The US Federal Reserve (Fed) kickstarted the tapering of its quantitative easing programme in November and is expected to resume its tightening monetary cycle soon. While this may increase market volatility, preferred securities should remain a compelling asset class in 2022. However, as we expect US rates to rise only modestly, this probably won't affect investors' appetite for yield. As ever, we should navigate any uncertainties with active management and credit selection while considering environmental, social, and governance (ESG) factors.

Preferred securities: From active management to sustainable investing

Resilient performance despite market headwinds

News concerning record-high daily COVID-19 cases and new variants, as well as rising US inflation and Fed rate-hike expectations, have seen the US 10-year Treasury yield surge over the year to date. Yet, preferred securities, with their high-yielding buffer and strong credit fundamentals, were resilient against other major fixed income sectors during these uncertain times. As of 30 November, preferred securities posted a 1.91% return, while US high-yield bonds and US investment-grade corporate bonds posted returns of 3.42% and -0.78%, respectively[1].

A positive environment for preferred securities

The outlook for preferred securities in 2022 looks positive. The US economy has recovered nicely and continues to improve. Fiscal policy has been supportive and monetary policy is likely to remain so in 2022. Importantly, we are not overly concerned about inflation over the longer term and believe we are still in a lower-for-longer interest-rate environment. Plus, there remains substantial global demand for yield, with US yields looking particularly attractive. In turn, this should help maintain relatively low rates. All of this results in a positive environment for preferreds, with credit spreads remaining stable and rates low.

Given the Fed started tapering in November, we think it is inevitable that volatility will increase. During this time, active management is going to become increasingly important, and we have many tools at our disposal to take advantage of volatility.

Our first tactic is to increase the weightings of fixed to floating rate securities versus fixed for life securities, which are substantially held in preferred ETFs. These are sensitive to flows from retail investors.

However, US$1000-par preferreds are held mainly by institutions with relatively stable movements. In addition, many US$1000 preferreds are fixed to floating rate securities, whereby during the first five years, the security will have a fixed coupon but then float at a spread over a benchmark. This offers investors some coupon protection, even in a rising rate environment.

Another method is to lower the duration of the preferred securities portfolio to mitigate the effect of a rising rate environment. As rates bottomed out, we began trimming the duration from over 7 years in 2018 to 4.16 years at present[2].

Moreover, we take a proactive approach to sector allocation and diversification, which a passive ETF cannot do. Unlike many preferred funds and certainly

[1] Source: Manulife Investment Management and Bloomberg, as of 30 November 2021. Returns in US dollar. Preferred securities = ICE BofAML US All Capital Securities Index. US High Yield = ICE BofAML US High Yield Index. US investment grade corporate bond = ICE BofA US Corporate Index. Past performance is not indicative of future performance.

[2] Source: Manulife Investment Management, as of 30 November 2021.

preferred ETFs with a significant weighting in the financial services sector, we are currently far more diversified with overweight exposures to the utilities, energy, and communications sectors.

In addition to alpha generation, investors are becoming increasingly conscious of sustainable investing factors. As more information is provided on the ESG practices of companies, analysis of these factors has featured more prominently in our investment process. ESG is an important element that explains why we are significantly overweight in the utilities sector.

Utilities demonstrate how improving ESG profiles can deliver outperformance

Utilities really are at the forefront of the energy transition occurring in the US. 20 years ago, utilities generated close to 50% of their electricity from coal generation. Nowadays, more and more US states have realised that one way to help fight against climate change is to de-emphasise coal generation and encourage renewables.

So, from an ESG standpoint, the utilities sector is now one of the leading segments of the S&P 500. Because US utilities are regulated, they earn a regulated return on any investments they make in transmission lines and generation. Since there is pressure on states to reduce carbon dioxide emissions, potential investments in renewable energy are likely to be approved.

Our credit analysts spend a lot of time studying ESG considerations and have developed a proprietary ESG scoring system. We then incorporate the scores into our relative value analysis. Companies with improving ESG profiles tend to outperform, particularly in the utilities sector. We have identified several names that have outperformed because of their renewables push has helped boost their ESG scores. An example of this is a Pennsylvania-based utility company.

We see tremendous value in the utilities preferred space, as many of these securities are not trading on their underlying fundamentals:

1. From an economic standpoint, the utilities sector has limited exposure to the coronavirus.
2. Common equity valuation multiples among utilities are at their lowest levels in a decade. We believe the convertible preferred securities of utility issuers will benefit as valuation multiples rise.
3. Utilities earn a regulated return, depending on what the state regulator allows. This could be between 9% and 9.75%.
4. We believe that US President Biden will provide incentives to encourage renewable energy investments, resulting in even more visible earnings and cash flows over the next few years.

The energy sector stands out amid a recovering global economy

Under a scenario where the global economy continues to improve, we expect recovery plays to outperform. Energy would be a beneficiary of any upturn. In fact, we've already seen this play out, particularly in the energy space, as credit spreads tightened significantly this year. Indeed, energy credit spreads are expected to tighten further, as many energy preferreds are still trading below pre-COVID levels.

It is important to note that our preferred energy names do not have direct commodity price exposure, as they are midstream companies that transport oil or gas in their pipelines. We hold a favourable view, and this is based on two reasons:

1. Many of these companies are diversified into different areas of the midstream space, such as natural gas pipelines, gasoline pipelines, and storage.
2. We believe natural gas has better long-term growth prospects than oil. Since it is difficult to build energy infrastructure in the US, this will result in higher average natural gas prices and, importantly, puts a greater value on existing energy infrastructure.

Financial services should benefit from higher rates

The financial service sector is expected to be another beneficiary of the improving economic environment, given the solid fundamentals of banking and insurance companies.

Higher interest rates are generally favourable for these names. And as yields moved higher over the past year, the earnings of financial services companies have improved markedly. We also see value in the sector because the market is not recognising balance-sheet strength, and yields are expected to remain stable.

Default rates should remain low

We think that very few, if any, preferreds will default in 2022. Historical default rates among preferred securities have been low[3] primarily because issuers are generally well-established, high-quality companies with solid balance sheets.

Conclusion

The economic environment should continue to improve as the world becomes fully vaccinated. This will result in further credit spread tightening, which provides positive support for preferred prices. Most investors do not realise that preferreds are less interest-rate sensitive due to their callable features and fixed-to-floating rate structures. In a transitioning market, as the Fed begins to taper its asset purchases, we believe that active management and credit selection with a consideration of ESG factors will be vital to the outperformance of preferred securities.

[3] During 1990-2020, default rates for global high yield bonds and preferred securities were 4.07% and 0.32% respectively. Source: Global high yield bonds are sourced from Moody's Investor Services, as of 31 December 2020. Default rates for preferred securities for the periods of 1990-2017 were sourced from Wells Fargo. Starting from 2018 default rates for preferred securities were calculated by Manulife Investment Management based on ICE BofA US All Capital Securities Index.

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