



# REIT Preferreds: A DIFFERENTIATED INCOME STRATEGY

## Overview

With some attributes of debt and some of equity—plus the unique operational structure of the issuing companies—it’s no wonder REIT preferred shares are considered a niche investment. But this often-overlooked market segment has offered a reliable source of income, and thanks to its spread cushion, is well-positioned to navigate a changing interest rate environment relative to other fixed income investments.

To better understand the potential for REIT preferreds to enhance portfolio yield, we’ll start by building familiarity with the structure of preferred securities in general and REIT preferreds specifically, then dive into performance patterns, interest rate considerations and comparisons to other asset classes.

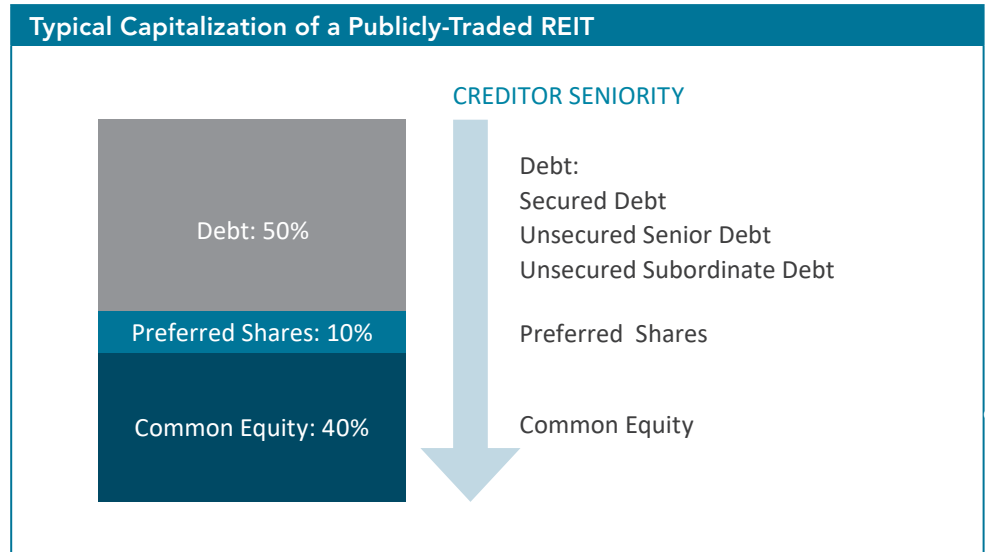
### TABLE OF CONTENTS

<b>Overview</b> .....	<b>1</b>	<b>How have REIT preferreds performed historically?</b> .....	<b>8</b>
<b>How do preferred shares work?</b> .....	<b>2</b>	Historical returns compared to fixed income investments.....	8
Where are preferred shares? .....	2	Historical returns compared to all preferred shares? .....	9
What type of companies issue preferred shares?.....	2	When have REIT preferreds sold off?.....	10
How big is the market? .....	3	REIT preferreds performance when other	
<b>What should I know about how REIT preferreds are</b>		market segments have declined .....	11
<b>structured?</b> .....	<b>4</b>	REIT preferreds performance during financial crisis .....	13
What is the maturity profile? .....	4	What is the default rate for REIT preferreds? .....	13
How do the dividends work? .....	4	How correlated are REIT preferreds to other asset classes?...	14
Do REIT preferreds typically offer any protections?.....	4	How volatile are REIT preferreds? .....	14
Are shares rated by major credit agencies?.....	5	<b>What happens to REIT preferreds when interest rates rise?....</b>	<b>15</b>
<b>How do REIT preferreds trade on the secondary market?.....</b>	<b>6</b>	What is the duration profile of REIT preferreds? .....	15
How are shares traded? .....	6	What do spreads currently look like? .....	16
How liquid are REIT preferreds?.....	6	What has happened during rising rate periods? .....	16
<b>What are risks of preferred shares and REIT preferreds? .....</b>	<b>6</b>	<b>How do REIT preferreds stack up against other</b>	
What are the most prominent risks? .....	6	<b>non-traditional fixed income investments</b> .....	<b>17</b>
Do any market mechanisms offset these risks? .....	7	Compared to other non-traditional	
Do any attributes of REITs offset these risks?.....	7	bond strategies, how do REIT preferreds look? .....	17
		What about REIT preferreds vs. US high yield bonds?.....	18
		<b>Conclusion</b> .....	<b>19</b>

## How Do Preferred Shares Work?

### *Where are preferred shares in the capital structure?*

Preferred shares pay a stream of fixed- or floating-rate dividends, much like the coupon payments made on traditional bonds. As shown below, preferred shares are junior to debt obligations and senior to common equity.



For investors, preferreds act like bonds because of their income stream—but because preferreds are subordinate to bonds, investors are compensated for the additional risk. Compared to corporate bonds, yields on preferreds have been higher and spreads wider. At the same time, preferred shares may not share in the same upside potential of common equity.

### *What type of companies typically issue preferred shares and why?*

For the issuing company, preferred shares are a form of equity. As such, preferreds can help the issuer reach regulatory capitalization targets.

Within the US preferreds market, the most active issuers are in the bank, insurance and REIT sectors<sup>1</sup>—sectors which are broadly characterized by big companies with steady revenue streams and transparent cash flows, making them ideal candidates for issuance of preferred shares.

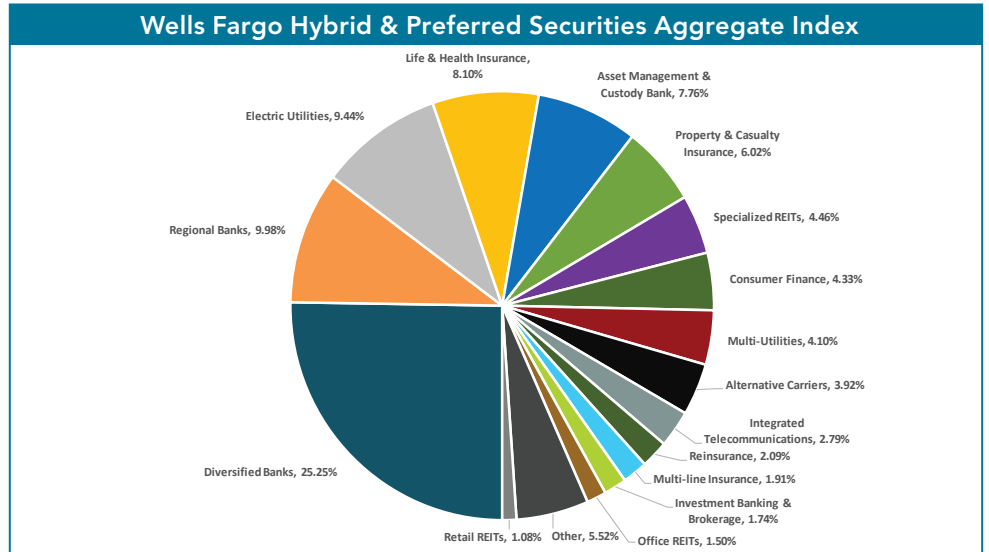
REITs also typically issue preferred shares when the costs of issuing debt are high.<sup>2</sup> Additionally, the perpetual nature of preferreds means the issuing REIT faces reduced refinancing risk, compared to issuing a traditional corporate bond with a fixed maturity.

