COHEN & STEERS

Yields, regulations reinforce a positive preferred securities outlook

We see scope for good relative performance, given appealing valuations and structures that can benefit from high interest rates. Solid issuer fundamentals today and tighter bank regulations to come may provide a credit tailwind.

by **William Scapell, CFA, Elaine Zaharis-Nikas, CFA** and **Jerry Dorost, CFA**

KEY TAKEAWAYS

High income, resetting payments and discounted prices

Preferreds offer value in a "higher for longer" environment: 7–9% yields from investment-grade issues with resetting dividend structures and deep discounts to par.

Earnings and new regulations provide clarity for investors

Recent results and stress tests spotlight the health of the banking sector after the spring's volatility, while tighter regulations may be supportive of credit for several years.

Rate-hiking cycle's approaching end likely bullish for fixed income

Although we expect the Fed to keep rates high for some time, inflation and growth are slowing. An end to the rate-hiking cycle potentially sets the stage for stronger returns.

High income, resetting payments, discounted prices

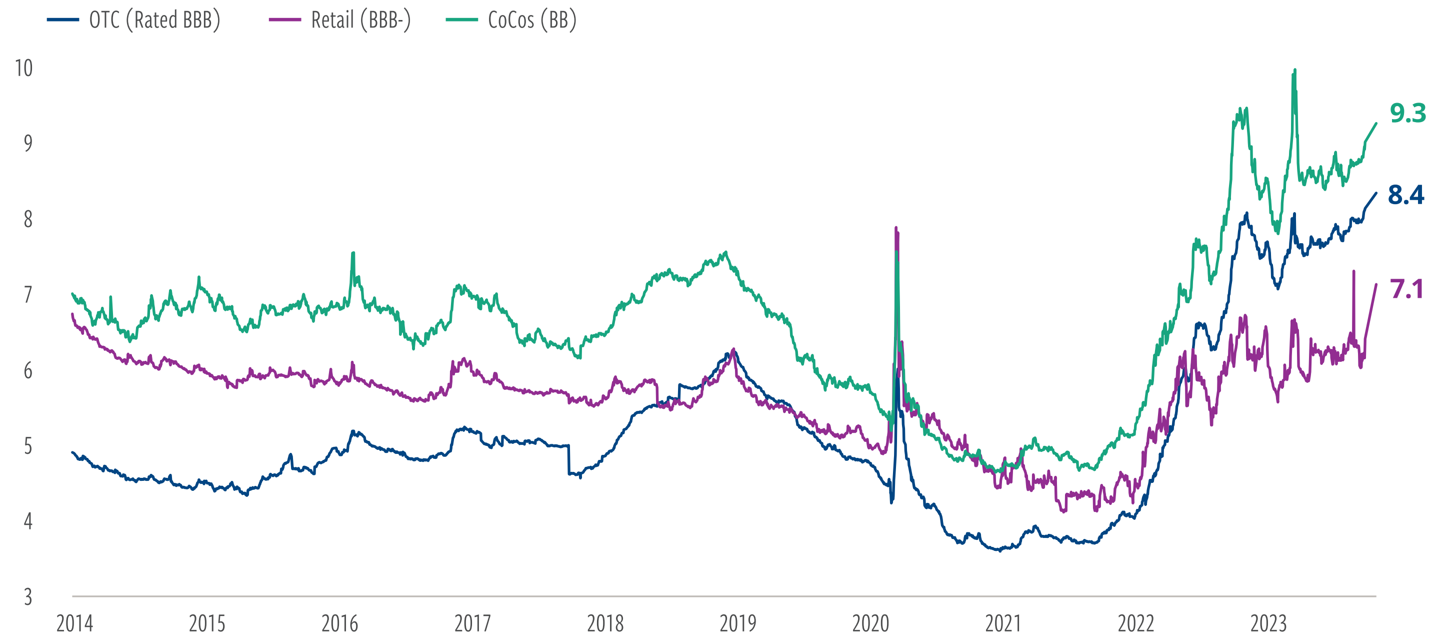
High-quality preferred securities, primarily issued by investment-grade-rated companies, currently offer 7–9% yields—considerably greater than what's available from investment-grade corporate bonds (Exhibit 1). Yields on over-the-counter (OTC) and contingent capital (CoCo) securities, which compose more than 80% of the market, are generally much higher than those on exchange-listed issues. We see better value today in OTC securities, partly for this reason.

