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PFFD – Global X U.S. Preferred ETF

GLOBAL X ETFs RESEARCH

# Divergence in U.S. Banks: Opportunities in Preferreds (Part II)

In Part I of this series, we explored the disparities between regional and the largest diversified banks, delved into concerns raised by rating agencies, examined proposed regulatory changes, and scrutinized differences in loan exposure between Global Systematically Important Banks (G-SIBs) and smaller depository institutions.

In this installment, we delve into the compelling opportunities presented by this macro landscape in preferreds issued by G-SIBs. As the primary issuers of preferred shares, we believe that the resilience of G-SIBs can make them an attractive addition to investors' portfolios. We will also investigate how G-SIBs have emerged as major players in the preferred market, how market cap-weighted preferred funds can balance exposure to the largest issuers while mitigating idiosyncratic risk and explore how the Global X U.S. Preferred ETF (PFFD) may offer a solution for investors seeking alternative income with expanded exposure to the largest banking institutions and defensive companies and industries.

## Key Takeaways

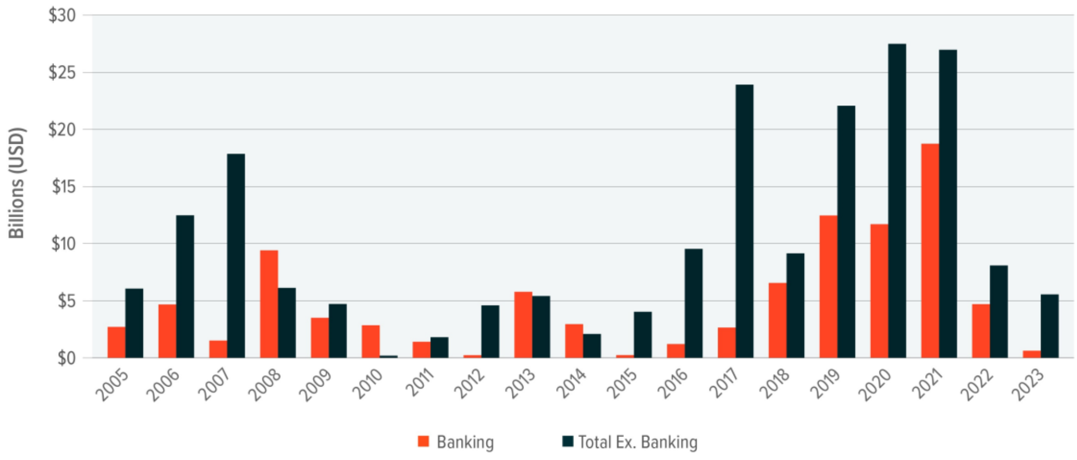
- Large banks increased preferred share issuance over a decade ago to meet capital requirements in the wake of the regulations set in motion by the global financial crisis and the declining interest rate regime. This trend has slowed materially in the current higher cost of capital environment, creating a positive backdrop for preferred shares.
- G-SIBs can offer attractive yields with low credit risk at the aggregate, but banks and preferred issuers still carry idiosyncratic risk. Market cap-weighted preferred funds provide diversified exposure to various securities while focusing on the largest issuers.
- The Global X U.S. Preferred ETF (PFFD) offers overweight exposure to G-SIBs compared to the more muted regional banking sector weight due to its market capitalization-weighted methodology. We believe that this feature, amongst others, makes PFFD an attractive investment option relative to other income-oriented asset classes.

## Largest Banks Create a Favorable Technical Backdrop for Preferreds

Banks have been the predominant issuers of preferred shares, a trend that began over a decade ago when the largest banks issued a substantial volume of preferred shares to meet heightened capital requirements. Although preferred share issuance has slowed down in the current higher cost of capital environment, as illustrated in the chart below, there was a notable surge in issuance by banks during the pandemic when interest rates were low. This slowdown in issuance since the start of current Fed hiking cycle has created a favorable technical backdrop for preferreds, helping to balance supply and demand dynamics.