<sup>1</sup> As per sector weightings in the Wells Fargo Hybrid and Preferred Securities Aggregate Index (ticker: WAGG), a market cap-weighted index designed to track the performance of non-convertible, \$25 par preferred securities listed on US exchanges; <https://www.wellsfargoresearch.com/Indices/Details/7>

<sup>2</sup> “An Analysis of REIT Security Issuance Decisions”, Walter I. Boudry, Jarl G. Kallberg and Crocker H. Liu, 2010; Cornell University, School of Hospitality Administration; <http://scholarship.sha.cornell.edu/articles/271>

*How big is the market?*

The global universe of preferred securities is approximately \$973 billion.<sup>3</sup>



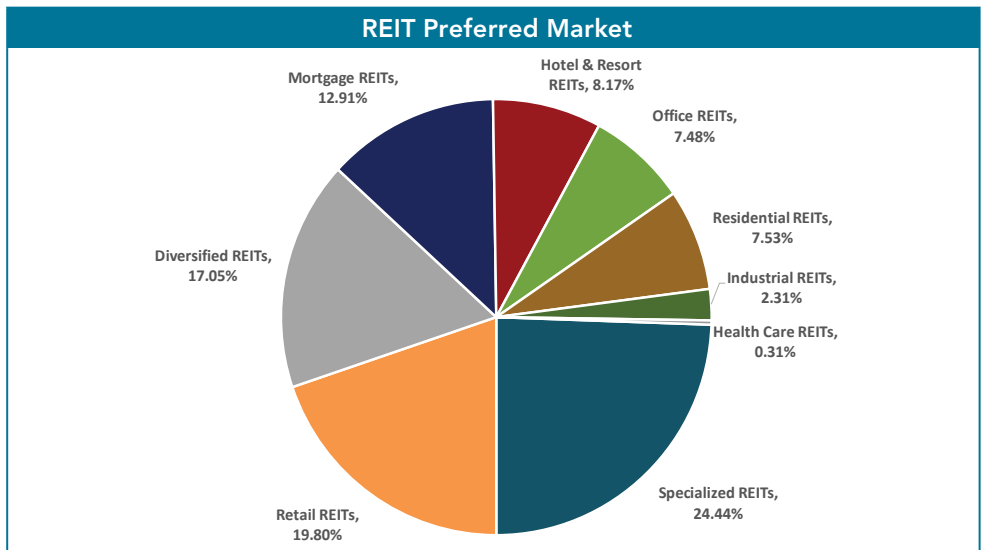
Source: wellsfargoresearch.com. Online data updated through 6/30/19. Numbers may not add to 100% due to rounding.

The market for preferreds issued by US-based REITs is a comparatively small slice of the overall global market for preferred shares. As shown below, the US REIT preferreds market is comprised of approximately 130 issues and totals \$22 billion. Diversified, retail, and specialized REITs are responsible for the bulk of the issuance.<sup>4</sup>

REIT PREFERRED MARKET CAP  
\$22 billion USD

NUMBER OF ISSUES  
126

AVERAGE ISSUE SIZE  
\$177 million USD



Source: Wells Fargo, Bloomberg, Orinda Asset Management. As of 6/30/19. Numbers may not add to 100% due to rounding.

<sup>3</sup> “The Case for Preferred Securities”, William Scapell, CFA, Cohen & Steers, Inc., June 2018

<sup>4</sup> Wells Fargo, Bloomberg, Orinda Asset Management

## What Should I Know About How REIT Preferreds are Structured?

### *What is the maturity profile?*

REIT preferreds are typically “perpetual”—meaning there is no set maturity date—but the securities are generally callable at par after a specified number of years. Call protection is typically offered for five years.

Preferreds issued with high coupons may trade above par until they become callable or shortly before—a concern for some investors. If an issue trades at a premium to par, however, that doesn’t mean an investor will necessarily lose money when the issue is called at par, due to the coupons he or she will receive until the call date.

For example, let’s say a \$25 par preferred is trading at \$26 with an 8% coupon that is callable in two years. This security will yield just over 5.8% to the call date, which represents 7.7% current yield for two years, and a roughly 4% one-time loss. If all cashflows are discounted to the present, it would equal an IRR (internal rate of return) of approximately 5.8%—which is what the yield to maturity (to the call date, in this case) represents.

Of course, even if a preferred is currently callable, it may not be called immediately. In that case, the investor enjoys an extended period of receiving above-average coupons.

### *How do the dividends work?*

Dividend payments are usually fixed but can be floating or structured with a fixed-to-floating format. Dividend payments on preferred shares are not contractual obligations for the issuer—an important point of distinction compared to traditional corporate bonds. Dividends are paid at the discretion of the issuer’s board of directors. As such, delaying or skipping a dividend payment on preferred shares does not constitute a default.

REIT preferreds, however, are almost always offered as “cumulative” securities: Dividend payments can be deferred, but must be paid to preferred security holders in full before common shareholders receive any dividends. Preferred shares issued by companies in other industries are typically non-cumulative.

### *Do REIT preferreds typically offer any investor protections (e.g., covenants)?*

REIT preferreds commonly offer protection to investors in the event of a takeover or leveraged buyout via change-of-control provisions. While REIT preferreds are generally considered a non-voting share class, holders often have the ability to add board members after a certain number of missed dividend payments—often referred to as an “equity light” voting provision.

Here's an example of a structure for a new REIT preferred issuance:

Issuer	Dividend	Maturity	Call Feature	Other Provisions
ABC Shopping Center REIT	Quarterly – Fixed at 5.50%	Perpetual	Callable at par after 5 years	<ul style="list-style-type: none"> <li>Change of control provision: Holders can convert preferred holdings into common stock</li> <li>Right to elect two additional directors if preferred dividends are deferred for six quarters</li> </ul>

S&P Rating	% of REIT Preferred Universe
A to A-	23%
BBB+ to BBB-	32%
BB to BB-	3%
Unrated	42%

As of June 30, 2019.

Source: Wells Fargo Bank, Bloomberg.

### Are shares rated by major credit agencies?

REITs can have credit agencies provide a rating for their preferred shares—just like traditional corporate bonds—but roughly half of REIT preferreds are offered without ratings. Because issue sizes are typically small, many REITs choose to forego the expense of the ratings process.