We also favor them for their fixed-to-reset structures, in contrast to exchange-traded issues, which are largely fixed rate in perpetuity. With the periodic payment resets of OTC preferreds, just the passage of time (if we experience "higher for longer" rates) should lead to significant increases in income for investors if the securities are not called (Exhibit 2, page 3).

EXHIBIT 1

Preferreds' income levels are very high in historical context

Yield to maturity (%)
January 2014–October 2023



At October 31, 2023. Source: ICE BofA, Cohen & Steers.
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Most OTC preferreds' reset spreads are in the range of 250–400 basis points. Many reset over short rates, such as the secured overnight financing rate (SOFR), while others reset over longer benchmarks, such as 5-year U.S. Treasuries. As of October 31, 2023, SOFR was 5.4%, while 5-year Treasuries yielded 4.8%. So, securities resetting today would offer rates in the 7.5–10.0% context—generally much higher income rates than they currently pay. In our view, this makes shorter-reset issues particularly attractive "paid-to-wait inflation-beaters" in the near term.

Issuers also have the right to redeem the securities at par value at the reset date. But with many shorter-reset securities currently trading at discounts to par, a redemption would only increase these securities' total return. And if a security is called, investors can then use the proceeds to invest in issues that are most likely yielding more.

High-yield bonds and leveraged loans (also known as floating-rate loans or bank loans) have been strong performers of late, in part because they, too, can offer lower interest rate sensitivity. Floating-rate instruments have benefited investors in a rising-rate environment. But while high-yield bonds and leveraged loans offer greater pre-tax yields than preferreds, they are (as a market) substantially lower-quality investments. For instance, the high-yield market has a B+ average rating, described as "highly speculative" by the rating agencies.

Remember, too, that most preferreds pay qualified dividend income, which for U.S. investors in the highest tax bracket is taxed at just 23.8%. This favorable tax treatment can effectively eliminate high-yield bonds' pre-tax income advantage.

EXHIBIT 2

Reset structures can provide benefits in a higher-rate environment

Examples of preferreds with near-term coupon resets

Issuer	Market	Structure	Coupon	Call/float/reset	Reset spread	S&P rating
Already floating						
Company A	Institutional	Floater	9.83	30 days	SOFR + 445	BB+
Company B	Institutional	Floater	8.88	30 days	SOFR + 350	BBB-
Resetting in near future						
Company C	Retail	Fixed/float	7.60	5/15/2024	SOFR + 542	BB+
Company D	CoCo	Fixed/float	8.00	6/15/2024	5 YR TSY + 567	BB-
Company E	Institutional	Fixed/float	6.50	10/23/2024	SOFR + 443	BBB-
Company F	Institutional	Fixed/float	5.95	5/15/2025	SOFR + 417	BB+
Company G	Institutional	Fixed/float	4.88	10/15/2025	5 YR TSY + 455	BBB-

At October 31, 2023. Source: Bloomberg, Cohen & Steers.

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Yield spreads indicate value for preferreds

Exhibit 3 shows the option-adjusted spreads (relative to U.S. Treasuries) on OTC preferred securities, investment-grade bonds and high-yield bonds. As shown, the spreads on investment-grade bonds and high-yield bonds are currently near or below their historical averages. This likely reflects higher all-in yields on bonds, given higher Treasury rates. It also reflects expectations that the current economic slowing is unlikely to result in recession.

