Preferred Securities Primer

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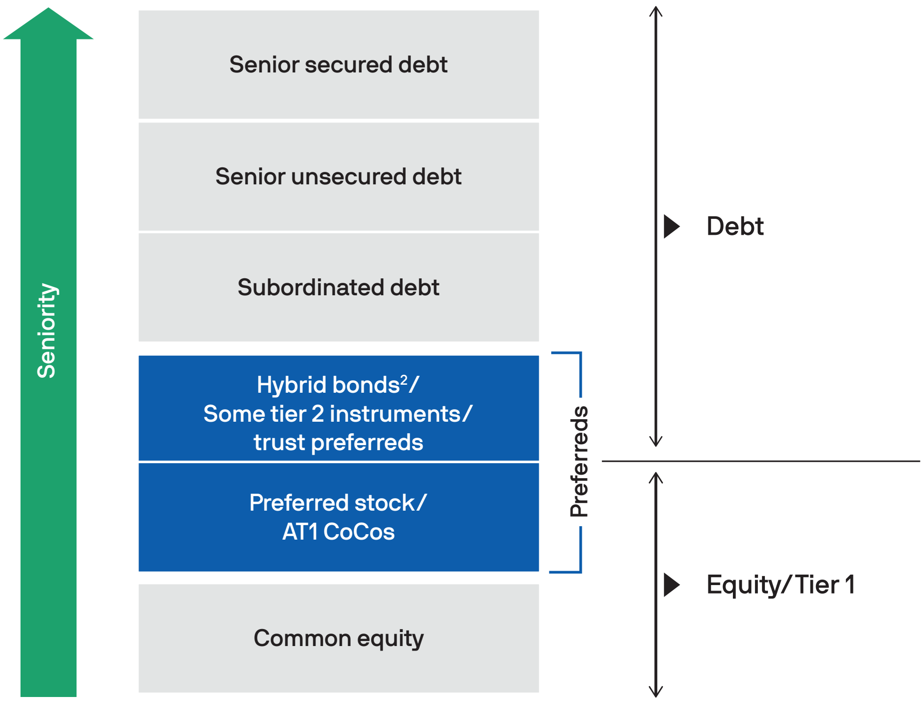
What are preferred securities?

Preferred securities are fixed income instruments that typically sit above common equity but below traditional senior and subordinated debt in a company's capital structure. These may also be referred to in the market as hybrid securities since they have both debt- and equity-like characteristics. Similar to debt, they pay a predetermined fixed or floating rate coupon, have a set face value and may be callable by the issuer during the life of the security. Similar to equity, payments can be deferred or suspended, and the instruments are typically perpetual or have very long-dated maturities. The global preferred securities market is approximately $1.2trn[1].

Capital structure



[1] CAD retail preferred market excluded.

[2] Deferrable Subordinated Debt.

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The main types of preferred securities are traditional preferred stock, hybrid bonds and additional tier 1 contingent convertibles (AT1 CoCos). Below are typical characteristics for each type, though at times some securities may differ from these qualifications.

Types of preferred securities

	Traditional preferred stocks	Hybrid bonds	AT1 CoCos
Maturity	Perpetual	Long-dated or perpetual (non-US)	Perpetual
Issuer call option	Between 5–10 years from issuance	Between 5–10 years from issuance	Between 5–10 years from issuance
Format	$1000 par (institutional) or $25 par (retail); exchange traded	Most $1000 par institutional	$1000 par institutional
Payment obligation	Discretionary payments that can be suspended indefinitely without triggering a default. Payments may be either cumulative or non-cumulative. US Bank and insurance preferreds are non-cumulative	Deferrable but cumulative. For US issuers, payments are generally deferrable for a specific number of years, after which, must be paid	Discretionary, non-cumulative payments that can be suspended indefinitely without triggering an event of default. Several explicit payment cancellation triggers
Payment type	Dividend	Interest	Interest
Coupon type(s)	Fixed to floating rate[3], fixed for life	Most fixed to floating rate[3]	Fixed to floating rate[3]
Capital structure priority	Above common equity but below all debt	Above preferred stock or equivalent but below all other debt	Above common equity but below all debt
Predominant issuing region	US	Global	Non-US
Predominant sectors	Banks, diversified financials, REITs, insurance, utilities	Insurance, utilities, energy (i.e., pipeline & integrated), communications	Banks (Europeans banks being vast majority)
Other	Typically have dividend stoppers which require the common equity dividend to be suspended before payment can be suspended on the preferred stock		Contingent convertibles explicitly state a minimum bank capital level that if breached would result in a conversion into common equity or a write down of principal