In terms of relative value, rated REIT preferreds carry an average current yield of 6.02%; for unrated REIT preferreds, the average current yield is 7.11%, as shown below.

REIT Preferreds: Rated and Unrated				
	# of Issues	Dollars at Recent Price	% of WHPSR	Wtd. Avg. Strip Yield
<b>Rated</b>				
\$250 Million and Higher	19	\$ 6,690,577,400	30.0%	5.60%
\$150 - \$250 Million	23	4,703,741,200	21.1%	5.75%
Up to \$150 Million	13	1,425,819,600	6.4%	8.86%
<b>Rated Subtotal</b>	<b>55</b>	<b>\$ 12,820,138,200</b>	<b>57.5%</b>	<b>6.02%</b>
<b>Unrated</b>				
\$250 Million and Higher	6	\$ 1,850,287,484	8.3%	7.34%
\$150 - \$250 Million	17	3,197,109,806	14.3%	6.79%
Up to \$150 Million	48	4,428,770,660	19.9%	7.25%
<b>Unrated Subtotal</b>	<b>71</b>	<b>\$ 9,476,167,950</b>	<b>42.5%</b>	<b>7.11%</b>
<b>Total Rated &amp; Unrated</b>	<b>126</b>	<b>\$22,296,306,149</b>	<b>100.0%</b>	<b>6.48%</b>

Source: Bloomberg and Orinda Asset Management; June 30, 2019.  
Past performance is no guarantee of future results.

## How do REIT Preferreds Trade on the Secondary Market?

### *How are shares traded?*

REIT preferreds are primarily listed and trade via exchanges, though some trade over-the-counter.

### *How liquid are REIT preferreds?*

The average monthly trading volume of REIT preferreds is \$1.3 billion, representing roughly 6% of the \$22 billion market.<sup>5</sup> By comparison, the US high yield bond market tallies an average monthly trading volume of \$224 billion, representing roughly 19% of its \$1.2 trillion market.<sup>6</sup>

Many market participants—including our team at Orinda Asset Management—believe the relative inefficiencies of the secondary market for REIT preferreds create opportunities for experienced, active managers to add value.

## What are the risks of preferred shares in general, and REIT preferreds in particular?

### *What are the most prominent risks?*

As discussed above, preferred shares sit between common equity and debt in a company's capital structure. Senior to common equity in "liquidation preference", preferreds typically have no voting rights and, if not convertible, none of the unlimited upside available in stocks.

Preferreds pay a fixed coupon like a bond, but lack the two structural features that appeal to most bond investors: The certainty of a maturity and a senior claim on a company's assets. Preferreds are callable after a term—meaning their duration extends when rates rise and the call option becomes less valuable—but the likelihood of a call may compress much of an investor's upside from a decline in rates.

Additionally, preferreds can be illiquid, particularly in times of stress, and companies may electively turn off coupons without default when cash is constrained.

<sup>5</sup>Wells Fargo Hybrid & Preferred Securities REIT Index as of 12/31/18.

<sup>6</sup>US corporate bond daily trading volume data provided by SIFMA, from FINRA TRACE; 2017 YTD average daily trading volume of all US high yield corporate bonds = 12.3bn, as of 5 December 2017; <https://www.sifma.org/resources/research/us-corporate-bond-trading-volume/>. Average monthly trading volume = average daily volume multiplied by 20. Size of US high yield corporate bond market data: "Credit Strategy Weekly Update," J.P. Morgan, North American High Yield and Leveraged Loan Research, 6 January 2017, [https://markets.jpmorgan.com/?#research.na.high\\_yield](https://markets.jpmorgan.com/?#research.na.high_yield); as cited by <http://www.peritusasset.com/2017/06/the-high-yield-market-market-size-ownership-funds-and-opportunities-3/>

### *Do any market mechanisms help offset these risks?*

Little credit protection, minimal participation in growing profits, exposure to rising rates but not to falling rates, and liquidity risks—do preferreds have anything going for them? Fortunately, these concerns can be addressed in multiple ways.

#### *Higher Yields*

The first, most obvious risk mitigation mechanism is that preferreds have paid higher yields to compensate investors for bearing these left-tail risks. While some may see these as “sucker yields”, many experienced investors believe every risk has a price and there are no bad securities, only bad prices. In fact, most fixed income investments entail tradeoffs between yield and embedded benefits to the issuer, like call options or coupon deferral.

#### *Diversification*

A second approach to risk mitigation is diversification. Owning a portfolio of different preferreds allows an investor to isolate and quarantine idiosyncratic risks from company credit or an unexpected call. Even the systematic risk of movements in the yield curve can be addressed in the portfolio context: Owning direct hedges (such as swaps), indirect hedges (such as common stocks), or even diversifying internationally have the potential to mitigate preferreds’ risk.

### *Do any attributes of REITs help offset these risks?*

Structural protections can help prevent abuse or unwanted surprises—and REIT preferreds are one area where many such protections are available. Mechanisms range widely, from 5-year non-call protection to change-of-control covenants forcing a full redemption at par if a leveraged or private party acquires the issuing company.

Covenants are rare in preferreds, but REITs generally include a number of bond-like covenants to sweeten the deal for investors. More importantly, REIT preferreds are cumulative, meaning skipped dividends must be paid in arrears. This acts as a deterrent to coupon suspension, but in the case of a genuine liquidity squeeze, it means companies must make investors whole once stressful period is passed—which many issuers have historically done.

**Notably, this structural feature is not permitted by financial services regulators who require full cancellation of a bank or insurance company’s preferred dividend (and possible principal write-down) for the instrument to qualify as statutory equity capital.** Some preferreds—more often in the financial sector—have introduced a floating rate toggle, possibly as compensation for these structural risks. In a rising rate environment, issuers would be disciplined to fully call Tier 1 equity instruments rather than pay floating interest.

#### *REITs as preferred issuers: Distinguishing attributes*

By nature, REITs have several attributes that we believe distinguish them as more reliable counterparties. First, REITs typically own hard assets which appreciate

over long periods of time, pay fixed recurring income streams, and hold their value in a liquidation, unlike many industrial and financial companies.

Further, tax law requires REITs to pay out 90% of their taxable income to common shareholders in the form of dividends. Due to its seniority, a preferred dividend must always be paid before a common dividend. Due to the long-term nature of commercial real estate leases, it is unusual for a REIT not to have taxable income for any period and therefore be exempt from paying common dividends.

Lastly, as we noted above, preferred shareholders are senior to common shareholders in the capital structure.

In summary, REIT credit is positioned to be more stable, more predictable and less volatile than that of many other sectors of the preferred market. Moreover, REIT preferred securities themselves offer several direct and indirect structural protections that are very desirable from the point of view of preferred shareholders—making them uniquely capable of offsetting much of the innate risk asymmetry of preferred stock.