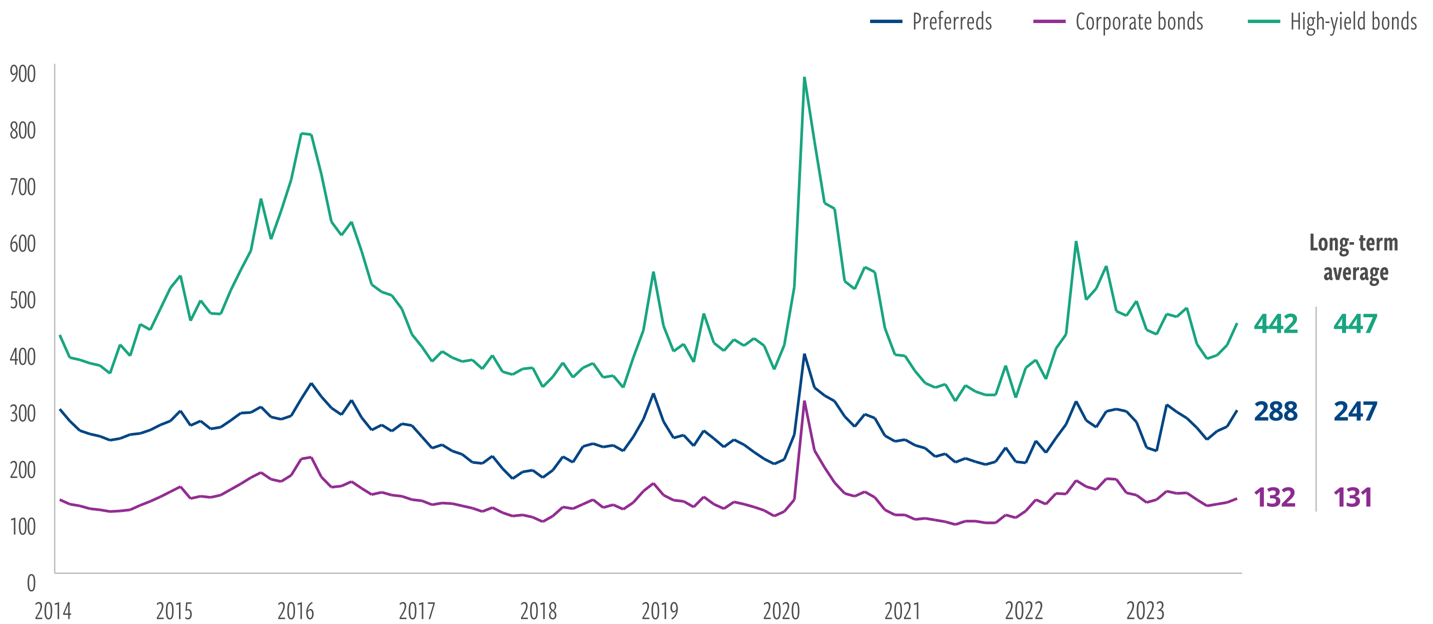
By comparison, the spread on the preferred index remains wide of its historical average, after widening meaningfully earlier in the year. Given their pricing, we view preferreds as having more attractive relative value than investment-grade and high-yield bonds. As such, in our view, preferreds have greater capacity to absorb potential downside, whether it comes from higher interest rates and/or a weaker credit environment.

EXHIBIT 3

Preferreds appear more attractively priced than high-yield bonds

Option-adjusted spreads

January 2014–October 2023



At October 31, 2023. Source: ICE BofA.

