

REPORT:

# Why Preferred Equities Make Sense in the Current Market Environment



# What Are Preferred Equities?

Nearly all investors are familiar with common stocks. But far fewer understand the concept of and advantages associated with preferred equity investments.

Often referred to as a hybrid asset class, preferred stocks have both debt-like and equity-like properties (Bratton and Wachter, 2012). Like fixed income instruments, they pay distributions at regular intervals. These distributions are paid at a rate that is pegged to the preferred stock's par value. For example, an investor who purchases 1000 preferred shares that pay a 5% annual dividend on a par value of \$100 USD per share will receive \$1250 USD per quarter. Some preferred stocks have a maturity date that expires after a certain amount of time (usually 30 years), whereas others are perpetual in duration (Benham, 2011). The yields on preferred shares are generally higher than yields on both the bonds and common stocks issued by the same company (Bajaj et al., 2005).

In turbulent economic environments, companies may be forced to suspend preferred dividend payments, but it's worth noting that preferred shareholders have legal precedence over common shareholders when it comes to those payments (Alver, 2007). It's also rare for companies with strong track records of making consistent payouts to shareholders to suddenly stop—even during a recession. If a company does decide to take this step, distributions to common shareholders must be cut first. When the company decides to resume paying dividends, preferred stockholders must receive all of the missed payments before any new payments can be made to common shareholders. It's also of note that missed dividend payments will accumulate on cumulative preferred shares, but not non-cumulative preferred shares.

Like common stocks, preferred equity confers an ownership stake in the company issuing shares. This ownership stake does not entitle preferred shareholders to the residual profits that are claimed by common shareholders, but it does give them priority over common stock owners in cases of bankruptcy.

**Figure 1** compares the properties of preferred equity to those of common stocks and bonds.

<b>Attribute</b>	<b>Common Stocks</b>	<b>Bonds</b>	<b>Preferred Stocks</b>
<b>Current Yield</b>	1.37% (S&P 500 Dividends)	3.10% (10Y Treasury)	5.84% (ZECF+ Preferred Equity)
<b>Maturity</b>	Perpetual	Generally 0-30 Years	Generally 30+ Years or Perpetual
<b>Shareholders Entitled to Residual Profits?</b>	Yes	No	No
<b>Voting Rights?</b>	Yes	No	No
<b>Regular Payments Pegged to Par Value and Interest Rate?</b>	No	Yes	Yes
<b>Can Distributions be Missed Without Default?</b>	Yes	No	Yes (Must be Paid Before Common Dividends Resume)
<b>Historic Yield Compared to Other Instruments</b>	Lower than Bonds and Preferreds	Higher than Common Stock, Lower than Preferreds	Higher than Bonds and Common Stocks
<b>Priority in Bankruptcy</b>	Lowest	Highest	Middle
<b>Are Missed Payments Cumulative?</b>	No	No	Sometimes (If preferred share is cumulative)
<b>Level of Price Stability</b>	Low	Relatively High	Relatively High
<b>Interest Rate Risk</b>	Low	High	Medium

**Figure 1:** Comparing the Properties of Preferred Stocks to Common Stocks and Bonds

The majority of preferred shares are issued by financial and insurance companies, and thus most preferred equity funds and portfolios are primarily composed of offerings from this sector. This is due to the fact that financial institutions tend to feature capital structures that can support frequent dividend distributions, whereas non-financial companies generally lack the fiscal infrastructure needed to support preferred equity financing.

# Who Should Consider Owning Preferred Equity in the Current Economic Environment?

In the wake of the coronavirus pandemic, prices have been rising across domestic and international markets. June's CPI index jumped by 9.1% year over year, with core inflation rising more than 6%. And despite rapidly spiking prices on goods ranging from food to used cars, asset prices have declined. For example, as of mid-July, the S&P 500 Index and Dow Jones Industrial Average are down 18.19% and 13.76% respectively. Alternative asset classes like cryptocurrencies and private equity have also posted negative returns on the year.

Given the combination of soaring prices and declining financial instrument values, many investors are being forced to liquidate assets to maintain their quality of life. However, such investors may benefit from reallocating rather than liquidating their holdings. These investors, especially retirees and others who need consistent cash flow, could reduce the burden associated with higher living costs by gaining exposure to high-yield investment opportunities.

Since bonds and other instruments that traditionally provide reliable income streams are currently yielding negative real returns, individuals seeking high-yield opportunities may need to consider alternative asset classes like preferred equity. On average, preferred shares yield between 5 and 8 percent per year, and although there is a risk of some companies reducing or suspending dividends during a recession, certain preferred shares (i.e. from companies that have paid consistent dividends for decades) offer consistent cash flow that does not appear to be at risk in the near future.