## How have REIT preferreds performed historically?

### *How do the historical returns look compared to other fixed income investments?*

REIT preferreds have historically been very competitive to the broader universe of preferred shares, the US high yield bond market, and the investment grade corporate bond market.

For the 10-year period ended June 30, 2019, REIT preferreds have generated an average annual return of 11.29%, comfortably outpacing the 8.38% return of the broader preferreds market and surpassing the performance of US high yield and investment grade corporate bonds, which respectively returned 9.24% and 6.07%. The same pattern of outperformance by REIT preferreds is also evident for the five-year period, as shown below.

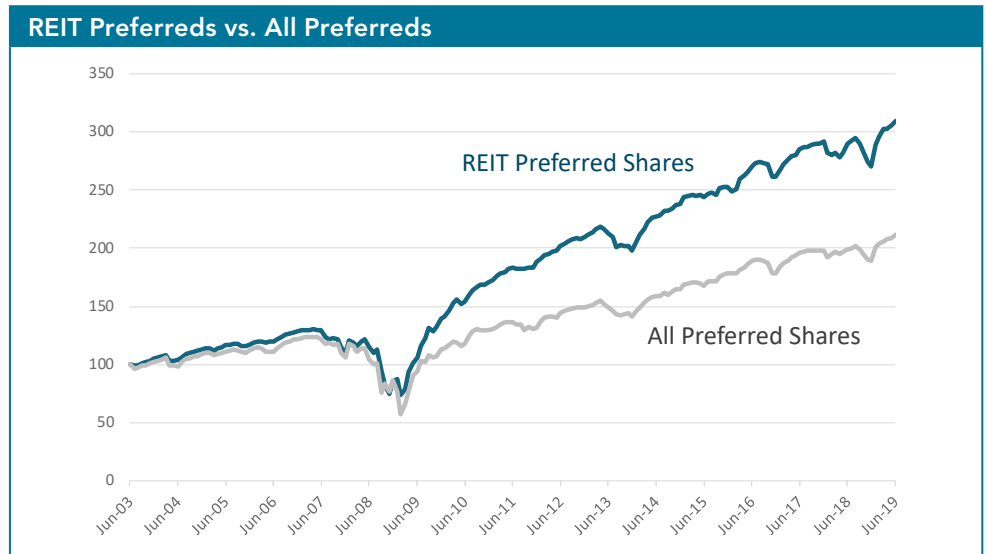
Historical Returns <i>as of June 30, 2019</i>				
	Compound 1-Year Return	Avg. Annual 3-year Return	Avg. Annual 5-year Return	Avg. Annual 10-year Return
REIT Preferred Shares	6.49%	4.61%	6.31%	11.29%
All Preferred Shares	6.08%	3.85%	5.86%	8.38%
US High Yield Bonds	7.48%	7.53%	4.70%	9.24%
Investment Grade Corporate Bonds	10.72%	3.95%	4.08%	6.07%

Source: Bloomberg. Please see disclosures for indices used. **Past performance is not a guarantee of future results.** Index performance is not indicative of fund performance. To obtain fund performance, call 925-253-1300 or visit [www.orindafunds.com](http://www.orindafunds.com).



*How do the historical returns look compared to all preferred shares?*

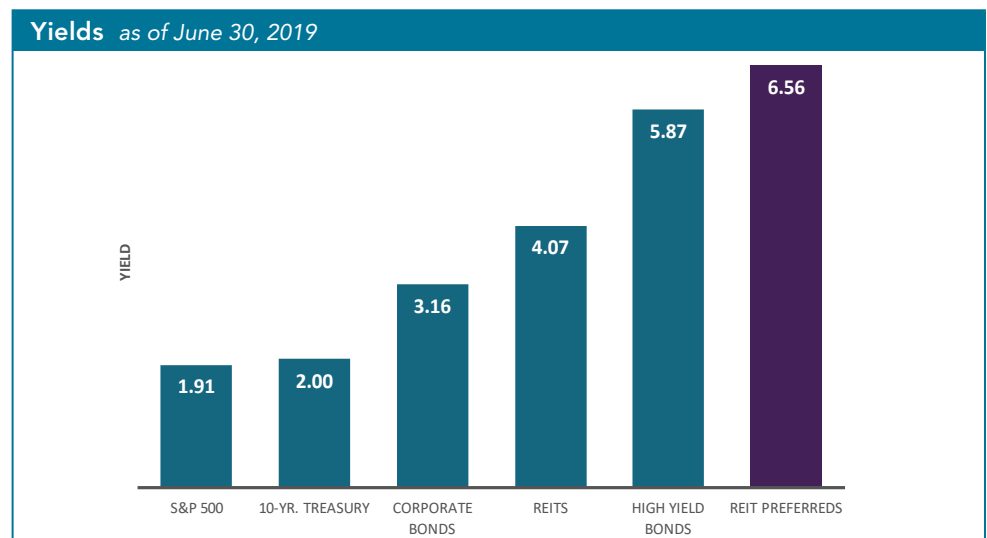
As shown below, REIT preferreds have historically outperformed the market for all preferred shares.



Source: Bloomberg. Data from June 30, 2003 – June 30, 2019. Please see disclosures for indices used. **Past performance is not a guarantee of future results.**

This consistent outperformance can be explained by the primary drivers of total return for REIT preferreds, which include:

1. *Comparatively higher yields.* REIT preferred issuances are often small, unrated and traded in a relatively inefficient secondary market. These characteristics mean investors can demand comparatively higher yields, boosting the income component of total return.



Source: Bloomberg. Please see disclosures for indices used. **Past performance is not a guarantee of future results.**

