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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Mitigating Risk When Investing in Preferred Securities

L. PHILLIP JACOBY IV is Executive Director and Chief Investment Officer at Spectrum Asset Management, Inc. He joined Spectrum in 1995 as a Portfolio Manager, and most recently held the position of Managing Director and Senior Portfolio Manager until his appointment as CIO in January 2010, after the planned retirement of his predecessor. Before joining Spectrum, Mr. Jacoby was a Senior Investment Officer at USL Capital Corporation, a subsidiary of Ford Motor Company, and Co-Manager of the preferred stock portfolio of its U.S. corporate financing division for six years. He began his career in 1981 with The Northern Trust Company, Chicago, and then moved to Los Angeles to join E.F. Hutton & Co. as a Vice President and Institutional Salesman, Generalist, Fixed Income Sales, through most of the 1980s. Mr. Jacoby holds a B.S./B.A. in finance from the Boston University School of Management.

SECTOR — GENERAL INVESTING

TWST: Please give us a brief background on Spectrum Asset Management and about your role in the firm.

Mr. Jacoby: Spectrum is a specialty manager in preferred securities, and we've been in business since 1987. The firm was purchased by Principal Global Investors in 2001. We're headquartered in Stamford, Conn., as a joint, SEC-registered investment adviser and a broker/dealer.

Preferred securities encompass a whole host of various junior subordinated fixed income products from plain-vanilla, or ordinary, preferred stock to more complicated hybrid securities in many different structural forms. We manage and participate in a whole host of various investment platforms, primarily on a subadvisory basis with a number of open-ended mutual funds for our parent company, Principal Global, and for Nuveen Investments, which is in the closed-end fund business.

The open-end fund platform with Principal has a $4.5 billion dedicated preferred securities fund — the symbol is PPSAX — for U.S.-based investors and separate large UCITS fund available to non-U.S. investors. We also manage four open-end mutual funds that are distributed exclusively in Japan, and serviced by PGI, Tokyo.

The closed-end fund part of our business is affiliated with Nuveen Investments, where we subadvise on three of their closed-end funds, namely JTP, JPS and JHP. We also have a whole host of separately managed account responsibilities that are available through a large array of broker/dealer platforms across the country.

So it's a very long list of responsibilities that brings our total assets under management to over $14 billion. My individual role here at the firm is Chief Investment Officer of Spectrum, and I have been in that role for three years now, and I have been with the firm since 1995.

TWST: As you said, Spectrum focuses on preferred securities. Why did the firm pick that particular area? What makes preferred securities a good place to invest?

Mr. Jacoby: Well, preferreds are rather complicated, which is what we like. We like complexity because it offers an opportunity to implement our program adroitly. Preferreds can be viewed as junior subordinated capital. It is an area of a company's capital structure, which is senior to common equity, but junior to senior debt. Coupons are also allowed to be deferred, so there is an element of not only lower recovery in the event of default, but also a risk that coupons can be deferred without accelerating that default. So there is a two-sided element to the risk aspects of a preferred.

They are very loss absorbent in both respects and are becoming even more loss absorbent as the rules change in the global banking industry in particular. So for that subordination, we seek to get paid a high level of premium. For the most part, a preferred security ought to be the highest-yielding form of capital in an issuer's capital structure. So it's a higher-yielding program based on generally high-quality issuers from an enterprise ratings perspective. In fact, even though many of the issues have below investment grade preferred securities ratings, the company's enterprise ratings are solid investment grade.

TWST: Does that complexity you mentioned scare away some investors?

Mr. Jacoby: Well, I think that it could but I don't think that complexity in and of itself scares the investors more than just the general feel for the macro risk environment that make all risky assets seem somewhat scary at times. So I think those investors who choose not to participate are reacting more to the market as a whole than to the preferred securities space.

TWST: What makes one security more attractive than another?

Mr. Jacoby: Well, it's really about the yield and the structural risk you have to accept in order to earn the yield. There are also elements of a story in the preferred market, much like when one purchases a common equity, they purchase a story. And with preferreds there is a story to the sector, and that is encompassed in three different areas that we refer to in general as a "technical trifecta."

There are a number of changes underway in banking regulation, which are impacting U.S. bank trust preferreds, and also in global bank regulation, which are impacting non-U.S. preference shares and hybrids issued by the foreign banks. Basically, what is happening is that the existing structures of preferred are effectively being phased out of net core capital. We identified this trend about two years ago now, and it seems to be playing out as expected so far, which is a good thing for investors and it still has some room to run. As a result, what were typically long-dated issues, or perpetual issues, are becoming de facto intermediate issues by regulatory choice or design. Effectively, what used to be core capital of the banks will no longer be core capital as we move through these phase-in periods through 2022. So banks that used to earn an equity credit, a regulatory equity credit, for a certain preferreds will no longer be allowed that equity credit, and as a result banks will have to pay something for nothing, and no one ever would like to do that.