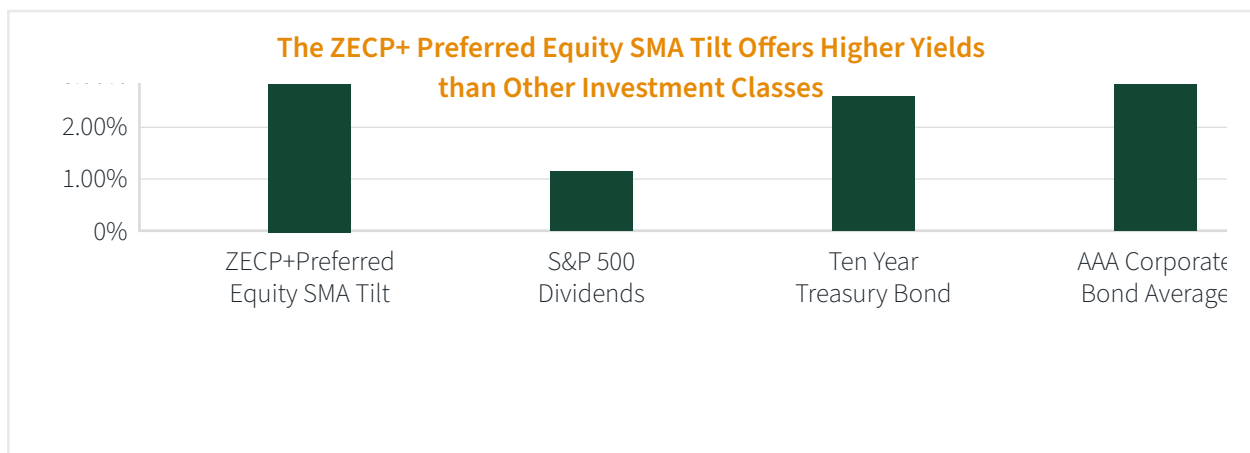
# What Is the Zacks ZECP+ Preferred Equity SMA?

The Zacks Earnings Consistent Portfolio (ZECP) is an ETF that is composed of companies with sustained track records of generating steady earnings. These companies are diversified across a variety of sectors, and each business in the portfolio has a wide moat that provides a competitive advantage over peers. Companies with wide moats are more equipped to withstand financial shocks and deliver solid returns when competitors are slashing forward guidance on earnings.

In addition to the flagship ETF, Zacks' ZECP+ suite offers custom asset allocations using satellite portfolios that are accessible, portable, and inexpensive for all investors. ZECP+ allows clients to own both the ZECP ETF and one or more tilt portfolios in separately managed accounts (SMAs). Each SMA tilt portfolio is built on a specific asset class or investment theme. For example, the Preferred Equity SMA Tilt aims to provide current income that is minimally correlated with the performance of broad stock indices.

Each ZECP+ SMA is carefully constructed and monitored by a member of the investment committee at Zacks Investment Management. Financial advisors and their clients can select multiple tilts to complement their ZECP holdings at no additional cost, and they can defer to the Zacks team when it comes to selecting the appropriate combination. Zacks will allocate capital based upon the individualized needs and goals of each client.

The Preferred Equity SMA tilt is composed of approximately 40 holdings that provide an average weighted yield of 5.84%. **Figure 2** shows that the yield on the Preferred Equity SMA is substantially larger than that of other financial instruments. Combined with ZECP, the Preferred Equity SMA tilt can help your clients generate current income that can ease inflationary pains, and, most importantly, this income can be generated without having to liquidate assets.

