

Index Profile | Fixed Income – Preferred Stocks and Hybrids Index

Preferred stocks and hybrids

A market sweet spot?

November 2021



**FTSE
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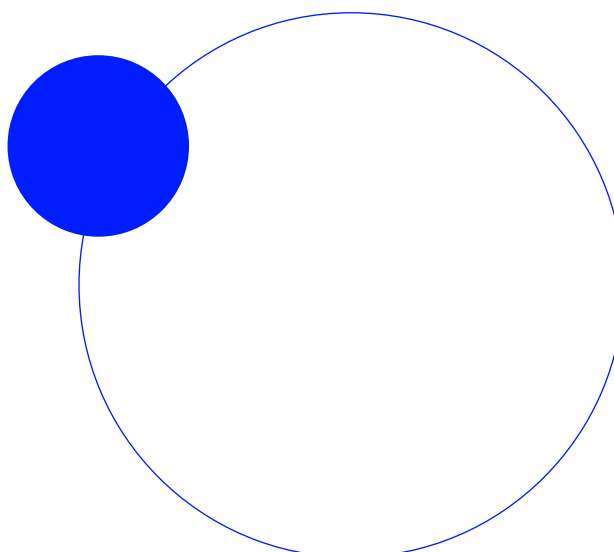
Michael Hampden-Turner
Director,
FTSE Russell fixed income
+0 789 442 0210
Michael.hampden-turner@lseg.com



Introduction

Investors are nervous about the outlook for both fixed income and risk assets, and the new FTSE US Preferred Stock & Hybrids Index series could offer a mitigation to these concerns in the current macro environment. This introductory article examines the risk characteristics of the index and explains why it might outperform in the current market environment. There is also a ‘no-jargon’ introduction to the mechanics of the underlying securities.

The fixed income indexes more broadly look to be at risk to both increasing inflation and curve steepening, which we discuss in section 3. In such an environment, investors might normally be more attracted to credit, hoping the additional “carry and roll” might cushion curve steepening. However, credit spreads are currently tight relative to history—especially in investment-grade assets—forcing investors into lower quality assets to find yield.



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Preferred stock & Hybrids index occupies a potential market sweet spot

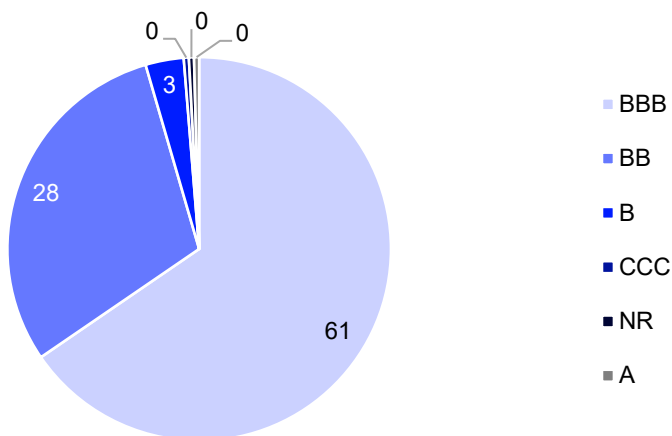
In the current market environment, the index offers the following advantages relative to other fixed income sectors:

- **Financial focus at this point in the credit cycle** - a cyclical financial sector that has historically outperformed in a “recovery” environment.
- **Greater resilience in a curve steepening environment** - financials tend to outperform corporate credit when yield curve steepen as their margins improve.
- **Long legal maturity but short dated to first call** - ironically a (potentially) perpetual instrument tends to offer short-dated first call date in a healthy economy, providing investors long-dated yields to a short-dated instrument. This high turnover of paper means that coupons reset more frequently than more senior debt. However, this advantage can flip in stress conditions.
- **Non-recourse leveraged exposure to familiar names** - index constituents are familiar, well-regulated companies, relative to some high yield indexes. Leveraged exposure is achieved without derivatives or margin calls.
- **High coupon income with tax advantages for some categories of investor** - particularly for institutional investors.
- **Higher yield investments offer some protection in a rising rates environment** - preferred stock & hybrids benefit from higher yield/carry/roll-down, which means they do better in a gradually steepening yield curve environment than an investment grade index.
- **Spread compression** - preferred stock & and hybrids are high beta to their peers and have historically outperformed in a credit rally. Investment grade indexes have less “squeeze” potential currently. High beta works both ways, however, and tends to be more at risk in sell-off.

