Understanding quality, ratings and long-term compensation of preferred securities

Preferreds provide attractive income and total returns from high-quality securities; despite added risks, default rates can be lower than credit ratings suggest.

by **William Scapell, CFA, Elaine Zaharis-Nikas, CFA** and **Jerry Dorost, CFA**

KEY TAKEAWAYS

Tailwinds suggest potential for continued strong performance

The outlook for preferreds remains favorable given the end of the rate-hiking cycle, issuers' strong fundamentals, the securities' attractive valuations and discounts to par value.

Expected default rates are reflected in credit ratings

Most preferreds have ratings in the BBB–/BB+ range, categories historically associated with very modest default rates. And cases exist where investors suffered no material losses despite defaults.

Total returns provide a full picture of risk compensation

Investors are paid more for investing in preferreds, compared with senior debt. And they have been well compensated for the additional risk, based on historical returns.

Tailwinds suggest potential for continued strong performance

Preferred securities had a strong year in 2023, returning 8.2% despite the well-publicized banking sector turmoil in the first quarter. Looking ahead, we see good reasons to remain optimistic about their potential, including:

End of rate-hiking cycle: Central banks around the globe are likely at terminal rates as inflation softens, with rate cuts expected in 2024. Since 1990, preferreds have returned an average of 14.2% in the 12-month periods following Fed rate hikes (and 8.2% in the 24-month periods following hikes).

Strong issuer fundamentals: Bank capital levels remain solid and asset quality resilient. Moreover, last year's volatility in the banking sector is expected to lead to still stronger regulation and safer institutions, providing additional support for the primary issuers of preferreds.

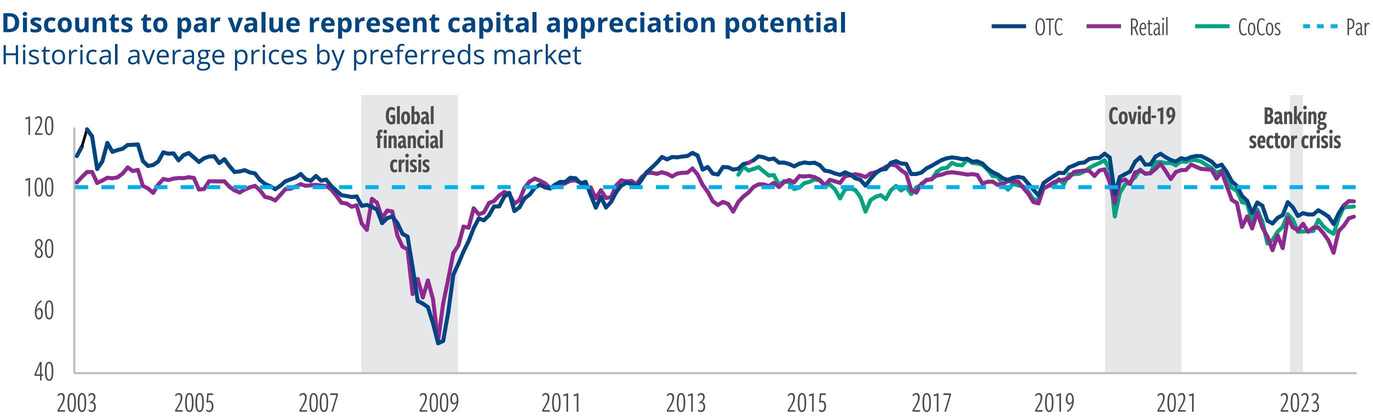
Discounts to par value: Preferreds continue to trade at discounts to par, but they typically trade near or above par (Exhibit 1). We believe current prices present a potential capital appreciation opportunity (in addition to preferreds' high, tax-advantaged income rates).

Attractive valuations: Current preferred yield levels offer equity-like return potential for long-term investors. Preferreds' credit spreads are closer to their historical norms, in contrast to those of investment-grade and high-yield bonds, which are well inside of their long-term averages (Exhibit 3, page 5).

Against this backdrop, we recognize that gaps exist in investors' understanding of preferreds. We address these issues in the following pages.

