

Preferred Securities

The preferred and capital securities market had a total return of 8.2% in 2023, as measured by a blended benchmark consisting of 55% ICE BofA U.S. IG Institutional Capital Securities Index, 20% ICE BofA Core Fixed Rate Preferred Securities Index and 25% Bloomberg Barclays USD Developed Market Contingent Capital Index).

Investment Review

Preferred securities advanced in 2023, overcoming turmoil in the banking sector (the main issuer of preferreds) early in the year. In the U.S., the sudden collapse of Silicon Valley Bank, Signature Bank and First Republic Bank in early 2023 raised concerns about funding and contagion risk. In Europe, struggling Credit Suisse was acquired by rival UBS in March. Financial regulators took swift action to mitigate contagion risk; the Fed and other central banks assured that funding would remain readily available in the global banking system.

Concerns around these events eased as the period progressed and fundamentals of the broader banking system remained healthy and resilient. Industry data and individual company comments suggested that the well-publicized U.S. regional bank failures were idiosyncratic and not reflective of systemic risk. Credit Suisse, meanwhile, appeared to be an outlier among European banks. Overall, the banking sector in the U.S. and Europe continued to generate solid profitability and strong capitalization.

Index Performance (US\$)

	Linked Index ⁽¹⁾
Q4 2023	6.87%
1 Year	8.21%
3 Year	-0.76%
5 Year	4.56%
10 Year	4.84%

(1) Linked Index: The linked blended index consists of 50% ICE BofA Capital Securities Index and 50% ICE BofA Fixed Rate Preferred Securities Index through 12/31/2016. Thereafter, it consists of 60% ICE BofA US IG Institutional Capital Securities Index, 30% ICE BofA Core Fixed Rate Preferred Securities Index, and 10% Bloomberg Developed Market USD Contingent Capital Index through 12/31/2018. Thereafter, it consists of 60% ICE BofA US IG Institutional Capital Securities Index, 20% ICE BofA Core Fixed Rate Preferred Securities Index, and 20% Bloomberg Developed Market USD Contingent Capital Index through 3/31/2022. Thereafter, it consists of 55% ICE BofA US IG Institutional Capital Securities Index, 20% ICE BofA Core Fixed Rate Preferred Securities Index, and 25% Bloomberg Developed Market USD Contingent Capital Index.

Data quoted represents past performance, which is no guarantee of future results. Risk of loss is possible.

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Periods greater than 12 months are annualized.

Bond yields were volatile in the period, but pressures lessened in the final months. Bond yields rose sharply through most of the period as the U.S. Federal Reserve and other central banks continued to raise interest rates in an effort to contain inflation; yields then declined late in the year on signs of moderating inflation and dovish signals from the Fed. The yield on the 10-year U.S. Treasury retreated to 3.9% by year end, about where it stood at the start of 2023 after peaking near 5.0% in October. In this environment, preferreds outperformed Treasuries by a wide margin but trailed high-yield debt.

New supply of preferred picked up late in the year amid the better tone in markets. There were a number of deals near year-end as declining yields and a better total return environment encouraged issuance ahead of the holiday season. Most of the activity was in Europe, with contingent capital securities (CoCos) issuance totaling about \$10 billion in November alone, including the first new UBS CoCo since the bank's merger with Credit Suisse in March. The new supply was easily absorbed by healthy demand for above-average income, in both the U.S. and Europe. We expect supply to pick up again in the coming months after a lull during the holiday season.

Investment Outlook

We believe the interest rate-hiking cycle is at an end, with rate cuts likely in 2024. The cycle change sets up the potential for further strong returns for preferreds in coming quarters. Markets have begun to price in rate cuts, but we believe there is scope for further gains. We expect performance to be strong as the cutting cycle materializes, as lower yields on money market funds and short-term bonds are likely to lessen the appeal of those safe havens and result in investor demand for higher-income solutions such as preferred securities. Moreover, valuations are generally attractive for long-term buyers today, in our view, as preferreds offer some of the highest yields found among investment-grade securities. With income rates of 6–10%—much of which is treated as tax-advantaged qualified dividend income (QDI)—we believe preferreds can offer equity-like returns for term investors.

