Brompton Flaherty & Crumrine Investment Grade Preferred ETF **BPRF**

Brompton Flaherty & Crumrine *Enhanced* Investment Grade Preferred ETF **BEPR**

Portfolio Manager Commentary - December 31, 2023

Market and Credit Environment

The benchmark preferred index[1] total return for the fourth quarter of 2023 was 6.3%. For comparison, over the same period the ICE BofA US Corporate Index[2] total return was 7.9%, the ICE BofA US High Yield Index[3] total return was 7.1% and Bloomberg U.S. Aggregate Index[4] total return was 6.8%. The benchmark preferred index total return for 2023 was 9.7%. For comparison, over the same period the ICE BofA US Corporate Index total return was 8.4%, the ICE BofA US High Yield Index total return was 13.5% and Bloomberg U.S. Aggregate Index total return was 5.5%.

2023 was a year marked by historically high volatility for preferred and contingent capital (CoCo) securities. Fortunately, we ended the year on a very positive note, but it was anything but a smooth ride. Preferred and CoCo markets began 2023 with a strong rally, reversed course a few months later into deep negative territory as a banking crisis and higher interest rates unfolded, and spent the rest of the year in recovery mode as banks slowly demonstrated with each earnings release that the crisis wasn't expanding and interest rates stopped their relentless march higher. Treasury bills and money funds provided investors with nearly risk-free alternatives at attractive yields, which contributed to the challenges facing a credit market recovery.

Investors have spent the better part of two years trying to anticipate the Federal Reserve's next move, and notably the timing of a "pivot" to rate cuts rather than increases. The Fed hiked rates four times during the year for a total of 1.0%, and a cumulative total of 5.25% since the first tightening in March 2022. Markets initially met increases with skepticism as indicated by the near-record levels of Treasury yield-curve inversion, an indication that markets believed the Fed was likely to overshoot with rate hikes and push the economy into a recession. Investors finally relented in mid-2023 and adopted a "higher-for-longer" outlook, resulting in 10- and 30-year Treasury yields above 5% and a much less-inverted yield curve by mid-October.

The Fed's rhetoric had begun to soften a bit by this point, along with modestly favorable inflation data, but it was the Federal Open Market Committee (FOMC) meeting on November 1 that gave investors hope for a near-term pivot. That outlook was solidified in mid-December when the FOMC projected larger than expected rate cuts in 2024. The result was a fierce Treasury rally (lower interest rates) over the last two calendar months of 2023 and a corresponding rally in nearly all risk assets (including preferreds and CoCos). From October 19 to year end, 5-, 10-, and 30-year Treasury yields dropped more than 100 basis points to 3.85%, 3.89%, and 4.05%, respectively.

The fixed-reset coupon structure prevalent in preferred and CoCo securities, and corresponding "intermediate" average portfolio duration, was expected to dampen the effects of interest rate changes over an interest rate cycle. However, the sheer magnitude and speed of the moves in Treasury yields in 2022 and 2023 (from a very low starting point) resulted in much higher volatility, along with some unintended consequences in the economy. Fed policy is a tool used to influence the economy and investors have been laser-focused on it, but it is a blunt instrument at best, and longer-term market direction will be determined by a broader array of economic factors, including the effects of positive market reactions to a possible Fed pivot.

The regional banking panic was certainly an unintended consequence of this interest rate cycle, and banks with severe problems were quickly exposed. Preferred and CoCo markets are heavily concentrated in financials, and negative performance reflected the strong risk-off move related to banks in spring 2023. While most banks experienced some level of stress, notably on a mark-to-market basis for assets and higher funding costs for liabilities, we have consistently held that mismanagement was bank-specific and that the global banking system was strong and able to adjust to these disruptions. Regulatory actions to provide liquidity, along with bank-specific changes to sourcing deposits, have stabilized banking markets. It is also worth noting that the 100+ basis point drop in Treasury yields to end the year should substantially improve the mark-to-market issues that have plagued banks throughout the year.

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(1) The benchmark preferred index is the ICE BofA 8% Constrained Core West Preferred & Jr Subordinated Securities Index (P8JC).

(2) The ICE BofA US Corporate Index (C0A0) tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market.

(3) The ICE BofA US High Yield Index (H0A0) tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market.

(4) The Bloomberg US Aggregate Bond Index is a broad-based index that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

Insurance companies have experienced their own challenges, especially property and casualty underwriters, as worldwide weather events remained elevated and high inflation boosted claim costs. Broadly speaking, however, insurers have benefited from this interest rate cycle, and earnings have continued to be healthy. Insurance companies struggled in the low-rate environment that persisted for years, as they were unable to invest at attractive levels and net spread was squeezed. Although they too experienced some mark-to-market asset decline from the increase in interest rates, they also have benefited by investing incoming premiums at substantially better levels, and their liabilities have improved as discount rates increased.

Energy/Pipeline companies benefited from relative stability in commodity markets, along with improvements in system volume metrics. Earlier in this economic cycle they were forced to retrench as capital became more expensive and COVID disrupted their ability to launch new projects. The result was a sharp pullback in expenditure and improvement in cash flow and leverage metrics. While most would have enjoyed a continuation of pre-COVID growth trends, the discipline exhibited during this difficult time has improved credit metrics for fixed-income investors.

Outlook

There is no question the last few years have been very challenging for investors, and we should not lose sight of the unique and material impact of the COVID pandemic on every aspect of the economy and markets. This economic cycle has been different than others, and there has been much on-the-job training (learning) required to address the widely varied consequences of COVID-era reactions and policies. Economic supply-demand imbalances have been new and unpredictable, while policymakers have been forced to rely mostly on traditional tools for guiding the economy. We are hopeful the policy choices in recent years, both good and bad, have brought us back to a more balanced economic state. Reducing the fear and uncertainty prevalent in recent years is critical to reducing market volatility moving forward.

