Brompton Insights

4 Reasons to Own U.S. Preferred Shares Now

September 13, 2023

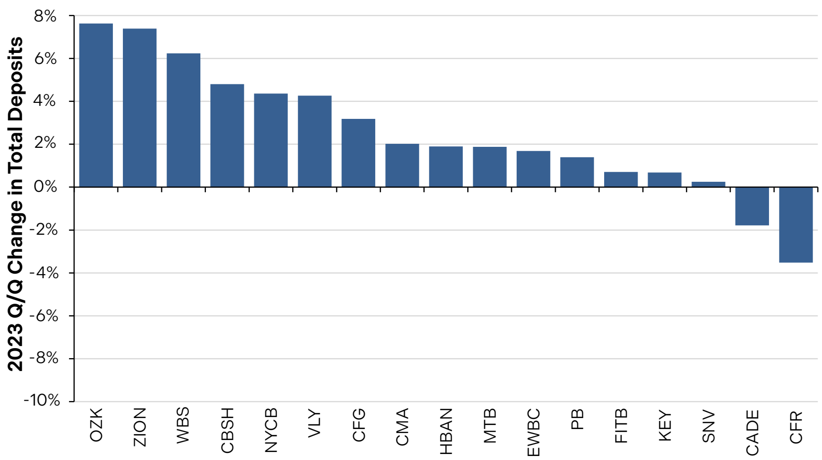
Fund in focus: [Brompton Flaherty & Crumrine Investment Grade Preferred ETF (BPRF, BPRF.U)], [Brompton Flaherty & Crumrine *Enhanced* Investment Grade Preferred ETF (BEPR, BEPR.U)]

U.S. preferred shares sold off in Q1 2023 amid investor nervousness about deposit liquidity concerns at several U.S. regional banks (Silicon Valley Bank, Signature Bank, First Republic Bank) and Credit Suisse, a major Swiss bank. While well-capitalized by regulatory standards, these banks were unable to meet liquidity demands related to a classic run-on-the-bank, and regulators brokered a forced sale of these institutions to stronger banks.

For U.S. bank depositors, unrealized losses in investment and loan portfolios was the primary concern that led to deposit flight. These unrealized losses were almost entirely due to higher interest rates reducing the prices of U.S. Treasuries and related securities that make up the bulk of banks' investment portfolios. The more severe asset-liability mismatches have been bank-specific and, in our view, do not represent a threat to the overall 5,000-member global banking system.

Q2 2023 earnings, reported in July, showed that earnings were in line with analyst expectations. Capital ratios remained strong and regional banks especially have generally been successful in attracting or retaining deposits. Non-interest-bearing deposits are down, in most cases replaced by more expensive interest-bearing deposits, a more costly source of bank funding. Investors were generally reassured by Q2 results and U.S. bank stocks staged a minor rally after earnings season.

U.S. Regional Bank Deposit Growth



Source: Morgan Stanley Research, August 1, 2023, based on 17 mid-cap U.S. banks covered by Morgan Stanley

U.S. banks are major issuers of U.S. preferred securities, but there are issuers in other business sectors as well, and fundamentals appear to be solid across the board. Insurance, pipeline, telecom and utilities issuers were historically more stable and their preferred share issues provide stability and diversification to a U.S. preferred share portfolio.

With global banks slowly regaining investor confidence and with other segments of the market in good shape, we have 4 reasons why investors should consider initiating or adding to a position in U.S. preferred shares currently:

