Manulife Investment Management

Portfolio Insights

Preferred Securities: A gateway to compelling income opportunities

Q3 2020

Introduction

The first half of the year unfolded in a way no one could have forecasted. After the signing of the long-awaited Sino-US trade pact in January, the spread of the COVID-19 pandemic ("pandemic") soon roiled global asset markets, leading to unprecedented volatility and drawdowns. Nevertheless, the unexpected market dislocations have also created significant opportunities for investors across a wide range of asset classes.

We believe preferred securities ("Preferreds") are one of these compelling opportunities, due to both cyclical and structural factors. Cyclically, Preferreds have experienced a sell-off disproportionate to their underlying fundamentals, creating attractive entry points for active managers. Structurally, we believe that the inherent properties of this asset class help position it well moving forward. While challenging economic conditions impact most assets, Preferreds' dependence on more established issuers, largely investment grade companies that issue Preferreds and low historical default rates all make it well-placed to navigate the current challenges.

Still, this economically challenging period raises questions about the asset class: How will Preferreds be impacted by the current pandemic?
How defensive will preferred issuers be, under this environment vis a vis previous economic downturns?

At Manulife Investment Management, our longstanding history and deep expertise in Preferreds allow us to not only tap the potential of this asset class, but also actively manage risks. Our portfolio managers boast over 25 years' experience, including in important sectors such as utilities, energy and finance. In addition, as an established player in the market, we have access to the industry's largest issuers and latest pricing information.

As interest rates stay "lower for longer" in this complex economic environment, Preferreds can remain an increasingly compelling option for investors looking for a sustainable and attractive source of income.

The case for Preferreds

For investors seeking sustainable and attractive income in the current environment of increased market volatility, Preferreds offer uniquely compelling opportunities. It can offer some of the highest returns amongst the fixed-income sectors – comparable to those of high-yield bonds – and yet hold average credit ratings of investment grade bonds.

Indeed, the recent market volatility has created exceptional opportunities in the asset class. In addition, we believe they will also benefit from cyclical tailwinds, structural trends, as well as inherent superior characteristics vis a vis other asset classes and income alternatives.

Cyclical opportunities: Unexpected dislocations and opportunities from market sell-offs

Unique cyclical opportunities have emerged for Preferreds, in the wake of the significant market sell-offs in the first quarter. Concerns over the spread of the coronavirus resulted in the S&P 500 falling by over 12% in March alone, while increased volatility also affected credit markets, as flights-to-safety saw investors selling out of relatively riskier debt into US Treasuries. The resulting volatility has also negatively impacted other asset markets, including Preferreds, through a series of cascading margin calls.

1. Valuation metrics point to buying opportunities

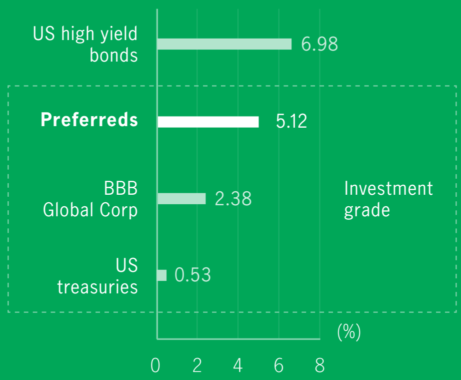
Preferreds issuers are typically well-capitalised companies (around 10% of which are in utilities and 75% in financials[1]) which use these securities to manage their balance sheet capital ratios. Preferreds are sold in both institutional and retail markets, targeting different groups of investors.

During the pandemic-related market sell-offs, while Preferreds were not spared from the volatility, the institutional market held up relatively well, and saw significantly lower volatility than the retail market, which is generally more susceptible to movements in ETF markets.

What are Preferreds?

Preferreds are subordinated, fixed-income instruments with equity-like features. Some preferred securities pay interest income to holders; some preferred securities pay dividend income to holders. Whether interest or dividend income, income from preferred securities ranks senior in priority of payment to dividends paid on common stock of an issuer. Preferreds typically offer higher yields than common stock dividends and bond coupons. However, unlike shares of common stock, Preferreds usually do not carry voting rights.

Yield to maturity of fixed income (as of 30 June 2020)



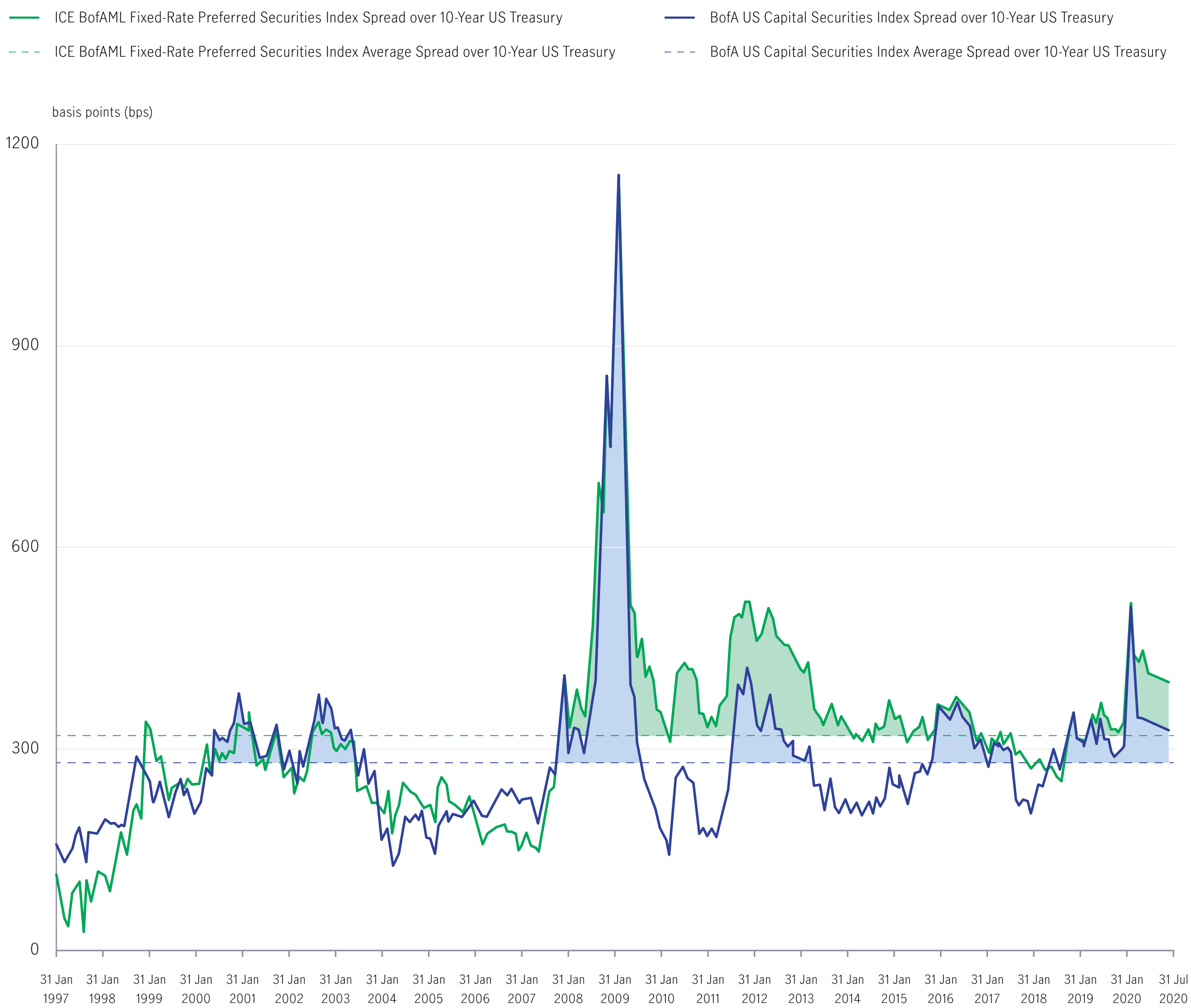
Source: Bloomberg, Manulife Investment Management, as of 30 June 2020. Preferred securities are represented by the ICE BofAML US All Capital Securities Index (IOCS). US High Yield are represented by ICE BofAML US High Yield Index (HOAO) . BBB Global Corporate bonds are represented by ICE BofAML BBB Global Corporate Index; US Treasuries are represented by ICE BofAML US Treasury & Agency Index (GOAO). For illustrative purposes only. Past performance is not an indication of future results.

