WHY PREFERRED STOCKS ARE ATTRACTIVE YET UNDERCOVERED

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Last week's Behind the Markets podcast featured a discussion with alternative investment manager Moelis Asset Management and its subsidiary Gracie Asset Management. Their investments are focused on opportunities in the credit space, but our conversation focused on the hybrid and preferred stock asset classes as unique opportunities in today's low interest rate environment.

Some highlights of our discussion—and background information on the asset classes—include the following.

Preferreds: Distinct Market and Structure

- Broad and Deep Universe: over $1 trillion in preferred stock outstanding, the highest level in history
- Issuers are primarily regulated, large-capitalization financial institutions in the U.S. and Europe
- Preferreds provide an investor with the ability to capture both debt- and equity-like characteristics as well as create asymmetric exposures (both long and short) to rates, credit spreads and curve shape with limited need for macro overlays and hedges.
- Since 2008, banks and brokerage firms have relied on preferred securities to replenish capital that was depleted during the financial crisis. In Europe, the contingent convertible security (CoCo for short) increased from 2% of global capital securities to almost 25% in the past nine years.

The Preferred Market Is Deeply Underserved

One topic we talked about is why Gracie and Moelis believe the preferred market is underserved by alternative and even traditional managers. Preferreds require specialized knowledge, given the complex and evolving nature of the market. Moreover, there is a coverage gap resulting from the hybrid debt and equity characteristics: many issuers are investment-grade companies with yields that are similar to the high-yield category.

The End of 60/40

- Investors are grappling with the ineffectiveness of fixed income to provide complementary returns for portfolios that are highly correlated with equities.
- The typical 60/40 portfolios have traditionally benefitted from declining rates and negative correlation between bond and stock allocations.
- Preferreds have exhibited low correlations to U.S. Treasuries, a difficult relationship to find in fixed income.
- Preferreds also provide a relatively high degree of income with less risk and moderate correlation to equities.

For those wanting to learn more about the preferred market, this was a very educational discussion; you can listen to the full conversation below.

Behind the Markets on Wharton Business Radio · Behind The Markets Podcast: Eric Felder & James Palmisciano

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DEFINITIONS

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

Preferred stock : A class of ownership in a corporation that has a higher claim on the assets and earnings than common stock. Preferred stock generally has a dividend that must be paid out before dividends to common stockholders and the shares usually do not have voting rights.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

Long (or Long Position) : The buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value, the opposite of Short (or Short Position).

Short (or Short Position) : The sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value, the opposite of Long (or Long Position).

Credit spread : The portion of a bond's yield that compensates investors for taking credit risk.

Curve : Refers to the yield curve. Positioning on the yield curve is important to investors, especially during non-parallel shifts.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Contingent convertibles (CoCos) : Adebt instrument that is convertible into an equity security if a certain contingency is met or trigger-event occurs

Investment grade : An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

High Yield : Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securitie.

60/40 Portfolio : A portfolio of 60% equities and 40% fixed income.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.