Manulife Investment Management

Preferred securities essential

A higher quality investment with **more attractive yield**

Amidst ever-changing global economy coupled with lower for longer interest rate environment, investors are seeking higher quality investments with more attractive yields.

Preferred securities: A US$1 trillion market

The global preferred securities is value over US$1 trillion, close to that of the US high yield bonds.

Over 90% of preferred issuers are rated as investment grade. With similar yields of global high yield, preferred securities offer higher credit quality[1].

	Average credit rating	Yield to maturity	2019 return
Preferred securities market	BBB- (Investment grade)	5.04%	+18.4%
Global high yield bond market	B+ (Non-investment grade)	5.67%	+14.0%

Source: Bloomberg, as of 31 December 2019.

What are preferred securities?

Issued by corporates, preferred securities rank between senior bonds and common stocks in the capital structure[2] of a corporate. They can be broadly classified into two types – preferred bonds and preferred stocks:

Preferred Debt:
Have features similar to bonds with regular interest payments[3], maturity dates and credit ratings, and no withholding taxes for non-US investors.

Preferred Stocks:
Generally with fixed dividends unaffected by the company's profits and paid before the dividends for common stocks; yet mostly without any attached voting rights. Withholding taxes are required in the US when investing in preferred stocks.

Priority of dividends and claims in the capital structure
In the event of corporate financial distress or a bankruptcy, a company's preferred securities are senior to common stock but subordinated to traditional bonds.

Priority of dividends and claims

[1] Preferred securities markets represented by ICE BofAML US All Capital Securities Index (IOCS), Global High Yield represented by ICE BofAML Global High Yield Index (HW00). For illustration purpose only. Historical performance is not indicative of future.

[2] Capital structure means that a corporate raises fund through issuing securities such as stocks, bonds and hybrid securities.

[3] Preferred securities issuers pay a dividend or interest to the holders, in two categories: cumulative and non-cumulative. For cumulative preferred securities, if the issuer does not pay a dividend on time, the dividend payable will accumulate and the holders are entitled to these cumulative dividends prior to common stock holders. For non-cumulative preferred securities, if the issuer cannot afford to pay the dividend in full, the holders of preferred securities have no right to claim the remaining part of the dividend in the following years. For illustrative purposes only.

The difference between $25 par and $1,000 par markets

The preferred securities market is primarily comprised of two types of issues: $25 par value securities target for retail investors and $1,000 par value securities target for institutional investors. $25 par securities are traded on the major stock exchanges, and the denomination of $25 par securities in small sizes enable a retail investor to buy 100 shares for around $2,500. In contrast, $1,000 par securities traded over-the-counter and are mainly purchased by institutional investors. Its higher denomination also acts as a hurdle for most retail investors.

Retail preferreds and passive exchange-traded funds (ETFs) for $25 par value securities may lead to higher volatility driven by sentiment and capital flows, which may also create pricing distortions among $25 and $1,000 par securities in the secondary market prices, even if they are from the same issuer with similar terms. The mispricing in preferred securities offers opportunities for professional investment managers to add alpha for their portfolios.

Mispricing in preferred securities offers opportunities for professional investment managers to add alpha for their portfolios

Preferred securities are primarily issued by large enterprises

Utilities

Regulated utilities provide stable and predictable stream of earnings that are secured by a lack of competition and low sensitivity from commodity prices and the economic cycle.

In the US, the industry is highly regulated, companies have very clean balance sheets and have an average rating of investment grade at BBB-, illustrating the higher quality nature.

Average returns of preferred securities in the past three years: **8.5%**

Communications

The communications industry includes cable, satellite, media and entertainment businesses. With the advent of the 5G era, the entire industry chain is expected to be upgraded concurrently, while expanding the scope of their applications at the same time.

This sector, like the utilities industry, is also regulated by the government and their business are less affected by global trade.

Average returns of preferred securities in the past three years: **10.2%**

Banks

Banks are the main issuers of the preferred securities market. The balance sheet of the banking industry stands at its strongest level in 50 years while their Tier 1 common capital ratio remains stable.

Despite the low rate environment may weigh on the net interest margin of the banking industry, low interest rates coupled with continuous economic growth will benefit loan growth and support the overall revenue of the banking industry.

Average returns of preferred securities in the past three years: **6.9%**

Insurance

With similarities to the banking sector, the insurance company balance sheets are very strong. The insurance sector is regulated by regulators and have strict guidelines for how much risk-based capital a company should have. Property and Casualty (P&C) are relatively attractive among insurers as they are seen as less sensitive to declining interest rates and their earnings will likely improve as they are better positioned to increase pricing after recent natural catastrophes.