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Deep discounts to par represent capital appreciation potential

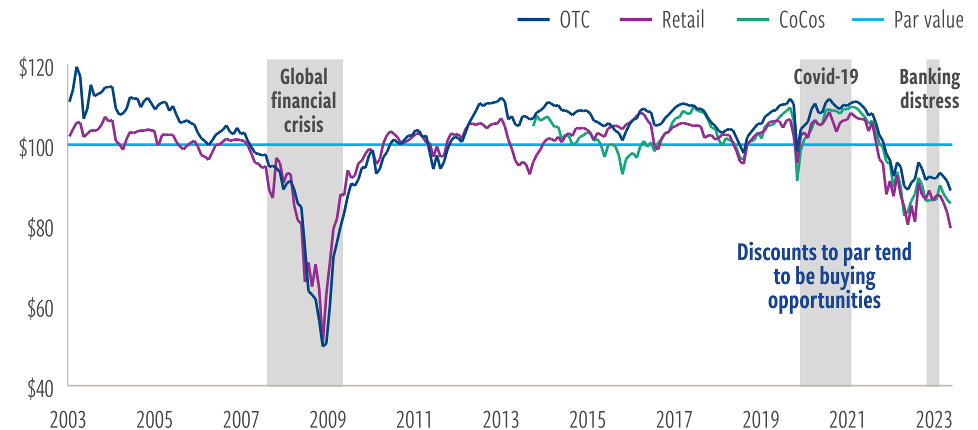
Given what has happened with interest rates during the past 18–24 months, discounts to par values exist across the fixed income market. Although preferreds have partially rebounded from their March lows, they continue to trade at meaningful discounts (Exhibit 4).

Historically, the OTC and CoCo markets have both traded at a premium, while the retail market has traded at only a slight discount. We believe current prices present a potential capital appreciation opportunity in preferreds (in addition to the securities' attractive income rates); any reversion to the mean, potentially spurred by more clarity around Fed policy, would imply an appreciable price move.

EXHIBIT 4

Preferred securities offer deep discounts to par value

Historical average prices by preferreds market
March 2003–October 2023



Since March 2003[(a)]	OTC	Retail	CoCos
Current average price	88.59	79.22	85.39
Discount to par value	(11.4%)	(20.8%)	(14.6%)
Historical average premium (discount) to par[(a)]	2.1%	(1.3%)	0.9%

At October 31, 2023. Source: Bloomberg, Cohen & Steers.
Past performance is no guarantee of future results. (a) Average since March 2003; average for contingent capital securities since January 2014 inception. The information presented above does not reflect the performance of any fund or other account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above. There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend will begin. See end notes for index associations, definitions and additional disclosures.

Segments of the preferreds market are trading at 11–20% discounts to par value, on average, representing historically uncommon value.

Bank earnings and new regulations provide clarity

Bank earnings reports over recent quarters have gone a long way toward calming investor concerns about the banking sector. Our view is that idiosyncratic fundamental challenges drove recent bank failures—the failed U.S. regional banks experienced substantial deposit flight, putting investors on edge about funding stability. However, funding pressures have eased; deposit outflows peaked in the first quarter of this year and have stabilized since then. Industry challenges remain, so security selection is important. That drives our positioning within U.S. banks primarily toward the largest banks and (to a lesser extent) the largest super-regional banks.

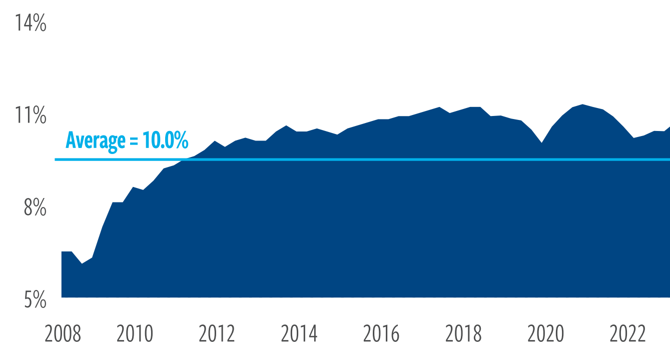
Almost all banks have strengthened capital this year through retained earnings, lower stock buybacks and balance sheet optimization (Exhibit 5). We expect that capital building will continue as banks prepare for higher capital requirements, more stringent regulation and macro uncertainty. The capital improvement story is nuanced, as some banks have large unrealized losses on their security portfolios, which is a consideration in our security selection.