EXHIBIT 1

Discounts to par value represent capital appreciation potential
Historical average prices by preferreds market



Since March 2003	OTC	Retail	CoCos
Price	95.95	90.97	94.26
Discount to par	**(4.1%)**	**(9.0%)**	**(5.7%)**
Average premium/discount to par[(a)]	2.0%	(1.4%)	0.7%

At February 29, 2024. Source: ICE BofA, Cohen & Steers.
Past performance is no guarantee of future results. (a) Average since March 2003; average for contingent capital securities since January 2014 inception. The information presented above does not reflect the performance of any fund or other account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above. There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend will begin. See endnotes for index associations, definitions and additional disclosures.

A unique role in capital markets

Preferred securities play a unique role in capital markets. A form of equity for issuers, they help companies reach capitalization/leverage goals for regulatory and ratings agency purposes. Yet, for investors, preferreds act like bonds, offering a fixed or floating rate of income. Issued at par value like debt instruments, preferred prices fluctuate with changes in interest rates or credit fundamentals, and thus can trade at premiums or discounts to par.

Preferreds come in two varieties: perpetual and hybrid, as shown in the simplified corporate capital structure below (Exhibit 2). Perpetual preferreds are special forms of high-dividend-paying equities that have existed for more than a century. Hybrid preferreds are a more modern invention created in the 1990s. These instruments are forms of long-term, junior subordinated deferrable debt. As forms of debt, these securities pay interest income.

Preferred securities are so named because of their "preference" (superior position) over common shares in the capital structure, which gives them priority claim to company assets in the event of bankruptcy. However, preferred holders are subordinated to debt investors.

EXHIBIT 2

Preferreds are subordinated to conventional debt instruments

Credit class rankings

Credit class ranking	Ratings examples (S&P) J.P. Morgan	Ratings examples (S&P) Bank of America
Senior unsecured debt	A–	A–
Subordinated debt (Tier 2)	BBB+	BBB+
Hybrid debt preferreds (Tier 2)	BBB–	BBB–
Perpetual preferreds (Tier 1)	BBB–	BBB–
Common stock	N/A	N/A

At February 29, 2024. Source: Bloomberg.
The mention of specific securities is not a recommendation or solicitation to buy, sell or hold any particular security and should not be relied upon as investment advice.

Why do companies issue preferreds?

Companies typically issue preferreds to manage their equity or leverage positions, often for regulatory and ratings agency purposes. While preferred yields generally are much higher than those of bonds from the same issuer, they represent a more cost-effective form of equity than common stock. By contrast, issuing bonds would increase, not decrease, leverage. Moreover, hybrid preferreds are classified as debt for tax purposes, allowing issuers to write off associated interest expenses, further reducing costs.

Most large banks and insurance companies issue preferreds to meet regulatory capital requirements (meant to protect depositors and ensure the stability of the financial system). However, regulatory guidelines often impose limits on their usage in the equity mix. Companies commonly maximize their use of preferreds within the capital mix, given the cost advantage over common equity. Also, since ratings agencies treat preferreds as equity, companies, including many utilities, often employ them to attain or maintain desired credit ratings. Notably, credit ratings typically are closely connected to general funding costs, so preferred issuance can assist in lowering companies' overall cost of funds.

Different risks and rewards, compared with bonds

As income securities, preferreds share many of the same risks as bonds, including interest rate risk, call risk and reinvestment risk. Preferreds also have credit risks, but certain aspects of credit risk are unique to preferreds.

Payment risks

Preferreds typically have greater payment risks than bonds. Perpetual preferreds pay dividends, which are discretionary by nature (similar to common stock dividends). Hybrid preferreds, although forms of debt, have deferrable payments. Unlike with conventional bonds, payments can be legally deferred for extended periods of time, typically up to five years.

Ordinarily, common dividends of companies must be halted before preferred payments are suspended. Perpetual preferred payments can either be "cumulative," meaning missed payments would be due in the future (effectively, only deferred), or "non-cumulative," allowing for the omission of payments. Hybrid preferred payments typically accumulate if deferred.

While payments can be suspended, in practice, stoppage typically only occurs during significant economic stress for companies. Non-payment of a preferred security is often seen as a distress signal, potentially further impacting access to funding and capital.

It is crucial to distinguish between the suspension of preferred and bond payments. Bond payment cessation can quickly lead to bankruptcy, as companies lack the right to suspend payments. This contrasts with preferred securities payments, where suspension can give companies time to recover while conserving cash. Interestingly, instances of preferred payment suspensions have occurred that ultimately resulted in no material harm to preferred holders, as the missed payments were later made up in arrears.