Average returns of preferred securities in the past three years: **7.9%**

Source: Bloomberg, as of 31 December 2019. Preferred securities markets measured by ICE BofAML US All Capital Securities Index (IOCS). Industry breakdown follows Bloomberg Barclays Level 2-3 Class classification. Performance information is for information only.

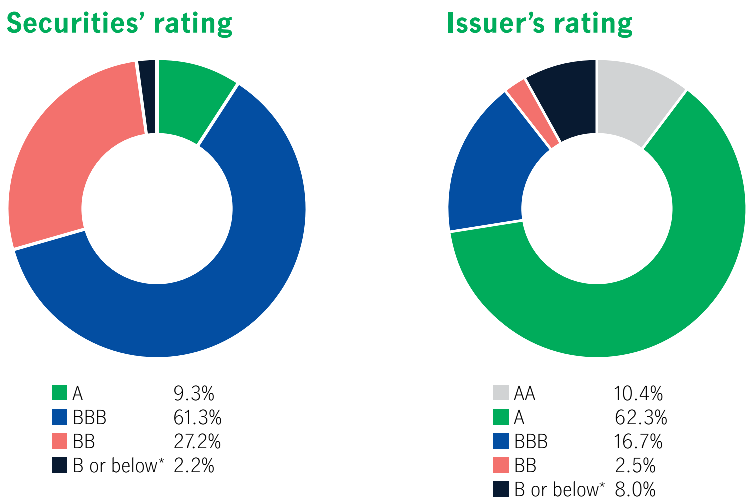
Preferred securities
Issuer's ratings
~90% Investment grade[2]

In the past ten years, preferred securities **defaults** averaged **0.05%**[3]

Most preferred securities are investment grade

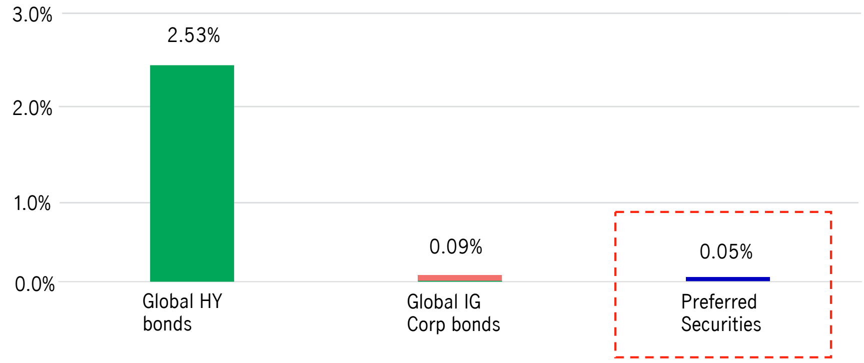
- The average credit rating of preferred securities is BBB-, an investment grade (IG)[1].
- 70% of preferred securities issuers are rated as A or above. Even if a preferred securities' rating is generally 3-5 notches lower than the issuer's rating based on their subordinate capital structure position, most of them are investment grade in nature. For example, one issuer's credit rating can be AA, yet the preferred securities it issues may be rated BBB.
- Based on the excellent credit of the majority of issuers, preferred securities have a lower default rate historically. In the past ten years, the default rate for preferred securities averaged at 0.05%[3], close to that of IG bonds.

Preferred securities' rating:



Source: Bloomberg, Manulife Investment Management, as of 31 March 2020. Preferred securities are represented by ICE BofAML US All Capital Securities Index. Due to rounding, the total may not be equal to 100%.
* B or below includes non-rated issuers.

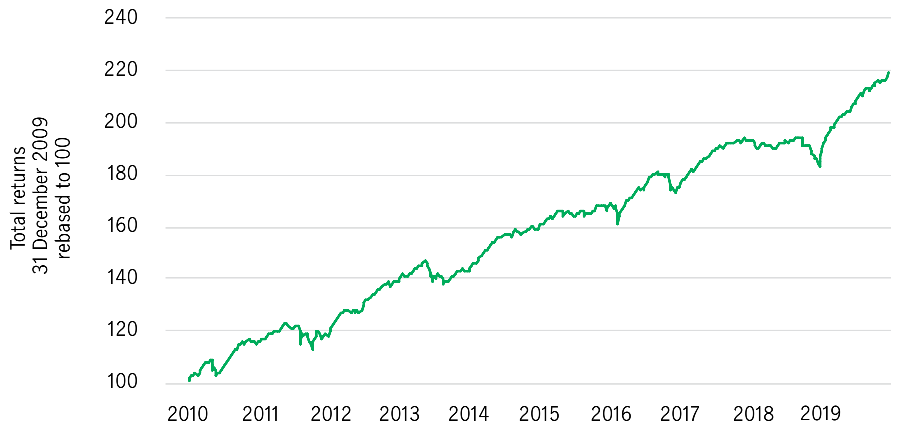
10-year average default rate of the bond market (2010-2019)



