2021 AICA Tax Free and Tax Advantaged Income For Investors event Day 1 Panel #2; "Using Preferred Equity to Diversify Your Taxable Income Portfolio"

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Michael Spatacco, director of cash management for BanCroft Capital moderates the second panel of day 1 of the 2021 AICA Tax Free and Tax Advantaged Income event; "Using Preferred Equity to Diversify Your Taxable Income Portfolio". Read the transcript below to hear the discussion among Mr. Spatacco and panelists Brenda Langenfeld from Nuveen, Brian Cordes from Cohen and Steers, and Eric Chadwick from Flaherty & Crumrine.


Michael Spatacco


Brenda Langenfeld


Brian Cordes


Eric Chadwick

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John Cole Scott: All right, would Michael and the rest of the panel come on stage? I'm going to go off camera for you guys.

Michael Spatacco: Thanks, John. Welcome everybody to the Active Investment Company Alliance panel number two of the day. I know that previously you were on a municipal panel, so we're hoping to bring some expertise from a different sleeve, a little bit different part of the marketplace and one that has been considered historically just a sliver off of the tax advantages of munis. But I think that's a world that's changing and so I'm very excited today to speak to our panel. We have a very esteemed panel here and I'll give a brief quick introduction.

We have Brenda Langenfeld, CFA, she is a portfolio manager at Nuveen. Thank you for coming, Brenda. We have Brian Cordes, who is a VP of client partnerships at Cohen and Steers. And we have Eric Chadwick who is president and portfolio manager at Flaherty & Crumrine. Thank you everybody for coming, appreciate the time, and know that the time of this panel and our audience is extremely valuable so want to do everything that we can to maximize it for them.

I'm Michael Spatacco, I'm director of cash management for BanCroft Capital, and I've known John Cole Scott for quite a while. We both share a passion for closed-end funds, and my firm's part of the underwriting syndicate for the new issue closed-end funds so big fan of CEF 2.0 and the structure that has kind of breathed life back into this entire world. I thought it had an interesting bit of value in the 1.0 structure, but obviously it's a whole different world. And I think everyone here shares some affinity for closed-end funds, but we're here today to talk about preferreds and how you can use preferred securities and how you do use preferred securities in your portfolios to generate income in what is as we all know a pretty close to zero yield world.

So if it's okay with everybody I'm just going to kick it right off here and go into the questions. First question's going to be for Brenda. Preferreds as it has been said, they're not a true bond, they're in between and have been considered on the edge for a while. Have you seen the perception of that changing from historical perception? And the existing perception and what you see as the future marketplace, how does that change the way you integrate preferreds into your portfolio?

Brenda Langenfeld: Yeah, thank you. The asset class has definitely earned its hybrid name as you alluded to. Many of the securities are equity on the issuer's balance sheet, especially in the banking sector. They're perpetual, they're dividend paying, but they're all packaged to look like a coupon paying bond, particularly in the thousand dollar par segment of the market. Also a lot of the universe is perpetual, so that makes them excluded from broad fixed-income indices likes you see from Bloomberg and [inaudible]. And then finally noting, most of the $25 par securities are listed on the NYSE, so a lot of that equity-like appearance for those securities.

But to make the bond argument, the securities do have a par amount. Some securities do have a state of maturity, granted it might be very long-dated. But also the dividends are static in that they are fixed at least initial non-call period of a security, which is different than common stock. And also if it's short enough, there are a few preferreds that will end up in bond indices if they have a 30-year final on it. So kind of giving some background of why we would say maybe it's not bond-like, but we have seen great adoptions of preferreds by asset managers over the years.

Particularly I can speak to that in-house here at Nuveen, we've seen prospectus changes for either new products coming online or existing products that would now allow for preferreds as part of the investment universe even though those securities are out of index. So you might have it that a core or core plus mandate will allocate to preferreds even though it's out of index. As a result, we've seen greater liquidity, I would say, and sponsorship of the $1,000 par segment of the market. Again coming back to that familiarity of they look and feel like a bond, bond people are more willing to embrace that segment of our market.

Also I think the fact that we're dominated by financial services and investment-grade rated issuers, these are names that portfolio managers know and love and they're willing to move down the capital structure and allocate to a security that is out of index even though the issuer most often is part of that broad bond index. So again, speaking in-house, we see allocations to preferreds in core, core plus, high yield mandates, even some ESG mandates. We're seeing more preferreds there.

So like I said, greater liquidity, as a result we would see more issuance to the $1,000 pars. So it's really a reversal of what we saw pre-Global Financial Crisis, of the $25 par segment, that exchange-traded segment really being what you would consider preferred. It's now moved more towards the $1,000 par segment of the market. So as I mentioned, we allocate and favor the $1,000 par segment, not only because of the liquidity, also due to valuations compared to the $25 segment. And just a final note of what I would say is really the broadest appeal for bond investors is an investment-graded preferred security in the $1,000 par format. That is definitely where we see the most interest and the broadest investor base.

