PORTFOLIO MANAGER COMMENTARY - DECEMBER 31, 2020

U.S. Economic Conditions

The economy exited 2020 in a substantially better position than seemed possible last spring. Inflation-adjusted gross domestic product (real GDP) fell 5.0% in the first quarter of 2020 as the pandemic unfolded, plunged 31.4% in Q2 on unprecedented steps to slow its spread, and rebounded 33.4% in Q3 as the economy reopened. Those swings in Q2 and Q3 were by far the largest since quarterly GDP statistics began in 1947. Economists forecast 4.5% real GDP growth in Q4, which still would leave the economy about 2.3% smaller than its level in Q4 2019. Looking ahead, economists expect 4.0% real GDP growth in 2021, with a sluggish first quarter followed by solid expansion over the remainder of the year as vaccines accelerate progress against COVID-19.

After reaching a 50-year low of 3.5% in late 2019, the unemployment rate surged to a high of 14.7% in April 2020. It ended the year at 6.7%. From a peak level of 152.5 million nonfarm payroll jobs in February 2020, employment fell by 22.2 million jobs in just two months before gradually climbing back to 142.6 million in December, although that means nearly 10 million job losses since the start of the pandemic. Moreover, total payroll jobs are roughly 12 million below where they would have been if job growth continued at its prior rate of about 1.5%. There is still a long way to go before employment fully recovers from the pandemic.

Higher wages offset some of the pain for those who remained employed, and jobless benefits and other transfer payments provided needed support for those who lost jobs. As a result, over the past year real disposable personal income rose, but real personal spending fell with many activities curtailed. Higher income and lower spending pushed the average personal savings rate up to a record 15.7% over 12 months ending in November. Although some individuals are experiencing significant financial hardship, aggregate consumer balance sheets are in very good shape. Consumer spending is likely to remain cautious in Q1, but warmer weather and wider availability of coronavirus vaccines should prompt a rebound in consumer spending over the balance of 2021.

Investment spending was mixed in 2020. Business investment rose strongly in the third quarter, but it remains below its Q4 2019 level, mostly due to lower nonresidential construction. Office building occupancy remains low, which caused a drop in investment in nonresidential structures. In contrast, residential investment boomed in 2020. However, because residential investment is only one quarter the size of business investment, overall investment spending remains down a little more than 2% since Q4 2019. Looking ahead, business investment should pick up gradually as excess capacity declines with economic recovery. Residential investment – fueled by rising wages, low mortgage interest rates and migration from high-density urban to lower-density environments – should remain strong in 2021, albeit below its recent torrid pace.

Government spending performed its usual countercyclical role during a recession. Government consumption rose over the first half of 2020 as other sectors contracted. Government spending subsequently declined in Q3 as GDP elsewhere recovered. At the federal level, the jump in spending was deficit-financed, pushing the budget deficit for 12 months ended in December 2020 to $3.3 trillion on $6.8 trillion in spending, which was up 50% over 2019. A sharp increase in private savings and the Federal Reserve's balance sheet expansion made that debt easy to finance, although federal government debt-to-GDP rose more than 20 percentage points to end Q3 at almost 109%. This is not a near-term worry, but it has longer-term implications for economic growth and could limit fiscal options over coming years.

Inflation slowed as the economy fell into recession. The personal consumption expenditures deflator excluding food and energy touched a low of 1.2% year-over-year in June and edged up to 1.6% as of November 2020, well below the Fed's 2% inflation target. Economic recovery should close the gap between current and potential economic growth, pushing inflation upward, although global excess capacity could make this a slow process.

Monetary policy eased vigorously at the onset of the pandemic and has remained highly accommodative given outlooks for employment and inflation. The Federal Reserve cut the federal funds rate target by 1.5% to nearly zero in 2020; it forecasts no change through 2023. Moreover, the Fed's balance sheet grew from about $4.2 trillion in February to nearly $7.4 trillion at year-end 2020, leaving markets awash in liquidity. While probably not a significant risk for 2021, growth in the money supply could fuel a quicker rise in inflation than the Fed currently expects as the pandemic recedes.

Although bankruptcy filings increased notably in 2020, bank loan problems have remained modest. Most U.S. banks roughly doubled loan-loss reserves relative to nonperforming loans in 2020, in expectation of significant credit deterioration. For the most part, that has not materialized. Consumer loan charge-offs and delinquencies were down from Q4 2019. Commercial and industrial loan problems did increase, but they are only slightly higher than in Q4 2019. There is little doubt that some of these borrowers will default in 2021, but so far, most U.S. banks have not experienced a spike in loan defaults.

At the same time, banks reduced payments to shareholders, with steady or lower dividends and little to no share repurchases since the first quarter, all while making respectable profits. As a result, despite significantly increasing loan-loss reserves, banks' capital ratios improved substantially in 2020. Capital and reserve strength was evident in a second round of stress tests that that Federal Reserve conducted on the nation's largest banks. From an average starting common equity Tier 1 ("CET1") ratio of 12.2%, the average ratio fell to 9.6-9.7% under severe economic assumptions used in the tests, a smaller decline than in earlier tests, due to larger loan-loss reserves, and well above the 4.5% minimum set by the Fed. Moreover, no bank in the exercise failed its stress tests. We think these results highlight the major improvement in bank credit quality since the financial crisis, and we remain confident owning their preferred securities.

