Brompton Flaherty & Crumrine Investment Grade Preferred ETF

TSX:BPRF

Brompton Flaherty & Crumrine *Enhanced* Investment Grade Preferred ETF

TSX:BEPR

Portfolio Manager Commentary - June 30, 2022

Preferred Market Conditions

While investors may have hoped that the first quarter of 2022 wouldn't repeat itself, the second quarter simply brought more of the same. April was a bad month for all fixed income markets, including preferreds, as measures of inflation showed only slight easing and lockdowns in China added to supply side stress. The preferred market (particularly listed retail preferreds) staged a mini-rebound in May as economic growth appeared to be moderating and messaging by certain Federal Reserve board members suggested a pause in rate hikes could be warranted at the September meeting. However, June was another negative month as measures of inflation remained persistently high and the Federal Reserve raised the Fed funds rate by another 0.75%. As of this writing, markets now expect another 0.75% increase at the Fed's next meeting in July and for the Fed funds rate to end the year at around 3.50%.

Portfolio performance year-to-date was driven by higher interest rates and wider credit spreads. Although portfolio interest-rate duration was intermediate, the move in interest rates has been substantial. Our focus on intermediate duration and call protection – owning fixed-reset or fixed-float structures with healthy backend reset spreads and avoiding most low-coupon fixed-rate securities – has resulted in less overall impact from higher rates than some other segments of preferred and credit markets. For comparison, the Bloomberg US Long Credit Index[1] total return over the year-to-date through June 30 was -22.4%, and the Bloomberg US Aggregate Bond Index[2] total return was -10.3%. If reset today, many of the securities in the portfolio would set at higher rates than their initial front-end coupons, although many won't reset for another 2-5 years.

The impact of interest-rate duration on the portfolio was largely as expected given the magnitude of the shift upward in the yield curve. However, dramatic credit spread widening was unexpected and had an additional negative impact on performance during the period. Markets loath uncertainty, and much of the move in credit spreads is a result of uncertainty and fear. Market trading depth has been thin and liquidity at a premium, resulting in markets moving lower most days as investors continue to reduce exposure and funds sold securities to meet outflows.

On June 23, the Federal Reserve released its 2022 large-bank Dodd-Frank Act stress test results. They were mostly as expected, and all 33 banks "passed" the 2022 stress test amid the prevailing global economic uncertainty. Under the 2022 "severely adverse scenario", the average minimum common equity Tier 1 (CET1) capital ratio for this year's 33 bank participants was 9.7% versus 10.6% in the June 2021 test (only 23 banks took the test last year). The results of this year's stress test demonstrate that large U.S. banks remain "well-capitalized," reporting high capital levels, and no bank breached minimum capital requirements during the two-year stress period. Under all scenarios, the 33 large banks maintained capital buffers that were significantly above the Fed's required minimum, after capital actions. Large U.S. banks are well prepared for a recession, should one arrive, over the next several years.

The Fed also conducted its 2022 Comprehensive Capital Analysis and Review (CCAR) to evaluate bank capital plans in light of the stress tests. Our main CCAR takeaway is that banks continue to exercise discipline regarding common shareholder returns. At the same time, banks maintain flexibility to increase dividends and share repurchases if earnings accelerate during 2H22 as projected. Given risk from monetary policy tightening, we expect all banks to maintain conservative capital and loan-loss positions over coming quarters, which should continue to support preferred investors.

Outlook

We think markets underappreciate the credit fundamentals of preferred and contingent capital ("CoCo") securities in this environment. Both investment grade and high-yield indices are dominated by nonfinancial companies, which are more exposed to rising interest rates. That is less of a concern for investment grade companies — although the interest-rate duration of the investment grade bond index is longer than the preferred index — but it is a clear risk for many high-yield companies. In contrast, financial companies, which are by far the largest issuers of preferred securities, tend to benefit from rising rates. Banks today are asset-sensitive, meaning interest income tends to rise more quickly than deposit cost as interest rates move up, boosting margins. Higher rates mean insurance companies earn more on their investment portfolios. Finance companies also tend to raise their lending rates faster than their funding costs.

Of course, credit risk also increases because tighter monetary policy increases the risk of recession, so there is a limit to the benefit of higher rates for financial companies. However, (a) we think rates would need to rise considerably further before that risk becomes worrisome, and (b) problems at households and businesses to which financial firms lend would come before loan quality deteriorates.

Fed policy has and likely will continue to tighten financial conditions, and it should be successful in reducing aggregate demand and inflation. However, forecasting the timing and impact of other macroeconomic issues such as supply-chain disruptions, COVID policies, and the Russia-Ukraine war are nearly impossible. Resolution of any one of these issues, let alone all of them, is likely to have a dramatic positive impact on inflation expectations and market sentiment. Preferred and CoCo issuers, along with U.S. consumers broadly, are in a strong position to weather this storm – but time is the only remedy for macroeconomic issues outside the Fed's purview. Holding or adding to investments when markets are lower and sentiment is weak can be uncomfortable for investors, but we believe there is opportunity in preferred and CoCo markets for long-term investors seeking income and solid credit quality.

Annual Compound Returns[3]	**YTD**	**1-YR**	**3-YR**	**5-YR**	**10-YR**	**S.I. BPRF[4]**	**S.I. BPRF.U[5]**
BPRF - Brompton Flaherty & Crumrine Investment Grade Preferred ETF (CAD-H)	(13.7%)	(13.0%)	0.2%	-	-	1.9%	-
BPRF.U - Brompton Flaherty & Crumrine Investment Grade Preferred ETF (USD)	(13.8%)	(13.2%)	-	-	-	-	0.8%
BEPR - Brompton Flaherty & Crumrine *Enhanced* Investment Grade Preferred ETF (CAD-H)	(19.2%)	(17.4%)	(1.7%)	0.6%	6.1%	-	-
ICE BofAML 8% Constrained Core West Preferred & Jr Subordinated Securities Index	(13.9%)	(13.3%)	0.6%	-	-	2.6%	0.2%

(1) The Bloomberg US Long Credit Index measures the performance of investment grade, US dollar-denominated, fixed-rate, taxable corporate and government-related debt with at least ten years to maturity. It is composed of a corporate and a non-corporate component that includes non-US agencies, sovereigns, supranationals and local authorities.

(2) 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).

(3) Returns are for the periods ended June 30, 2022 and are unaudited. The table shows the Fund's compound returns for each period indicated compared with the ICE BofAML 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 ETF on its units in the period shown were reinvested at Net Asset Value per unit in additional units of the Fund.

(4) BPRF inception date October 15, 2018.

(5) BPRF.U inception date August 8, 2019.

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