EXHIBIT 5

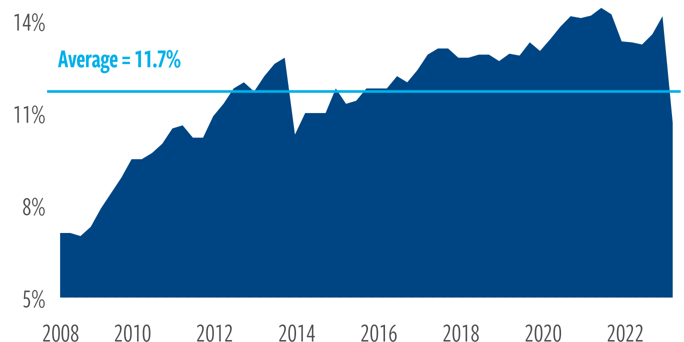
Bank capital levels remain nearly double 2008 levels

Core capital ratios of major banks
June 2008–June 2023

U.S. banks[a]



European banks[b]



At June 30, 2023. Source: Bloomberg.

Past performance is no guarantee of future results. The core capital ratio is the ratio of core (common equity) capital to total risk-weighted assets. Banks must meet a minimum core capital requirement, as dictated by local banking laws and regulations. Higher core capital ratios have helped to strengthen banks' balance sheets and to improve their credit quality. (a) Core capital ratios based on the largest U.S. banks, including Bank of America Corporation, JPMorgan Chase & Co., Citigroup Inc., Wells Fargo & Company, U.S. Bancorp, PNC Financial Services Group, Inc., Truist Financial Corporation, Regions Financial Corporation, KeyCorp, M&T Bank Corporation, Comerica Inc., Synovus Financial Corp. and First Horizon National Corporation. (b) Core capital ratios based on the following 15 major European banks: HSBC Holdings plc, Deutsche Bank AG, BNP Paribas SA, Crédit Agricole S.A., Barclays PLC, Société Générale SA, Banco Santander SA, NatWest Group plc, UBS AG, Credit Suisse Group AG, UniCredit SpA, Lloyds Banking Group plc, Intesa Sanpaolo SpA, Commerzbank AG and Banco Bilbao Vizcaya Argentaria, S.A. The mention of specific securities is not a recommendation or solicitation for any person to buy, sell or hold any particular security and should not be relied upon as investment advice. See end notes for additional disclosures.

While industry deposits have stabilized, this has come at a higher cost to the banks, given the competitive funding landscape. That pressures the spread between asset yields and funding costs, known as the net interest margin. Banks with strong funding profiles, granular deposit bases and low loan-to-deposit ratios should have more resilient net interest margins.

Credit quality, while weakening somewhat, continues to be healthy, with loan charge-offs still below longer-term averages for all areas except certain commercial real estate (CRE) portfolios. Banks are tightening lending standards and proactively building reserves for future loan losses as they prepare for a slower economy.

The Fed's stress tests evaluate banks' financial resilience to ensure they are sufficiently capitalized and able to lend even in a severe recession.

Regional lenders tend to have much larger concentrations in CRE loans than the largest banks. We consider these CRE exposures in relation to capital levels, and we note risk-mitigating factors such as reserves taken against parts of their CRE books, CRE composition (e.g., most areas of CRE lending have much healthier profiles than office, in our view), loan-to-value ratios and maturity schedules.

In addition to favoring larger, high-quality banks, we generally like insurance companies and non-financials, such as utilities and telecom companies. As mentioned previously, we also like resetting payment structures that can take advantage of the rising-rate environment.

Stress test results reaffirm banking sector's resiliency

The Federal Reserve's latest annual bank stress test results confirm that the banking system appears strong. The stress tests evaluate how large banks are likely to perform under hypothetical economic conditions. All banks tested maintained capital ratios significantly above minimum requirements in the modeled scenario of severe global recession.

