trillion in negative-yielding debt globally<sup>3</sup>, forcing investors to look beyond the government-bond market for income.

When combined, these factors generate tremendous demand for higher-yielding securities like preferred securities, particularly as they feature stronger credit quality and lower default rates than high-yield bonds.

### Better credit quality and lower default rates

Preferred yields are similar to those from high-yield issues<sup>4</sup>. However, the average credit quality of

<sup>1</sup> Source: Manulife Investment Management and Bloomberg, as of 30 November 2020. Returns in US dollar. Preferred securities = ICE BofAML US All Capital Securities Index. US High Yield = ICE BofAML US High Yield Index. Past performance is not indicative of future performance.

<sup>2</sup> OCED Historical population data and projections, 2019.

<sup>3</sup> Bloomberg Barclays Global Negative Yielding Debt Index, as of 30 November 2020.

<sup>4</sup> Source: Bloomberg, ICE/BofAML indices and Manulife Investment Management, Yield to Maturity, as of 30 November 2020. US high yield

preferred securities is BBB- or investment grade. High-yield bonds may indeed offer slightly higher yields, but at the cost of a lower credit rating (their average credit rating is B+, which is below investment grade)<sup>5</sup>. Furthermore, default rates are low for preferred securities, historically standing at only 0.33% – which makes sense given the average investment-grade rating. In contrast, global high-yield bonds have had a 30-year default rate of 4.06%<sup>6</sup>. We believe the credit quality and default rate of preferred securities should not be adversely affected under the current environment.

What also distinguishes preferred securities from other areas of the fixed income market, particularly high yield, is that they are less sensitive to changes in interest rates. Many of them come with a fixed-to-floating-rate coupon structure whereby for the first 5 or 10 years of the life of the security the coupon is fixed, after which it floats. Even in a rising rate environment, investors are offered some coupon protection. This further adds to their core appeal – attractive yields with reduced credit risk – and explains why we believe they may be one of the valuable portfolio tools.

In terms of sector preference, investors should be looking for companies with strong fundamentals, stable balance sheets, and attractive yields, particularly those in the US utilities, energy, and financial sectors.

### Sectoral focus – Financials, utilities, and energy

In the **utilities** space, we believe that convertible preferred securities show attractive opportunities right now. Issuer fundamentals are solid, with virtually all US utilities reiterating the earnings growth guidance given before the lockdowns. The positive catalysts stemming from their investments in renewables also look set to become even more optimistic under a Biden presidency. Although the sector has acted as a defensive hedge in 2020's volatile markets, utility stocks are also at 20-year

lows as compared to S&P 500 valuations – boosting future return potential<sup>7</sup>.

As for **energy**, we see investment opportunities in midstream companies with diversified business models (e.g., natural gas pipelines and gasoline storage). Given that natural gas is principally used for heating and electricity generation, we expect robust cash flows to continue.

**US financial companies** have boosted their capital reserves since the 2008 Global Financial Crisis. Balance sheets are in the best shape in decades<sup>8</sup>, a key factor supporting their resilience amid a challenging economic environment. Also, except for one large US bank, all the major institutions have maintained their common dividends. We believe the market is discounting these fundamentals.

While there is geographic concentration risk to the US, we think their risk-return profile remains attractive. This stands in contrast to European financial institutions, which may also be forced by the regulators to halt dividend payouts.

### Conclusion – A strong play in a low-yield world

As yields on traditional fixed-income securities, such as developed-market government bonds, continue to trend lower, preferred securities are providing investors' portfolios with compelling yields. What's more, they have lower volatility, defaults, correlations, and interest-rate sensitivity. With the "search for yield" theme likely to continue in 2021, we believe preferred securities may provide the balance between yields and quality that investors clearly seek.

bonds, with yield-to-maturity 5.31%, are represented by Bank of America Merrill Lynch High Yield Index; Preferred securities, with yield-to-maturity 4.37%, are represented by ICE BofAML US All Capital Securities Index. Yield to maturity is the rate of return anticipated on a bond if it is held until the maturity date. It is not an accurate reflection the actual return that an investor will receive in all cases.

<sup>5</sup> Average credit ratings refer to Standard & Poor's ratings, as of 30 November 2020.

<sup>6</sup> Global high yield bonds default rate is sourced from Moody's Investor Services, as of 31 December 2019. Preferred Securities default rate from 1990-2017 was calculated by Wells Fargo. Beginning in 2018 Manulife Investment Management used the ICE BofAML US All Capital Securities Index to calculate the annual default since Wells Fargo stopped providing related information after 2017. As of 31 December 2019. Past performance is not indicative of future performance.

<sup>7</sup> BofA Research, 1 June 2020.

<sup>8</sup> Federal Deposit Insurance Corporation (FDIC), November 2020.

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