[1] ICE BofAML US All Capital Securities Index, as of 30 June 2020. The securities mentioned are for illustrative purposes only, and do not constitute any investment recommendation or advice. It should not be assumed that an investment in these securities or equities was or will be profitable. Information about the asset allocation is historical and is not an indication of the future composition.

To illustrate: the spread between institutional Preferreds (represented by ICE BofAML US Capital Securities Index, or the c0cs, which is the institutional US$1,000 par preferred securities) and 10-year US Treasuries remained elevated at 3.24% as at end-July, around 46 basis points above the long-term historical average of 2.78% (see Chart 1), presenting attractive entry points for investors.

Meanwhile, opportunities also look attractive in another retail segment within Preferreds: looking at the spread of the ICE Bank of America Fixed Rate Preferred Securities Index (p0p1, which is retail preferreds) over 10-year US Treasuries, it was well above 5% at one point, compared to the historical average spread of 3.16% (also Chart 1).

Chart 1: Preferreds historical spreads over US Treasury



Source: Bloomberg as of 31 July 2020. "Preferred spread" is represented by the spread of ICE BofAML US Capital Securities Index (c0cs) and ICE BofAML Fixed Rate Preferred Securities Index (p0p1) over 10-year US Treasuries.

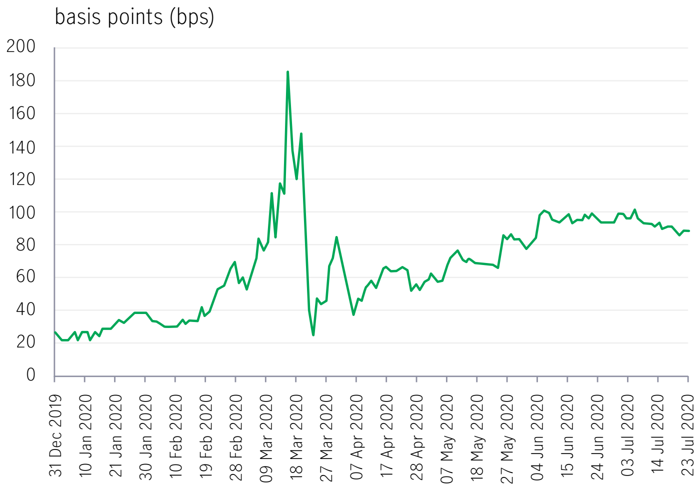
2. Dislocations between retail and institutional segments spell opportunities

The compelling opportunities created by the sell-off can be viewed from another perspective: the difference in spreads between the retail and institutional markets. As explained earlier, Preferreds are sold in both markets and the difference in spreads can offer buying opportunities.

Chart 2 illustrates the yield differential between the retail and institutional markets after the first-round of sell-off. Our investment team has historically taken advantage of such market dislocations, as retail outflows can present rare buying opportunities (see more in "A potential haven for active managers" below). During the sell-offs, the retail spread over institutional hit a high of 1.86%, and has since settled at 0.89%[2].

Chart 2: Retail versus institutional yield-to-maturity spread

Retail premium



Source: Bloomberg as of 31 July 2020. "Preferred spread" is represented by the spread of ICE BofAML US Capital Securities Index (c0cs) and ICE BofAML Fixed Rate Preferred Securities Index (p0p1) over 10-year US Treasuries. Retail premiums are the difference between p0p1 and c0cs.

3. Preferreds' credit quality shows resilience

The market sell-offs also illustrated and reinforced our previous point that Preferreds embrace higher credit quality. Consider these latest developments in the US high-yield sector versus Preferreds – the latter shows resiliency both in terms of default and fallen-angel risks:

Year-to-date (June 2020)[3]:

US high-yield: 60 companies totaling US$100 billion in bonds and loans defaulted. The market experienced US$191.4 billion in fallen angels (i.e. investment-grade companies that were subsequently downgraded to high yield)[4].

Preferreds: No defaults were recorded throughout the first half of the year. The market has experienced US$566 million in fallen angels (only 10 out of 20 downgrades representing US$1.5 billion in total[5]).

[2] Bloomberg, Federal Reserve Bank of St. Louis, as of July 2020.

[3] JP Morgan, as of 30 June 2020Total US high-yield fixed income outstanding issuance was US $1.24 trillion at 31 December 2019 and grew to US$1.35 trillion by 30 June 2020. Total US Preferred securities (i0cs) outstanding issuance was US$325 billion at 31 December 2019 and increased to US$327 billion by 30 June 2020.

[4] The first quarter of 2020 witnessed $149.4 billion of fallen angels, or companies that were investment grade and subsequently downgraded to high yield. The second quarter experienced $42.0 billion of fallen angels (JPM data). CreditSights has identified 61 issuers as having a very high risk of downgrades to high yield, this represents $156 billion and 24 billion euros of BBB-rated debt within investment grade indices.

[5] Out of 537 issues when using the i0cs ICE BofA US All Capital Securities Index.

4. More favourable tailwinds ahead

Preferreds have lagged in this recovery relative to US and global corporate bond indices. The US Federal Reserve's program has led to strong returns in the US corporate bond market. Chart 3 shows that retail Preferreds (represented by BofA Core Plus Fixed Rate Preferred Security, p0p4) are currently trading at a discount to par, unlike the US Corporate Index trading at an 11% premium. We believe these high relative yields, combined with attractive valuations, can offer favourable tailwinds for the asset class (see Chart 3).