Michael Spatacco: Thank you very much. Would like to give Eric and Brian an opportunity to follow-up on that. Just for the audience's understanding, that's the way I like to run things. We give everybody a question and then there's a bit of inter-Q&A between there, and then we'll go back to more questions and we'll get to audience questions at the end. So please don't hesitate to throw your questions in the Q&A section. Brian and Eric, take it away.

Brian Cordes: I would just add to that and maybe this'll be helpful for the audience. I'd say while they are hybrid securities, and they do have characteristics of both equities and fixed income as Brenda alluded to, I'd say 90% of the investors and our clients are allocating to preferreds as a part of the fixed-income portion of their portfolio. And I'd say generally speaking you can find allocations anywhere from 5-15% of that fixed-income portfolio being allocated to preferreds.

And I'd say over the years where I've seen most of those funds being sourced from has been from a high-yield allocation. And part of that is because the income you can get from that market of course has come in dramatically. But with preferreds you're able to get a high yielding security from a highly rated issuer base. In fact if you look across our strategies, and I'm sure it's the same for Brenda and Eric as well, 90% of the issuers in our portfolios are actually investment-grade rated at the senior debt level. So just something else to think about there.

Eric Chadwick: Yeah, I think Michael, I would encourage people not to be scared away by the hybrid designation. This is the only market we focus on here and it's because it's a wonderful market. It's relatively unique, it's a little bit different than your on-the-run plain vanilla corporate bond. And if you have an active manager managing that investment for you via some fund product, it is absolutely a great place to be, it's one where active management can add value in addition to just earning your coupon and income. And so I think I would kind of turn it on its head a little bit and encourage you to think about why it's great to be in something that's not just a plain vanilla bond fund.

There's a lot of opportunity, there's a lot of different structures. Brenda alluded to the different types of markets, the buyer base. It really just brings a lot of dynamic aspects to it that for fund managers is not only what makes it enjoyable, it's what allows you to add value along the way. It's still a relatively unique market in that sense and we think that's part of what brings people back to it, and has attracted more and more of the core fixed income or core plus fixed-income guys adding this type of product because it's one of the few places you can still incrementally add to your overall portfolio.

Michael Spatacco: So I'm actually going to go up the batting order a little bit here because what you just said there, Eric, leads me into a question for you. You're an advocate for active management, how do you view the risk-return portfolio of these securities versus themselves historically, versus some other similarly correlated asset classes? And in that what makes active management the critical component?

Eric Chadwick: Yeah, I think the hybrid nature that we just talked about means that you end up with lots of variations. There's not one type of preferred or one type of structure that you just call a preferred. And Brenda touched on a lot of these points, but whether it's $1,000 versus $25, whether it's taxable versus tax-advantaged, whether it's currency, whether it's fixed to float period, you name it. And as I mentioned earlier, I wouldn't let any of those things scare you away from the market as long as you've got an active manager that knows the market and knows how to utilize and take advantage of those features.

It's one of the few investment segments of the market where a passive approach to investing is not all that good. Because you really do need to be assessing the different pieces of the market, the different structures, thinking about where you want to position the portfolio for an income goal or a total return goal, etcetera. And there's just lots and lots of opportunities to do that within the market that doesn't exist in so many other markets. Almost every security in the preferred market is callable, it's just a question of how long until it's callable. And so managing call risk is a huge part of what we do in active management.

All of our firms are doing that, and really thinking about not only how do we produce income for investors, but how do we produce sustainable income for investors without introducing some artificial cliff when interest rates go down? So an environment like we're in now currently is a pretty good example of why call protection matters, because interest rates have gone to very low levels but preferreds are kind of one of those few asset classes where you can still earn a very good spread for being down the capital structure in a preferred security.

As far as risk-return profile goes, and on a historical basis, I think one of the brightest spots of our market these days is just fundamental credit quality. And Brenda mentioned it's highly concentrated in financials, and that's definitely true, banks, finance, insurance companies. But if you look at the last decade coming out of the financial crisis, a little over a decade ago, and the amount of progress that's been made on the bank regulatory side and the balance sheets of the banks, the underlying credit quality is about as good as it's ever been probably. Particularly true for the banking space. That really gives you a good starting point for making a credit investment at this level of rates. It's really important that you have good credit quality, you're not having to reach into a riskier space to earn income.

Brian alluded to this earlier, that almost all of our securities are investment grade securities at the senior unsecured level or the issuer level. And that's a really important point because you're not having to take additional credit risk to earn extra income. And that's what people find themselves doing in this type of environment, is that they're getting squeezed on interest rates, they're getting squeezed on corporate bond spreads, how in the world do we add income? Well, you either take more duration risk or you take more credit risk. Or you could take structural risk as well, but the preferred market I think sits in that unique spot where you don't have to take those extra risks. You're getting paid a lot of extra coupon and subordination premium because you are subordinated, but you're subordinated in a security that is otherwise an investment-grade issuer and the probability of default is very, very low as a result of that.

