

Bond Market Perspectives

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An Oscar-Worthy Performance from Preferred Securities

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Highlights

Preferred Securities exhibited both strength and resilience during the ups and downs of the fixed income market in recent months—an Oscar-worthy performance.

An improving supply-demand balance and attractive valuations benefited preferred securities.

We continue to find preferred securities attractive, particularly for income-seeking investors, and believe valuations have room for further improvement.

Preferred Securities

Preferred securities come in a variety of forms ranging from traditional preferred stock to hybrid forms of preferred stocks, which possess many debt, or bond-like, characteristics. Hybrid issues offered companies the benefit of both equity and debt issuance, hence the name “hybrid.” Many hybrids were considered equity for regulatory purposes and therefore could still be counted towards a financial firm’s minimum capital requirements. However, hybrid’s bond-like characteristics enabled them to be counted as debt for balance sheet purposes. Since debt and equity have different balance sheet implications, the added flexibility was attractive to issuing corporations. Furthermore, interest payments could be deducted for tax purposes unlike the dividends paid for traditional preferred stock. Under new financial regulations hybrids no longer qualify for capital requirements and corporations will likely redeem a significant number of issues in coming years.

High-yield bonds may have taken the Oscar for the best lead role in fixed income markets over recent months, but Preferred Securities deserve to win for a supporting role. The bond market witnessed ups and downs over the past few months and one sector managed well in both environments: preferred securities. In what we continue to expect will be a low return environment for bonds overall in 2011, finding an actor, such as preferred securities, that can do well in a variety of roles or environments is rare and certainly desirable.

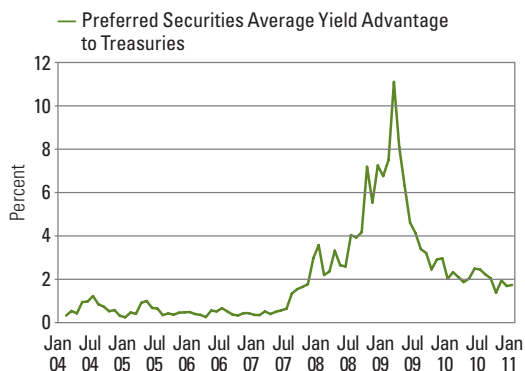
The resilience of preferred securities was first evident last year when the final three months of 2010 witnessed the worst high-quality bond performances in several years, as the Barclays Aggregate Bond Index declined 1.2%. Preferred securities suffered modest price declines but finished the quarter unchanged on a total return basis, as income offset price declines. The strong relative performance was notable given the long-term nature of preferred securities as most are originally issued with 30-year and longer maturities.

Preferred securities benefited from a favorable supply-demand dynamic that helps explain recent performance. Issuance of new preferred securities has been almost non-existent in the past 12 months and much of that is due to financial regulation. The Dodd-Frank Financial Reform Act stipulated that preferred securities could no longer count towards required minimum capital (i.e., financial assets to be held as a buffer against periods of stress) for financial companies after 2016. The regulation was aimed at bolstering the quality and quantity of minimum capital so that banks and financial companies would be more able to survive future economic downturns on their own without government assistance.

Not only has new issuance evaporated but corporations have also been proactive so far in 2011, retiring preferred securities in order to meet new capital requirements even though the new rules do not begin to phase in until 2013. A few financial companies, including Wells Fargo and Citigroup, have redeemed preferred securities taking advantage of low interest rates to issue traditional corporate bond debt in its place. Credit Suisse went a step further and successfully issued a new type of convertible security that will count towards required minimum capital known as contingent convertible security, or “co-co” for short. In sum, many companies have started to transition away from the preferred market. Limited new issuance and a shrinking market helped support the preferred market.



1 Preferred Security Valuations Have Improved, but Remain Well Above Pre-Crisis Levels



Source: Bank of America Merrill Lynch Index Data, LPL Financial 02/25/11

Past performance is no guarantee of future results.

Attractive valuation, in addition to a favorable supply-demand balance, has also bolstered the sector. Valuations have improved since the peak of the financial crisis but remain above pre-crisis levels as the average yield advantage, or spread, to Treasuries indicates [Chart 1]. With average yield advantage of 1.7% above comparable Treasuries we find preferred securities attractive. While we do not expect preferred securities to return to the narrow yield spreads that prevailed before the financial crisis we believe there is room for additional improvement as the market shrinks and investor demand for yield remains high. In a low-yield world, the average yield of 6.7% (as of February 25, 2011) is appealing, according to the Merrill Lynch Preferred Securities Index.

To be sure, preferred securities do entail risks. Issuer concentration is a potential risk as the vast majority of preferred security issuers are financial companies. We believe financial issuers have turned the corner as witnessed by steady improvement in company earnings over recent quarters. However, should the economy fall back into recession or suffer a setback resulting from rising oil prices rise, preferred issues may be adversely affected. In addition, the preferred securities market involves issuers rated both investment-grade and below investment-grade. Lower-rated issues are more sensitive to changes in the economy. Financial regulation, which once posed a risk to preferred holders, may slow the growth of financial companies. But from a debt holder perspective we view the risk controls, which include a higher capital base, positively as they may reduce the risk of missing any interest payments. Finally, an extended bout of risk aversion, similar to what occurred last week that led to good performance of high-quality bonds, may lead to underperformance of preferred securities relative to higher quality segments of fixed income markets.

The Oscar-worthy performance may lead to more roles for preferred securities. We continue to find preferred securities attractive, particularly for income-seeking investors.

- We believe the risks outlined above are lower probability events given the economic backdrop.
- Attractive valuations, which we believe have room for further improvement, help offset the potential risks.
- Furthermore, financial issuers' gradual transition away from preferred securities by redeeming existing issues coupled with low issuance provides a favorable supply-demand backdrop.
- Redemptions may also help the preferred securities market become shorter-term in duration as some long-term maturities may never be realized.
- Finally, in a low-yield world, preferred securities have provided an attractive yield at a time when we believe yield will be the primary driver of fixed income investors' return going forward.



IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

High-Yield/Junk Bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise, are subject to availability, and change in price.

Spread is the difference between the bid and the ask price of a security or asset.

Preferred Stock investing involves risk which may include loss of principal.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of a fund shares is not guaranteed and will fluctuate.

The Merrill Lynch Preferred Stock Hybrid Securities Index is an unmanaged index consisting of a set of investment-grade, exchange-traded preferred stocks with outstanding market values of at least \$50 million that are covered by Merrill Lynch Fixed Income Research. The Index includes certain publicly issued, \$25- and \$100-par securities with at least one year to maturity.

This Barclays Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

Contingent Convertible securities are bonds that can be mandatorily converted into shares of common stock in the event that financial stress causes a financial institution's minimum level (a trigger). The securities can allow a financial institution to avoid issuing new common shares or retaining more earnings to bolster minimal regulatory capital levels.

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