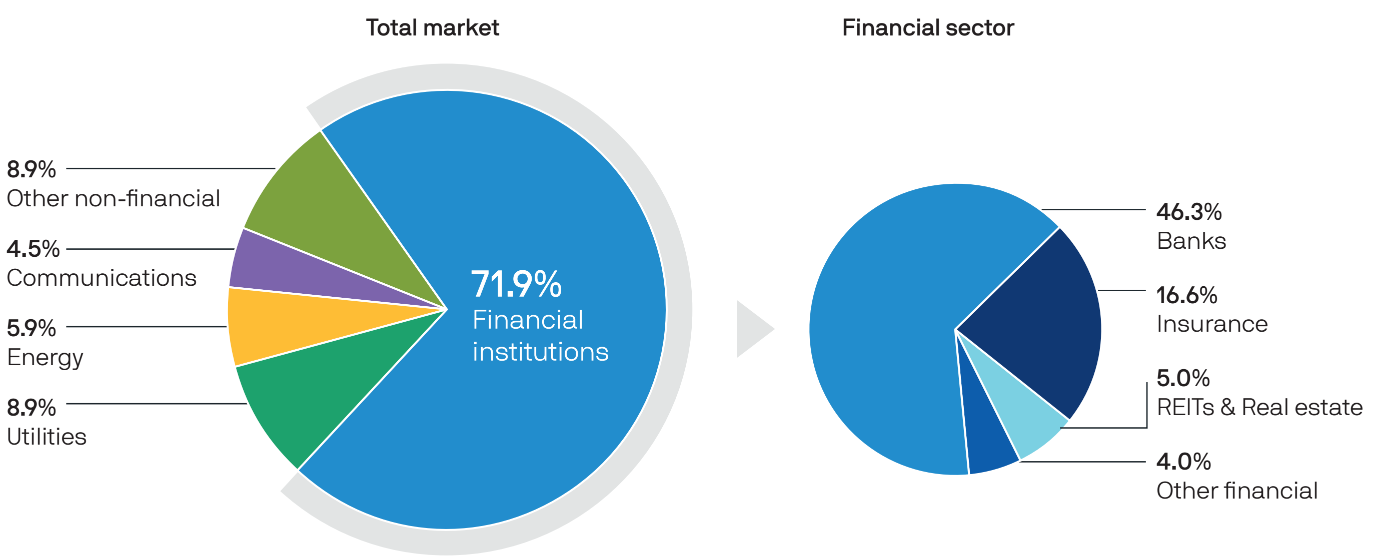
[3] Fixed to Floating Rate includes floating rate securities and securities that the market may refer to as fixed to fixed rate. The market typically refers to securities as fixed to fixed rate if the reset rate following the first fixed rate period has a tenor of greater than one year. An example of this is a security that pays a fixed rate for five years then, if not called, resets off the five-year Treasury rate to determine the coupon for the next five years.

Note: There are other securities that we would classify as preferred securities, more so outside of the U.S., that do not fit one of these main types; however, they are a smaller part of the overall universe. Legacy trust preferred securities have features that resemble hybrid bonds.

Who issues preferred securities, and why?

Financial institutions represent the majority (70%+) of the market. Banks represent the largest portion of the overall market, followed by insurance companies. Both global banks and some insurance companies use preferreds as a way to meet regulatory capital requirements. Most other companies, including insurance, issue because the securities receive favorable ratings agency treatment: a portion of the issuance is viewed equity-like and therefore does not increase leverage ratios in the same magnitude that traditional debt would.