1) Yields are attractive, and are moving higher due to floating-rate resets

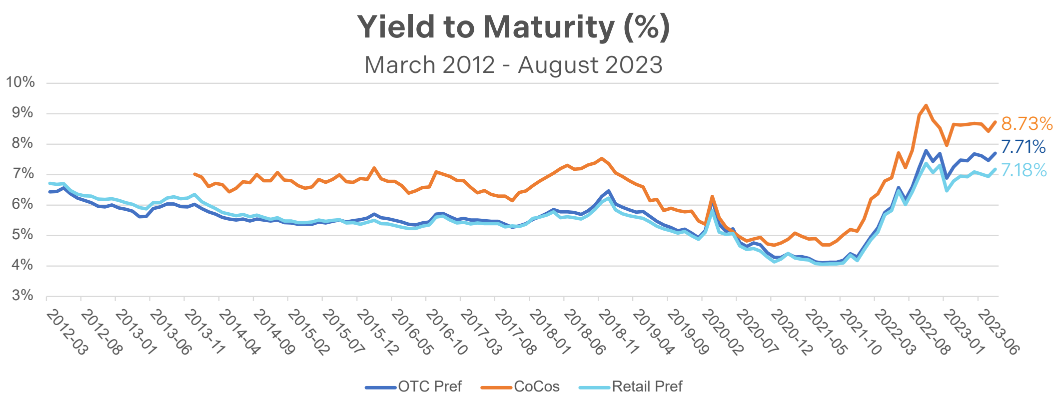
New issuance so far in 2023 has been more robust than in 2022, and coupons have improved over 2022. U.S. banks issued in the range of 6.25%-7.625% for their front-end coupons, with international issuers' AT1 issues priced at 7.50%-8.50%. Back-end spreads mostly remained in the 300-400 bps range, which is attractive based on credit metrics of most issuers.

BPRF and BEPR's exposure to currently floating-rate preferreds was another significant benefit to the portfolio over the trailing one year. As interest rates have risen over the past year and a half, these securities have been among the best performers. Most have reset formulas that are based on a spread above 3-month LIBOR (largely being replaced with SOFR), which has risen along with Fed rate hikes.

	8/31/2022		8/31/2023	
BPRF Portfolio Coupon Type	Current Yield	Average Coupon	Current Yield	Average Coupon
Fixed	6.22%	6.30%	7.56%	7.33%
Fixed-Float/Reset	6.30%	6.40%	6.91%	6.59%
Floating	6.11%	5.44%	9.60%	8.53%
Wtd Avg of Securities	6.33%	6.27%	7.30%	6.88%

Source: Flaherty & Crumrine, August 31, 2023

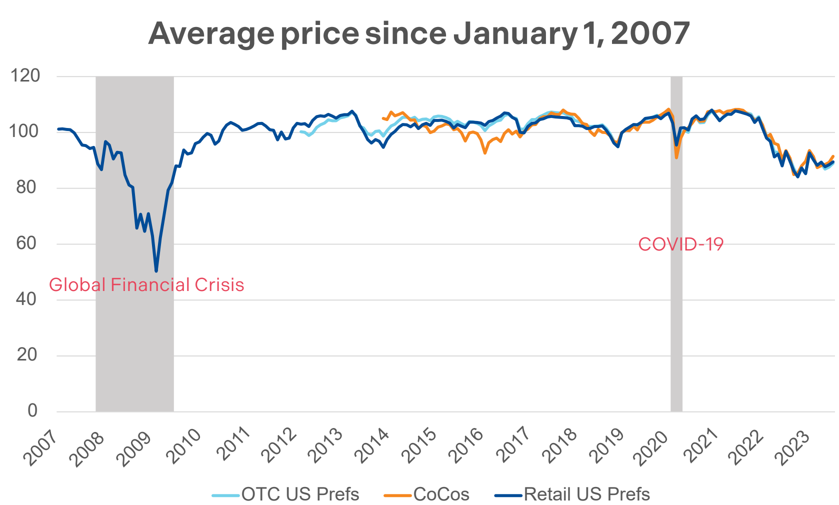
The impact of coupon resets in the portfolio has been material. The average floating-rate coupon in the portfolio has increased over the past year from 5.44% on 8/31/2022 to 8.53% on 8/31/2023 (see table above). These higher resets, along with reinvestment into new issues with higher coupons, have increased the average coupon for the entire portfolio from 6.27% to 6.88% over the same period.