Preferred Market Conditions

Investors won't soon forget the wild ride that started in March and continued (thankfully, in a positive direction) for the balance of 2020. Much of the market's early selloff was driven by fear and uncertainty, and market technicals (particularly deleveraging) accelerated the decline. There are, however, a few important factors firmly behind the Fund's performance, the market rebound and a continued rally in preferreds and contingent-capital ("CoCo") securities. We believe many of those factors will continue through 2021.

Credit quality remains a bright spot within most sectors that issue preferreds – most notably financials. Not all issuers are created equal, but in general banks and other financial issuers have been out in front of loan losses related to COVID-19 – adding aggressively to reserves while adjusting operations to continue serving customers and earning a profit. Not all borrowers will be able to meet their loan obligations, but we believe banks have strong balance sheets and will continue to be a source of strength for the broader economy. Loan losses generally have been absorbed within ongoing earnings and do not appear to threaten capital. Energy was a difficult sector for most of the year but rebounded nicely in the fourth fiscal quarter as investors gained confidence in these credits and enjoyed some of the highest yields available in preferreds. Financials and energy were 73.7% and 12.0% of the portfolio, respectfully, as of December 31, 2020.

Compared to the start of 2020, interest rates moved materially lower and are forecast to remain near these levels for several years. Declining interest rates had a large impact on most fixed-income securities, including preferreds and CoCos. Interest-rate duration varies among individual preferreds and CoCos, and longer duration securities certainly outperformed shorter duration. However, the real impact of low rates on our market has been on all-in yields and a corresponding compression in spreads. As Treasury rates moved lower, fixed-income yields moved lower as well – and preferreds/CoCos, offering a spread to Treasuries in excess of investment-grade corporate bonds, benefited greatly from this compression. We've referred to this before as a global search for yield, and this search accelerated as U.S. interest rates declined materially. (Many global rates were already low, so the U.S. compressed relative to other markets). With business and consumer spending down as a result of the pandemic, savings are up, and investors have cash that needs to be invested. Yield is difficult to find in a low-rate environment, and preferreds/CoCos continue to offer a yield advantage over many alternatives.

A discussion of lower interest rates and economic recovery isn't complete without acknowledging the important role of the Federal Reserve. Beginning in March, the Fed quickly resurrected the emergency credit and liquidity facilities it used in the financial crisis of 2008-2009. In addition, it aggressively eased monetary policy through both lower short-term rates and quantitative easing (i.e., securities purchases). This time around, it added direct investments in both investment-grade (IG) and high yield (HY) corporate bonds – with ETFs as a primary investment vehicle. In addition to factors mentioned above, this led to a "pile-on" trade in these markets as investors followed the Fed's lead. It is difficult to measure the impact directly, but there's little question the Fed's actions were important factors in improving investor confidence.

Portfolio Results

Over the six months ending December 31, 2020, Flaherty & Crumrine Investment Grade Preferred Income Fund (the "Fund) US dollar-denominated investment portfolio (before the impact of expenses and hedging currency risk between U.S. and Canadian dollars) outperformed the ICE BofA hybrid preferred securities index, which tracks the investment-grade US dollar-denominated taxable preferred securities market structured for retail investors. The Fund's portfolio also outperformed the ICE BofA capital securities index, which tracks the investment-grade U.S. dollar-denominated taxable preferred market structured for institutional investors. Over the full calendar year, the Fund's portfolio underperformed both the Corporate US Capital Index and the Hybrid Preferred Securities Index.

After significantly underperforming their fixed-rate counterparts during the first half of 2020, the portfolio's fixed-float exposure (62.2% of the portfolio as of December 31, 2020) was a significant contributor to outperformance over the second half of 2020. To provide some perspective, fixed-float preferreds experienced sharper declines in February and March as declining interest rates and wider credit spreads resulted in projected reset rates that were lower than new issue coupons. Even during the initial months of the recovery fixed-float preferreds remained unloved and investors favored fixed-rate preferreds without the coupon reset risk. However, broad demand for attractive yield and good credit quality narrowed credit spreads significantly over recent months, pushing new issue reset spreads within reach of pre-pandemic levels. With new issue coupons also significantly lower, fixed-float preferreds looked attractive again, particularly since they have typically had longer call protection which is critical for protecting income in a low yield environment.

