



## Preferred Securities Are The ‘Sweet Spot’ In This Market

Friday, October 8, 2021

Chuck Jaffe, in this episode of The NAVigator podcast interviewed Eric Chadwick, president and portfolio manager at Flaherty & Crumrine. Read the Q & A below as Eric says that at a time when investors are searching for yield and are being tempted to take on more risk to get it, preferred securities are shining, providing a relatively attractive return without adding danger to the portfolio. Chadwick notes that preferreds now are offering the best credit quality he has seen



Eric Chadwick

in years, and at shorter durations, making them less risky than high-yield and emerging-markets debt, and more in line with investment-grade bonds. That said, those conditions have generated significant demand for preferreds, generating premiums that closed-end fund investors must consider.

The podcast can be found on AICA’s website by clicking here: <https://aicalliance.org/alliance-content/pod-cast/>

**CHUCK JAFFE:** Eric Chadwick, president and portfolio manager at Flaherty & Crumrine, specialists in preferred securities is here, and we’re discussing the benefits of owning preferreds via closed-end funds, this is The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator’s brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund

industry. From users and investors to fund sponsors and creators, if you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. And today it is pointing us in the direction of Eric Chadwick, president and portfolio manager at Flaherty & Crumrine, where they run nearly \$5 billion in assets under management, all of it in preferred securities. You can learn more about the firm and its funds at PreferredIncome.com. Eric Chadwick, thanks for joining me on The NAVigator.

**ERIC CHADWICK:** Chuck, it's a pleasure to be here. Thanks for having me.

**CHUCK JAFFE:** These days with yields being what they are and everybody being yield starved, preferreds are a way to get more yield, but they're not the way that most people go after more yield. So explain a little bit about why a fixed-income portfolio's not really complete in your minds' eye with a slug of preferred securities.

**ERIC CHADWICK:** Yeah, preferreds really are kind of a niche asset class, and they always have been although they are kind of becoming a little more mainstream these days as the market grows and the investor base grows. But we think of preferred securities really kind of being the sweet spot in this type of environment, as investors are really searching for yield and the temptation of course is to take more risk in order to achieve that goal of higher yield. We think you can accomplish similar goals in preferred securities without having to take those additional risks. So it will provide you an attractive level of income, the credit quality of the underlying issuers is really fantastic and in many cases about as good as it's been in a long time, and you can be invested in a product that's got very much intermediate type durations. So you're not having to take a lot of credit risk or interest rate risk on top of what you might take on more like an investment grade bond portfolio. So we think of preferreds as being an allocation within a fixed-income portfolio that oftentimes take the place of things like high yield or perhaps EM debt, things that are far riskier on the credit side, and allows you to really achieve those goals which are again so much more difficult in an environment like this with low interest rates.

**CHUCK JAFFE:** Is the benefit, the ability to get more yield without necessarily adding a lot of risk, is that about structure, is that about the underlying companies that are issuing preferreds? Is there something in preferreds specifically that makes that so that you're getting the yield but you're not going out and buying junk?

**ERIC CHADWICK:** Yeah, that's a great question. The two keys to those points is the issuers of preferreds tend to be in the financials industry, so banks and insurance companies are by the far the dominant issuers, but they are also almost entirely investment-grade issuers at the senior unsecured level. So preferreds are down the capital structure or a subordinated position, but they are issued by investment-grade issuers. So when you think about taking more credit risk in a high-yield portfolio, in preferreds you're buying basically IG issuers, which is really important, and that's really the distinction between taking more risk at the high-yield level. On the interest rate side however, and this is really where you achieve the duration benefits, most preferreds these days have some sort of fixed reset coupon structure. So it's a fixed-rate security for a while and becomes some sort of floater or resettable security on the back end. The benefit of that structure is that it greatly reduces the amount of duration risk or interest rate risk that you have to take. So in the event we really do see interest rates kind of normalize and start to move higher as the Fed raises rates eventually and the economy continues to do better, preferreds really should perform quite well in that environment relative to perhaps other longer duration fixed income that you may be owning again in search of a higher yield.

**CHUCK JAFFE:** Anybody's who's searching for higher yield looking for getting better returns in closed-end funds is typically looking for some tax benefit as well, or potentially looking at tax benefits. In the case of preferreds are there tax benefits?

**ERIC CHADWICK:** Yes, most of the time there are. So preferred securities are generally considered equity securities for taxes, which means that the distributions on those securities are QDI eligible. And QDI is qualified dividend income that's been incorporated into the tax code, meaning that you pay basically capital gains tax rates on the dividends rather than ordinary income rates. So particularly for folks in higher income tax brackets, that can be a very meaningful reduction in the tax rates on the distributions that you're receiving. Within a closed-end fund or even an open-end fund product, for the most part those are passthrough entities, so the amount of QDI income that the fund earns on the portfolio is passed through to investors. And in most cases if you're a retail type investor you'll receive that information on a Form 1099 like you would for any other investment account that you have that's reporting that type of income. So it really is fairly straightforward and it'll just show up on your 1099 reporting. Many investors don't think about after-tax yields these days, but it

really is a very large benefit to not be taxed at the highest income bracket and rather being taxed at the capital gains rate, which can be more like 20% rather than 37%. So it's a nice benefit and closed-end funds and open-end fund products allow the passthrough of that tax treatment to investors.

