

PREFERRED SHARES AND HYBRID CAPITAL

ASSET CLASS PRIMER



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FOUNDER - TREVOR MONTANO, CFA

Deep financial services sector expertise is necessary to effectively navigate the risks and opportunities in preferred and hybrid capital securities. Trevor has 20 years of experience investing in, raising capital for and advising financial institutions.



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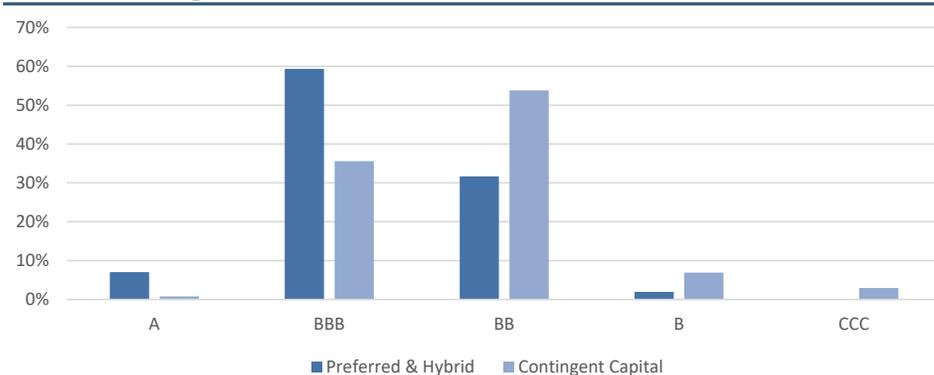
- Partner & Managing Director, Moelis & Company
 - Provided strategic and financial advice to financial institutions including banks, specialty finance and fintech companies
 - Chief Investment Officer, U.S. Department of the Treasury
 - Actively managed Troubled Asset Relief Program (TARP) investments in financial institutions, ~\$5bn in investments in ~100 institutions, majority in preferred and hybrid capital securities
 - Served on over 10 U.S. Bank Boards of Directors and the U.S Treasury Federal Financing Bank (FFB) credit committee
 - Citigroup & UBS Investment Bank financial institutions investment banker
 - M&A origination and execution, capital raising and debt underwriting
 - Structured, underwrote and distributed preferred and hybrid securities
 - Completed more than 30 strategic M&A and capital transactions for financial institutions valued at over \$35bn
 - Columbia Business School M.B.A., Chartered Financial Analyst and CFA Society of Washington D.C. Board Member, Member Economic Club of Washington D.C.
 - Member of Board of Trustees and Chair of the investment committee at George Mason University Foundation (\$300mm)
- ✓ Financial institution bottom-up analysis
 - ✓ Preferred and hybrid capital security portfolio management
 - ✓ Board of Directors and investment and credit committee experience
 - ✓ Structured, underwrote and distributed preferred and hybrid capital securities
 - ✓ Trusted strategic financial institution advisor
 - ✓ Deep regulatory expertise

TRILLION-DOLLAR ADDRESSABLE MARKET

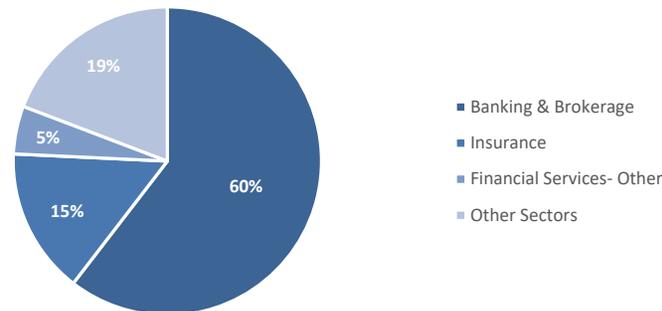
Preferred and hybrid capital securities are a commonly overlooked trillion-dollar asset class, best defined as an investment grade fixed income credit product with certain equity like characteristics

- The preferred and hybrid capital market is estimated at \$1.1T across currencies, continents and industries
- USD denominated securities estimated at \$700bn, with ~\$550bn index eligible
- Approximately 80% of USD securities trade over-the-counter (institutional \$1,000 par) with the remainder exchange traded (retail \$25 par)
- Majority of securities (by dollar value) are investment grade
- Banking, brokerage & insurance company securities comprise ~75% of outstanding USD index eligible securities