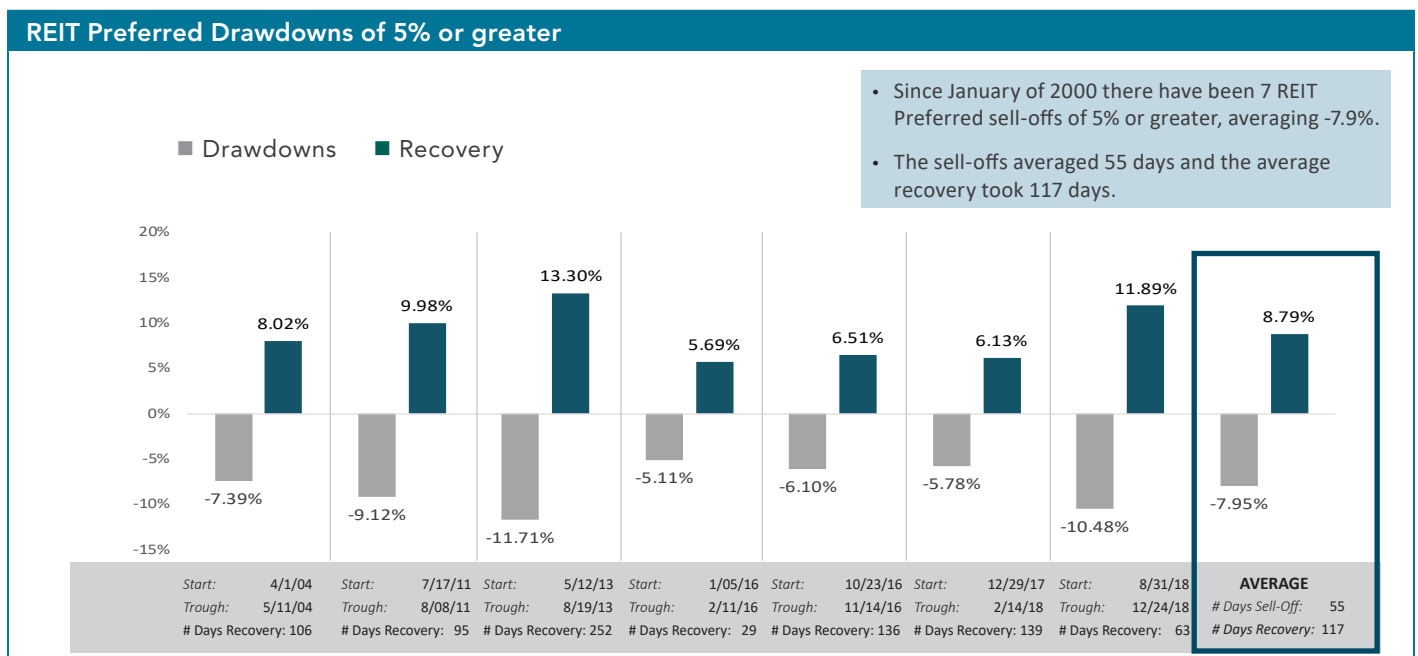
2. *Cumulative dividends.* Income is further boosted by the common requirement that REITs make up any shortfall in dividend payments. As shown in the REIT Preferred vs. All Preferred chart on the previous page, the performance of REIT preferreds began to markedly diverge from the performance of all preferred shares around the time of the global financial crisis. This divergence can be attributed to the cumulative nature of REIT preferred dividends.
3. *Investor-friendly rules.* To receive preferential tax treatment, REITs must pay out at least 90% of their taxable income to common shareholders as dividends—which means REITs are significantly less likely to skip or delay dividend payments, compared to other issuers of preferred securities.

### When have REIT preferreds sold off?

While REIT preferreds have historically posted attractive returns, the asset class hasn't been immune to selloffs. Here we take a closer look at drawdowns—both within the REIT preferred space, and how REIT preferreds traded when other market segments have been under pressure.

First, we'll examine drawdowns in absolute terms: Periods during which REIT preferreds declined by more than 5% between January 3, 2000 (the inception of the benchmark REIT preferreds index) and June 30, 2019. Because our goal is to illustrate typical performance trends, our review excludes the financial crisis; we have dedicated a later section to a discussion of the financial crisis.

As shown below, seven periods meet these drawdown criteria. On average, REIT preferred shares declined 7.9% over 55 days and recovery to the prior peak lasted 117 days. Of note, drawdowns in REIT preferreds—especially sell-offs greater than 10%—have historically been excellent entry points for patient investors.



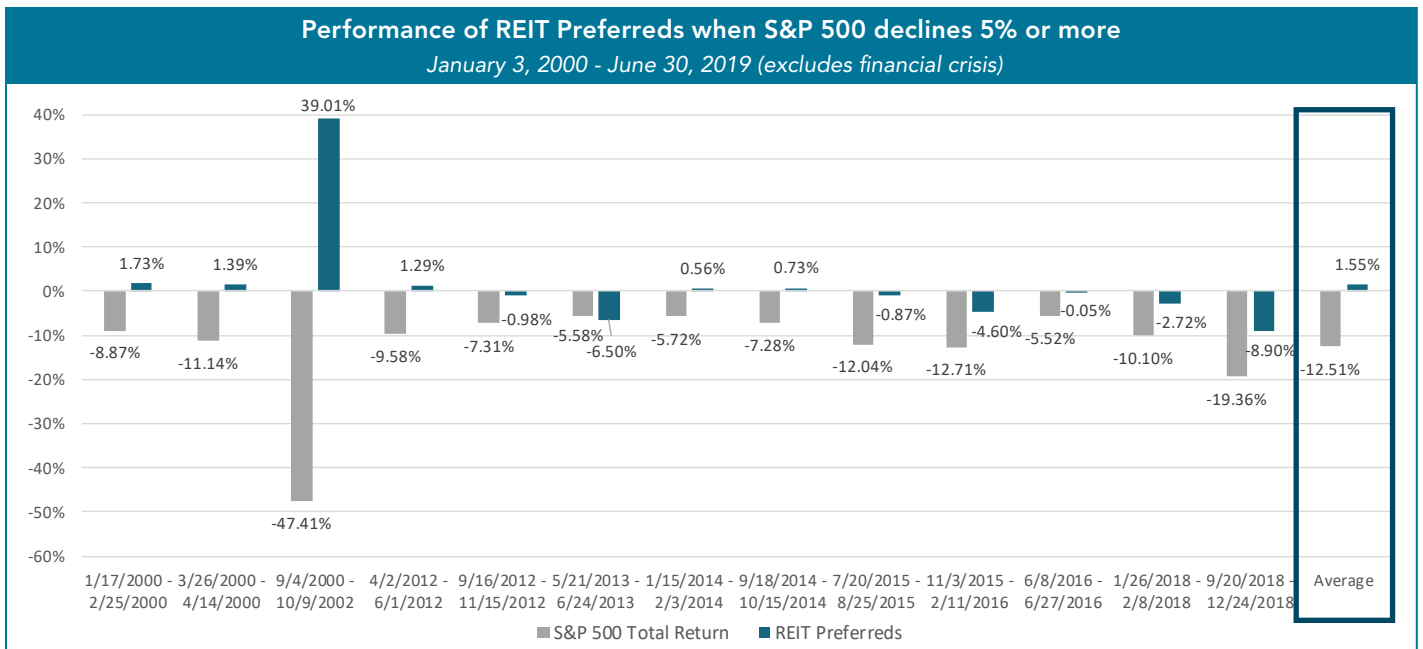
Source: Bloomberg, REIT Preferred Stock – Wells Fargo Hybrid & Preferred Securities REIT Index. Past performance is not a guarantee of future results.

REIT preferreds can be impacted by negative sentiment surrounding the broader market. As such, drawdowns are often characterized by indiscriminate investor selling despite positive REIT industry fundamentals. During the drawdown in early 2016, for example, the equity markets saw the worst start to a year as of mid-February with the S&P 500 down just over 10% by February 11. The equity market in China got things started with extreme volatility as soon as the year started declining over 22% in January. The sell-off spread from growing concerns over a global slowdown and potential problems with European banks.