Risk characteristics of the FTSE US Preferred Stock & Hybrids Index

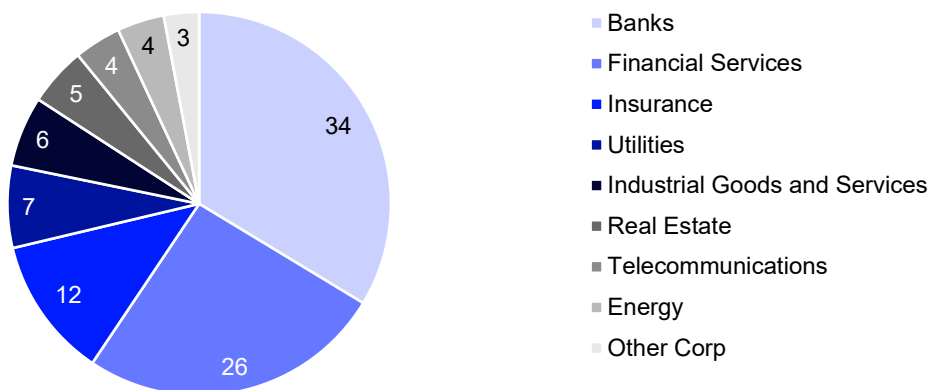
The risk characteristics of the index are what define its performance relative to similar IG or HY credit indexes. We will go through the defining characteristics in turn.

Chart 1: IG/HY “crossover” risk characteristic, %



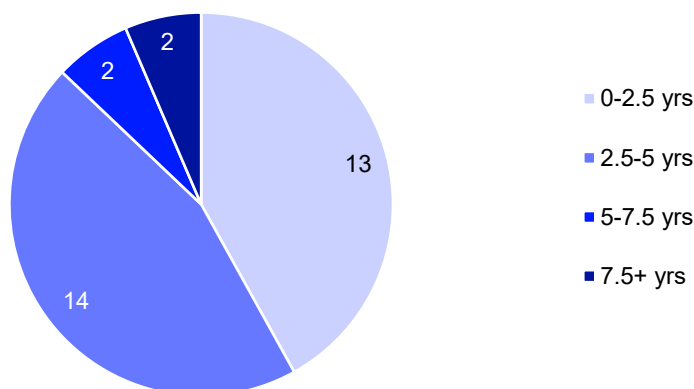
Source: FTSE Russell, Yield Book, data as of September 30, 2021.

Chart 2: More than two thirds financial sector, %



Source: FTSE Russell, Yield Book, data as of September 30, 2021.

Chart 3: Short time to first call, %



Source: FTSE Russell, Yield Book, data as of September 30, 2021.

It is a crossover index - Chart 1 illustrates that this index occupies a space between investment grade and high yield. As discussed in our “beginner’s guide”, this rating is due to subordination in the capital structure rather than poor company fundamentals. Crossover is a popular investment point in Europe, where riskier high yield bonds are less common than in the US.

It is predominantly financials - Chart 2 illustrates how the index is dominated by financial institutions. The biggest banks issue the most subordinated debt to support their activities, and thus are primarily represented in this index.

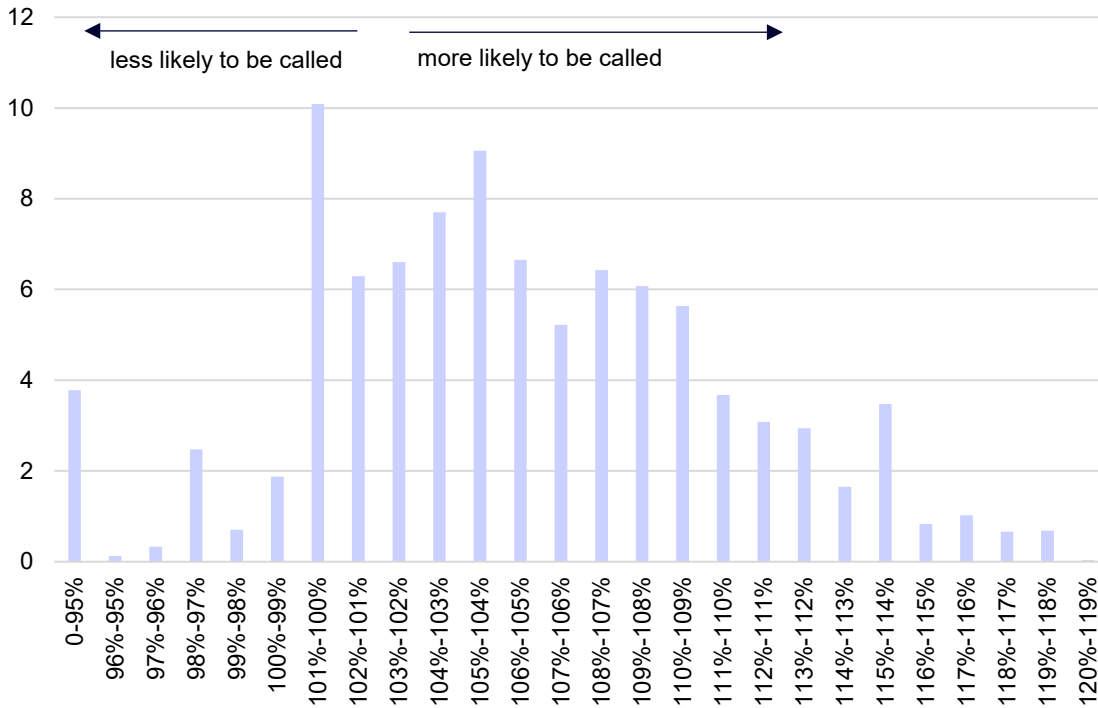
It is short-dated, but there is a twist - Chart 3 illustrates how the average number of years to first call date is very low. This is important because, generally, there is an investor expectation that bonds are called on this date. This makes a portfolio of preferred stock & hybrids less at risk to a steepening yield curve environment than an equivalent corporate investment grade portfolio, which is typically more like six-to-eight years in average maturity. The twist is that, in stress periods, calls are less likely to occur, and the average maturity increases, which has an adverse effect on the risk profile.