Under the severely adverse scenario, the aggregate common equity tier 1 (CET1) capital ratio of the 23 banks tested fell from an actual 12.4% in the fourth quarter of 2022 to a minimum of 9.9% before rising to 10.5% at the end of the two-year projection horizon. The 2.5 percentage point aggregate decline exposed in this year's test was smaller than the aggregate decline of 2.7 percentage points last year (but comparable to aggregate decreases in recent years).

Rising bank capital requirements further supportive of credit

Banks, the largest issuers of preferreds, are highly regulated companies bound by strict safety and soundness requirements. After the global financial crisis (GFC), those requirements increased significantly, and the market had 13 years with no meaningful defaults. Unfortunately, the requirements were eased on the heels of deregulation passed by Congress in 2018, a move that directly influenced the events of this year. (Similarly, the 1999 repeal of Glass-Steagall, which had strictly limited investment banking activities, preceded the GFC). But regulation is set to harden meaningfully again, and we expect this will result in another extended period of very low default rates.

In late July, U.S. bank regulatory agencies announced a proposal to increase resilience in the banking system. To be phased in by 2028, the measures would implement the previously planned final components of the international Basel III agreement and include the material changes in response to the banking turmoil earlier this year (Exhibit 6).

The plan would result in increased capital requirements and more rigorous standards applied to a wider set of banks. One aspect of the proposal calls for a shift from internal models for calculating risk-weighted assets to a “standardized” methodology. On balance, this change would increase capital requirements by 5–20%, depending on the bank. The proposal would also require all banks with total assets of $100 billion or more to include unrealized gains and losses from certain securities in their capital ratios. Indeed, the previous relaxation of mark-to-market rules (stemming from 2018 deregulation edicts) significantly contributed to the bank failures earlier this year, as not marking securities to market allowed large capital holes to form over time as rates rose.

While implementing all aspects of these proposals will take time, we believe the additional measures could provide a profound tailwind for bank preferred holders (and creditors in general), just as the harsher regulatory requirements did for many years following the GFC.

EXHIBIT 6

New regulatory requirements should strengthen credit profiles

Proposed banking regulations

New standards would apply to a broader set of banks

- Banks with assets of $100+ billion subject to new rules
- Would align regulatory capital calculations across all applicable banks
- Would expand supplementary leverage ratio requirement to all applicable banks

Materially increased capital requirements

- Largest eight banks: 19% increase in capital requirements, 25% increase in risk-weighted assets
- Other banks with assets of $100+ billion: 6% increase in capital requirements, 9% increase in risk-weighted assets
- Accumulated other comprehensive income (AOCI), which includes unrealized losses, would be factored into capital for category 3 & 4 (regional) banks; this was previously only done for global systemically important banks (G-SIBs)
- Total loss-absorbing capacity requirements for U.S. G-SIBs would increase by 15%

Timing

- January 16, 2024, comment period deadline for the proposal
- Three-year transition period beginning July 1, 2025
- Fully phased-in capital requirements on July 1, 2028

At October 31, 2023. Source: Cohen & Steers.

Rate-hiking cycle's approaching end likely bullish

With inflation and growth slowing and monetary policy in restrictive territory, the Fed is likely at or near the end of the most aggressive hiking cycle in four decades. Historically, when the Fed stops hiking rates, short and long rates tend to fall over the following quarters, causing fixed income markets—particularly preferred securities—to perform well (Exhibit 7). This is because the end of the cycle is associated with inflation moderating. Moreover, growth usually decelerates, causing investors to anticipate the Fed's next move will be to cut rates.