## BANKS SLOWING DOWN PREFERRED ISSUANCE AS FUNDING COST RISE

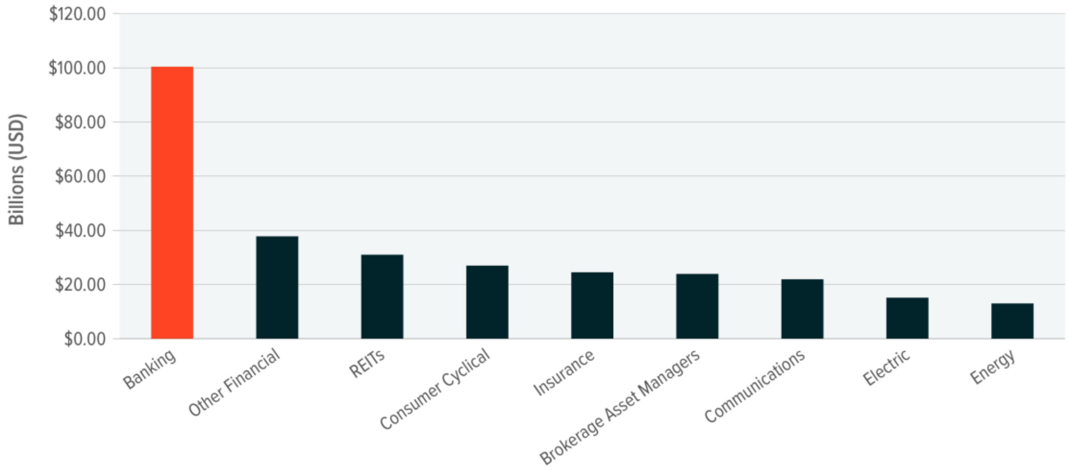
Sources: Global X ETFs with information derived from: Bloomberg, L.P. (n.d.). Data from 12/31/2005 to 9/30/2023. Preferred data encompasses the amount issued by US domiciled companies, actively traded preferred securities, and excludes agencies such as Freddy Mac and Fannie Mae.




As depicted in the graph below, banks continue to comprise the largest segment of the preferred market when considering the total amount outstanding. This holds true even considering the recent slowdown in preferred issuance by banks, which has been a strategic move to manage net interest costs.

## BANKS LEADING PREFERRED SHARE ISSUERS: TOP 10 INDUSTRIES, EXCLUDING GOVERNMENT AND QUASI-GOVERNMENT AGENCIES

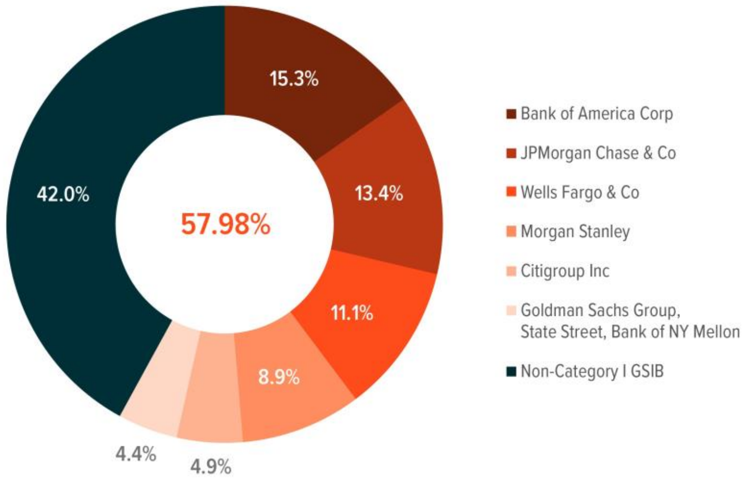
Sources: Global X ETFs with information derived from: Bloomberg, L.P. (n.d.). Data as of 9/30/2023. Preferred data comprises the amount outstanding for US domiciled companies and actively traded preferred securities, excluding government and quasi-government agencies.




Diving a layer deeper, the eight Category I G-SIBs collectively account for nearly 58% of the amount outstanding of U.S.-denominated preferred shares by banks.

## G-SIBS THE PREDOMINANT ISSUERS OF BANK PREFERREDS

Sources: Global X ETFs with information derived from: Bloomberg, L.P. (n.d.) Data as of 9/30/2023, preferred data is based on amount outstanding includes US domiciled companies and actively traded preferred securities. G-SIBs defined as category I Banks by the Federal Reserve's Annual Stress Test.