Majority (currently) likely to be called at first call date - Chart 4 is a histogram of prices relative to par and illustrates that only a small number of securities are currently looking less likely to be called. This is dependent on market conditions as improving macro sentiment will likely diminish the “at risk” pool further. Of course idiosyncratic risk remains, but the advantage of a diverse pool is that the risk remains low relative to a smaller pool of securities.

Yield pick-up - Charts 5, 8 and 9 illustrate the extra yield available from investment-grade bonds historically. In addition to implying more attractive returns, the charts also imply a more attractive carry and roll, making the index more resistant to an environment in which rates are increasing slowly. Yields are more complex to calculate when there is no definitive maturity.

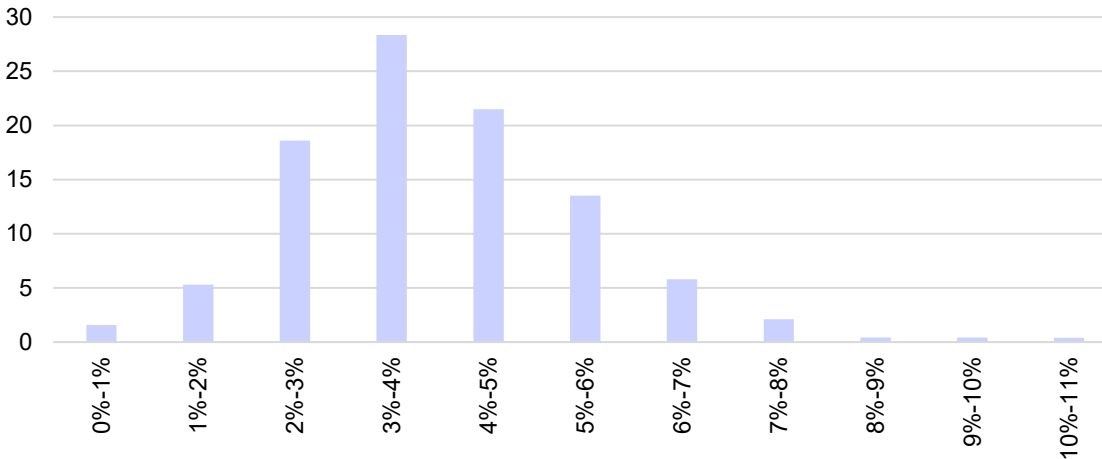
Complexity, uncertainty and liquidity premia - A latter section of this note explains the mechanics of the capital structure, and much of the additional yield that this sector attracts come from this. However, extra premium comes from uncertainties surrounding preferred stock & hybrids. They include: uncertain maturity date, the risk of extension, the risk of coupon cancellation, the lack of standardization in the sector and the need to read the bond term sheet carefully. These factors mean that these instruments are less liquid, less accessible to all investors and, therefore, tend to carry a premium that reflects these factors. This should be attractive to an investor who is comfortable to take diversified exposure to the whole sector as long as they are happy with the portfolio risk characteristics.