**CHUCK JAFFE:** I always talk about how I was really taught to how invest by my mother, and my earliest memories of preferred securities was my mother telling me that, "Hey, preferred, it doesn't mean we as buyers prefer them," and then she then explained what they were. And back in the day she was talking about this a long-term commitment you're making to a company and a company's making to you. But given interest rate situations and what you're saying about with risk, how much today is preferreds now shorter or intermediate term rather than the long-term stuff?

**ERIC CHADWICK:** Again, that comes down to really the way they've structured them. At the end of the day these do tend to be perpetual securities, which means they have no stated maturity date. But that's why you rely on both credit quality and the structure of the security to give you comfort that it's probably not as long term as you might think it would be just on face value. And again going back over a decade ago, most of the market was fixed-rate coupons. Everything was just a fixed-rate structure, which meant they were very long duration. So it required a lot of interest rate sensitivity to be able to invest in preferreds, which is just not something most investors care for.

**CHUCK JAFFE:** Well, my mom loved the long-term coupon, so I'm going to turn this around and get to where we said we were going to go at the very beginning. At Flaherty & Crumrine, you guys run the Preferred and Income Fund, the Preferred and Income Opportunity Fund, the Preferred and Income Securities Fund, and more. It is preferreds in a closed-end fund wrapper. So are there benefits to owning preferreds via closed-end funds? And again preferreds are a small market, how big a role are closed-end funds playing in that market?

**ERIC CHADWICK:** Yeah, we think closed-end fund structure is probably the best structure to be investing in preferred securities because inside the portfolio really does match the goals of buy and hold long-term ownership, because we really do want to be long-term investors. Not that we can't trade the securities in a shortened timeframe, but we are income investors, we're looking for the tax advantage, and at the end of the day buyers of closed-end funds are looking for income, sustainable income. And so the fact that you don't have lots of

flows in and out like you would in an open-end fund allows you to take those positions and not be impacted by short-term market moves or flows into or out of the fund. The other real benefit of closed-end funds of course is that you can add leverage to them, which increases the amount of income that you can distribute to shareholders. Leverage is kind of a double-edged sword, it an increase volatility as well. But our funds have been around a very long time, they've always had about a third of total assets in leverage, and you can see the long history, a successful history of producing sustainable income for investors. So the long-term nature of a closed-end fund and the lack of flows in and out fits very well with a niche asset class where you're looking to be a long-term investor and you can also take advantage of some of the inefficiencies of the market since it is a smaller niche market there are trading opportunities as well. So that just all ties together very nicely with the closed-end fund structure.

**CHUCK JAFFE:** I know that portfolio managers hate talking about premiums and discounts, so I don't really want you to talk about the specifics. But right now your funds are pretty much all at a premium, and my assumption is that's a reflection of the demand picture for yield that we talked about initially. So I'm curious, what happens generally with premiums and discounts if we wind up in a rising rate, rising inflation market?

**ERIC CHADWICK:** Yeah, that's a great question. Our funds have been trading extremely well, and if you look back at the history you can actually go back many, many years and see that our funds consistently trade at relatively small, modest premiums. And I think you're absolutely right, closed-end fund investors or investors in general are much more focused on the yield that they're able to achieve today and they're willing to pay a slight premium for that. Because again it's supply and demand, there's not a lot of options, there's not a lot of new closed-end funds coming to market offering this type of product or this type of yield. And so if you're an investor that needs to invest in the market and earn a return, you may be willing to pay a premium versus the net asset value. Premiums and discounts of course do change a lot over time and we think you need to stretch that time horizon out a little bit, not to days or weeks but really months and years. And ultimately the price will track the net asset value, but you can see some dislocations in there along the way. But at the end of the day as an advisor what we have control over is the net asset value, and the net asset value has performed very well in many different types of higher or rising interest rate

environments. And ultimately the price is simply driven by the flow side, the supply and demand of people moving their positions in or out, but it definitely does track over longer periods of time. And our advice usually is to the extent possible, take advantage of some of those discount opportunities and be a long-term investor. That game generally works out quite well for closed-end fund investors that are able and willing to take the longer-term view on the market.

**CHUCK JAFFE:** Eric, this has been really interesting. Thanks so much for joining me on The NAVigator to talk about it.

**ERIC CHADWICK:** Thank you, Chuck. It was great to be here, really appreciate it.

**CHUCK JAFFE:** The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. That's me, and you can check out my show on your favorite podcast app or by going to MoneyLifeShow.com. To learn more about interval funds, closed-end funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest, Eric Chadwick, president and portfolio manager at Flaherty & Crumrine, whose funds you can learn all about by going to the website, PreferredIncome.com. The NAVigator podcast is new every Friday, ensure that you don't miss anything by subscribing via your favorite podcast app. And if you like us, please leave a review. And until next week, happy investing everybody.

*Recorded on October 7th, 2021*

To request a particular topic for The NAVigator podcast please send an email to: [TheNAVigator@AICAlliance.org](mailto:TheNAVigator@AICAlliance.org)

Click the link below to go to the home page of Active Investment Company Alliance to learn more: <https://AICAlliance.org/>

**Disclosure:** *Listed closed-end funds and business development companies trade on exchanges at prices that may be above or below their NAVs. There is no guarantee that an investor can sell shares at a price greater than or equal to the purchase price, or that a CEF's discount will narrow or be eliminated. Nonlisted closed-end funds and business development companies do not offer investors daily liquidity: often on a small percentage of share on a quarterly or semi-annual basis. CEFs often use leverage, which can increase a fund's risk or volatility. The actual amount of distributions may vary with fund performance and other conditions. Past performance is no guarantee for future results.*