PENDULUM
ASSET MANAGEMENT

May 13, 2024

How Does Pendulum Asset Management Look at Preferred Stock?

One topic we (Pendulum Asset Management LLC, or “Pendulum”) are asked about is what is preferred stock and why do we allocate clients to preferred stock? Below will be a brief primer on what is preferred stock and how Pendulum looks at prospective preferred investments.

Summary:

- We believe certain classes of preferred stock look attractive as an alternative to fixed income
- We like to target discounted preferreds that reset from a fixed dividend to a floating one, where the issuer has the option to call/redeem the stock at face value
  - We prefer to invest in names that we believe have a high probability of getting called by the issuer, so that the preferred holder who buys at a discount receives their initial investment at face value, plus receive any outstanding dividends owed to them
- We may or may not invest in preferred stock for clients, depending on their individual situation; clients have received and continue to receive information on select preferred stock that we believe offer significant value in the market.

A Brief Primer on Preferred Stock:

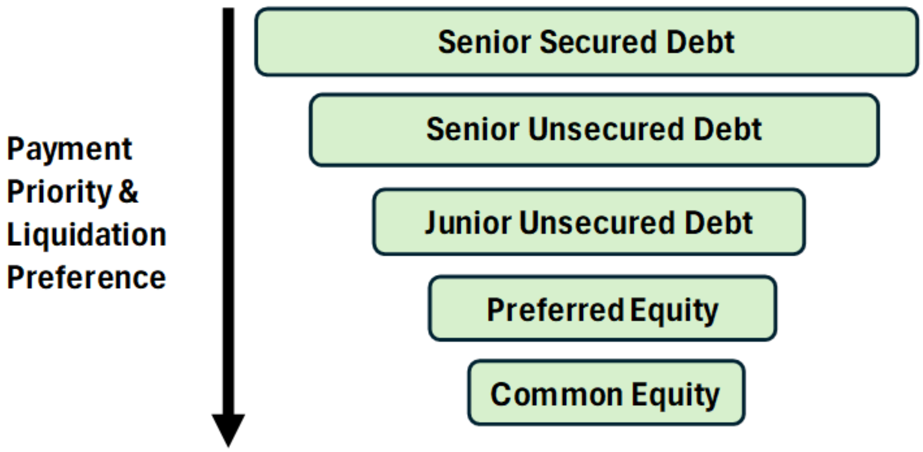
Preferred stock is given preference over common shares when it comes to the distribution of assets or the payment of dividends, hence the name. Preferred stocks are fixed income investments classified as equity and are issued primarily by REITs, banks and insurance firms. See below for quick summary on differences between common equity, preferred equity and debt:

Figure 1: Comparison Chart

	Common	**Preferred**	**Debt**
Ownership	Equity in company	Equity in company	No Ownership
Payment	Dividend at discretion of Company. No obligation to pay the dividend	Typically fixed dividend, paid periodically. Not considered an Event of Default to not pay the dividend BUT if missed, common will not be able to be paid dividend	Typically fixed interest, paid periodically. Company is obligated to pay interest payments. Missing will be considered an Event of Default
Maturity	Perpetual	Typically perpetual, with call date often ~5 years after issuance	Fixed Maturity
Risk/Return Profile	Highest potential risk, highest potential return	Higher risk than debt but lower risk than common equity typically. Returns made via dividends and potential capital gains if bought at a discount. Investor receives dividends plus face value (usually $25 per share) at time of redemption	Lower risk than common and preferred Returns made via interest and potential capital gains if bought at a discount. Investor receives interest plus face value of investment (usually $100) at time of maturity
Liquidation Preference	Lowest preference	Above common equity, lower than debt	Depending on type of debt. Above both common and preferred equity
Voting Rights	Yes	Typically No	No

Regarding payment priority and liquidation preference, see the chart below. Note that liquidation preference and principal loss are the inverse of one another; senior secured debt is going to be the first priority in liquidation/bankruptcy, and therefore be made whole before the senior unsecured, junior unsecured, preferred equity and common equity.