Subordination

As preferreds occupy a lower position in the capital structure, preferred holder claims are subordinate to those of others above them in the capital structure, including most bondholder claims.

As previously mentioned, companies that have suspended preferred payments have not always ended up in bankruptcy. However, in the event of bankruptcy, due to subordination, recovery rates can be quite low. In a 2009 report, ratings agency Moody's cited a recovery rate of just 15.9% for preferred holders in company bankruptcies that also involved senior debt defaults.(1) This compares with a 37% historical average recovery rate for senior unsecured bonds, according to another Moody's study.(2) Bankruptcies are intricate, and outcomes can vary widely, but preferred holders typically experience a more substantial value impairment, compared with bondholders.

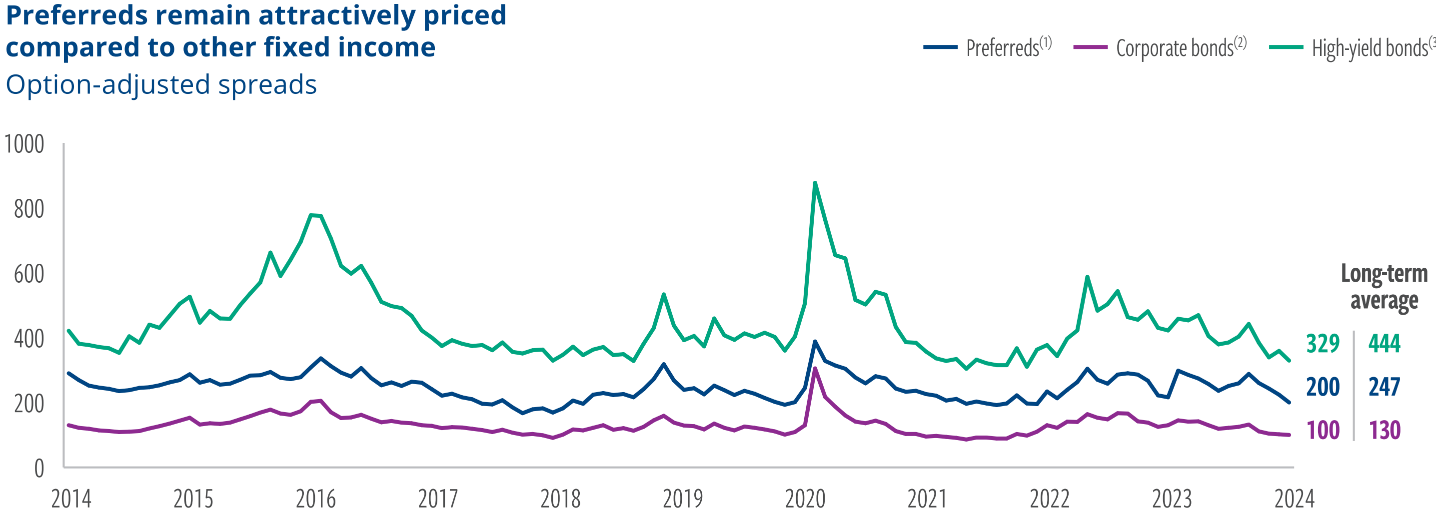
Higher income (the subordination premium)

Preferred holders are typically compensated for the risks they bear with much higher income rates than those available from more senior instruments, such as senior debt. The yield differential, or credit spread, between senior and preferred instruments of the same issuer is often referred to as the "subordination premium." This spread can vary considerably based on the quality of the issuer, the specific preferred security structure, and other characteristics. Exhibit 3 shows historical index spreads of investment-grade corporate bonds, high-yield bonds and investment-grade preferreds. Preferreds look more attractive currently, trading nearer to their historical spread than investment-grade and high-yield bond credit spreads, which have generally tightened to near historical lows.

EXHIBIT 3

Preferreds remain attractively priced compared to other fixed income

Option-adjusted spreads



At February 29, 2024. Source: ICE BofA.

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(1) Moody's Analytics: Preferred Stock Default Recoveries Approach Those of Senior Unsecured Bonds, November 2009.
(2) Moody's Ultimate Recovery Database, Special Comment, April 2007.