Chart 3: Preferred securities boast attractive relative valuation (as of 30 June 2020)

Index	Price	Premium (discount)
BofA Core Plus Fixed Rate Preferred Security	**$24**	**(1%)**
BofA US Capital Securities Index	$111	+11%
US All Capital Securities Index	$101	+1%
BofA Global Corporate Index	$111	+11%
BofA US Corporate Index	$112	+1%

BofA Core Plus Fixed Rate Preferred Security

1%

discount

Source: Bloomberg, as of 30 June 2020. Diversification does not guarantee a profit nor protect against loss in any market.

> *"The investment case for Preferreds is not just limited to compelling cyclical entry points or positive tailwinds. The structural features of the asset class are also equally impressive: quality companies issuing with lower default rates, strong performance during economic downturns, and the potential for enhanced portfolio diversification. Preferreds can also occupy a unique spot in portfolios for investors searching for income."*

Structural opportunities: Resilience in downturns and strong diversification properties

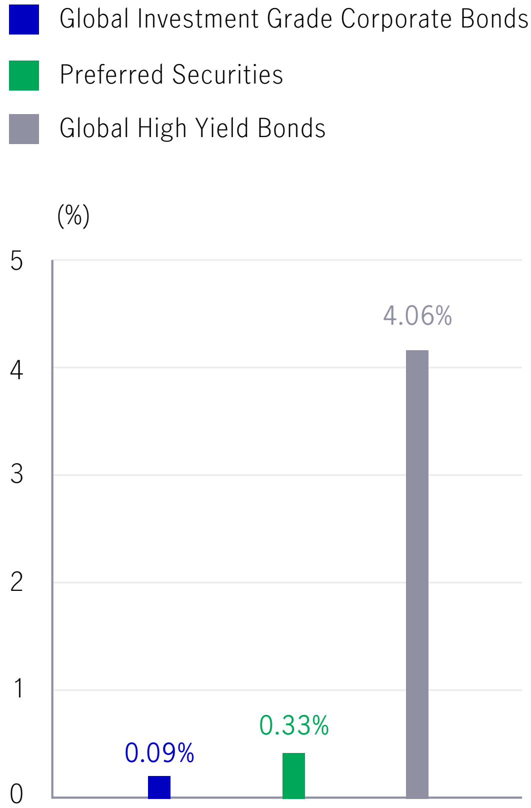
The investment case for Preferreds, however, is not just limited to compelling cyclical entry points or positive tailwinds. The structural features of the asset class are also equally impressive: quality companies issuing with lower default rates, strong performance during economic downturns, and the potential for enhanced portfolio diversification – the last being especially important benefit as correlations fluctuate in markets. It can also occupy a unique spot in portfolios for investors searching for income.

1. Resilience in economic downturn over the last three decades

One key benefit of Preferreds is the ability to get exposure to strong, stable companies. As mentioned earlier, many Preferred issuers are established utilities and financial firms which use the proceeds for investments and internal operations. In particular, the case for financials has notably improved, on the back of post-Global Financial Crisis reforms that have strengthened banks' balance sheets and increased the cushion for capital losses in an economic downturn. Because of this, Preferreds have historically seen lower default rates (see Chart 4). Over the past 30 years, default rates for Preferreds were lower than global high-yields and even global investment-grade bonds.

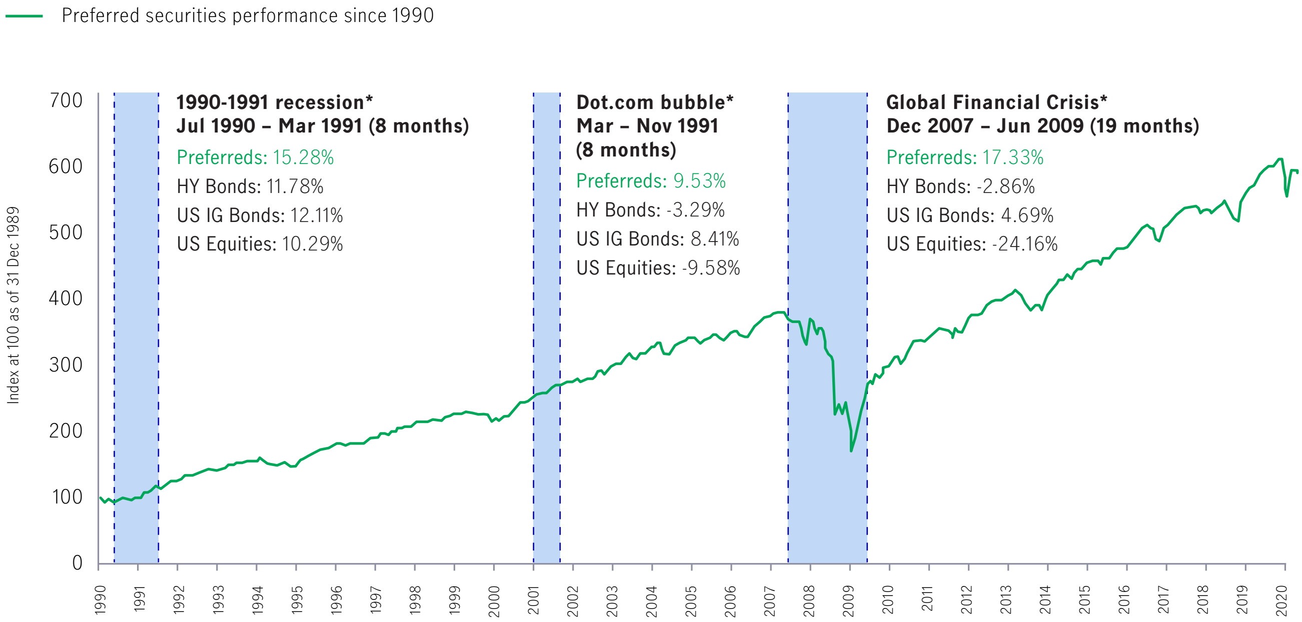
At the same time, Preferreds also tend to outperform in periods of economic downturns. Over the past three recessions in the US since 1990, Preferreds have displayed attractive performance versus other asset classes over this time period (see Chart 5). However, the Global Financial Crisis did hit Preferreds unusually hard, given that approximately 75% of the universe is financial companies.

Chart 4: 30-year default rates for income-yielding instruments



30-year (1990-2019) default rates are given. Global high yield bonds and global investment grade bonds default rate are sourced from Moody's Investor Service, as of 31 December 2019. Preferred Securities default rate from 1990 to 2017 are sourced from Moody's Investors Service, Preferred Securities default rate from 2018 to 2019 calculated the $25 Par preferreds market, sources from Bloomberg, as of 31 December 2019. Manulife Investment Management calculated Preferreds default rates for 2018 and 2019.

Chart 5: Preferreds excel in challenging economic environments



*Annualised returns.