While commodity prices declined broadly in March due to pandemic induced lockdowns, many commodity prices are trading at higher levels today than at the start of 2020. As of early January 2021, oil prices were above $50 per barrel while natural gas prices were near their highest level in two years. Nevertheless, energy companies remained under pressure throughout most of 2020, not primarily on credit concerns, but due to a shifting market landscape. Many energy companies in the preferred market have transitioned to a simplified corporate structure, making them look more like utilities rather than high-growth companies. Additionally, investor sentiment has shifted away from traditional energy production and distribution and toward green initiatives. However, positive trial results and initial delivery of coronavirus vaccines during the fourth quarter kindled anticipation for a demand rebound and energy preferreds rallied, outperforming all other sectors by such a large margin that even the portfolio's moderate exposure to energy companies (12.0% of the Fund portfolio as of December 31, 2020) contributed significantly to outperformance over the second half of 2020. The fact that energy preferreds offer among the highest yields available in the preferred market also helped investors put aside their aversion to the sector. We continue to emphasize that the Fund's exposure to energy is concentrated in pipeline companies, with limited direct commodity exposure. These companies have high-quality assets that continue to be utilized, often under take-or-pay arrangements with end-users. Consequently, pipeline credit metrics have remained largely unscathed by COVID-19.

The Fund sold securities to reduce its leverage ratio in March as prices plummeted and weakness in the Canadian dollar resulted in mark-to-market losses on currency hedges. The reduction in leverage was necessary in order to prevent a forced repayment, which could have been a very bad outcome at a time when markets were thin and liquidity was scarce. However, as in most deleveraging scenarios, the Fund sold positions that we would have preferred to keep, especially at the low prices that were transacted. These sales were a significant drag on performance in 2020, particularly against the Fund's benchmarks which are unlevered and have no intra-month transactions.

Outlook for the Preferred Market

2020 will go down as a year many would like to forget, with uneven economic, social, and personal fortunes and misfortunes experienced by so many. We are all hoping for a swift end to COVID-19 and related suffering. Markets are ending 2020 well out ahead of this healing process, looking forward to effective vaccines and a return to economic health – supported by continued accommodative monetary policy.

The portfolio remains concentrated in financials, which is consistent with our view of ongoing credit strength there. We continue to value call protection and current income, as they allow better control over reinvestment decisions and more stable distributions to shareholders. Nonetheless, there is a trade-off for the Fund's strong total return this year. As benchmark interest rates fell and credit spreads narrowed, prices rose but reinvestment yields declined. This is a natural part of fixed-income markets, but it does likely mean a trend toward lower coupons as issuers refinance older, higher-coupon securities when they become callable. Over time, lower reinvestment yields will put downward pressure on portfolio income.

In the meantime, we continue to monitor credits and security valuations closely and work to position our portfolios to meet their objectives – and for the best chance of recovery in asset values as the pandemic recedes. We remain cautiously optimistic on the preferred and CoCo markets, especially from the viewpoint of long-term income investors. Flow data indicates investors are returning to fixed-income, absorbing record levels of new issue debt over the last few months. However, we acknowledge that there is limited modern historical precedent for this pandemic and its global economic impact, making our "crystal ball" unusually cloudy.

Economic recovery will be uneven across sectors and regions, as COVID-19 continues to be a new and challenging virus, but we are at least beginning to turn a corner with vaccine production and distribution. We believe most preferred and CoCo issuers entered this latest crisis on solid footing and have taken steps necessary to weather this storm, but much uncertainty remains over the pace and extent of global recovery. In the meantime, we continue to monitor credits and security valuations closely and work to position the Fund's portfolio to meet its objectives.

We continue to see opportunity in the preferred and CoCo markets, especially from the viewpoint of long-term income investors. Pandemic risks will likely recede in 2021, leading to above-trend growth with low but gradually rising inflation: in short, a favorable credit environment. After a sustained rally since the lows in March 2020, credit spreads reflect that optimistic view. That means credit selection will be of paramount importance, and it remains at the heart of the Fund's investment process.

Annual Compound Returns[1]	1-Year	3-Year	5-Year	10-Year	Since Inception[2]
Flaherty & Crumrine Investment Grade Preferred Income Fund	(0.3%)	4.9%	7.6%	9.8%	5.8%
Hybrid Preferred Securities Index	7.0%	6.3%	6.3%	6.6%	5.2%
Corporate US Capital Index	9.5%	7.8%	7.9%	7.4%	5.8%

[1] Returns are for the periods ended December 31, 2020. The table shows the Fund's compound return for each period indicated, compared with the return for the ICE BofAML US Capital Securities US Issuers 8% Constrained Index (''Corporate US Capital Index'') and the ICE BofAML Hybrid Preferred Securities 8% Constrained Index (''Hybrid Preferred Securities Index'') (together the "Indices"). The Corporate US Capital Index includes investment-trade, fixed rate or fixed-to-floating rate $1,000 par securities that are structured for institutional investors and that receive some degree of equity credit from the rating agencies or their regulators. The Hybrid Preferred Securities Index includes taxable, fixed rate, US dollar denominated, investment grade preferred securities listed in a US exchange and structured for retail investors. Since the Fund is actively managed, the sector weightings and credit ratings may differ from those of the Indices. The Indices are also not leveraged, whereas the Fund employs leverage. Further the 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.

[2] Inception date December 15, 2004.

BROMPTON FUNDS

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