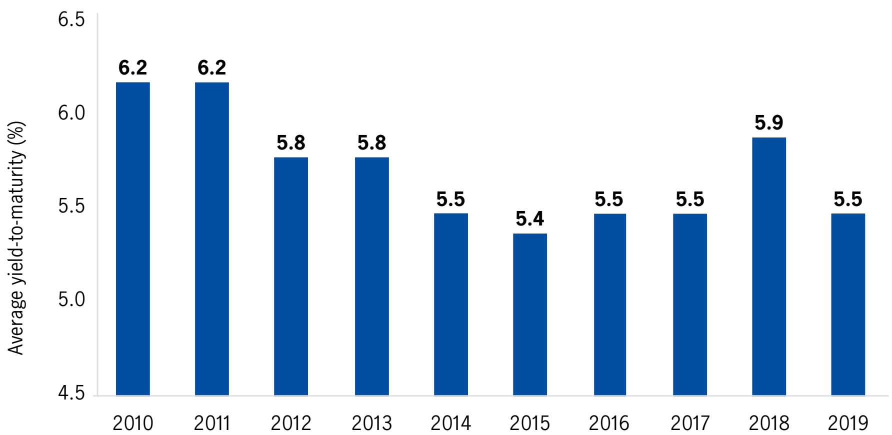
Source: Global high yield bonds and global investment grade bonds default rate are sourced from Moody's Investor Services, as of 31 December 2019. Preferred securities default rate from 1990-2017 was calculated by Wells Fargo. From 2018 to 2019, the preferred securities default rate has been based on the ICE/BofAML US All Capital Securities Index and has been calculated by Manulife Investment Management.

[1] Preferred securities are represented by ICE BofA Merrill Lynch US All Capital Securities Index, with average credit rating of BBB-.
[2] Source: Bloomberg, Manulife Investment Management, as of 31 March 2020. Preferred securities are represented by ICE BofAML US All Capital Securities Index.
[3] Source: Bloomberg, as of 31 December 2019. Preferred securities' default is calculated with data of US$25 face-value preferred securities.

The preferred market recorded positive returns in nine of the past ten years



The preferred market offered 5% yield or above in past decade



Source: Bloomberg, as of 31 December 2019. Performance of preferred securities markets from 2010 to 2012 is measured by 50% ICE BofAML Fixed Interest Preferred Securities Index (POP1) + 50% ICE BofAML US Capital Securities Index (COCS). Performance of preferred securities markets since 2013 measured by ICE BofAML US All Capital Securities Index (IOCS). Yield refers to yield of maturity.

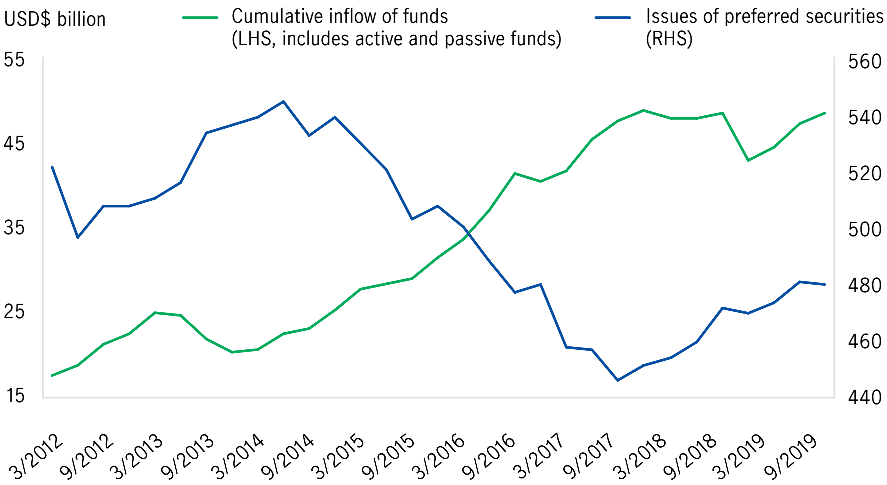
Preferreds maintained a yield of **5%** or above in past decade

There is a rich supply of preferred securities combined with strong credit ratings and compelling yield

Quality supply has bottomed out and rebounded

Since preferred securities can be regarded as equities in balance sheets without carrying voting rights, preferred issuance will not increase debt levels or dilute ownership. Therefore, companies are often willing to issue preferred securities with higher coupons for financing purposes.

In the past decade, the banking industry has once issued large amounts of preferred securities to fulfill the capital adequacy requirement by regulators. With the stress test showing the banks having fully compliant capital ratio and solid fiscal status, the banks' issuance of preferred securities has gradually decreased. Meanwhile, non-financial companies (such as utilities and communication ones) started to issue preferred securities amidst global economic recovery and low interest rate environment. Many of their issuances offer high credit quality with compelling yield. On the other hand, investors' demand of quality assets with higher yield is expected to remain strong amid low rates environment.