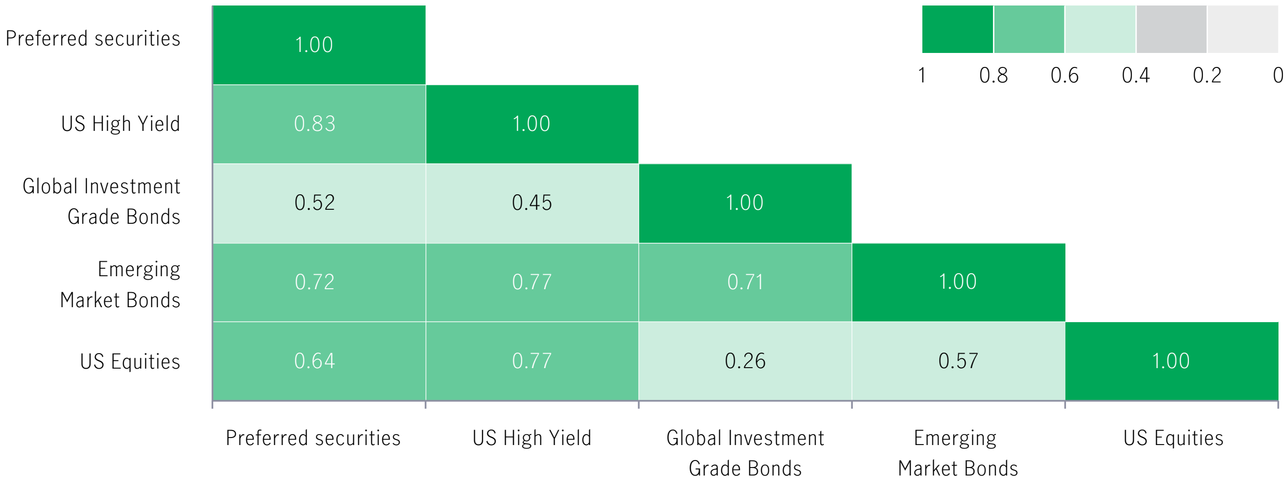
Source: Bloomberg, Manulife Investment Management. As of 30 Sept 2019. Preferred Securities = ICE BofAML Fixed Rate Preferred Securities Index; High Yield Bonds = ICE BofAML US High Yield Index; US IG (Investment Grade) Bond = Bloomberg Barclays US Aggregate Bond Index; US Equities = S&P 500 Index. Past performance is not indicative of future returns.

2. Diversification across markets and within the asset class

Finally, as correlations increase across markets, Preferreds have traditionally added ballast to investors' portfolios, particularly with major equity and fixed income asset classes (see Chart 6).

Chart 6: Correlations of Preferreds with other major asset classes

Time period: 07 July 2010 to 30 June 2020



Source: Bloomberg. Correlation coefficient is calculated based on weekly performance of indices shown to represent asset classes from 31 Dec. 2009 to 31 Dec. 2019. It is not possible to invest directly into an index. For illustrative purposes only. Correlation ranges from +1 (perfect positive correlation) to -1 (perfect negative correlation). Low correlation refers to correlation coefficient equal to or smaller than 0.5, moderate correlation between 0.5 and 0.75 (inclusive), and high correlation above 0.75.

Asset classes represented by: Preferred securities = A 50/50 blend of ICE BofAML US All Cap Securities Index and ICE BofAML Fixed Rate Preferred Securities Index, US Equities = S&P 500 Index, Global IG Bonds = Bloomberg Barclays Global Aggregate Index, EM USD Bonds = Bloomberg Barclays EM USD Aggregate Index, US High Yield = ICE BofAML US High Yield Index.

Diversification within Preferreds

The Preferreds' universe comprises a variety of different payment ranks, ranging from equity securities to hybrid securities and fixed income securities. Chart 7 shows the traditional capital structure on the left and the Preferreds structure on the right. At the top of the capital structure are senior notes or "baby bonds". A large part of the market is made up of junior subordinated debt, or "junior subs". These Preferreds are Trust or Hybrids.

At the bottom of the capital structure, just above a company's stock are preferred shares, also called preferred stocks. These securities pay dividends, unlike the rest of the Preferreds market which pays interest.

We can invest in all types of Preferreds, but with a limit of 30% in preferred shares to minimise tax implications for investors.

Preferreds sit above equities in the capital structure, and are junior to (or below) senior bonds (see Chart 7).

Chart 7: Preferreds in a company's capital structure

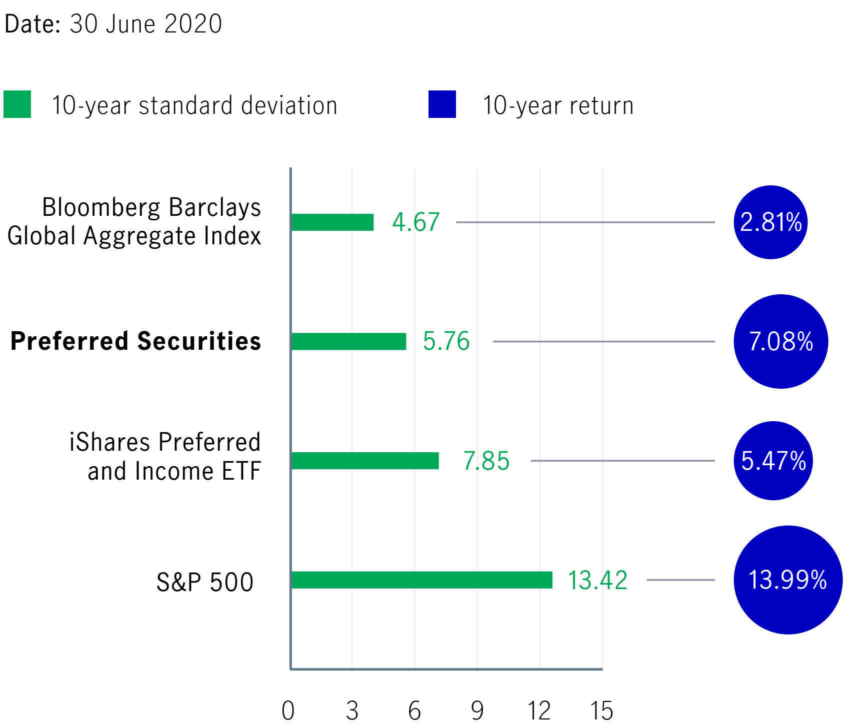
Source: BofA Global Research. Diversification does not guarantee a profit nor protect against loss in any market.

Preferreds offer unique strengths versus other asset classes, especially for income investors

Because the asset class has both bond and equity characteristics, its risk and return profile is usually between the two. Over the last 10 years, Preferreds have outperformed global fixed income with nearly the same standard deviation, while returning approximately 50% of the S&P 500 with less than half the standard deviation (see Chart 8).

This shows that adding Preferreds can help boost yields and return. Further, when compared to the industry's largest ETF, adding institutional par securities can help dampen volatility.