Sector and financials sub-sector breakdown



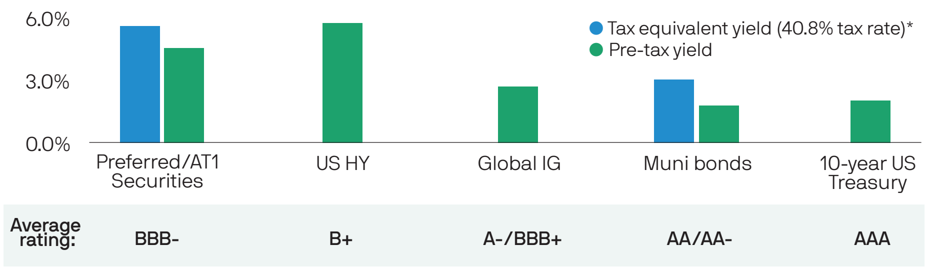
Source: Bloomberg, as of January 2022.
Other Non-Financial: Non-cyclical, Cyclical, Industrial, Basic Materials, Technology, Government, Diversified.
Other Financial: Investment Companies, Private Equity, Savings & Loans, Closed-end Funds, Diversified Financial Services.

Why invest in preferred securities?

High level of potentially tax-advantaged income

Preferred securities offer a high level of income when compared to many other fixed income asset classes. The higher level of income is due to credit risk, as well as the subordination premium paid to an investor in order to take on additional risk by moving to a lower part of a company's capital structure.

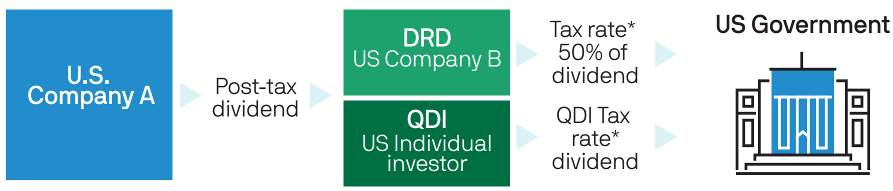
Comparable yields



Source: Bloomberg, BofA, J.P. Morgan Asset management. Data as of February 2022. Preferred/AT1 Securities represented by 75% ICE BofA US All Capital Securities Index and 25% Bloomberg Developed Market Contingent Capital Index. **Tax equivalent yield (TEY) assumes a full ordinary tax rate of 40.8%. For Preferred/AT1 TEY, we are assuming 75% investment in QDI-eligible securities (actual investment can vary with manager discretion).* This TEY will be subject to the QDI tax rate of 20% and a Medicare tax rate of 3.8% (23.8% total tax rate).

An important added benefit to preferred securities is that the income may be tax advantaged, enhancing yields. For individual investors, many preferred securities are qualified dividend income (QDI) eligible. QDI is taxed at the lower long-term capital gains rate rather than at the ordinary income tax rate. The highest federal long-term capital gains tax rate is 23.8% versus 40.8% on ordinary income, both of which include the 3.8% Medicare surtax. For certain corporations, many preferred securities are also dividend received deduction (DRD) eligible, which may provide tax-deductibility benefits, also enhancing yields.

Example tax structure for DRD and QDI eligible preferreds



Source: Barclays, Mazars. *Per the Tax Cut & Jobs Act of 2017. J.P. Morgan does not offer tax advice. Please consult your accountant for official guidance on taxation laws and regulations.

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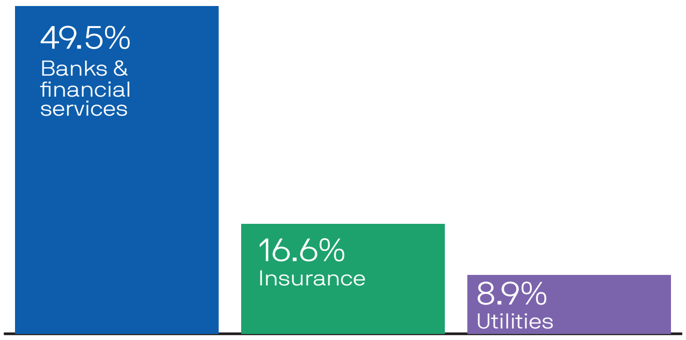
Investing in high-quality, investment-grade issuers in highly regulated industries

The average S&P credit rating of the preferred securities market is investment grade at BBB-. The majority of securities in the market have investment-grade ratings – and those that are not investment grade are generally rated BB +/-, the highest quality of the high yield rating spectrum. It is worth noting that preferred securities are lower rated than their issuer rating or their senior unsecured counterparts due to their subordination in the capital structure, as discussed above. In essence, this means that the issuer's rating is a few notches above the preferred securities rating, and therefore, the vast majority of issuers of preferred securities are solidly investment-grade companies.

