

Impact of rising interest rates on preferred securities



This report looks at the risks preferred investors may face in a rising-interest-rate environment.

We are currently in a period of historically low interest rates driven by global monetary policies designed to provide a very high degree of liquidity to the financial system. However, these policies will not continue indefinitely. Investors may disagree on the exact timing; however, there is a general consensus among most market strategists that higher interest rates are in our future. The Advisory Services Group (ASG) Fixed Income Strategy team shares this view as we expect investors will face substantially higher yields in the years ahead.

A rising rate environment can have a significant negative effect on the value of fixed-income investments; this impact is often more pronounced with securities that have long maturities. This is because interest rates and bond prices move in opposite directions — in other words, as interest rates move up, bond prices fall in value, and the longer your exposure is to a set of fixed payments, the greater your risk. Those fixed-income securities with the longest final maturities and the lowest coupons are the ones that are likely to be most negatively impacted should interest rates increase. Most new issue, fixed-income securities, including preferred securities, are being issued near all-time low coupons.

In late 2011 and into 2012, we encouraged investors to overweight preferred securities – during that time preferred securities well outperformed most other fixed-income asset classes. As investors have bid up the preferred sector, the sector is now fully valued, in our opinion. We are concerned that longer-term investors will be faced with higher interest rates that could substantially decrease the value of certain preferred securities; those securities that have low coupons are most at risk in a rising rate environment.

Should we enter a period in which the markets become risk averse, and/or interest rates rise sharply, we would expect preferred securities to fall in value. We are not predicting that we will see this type of environment in the near term, but we do believe that, given the price increases in the sector, the current risk/reward proposition is no longer in investors' favor.

Brian Rehling, CFA®
Chief Fixed Income Strategist

See important risk disclaimers and definitions on page 8.

Together we'll go far



Preferred securities explained

Investors have used the term “preferred security” as a blanket term to describe any security that typically trades with a \$25 par value, has a fixed dividend and is listed on a major exchange, such as the New York Stock Exchange (NYSE). Today, the preferred security market encompasses a wide range of structures with meaningful differences that can have a significant impact on individual security valuations and suitability. These securities that investors refer to as preferred securities could be either senior in nature (such as a senior unsecured debt instrument) or a deeply subordinated junior security.

Regardless of subordination, all of these securities have one element in common: They are all very long-term securities, which may make them sensitive to changes in interest rates. In addition, most of the new offerings in this space are coming to market with coupons that represent the lowest level most issuers have ever issued. Even though yields have fallen, so have the yields of most other fixed-income sectors; due to their long maturities and structural subordination, preferred securities remain among the highest-yielding fixed-income asset classes.

For a more detailed discussion on the various structural complexities found in the preferred market, please ask your Financial Advisor for a copy of our report titled, “A Guide to Investing in Hybrid Securities.” We recommend that those investors that lack a deep understanding of the many nuances in the preferred market look to a professional manager for their preferred allocations.

	Yield as of May 17, 2013
BofA Merrill Preferred Stock Fixed Rate Index	4.48%
30-year Treasury yield	3.15%
10-year Treasury yield	1.95%
Barclays US Aggregate Index	1.84%
Barclays Municipal Bond Index	2.14%
S&P 500 dividend yield	2.04%

Measuring the effects of rising interest rates – a difficult task for preferred investors

There are several primary factors that can cause the price of a preferred security to change. Such factors include a change in interest rates, a change in credit quality, a change in secondary market liquidity (demand), and changes in the regulatory or tax environment. In this report, we focus on the impact due to a change in interest rates – but investors should understand all of the risks associated with holding preferred securities.

We have long recommended that fixed-income investors understand duration and how it can be used to gauge the potential impact that an increase in interest rates could have on a fixed-income investment.

Duration measures the sensitivity of a bond’s price to a change in interest rates. The duration calculation can be broadly used by investors to approximate the percentage change in price for an instantaneous one percent parallel shift in the yield curve. For example, the price of a bond with a duration of five years would be expected to rise or fall 5% in price for every 1% change in market interest rates. The longer (higher) the duration, the more prices will fluctuate as interest rates rise and fall.

A look at call options

Determining the duration of a preferred security can be difficult and potentially misleading due to structural issues associated with many preferred securities. Specifically, most preferred securities contain a call option that is at the issuer's discretion.

While many investors have come to expect their preferred securities to be called early (such as five years after the security has been issued), a call feature would likely not be used by the issuer when interest rates begin to rise. The optionality of most preferred securities coupled with a very long final or even perpetual maturity presents an investor with a wide variability in the timing of potential cash flows. Regardless the extent of sophisticated analytics used to estimate the effective duration of a preferred security, the ultimate decision is binary. In simplest terms, the security with an option is either called away or it remains outstanding. The impact of that decision on an investor is significant.