Figure 2: Payment Priority and Liquidation Preference



Beyond the similarities and differences to debt, certain preferred stock may also have different types of features, including but not limited to:

Convertible: Certain preferreds may be convertible into common stock. Investors may trade their preferreds for common shares, usually at some predetermined ratio. This allows investors to earn dividend income on their preferred holdings while having the potential upside of owning the common.

Cumulative: If a company issues a dividend but does not pay it out, that missed dividend will be accumulated and must be paid in the future. If not paid in the future, the dividends keep accumulating. This is meant to be a protective mechanism for preferred holders; should preferreds not be paid, common will not be able to be paid any dividends.

Non-Cumulative: If a company does not pay its dividend to preferred holders, the dividend does NOT accumulate. Meaning, missed dividends do not need to be made up for.

Beyond the basic types of preferred, there are also differences in how dividend rates are calculated:

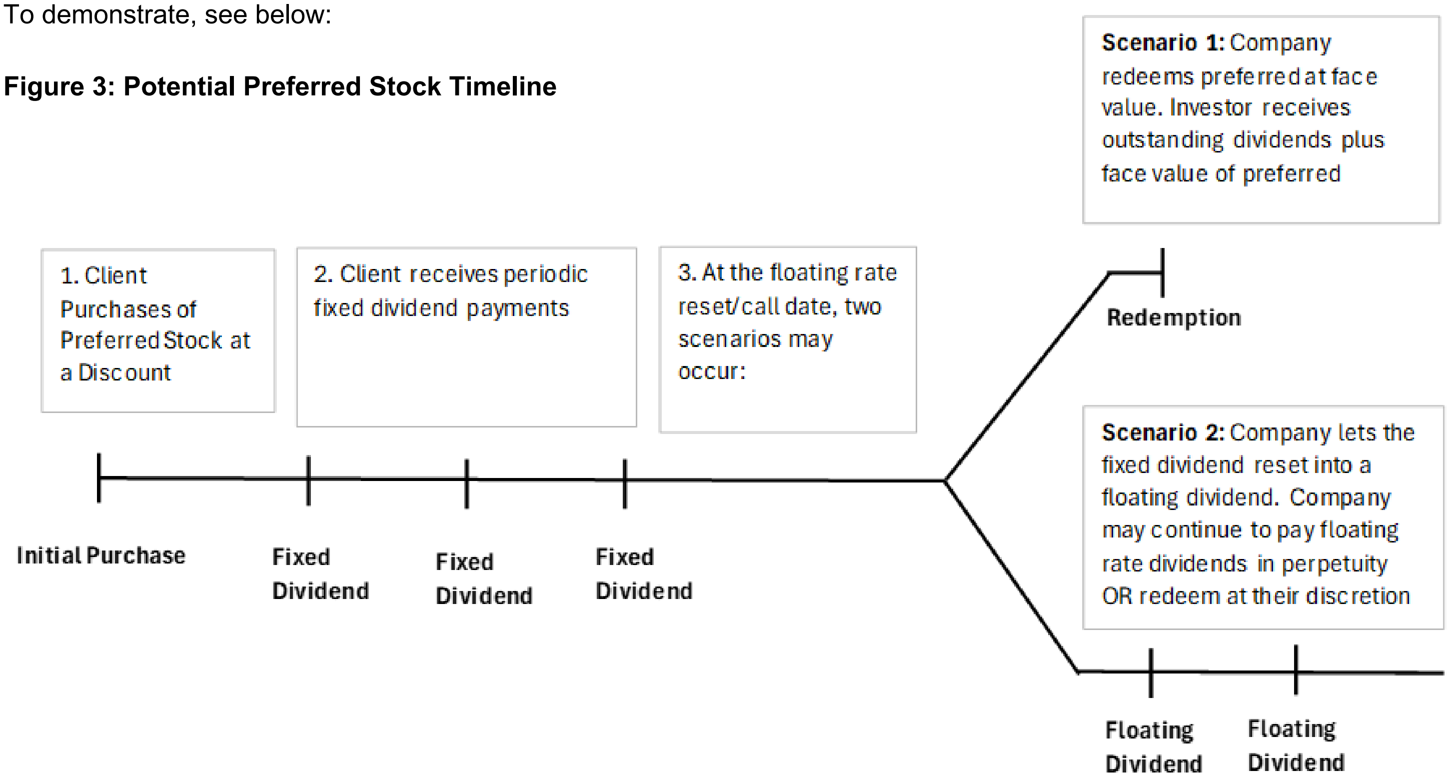
Fixed Dividend: Dividends are fixed either in perpetuity or until the company calls back the preferred and redeems