So credit quality in that concentration in financials is somewhat unique to the preferred market, it's also complimentary though versus your other asset classes. Because most likely your corporate bond portfolio, you could definitely own a lot of financials there too, but you can also own a TMT, you can own healthcare, you can own industrials and autos. You can really diversify your bond portfolio and you can get your financial exposure in your preferred portfolio where you're actually getting paid a lot more to own that financial exposure to begin with. So we think from a risk-return historical perspective, it's really kind of a sweet spot right now for trying to earn that income that you so desperately need and in a fixed-income portfolio without really having to reach way out into the risk category and take a lot of risks that you really otherwise wouldn't want to take.

Michael Spatacco: Give Brian and Brenda the opportunity to counterpoint, or just discuss it.

Brian Cordes: I think one of the points Eric made with regards to the issuer diversification versus what you can find in other areas of fixed income is another reason why we've seen so many allocate to preferreds and fund that from high yield. If you look at the high-yield universe, you've got 2% in banks and insurance companies. What you do have is more cyclically oriented issuers and you're not going to find those types of issuers for most part in the preferred market. And of course you do have roughly 70-75% coming from banks and insurance companies.

I would just also just back up one of the things Eric said with regards to the banks and being so healthy right now. I mean, you look at their capital levels, you also take into the fact the types of stress tests that they take part of, that the Fed subjects them to, the ECB. No other issuer base goes through that type of regulatory stress testing, and the banks have been tested for very severe adverse scenarios, and even after stressing for those types of events their capital levels are above where they were before anything happened whatsoever during the Financial Crisis. So the regulatory environment since the GFC has certainly led to banks being higher quality, much better capitalized, and as a preferred investor that just allows us to feel that much more confident in the ability to collect that income.

Michael Spatacco: Brenda?

Brenda Langenfeld: Yeah, one final point to note is I know we compare to munis to being a tax-advantaged asset class, so we get that comparison a lot. But we're talking about yields here in this discussion, we don't talk about tax-equivalent yields. We're comparing to other fixed income, fully taxable asset classes, and it still tilts in the favor of preferreds. Also given what Brian was mentioning about the regulation oversight stress test, as a result securities that are issued are perpetual dividend paying, and those are the QDI securities. So really by nature the asset class has evolved to be a tax-advantaged asset class, which is to the benefit of investors.

Michael Spatacco: I'm going to jump to Brian here and talk about flows into the sector. We've heard a little bit from everybody about how and why the integration is happening and some of the reasons behind it. Have you seen more flows coming in than historically? And what do you think are the reasons for that, and does it make it easier or more difficult? Does more demand in the space make your job inherently more difficult, or is it something where as Eric mentioned before it kind of plays into the hand of the active manager because of the expertise?

Brian Cordes: Well, I'll say flows have been very strong. If you just look at the open-end fund category, if you look at the flows this year, preferred open-end funds are net inflow of nearly $4 billion through the end of August. And that's just not a 2021 phenomenon, if you go back the last five calendar years, in total those same funds are net inflow nearly $14 billion. And if you look at the closed-end fund space, by and large all the preferred closed-end funds are trading at a premium, or at least the vast majority of them were trading at a 3% premium or even greater. So there has been a lot of capital flowing to the preferred market, and I'd say that's because of the high tax-advantaged income that they provide. Brenda was starting to allude to this, but if you look at yield spreads where they are today versus where they've been historically, versus other areas of fixed-income, they remain quite attractive, there's good relative value in preferreds.

And then third I would say is the diversification benefits. We talked about these being hybrid securities, but the fact of the matter is if you look back longer term they exhibit low correlation both to the S&P 500 and the Barclays Agg. So for those three reasons we've seen steady inflow over the last five years or so. And what's interesting to me is I've been at Cohen & Steers now for the last nine years, and I'd say the first four of those years the majority of the business we were seeing with preferreds was really from the retail side of our business. And I'd say for the last five years we've seen a significant pickup in interest from the institutional side of our business as well. So at this point the interest of preferreds is coming from a number of different areas, and I expect that flow to continue given the relative advantages that the asset class still possesses.

Eric Chadwick: Yeah, Michael, I would add that growth is really healthy for the market. At the risk of aging myself a little bit, I remember when new issue preferreds, if you could bring a $150-$200 million deal size, that was a pretty solid deal out of banks or utilities back in the day or whatever it was. But you look at the way the market functions today and it's almost unusual to see deal sizes below a billion dollars, and we're definitely seeing multibillion dollar deal sizes. Which I think just speaks favorably to the breadth of the market, the buyer base that Brian referred to, it's outside of just a core group of dedicated preferred managers. We have dedicated strategies, we think we do better than the average bond manager managing preferreds because of our expertise in it. But that being said the breadth of the market is really extensive and that participation I think brings securities, preferreds into a little bit more of the mainstream.