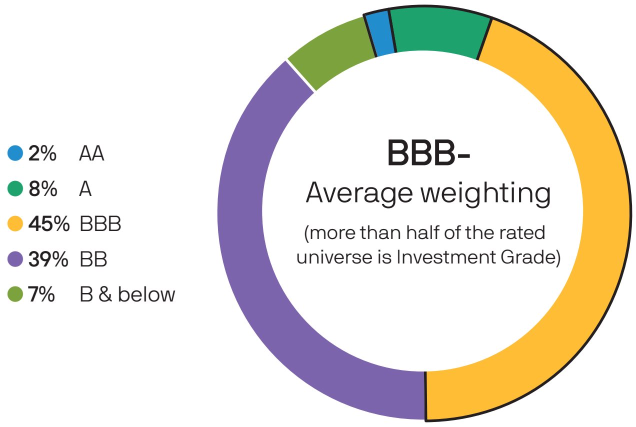
Additionally, much of the market can be found in highly regulated industries. Regulatory oversight can help enhance the safety and soundness of these institutions. For example, many banks are going through stringent regulatory stress tests in order to ensure their resiliency.

Over 70% of the preferreds securities universe is in highly regulated industries



Source: Bloomberg, as of January 2022.

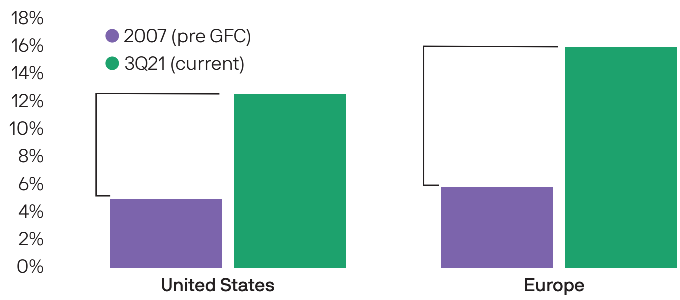
Rating distribution



Source: Bloomberg, as of January 2022. Market value % as a percentage of total rated universe.

Banks, specifically U.S. and European banks, comprise the largest percentage of the preferred securities market. Post the global financial crisis (GFC), banks have substantially strengthened their balance sheets and significantly improved capital quality and levels. Higher capital levels allow banks to absorb greater losses during times of market stress, therefore increasing their resiliency. During the COVID-19 pandemic, a post-GFC test to bank capital, banks continued to pay their preferred securities.[4] Regulators discouraged paying equity dividends but allowed preferred securities payments. Many viewed the banking sector as a part of the solution this time around, as opposed to the problem, underscoring the increased reliability of the banking industry.

Bank common equity tier 1 ratios (capital)



U.S.: Common equity tier one for U.S. GSIBs. SNL.

Europe: J.P. Morgan Asset Management, company data. 2007 is from the ECB sample of 15 euro area large and complex banking groups; the rest is J.P. Morgan Asset Management coverage universe.

[4] Note: These banks are those covered by J.P. Morgan Asset Management GFICC research analysts.

Provides diversification benefits and can complement your extended credit portfolio

Preferred securities have lower correlation to many other asset classes, providing strong diversification benefits. An investor with a well-diversified portfolio can benefit from adding an allocation to preferreds, using it as a component of their fixed income portfolio to drive low-correlated income and return.

Specifically, preferred securities are a good complement to extended credit portfolios, such as high yield. Historical risk-adjusted returns in preferred securities look comparable when viewed next to high yield, while having a higher average credit rating. In addition, the preferred securities market is heavily weighted toward financials, while the U.S. high yield market has a much smaller exposure to the sector, particularly in banks and insurance. Finally, if investing as an individual or eligible corporation, the income may be tax advantaged, potentially enhancing the after-tax returns.

Cross asset correlations

	Preferred blended*	US HY	US Agg	Munis	S&P 500
Preferred blended*	1.00	0.74	0.16	0.36	0.50
US HY	0.74	1.00	0.00	0.32	0.56
US Agg	0.16	0.00	1.00	0.42	-0.22
Munis	0.36	0.32	0.42	1.00	0.12
S&P 500	0.50	0.56	-0.22	0.12	1.00

Source: Bloomberg, 7-year correlation as of December 2021. *Preferreds comprised of 75% ICE BofA All Capital Securities Index and 25% Bloomberg Developed Market Contingent Capital Index (from December 2016 to present) and 25% Bloomberg European Banks CoCo Index (from December 2014 to December 2016).