Chart 8: Preferreds' performance and risk properties versus other asset classes

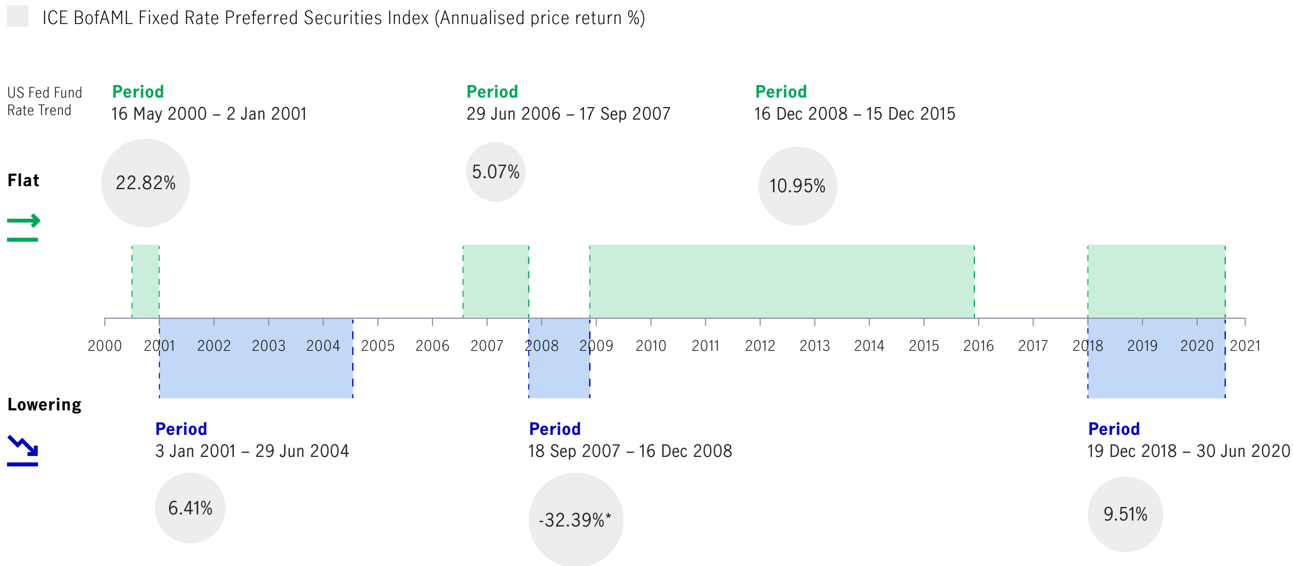


Source: Morningstar, as of 30 June 2020. A 50/50 blend of c0cs (institutional Preferreds) and p0p1 (retail Preferreds) are used as the proxy for Preferreds.

Under the current "lower for longer" interest rate environment, investors have been seeking investment instruments that offer attractive yield, especially in an increasingly complex environment. Therefore, from a secular approach, an important value proposition for investing in Preferreds is access to higher-yielding opportunities, under the current low-to-zero rates environments, and across different market cycles.

Chart 9 shows that Preferreds have historically performed well in periods of easing, or when the US Federal Reserve is on a pause. As rates have fallen globally, the demand for Preferreds is likely to increase as investors continue their aggressive search for yields.

Chart 9: Preferreds' performance during flat or declining interest rate periods



Source: Bank of America Merrill Lynch and Bloomberg, as of 30 June 2020. Annualised total returns in US dollars. Past performance is not an indicative of future performance. The oldest benchmark for Preferreds (ICE BofAML Fixed Rate Preferred Securities Index) was used for longer term research.

A potential haven for active managers

Active management is key to tapping into the vast investment opportunities offered by Preferreds. This has been demonstrated not only in short-term cyclical challenges, but also over the longer term through a range of market environments.

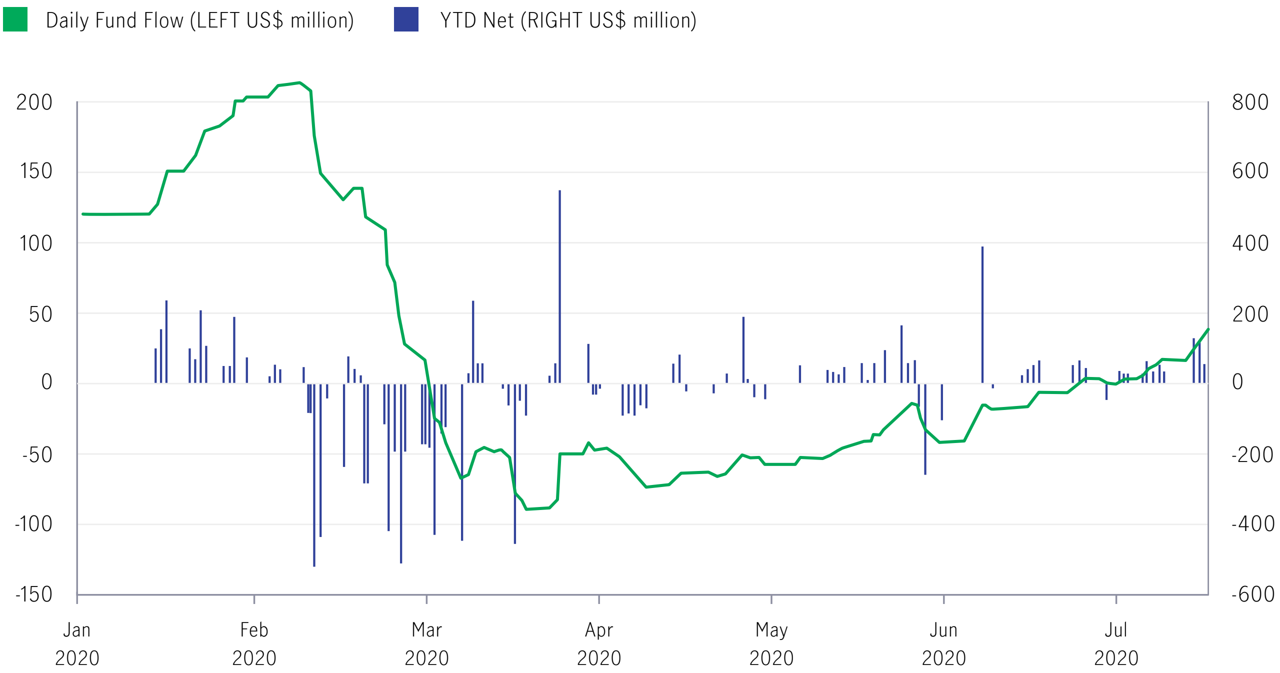
We can start by again examining the period of market sell-offs, using the industry's largest preferred security ETF (PFF) as shown in Chart 10. The daily and net flow are illustrated in green and blue.

As can be seen, there was massive selling started on 21 February and continued throughout most of March, causing a major dislocation between retail and institutional Preferreds markets. This scenario presented a golden opportunity for active managers to add value by taking tactical positions in the market.

Year-to-date flows for PFF are currently back to positive territory, standing at US$153 million as of end-July.

> *"Over the past decade, Preferreds returned nearly 50% of the S&P 500, with maximum drawdowns of 10.21% and 19.60% respectively (see Chart 11). Furthermore, Preferreds recovered fairly quickly in only two months. In comparison, the S&P 500 took three months, while global bonds took 17 months. The recent drawdowns have offered rich opportunities for active managers."*

Chart 10: Preferreds ETF market (PFF) flows hurt performance during sell-off but recovered



Source: Bloomberg, as of 14 August 2020.