Credit Rating Distribution



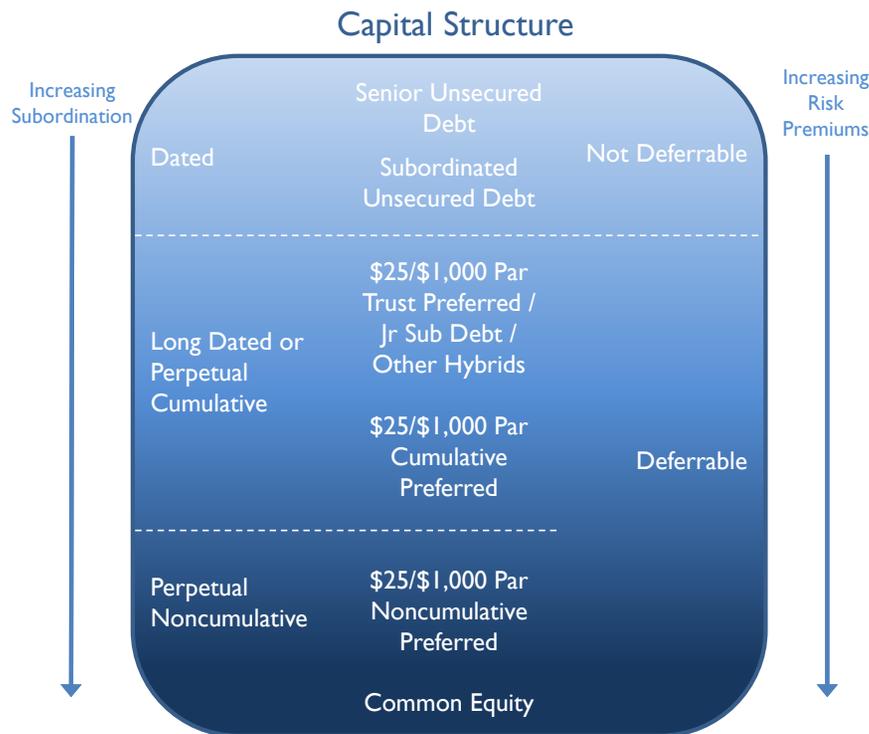
Industry Breakdown



Source: ICE BofAML indices and preferred research, market data as of June 30, 2021

PREFERRED AND HYBRID SECURITY OVERVIEW

Preferred and hybrid capital securities are a commonly overlooked trillion-dollar asset class, best defined as a fixed income credit product with certain equity like characteristics.



“Debt/Credit” Like Features

Scheduled periodic coupon/dividend payments

- Quarterly or semi-annual payments

Stated legal par/liquidation value

Credit ratings

- Generally rated by a combination of S&P, Moody's, Fitch and Kroll Bond Rating Agency(KBRA)

“Equity” Like Features

Permanence of capital

- Long dated maturities or perpetual

Loss absorption

- Lower in capital structure, subordinated creditor claim

Coupon/dividend discretion

- Flexibility in paying coupons/dividends without defaulting
- Cumulative interest/dividends accumulate while issuer defers payments
- Noncumulative interest/dividends do not accumulate

CAPITAL SECURITIES COMPARISON

Features	Senior Unsecured Debt	Subordinated Unsecured Debt	Trust Preferred & other Hybrids	Traditional Preferred Stock	Common Stock
Character	Debt	Debt	Debt	Equity	Equity
Priority of claims					
Nature of payment	Interest	Interest	Interest	Dividend	Dividend
U.S. Tax treatment	Fully Taxable	Fully Taxable	Typically Fully Taxable	Tax Advantaged DRD/QDI	Tax Advantaged DRD/QDI
Term	2-30 years	10-40 years	Typically 30-60 years	Typically perpetual	Perpetual
Payment deferral option	None	Typically, none	Yes, typically 5-10 years	Yes, typically indefinite	Yes, indefinite
Cumulative / noncumulative	N/A	N/A	Typically cumulative	Mostly noncumulative	Noncumulative
Typical ratings notching (vs LT issuer rating)	= LT issuer rating	↓ 1-2 notches	↓ 2-4 notches	↓ 3-4 notches	N/A