Total returns

	Total return		Volatility	
	High yield	Preferred	High yield	Preferred
One year	5.35%	3.66%	2.2%	2.1%
Three years	8.53%	9.85%	6.8%	9.5%
Five years	6.07%	7.18%	5.6%	7.5%
Seven years	6.01%	6.40%	5.3%	6.7%
Average rating	**BB–/B+**	**BBB–**	**BB–/B+**	**BBB–**

Source: Bloomberg, as of December 2021. *Preferreds comprised of 75% ICE BofA All Capital Securities Index and 25% Bloomberg Developed Market Contingent Capital Index (from December 2016 to present) and 25% Bloomberg European Banks CoCo Index (from December 2014 to December 2016).

Sector breakdown

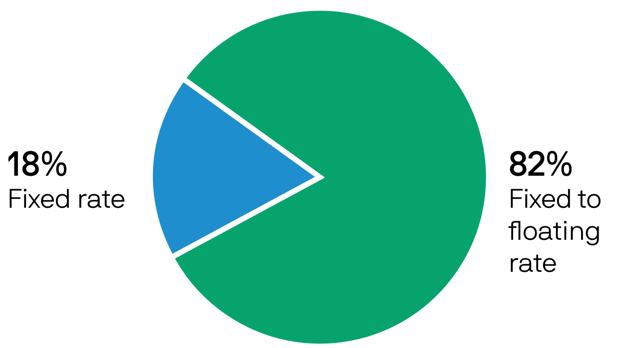
Preferred*		High yield	
Financial	**72%**	**Financial**	**11%**
Banks	46%	Banks	2%
Diversified financial services	3%	Diversified financial services	3%
Insurance	17%	Insurance	1%
REITs & real estate	5%	REITs & real estate	4%
Other financial	1%	Other financial	1%
Non-financial	**28%**	**Non-financial**	**89%**
Basic materials	1%	Basic materials	5%
Communications	4%	Communications	17%
Consumer, cyclical	2%	Consumer, cyclical	21%
Consumer, non-cyclical	2%	Consumer, non-cyclical	17%
Diversified	0%	Diversified	0%
Energy	6%	Energy	13%
Government	0%	Government	0%
Industrial	3%	Industrial	9%
Technology	0%	Technology	4%
Utilities	9%	Utilities	3%

Source: Bloomberg, as of January 2022. *Preferreds comprised of 75% ICE BofA All Capital Securities Index and 25% Bloomberg Developed Market Contingent Capital Index.

Can provide relatively attractive total returns in a rising rate environment

While preferred securities are typically long-dated or perpetual instruments, the fixed to floating rate structure in the market allows for less interest duration than typical long-duration fixed income assets. The substantial yield offered by going down in capital structure can help offset potential losses from rising interest rates, assuming an environment with a positive credit backdrop.