Zooming out into a longer horizon, over the past decade, Preferreds returned nearly 50% of the S&P 500, with maximum drawdowns of 10.21% and 19.60% respectively (see Chart 11). Furthermore, Preferreds recovered fairly quickly in only two months. In comparison, the S&P 500 took three months, while global bonds took 17 months.

Chart 11: Maximum drawdown in different asset classes

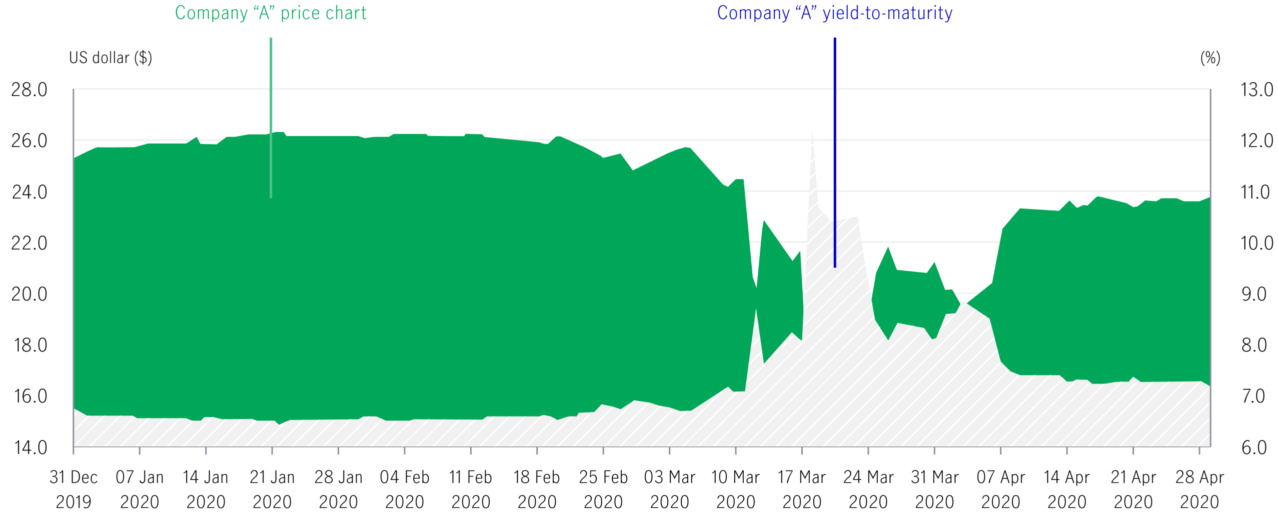
	Maximum drawdown	Recovery (months)	Maximum drawdown peak date
Bloomberg Barclays Global Agg	-7.66%	17 months	1 July 2014
Preferred Securities	-10.21%	2 months	1 Feb 2020
iShares Preferred & Income ETF	-16.56%	2 months	1 Feb 2020
S&P 500	-19.60%	3 months	1 Jan 2020

Source: Bloomberg, as of 30 June 2020. The above example is for illustration purposes only.

The recent drawdowns offered rich opportunities for active managers. Indeed, the dislocations in March 2020 produced strong buying opportunities for quality companies. For example, Company A (A name we've already owned and we historically add to when the market sells off irrationally) is in the communications and internet space, and generates consistent cash flows to pay off debt obligations. Its business is also less affected by the pandemic, given increased demand for internet services during this period.

The company's bonds traded marginally lower during the market volatility; however, its Preferreds fell by around 20% (see Chart 12). We took the opportunity to add to the security near the market bottom around US$20, a steep discount to par, with a yield-to-maturity of over 8%. In a few months' time, Company A's share price rebounded by 20%.

Chart 12: Company "A" price chart and yield-to maturity (year-to-date)



The above example is for illustration purpose only.

Source: Bloomberg, as of 31 July 2020. 10 years as of 30 June 2020, a 50/50 split of The ICE BofAML US Capital Securities Index and The ICE BofAML Fixed-Rate Preferred Securities Index was used as i0cs started in 2012. This material does not constitute an offer or an invitation by or on behalf of Manulife Investment Management (US) to any person to buy or sell any security. This material should not be viewed as a current or past recommendation or solicitation of an offer to buy or sell any investment products or to adopt any investment strategy. Technology does not promise any level of performance or guarantee against loss of principal. Past performance is not indicative of future results.

Our differentiated approach to Preferreds

Manulife Investment Management boasts a long history and significant presence in the Preferreds space, having started investing in the asset class since 1989.

Our Preferreds Income Team[6]

A seasoned investment firm
With assets under management (AUM) of US$406 billion and offices in 17 countries and territories, Manulife Investment Management is one of the world's largest investment managers.

Deep experience
Our dedicated portfolio managers have an average of over 25 years' experience, supported by a 37-person (14 based in Boston, 5 based in Toronto and 18 based in Asia) credit research team and a dedicated bank team.

Longstanding track record
Our Preferreds Income strategy was launched way back in 2002.

A leading player
With AUM of over US$4.9 billion in Preferreds strategy, Manulife Investment Management is a major player in the asset class.

Over the years, we have developed a rigorous and high-quality approach to assessing Preferreds. This approach leverages the latest information in our proprietary selection framework, as well as on the deep expertise of our team.

We believe that building a diversified portfolio of high-quality securities at above-average yields can generate high levels of income and help protect investors' capital. In sum, we aim to invest in issuers holding five key attributes:

Chart 13: Manulife Investment Management's selection criteria for preferreds

1

Enduring business models

A majority of preferreds are utility and financial issuers. The industry mix of the smaller convertible preferred market is more diverse. Most of our attention is spent on utilities and financials with multi-decade track records.

2

Strong balance sheets

We favor issuers which rank in the upper two-thirds of their industries with respect to balance sheet health. We have a distinct preference for higher-quality balance sheets. Interest coverage and debt-to-EBITDA are key metrics we use to help find these high-quality companies.

3

Sustainable free cash flow

The team looks for sustainable and defensive free cash flows.

4

Solid management teams

Investing in companies with management teams that have long track records of delivering strong performance.

5

ESG ratings

ESG analysis has been woven throughout the research process for over three years.

The above example is for illustration purpose only.

6 Manulife Investment Management, MFC Statistical Information Package, as of 30 June 2020. AUM includes assets managed by the institutional asset management arm of Manulife Investment Management on behalf of external clients, the Insurance business and other affiliated businesses, as well as US$316M of unfunded committed capital of Manulife IM Private Markets (US) LLC. The methodologies used to compile the total assets under management are subject to change and may not reflect regulatory AUM as reported on certain affiliates Form ADV.

1. Proven fundamental-driven research process

Fundamental research is the driving force behind our successful Preferreds Investment process. The analysis draws on the deep strengths of Manulife Investment Management's fixed income team, which boasts over 160 investment professionals, including 37 credit research analysts based in North America and Asia as of 30 June 2020.