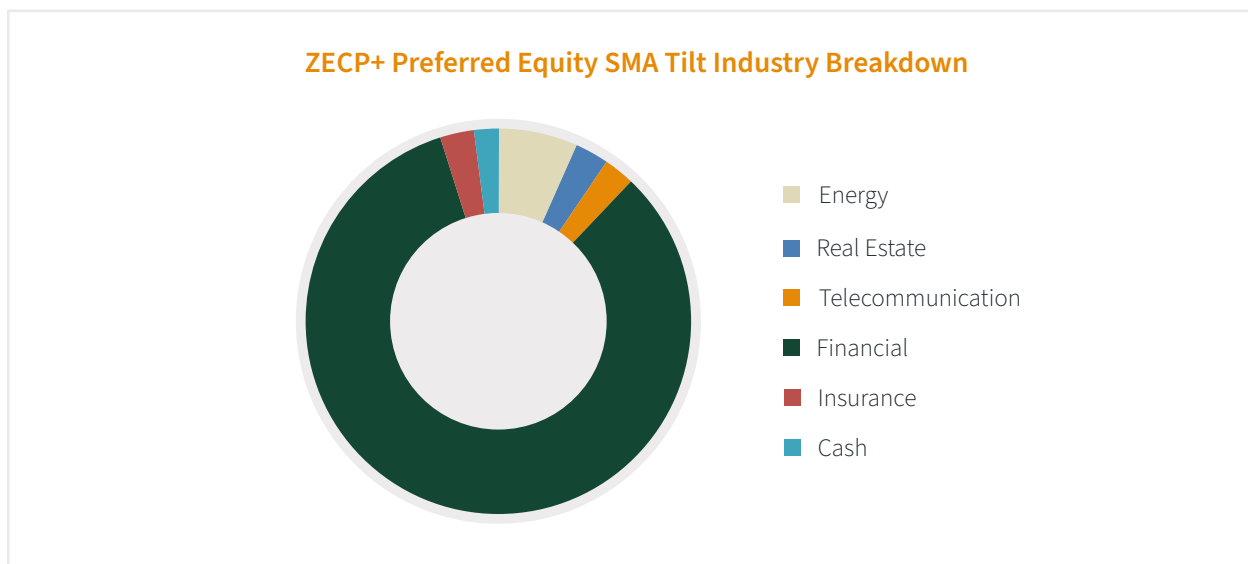


**Figure 2:** The ZECP+ Preferred Equity SMA Tilt Generates Higher Yields than Traditional Asset Classes

# The ZECP+ Preferred Equity SMA Tilt Provides a Diversified Portfolio of Current Income Streams

By allocating capital to the ZECP+ Preferred Equity SMA Tilt, investors not only gain exposure to companies with track records of producing consistent earnings, but they also get to hold preferred shares in companies that will distribute high levels of consistent income.

The portfolio has also been constructed with a low correlation to broad equity indices, with a combination of approximately 40 preferred equity holdings in real estate, financial, insurance, telecommunication and energy companies. As is the case for most preferred share portfolios the majority of holdings in the ZECP+ Preferred Equity SMA Tilt are offerings from the financial sector. Despite this concentration, the portfolio is still able to achieve diversified capital allocation through both inter- and intra-sector diversification. **Figure 3** shows the relative breakdown of holdings by industry.

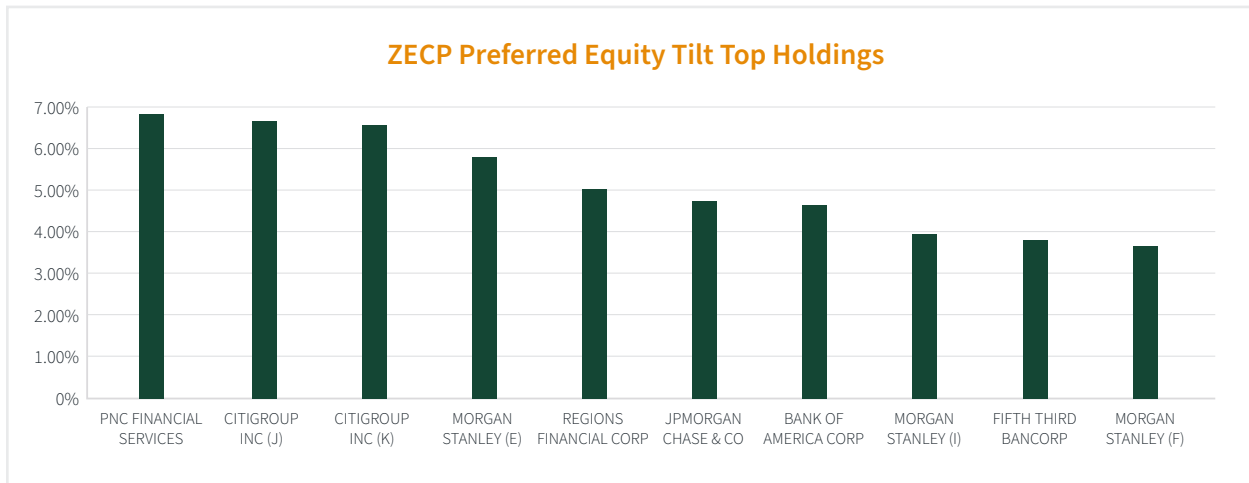


**Figure 3:** Shares in the ZECP+ Preferred Equity SMA Tilt are Diversified Across a Variety of Industries and Sectors Within Those Industries.