Chart 4: Index price histogram, %



Source: LSEG Data & Analytics, data as of September 30, 2021. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Chart 5: Index yield histogram, %



Source: LSEG Data & Analytics, data as of September 30, 2021. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Non-recourse leverage to major financial institutions

It is worth noting that the additional yield is created by subordination in the capital structure of major institutions rather than going down in institutional quality. The risk effect of this is to increase correlation risk, i.e., systematic risk to the whole sector, and decrease idiosyncratic risk, i.e., the risk of a credit event to a single name due to mismanagement or fraud. Charts 11 and 12 illustrate the biggest exposures in the index.

Chart 6: Top 10 issuers by market value – Preferred Stock

Issuer	Market value USD bn	No. issues
JP Morgan Chase & Co	35.32	21
Bank Of America Corp	24.43	22
Citigroup Inc	21.96	13
Wells Fargo & Co	18.74	13
The Charles Schwab Corp	10.72	8
Goldman Sachs Group Inc	9.28	13
Morgan Stanley	8.01	9
Truist Financial Corp	7.17	8
Capital One Financial Corp	6.85	8
Metlife Inc	9.71	7
TOTAL	149.19	122

Source: FTSE Russell, data as of September 30, 2021.

Chart 7: Top 10 issuers by market value – Hybrids

Issuer	Market value USD bn	No. issues
Prudential Financial Inc	7.53	8
The Southern Company	6.36	8
BP Capital Markets Plc	5.45	2
AT&T Inc	5.41	4
Vodafone Group Plc	5.04	4
Nextra Energy Capital Holdings Inc	3.06	6
Enbridge Inc	2.70	3
Enterprise Products Operating LLC	2.69	4
Aegon N.V.	2.20	3
CMS Energy Corporation	2.18	5
TOTAL	42.62	47

Source: FTSE Russell, data as of September 30, 2021.

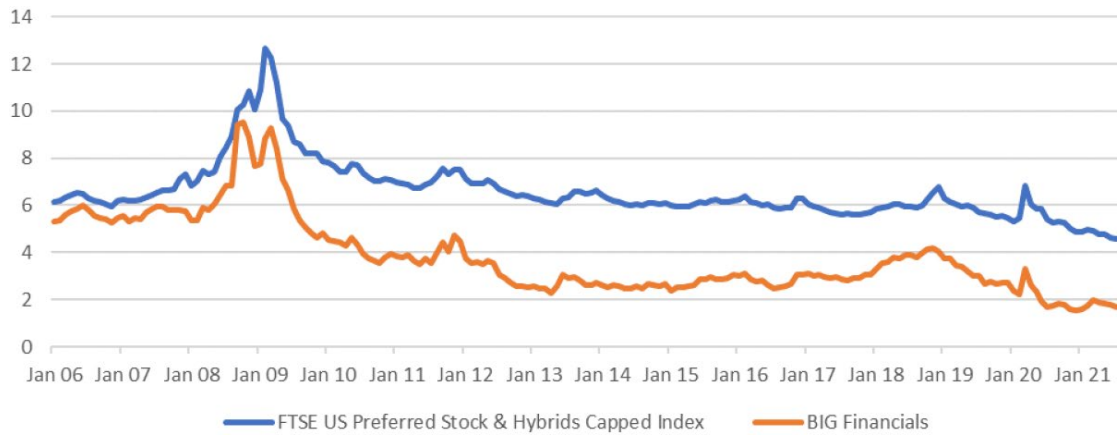
Smaller and less diverse than broader market indexes – While the index gives an investor broad exposure to financials and utilities, it does not offer the diversity of an index, like the US BIG or anything like as big a pool of underlying securities.

Chart 8: Market characteristics relative to Broad Investment Grade Index

Index	Number of issues	Yield to maturity	Effective duration	Coupon	Market value \$bn
FTSE US Preferred & Hybrids Index	669	4.56%	4.19 years	5.61%	373
FTSE US BIG Index	8734	1.35%	6.37 years	2.56%	25,690
FTSE US BIG Corp Index	7314	2.02%	8.76 years	3.68%	7,175

Source: FTSE Russell, data as of September 30, 2021. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Chart 9: Average yield of Preferred Stock and Hybrids Capped versus Financials Broad Investment Grade, %