Fixed income analysts for corporate credit are organised by industry and sector, covering the entire quality spectrum. As companies move between investment-grade and non-investment grade status, analysts maintain the research base necessary to intimately comprehend each company, its management team and its competitive position in the industry.

Our analysts focus their efforts on selecting issues which the investment team believes offer the most value-added potential, and performing intensive fundamental analysis prior to any purchase. The analysis integrates a range of different inputs: a bond's potential return, credit risk, interest rate risk, structure and supply/demand features are all carefully evaluated within the framework of other alternatives.

The analyst team recommends ideas based on numerous valuation metrics, including financial statement analysis, as well as qualitative issues such as competitive position and assessment of management. Analysts are directly responsible for following securities in their sector that are owned within portfolios, for interpreting changes and anticipating new information. Once purchased, analysts perform ongoing analysis and review of individual holdings, to monitor factors that may change the team's outlook.

The Preferreds Income team uses a multi-step process to identify and research equity, preferred equity and fixed income securities for inclusion in the portfolio. The team seeks to construct a diversified portfolio to effectively manage risk and volatility.

2. ESG emerging as a key selection criterion

As with all asset classes, ESG is an integral part of our Preferreds investment process. This is particularly so as utilities and financials have traditionally comprised a large part of Preferreds issuance.

ESG considerations play a huge role in utilities due to its legacy in using "dirty" energy such as coal. We view this issue seriously as we look for a longer-term shift to clean energy, which holds benefits for both our investors as well as the environment.

Manulife Investment Management has a robust ESG policy, which outlines our belief that ESG factors contribute to the overall profile of an investment, and that management of ESG risks and opportunities can lead to long-term sustainable returns. We are committed to integrating ESG analysis into our existing fundamental research processes, and view ESG as a natural complement to our strengths as a boutique active investment manager.

Our ESG Research and Integration Team (of eight dedicated members) supports investment analysts and portfolio managers, to better identify relevant ESG factors in making investment decisions, and to identify investee companies suitable for our ESG engagement program.

> *"Over the years, we have developed a rigorous and high-quality approach to assessing Preferreds. It leverages the latest information in our proprietary selection framework, as well as on the deep expertise of our team.*
>
> *Fundamental research is the driving force behind our successful Preferreds Investment process. The analysis draws on the deep strengths of Manulife Investment Management's fixed income team, which boasts over 160 investment professionals, including 37 credit research analysts based in North America and Asia.*
>
> *We view ESG analysis as a natural complement to our strengths as a boutique active investment manager."*

Chart 14: Manulife Investment Management's ESG approach to Preferreds

1 ESG Due Diligence

ESG Integration Approach

- ESG analysis supports better informed decisions for active investing
- Investment teams apply industry and regional expertise to assess material ESG factors

Resources

- Investment teams have access to specialised third party ESG research and data, periodic ESG trainings, and dedicated internal ESG specialists

Decision

- Understanding ESG factors enhances the assessment of companies risk/reward profiles, and thus potential returns
- Investments in companies with elevated ESG risks may be appropriate depending on the strategy

2 ESG Risk Monitoring

Daily Risk Reporting

- Daily reports highlight the highest-risk names for each strategy
- Pre-trade acknowledgement required to invest in companies with aggressive accounting practices

Portfolio Analysis Reports

- Portfolio monitoring helps to analyse ESG performance
- Highlights portfolio trends versus the benchmark and exposure to thematic ESG risks/opportunities

ESG Risk Reviews

- Investment teams have quaterly portfolio reviews with the ESG team to discuss their investment approach to ESG issues at the company and portfolio level

3 Active Ownership

Engagement

- Engagement enables better understanding of companies' risk mitigation activities and changes to their risk/return profile
- We participate in private and collaborative engagements

Ongoing Review

- Follow-up meetings are considered based on evidence of company progress, significance of investment for overall portfolio, etc.

Proxy Voting

- ESG analysts provide views on ESG-related matters
- Investment teams will override external proxy service provider's recommendation when in the best interest of clients

For illustrative purposes only.

Expertise and access drive value for investors

The Preferreds team's deep experience and expertise in the industry is integral towards securities selection and creating opportunities for investors.

Co-portfolio managers Joseph Bozoyan (Joe) and Bradley Lutz (Brad) lead the team, while Richard Baker (Rick) is our client portfolio manager.

Joe has previously served as a managing director and senior investment analyst on Manulife's Intrinsic Value Team, providing dedicated research for all strategies managed by that team. Joe has deep experience in the energy, utilities, and REITs sectors.

Brad was previously our senior investment analyst, working on the fixed income strategies. His expertise is in the power & utility, aerospace & defence, and industrial sectors. Brad also manages the synthetic corporate at the collateralised debt obligation (CDO) product group and most recently, at Declaration Management & Research – an affiliate of Manulife Investment Management.

Rick works with the US-based fixed income investment teams to support our client facing teams, ensuring effective communication and positioning of our investment strategies with clients, prospects and consultants.

The diverse wealth of skills, talent and experience creates an ideal environment for the team to maximise its potential in managing the asset class.

The Preferreds team

Joseph Bozoyan
Co-portfolio manager

Bradley Lutz
Co-portfolio manager

Richard Baker
Client portfolio manager

Investment opportunities in utilities and financials

Having discussed the unique opportunities that the Preferreds markets offer, coupled with Manulife Investment Management's unrivalled experience and expertise in the asset class, let us now explore the outlook in two key sectors: utilities and financials.

A. Electric utilities: Strong potential in a traditionally defensive play

Regulated electric utilities, one of the largest issuers of Preferreds, are known for their defensive nature in economic downturns. This is because while other sectors may face a significant deterioration in demand as economy activity slows, demand for electricity stays relatively stable throughout the various stages in the business cycle.

While this traditional economic resilience is usually reflected in market prices of utility Preferreds, this did not hold in the extreme market volatility experienced in February and March this year. Indeed, utilities saw substantial downward pressure amid the market sell-offs then, as correlations for the different assets converged (towards perfect correlation among price movements). Utility equity and bond prices have begun to recover, as the extreme volatility levels have since receded, with investors starting to search for yield and defensive sectors again.