We've seen similar things in the past with the REIT market for example. Where more and more interest and more and more growth brings it into a more mainstream, more understandable, more accepted asset class. And I think preferreds have definitely made huge strides in that regard over the last really decade, but as Brian alluded to really in the last five years I think it's been really important in that regard. So we've seen lots of good issuance, some of it's refinancing, some of it's net issuance. Changes on the regulatory side did drive some of that.

And it's important to remember that preferreds are mostly issued for regulatory purposes, that or rating agency purposes. But there's a reason it's mostly financials that issued preferreds and not your everyday industrial company most of the time, so that aspect isn't going to change. But all of those factors, the regulatory backdrop, the requirements, the income, the spread and the structure have all really accumulated to really shine a very favorable light on the preferred market, and I think that's why it's attracting the interest that it is.

Brenda Langenfeld: One final thing to add too is I feel it's also been coming, and truthfully challenging to maintain your exposure to preferreds if you're trying to do it on your own given the technical landscape. It's been trending and shrinking that the $25 par segment has been shrinking. Whereas parks like ourselves, you're opening up to as broad of an investment landscape as possible with preferreds and not just solely focusing on one segment of the overall preferred market. So doing a service of active manager and having geographical diversification as well if we're including contingent capital securities in there, that type of exposure, you're really not able to have in a passive type of strategy.

Michael Spatacco: That's great, thank you very much. And honestly Eric, I think you're only dating yourself if you remember when preferreds were a nickel.

Eric Chadwick: No comment.

Michael Spatacco: I think you're good inside of that. I know we had touched on some of the correlated assets, some of the asset classes that have traditionally been considered either a competitor to-- competitor is the wrong word, but an asset class that's competing for allocated dollars to preferreds. What are some of those, and what are some of the advantages that preferreds have over them? And it's kind of a question to everybody but I'll throw it to Brian first.

Brian Cordes: Yep, so I'd say the first is high yield as I said. And if you look at high yield today you're going to get about 4.6-4.7% on a single B+ credit quality. You look at a BBB set of preferreds and you're going to be getting 4.2%. But then there's also tax considerations where taxes are a consideration for clients. Because a large portion of preferred income's going to be treated as qualified dividend income, your after-tax yield is actually a bit more than what your after tax yield would be in high yield at this point. So high yield continues to be a source. I'd also say just investment-grade corporate bonds, right now preferreds are yielding about 200 basis points more. If you're worried about rising interest rates, you look at the duration on the corporate bond index and it's a little over eight years. I know our strategy, which strategy that you're looking at that we manage, duration can be anywhere from 2.3 years to 4.3 years right now, so roughly half the duration.

And the third has been munis, that's started to occur over the last few years and it's because again the after-tax income that you can get from preferreds. I think many are surprised by the fact that the default rate in preferreds is as low as it is. Just looking back historically it's about 2% a year, certainly higher than what you would see in munis but certainly lower than what you'd get in high yields. So we've done a number of different studies on that, and what we've found is even if you were to just blend a portfolio 50-50 between munis and preferreds, you actually end up increasing your Sharpe Ratio, your risk-adjusted return becomes more attractive by marrying the two together. So those are the three main areas where we've had our conversations.

Michael Spatacco: Real quickly there, one of the things that I've seen in our everyday business as we deal with corporate issuers and trying to get bonds allocated when we're in a capital markets transaction is some of our institutional retail clients, these things are two, three, four and 10 times oversubscribed sometimes. So the availability of corporate bonds has probably gone down because of the outright demand for it, and that might be also pushing some demand into the corridor as well. Eric, Brenda?

Eric Chadwick: I guess I would just comment kind of broadly, preferreds ought to be one of your asset class boxes. So as much as munis, high yield, EM debt, CLOs, leveraged loans, if you're running a fixed-income portfolio preferreds ought to be a segment that you consider in that scenario. I think there's a lot of historical reasons why that wasn't the case before, but they're a very compelling product. And especially when you think about risk-return, things like liquidity used to be more of an issue, but as we talked about earlier, the depth and breadth of this market has changed so dramatically.

We've touched on duration a number of times, again 20 years ago to own preferreds you had to accept very long duration, it was just the structure of the securities. That has completely changed with the fixed-to-float or fixed-to-reset structure dominating the issuance that we're seeing today. Brian talked about duration of the funds, we're in a very similar situation. But I would say most preferred funds absent leverage are inside of five years on a duration basis, which is going to be extremely competitive with just an investment-grade bond fund.

So I think regardless of which asset class you're trying to allocate to, I think you should be assessing preferreds side by side with those other asset classes and especially looking at the risk-return. How much am I really reaching? What are the risks that I'm taking? In high yield you're taking credit risk, there's no question about that. In preferreds you're taking subordination risk. We think that's a really smart tradeoff but we're biased in that regard. But those are the types of assessments I think that need to take place.