- Should interest rates remain low or decline, an investor may expect an outstanding preferred security to be called away at the first available date – thus a relatively short duration.
- However, if interest rates increase, the issuer may elect to keep the same security outstanding – thus lengthening the potential duration of the security substantially.

Thus, investors relying solely on a duration calculation to estimate potential interest rate risk in securities that contain embedded options may find that the impact of a rising rate environment may be greater than expected – depending on the extent and speed of an interest rate increase.

Currently, many preferred capital securities are trading at a premium to their underlying par (redemption) values, and they are being priced to a shorter call date. Such valuations significantly reduce their simple duration calculation; however, if rates begin to rise, the chance of a call by the issuer could decline dramatically and the preferred stock may begin to trade like a long-term investment, putting downward pressure on the price.

A preferred security investor concerned about the impact a rise in interest rates may have on the value of their investment should consider the duration to maturity. This duration can be significantly longer than the current stated duration.

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In a rising rate environment, most preferreds will become long-duration securities

Below is a representation of the potential price impact on a 30-year preferred security in which interest rates increase by 1%, 2% and 3%. Remember, many preferred securities have much longer or even perpetual final maturities.

	Yield	Duration	Par value	1% increase	2% increase	3% increase
30-year security	5.00%	15.45	\$25	\$21.50	\$18.75	\$16.50

Source: Wells Fargo Advisors; assumes an instantaneous shift in the yield curve

When interest rates increase substantially, the price of preferred securities will tend to decline, even if the fundamentals of the company are improving and the common stock is increasing in value. Most preferred capital securities were issued with maturities of greater than 30 years and can be perpetual (no maturity date). Clients that own these securities need to be aware that this volatility exists and should be prepared for a decline in the price of their securities if rates begin to rise.

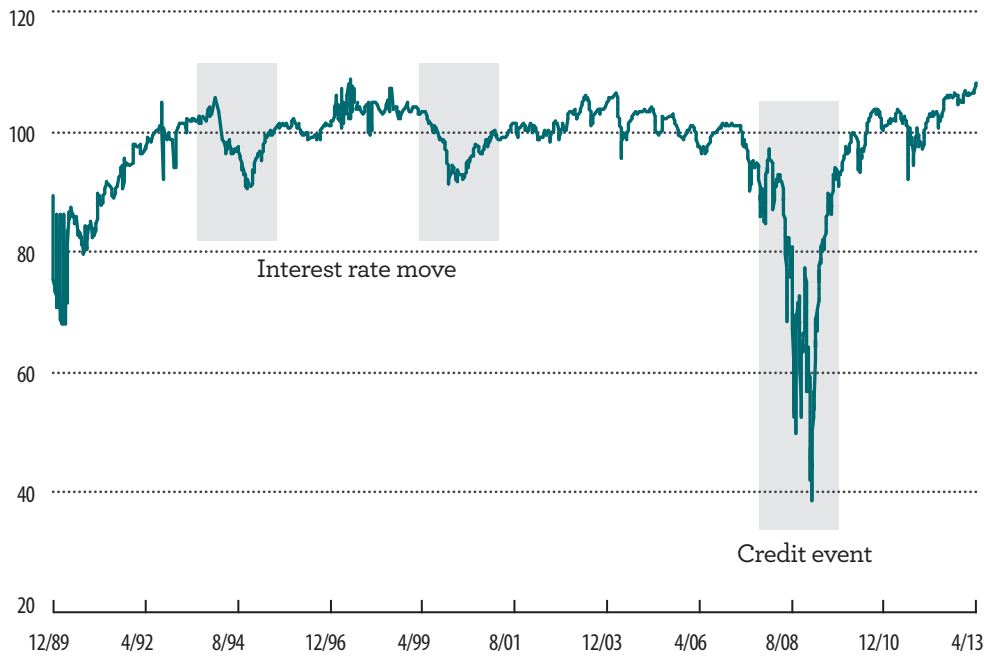
The graph on page 5 looks at past price performance of the BofA Merrill Lynch fixed-rate preferred stock index. Over the last 25 years, there have been two periods in which longer-term interest rates moved significantly higher. During a 12-month period beginning in late 1993, the 10-year Treasury yield increased by about 2.75%; during that same period, the fixed-rate preferred stock index fell by almost 13% in value. Then in late 1998, longer-term interest rates again moved higher over the following 15 months by roughly 2.50%; during that same period, the index fell by just over 12% in value. A similar interest rate move today would likely result in significantly bigger losses for preferred investors given the much lower prevailing yield and coupon environment, which will limit the cushion that preferred investors have traditionally seen during periods of higher interest rates.