Tax advantages

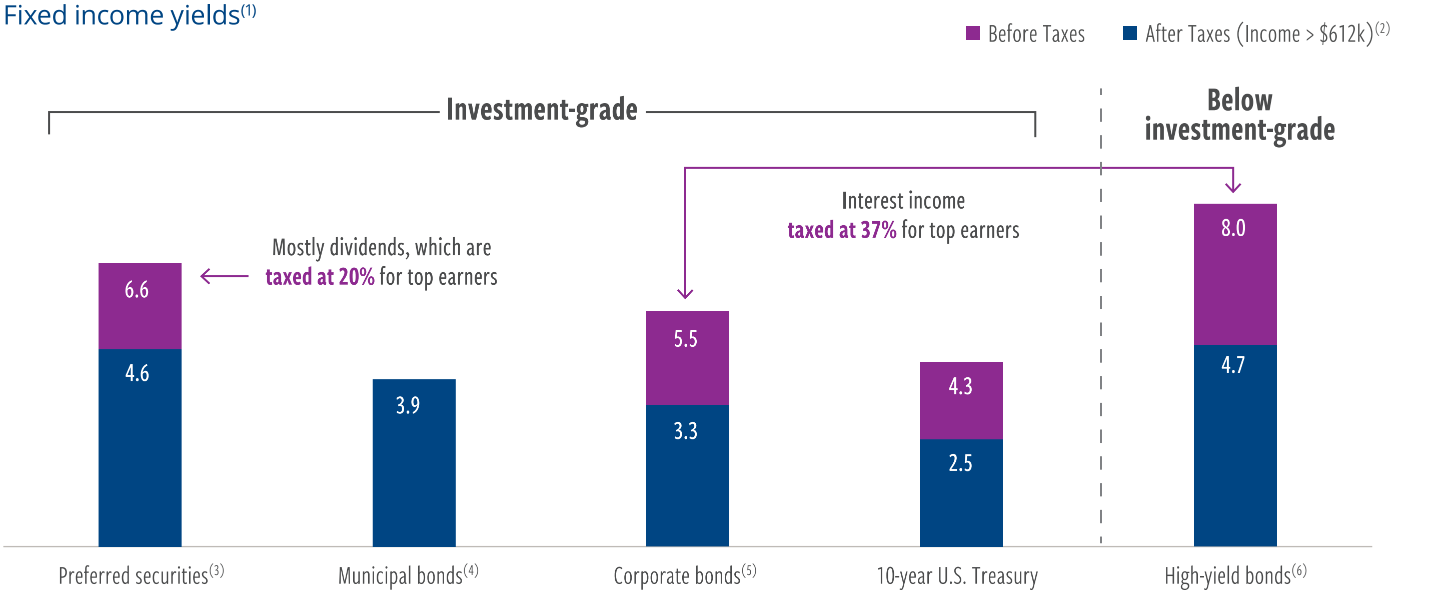
U.S. individual investors can benefit from qualified dividend income (QDI) tax rates, which stand at 20% (plus the 3.8% Medicare surcharge) for investors in the top tax bracket and are applicable to most preferred dividends. As well, U.S. institutional investors structured as C-corporations can take advantage of the "dividend received deduction" (DRD) tax treatment, reducing the tax rate on income from qualifying preferreds to just 10.5%. Below, we illustrate pre- and post-tax income rates, assuming QDI taxes for investment-grade preferreds, compared with a few other fixed income assets (Exhibit 4).

Hybrid preferreds (which pay interest, not dividends) do not offer tax advantages to U.S. investors. However, the rates they pay can still be attractive. Additionally, non-U.S. investors who buy these instruments can sidestep the tax complications associated with U.S. dividend income.

EXHIBIT 4

Preferreds can offer tax-advantaged income for U.S. investors

Fixed income yields[1]



At February 29, 2023. Source: Cohen & Steers, Bloomberg, ICE BofA.

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Expected default rates are reflected in credit ratings

Default risk is perhaps the greatest investor misperception about preferreds, but to best understand this, we need to first address preferreds' equity treatment and how credit ratings agencies arrive at their credit grades.

Different types of preferreds offer companies different types of equity treatment. Generally, the more "equity-like" the security, the more "equity credit" it affords. Issuers choose structures aligned with their goals.