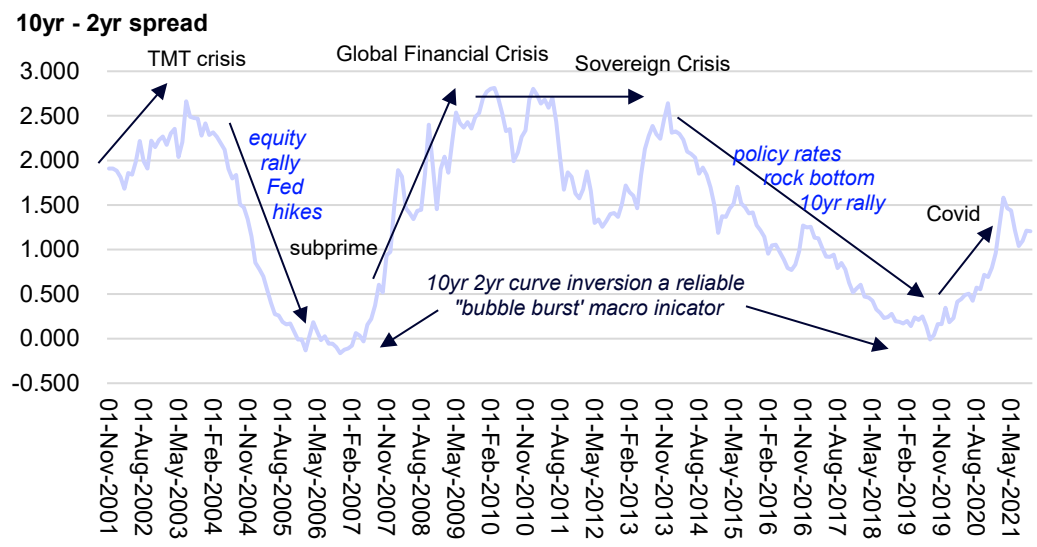
Source: FTSE Russell, data as of September 30, 2021. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Macro backdrop makes preferred stock & hybrid bonds more attractive

High inflation and a sell-off of longer dated treasuries have been making headlines recently. If inflation, off the back of COVID-19 recovery, remains persistent, the Fed and other central banks will need to both unwind QE and begin to raise rates. US 10-year breakeven inflation (implied inflation) has more than doubled in the last 18 months, suggesting that the market thinks this may be true. But, at the time of writing, the strength of the recovery is still uncertain. The combination of uncertainty of inflation and rates is likely to help increase term premia and steepen curves.

The graph below illustrates how COVID-19 recovery initiated a steepening US yield curve, and with the Fed still cautious, this seems unlikely to reverse unless we see a major resurgence of the pandemic.

Chart 10: US 2s10s benchmark yield spread over the past 20 years, %



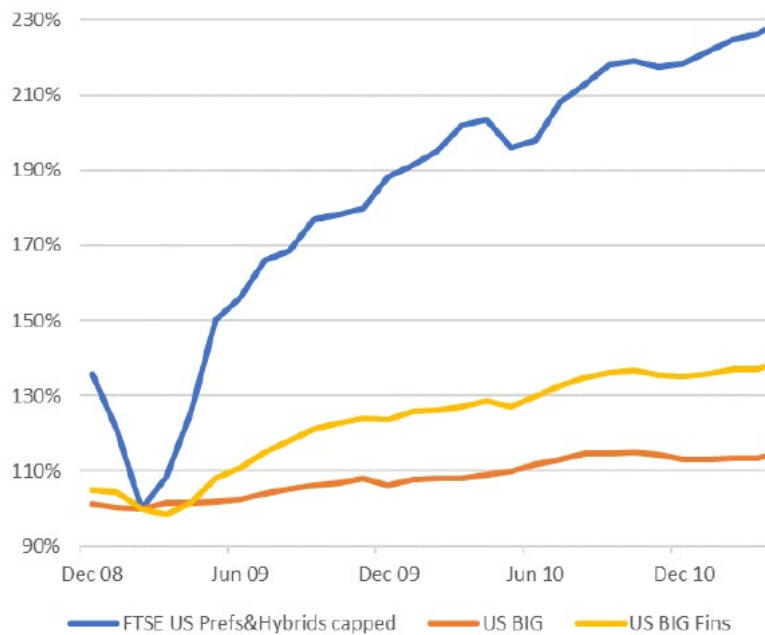
Source: LSEG Data & Analytics. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

This macro observation is important because, historically, there has been a correlation between a steepening yield curve and financial sector outperformance, banks in particular benefit. Steeper rates curves are good for banks as they tend to improve their margins, and also benefit from their ability to affect maturity transformation (essentially borrow short and lend long). This is important when understanding the risk profile.

Banks also benefit more directly than corporates from lower credit spreads. Clearly all corporates benefit from better borrowing rates but financials get bottom-line benefit in a credit spread compression environment, which lowers their cost of borrowing and increases their margins. As a high-beta index, we would typically expect preferred stock & hybrids to outperform other investment grade bonds in a credit spread compression.