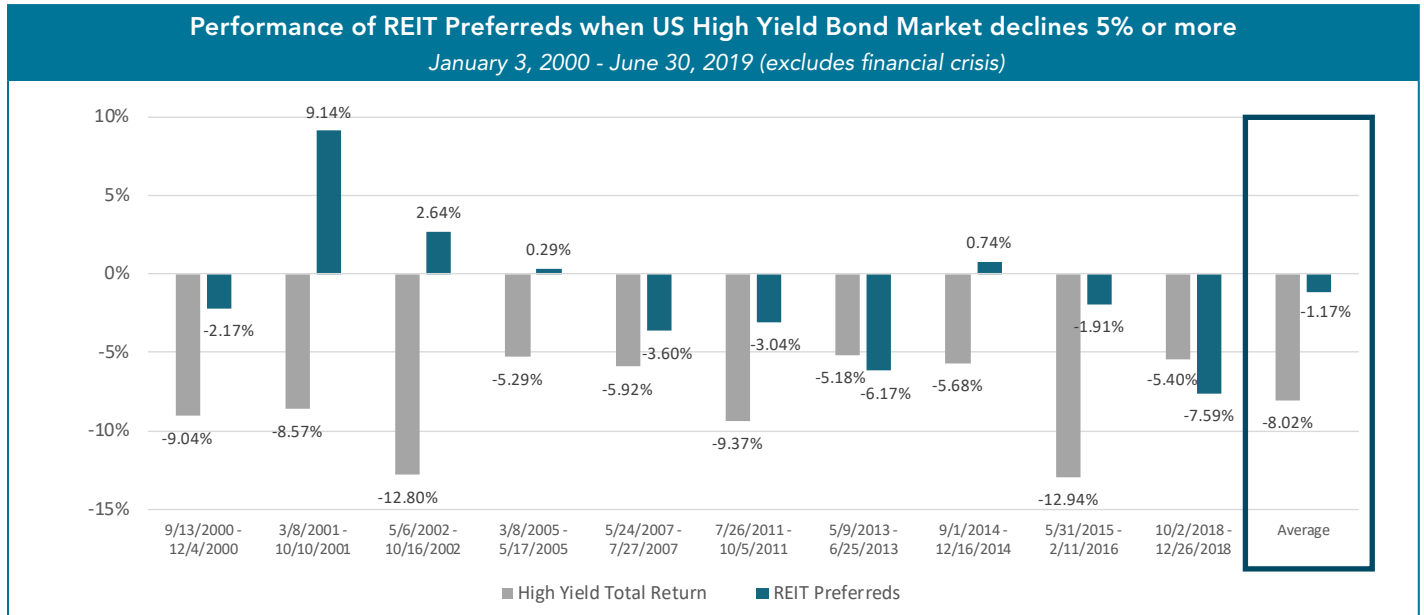
*How have REIT preferreds performed when other market segments have declined?*

Below we see thirteen periods during which the S&P 500 Total Return Index declined by more than 5% between January 3, 2000 and June 30, 2019, excluding the financial crisis. On average, REIT preferreds outperformed the benchmark US equity index by 14.06%. Furthermore, REIT preferreds on average posted a positive return of 1.55% while US equities sold off an average of 12.51%.

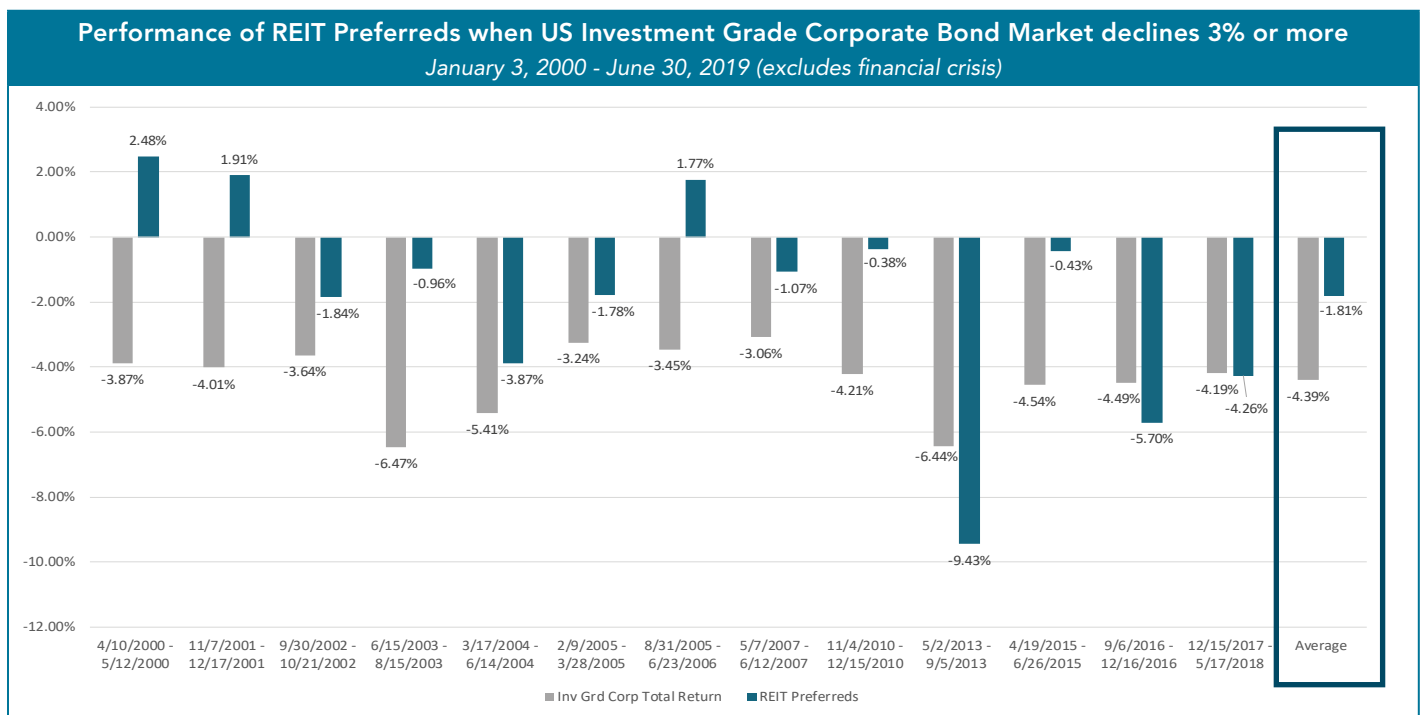
It's important to note that the above-mentioned average calculations are impacted by an outlying period (September 4, 2000 – October 9, 2002), as shown below. If we remove this outlier, we see that REIT preferreds outperformed the benchmark US equity index by an average of 8.02%, with REIT preferreds posting an average decline of 1.58% while US equities sold off an average of 9.60%.