KEY STRUCTURAL CONSIDERATIONS

Key Structural Considerations

Coupon types

- Fixed-for-life coupons/dividends
- Fixed-to-floating rate securities adjust periodically based on a specified index after a 5-10-year fixed rate period

Call Options

- Most securities have an issuer call option, 5-10 years from issuance
- Par call typically shortens effective duration

Extension risk

- Risk that a security is not called on its first call date, varies based on coupon type

Security Rate Structure Examples

Fixed-for-life: Retail (exchange-traded) fixed rate; 7.0% dividend/interest rate, callable in 2025 at par

Issued 2020
non-call 5yrs

Callable
2025

Effective duration: 3.7

Fixed-to-floating rate: Institutional (OTC-traded) fixed-to-floating rate; 7.0% dividend/interest rate, callable in 2025 at par, SOFR + 685bps thereafter

Issued 2020
non-call 5yrs

Callable
2025

Effective duration: 3.2

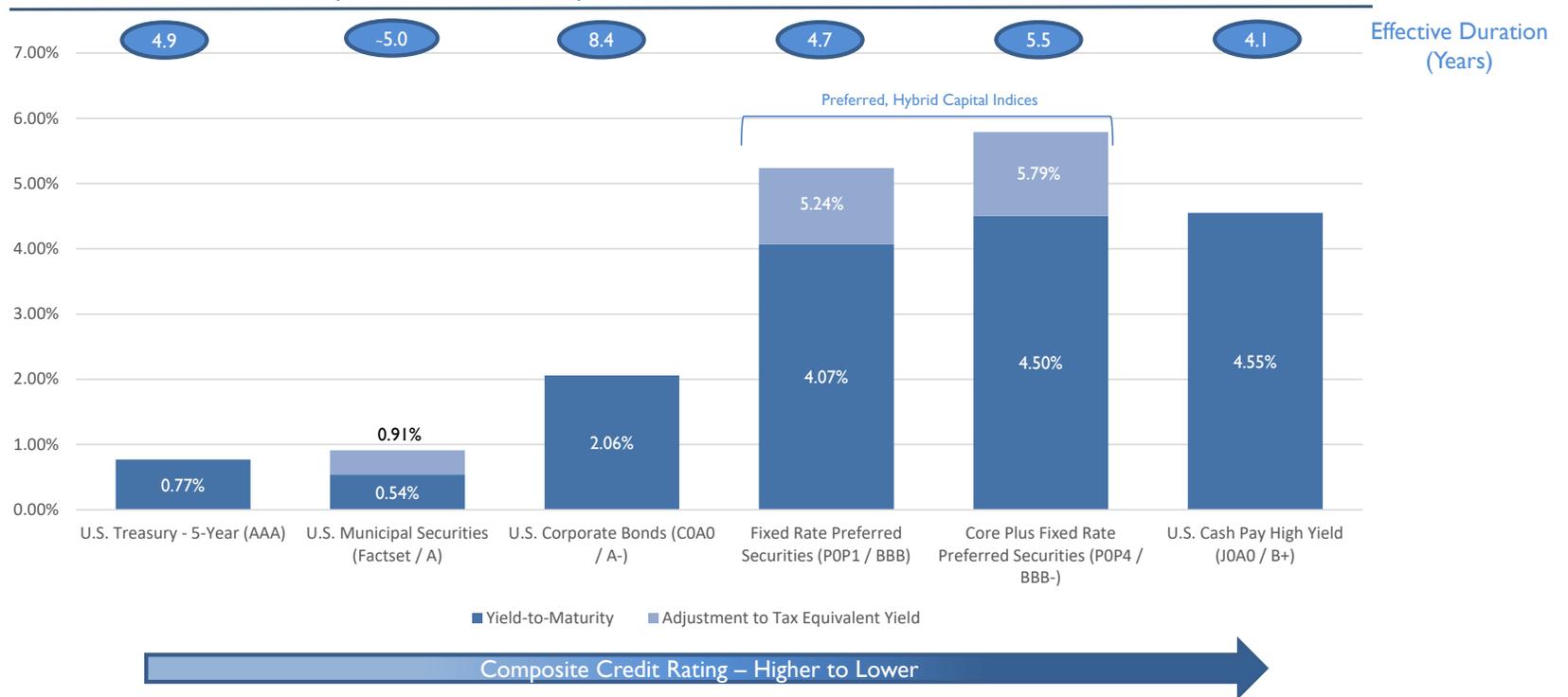
Floating rate: Institutional (OTC-traded) coupon LIBOR + 579bps dividend/interest rate, resets quarterly, currently callable at par