Fixed to Floating: Dividends are fixed at issuance, but reset to a floating rate index, usually coinciding with the call date for the preferred. What this mean is that the company usually has the option to let the coupon reset to floating (paying at an index, typically SOFR + a % spread), or they can redeem the preferred. The company would typically exercise its option to redeem a preferred when the new floating-rate coupon exceeds what it can refinance the preferred for. This is by design, as the floating rate coupon is usually meant to be punitive to incentivize a redemption. We like preferred stock that fits this coupon profile.

Pendulum's Targeted Preferred Stock Profile:
As mentioned in the summary and above, we believe that the most attractive preferred stock type in the marketplace currently is the fixed to floating preferred, bought at a discount to face value, that we believe may be called/redeemed at face value at the time of dividend reset.

To demonstrate, see below:

Figure 3: Potential Preferred Stock Timeline



Why would a company call/redeem their preferred stock? As mentioned above, if a newly reset rate is significantly higher than where the company believes they can refinance, then logically they would call the preferred and either do nothing else or issue a new one at a lower rate. Again, the reset coupon is usually meant to be punitive to ensure that investors are called out of their holdings.

On the other hand, if a company decides for whichever reason, that it is not worth it to call/redeem the preferred stock, this is not necessarily a bad outcome, as the investor may then own a floating rate instrument that pays a noteworthy dividend.

Before ending, we need to discuss a few key risks that are present with buying callable preferreds (and preferreds in general):

- **Call & Reinvestment Risk:** If a company calls the preferred in a declining interest rate environment, the proceeds may have to be reinvested at lower yields.
  - In other words, the company has the option to call the preferred at the call date. Meaning, the owner of the preferred is short the call option, which carries its own cost that needs to be considered. While we can go into much deeper detail surrounding this topic, know that we believe that we hedge for this cost by buying preferreds at a discounted price
- **Credit Risk:** If the company fails to pay any of its existing debt or if there is a general credit rating downgrade, this may affect the price of its preferreds. Also, should credit issues arise, and the company decides to NOT pay the dividend, regardless if the preferred is cumulative or not, this may cause its price to decline
  - To hedge for this, we do a deep dive on all parent companies of the preferreds we invest in, and pay close attention to the dividend coverage of the preferreds as well as the company's general standing on credit
- **Liquidity Risk:** While exchange traded, many preferred issuances are thinly traded, and so it may be difficult for investors to sell their holdings at or near its perceived value
- **Delisting Risk:** One risk that is not given enough consideration is, what happens if the company/issuer is acquired by a private entity? Often times, we have seen issuers deciding to delist their preferreds from the exchanges post-closing of acquisition, greatly impacting liquidity. While we view this an opportunity in of itself (buying delisted preferreds), it is a key risk often overlooked.

We believe preferred stock plays a role in client portfolios since we believe that there is significant income and capital appreciation potential. We may or may not invest in preferred stock for clients, depending on their individual situation; clients have received and continue to receive information on select preferred stock that we believe offer significant value in the market.

Please reach out at eric.kruglak@penduluminvest.com if you have any questions.

Disclaimer:

This presentation contains general information that is not suitable for everyone and was prepared for informational purposes only. Nothing contained herein should not be construed as a solicitation to buy or sell any security or as an offer to provide investment advice. Pendulum Asset Management, LLC is a registered investment adviser. For additional information about Pendulum Asset Management, LLC, including its services and fees, send for the firm's disclosure brochure using the contact information contained herein or visit advisorinfo.sec.gov.

We are neither your attorneys nor your accountants and no portion of this material should be interpreted by you as legal, accounting or tax advice. We recommend that you seek the advice of a qualified attorney and accountant.
This communication contains certain forward-looking statements that indicate future possibilities. Due to known and unknown risks, other uncertainties and factors, actual results may differ materially. As such, there is no guarantee that any views and opinions expressed herein will come to pass.