Markets currently price in little risk of recession, but we remain a bit more cautious. We expect rate cuts to follow from slower economic growth, as more modest growth will be necessary to lower inflation. Signs of slower growth are abundant, with the “long and variable” lagged impacts of recent rate hikes being felt across economies. We believe a recession (should one occur) is likely to be mild, supported by the generally strong state of consumer balance sheets. However, the recent rate-hike cycle was the most aggressive in decades. Accordingly, we have to respect the possibility of a more

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significant slowdown. For this reason, we are somewhat more cautious on credit spreads. We generally favor higher-quality issuers as well as more defensive security structures. That said, we still see good value in select higher-yielding issues, including certain recently issued securities with attractive income rates and ample credit spreads.

Preferred securities, as a whole, offer solid credit quality and should perform well even in a mild to modest recession.

Financial issuers, including banks and insurance companies, are the largest issuers of preferreds (followed by utilities, telecoms and other more utility-like issuers). While the U.S. banking sector underwent a dramatic loss of confidence in the spring of 2023, we believe the banks that failed were outliers in their weak metrics. By contrast, the asset quality, funding and capital of the majority of large banks in the U.S.—as well as in other developed markets, including Europe—are strong, and banks have taken numerous steps to improve their capital and funding positions in recent quarters. A rate-cutting cycle would likely further bolster capital and funding; unrealized losses on bond holdings would diminish, and lower short rates would take pressure off funding costs and sources. Finally, we believe that the aggressive measures bank regulators have proposed in the wake of the failures—including demands for still higher capital ratios—will further galvanize the industry and support tighter credit spreads. These measures should provide a tailwind to preferreds, buoying their prices, as spreads and yields are likely to fall over time as risks diminish.

Diversification in insurance, utility, telecom and other sectors makes sense to us, and tax advantages could become more important. In addition to banks, the preferred securities universe includes issuance from the insurance, utility and telecom sectors, among others. We believe the health of these major sectors to be good, and we also believe it is important to diversify preferred holdings, particularly as the economy slows. In addition, as we look to the U.S. election in 2024, we note the swelling of the U.S. deficit in recent years, which was caused in part by Covid-related spending. We do not currently expect changes to tax rates, but we do believe the deficit will become a significant focus for Congress in coming years. In this environment, we believe investors should favor tax-advantaged issues such as preferred securities, which offer distributions taxed at QDI rates (about 23.8% for top earners). We do not now expect changes to tax rates, but believe the deficit will become a significant focus for Congress in coming years.

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The Bloomberg Developed Market USD Contingent Capital Index includes hybrid capital securities in developed markets with explicit equity conversion or write down loss absorption mechanisms that are based on an issuer's regulatory capital ratio or other explicit solvency-based triggers.

The ICE BofA Core Fixed Rate Preferred Securities Index tracks the performance of fixed-rate US dollar-denominated preferred securities issued in the US domestic market, excluding \$1000 par securities.

The ICE BofA US IG Institutional Capital Securities Index tracks the performance of US dollar denominated investment grade hybrid capital corporate and preferred securities publicly issued in the US domestic market.

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Investing in any market exposes investors to risks. In general, the risks of investing in preferred securities are similar to those of investing in bonds, including credit risk and interest-rate risk. As nearly all preferred securities have issuer call options, call risk and reinvestment risk are also important considerations. In addition, investors face equity-like risks, such as deferral or omission of distributions, subordination to bonds and other more senior debt, and higher corporate governance risks with limited voting rights.

Strategies focusing on preferred securities may invest in below-investment-grade securities and unrated securities judged to be below investment grade by the Advisor. Below investment-grade securities or equivalent unrated securities generally involve greater volatility of price and risk of loss of income and principal, and may be more susceptible to real or perceived adverse economic and competitive industry conditions than higher grade securities. The benchmarks may not contain below-investment-grade securities.

Contingent capital securities (sometimes referred to as "CoCos") are debt or preferred securities with loss absorption characteristics built into the terms of the security, for example a mandatory conversion into common stock of the issuer under certain circumstances, such as the issuer's capital ratio falling below a certain level. Since the common stock of the issuer may not pay a dividend, investors in these instruments could experience a reduced income rate, potentially to zero, and conversion would deepen the subordination of the investor, hence worsening the investor's standing in a bankruptcy. Some CoCos provide for a reduction in the value or principal amount of the security under such circumstances. In addition, most CoCos are considered to be high yield or "junk" securities and are therefore subject to the risks of investing in below investment-grade securities.

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An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes. Index comparisons have limitations as volatility and other characteristics may differ from a particular investment. The Fund is actively managed. The composition of the Fund is not constrained by the composition of the benchmark.

The views and opinions in the preceding commentary are as of the date of publication and are subject to change. There is no guarantee that any historical trend discussed above will be repeated in the future, and there is no way to predict precisely when such a trend might begin.

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