Source: Bloomberg, Flaherty & Crumrine, August 31, 2023

2) Preferreds are trading at appealing discounts to par value

U.S. Preferreds are trading at discounts to par value not seen since the global financial crisis, with segments priced as low as 88 cents on the dollar. U.S. Preferreds typically trade near par and can sell at a premium. Current discounts represent a potentially substantial capital appreciation opportunity for investors when interest rates eventually decline.



Source: Flaherty & Crumrine, Bloomberg, July 31, 2023. OTC US Prefs = ICE BofA 8% Constrained Core West Preferred & Jr Subordinated Securities Index, CoCos = ICE USD Contingent Capital Index, & Retail US Prefs = ICE BofA Fixed Rate Preferred Securities Index

3) Preferreds historically have provided their best returns in periods following a market correction

In many cases, returns in periods after a market correction have been in the double-digits. With preferreds still at depressed levels, the opportunity to participate is still timely.

			6 month forward return			12 month forward return		
	Period	S&P Preferred Stock Max Drawdown	S&P Preferred Stock TR	S&P 500 TR	Bloomberg U.S. Agg Bond TR	S&P Preferred Stock TR	S&P 500 TR	Bloomberg U.S. Agg Bond TR
2008 global financial crisis	2007-05-08 - 2009-03-09	-44.0%	143.9%	54.6%	5.9%	185.8%	72.3%	9.3%
Euro sovereign debt crisis	2011-05-17 - 2011-10-04	-10.8%	15.9%	25.9%	1.0%	23.4%	33.0%	4.8%
Taper tantrum	2013-05-08 - 2013-08-19	-8.3%	7.9%	12.3%	3.1%	15.6%	22.9%	6.0%
2018 rate rising	2018-01-08 - 2018-12-27	-5.9%	13.3%	18.7%	6.4%	20.1%	32.8%	9.2%
COVID	2020-02-20 - 2020-03-23	-31.0%	42.5%	46.0%	5.8%	54.4%	77.8%	3.1%
High inflation and high rates	2021-09-16 - 2022-10-21	-19.2%	9.6%	11.1%	7.3%	–		
Banking distress	2023-02-02 - 2023-03-20	-11.2%	What will happen in 6 months or 12 months?					

Source: Refinitiv Eikon Datastream, July 31, 2023

4) U.S. Preferreds had strong performance after past interest rate hike cycles ended

We cannot be sure that the U.S. Federal Reserve has completed hiking interest rates, however market participants believe that if the Fed isn't finished, it is very close to the end. U.S. preferred shares have a history of strong performance in periods after the end of an interest rate hike cycle.

	Time Period	Interest rate hike	6 month forward return	12 month forward return
2005-2006: The Housing Market Boom	2004-06-30 - 2006-06-29	+4.00%	9.7%	4.5%
2015-2018: Returning to Normalcy	2015-12-17 - 2018-12-20	+2.25%	13.3%	19.0%
2022: High Inflation and Interest Rate Hike	2022-03-17 – present	+5.25%	?	?

Source: Refinitiv Eikon Datastream, U.S. Preferreds represented by S&P U.S. Preferred Stock Total Return Index, July 31, 2023

Fixed-income markets, including the preferred market, have struggled over the last 18 months amid a historically rapid rise in interest rates. We believe that this has set the stage for U.S. Preferreds to provide investors with attractive coupons and the opportunity for capital gains over the coming periods.

Brompton's Approach:
Brompton Flaherty & Crumrine Investment Grade Preferred ETF (BPRF, BPRF.U) and **Brompton Flaherty & Crumrine *Enhanced* Investment Grade Preferred ETF (BEPR, BEPR.U)** offer ways to invest in the U.S. preferred share market with the benefit of active management by the longest tenured U.S. preferred share specialist, Flaherty & Crumrine Incorporated.

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