Consequently, there should be a gradual, but sometimes lumpy, redemption cycle of a very significant portion of the preferred market, namely the banking sector. In the U.S., the redemption cycle has started in the trust preferred market due to the Dodd-Frank bill, and the replacement capital is plain vanilla, noncumulative preferred stock. In the foreign sector, the new Basel III rules on capital should accelerate a similar redemption cycle in three to four years. So those are the first two elements of the "technical trifecta."

And the third element is what we refer to as the "rating agency equity credit knockdowns," and this is a very unique change, because back in the mid-2000s rating agencies allowed preferreds to be issued with various equity-like features, such as replacement capital covenants, longer maturities of, shall we say, 50 years or 60 years rather than 30 years, and extended coupon deferral options. Rating agencies would then view these features as having equity-like features, and as a result nonbank issuers, nonregulated issuers such as industrials and a whole host of insurance companies issued a lot of enhanced equity capital securities and got a 75% equity credit as tax deductible debt, effectively. A lot of these so-called enhanced equity capital securities were issued in the mid-2000s, 2005, 2006 and 2007 as very tax-efficient and very cheap equity for these issuers.

But when the financial crisis played through, the rating agencies changed their minds on the allowance of these features of having equity credit, which was a rude awakening for issuers. Basically what happened was that the issuers had expected a 10-year benefit on the equity credit, but they only got about four years worth since the rating agencies took back 50% of the credit. So as a result, the issuers were left with more expensive debt than they had initially intended rather than inexpensive equity. Consequently, these issuers should be looking to retire this expensive debt at the first call dates, which are coming up mostly in 2016 and 2017.

All told, there are some very unique aspects to the preferred securities market that can foster a story in addition to the sector having the yield supplemented by being subordinated capital. It can be really complex, but at the same time it can be quite compelling on a relative yield basis compared to other asset classes. All these complexities make active management a better way to sleep at night with preferreds rather than passive management, which can lead to some night sweats from mispricings and exposure to big concentrations that can be called away, which only leads to rather material reinvestment risk.

TWST: You talked about some of the regulatory changes and other factors that are positives. Are there issues floating around out there that may negatively impact the space?

Mr. Jacoby: Well, I think that there are, but at this point in the cycle, nobody seems to care. From a broad market perspective, we have almost returned to the tone of 2006, when people really didn't care about risk — it was more about what's the yield — because we are again in this massive meltup in credit prices, which is leading to a massive decline in nominal yields. Irrespective of there still being some reasonable spread versus Treasuries, nominal yields in the broad fixed income markets have never been so low. We owe the inability to retire on income earned from financial assets to the Fed and its persistent grind toward financial repression.

Highlights

L. Phillip Jacoby IV of Spectrum Asset Management discusses the complexities and risks associated with investing in preferred securities, particularly against the current macroeconomic backdrop. Mr. Jacoby shares insights into the changes underway in banking regulation, which are impacting U.S. bank trust preferreds, and also in global bank regulation, which are impacting non-U.S. preferred shares and hybrids. He says a focus on credit and structure are critical to understanding preferred securities. Mr. Jacoby also shares his firm's top-down, country-specific approach to investments, as well as how constructing a diversified portfolio further lowers risk. Companies include: Capital One Financial Corp. (COF); Wells Fargo & Company (WFC) and National Bank of Greece SA (NBG).

Anyway, back to these issues that could present elements of risk in preferred securities, certainly as we play through the credit cycle and economic cycles, the rules for banking will be changing. The regulators are now requiring more loss-absorption features in preferred stock, and very importantly on bank stock common dividends as well remembering that common dividends are in a first-loss position. As a result, preferreds will be more perpetual once we go through this "technical trifecta," where existing preferreds get called away or tendered for, and then get replaced by the new preferreds. These new preferreds are effectively engaged in a global paradigm shift from a risk perspective given the requirements to have more loss-absorbing features.

Moreover, prospective dividend deferrals will be very objective rather than subjective. In other words, deferrals will come on a rules basis. For example, the Basel III requirements have a rule set called the Conservation Buffer. In that rule set, there are requirements for banks, not just foreign banks, but also U.S. banks, to objectively reduce or restrict distributions on core capital, such as common stock and preferred stock. These distributions are defined as discretionary capital payments on common stock, preferred stock and deferrable debt payments in addition to salaries and bonuses as you might expect.

So when banks end up going through a period of difficulty, like is often modeled in these stress tests, the banks, as their capital declines through certain thresholds, will be required to reduce or even turn off their dividends. That offers a completely different set of risk concerns to the market — especially to the common stock holders.

But today, given that banks are far better capitalized than they were going into the Great Recession, the risk really isn't an immediate concern. But certainly when we work our way into that next recession, and there will be another recession, we need to take note as to how far away banks are from their distance to trigger within the context of those distribution restrictions. And if you just look at what the most recent stress tests showed for U.S. banks, for example, every single bank, except **Capital One** (COF), would have been under some type of dividend restriction or distributional restriction.

TWST: Do you have global preferred shares as well as domestic preferreds in Spectrum's portfolios?