As investors look to this traditional haven of utilities in an economically challenging environment, how will the unique

Chart 15: 2020 S&P 500 sector performance and EPS revisions

		Consensus EPS as of 31 Dec 2019			Consensus EPS as of 30 Jun 2020			
	YTD - Price Return	2020 31 Dec 2019	2021 31 Dec 2019	2022 31 Dec 2019	2020 30 Jun 2020	2021 30 Jun 2020	2022 30 Jun 2020	Change in '20 EPS
Financials	-24.62%	$38.25	$41.60	na	$23.18	$31.88	$37.73	-39.4%
Utilities	-12.61%	$16.51	$17.30	$18.07	$16.22	$17.21	$18.22	-1.8%
Healthcare	-1.72%	$73.61	$80.64	$86.69	$66.27	$76.49	$84.84	-10.0%
Energy	-37.02%	$25.84	$28.71	$34.76	($1.00)	$8.56	$18.26	-104%
IT	14.21%	$74.05	$83.78	$81.85	$69.07	$79.57	$83.42	-6.7%
Consumer discretionary	6.60%	$44.34	$49.59	$54.58	$17.13	$36.03	$44.61	-61.4%
Consumer staples	-7.05%	$32.03	$34.36	$36.43	$29.70	$32.05	$34.86	-7.3%
Industrials	-15.50%	$40.68	$45.52	$52.13	$17.99	$32.29	$38.68	-55.8%
Communication services	-0.97%	$9.68	$10.86	$14.47	$7.53	$9.20	$10.66	-22.2%
Real Estate	-14.02%	$12.70	$13.33	$13.60	$10.70	$11.85	$12.54	-15.8%
Materials	-8.04%	$21.01	$24.18	$26.57	$14.61	$18.79	$20.84	-30.4%
S&P 500 Index	**-4.04%**	**$177.82**	**$196.70**	**$210.38**	**$126.86**	**$163.34**	**$187.71**	**-29%**

Source: FactSet, as of 30 June 2020.

economic challenges of the pandemic impact this sector? How defensive will the sector's earnings be, compared to previous economic downturns?

Overall, we have a positive view on the electric utilities sector over the short to medium term, primarily because of their very positive fundamentals but also due to its underperformance trailing defensive sectors, as well as attractive valuations.

Utilities have trailed every other defensive sector except energy, despite the lowest earnings per share (EPS) revisions of any sector in the S&P 500 in the current market environment[8]. During the early stages of the pandemic and the market sell-offs, there were concerns that electricity utility demand may significantly decrease, as stay-at-home orders would decrease consumption among commercial end-users such as restaurants and office. While demand from the commercial sector did fall, residential demand – a higher margin business – increased as most of the US population started working from home. This shift in demand is reflected in the minimal change in forecast to the utilities sector earnings – in line with an expected decrease of 1% in 2020 and 2021.

Indeed, despite being a defensive sector, EPS revisions are less than -1.8% in 2020, while utilities remain down around 12.6%, underperforming major indices such as the S&P 500 (see Chart 15). Other defensive sectors have remained resilient under market pressure: healthcare and consumer staples only decreased by 1.7% and 7%, respectively[7].

In addition, utilities are seeing its lowest valuation since the early 2000s, based on historical price-to-earnings (P/E). There are also wide valuation gaps against US treasuries and the Moody's Bond index. Based on the current interest rate outlook and market P/E, the sector is approaching its lowest relative valuation since the 2000 tech bubble, with its sharpest slide to a substantial margin in 30 years.

B. Financials: Resilience amongst well-capitalised institutions

We also believe that financial services companies, another significant issuer of Preferreds, are currently well-positioned, primarily given their strong balance sheets.

The current strength of US financial institutions is due to the reforms which took place after the Global Financial Crisis. The government compelled banks to tighten their lending standards because of their weak balance sheets, and to hold additional capital against potential losses. As a result, banks' capital levels are at all-time highs, which is especially important since they now support their customers through the pandemic-related economic disruptions.

In fact, we have seen announcements from large and small cap banks on plans to support their customers, including a pledge from banks to suspend share buybacks, with some even expanding dividend buybacks.

Insurance companies, regulated by the states where they operate, are similarly well-positioned from a balance sheet standpoint. Property and casualty (P&C) insurance companies are benefitting from increases in premiums paid, as these companies have been raising prices owing to years of higher-than-expected claims.

We are therefore seeing a lot of value in the financial services sector, as we believe the market is not giving these securities due credit for their strong fundamentals.

> “*Utilities*
>
> *Overall, we have a positive view on the electric utilities sector over the short to medium term, due to its underperformance trailing defensive sectors, as well as positive valuations.*
>
> *Financials*
>
> *We believe that financial services companies, another significant issuer of Preferreds, are currently well-positioned, primarily given their strong balance sheets.*
>
> *We have seen announcements from large and small cap banks on plans to support their customers, including a pledge from banks to suspend share buybacks, with some even expanding dividend buybacks.*”

[7] FactSet, as of 30 June 2020.

[8] Bank of America report, 1 July 2020.

Conclusion

As we move into an increasingly complex market environment, with low to zero interest rates and high volatility, investors are seeking assets that offer attractive yields as well as strong diversification potential. Preferreds as an asset class offers this unique opportunity.

The volatility and uncertainty earlier this year has not spared Preferreds. Indeed, Preferreds declined along with other asset classes during the drawdowns in the selloff. This volatility, however, has produced attractive opportunities for investors, as evidenced by the long-term fundamental characteristics of the asset class.

Manulife Investment Management is uniquely positioned to help investors take advantage of these opportunities. Our established position in the Preferreds market, coupled with our experienced team, has produced impressive results for investors. We are confident this will remain as our differentiated approach and deep expertise had served us well all these years.

Index definition

The ICE BofAML Fixed-Rate Preferred Securities Index (p0p1, $25 par preferred) tracks the performance of investment-grade only, fixed-rate US dollar-denominated preferred securities issued in the US domestic market, inception 1989.

The ICE BofAML Fixed-Rate Core Plus Preferred Securities Index (p0p4, $25, $50 and $100 par preferreds) tracks the performance of fixed-rate US dollar-denominated preferred securities issued in the US domestic market.

The ICE BofAML US Capital Securities Index (c0cs, $1,000 par preferred) is a subset of the BofAML US Corporate Index including all fixed-to-floating rate, perpetual callable and capital securities.

ICE BofAML US All Capital Securities Index (i0cs) is a subset of the BofAML US Corporate Index including all fixed-to-floating rate, perpetual callable and capital securities, inception since 2012.

The ICE BofAML US Corporate Index (C0A0) tracks the performance of US dollar-denominated investment-grade corporate debt publicly issued in the US domestic market.

ICE BofAML US High Yield Index (HOAO) tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market.

ICE BofAML BBB Global Corporate Index, a subset of the ICE BofA US Corporate Master Index tracking the performance of US dollar denominated investment grade rated corporate debt publicly issued in the US domestic market.

ICE BofAML US Treasury & Agency Index (G0A0) tracks the performance of US dollar denominated US Treasury and non-subordinated US agency debt issued in the US domestic market.

Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

Bloomberg Barclays EM USD Aggregate Index is a flagship hard currency Emerging Markets debt benchmark that includes USD-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers.

S&P 500 Index – A stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

Investment Considerations

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A widespread health crisis such as a global pandemic could cause substantial market volatility, exchange trading suspensions and closures, and affect portfolio performance. For example, the novel coronavirus disease (COVID-19) has resulted in significant disruptions to global business activity. The impact of a health crisis and other epidemics and pandemics that may arise in the future, could affect the global economy in ways that cannot necessarily be foreseen at the present time. A health crisis may exacerbate other pre-existing political, social and economic risks. Any such impact could adversely affect the portfolio's performance, resulting in losses to your investment

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Important Information

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