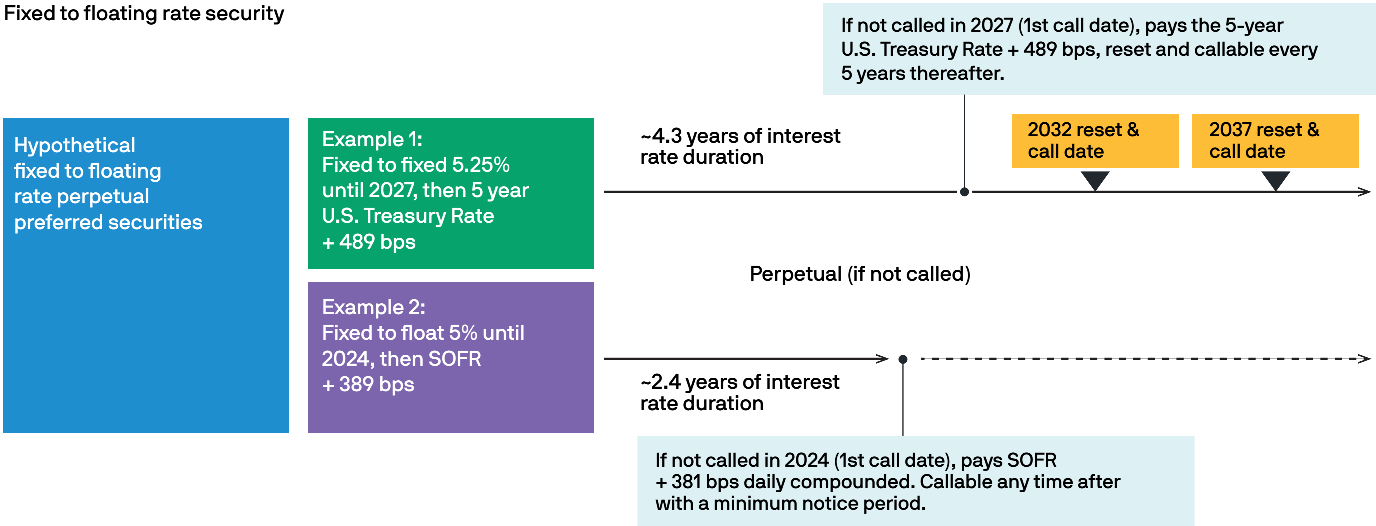
Coupon type of the preferred market



Source: Bloomberg, as of January 2022.

Fixed to Floating Rate includes floating rate securities and securities that the market may refer to as fixed to fixed rate. The market typically refers to securities as fixed to fixed rate if the reset rate following the first fixed rate period has a tenor of greater than one year. An example of this is a security that pays a fixed rate for five years then, if not called, resets off the five-year Treasury rate to determine the coupon for the next five years.

Fixed to floating rate security



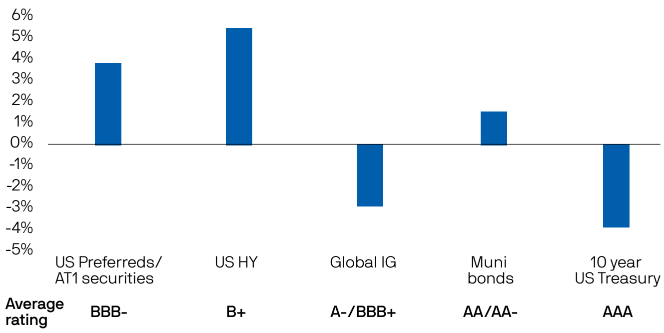
Note: SOFR is Secured Overnight Financing Rate.

The example is shown for illustrative purposes only and is not intended as an offer or solicitation with respect to the purchase or sale of any security.

In recent rising rate environments, preferred securities have provided relatively attractive returns. Higher interest rates also can meaningfully improve bank earnings, which can be a positive for credit and many preferred securities. For example, two periods of rising rates are shown below. In 2021, when the Federal Reserve did not hike, many investors expected a hiking cycle to soon occur, causing a rise in Treasury rates.

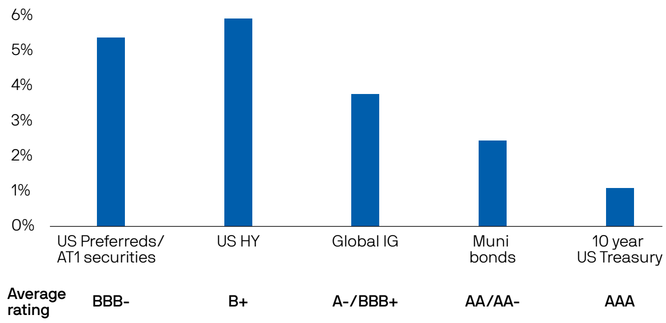
2015 was a true hiking cycle, and the asset classes all shown below had an average positive return on an annual basis. The preferreds asset class provided returns on the higher end of the spectrum in both the time periods. Notably, these returns do not take into account any potential tax advantage that may be received from owning preferreds.

2021 total returns



Source: Bloomberg. US Preferreds/AT1 securities: ICE BofA US All Capital Securities Index; US HY: ICE BofA US High Yield Constrained Index; Global IG: Bloomberg Global Aggregate – Corporate Index; Muni Bonds: Bloomberg Municipal Bond Index; 10 year US Treasury: 10 Year US Treasury.