Effective duration: 0.2

ATTRACTIVE RELATIVE FIXED INCOME YIELDS

Preferred and hybrid capital securities have higher full tax equivalent yields relative to other popular fixed income asset classes

Fixed Income Yield Comparison, Full Tax Equivalent Yield¹



Source: FactSet, ICE BofAML indices as of August 31, 2021

¹ Indices with securities typically a) subject to ordinary income tax, no adjustment, b) subject to qualified dividend income tax, grossed up assuming top capital gains tax rate of 23.8% and c) non-taxable, yields grossed up by top individual tax rate of 40.8%. U.S. Municipal Securities yield is FactSet calculated benchmark yield not YTM.

FOR DISCUSSION PURPOSES ONLY

PREFERRED SECURITIES U.S. TAX CONSIDERATIONS

Perpetual preferred security distributions are typically taxed at advantageous capital gains tax rates for individual U.S. investors and C corporations typically receive a dividend received deduction, enhancing after tax returns

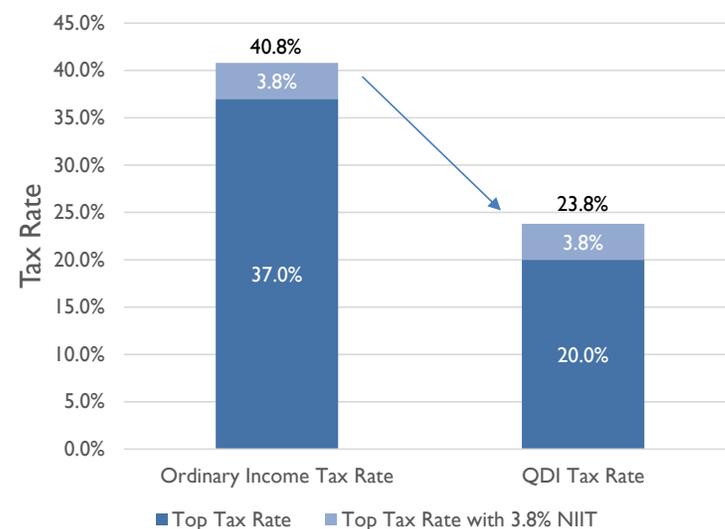
Individuals: Qualified Dividend Income (QDI)

Distributions on most preferred securities are treated as QDI, taxed at a top tax rate of 20%, versus 37% for interest income (plus a 3.8% Net Investment Income Tax “NIIT”).

Corporations: Dividend Received Deduction (DRD)

Corporate investors in the U.S. may garner tax benefits on preferred securities investments. Dividends issued directly from one tax-paying C corporation to another are generally eligible for the Dividends Received (tax) Deduction. The extent of the DRD depends on the ownership stake, with a minimum of a 50% deduction and a maximum of 100%.

Individual Tax Rates Compared



RELATIVE EXPOSURE COMPARISON

	Passive ETFs	Actively Managed ETFs	Open End Mutual Funds	Closed End Mutual Funds
Management Fee (Net Assets)	~40-60bps	~85bps	70bps+ (excl sales charges)	~100-175bps
Performance Allocation (Annual)	No	No	No	No
Leverage	✘	✘	✘	up to 0.5x
Actively Managed	✘	✔	✔	✔
Typical Diversification	100-500 positions	100-300 positions	200-300 positions	100-300 positions
Liquidity	Daily (Exchange)	Daily (Exchange)	Daily (Fund at NAV)	Daily (Exchange)