It is worth noting that the most significant period of negative price performance for preferred investors over the last 25 years was not due to higher interest rates but rather the result of a negative credit and liquidity environment. At today's low yields, and in an environment in which many investors are reaching for yield, we view an unexpected change in the credit environment as a significant risk for preferred security investors.

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Historical performance for preferred securities

BofA Merrill Lynch Fixed-Rate Preferred Index



Source: BofA Merrill Lynch Fixed Rate Preferred Index – FactSet

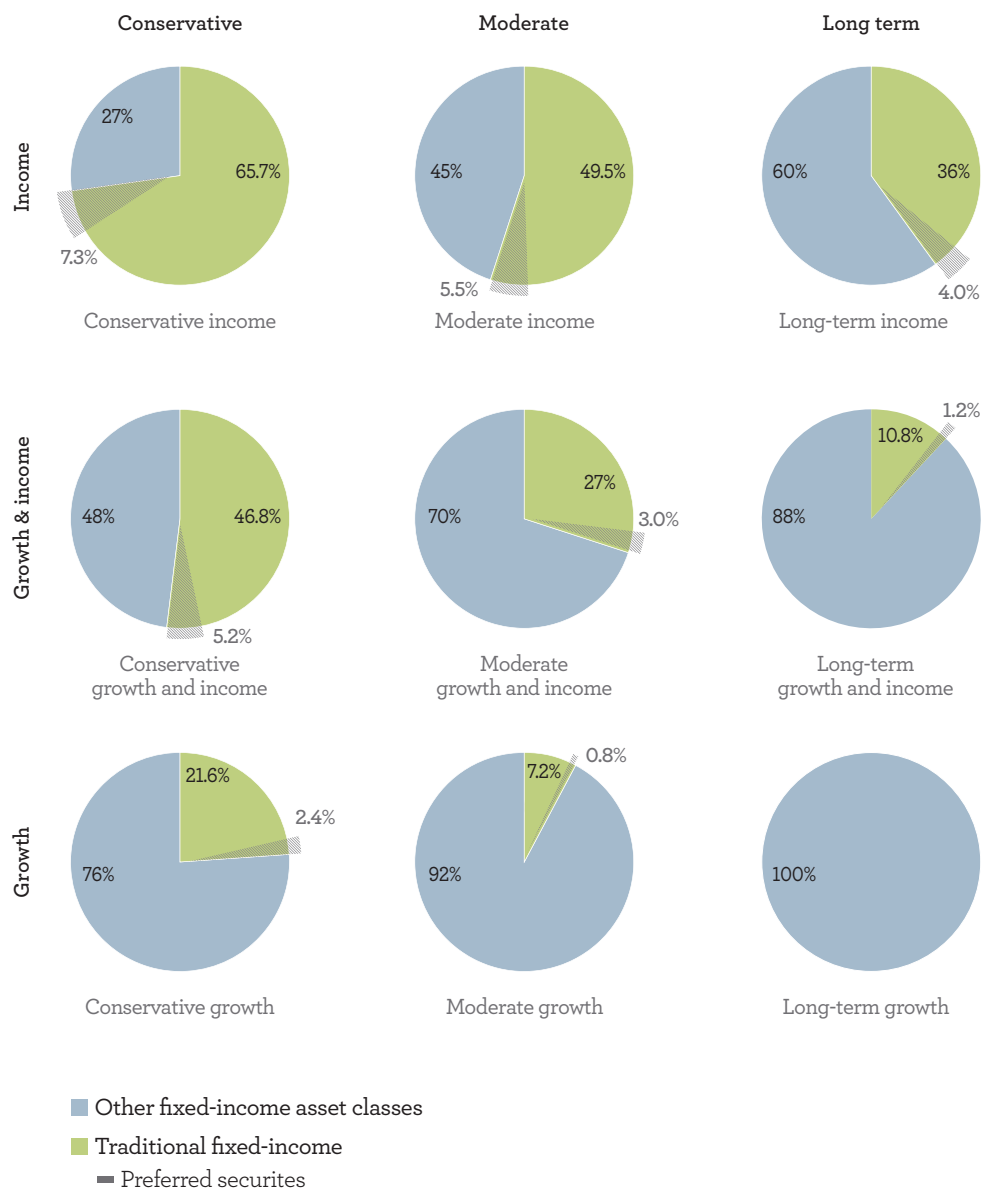
Setting the allocation of preferred securities for your portfolio

There are a number of features that investors often embrace when adding higher-yielding securities to their portfolio: longer maturities, lower credit quality, less liquidity and a loss of structural protections. Preferred securities contain most if not all of these qualities, thus offering yields that are greater than most other fixed-income investments. In some cases, investors have significantly over allocated assets to preferred securities. With prices still at or near all-time highs for many of these securities, investors who are over-allocated should take this opportunity to return to recommended allocations.