Mr. Jacoby: Yes, we do. Our portfolio is about 50% U.S., and 50% non-U.S.

TWST: Do you look at it from a top-down perspective?

Mr. Jacoby: We do. Our opinion is you have got to take a top-down country orientation because of the still very strong linkage between a sovereign credit, such as Italy and their banks. The eurozone structure is rather unique in that banks have a high amount of sovereign risk on their balance sheets. All they did with the long-term repo operations, which gave them unlimited funding from the European Central Bank, was to use it to purchase more sovereign debt to buy down the yields of Spain and Italy. So we do have a country preference, which is to avoid owning the territories such as Greece, Italy, Ireland and Portugal, but with a preference to own the more core countries such as France and Germany and even the countries that are outside the eurozone but within the European Union, such as Great Britain.

1-Year Daily Chart of Wells Fargo & Company

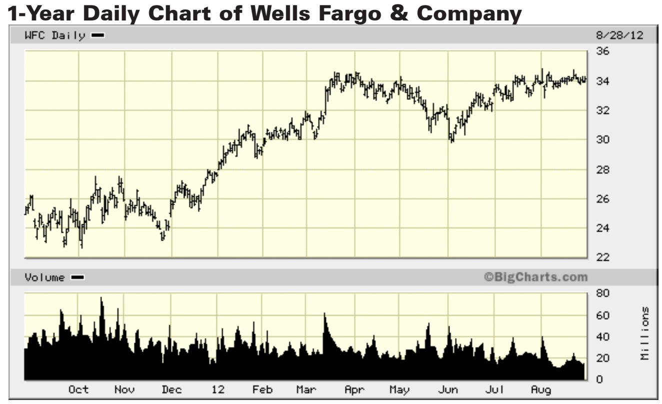

Chart provided by www.BigCharts.com

> ***"Our opinion is you have got to take a top-down country orientation because of the still very strong linkage between a sovereign credit, such as Italy and their banks."***

So despite the higher nominal capital levels, these risks are out there because the triggers in the Conservation Buffer are just as high, but they get varying degrees of focus or very little focus when there is such a food fight to buy income. Right now, given that credit is reasonably constructive, and capital is certainly more than adequate, the market doesn't focus on these things right now, and that's why **Wells Fargo** (WFC), for example, can price their noncumulative preferred stock at 5.2% compared to almost 8% just four years ago.

That being said, I'd be more concerned about getting paid as a common-stock holder in back stocks than I would be as a preferred-stock holder in bank stocks because common dividends will be the first line of defense with no ability by managements to borrow in order to pay them if loan losses cross the objective 7% common equity Tier-I capital line. The new rules just will not allow managements the flexibility that they used to have to pay prospective dividends.

TWST: What makes Spectrum sell a preferred stock?

Mr. Jacoby: Any combination of unacceptable yield and structural risk and limited upside as a result of both. Certainly the risk of deferral and price destruction because that risk would be a key driver in our decision as well.

For example, Greece had very good bank, called the **National Bank of Greece** (NBG), that had issued a preferred. The bank was doing quite well domestically, but it, unfortunately, it was located smack in the middle of a huge economic crisis. As a result, we thought that this country risk could lead to an effective run of the bank, and that this could therefore prevent them from ultimately paying on their preferred. So we were out of Greece, out of **National Bank of Greece**, two years ago.

TWST: What do you believe Spectrum Asset Management does well that gives it a competitive advantage?

Mr. Jacoby: Well, I think that because the complexities of preferred securities are our specialty, we have a very keen focus on credit and a very keen focus on structure. So from that orientation, we deploy a diversified philosophy to spread out the risk of being in the asset class across many credits and across as many structures as possible. Consequently, our average credit exposure is about 2%, which compares to others that could add as much as 5% to 10% in a single name. So Spectrum has a very diversified investment approach — more so than others likely do.

We're conservative in our risk orientations. More recently, we have started exploring opportunities to not only have benefits from diversifying away what I characterize as the unsystematic risk or the specific business risk, but also mitigating the systematic risk of being in a risky asset class like preferreds altogether. As you know, through modern portfolio theory, systematic risk cannot be diversified away because it is general market risk. You have to hedge it down, but that has a cost and a commensurate reduction in yield caused by reducing that market risk.

One thing that we learned in this crisis is that systematic risk can go many steps further and lead to systemic risk and that can get very extreme — the Lehman crisis is a good example. These so-called tail events seem to happen more frequently these days, so we're in the process of exploring some new portfolio tools to help us mitigate these macro risks in order to allow our clients to earn good income and a better sleep at night — this, in itself, should help to give our clients a competitive advantage too.

TWST: Thank you. (LMR)

L. PHILLIP JACOBY IV
Executive Director & Chief Investment Officer
Spectrum Asset Management, Inc.
2 High Ridge Park
Stamford, CT 06905
(203) 322-0189
(203) 968-1455 — FAX
www.samipfd.com
e-mail: info@samipfd.com