September 2015 to March 2019 total returns (annualized)



Source: Bloomberg. US Preferreds/AT1 securities: ICE BofA US All Capital Securities Index; US HY: ICE BofA US High Yield Constrained Index; Global IG: Bloomberg Global Aggregate – Corporate Index; Muni Bonds: Bloomberg Municipal Bond Index; 10 year US Treasury: 10 Year US Treasury.

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Why active management?

Credit selection

Preferred securities provide higher yields than traditional fixed income due to the additional risk an investor takes by moving to a lower part of a company's capital structure. Payments on many preferred securities may be discretionary and non-cumulative, so ensuring that the issuer has strong credit fundamentals and earnings power is important in order to avoid non-payment risk, which can lead to a significant price loss. Selecting a manager with breadth and depth in credit research should be a priority for investors.

The research platform at J.P. Morgan Asset Management's Global Fixed Income, Currency, & Commodities Group has the expertise needed to provide valuable insights in this area. Our portfolio managers can leverage 21 dedicated investment-grade research analysts with an average of over 18 years of experience to build a portfolio well positioned to capture idiosyncratic alpha opportunities.

Market technicals, such as indiscriminate buying by ETFs, can push retail preferreds into negative yield territory. Active managers can take advantage of these opportunities.

Date	6/23/21
Issuer	US Bancorp
Ticker	USB
Coupon	5.50%
Maturity	Perpetual
Ratings	Baa1/BBB+
Yield to call	-0.22%
Next call date	10/15/23
Format	Retail ($25 par)

Source: Bloomberg

Note: Price/yield based on Bloomberg VWAP for date listed.

Variation in security structures

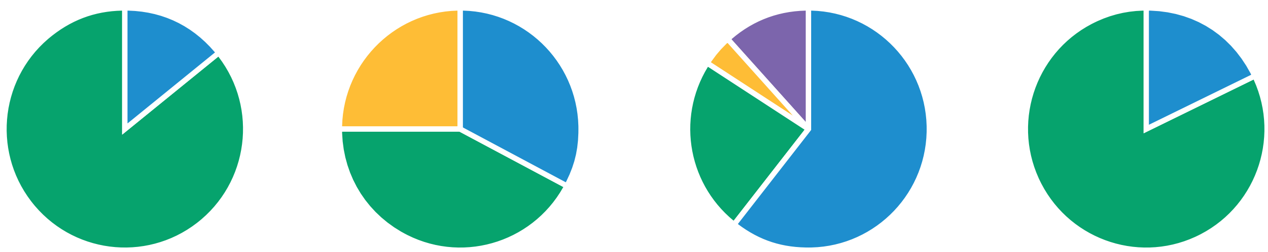
The preferred securities market has a varying degree of structures or individual security characteristics that are impacted in different ways by different market environments. In terms of coupon types, there is a fixed to floating rate market and a fixed for life market that can have different interest rate duration characteristics. Within the fixed to floating rate market, the benchmark rate that the security floats off can vary (e.g. Libor, SOFR, 5-year constant maturity Treasury, 5-year swaps) as well as the spread received on top of that benchmark rate.

The call optionality of the securities varies as well. In the U.S. there is a retail market where the securities are issued in $25 par denominations and are exchange traded. These can have a different liquidity profile and investor base when compared to the $1000 par institutional market. There can be arbitrage opportunities between these markets at times that an active manager can take advantage of.

Within the global banking sectors, implementation of global banking standards have been different, which is why U.S. banks issue preferred stock and European banks issue CoCos in order to fulfill their allowance of additional tier 1 capital. As discussed, European AT1 CoCos have explicitly stated triggers for conversions or write-downs and those can be different across securities, providing different risk profiles. A manager who has deep expertise in preferred securities is key to navigating this type of market.

Preferred securities market breakdown

Market type | **Regional breakdown** | **Currency breakdown** | **Coupon type of preferred market**



Market type		Regional breakdown		Currency breakdown		Coupon type of preferred market	
14.21%	Retail	**33.05%**	U.S.	**60.75%**	USD	**18.00%**	Fixed rate
85.79%	Institutional	**42.00%**	Europe	**23.53%**	EUR	**82.00%**	Fixed to floating rate
		24.95%	Other	**4.21%**	GBP		
				11.52%	Other		

Source: Bloomberg, as of January 2022.

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