We currently recommend that 10% of a traditional fixed-income portfolio be allocated to preferred securities. Because of their high volatility, we recommend that such exposure to the preferred sector be diversified among a variety of issuers, sectors and structures. We strongly recommend that investors consider a professional manager for their preferred allocations. Managers have the resources to monitor changing market and regulatory conditions to better optimize a preferred portfolio. In addition, manager access to the \$1,000 preferred market opens up significant new pockets of liquidity and additional structures to optimize value.

Remember our 10% allocation recommendation is a percentage of our traditional fixed-income allocations. When looking at your overall portfolio, you may want to employ our 10% recommended preferred allocations within your traditional fixed-income allocation. The following chart illustrates the 10% recommended preferred allocation within the traditional fixed-income segment of our strategic asset allocation models.

Recommended fixed-income allocations based on Wells Fargo Advisors' strategic asset allocation models



For full detail on Wells Fargo Advisors' strategic asset allocation models, please ask your Financial Advisor for a copy of our "Strategic Allocation Models" report.

Improving your portfolio of preferred securities

If you are not comfortable with the potential for falling prices and are concerned about a rising-rate environment, there are actions you can take:

- Make sure you are not over-allocated to preferred securities.
- Consider selling preferred securities that are trading near par or at a discount. These securities have longer durations (more price risk) than comparably rated preferred securities that are trading at a premium.
- Diversify your holdings.
- Consider a managed solution – specifically a manager that has access to \$1,000 institutional preferreds.

In some cases, preferred securities that currently pay a fixed rate move to an adjustable rate on a future date; this often occurs on the date the security is callable by the issuer. While investors face the possibility that the security will be called before the rate begins to adjust, these types of securities also offer some level of income preservation in a rising-rate environment. In such a rising-rate scenario, investors would either receive the new adjustable rate on the call date or the security will be called at par and investors can reinvest proceeds, taking advantage of the higher prevailing interest rates. Should short-term rates decline, the dividend rate on fixed-to-floating-rate preferred securities may decline, and the issuer may leave the security outstanding. These types of fixed-to-floating rate structures are prevalent in the \$1,000 institutional preferred market. While individual investors have limited or no access to the \$1,000 preferred market, investors can gain access through the use of managers. In the current interest rate environment, we view this as a superior structure and recommend that individuals look for access through managers.

Investors with an income objective should consider diversifying into other income-producing products. Higher-yielding securities expose an investor to added risks. Diversifying your exposure to sectors such as emerging-market debt, high yield, bank loans and various dividend equity solutions may help reduce risk associated with an increase in U.S. Treasury rates. Diversification is an important part of any portfolio and asset allocation strategy.

Talk to your Financial Advisor

Fixed-income investments are, and will continue to be, an important part of most asset allocation strategies, and the asset class will likely remain an important part of your allocation strategy, even in a rising-rate environment. For investors who are unsure of just what percentage of their portfolio should be allocated to fixed-income investments, work with your Financial Advisor in employing the current Wells Fargo Advisors asset allocation models.

Income-seeking investors should consider diversifying into other income-producing products, such as emerging-market debt, high yield, bank loans and dividend equity solutions.

Important disclaimers

Investing in fixed-income securities involves certain risks, such as market risk if sold prior to maturity and credit risk, especially if investing in high yield bonds, which have lower ratings and are subject to greater volatility. All fixed-income investments may be worth less than original cost upon redemption or maturity.

Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline of the value of your investment.

There are special risks associated with investing in preferred securities. Preferred securities generally offer no voting rights with respect to the issuer. Preferred securities are generally subordinated to bonds or other debt instruments in an issuer's capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable, which may negatively impact the return of the security. Preferred dividends are not guaranteed and are subject to deferral or elimination.

Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.

An index is unmanaged and not available for direct investment.

Diversification cannot eliminate the risk of fluctuating prices and uncertain returns.

High-yield bonds, also known as junk bonds, are subject to greater risk of loss of principal and interest, including default risk, than higher-rated bonds.

Bank loans have speculative characteristics including the risk of non-payment of principal and interest. Other risks include insolvency, collateral impairment, illiquidity and the risk of bankruptcy.

Benchmark definitions

The BofA Merrill Lynch Fixed Rate Preferred index is a market capitalization-weighted index designed to reflect the total return performance of the fixed rate U.S. dollar-denominated preferred securities market.

The Barclays U.S. Aggregate Bond Index is unmanaged and is composed of the Barclays U.S. Government/Credit Index and the Barclays U.S. Mortgage-Backed Securities Index, and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities.

The Barclays U.S. Municipal Bond Index is an unmanaged index composed of long-term tax-exempt bonds with a minimum credit rating of Baa.

Investment and Insurance Products: ► NOT FDIC Insured ► NO Bank Guarantee ► MAY Lose Value

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