For example, the US utilities sector has experienced an increase in regulation since 2008, which benefits investors. In the meantime, many companies have upgraded their production capacity, invested in sustainable energy production technologies and looked for M&A opportunities. Therefore, utility's companies turned to the preferred securities market for their financing needs to raise funds for future developments.

Dominion Energy, a US-listed major energy service company with a BBB+ (investment grade) credit rating, provides electricity or natural gas to 7.5 million customers in 18 states. It has launched a series of business plans in recent years. Apart from having reduced its carbon intensity by 50% from 2000 through 2017, the company also announced a further 50% reduction in carbon emissions and a 50% reduction in methane emissions from its gas assets by 2030. In 2018, the company announced several M&A deals and started a variety of renewable energy projects, including solar and wind energy. The company issued bonds and preferred securities during the period to raise funds for business development.[1]

Example: Various types of securities issued by Dominion Energy[2]

	Coupon rate	Maturity date (dd/mm/yy)	Security ratings
Senior bond	2.45%	15/01/23	BBB
Preferred security	7.25%	01/06/22	BBB-
Common stock	4.43% (dividend yield)	N/A	N/A

1 Source: Company website.
2 Source: Bloomberg, as of 31 December 2019. Credit rating by Standard and Poor.

Manulife's professional investment team

25 years+
Investment experience by the US-based lead managers

40+
US fixed income investment experts

US$5.3billion
AUM in preferred securities, and one of the key players in the market

Source: Manulife Investment Management, as of 30 September 2019

Types of preferred securities

Preferred debt (including subordinated debt and junior subordinated debt)	✓ Normally with regular payouts ✓ Mostly with a maturity date ✓ Non-US investors are not subject to any withholding tax
Traditional preferred stock	✓ Senior to common stocks in the capital structure; no voting rights ✓ With a maturity date or perpetual in nature ✓ For dividend: Non-US investors are subject to a withholding tax of about 30% while US investors enjoy a tax advantage
CoCos	✓ Must be a perpetual bond ✓ Coupon payments that can be omitted or cancelled at the issuer's discretion ✓ Subject to bond covenants, part or all of the CoCos will be converted to common shares or even cancelled in the event that: 1) An issuer's capital ratio falls below the required level; 2) Regulators believe that the bank's capital ratio is too low

Glossary of preferred securities

Floating rate and fixed-to-float rate	• The coupon of a floating rate security is tied to a short-term benchmark rate plus a premium, such as the 3-month interbank rate plus 400 basis points. • A fixed-to-float rate security pays a fixed coupon for a stated number of years, and then floats. Some reset the coupon rate according every quarterly or semi-annually, for example, 3-month interbank rate plus 300-450 basis points. • This feature has broader appeal for institutional investors given a lower duration and some protection from rising rates.
Cumulative/non-cumulative	• "Cumulative" means that any deferred coupons continue to accrue as a liability to the issuer. Generally speaking, the holders of cumulative preferred securities are entitled to the coupon prior to common shareholders. • For "non-cumulative" securities, the issuer has the right to cancel the coupon due without being in default. • Cumulative preferred securities are senior to non-cumulative preferred securities in the capital structure.
AT1/T2	• Under the Basel III regulations, a bank's capital ratio is composed of three types: Additional Tier 1 Capital (AT1), Tier 2 Capital (T2), and Core Equity Tier 1. • In the capital structure, a Tier 2 bond has the highest priority of claim on an issuer's assets, followed by an AT1 bond and then a common share. In other words, the holders of a Tier 2 bond can receive the proceeds of liquidated assets first, followed by the holders of an AT1 bond and common share respectively. • CoCos, if they fulfill the related requirements, could qualify as either AT1 or AT2 capital of a bank under Basel III.
Callable	• The issuer can redeem the security prior to its maturity. • Callable terms are favourable to issuers as they can redeem and reissue new bonds with a lower coupon in a rate cut environment.
Convertible bond	• Under certain conditions, the issuer can convert the security into common shares.
Perpetual bond	• A bond with no maturity date or a long maturity period. • Most perpetual bonds include early redemption terms. The issuer, for instance, can redeem the bond five years following the issuance with 30 days' notice.
Effective duration	• A bond price is affected by interest rate changes while duration reflects the sensitivity of a bond price to the movement of interest rates. The longer the duration of a bond, the greater its price decline when interest rates increase. • While a traditional bond has one maturity date, some preferred securities have long maturity periods with early redemption terms. These conditions will be reflected in the calculation of "effective duration" to obtain an accurate and effective indicator.