Fundamental credit metrics remain healthy. Aggregate nonfinancial corporate balance sheets show good liquidity, modest interest expense relative to earnings, and cash flow exceeding investment spending. However, bank loan performance has deteriorated in recent quarters. Charge-offs and delinquencies increased modestly in most loan categories, but there are areas of sharper deterioration. Not surprisingly, commercial office loans are under stress from low occupancy rates, although other commercial real estate loans generally are performing well. Commercial and industrial loans also show little strain. However, consumer loan delinquencies and charge-offs are up considerably. Although higher delinquencies and charge-offs always merit attention, they are up from unusually low levels, and banks have been expecting them. For the past two years, banks increased loan-loss reserves in anticipation of a possible recession. We think they are well prepared to manage a possible downturn in the credit cycle.

Looking ahead, our base case is for the U.S. economy to experience a growth slowdown and gradually falling inflation that results in rate cuts beginning around mid-2024. However, ongoing inflation pressure from a tight labor market and rising home prices should limit rate cuts to 0.50-1.00%, not the 1.25-1.50% that markets currently anticipate. We expect intermediate- and long-term Treasury yields to end 2024 near current levels. Short-term rates should closely follow cuts to the fed funds target, leaving the yield curve less inverted or slightly positive. Slower economic growth should push credit spreads modestly wider. If that is right, 2024 probably will not see a major preferred market rally, but it should be a good year.

Preferred and CoCo security yields have increased with interest rates over the past several years and provide an attractive level of income. Although risks to the outlook remain, we believe there is opportunity in preferred and CoCo markets for long-term investors seeking income and solid credit quality and we are optimistic about the coming year.

Annual Compound Returns[5]	1-YR	3-YR	5-YR	10-YR	S.I. BPRF[6]	S.I. BPRF.U[7]
BPRF - Brompton Flaherty & Crumrine Investment Grade Preferred ETF (CAD-H)	6.5%	(1.3%)	3.5%	-	2.7%	-
BPRF.U - Brompton Flaherty & Crumrine Investment Grade Preferred ETF (USD)	7.0%	(1.3%)	-	-	-	2.1%
ICE BofAML 8% Constrained Core West Preferred & Jr Subordinated Securities Index	9.6%	(0.9%)	4.4%	-	3.6%	2.1%

Annual Compound Returns[8]	1-YR	3-YR	5-YR	10-YR	S.I. BEPR[9]	S.I. BEPR.U[10]
BEPR - Brompton Flaherty & Crumrine *Enhanced* Investment Grade Preferred ETF (CAD)	7.1%	(2.5%)	3.3%	5.0%	4.4%	-
BEPR - Brompton Flaherty & Crumrine *Enhanced* Investment Grade Preferred ETF (USD)	7.3%	-	-	-	-	(5.9%)
ICE BofA Indices	9.6%	(0.8%)	-	-	5.0%	(1.7%)

[5] Returns are for the periods ended December 31, 2023 and are unaudited. The table shows the Fund's compound returns for each period indicated compared with the ICE BofA 8% Constrained Core West Preferred & Jr Subordinated Securities Index ("Preferred & Jr Subordinated Securities Index"), (the "Index"). The Preferred & Jr Subordinated Securities Index tracks the performance of US dollar denominated high grade and high yield preferred securities and deeply subordinated corporate debt issued in the US domestic market. Qualifying securities must be rated at least B3, based on an average of Moody's, Standard & Poor's and Fitch and have a country of risk of either the U.S. or a Western European country. The Index is calculated without the deduction of management fees, fund expenses and trading commissions, whereas the performance of the Fund is calculated after deducting such fees and expenses. Past performance does not necessarily indicate how the Fund will perform in the future. The information shown is based on Net Asset Value per unit and assumes that distributions made by the Fund on its units in the period shown were reinvested at Net Asset Value per unit in additional units of the Fund.

[6] BPRF inception date October 15, 2018.

[7] BPRF.U inception date August 8, 2019.

[8] Returns are for the periods ended December 31, 2023 and are unaudited. The table shows the Fund's compound returns for each period indicated compared with the ICE BofA Indices. IceBofA Indices is comprised of the Preferred & Jr Subordinated Securities Index from 12/1/2021 to present, the ICE BofA 8% Constrained Non-DRD Eligible Core West Preferred & Jr Subordinated Securities Index (P8JN) from 4/1/2012 to 11/30/2021, and 50% ICE BofA Hybrid Preferred Securities 8% Constrained Index (P8HO) and 50% ICE BofA US Capital Securities US Issuers 8% Constrained Index (C8CT) from 12/15/2004 to 4/1/2012. P8JN is a subset of the Preferred & Jr Subordinated Securities Index that includes only non-DRD eligible preferred securities. P8HO includes taxable, fixed rate, US dollar denominated, investment grade preferred securities listed on a US exchange and are structured for retail investors, while C8CT includes investment grade, fixed rate or fixed to floating rate $1,000 par securities that are structured for the institutional investors and receive some degree of equity credit from the rating agencies or their regulators. ICE BofA Indices are calculated without the deduction of management fees, fund expenses and trading commissions, whereas the performance of the Fund is calculated after deducting such fees and expenses. The ICE BofA Indices are also not leveraged, whereas the Fund employs leverage. Past performance does not necessarily indicate how the Fund will perform in the future. The information shown is based on Net Asset Value per unit and assumes that distributions made by the Fund on its units in the period shown were reinvested at Net Asset Value per unit in additional units of the Fund.

[9] BEPR inception date December 15, 2004.

[10] BEPR.U inception date February 4, 2022.

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