I think in so many cases we've seen this particularly at the consultant level, preferreds just simply aren't a box. They're just an asset class that people don't spend the time to get to know and understand. They don't reach out to experts like us to say, "Well, what is this asset class? Why are you investing in it? Why is it the only strategy you run?" And I think it's a really good question that people ought to be at least asking the question so that they can learn about it. I think they're going to find favorably that it really does have a place in your fixed-income portfolio.

The 5-15% is very consistent that Brian mentioned. I completely agree with that, that that's mostly what you see. But there are so many portfolios where it's a zero, and it's a zero because it's just not on the list. So I would encourage people to put it next to all the other asset class checkboxes that you're looking at and give it a fair assessment.

Brenda Langenfeld: Yeah, I agree Eric. I think we should lobby for a box on the RSPs that we get. Because I'm sure you both will get the question of, "Okay, we want to do preferreds but I need to put this in a box." And preferreds isn't one of the boxes that US large cap equity, are you fixed income, are you alt? So hopefully there is that development down the road.

But kind of building off your point you made earlier, Eric, in that good or bad, not all preferreds are created equally. And I do think there is that perception that, "Okay, preferreds are perpetual, that has to be a long duration. I don't want that right now." But really you have coupons that can reset for the majority of the universe now. And also really starting in 2019, the marketplace in the fixed-to-fixed, fixed-to-floating, we've really shifted to a constant maturity treasury as the reference index for resets. Which thankfully then also removes the LIBOR component of the asset class, which is another topic that we get asked about frequently. So just overall if I look at index data where really about 33% of the asset classes now benchmark to a constant maturity treasury, typically the five-year, which is a promising evolution of the asset class.

Michael Spatacco: I think we have at least one more question before Q&A, and I do appreciate everybody. It seems like we have some Q&A piling up, so that's always a good thing, makes for a better discussion on the backend. So please don't hesitate to fire into that Q&A session and we will do our best to apportion as much time as necessary.

The one word that continues to come up is duration, and I think that that is one of the true differentiators in the space. It's been touched on and I certainly don't want to beat a dead horse but it's also something that a lot of investors struggle to understand the concept of. And so what I'm hoping is that we can help everybody to understand what it means to your portfolio. I think that's the key, is more than we don't need to do this *Sesame Street* thing where we break out the puppet show and 101 here. But I think what it means for you in your daily life and how you view duration of this asset, how positive you think it is. Brenda, you just talked, so I will go to Eric and then Brenda and Brian.

Eric Chadwick: Yeah, duration's one of those things where in some cases you need duration. Insurance companies that have long-dated liabilities for example want duration on the asset side to help better match the duration and their liabilities. For the average investor though, particularly the retail investor, duration is not usually something you're seeking out. Because duration again very fundamentally is just a measurement of the exposure, the price of a security to changes in interest rates. A very simplified version, but in effect that's what it is. So if interest rates go up, and that's a broad term, interest rates but let's just think curve in general goes up, fixed-income securities usually go down in price as a result of that.

And so when you talk about duration, the longer duration or higher the number, the more interest rate sensitivity you have exposed to higher interest rates. So generally speaking, a five-year bond is going to have a duration of let's say four or four and a half, and a 10-year bond's going to have a duration of let’s say seven to eight. So you can see there that as you go out the curve you’re exposing yourself to a little bit more sensitivity, the price of the securities to changes in interest rates.

When it comes to preferreds, I think the evolution of the product and the fixed-to-reset as Brenda mentioned, the reset function on the backend really does change the picture for preferred investors where in effect you can get very similar yields that you’ve always been able to get into preferreds because of the subordination premium, without taking the extra duration risks. So I think of duration as one of those things that why take it if you don’t have to or if you’re not looking to take it? So I think you can think about it in that sense, where if I can get the same amount of return more or less without taking a lot of interest rate sensitivity, why would I not want to do that?

And the preferred market I think has evolved to be a really sweet spot for both the combination of income that you can earn, which is an attractive level of income, the credit profile that we talked about, plus you have the duration of a real intermediate bond fund. Which the world is full of intermediate bond funds, that’s what the bulk of fixed-income portfolios look like. So I think most investors are comfortable taking that level of duration exposure, but it’s definitely not outsized.

And Brian compared it earlier to even the high yield market, or we talked earlier about the muni market. In most cases the preferred market right now is going to come in with as much as half the duration exposure of what you’re seeing in other markets. Which is some of it’s the evolution of it, it hasn’t always looked like that, and I think a lot of people will remember the old days and still be scared of duration. But it’s worth understanding that the changes that have come in the marketplace and why that really makes for a much different investment today than it did maybe even 10 years ago.

Michael Spatacco: Thank you. Brenda?