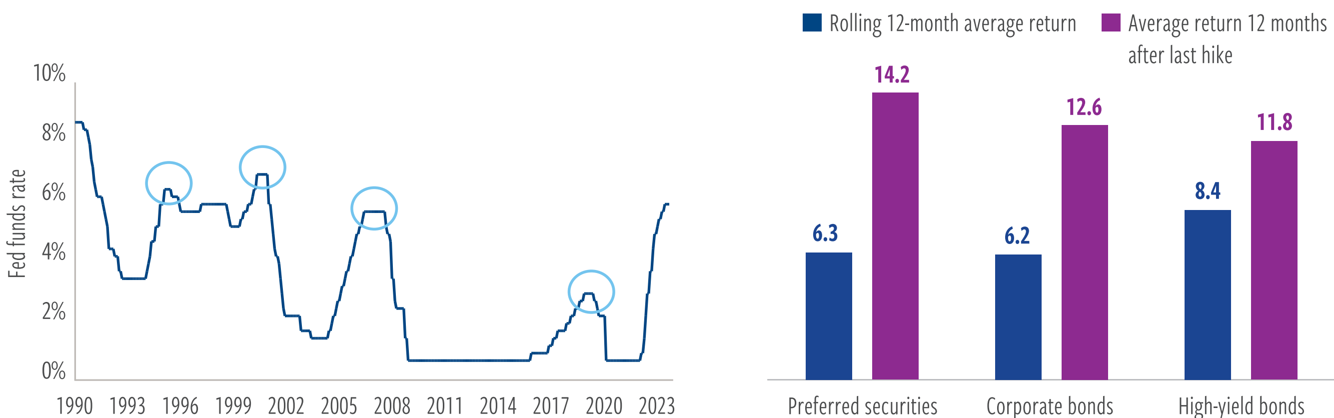
Of course, cycles can differ, and we believe short rates may come down slowly this cycle. This is because we believe inflation, while no longer out of control, could be "sticky" and remain above the Fed's 2% target for some time. What is more, the aggressive central bank tightening in recent quarters has the potential to lead to a recession. Hence, we believe it makes sense to own quality and be somewhat cautious around credit.

As described above, we favor preferred securities with good reset structures that can benefit from higher rates when their dividends reset. In the near term, securities with shorter terms to the reset (including floating-rate issues) could fare best as rates remain high. However, we believe that securities with longer terms to reset (higher durations) could be poised for the strongest total returns over the intermediate term.

EXHIBIT 7

Returns are particularly strong following rate-hiking cycles

Rolling 12-month returns and 12-month returns after the end of rate hikes (%)
January 1990–October 2023



At October 31, 2023. Source: ICE BofA, Cohen & Steers.
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Index definitions and important disclosures

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Preferred securities: OTC: ICE BofA U.S. IG Institutional Capital Securities Index tracks the performance of USD-denominated investment-grade hybrid capital corporate and preferred securities publicly issued in the U.S. domestic market. **Retail:** ICE BofA Core Fixed Rate Preferred Securities Index (credit quality: BBB-) tracks the performance of fixed-rate U.S. dollar-denominated preferred securities issued in the U.S. domestic market. **CoCos:** The Bloomberg Developed Market Contingent Capital Index (credit quality: BB) 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. **Investment-grade bonds:** ICE BofA Corporate Master Index (credit quality: A-) tracks the performance of U.S. dollar-denominated investment-grade corporate debt publicly issued in the U.S. domestic market. **High-yield bonds:** ICE BofA High Yield Master Index (credit quality: B+) tracks the performance of U.S. dollar-denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market. **U.S. Treasuries:** ICE BofA U.S. Treasury Index tracks the performance of U.S. dollar-denominated sovereign debt publicly issued by the U.S. government in its domestic market.

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Duration risk. Duration is a mathematical calculation of the average life of a fixed income or preferred security that serves as a measure of the security's price risk to changes in interest rates (or yields). Securities with longer durations tend to be more sensitive to interest rate (or yield) changes than securities with shorter durations. Duration differs from maturity in that it considers potential changes to interest rates, and a security's coupon payments, yield, price and par value and call features, in addition to the amount of time until the security matures. Various techniques may be used to shorten or lengthen the Fund's duration. The duration of a security will be expected to change over time with changes in market factors and time to maturity.

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