We observe a similar pattern when examining periods during which US high yield bonds sold off by more than 5%. As shown below, REIT preferreds outperformed high yield bonds by an average of 6.85%, demonstrating their ability to offer historically attractive returns.



Lastly, we examine the performance of REIT preferreds when investment grade corporate bonds declined by more than 3%. On average, REIT preferreds have outperformed by 2.58%, another demonstration of their historically attractive returns.



### *How did REIT preferreds perform during the financial crisis?*

Many areas of the market, including REIT preferreds, experienced extreme volatility during the financial crisis. At the time, REIT preferred shares were widely held in closed-end funds, which used leverage via the auction rate preferred market—a short term financing method also used by many municipal entities.

In early 2008, the auction rate preferred market stopped functioning as expected. Eventually, many closed-end funds became forced sellers, which drove prices lower and fed a cycle of additional forced selling. Some closed-end funds were completely liquidated and shut down during the financial crisis.

As shown below, REIT preferred shares declined 50.70% during the financial crisis, reaching a bottom in November 2008. In early 2009, when forced selling stopped, the REIT preferred market started to see a rapid recovery. By the end of September 2009, the market had returned to its June 2007 level.

Returns During Financial Crisis		
<i>June 29, 2007 – March 9, 2009</i>		
	Total Return for Full Period	Equivalent Annualized Return
REIT Preferred Shares	-50.70%	-34.10%
All Preferred Shares	-64.51%	-45.71%
US High Yield Bonds	-27.87%	-17.52%
US Investment Grade Bonds	-4.10%	-2.44%

Source: Bloomberg. Please see disclosures for indices used. **Past performance is not a guarantee of future results.**

### *What is the default rate for REIT preferreds?*

Given their negligible history of defaults, credit losses associated with REIT preferreds have historically been considerably lower relative to other high-yielding debt investments.

From the period 2000 to 2017, the REIT preferred market experienced an average annual default rate of 0.89% of the outstanding issuance versus 3.17% for high yield. The average recovery rate for REIT preferred issues was 49% compared to 42% for high yield. Additionally, approximately half of all REIT preferred defaults were concentrated in sub-prime mortgage REITs which failed during the financial crisis and no longer exist in their prior form.<sup>7</sup>

<sup>7</sup>JP Morgan, Moody's Investor Services, Bond Investors Association

### How correlated are REIT preferreds to other asset classes?

As shown below, REIT preferreds have historically offered low correlation to other major asset classes.

It's important to note that, while REIT preferreds offer attractive longer-term diversification potential, there's no such thing as a free lunch. During bouts of interest rate sensitivity—such as the 2013 “Taper Tantrum”—many asset classes sold off in lockstep and saw correlations tick up, including REIT preferreds.

Correlation to REIT Preferreds as of June 30, 2019				
	One Year	Three Years	Five Years	Ten Years
All Preferred Shares	0.88	0.92	0.91	0.84
US High Yield Bonds	0.53	0.54	0.53	0.59
Investment Grade Corp Bonds	0.12	0.41	0.39	0.56
S&P 500 Index	0.42	0.38	0.36	0.39

Source: Bloomberg. Please see disclosures for indices used. **Past performance is not a guarantee of future results.**

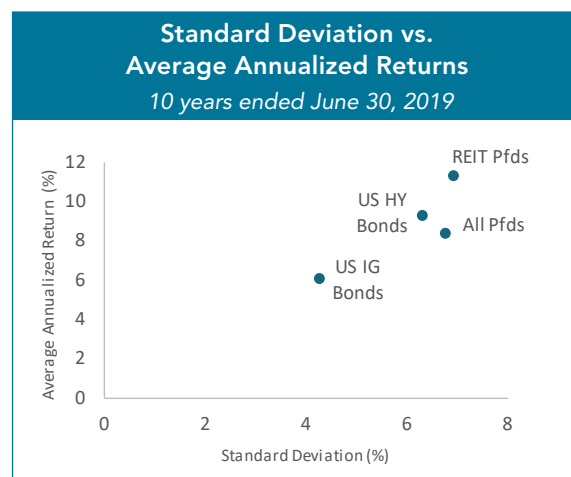
### How volatile are REIT preferreds?

In terms of volatility, REIT preferreds have been competitive with other major asset classes. While REIT preferreds have had a slightly higher standard deviation compared to high yield and corporate bonds, it's important to note that the financial crisis had a bigger impact on REIT preferreds. If you consider pre- and post-crisis averages, you'll note that REIT preferreds compare more favorably.

In our view, it is equally informative to consider pre- and post-crisis averages as well as standard deviation within the context of average annualized returns. From this perspective, we see REIT preferreds have delivered attractive risk-adjusted returns over a 10-year period.

Standard Deviation as of June 30, 2019					
	One Year	Five Years	Ten Years	Pre-Crisis (6/30/03– 6/30/07)	Post-Crisis (12/31/09– 6/30/19)
REIT Preferreds	6.98%	5.20%	6.92%	2.84%	5.26%
All Preferred Shares	6.53%	5.44%	6.77%	5.22%	6.11%
US High Yield Bonds	4.49%	5.04%	6.32%	3.89%	5.05%
Investment Grade Corporate Bonds	3.14%	3.92%	4.28%	4.11%	4.25%

Source: Bloomberg. Please see disclosures for indices used. **Past performance is not a guarantee of future results.**



Source: Bloomberg. Please see disclosures for indices used. **Past performance is not a guarantee of future results.**

## What happens to REIT preferreds when interest rates rise?

### *What is the duration profile of REIT preferreds?*


When it comes to duration—an important measure of a security’s sensitivity to changes in interest rates—the structure of a preferred security is especially important.

At first blush, investors may think a preferred security with a fixed coupon and perpetual maturity would be saddled with a high duration and substantial interest-rate risk. The duration profile of REIT preferreds, however, is quite different, due to the call options commonly embedded within the securities.<sup>8</sup>

Callable bonds and preferreds embed an option (typically available after 5 years) for the issuer to redeem the bond or preferred stock early at par. When that option is in-the-money—that is, when the security is trading at a premium—we tend to assume it will be exercised and thus the final maturity of the preferred is its call date.

Of course, this assumption is vulnerable to changes in interest rates: As rates rise, the option value falls and is less likely to be exercised. This means that duration extends just when we don’t want it to—a property called negative convexity. For this reason, many investors aim to be very conservative in their assumptions about which preferreds may be called.

A theoretical duration model may include a binary option tree to evaluate the probability of a call. For illustration purposes, below we show a calculation of the modified duration of a preferred security with 50% chance of a call in 5 years and 50% chance of never being called.