### Diversifying Across Issuers to Help Lessen Idiosyncratic Risk

As highlighted in Part I of this series, G-SIBs stand out as an attractive option, offering high yields and seemingly low credit risk. However, it's essential to acknowledge that banks and other preferred issuers carry a level of idiosyncratic risk stemming from various factors, including regulatory constraints, revenue streams, credit exposure, and duration risk. Moreover, the preferred market is somewhat opaque compared to more traditional asset classes like common equity or fixed income, with a significant portion of preferreds featuring built-in optionality, such as callable preferreds, embedded covenants, and different coupon types. Due to these considerations, market cap-weighted preferred funds emerge as an appealing vehicle to gain exposure towards a wide variety of different securities, while maintaining exposure towards the largest issuers.

### PFFD Favors G-SIBs and Large Institutions Alleviating Regional Bank Uncertainty

The Global X U.S. Preferred ETF (PFFD) offers exposure to Global Systematic Banks (G-SIBs) and other high-quality preferred issuers in a market cap weighted structure. This strategy can also mitigate idiosyncratic risk by capping issuer exposure at 10% upon rebalance and by exclusively including issuers domiciled in the United States to alleviate international risk. In addition, each preferred must be exchange traded helping to add a layer of liquidity and must have a credit rating by at least one of the three major rating agencies. The only exception being convertible preferreds, which make up a small segment of PFFD.

Diving into the credit quality of the individual preferreds within PFFD, over 60% of the 250+ preferred securities, on a weighted average, have an investment grade rating (BBB- or higher), highlighting the quality component as of 09/30/2023.[1] Preferreds typically have a credit rating 1–2 notches below the issuers' long-term credit rating, underlining the robust credit ratings of the issuers found in PFFD.[2] As illustrated in the table below, the top 10 issuers in PFFD maintain high credit ratings, reinforcing the solvency of the underlying issuers and G-SIBs such as Wells Fargo, Bank of America, JP Morgan, Morgan Stanley, Goldman Sachs and more being the key issuers in PFFD. The ETF also includes exposure to entities like AT&T and Public Storage, both of which boast investment-grade long-term credit ratings as of 09/30/2023, adding a layer of diversification outside of financials.[3]

## PFFD - TOP 10 ISSUERS: SIGNIFICANT EXPOSURE TO G-SIBS

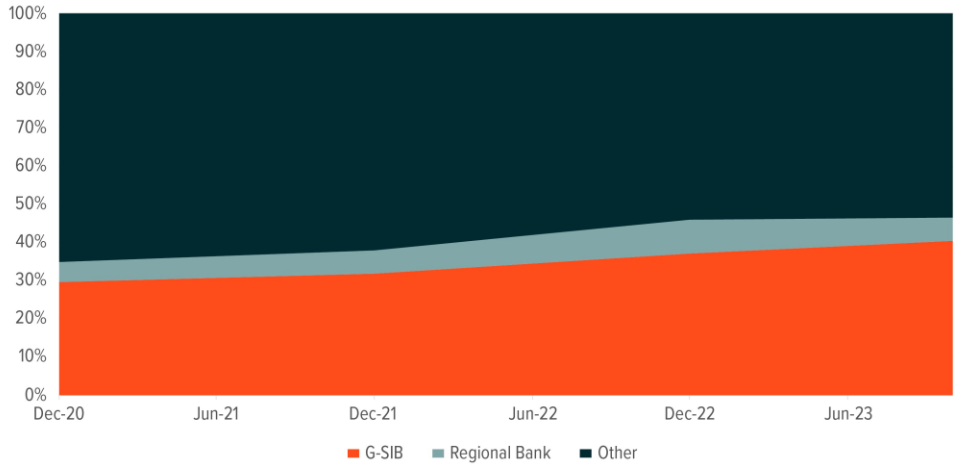
Sources: Global X ETFs with information derived from: Bloomberg, L.P. (n.d.) Data as of 9/30/2023.
Issuer Credit Rating is determined by the Bloomberg Composite Credit Rating. Holdings are subject to change.

| PFFD | Weight | Issuer Credit Rating |
|---|---|---|
| Wells Fargo & Co | 10.15% | BBB+ |
| Bank of America Corp | 9.92% | A- |
| JPMorgan Chase & Co | 7.33% | A- |
| Morgan Stanley | 6.13% | A- |
| AT&T Inc | 3.76% | BBB |
| Public Storage Operating Co | 2.85% | A |
| Goldman Sachs Group Inc/The | 2.54% | BBB+ |
| US Bancorp | 2.51% | A |
| Capital One Financial Corp | 2.40% | BBB |
| Citigroup Capital XIII | 2.27% | - |

The market cap structure of PFFD plays a pivotal role in enhancing exposure to G-SIBs, especially given the diminishing popularity of regional bank preferreds over the past year. The current allocation to regional banks is just below 5.9%, down from approximately 8.8% in December 2022. G-SIBs now constitute a substantial 40.5% of the portfolio, compared to 37.1% at the end of 2022, providing investors with opportunities to enhance their yield potential while maintaining their exposure to the largest banks in the United States.

