

## The “Pull Toward Par”

It’s no longer your grandmother’s preferred stock market of fixed-rate perpetuals in utilities and railroads. The “hybrid” market has evolved and grown over the years into a \$460 billion market of preferred stock, junior subordinated debt, and contingent convertible capital securities. Roughly 77% of the hybrid market is structured as an adjustable-rate security rather than a fixed rate (for life) security. The most common type of adjustable-rate capital security is the 5-year fixed-to-refixed structure. The terms of these fixed-to-refixed securities are typically:

<b>Maturity</b>	<ul style="list-style-type: none"> <li>• Perpetual or 40 years</li> </ul>
<b>Coupon</b>	<ul style="list-style-type: none"> <li>• Fixed rate and originally priced at a spread (e.g., +325bps) off the 5-year US Treasury note</li> </ul>
<b>Call or Redemption</b>	<ul style="list-style-type: none"> <li>• Non-call for 5 years</li> <li>• If not called, the coupon resets at the then current 5-year US Treasury rate plus the initial spread (e.g., +325bps) for another 5-year term (let’s call this the “backend spread”)</li> <li>• Some are callable every payment date while others are not callable until the next reset 5 years later.</li> </ul>

The paper basically trades to where the market *thinks* a new issue with the same fixed-to-refixed structure would come, though there are indeed inefficiencies that benefit active management. Issuers of hybrids are capital intensive (e.g., banks, insurance, utilities, and industrials) so there are issuance cycles or waves that play through depending on variable capital needs. The issuance wave of 2020-2021 (a period when the Fed was making “easy” money with QE and keeping the federal funds at zero) saw hybrid issuance come at low coupons (e.g., 4%) with generous spreads (e.g., +300-325bps) which would reset 5 years later. This type of issuance is now trading at 10–15-point discounts because the Fed has raised the federal funds rate by over 500bps in just 18 months which has raised the UST yield curve significantly negatively impacting credit prices. If the backend reset spreads are wide enough, the expected new coupon (estimated to be reset off today’s 5-year UST yield) can act like a quasi-maturity because the paper would be expected to be redeemed at par with a more economic (i.e., lower) current market spread. If the backend spread is below the current market (e.g., +300bps), then the coupon could reset higher, but the paper would not be redeemed because the initial issuance spread is economic for the issuer to leave outstanding.

Either way though, the price should rise or be **“pulled toward par”** as the coupon reset date approaches because the coupon will reset based off the 5-year US Treasury rate at that time.

From the price perspective, it doesn't matter whether treasury yields go up or down – see the "XYZ" example below:

Current Market Price	Initial Coupon	Issuance Spread	5yr UST at Issuance	5yr UST "Today"	Assumed Coupon if Reset "Today"	Assumed Spread of Current Market Issuance	Forecast Est. Future Price if "Today"	Value of the "Pull Toward Par"
<b>a</b>	<b>b</b>	<b>c</b>	<b>d=b-c</b>	<b>e</b>	<b>f=e+c</b>	<b>g</b>	<b>h=c/g</b>	<b>i=h-a</b>
<b>"XYZ" Example ~ Simple Method to Estimate the "Pull Toward Par"</b>								
\$83.00	4.00%	3.00%	1.00%	4.45%	7.45%	3.25%	\$92.31	\$9.31
\$83.00	4.00%	3.00%	1.00%	1.00%	4.00%	3.25%	\$92.31	\$9.31
<b>Voya 6.125% = Actual "Pull Toward Par" ~ Compared to Simple Method</b>								
Px. 5/31/22	Initial Coupon	Issuance Spread	5yr UST at Issuance	5yr UST at Reset	Assumed Coupon if Reset "Today"	Spread of Current Market Issuance	Est. Future Price if "Today"	Value of the "Pull Toward Par"
\$94.00	6.13%	3.36%	2.77%	3.75%	7.11%	3.35%	\$100.30	\$6.30
<b>Voya 6.125%</b>	Day of reset 9/15/23			<b>4.39%</b>	<b>7.75%</b>	Source: Bloomberg	<b>\$100.50</b>	<b>\$6.50</b>

Notice that the "pull toward par" is a function of:

- (a) time aging to the coupon reset date, and
- (b) market spread for the issuer at the time of coupon reset.

So, if spreads widen significantly then the "pull" may not transpire as originally expected, which is why credit choice and structure choice are critical when selecting perpetual capital securities. Notwithstanding, if credit spreads stay reasonably stable, the "pull toward par" can be expected with some degree of confidence because the reset mechanism updates relative to the benchmark 5-year treasury yield. Indeed, when US Treasury yields rise like they have (and may stay high for longer), investors may receive not only the price benefit of a "pull toward par" as the paper ages to the reset date, but also a potential significant income pickup because market yields on 5-year treasuries may have risen significantly since the time of issuance too.

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