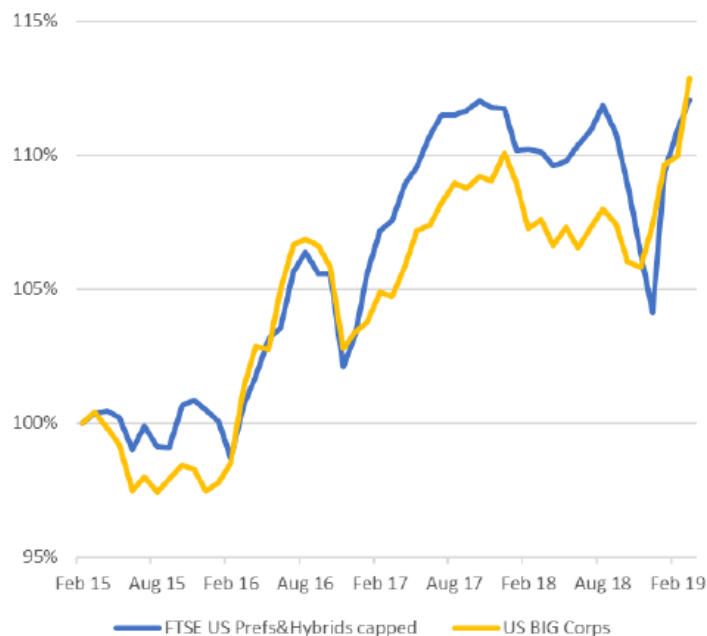
We can see this by “backtesting” index performance through different macro-economic conditions. For example, the post-GFC period saw a combination of these macro scenarios drive significant outperformance, as seen in Chart 11. Credit spreads rallied, especially the financial sector and curves steepened. Preferred stock & hybrids notably outperformed corporates and senior unsecured financials.

Chart 11: Outperformance post-GFC - risk rally and steepening driving a double boost



Source: FTSE Russell, LSEG Data & Analytics, data as of September 30, 2021. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

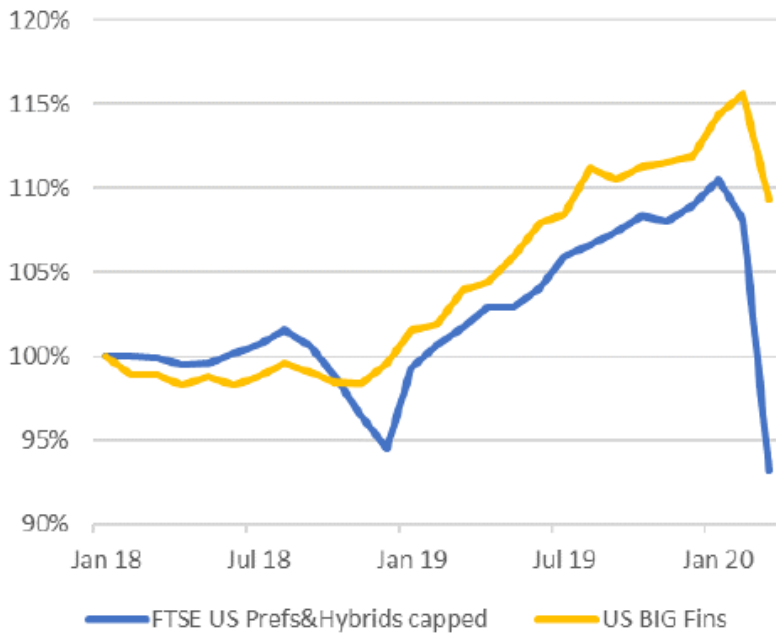
Chart 12: Neutral. Boost from risk rally, drag from curve steepening (fins underperform)



Source: FTSE Russell, LSEG Data & Analytics, data as of September 30, 2021. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