## PFFD'S RISING EXPOSURE TOWARDS G-SIBS

Sources: Global X ETFs with information derived from: Bloomberg, L.P. (n.d.) Data from 12/31/2020 to 10/15/2023.




In addition to G-SIB exposure, PFFD offers diversified exposure to defensive sectors such as Utilities and Telecommunications. This diversification can be particularly relevant in late-cycle markets. Non-financial exposure comprises nearly 27% of the fund's weighting in aggregate.

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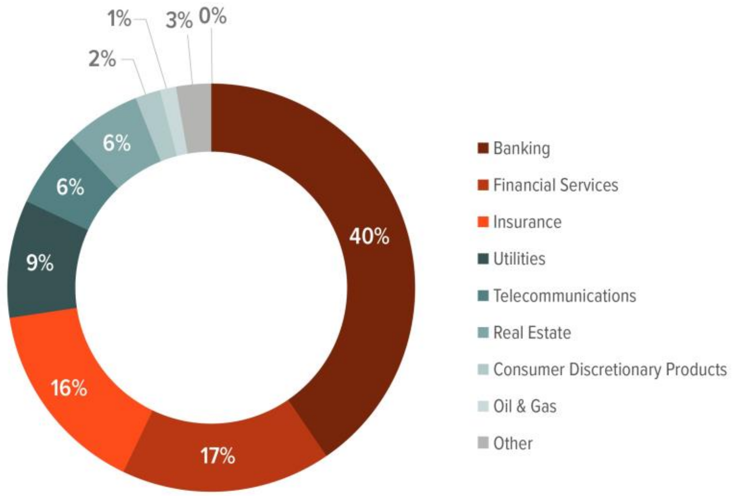
**PFFD INDUSTRY EXPOSURE**

Sources: Global X ETFs with information derived from: Bloomberg, L.P. (n.d.). Data as of 9/30//2023. Data is derived from GICS Industry data for PFFD. Holdings subject to change. Current and future holdings subject to risk




## PFFD’s Appealing Valuations on the Backdrop of Higher Rates

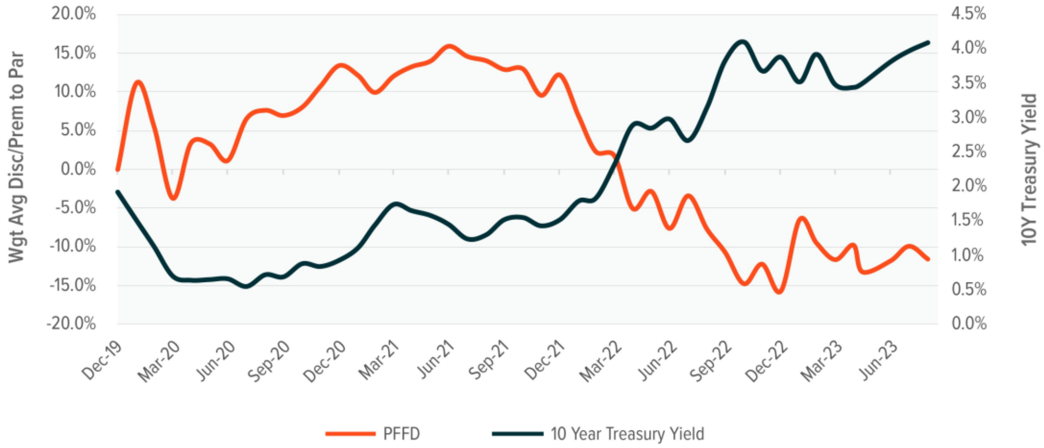
The high allocation towards investment grade securities and issuers dampened the performance of PFFD during the current rising interest rate environment that began in 2022. This phenomenon was triggered by the Federal Reserve's decision to tighten the federal funds rate, which reached a 22-year high at 5.5%, aimed at curbing inflation. As a result, the 10-year Treasury yield surpassed 4.8%, a level not seen since the Global Financial Crisis (GFC).[4] The consequences of this rising rate environment have continued to impact PFFD since the first-rate hike occurred in March 2022. PFFD's option adjusted duration (OAD) profile was measured at 5.34, as of 9/30/2023.[5]

PFFD is currently trading at a 16% weighted average discount, meaning investors have the potential to secure higher dividends while also leaving room for potential upside participation.