Since the Basel III banking regulatory reforms enacted after the global financial crisis (GFC), banks require equity-like preferreds, as only non-cumulative perpetual preferreds count as bank equity (or "Tier 1 capital"). In jurisdictions outside the U.S., contingent capital securities (CoCos) are widely issued by non-U.S. banks to meet capital requirements; these possess the added feature that they will write down or convert to common stock if the issuer's capital level falls below a specified threshold or if there is a non-viability event.

Although banks no longer use them, less equity-like hybrid issues are still in broad use by other industries. Hybrids are issued by insurance companies, utilities, telecoms and other businesses to meet their equity needs. Since they are less equity-like, these structures typically receive only 25–75% equity credit from ratings agencies. Consequently, only a portion of the issued amount is usually considered equity, depending on the specific structure.

Credit ratings agency treatment

Preferred securities are rated on the same scale as debt instruments. So, how do ratings agencies account for the complexities of these instruments in their ratings?

Ratings agencies first establish baseline views of companies' credit strengths based on fundamental factors. They then adjust or "notch" the ratings of preferreds (and other instruments) relative to the baseline, considering the particular attributes of each security. Depending on the issuer and structure, preferred stocks may be rated up to six notches lower than the ratings of the senior debt of the same issuer. Notching typically increases with lower senior debt ratings, as this can influence the perceived likelihood of non-payment.

Notably, ratings agencies view a preferred payment halt as a default. Since companies can suspend preferred payments without stopping bond payments, the agencies perceive a higher default probability for a preferred than for a bond. Consequently, agencies usually apply additional notching to reflect this elevated default risk. They may also add credit notching to reflect the potentially lower preferred recovery rates in bankruptcy scenarios. As a result, preferreds may receive lower ratings due to both a higher default probability and greater severity in the event of a default involving bankruptcy.

Same rating, same expected default probability, whether preferred or bond

Ratings agencies meticulously adjust for the risks of preferred securities to place them on the same ratings scales as senior bonds and other debt obligations. All securities in the same ratings category—regardless of whether preferred, senior debt or another type of debt—are expected to have a similar default rate on average.

A 2012 Moody's study indicated the robustness of its methodologies regarding preferred ratings. In the report, Moody's concluded that the impairment rates (default or omission of payments) of preferred securities they rated were "...similar to average cumulative default rates of global corporates overall and by like rating category."[(3)]

Exhibit 5 below reinforces the idea that default rates are correlated with ratings, with historical defaults significantly increasing for lower-rated instruments. The results are taken from a recent study by S&P Global on the average historical default rate for global financial services companies (the primary issuers of preferreds) by ratings category. Most preferred securities feature ratings in the BBB–/BB+ range, categories historically associated with very modest default rates—under 1%. While past results might not perfectly predict future outcomes, a long historical precedent exists.

This same S&P study also indicated very low global default rates for banks and insurance companies—around 50 basis points—over the 40-year time frame covered, which includes the GFC.

Defaults among non-bank financial institutions have also been minimal. Notably, this data does not account for the ratings of the organizations. However, it is important to recognize that most large financial issuers have high ratings and strong balance sheets. This is attributable to both regulatory and market requirements, as these issuers prioritize a low cost of funding, a benefit available only to high-quality issuers. Further discussion on the influence of bank regulation is provided below.

EXHIBIT 5

Default rates generally correspond with credit ratings

Weighted average default rates in the financial services industry (%)
1981–2021

AAA	AA+	AA	AA–	A	A–	BBB+	BBB	BBB–	BB+	BB	BB–	B+	B	B–
0.00	0.00	0.03	0.04	0.10	0.10	0.09	0.24	0.38	0.68	0.43	0.63	1.82	2.29	3.75

Global annual default rates by sector (%)

Banks	Non-bank financials	Insurance	Non-financials
0.49	1.03	0.48	1.85

At December 31, 2021. Source: S&P Global: "Default, Transition, and Recovery: 2021 Annual Global Financial Services Default and Rating Transition Study.
Past performance is no guarantee of future results. There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend will begin. See endnotes for additional disclosures.

(3) Recovery Rates on Defaulted Corporate Bonds and Preferred Stocks, 1982–2003, Moody's Special Comment, December 2003.

Default experience: Are you paid for the additional risks?