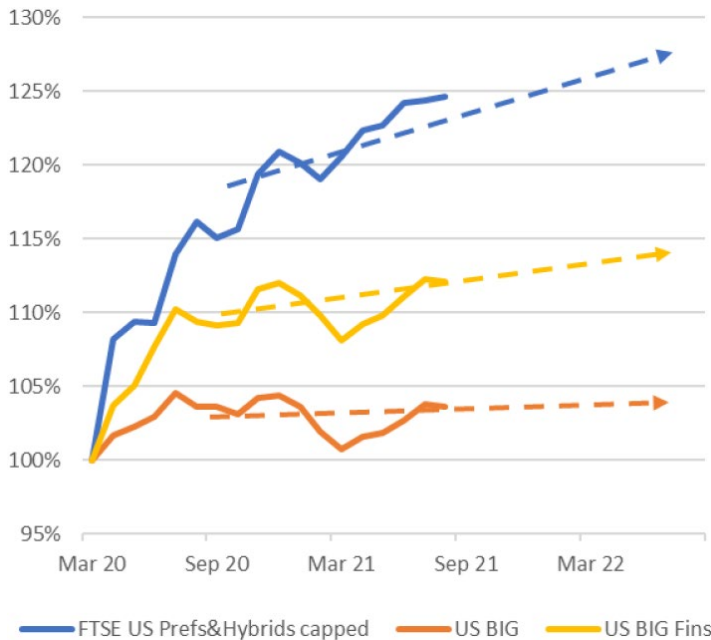
Chart 12 illustrates a period with a combination of headwinds and tailwinds which ends up with neutral performance. It is a period of slow curve flattening, which is negative for financials, and slow tightening of credit spread, which is positive for all credit. Normally, tightening spreads would see the high beta index outperform, but in this instance the positive and negative combination adds up to a neutral performance relative to the corporate BIG index.

Chart 13: Underperformance heading into COVID-19, which saw expectations for rates lower for longer and a risk asset correction



Source: FTSE Russell, Yield Book Source: FTSE Russell, data as of September 30, 2021. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Chart 14: Future outperformance drivers – yield/carry/roll-down and attractive macro backdrop for financials



Source: FTSE Russell, Yield Book Source: FTSE Russell, data as of September 30, 2021. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

High beta does mean higher risks, especially in periods of macro risk such as COVID-19. Chart 13 illustrates the potential underperformance in a scenario where there was a significant resurgence of COVID-19, for example. This is not a central scenario but remains a tail-risk.

A more central scenario is illustrated in Chart 14. The index bounced back faster than US BIG Financials (admittedly recovering from a much lower base), but is now outperforming as the expectations for inflation and steeper yield curves entice investors into the sector. The Fed has yet to move and QE remains in place, which suggests that the trend outlined in chart 14 has further to go.

A beginner’s guide to preference shares and hybrid bonds

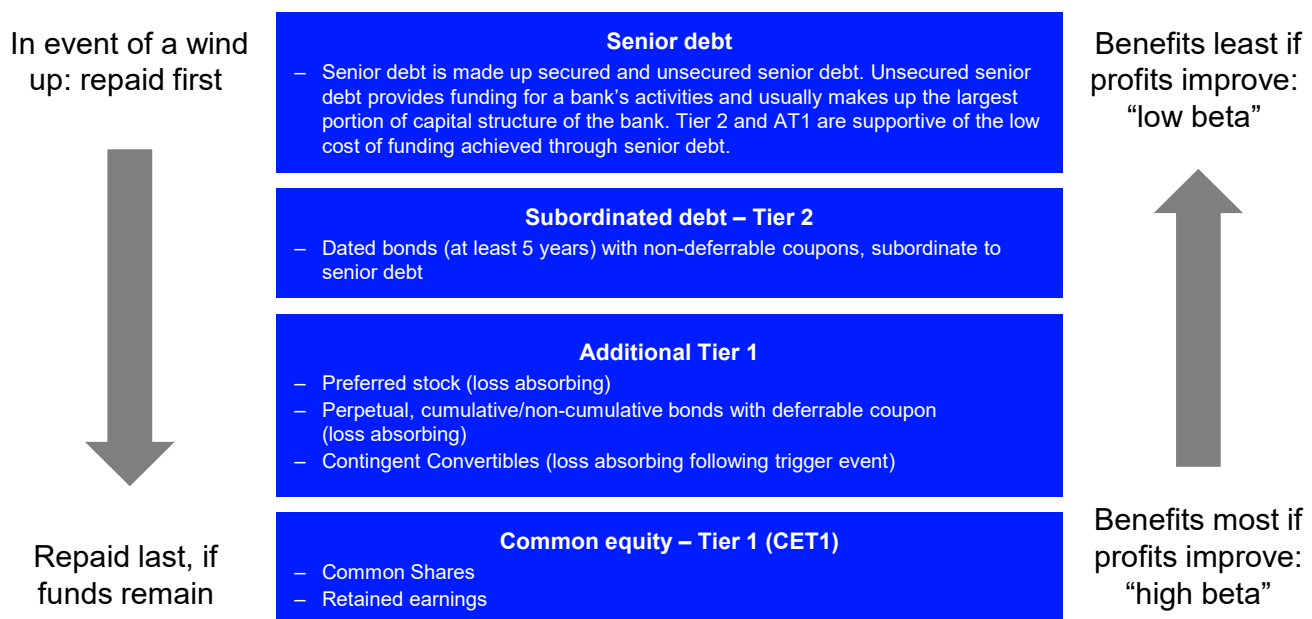
If you think you know all about subordinated debt, regulations, and the capital stack, then you are not going to find this section very useful — this is a no-jargon explanation to help create a high-level understanding of the risks and motivations for investors in hybrid and preference instruments.