Brenda Langenfeld: Yeah, so thinking about when I mentioned the constant maturity treasury reference of securities. Taking this low environment that we’re in, interest rate environment, if we had rates in similar levels today, some securities when they would reset, they would actually be a higher coupon than what they are today. Probably also means that that security will be redeemed. But they think about it that really then you only have five years of interest-rate exposure there on that type of security, the typical non-call period of a security. And then if we have higher rates, what segments of the market will suffer as the lower coupon fixed-rate securities? Those will what we have to say duration extension risk. So today it might not appear to be very long duration, but as the curve changes, rates change, so does the duration of those instruments. So actually you’re increasing your interest rate sensitivity at the most inopportune time.

Final mention of these, coming back to the fixed-rate reset securities is that in those rising rate environments, sometimes we’ve even broken the bond math of rates are higher, these prices should be lower because there’s demand for those intermediate type duration securities. So you might not always see prices lower in a rising rate environment for those securities.

Brian Cordes: I would just backup what Brenda just said there with looking back at the Taper Tantrum. We're talking about tapering right now, I don't think it'll be a tantrum this much this time as everyone's expecting it. But you go back to 2013 just to give people some context, the institutional preferreds, those fixed to reset securities, they ended 2013 up +4.5%. But if you looked at the retail preferred market or the $25 market, they lost roughly 4.5%. So you had over 900 basis points in dispersion of return between the two different types of preferreds, and just goes to show you the importance of those fixed-to-reset structures to lower duration in that environment.

Also the point she made on duration extension risk, and Eric had mentioned earlier some of the ETFs that play in the preferred space. Some of the largest ETFs in the preferred space are only accessing that $25 market. And you may look at their duration right now and it may say mid-fours, but they're going to be subjected to that duration extension risk which you're not going to find in a lot of the strategies that I know we're all running.

Michael Spatacco: That is wonderful. Thank you very much everybody for giving robust answers. Everybody really doubled down upon their thoughts and it's much appreciated. That gives us roughly 20 minutes for Q&A and other various questions that arise from those conversations. But we're going to go in chronological order here and just fire 'em off.

With the impact of institutional investors in the preferred space, and even your funds, any interesting 13 filers?

Eric Chadwick: I assume they mean 13F filers. You know, the impact is I think we've kind of covered it. It's definitely broadened the investor base. It has led to a lot of demand, a lot of flows. There's no question it does push prices up of course, whether it's institutional or retail, it doesn't really matter where the flows are coming from. But expansion I would say of usage by non-dedicated fixed income investors has definitely been a tailwind for our market. Interestingly 13F is maybe a little bit off to the side here, but just generally speaking only certain equity securities are reported on some of these regulatory filings. There's a whole bunch of our market that doesn't ever get reported.

So it's really tough to read too much into that aspect of it other than just broad filings from insurance companies or other types of investors definitely support our case that the breadth of the market is just growing, and has been growing and probably continues to grow given all the factors that we talked about earlier.

Michael Spatacco: Anybody else want to take a swing at it or should we move onto the next one? Next one it is. All right, is the new issuance of $25 shares going to shrink dramatically in favor of the $1,000's? I know Brenda you had some strong opinions on this one, I'll give you the chance to field it first.

Brenda Langenfeld: Yeah, thank you. So no, that segment of the market is not going away. There is some attractive characteristics of it both for investors and for issuers. One, large money center banks, they want a diverse investor base as well. They can't always come to us with every deal. So they'll issue in $25 par format and $1,000 par format maybe a couple times a year depending on their refinancing needs. Also I know just speaking with other underwriters and things like that, there's some issuers that really want only $25 par fixed rate. It's easier for treasurers or a CFO to factor that in for cost of capital.

Also there are some issuers that are quite small, Eric mentioned we're seeing larger deal sizes especially, but there's some issuers they just can't issue in large size. So what you want to do is try to strike a balance of a deal size that's maybe $100 to $200 million, that you'll have a diverse investor base because you'll need to allocate your retail investors to satisfy listing requirements, but then also you have a handful of large institutional investors like ourselves have sponsorship of those deals that gets a relatively broad investor base. So that's attractive for those type of issuers.

Michael Spatacco: Brian, Eric?

Eric Chadwick: I would certainly echo the fact that it's not going away. We've seen this between $25's and $1,000's, there's movement between the two. Some if it's issuer driven, some if it's demand driven, and I think what we're seeing now is more demand driven than anything else. The demand's coming from institutional investors to buy institutional preferreds, better structures, better liquidity, bigger deal sizes, all of those things. But the $25 par market is not going away, it's been around in some form. It was in effect the original preferred, it wasn't $25. But whether it was a $10 par or $100 par or $50 par, there's been all variations of it. But that's in effect what the $25 par market is now and it always serves a purpose.

As much as we like to think investors only buy actively managed funds in this product, the reality is a lot of individual advisors buy preferreds and they buy $25 pars on their own for various reasons. Within the large systems like a Merrill Lynch or a Wells Fargo or a Ray James, those type of retail oriented systems, it's a very solid product for them and they have a lot of success placing that product with their investors. I don't think there's going to be any change to that.

Michael Spatacco: Well, given the opportunity to counterpoint momentarily, I think we'll move on to the next question. Why such a wide variance in premiums and discount in this slice of the universe? Brenda, Eric, you want to go for it?