Furthermore, historical data provides valuable insights, suggesting that U.S. policy rates tend to remain at their peak for approximately 7 months on average.[6] Considering the possibility of rates declining sooner than anticipated, preferred securities may present a promising opportunity to capitalize on falling rates compared to other income investment strategies.

## PFFD - PREFERREDS WEIGHTED AVERAGE DISCOUNT/PREMIUM TO PAR

Sources: Global X ETFs with information derived from: Bloomberg, L.P. (n.d.). Data as of 9/30//2023.
Data is based on the difference between the market price and par value.



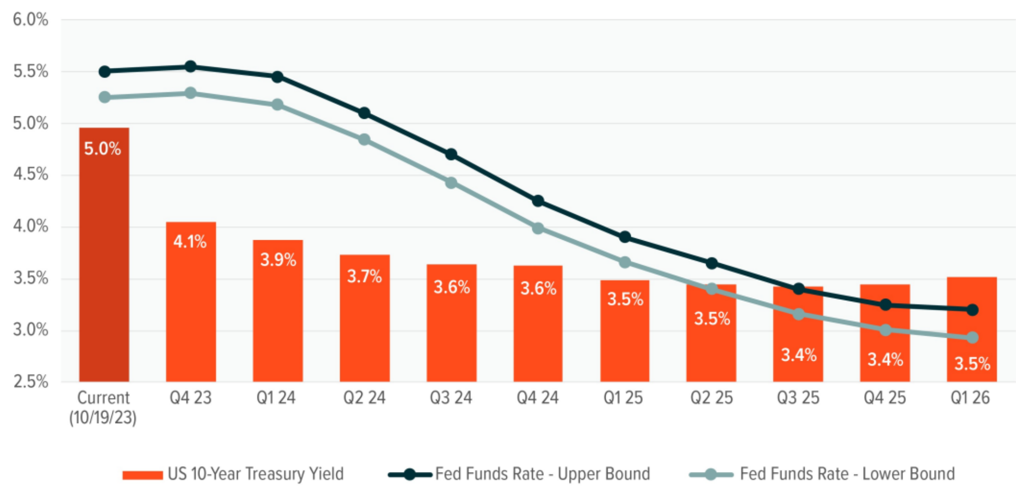

**Data presented represents past performance. Past performance is no guarantee future results.**

### Navigating Shifting Market Dynamics: PFFD's Duration Advantage

The transformation of PFFD's duration profile, potentially transitioning from a headwind to a tailwind, is further corroborated by the expectations within the Federal Funds Futures market and the outlook for bond yields across the yield curve. A closer examination of the Federal Funds Futures Market in the near term reveals that markets presently assign a mere 18.6% probability to an additional 25 basis point rate hike in November, with a 39% chance for December, based on data as of September 30th.[7] Notably, market sentiment already incorporates expectations of rate cuts for the years 2024 and 2025. Furthermore, this sentiment is underscored by the anticipation of declining bond yields across the entire yield curve, encompassed from the policy rate to the long end, as typified by the 10-year Treasury.

## POLICY AND LONG-TERM RATES ANTICIPATING FALLING DURATION RISK

Sources: Global X ETFs with information derived from: Bloomberg, L.P. (n.d.). Data as of 10/19/2023. Data beyond 10/19/2023 "Current" is forecasted and based on estimates derived from the Bloomberg Terminal with estimates based on data as of 10/19/2023.

