Vanguard

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Portfolio perspectives

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Adam Herdel, CIMA®

Vanguard Portfolio Solutions

Preferred securities: Stocks or bonds?

The low interest rate environment over the past decade-plus led some advisors and portfolio managers to look beyond the traditional bond universe to increase the yields of their fixed income allocations. One category that we identified in our 2023 advisors trend data was preferred stocks, which were present in approximately 13% of the nearly 1,200 fixed income portfolios we analyzed.

Incorporating the characteristics of stocks and bonds

Preferred securities are generally considered a hybrid security, meaning they incorporate both equity and fixed income characteristics. Like common stock, preferred securities represent ownership of a company and can be traded on a stock exchange. And while they typically don't have voting rights, preferred security holders do have a higher claim to distributions (that is, dividends) and, in the event of a liquidation, a higher claim to company assets than common stockholders.

Preferred securities also contain some of the attributes we commonly associate with bonds. For example, both securities can be issued at par value, and dividend payments are generally regular in the same manner that we expect from interest payments on bonds. Note that not all preferred securities operate in the same way, and some may offer different characteristics than those listed here.

Risk versus reward

Like any investment, preferred securities have their trade-offs between risk and reward, so you should consider what role they might play in diversified investment strategies. For example, preferred securities might deliver higher yields; however, this can come at the expense of higher volatility relative to traditional investment-grade bonds. Considering correlations of monthly returns over the last 20 years, preferred securities had a correlation of 0.5 with the broad U.S. equity market, while bonds had a correlation of 0.22. As Figure 1 shows, the higher correlation between preferred stocks and equities suggests that they don't offer the same diversification benefits to equities as their high-quality fixed income counterparts.

FIGURE 1: Preferred securities show a higher correlation to stocks than bonds

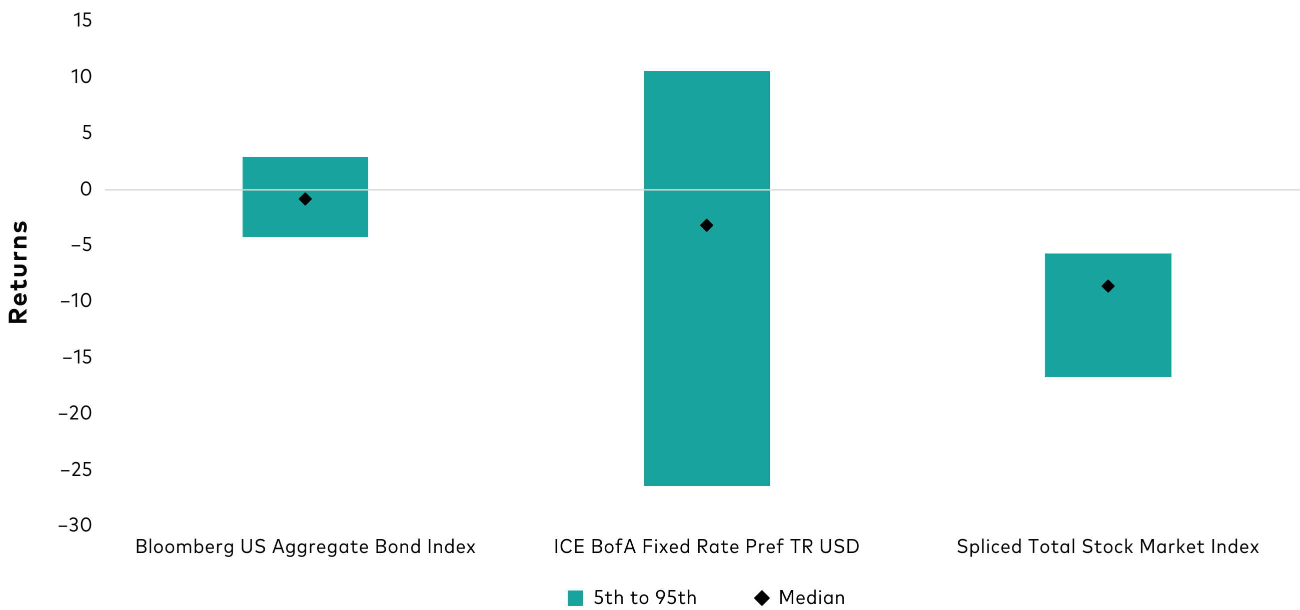
		1	2	3
1	S&P 500 TR USD	1.00		
2	Bloomberg US Agg Bond TR USD	0.22	1.00	
3	ICE BofA Fixed Rate Pref TR USD	0.50	0.37	1.00

Source: Morningstar Direct, as of April 30, 2024.

Because the role of the fixed income allocation is often to serve as the diversifier to equity risk, another lens we considered was the performance of preferred stocks relative to their investment-grade fixed income and equity counterparts during the worst decile of monthly equity returns over the past 20 years. Figure 2 below captures the distribution and median return for preferred stocks, equities, and the Bloomberg US Aggregate Bond Index during these months. Notably, high-quality fixed income delivered more consistent protection along with substantially lower volatility than preferred stocks when equity markets were at their worst. Thus, if the goal of your fixed income sleeve is to diversify equity risk, even marginal allocations to preferred stocks could produce unexpected drawdowns.

FIGURE 2: Preferred stocks show higher volatility than broad stocks and bonds

Monthly returns from May 2004 through April 2024



Past performance is no guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Source: Morningstar Direct. Data from May 2004 to April 2024.

Note: Broad U.S. equity is represented by the Dow Jones Wilshire 5000 Index through April 22, 2005; the MSCI US Broad Market Index from April 23, 2005, through June 2, 2013; and the CRSP US Total Market Index thereafter.

Next steps to consider: Understand your exposure to defensive assets

With the Bloomberg US Aggregate Bond Index boasting a yield-to-maturity in excess of 5.2% (as of May 29, 2024), bonds are earning real returns. Higher potential future returns for fixed income mean that allocations to high-quality fixed income could play a greater role in total portfolio returns moving forward. As such, it's important to have the right mix of income generation and equity market diversification within your fixed income sleeve. If you would like to capture greater insights into your fixed income allocation, please reach out to the Vanguard Portfolio Solutions team for a portfolio consultation.

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Bond funds are subject to interest rate risk, which is the chance bond prices overall will decline because of rising interest rates, and credit risk, which is the chance a bond issuer will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline.

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