Eric Chadwick: You know, I think part of it is just closed-end funds, it's not just this market. But I think for preferreds in particular, I think investors kind of go back and forth particularly in this type of an interest rate environment between caring more about yield versus caring more about premiums and discounts. And ultimately in the long run they both matter and they're both important, they both get considered. But I do think that part of the reason that closed-end funds and preferreds have been able to trade at premiums is because the yields are so attractive. Obviously the closed-end funds utilize leverage, so you're talking about yields with six handles on them in an environment where the long bond is barely squeaking out 2% for very long-duration Treasury. So I think yield has definitely been the primary driver behind closed-end fund trading in recent years, and the premium discounts to some degree just fall out of that. We definitely get those calls all the time where, "We'd love to buy it at a discount," but the reality is it's not going to trade at a discount anytime soon with those types of yields unless we see a dramatic change in market yields in general.

So I think the variance, the only other thing I would point out I guess is that managed distribution policies have definitely been a thing recently, and it's important to understand whether a fund is using one or not. It's not good, bad, or indifferent. I'm not commenting on whether it's a good idea or bad idea, but it does oftentimes explain some of the differences in premium discount and also in yields. So the managed distribution policies tend to trade very much higher yields and therefore very much larger premiums in most cases. So that's one variant I think, or one aspect that's within the closed-end fund market is really kind of hit or miss whether funds utilize that policy or not. But it does help to explain sometimes what the differences are in how these funds trade.

Brenda Langenfeld: I'll add that I think it's also just the nature of the asset class in that it's fairly certainly almost all of our products, the distribution is 100% QDI. Even though the assets within the portfolio maybe aren't all 100% QDI and that's just a function of how expenses are paid for example. Also to note, recently the structure has turned to a term on the fund, which I think is helpful compared to the perpetual funds trade at premiums as well, but it's another thing that's helpful in keeping prices closer to NAV. But then also when you double up on it's a perpetual asset class in a perpetual vehicle, times whether it be interest rate outlook or concerns about leverage, it could be something that maybe investors wouldn't want to be a part of. This environment right now is definitely not on the forefront of concerns.

Michael Spatacco: Brian?

Brian Cordes: Can you hear me? All right, whoof. All right, so I'm just going to go back to the final comment I was making on the issuance. And that was if you look at it this year roughly 80% has been issued into the over the counter market or the institutional market, and that's been the case for the last few years. You have seen quite a bit of issuance in the $25 market this year too, but you're actually net negative issuance just given the amount of call activity you've seen and the redemptions that you've seen there. So the retail market as a percentage of the market that's shrunk a little bit this year, but we don't see that universe going away entirely. I agree with Eric there.

As far as the discounts go, I think it's obviously it's hard for us to get some color into that as I think as Eric and Brenda have already said. But yield is going to drive it. In fact I know we offer three closed-end funds in the preferred space, two of them are trading at premiums of about 3.5% and the other's trading at a discount of 3.5%. We can't really make any rhyme or reason out of it, but the yields across the board for all three of them anyway are pretty comparable at this point.

Michael Spatacco: If I'm not mistaken, does that get rid of all of them? I don't know that we can really address the last one, that's more of a question about other funds. But my question that I have remaining, and I've got to go back through my notes real quick here, make sure that I hit all the topics that I wanted to. With the closed-end fund index at a 3% premium roughly, how do you guys advocate for utilization of that structure in contrast to something like an ETF? That's a question that I run up against a lot when we're out is, "Hey, we'll wait for an IPO fund. If a closed-end fund IPOs we'll wait for it to check to a discount." But with so many funds at a premium, how does one advocate for the space as a whole? I'll throw that out broadly and don't all jump at once.

Eric Chadwick: I'll give it a shot, Michael. I think the reality is we live in a low interest rate environment, and not just in the US but globally. The US is kind of a bright spot when it comes to interest rates really. And then you think about within the US what asset classes offer that type of yield. And so the other comment I guess I would make is the closed-end fund structure is the perfect match for preferreds. We think of it as an income product. We think you make the most money by buying these securities, and you can have an active portfolio but having a core portfolio over a longer time horizon. We don't advocate these as day trading type securities, a lot of people lose when they try and do that.

And so the long-term nature of a closed-end fund, and I would argue even the old style is even better than the term trust version, although that's kind of the way things have moved on the IPO side. But they're a perfect match for a market where you're trying to add value over time and trying to clip coupons that are really attractive. And as we've talked about several times, tax advantaged. And so I think in a market like today, where else are you getting 6.5%? And if you don't like the leveraged version of it, you can buy an open-end version of it. But the closed-end fund side to the extent you want the leverage included in it is really a perfect match.