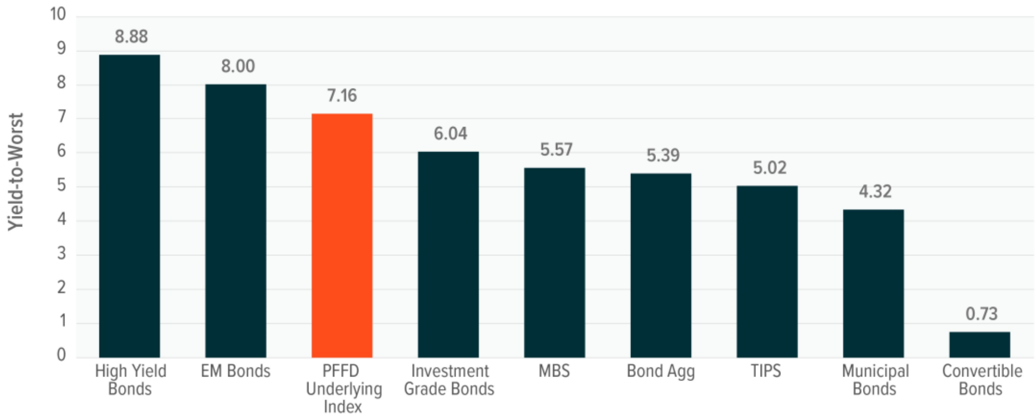


## Enhancing Yields with PFFD: Exploring Yield-to-Worst and Strategic Diversification

Beyond the potential advantages linked to this anticipated shift in market conditions, PFFD underlying index also boasts a robust Yield-to-Worst (YTW). This metric represents the lowest yield that a bond or preferred holder may receive, assuming all early retirement provisions are exercised by the issuer. The graph below illustrates that PFFD's YTW closely trails high-yield bonds, signifying a competitive yield profile. Additionally, PFFD positions itself favorably by concentrating on high-quality constituents, as indicated by the proportion of holdings with investment-grade status measured by the Bloomberg composite Rating scale as of 09/30/2023 and the augmented exposure to G-SIBs (Global Systemically Important Banks).

**PREFERREDS ROBUST YIELD-TO-WORST AGAINST FIXED INCOME ASSET CLASSES**

Source: Bloomberg as of 9/30/2023. Asset class representations are as follows Mortgage-Backed Securities, Bloomberg US MBS Index; Municipal Bonds, Bloomberg Municipal Bond Index; US Aggregate Bonds, Bloomberg US Aggregate Bond Index; Emerging Market Bonds, Bloomberg EM USD Aggregate Total Return Index; TIPS, Bloomberg US Treasury Inflation Notes TR Index; Investment Grade Bonds, Bloomberg US Corporate Total Return Index; Convertible Bonds, Bloomberg US Convertibles Composite TR Index; Bond Agg, Bloomberg US Aggregate Bond Index; PFFD Underlying Index, ICE BofA Diversified Core U.S. Preferred Securities Index; High Yield Bonds, Bloomberg US Corporate High Yield TR Index.




## Conclusion: Preferreds Can Be a Resilient Income Source

PFFD's strategic approach not only provides opportunities for diversification but also serves to mitigate uncertainties associated with regional banks. The enduring appeal of G-SIB preferreds stems from the robust balance sheets of these institutions, bolstered by stringent regulations implemented post the Great Financial Crisis (GFC). Moreover, with rates across the treasury curve reaching decade-high levels, the valuations present an enticing entry point. Given PFFD's exposure to G-SIBs and defensive sectors, it stands as an appealing alternative income source. Whether in a stable or falling rate environment, PFFD's potential for yield and strategic diversification can empower investors to navigate evolving market dynamics while seeking resilient income streams.

### Footnotes

1. Global X analysis with information derived from: Bloomberg L.P. (n.d.) {Data set}. Credit quality of PFFD's holdings are measured by the Bloomberg Composite Rating and measured as of 09/30/2023
2. CFI. (2023, January 18). What is Notching. Corporate Finance Institute. (Original publication date: June 30, 2020).
3. Global X analysis with information derived from: Bloomberg L.P. (n.d.) {Data set}. AT&T and Public Storage Investment Grade rating is derived from the Bloomberg Compsite Rating and measured as of as of 09/30/2023.

4. Global X analysis with information derived from: Bloomberg L.P. (n.d.) {Data set}. Effective duration is measured as of 04/30/2023.
5. Global X analysis with information derived from: Bloomberg L.P. (n.d.) {Data set}. Measures the callable bonds within PFFD and taking the weighted average of the callable date from 9/30/2023.
6. Sourced from Bloomberg, this data is measured from 12/31/1969 to 09/30/2023. It utilizes the Federal Funds Target Rate – Upper Bound Index from the trough to peak and peak to trough, while calculating the average since 1969.
7. Sourced from Bloomberg, this data is compiled from the World Interest Rate Probability Function as of 9/30/2023.