With preferred securities, it is not just defaults that matter—it's also what losses look like upon default. Due to their complexity and associated risks, preferred issuance is typically limited to high-quality companies with solid, predictable earnings and capital. The primary issuers in the market—banks, insurance companies and utilities—are highly regulated institutions, giving investors an extra layer of assurance due to rigorous regulatory oversight. As we have seen, defaults in these sectors have been low, historically. Yet it is important to understand that even in situations involving non-payment of preferreds, there have been cases where, ultimately, no material harm was done to investors.

The California utilities crisis in 2000–2001 provides interesting examples of preferred payment stoppages that ultimately were not harmful to investors. During that period, PG&E and Southern California Edison faced significant stress due to power price manipulation by Enron. The utilities stopped payments on their cumulative hybrid preferred securities in response to the distress. Fortunately, recovery occurred within a few months, aided by the California legislature. The utilities promptly paid all deferred preferred payments, including interest compounded at the coupon rates. In the end, preferred holders suffered no material losses despite the so-called defaults.

The California utilities example highlights an optimistic scenario. However, when companies recover, preferred holders tend to see some (or even significant) recovery in value. Accordingly, the worst outcomes for preferred holders normally are associated with corporate bankruptcies, which affect everyone in the capital structure. Lehman Brothers' bankruptcy during the GFC is a prime example. In that case, all investors across the capital structure—bondholders and preferred holders included—suffered significant harm.

Even in situations involving non-payment of preferreds, there have been cases where, ultimately, no material harm was done to preferred investors.

Total returns provide the full picture of risk compensation

As previously discussed, the outcome of preferred defaults can vary significantly. Therefore, to understand the compensation for the credit risk associated with preferreds, investors must assess not only the rate of defaults but also the actual harm incurred. We believe the best way to capture this is by focusing on total returns.

Exhibit 6 shows that over the past decade, the return experience of investment-grade preferreds has been favorable when compared with investment-grade corporate bonds on both an income and price return basis (with annualized total returns of 4.6% vs. 2.6%).

The substantial income advantage of preferreds was the most significant driver of their outperformance. Additionally, preferreds have exhibited better price performance over this period, partly due to their lower average duration than corporate bonds (owing to their resetting payment structures). The price performance of preferreds also reflects their quality, with little influence from defaults or impairments. To our knowledge, there were no impairments within the investment-grade preferreds index shown.

We also show a high-yield preferred index (with an average rating of BB+, just below investment-grade and better than high-yield bonds), which included the securities of the failed lender Silicon Valley Bank. As indicated, the annualized price returns for this index were inferior to the investment-grade preferreds index. However, the income generated by high-yield preferreds more than offset the drag on price over this time frame. Consequently, total returns for the index were slightly higher than even those of investment-grade preferreds.

EXHIBIT 6

Income from preferreds compensates investors for added risk

10-year annualized total return decomposition (%)

	Investment-grade preferreds (BBB)	Investment-grade bonds (A–)	High-yield bonds (B+)	High-yield preferreds (BB+)
Price	–1.0	–1.3	–2.1	–1.2
Income	5.6	3.9	6.4	6.1
Total return	4.6	2.6	4.3	4.9

At February 29, 2024. Source: S&P Global.
Past performance is no guarantee of future results. There is no guarantee that any historical trend illustrated above will be repeated in the future, and there is no way to predict precisely when such a trend will begin. Totals many not sum due to rounding. See endnotes for additional disclosures.

Despite historically offering much greater income rates than investment-grade preferreds, high-yield bond returns were slightly lower than those of preferreds over the past 10 years (4.3% vs. 4.6 for investment-grade preferreds). As illustrated, high-yield price returns detracted more than the income returns added.

This discrepancy stems from defaults and weak credit rather than duration (given that high-yield bonds have consistently offered the lowest duration among these indexes). The average rating in the high-yield market is just B+, a category typically associated with a high expected default rate. In Exhibit 5, we showed a 1.8% per annum default rate logged by S&P Global for B+ financial issuers. Exhibit 7 shows the meaningful disparity in default rates between all high-yield and investment-grade bonds.