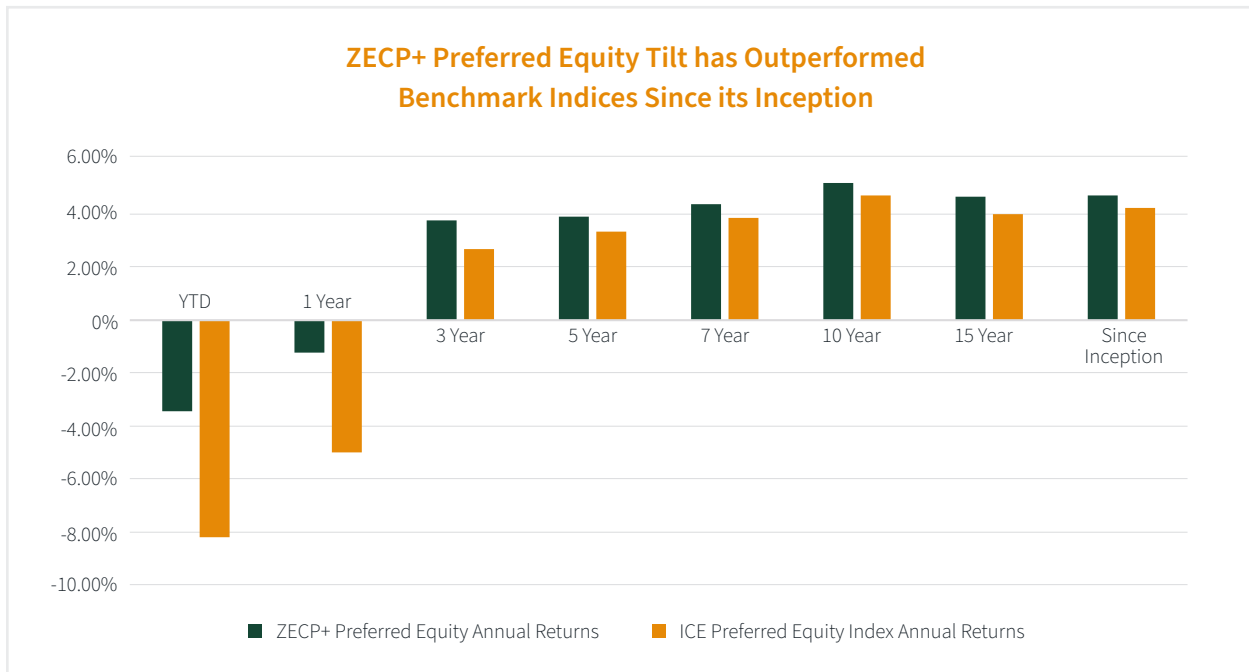
The top holdings in the ZECP+ Preferred Equity Tilt are shown in **Figure 4**. Within each industry group, a credit rating screen and distribution consistency rating are used to identify the most attractive constituents. After the initial selection process, holdings are optimized to minimize risk relative to a benchmark indicator, and the investment committee is constantly adjusting the portfolio so that holdings reflect all available real-time market data.

Notably, the ZEC+ Preferred Equity SMA Tilt has consistently outperformed preferred equity indices. **Figure 5** illustrates the performance of the SMA tilt versus the ICE E-L F&A Preferred Equity Index.

Zacks believes that this preferred equity vehicle will continue to help investors to generate reliable income during turbulent economic periods. Advisors who would like to learn more about ZEC+ can find a more detailed fact sheet below. They can also contact one of the representatives at Zacks Investment Management.



**Figure 4:** Top Holdings Within the ZEC+ Preferred Equity SMA Tilt Consists of High-Quality Financial Companies



**Figure 5:** The ZEC+ Preferred Equity SMA Tilt Has Consistently Outperformed Benchmark Preferred Equity Indices

**References**

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## Disclosure

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**The Fund's investment objectives, risks, charges, and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company and can be found at [www.zacksetfs.com](http://www.zacksetfs.com). Please read carefully before investing. A hard copy of the prospectuses can also be requested by calling 855-813-3507.**

Investing involves risk. Principal loss is possible. As an ETF, the funds may trade at a premium or discount to NAV. Shares of any ETF are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Transactions in shares of ETFs will result in brokerage commissions, which will reduce returns. The Fund is subject to management risk because it is an actively managed portfolio. The Advisor's judgments about the attractiveness, value, and stability of particular stocks in which the Fund invests may prove to be incorrect, and there is no guarantee that the Advisor's judgment will produce the desired results. Equity securities are subject to changes in value, and their values may be more volatile than those of other asset classes. Stocks of large companies as a group can fall out of favor with the market, causing the Fund to underperform investments that have a greater focus on mid-cap or small-cap stocks. Larger, more established companies may be slow to respond to challenges and may grow more slowly than smaller companies. Investments selected using quantitative methods may perform differently from the market as a whole.

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