## Glossary

**Duration:** A measure of a bond's price sensitivity to changes in interest rates. In general, the higher the duration, the more a bond's price will drop as interest rates rise (and the greater the interest rate risk).

**Option Adjusted Duration (OAD):** Is a metric that gauges how sensitive a bond's price is to interest rate changes while factoring in embedded options like call or put options.

**G-SIBs (Global Systemically Important Banks):** are financial institutions that have a significant impact on the global financial system due to their size, complexity, and interconnectedness. They are subject to stricter regulation and supervision to mitigate the risks they pose to the overall stability of the financial system.

**Diversified Banks:** Financial institutions that offer a wide range of banking services and products to both retail and commercial customers. They have diversified operations and business lines, providing services such as savings and checking accounts, loans, mortgages, credit cards, investment banking, wealth management, and insurance products.

**Regional Banks:** Financial institutions that operate in a specific geographic region or a limited number of states. They provide banking services to local communities and businesses, offering products such as deposits, loans, and mortgages. Regional banks serve as important sources of credit and financial support for small and medium-sized enterprises (MSEs) and individuals in their respective regions.

**ICE BofA Diversified Core US Preferred Securities Index:** tracks the performance of exchange-listed U.S. dollar denominated preferred stock and convertible preferred stock publicly issued by corporations in the U.S. domestic market.

**S&P 500:** S&P 500 Index tracks the performance of 500 leading U.S. stocks and captures approximately 80% coverage of available U.S. market capitalization. It is widely regarded as the best single gauge of large-cap U.S. equities.

**Uninsured deposits:** refer to the portion of a depositor's funds held in a bank that exceeds the maximum limit covered by deposit insurance. In the United States, the Federal Deposit Insurance Corporation (FDIC) provides deposit insurance coverage for eligible deposits up to $250,000 per depositor, per insured bank.

**Federal Funds Futures**: derivatives contracts based in which the underlying asset is the Federal Funds Rate

**Market Cap Weighted:** The index constiuetns are weighted according to the total market cap or market value of their available outstanding shares.

**Callable:** Callable or redeemable debt are debt issues that the issuer can redeem before the maturity date. When this happens, the issuer pays investors the call price (typically the face value of the bonds) along with accrued interest up to that point and ceases further interest payments.

**Covenants:** covenants are terms and conditions specified in financial contracts, such as preferred stock agreements or bonds. These provisions outline rights, obligations, and protective measures for both the issuer and investors, covering aspects like dividends, voting, and redemptions. They establish the framework for the issuer-investor relationship, ensuring compliance with agreed-upon terms.

**Coupon Type**: Preferred Coupon Type specifies how the dividend or interest rate on preferred stock or bonds is determined, whether it's fixed, floating, or adjustable based on factors like reference rates or market conditions. It clarifies the method for calculating investor income payments.

**Convertible Preferred:** Is a type of preferred stock that allows holders to convert their shares into common shares of the company at a predetermined rate. This feature provides flexibility, allowing investors to switch from fixed dividends to the potential for capital appreciation. It combines features of both preferred and common stock.

**Bloomberg Composite Rating:** Is a blend of a security's Moody's, S&P Global, Fitch and DBRS ratings. The rating agencies are evenly weighted when calculating the composite. It is calculated by taking the average of the existing ratings, rounded down to the lower rating in case the composite is between two ratings.

**Discount or Premium to Par:** Refers to the difference between the current market price of a bond and its par value. When a bond is trading at a price lower than its par value, it is said to be trading at a "discount to par." Conversely, when a bond is trading at a price higher than its par value, it is said to be trading at a "premium to par."

**Yield Curve:** A Yield Curve is a graphical representation that shows the yields or interest rates on a series of fixed-income securities, typically bonds, plotted against their respective maturities. The yield curve provides a snapshot of the current relationship between short-term and long-term interest rates.

**Basis Point:** A basis point, abbreviated as "bps," is a unit of measurement equal to 0.01% or 1/100th of a percentage point and is commonly used in finance to describe small changes in interest rates, yields, or spreads.

**Yield to Worst (YTW):** Is a financial metric that calculates the lowest potential yield from a bond or investment, considering factors like early call options and bond maturities. It helps investors assess the minimum possible return on their investment.

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