At its basic level, it is a regulator and rating agency mandated instrument that behaves like a subordinated bond until the entity is stressed. In a stress scenario, it will switch into equity or have equity-like characteristics, hence “hybrid.” For most of its lifecycle it is a bond. The mechanics for switching to equity vary from bond to bond, and require a detailed read of the bond’s legal documentation. The motivation for extending maturity or cancelling coupon for a period is to absorb losses in a downswing and give the company some room to maneuver by providing it with more equity.

To explain why this is useful, we are going to use an analogy of buying a house. Our protagonist’s name is Adam. He buys a house for US\$100,000 with a loan from the bank of US\$80,000 over 30 years, which he pays 4% interest on. Additionally, he borrows US\$10,000 over five years from his parents, on which he pays 8% interest. The final US\$10,000 contributed from his savings. Unfortunately, Adam loses his job, and, although he picks up some temporary work to help cover his costs, this doesn’t cover everything. If he fails to pay the bank, they will seize the house. Correctly guessing that his parents will be more sympathetic than the bank, Adam decides to ask his parents to suspend both interest and principal repayment while he gets back on his feet. They agree to this, but expect him to curtail his lifestyle.

The relationship between these creditors is like the relationship between creditors in a typical hybrid finance relationship. Adam’s mortgage represents the senior unsecured bond holders, doing the heavy-lifting part of the funding at relatively low cost and consequently offering little flexibility. The parental loan is like a hybrid bonds or preferred stock, with shorter duration, higher rate but a key component of flexibility. Adam’s stake is like the common equity holders — their capital is more at risk, but they get upside if it all goes well. Without the flexibility of the hybrid part, the structure may have collapsed during a stress period.

Chart 15: Diagram of capital structure or “stack” illustrating subordinated status



Preferred stock & hybrid bonds can suspend their coupons, or extend maturity, or both. Sometimes the interest owed is accumulated when not paid, sometimes it is just missed. The structures vary, but essentially are designed to offer the borrower flexibility to reduce their burden during stress periods from something that feels like debt, with a maturity date and a coupon, to something that is more like equity without coupons and no maturity date.

This is exactly the rationale for why regulators and rating agencies encourage preferred stock & hybrid bonds. It reduces the probability of a systemically vital entity needing to raise fresh equity capital in a stress period to meet liabilities. In the economic jargon, the flexible nature of subordinated debt means it can absorb losses through the credit cycle. By extension, it reduces the probability of needing a state bail-out, too.

Therefore, regulators, central banks and rating agencies have criteria that must be met if they are going to allow preferred stock or hybrid bonds to “count” as equity for the sake of capital requirement or rating calculations. If an institution is not getting “credit” for their hybrid then it is not worth paying a higher coupon to issue the bond.

The important concept for the capital stack is the priority of payments when things go wrong: the senior debt is repaid first, then the junior debt and then equity. Any loss or forbearance has to come from the bottom up. Adam has to sacrifice before his parents, and so on. However, in terms of “upside”, it is Adam who receives the benefit of capital appreciation, and his parents to a lesser extent in terms of a high rate of interest.

What makes preferred stock & hybrid bonds interesting to investors?

These instruments are used by large and well-regulated companies that are typically more “household” names relative to the constituents of high-yield indexes. For many investors, a more complex subordinated instrument on a well-established name is preferable to an invest in similar risk and return on less familiar names.

This is what makes subordinated debt interesting for investors. It typically carries a much higher return than senior debt and yet credit events for hybrids are relatively rare. Having said this, during the aftermath of the global financial crisis there was a surge in coupon and maturity deferrals.

Preferred stock & hybrids are complex and decisions to “call” debt are not always made on an economic rationale. In Europe, they have frequently had a political dimension. On average, the return has hugely exceeded losses (based on a limited history), but this risk can be highly idiosyncratic. Therefore, there is an advantage to holding the debt in a diversified index rather than “picking” bonds.

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Asia-Pacific

North America +1 877 503 6437

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