I guess I would argue, one to two, three percent premiums in a closed-end fund investing in preferreds is really not a big premium. We've seen a lot larger premiums in our funds, we've traded a lot larger premiums. And I think it's driven primarily because people are on the hunt for good income and it's a compelling argument. And so you're willing to pay that premium because you're going to own it for a long time, and you're going to more than make up those advantages in just simply the tax advantages alone of QDI income. It's going to more than offset that relatively small premium that you're paying.

If you're going to wait around for an IPO to trade at a discount, it's kind of like saying, "I'm going to wait for a 15% drop in the S&P before I put any money to work." You've been waiting a long time for that if that's what you've been waiting on. I'm not sure that's going to be any different. There may be those types of opportunities, but if you wait around 10 years for it, you've lost out on a whole lot of total return and income in the meantime. So that's going to be awfully tough to make up.

Michael Spatacco: And touching on leverage, we're probably close to one of the cheapest all-time zones to deploy leverage. I don't know that historically there's ever been an easier or cheaper time to do it. And so obviously leverage is great on the way up and less great on the way down, but at the costs currently it does in my opinion and obviously the opinion of some of our investors who've been playing in the closed-end funds, makes sense to consider.

Eric Chadwick: Yeah, leverage is cheap from an all-in cost basis, but I also think leverage is extremely efficient in the closed-end fund space. You can't get this type of leverage at the individual level. Of course you can borrow money, you can margin things, whatever. But you can't get this type of efficiency and the leverage that you can get inside of a closed-end fund.

We get the question sometimes, “Why don’t you take leverage off when interest rates are going up?” Or ,”Why don’t you take leverage off when the market’s going to go down?” Well, if you knew that in perfect hindsight of course you might do that, but the reality is if you take leverage off you’re going to reduce the distribution rate. And at the end of the day we’re trying to produce high current income, and leverage is just a core part of that closed-end fund strategy. To me it doesn’t exist without it. You can buy an open-end version of it if you don’t want it, but you can’t just strip leverage off a closed-end fund and think you have the same product. It’s really a core aspect, it’s really efficient to have it included, and it’s also included at very reasonable levels by regulation. The 40 Act restricts how much leverage you can put on for a reason, and that helps to balance I think for investors wanting to get into a modestly levered product to earn the extra income.

Michael Spatacco: Thank you very much. We have late-breaking Q&A here and I would love to try and get it in. We still have a few minutes left. Any use of at the at the money or secondaries when at a premium? I don’t know if this group specifically has entities that have considered it or utilized it, but I know of one entity that was hovering at or around their NAV and strongly considering the use of that marketplace if and when they’re able to get up above to a premium. Is that something that is a goal? Something that’s precluded for you? How does that sound to everybody here?

Brenda Langenfeld: We often have conversations with product with respect to that.

Eric Chadwick: We have ATMs in place, Michael. And I think the argument really for it has been that it has to be accretive. The thing about ATMs remember, is you can’t issue shares at a discount. So you have to be issuing shares at a premium and it’s accretive in net asset value. And in the case of our funds we have some of our older funds that have been around since 1991 that were issued in a totally different time and not that big of funds. So from an expense ratio standpoint, the ATM can be really favorable. So we think the ATM structure is designed to be favorable for investors and for the fund over time, and is something that to the extent it’s in place can be really advantageous. So we do have that for all five of our closed-end funds.

Brian Cordes: We look at secondary offerings all the time if it makes sense for some of the strategies that we run, even outside of the preferred space. We did one not to long ago on a couple of our other offerings, so something we are always taking a look at.

Michael Spatacco: There was one last question about the difference between being a smaller investor and a larger investor, and I feel like that we covered pretty largely in the active management section. Where the scale of the players in question on today’s panel obviously have some horsepower and a team behind them.

So can’t say thank you enough to our panel participants, this has been great. I appreciate everybody’s time, and being conversational about it and open to filling in with any dumb Q&A from the panel moderator here doing some juggling. Appreciate everybody and I think with that we’re going to turn it back over to John. Thank you very much, everybody.

John Cole Scott: Yeah guys, thank you so much. Feel free to drop off the stage and I'll just do the closing remarks from here so we don't have to go out and come back in.

All right, everyone thank you for attending this, whether it's live or the replay. I want to go over a couple things, tomorrow's session there's a fireside chat with Parametric followed by a panel on MLP investing, another thoughtfulness on tax-efficient yields but mostly from the equity side of the conversation. And also remind you that October 14th we're having the Seeking Alpha authors and the closed-end fund analysts event, a one-day two-panel event on the same platform. Please feel free to share the links of the replay. The replay will be up as soon as we get compliance approval.

Could not thank enough our members at AICA that actually give us the financial resources to produce and pull off all of these events. Please take the survey that you'll see either on the homepage in the event or in the email follow-ups. And please let us know what you thought, even if it's not through the survey, we're always looking to improve. This kicks off our fall fiscal year 2021 of work and we're really glad that you could be part of it today. So with that, feel free to stick around if you'd like and mingle at the tables, and we'll see you next time.

Recorded on September 29, 2021.

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