Preferreds' relative returns worsen when financials perform poorly

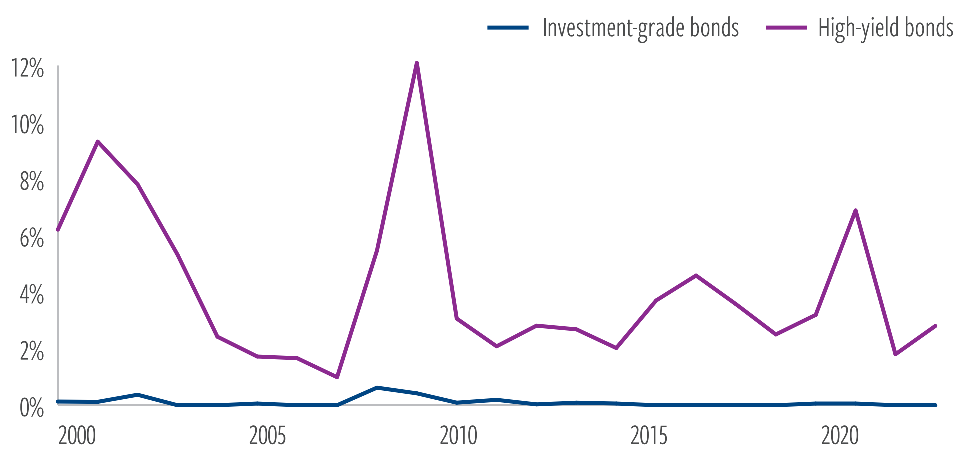
Given that financial issuers account for the majority of the preferreds market, it is unsurprising that preferred securities often face challenges during periods of financial strain. Exhibit 8 (see page 12) displays the 20-year return history, encompassing the GFC period. Investment-grade preferreds still outperformed investment-grade corporate bonds over this period, although they underperformed high yield. (The inception date for the below-investment-grade preferred index is December 31, 2012.)

In light of the bank volatility during 2023, we also present returns for just the past five years to emphasize the recent impact. A relatively new CoCos index is included as well. Returns for investment-grade preferreds still appear favorable; recent price drawdowns have had a greater impact on high-yield preferreds. Notably, the CoCos index generated total returns over the past five years that significantly exceeded those on investment-grade corporate bonds, despite the write-down of Credit Suisse CoCo instruments last year.

EXHIBIT 7

Normal cyclical defaults typically offset high yield's income advantage

Historical U.S. 12-month default rates (%)



At December 31, 2021. Source: Moody's Investors Service, Cohen & Steers.
Past performance is no guarantee of future results. There is no guarantee that any historical trend illustrated above will be repeated in the future or any way to know in advance when such a trend might begin. Investment-grade bonds are represented by securities rated Baa3 and higher by Moody's; high-yield bonds are represented by issues rated Ba1 and lower. See endnotes for additional disclosures.

EXHIBIT 8

Even with the significant distress of the GFC, preferreds have outperformed investment-grade bonds

20- and 5-year annualized total return decomposition (%)

	Investment-grade preferreds (BBB)	Investment-grade corporate bonds (A–)	High-yield bonds (B+)	High-yield preferreds (BB+)	Contingent capital securities (BB+)
20 years					
Price	–1.7	–0.7	–1.0	N/A	N/A
Income	6.4	4.8	7.4	N/A	N/A
Total return	4.7	4.1	6.4	N/A	N/A
5 years					
Price	–0.8	–1.9	–2.1	–2.0	–1.4
Income	5.3	3.8	6.1	5.9	4.7
Total return	4.5	1.9	4.0	3.9	3.3

At February 29, 2024. Source: Bloomberg.
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Bank credit cyclicality tied to bank regulation

The history of bank failures suggests low defaults over long periods for banks large enough to have public ratings. The S&P Global study (spanning 40 years) cited in Exhibit 5 underscores this trend, with an annual default rate of around 50 basis points. It is important to note that this time frame includes both the savings & loan (S&L) crisis of the 1980s and the GFC.

Banks tend to fail in cycles, with common drivers leading to multiple failures. While there are instances of large banks failing due to idiosyncratic reasons, such as the 1995 collapse of Barings Bank (precipitated by a rogue trader), the sector's risk is generally cyclical.

Exhibit 9 (see page 13) shows the cyclicality of U.S. bank failures since 1970. This FDIC data captures all banks, including smaller ones and mutuals, many of which likely did not have public securities outstanding. The 1980s were punctuated by the S&L crisis, when institutions failed in large numbers, attributed to factors including high inflation and aggressive Federal Reserve rate hikes that created large asset/liability mismatches. Moreover, uneven regulations initially capped the rate of interest the S&Ls were allowed to pay on deposits. The second period of bank failures, of course, was the GFC. Note how bank failures averaged just two a year in the period spanning 1994 through 2007. They were similarly low from 2014 through 2023.

While economic fluctuations can impact bank balance sheets, the role of bank regulation is equally significant. As we have written in other white papers, strengthening bank regulation historically has provided a powerful credit tailwind that benefits investors, whereas weakened regulation signals a need for greater caution.

The GFC was preceded by a period of relaxed bank regulation, notably marked by the repeal of the Glass–Steagall Act. This Depression-era law restricted banks' ability to engage in investment banking operations. With its repeal, banks assumed far more risk than they had previously. Following the GFC, bank regulation underwent significant strengthening, and it ushered in a decade with no meaningful bank failures.

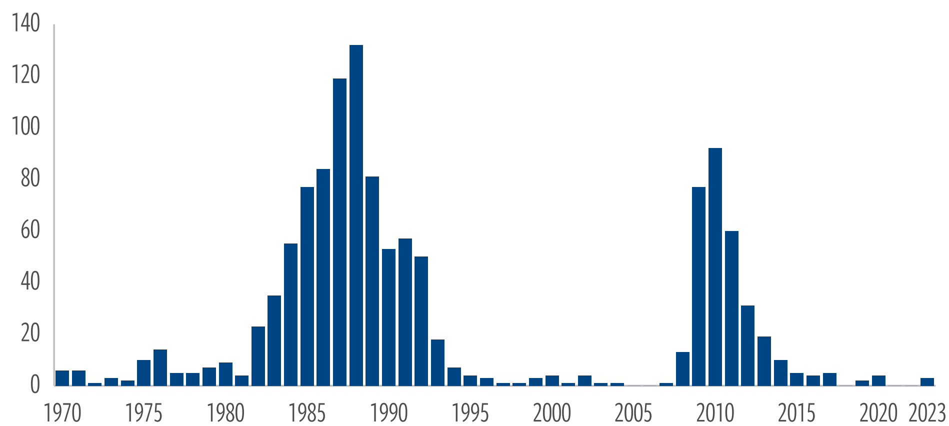
Regrettably, bank regulations were loosened once more in 2018 for all but the largest banks. Again, this relaxation contributed to an increase in bank failures. Notably, the banks that failed in 2023 did not have to "mark to market" even available-for-sale securities. Had they done so, they would have been compelled to maintain better capital positions, potentially averting the failures.

Presently, regulators are once again significantly strengthening bank regulation. The Fed has issued a 1,100-page paper outlining proposed reforms. We anticipate that these reforms will result in a stronger banking system for at least several years. From this perspective, we see scope for strong performance from preferreds in the years to come.

EXHIBIT 9

Strengthening bank regulation typically provides a credit tailwind for preferred investors

U.S. bank failures, 1970–2023



At December 31, 2023. Source: Federal Deposit Insurance Corporation.

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Conclusion

Preferred securities are complex instruments that provide capital for issuers and high-income opportunities for investors. Compared with senior bonds, they have higher risks of non-payment and greater subordination risks. However, issuance primarily comes from high-quality companies, as investors typically demand this level of quality to mitigate associated risks.

Ratings agencies recognize the additional risks of preferreds, relative to other parts of the capital structure, by assigning lower ratings than for more senior securities (such as senior debt) issued by the same company. These lower ratings aim to adjust for the additional risks of the preferred structure, such that their quality can be compared to that of other similarly rated instruments. Studies conducted by the ratings agencies largely support the accuracy of these ratings adjustments, based on historical credit experience. For instance, the default rates for BBB rated preferreds have been comparable to those for BBB rated senior debt.

Investors receive higher compensation for investing in preferreds, compared with senior debt, which is reflected in preferreds' return history. Total returns provide a comprehensive view of compensation for the associated risks, with preferreds historically offering superior total returns. Overall, we believe that long-term investors in a diversified portfolio of preferreds are well compensated for the risks inherent in these securities.

About the authors

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Index definitions and important disclosures

An investor cannot invest directly in an index, and index performance does not reflect the deduction of any fees, expenses or taxes. Index comparisons have limitations, as volatility and other characteristics may differ from a particular investment.

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