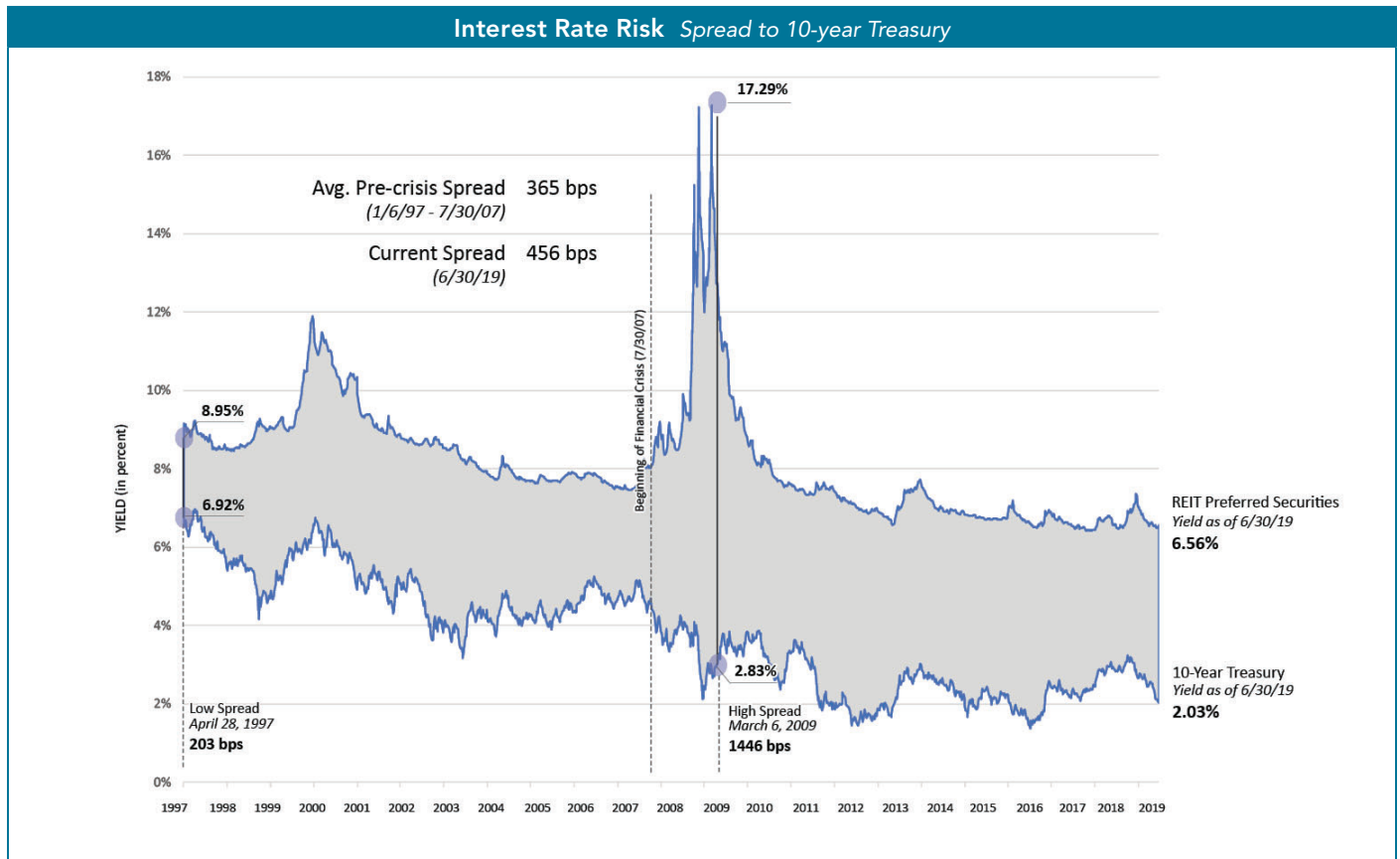
Modified Duration Calculation	
<i>Quarterly pay perpetual maturity security with 5-year call protection</i>	
<p><b>50% chance of a call in 5 years</b></p> <ul style="list-style-type: none"> <li>Assumed maturity date: Dec. 31, 2022</li> <li>7% coupon rate and 7% yield</li> <li>Modified duration = 3.912</li> <li>Weighted value = 1.956</li> </ul>	<p><b>50% chance of never being called</b></p> <ul style="list-style-type: none"> <li>Perpetual maturity</li> <li>7% coupon rate</li> <li>Modified duration = 15.286</li> <li>Weighted value = 7.643</li> </ul>
	
<p><b>Weighted average modified duration = 9.599</b></p>	

For illustrative purposes only, does not indicate actual outcomes. The scenarios illustrated reflect a typical preferred security at issuance with five years call protection from the date of issue, a 7% coupon, and issuance at par.

<sup>8</sup>Duration differs from maturity proportionally to the coupon. Duration is calculated as the present value cash-weighted term to maturity. A zero-coupon bond’s duration is its final maturity. For a coupon bond, even a perpetual preferred, the duration is much shorter than that. A 10% perpetuity has infinite maturity, but only 11 years’ duration at issue. As the coupon rate goes higher, the present value of the cash flows received early in the term are substantially more important than the term to maturity, and the duration shrinks.

### What do spreads currently look like?

REIT preferreds are currently trading at spreads comfortably above long-term averages. As shown below, the spread over the US 10-year Treasury stands at 456 basis points (bps), 91bps wider than the average pre-crisis spread of 365bps.



This significant spread cushion—and the implied room for tightening—can help REIT preferreds withstand increases in interest rates. On a total return basis, the combination of dividend income plus spread tightening can help offset the negative consequences of price declines due to a rising interest rate cycle.

### What has happened during past periods of rising rates?

While past performance isn't an indicator of future returns, it can be helpful to examine how REIT preferreds have performed during historical episodes of rising rates. Performance during each individual period depends heavily on why rates are rising and how quickly they are rising.

During protracted periods of rising rates, REIT preferreds have produced an average return of 5.26%, as shown below. It's important to note this average calculation is impacted by an outlying period for REIT preferred returns (December 18, 2008 – June 10, 2009), as shown on the next page. If we remove this outlier, we see that REIT preferreds have produced an average return of 2.32% during periods of rising rates.



Periods of Rising Rates: REIT Preferred Performance					
Start	End	10-yr. Treasury Low Rate	10-yr. Treasury High Rate	Difference	REIT Preferred Returns
November 7, 2001	April 1, 2002	4.22%	5.44%	1.22%	5.40%
June 13, 2003	May 13, 2004	3.13%	4.85%	1.72%	1.18%
June 2, 2005	May 12, 2006	3.89%	5.19%	1.30%	2.99%
December 18, 2008	June 10, 2009	2.08%	3.98%	1.90%	34.66%
November 27, 2009	April 5, 2010	3.21%	4.01%	0.80%	16.23%
October 6, 2010	December 15, 2010	2.41%	3.53%	1.12%	1.31%
July 25, 2012	February 13, 2013	1.43%	2.05%	0.62%	4.61%
October 23, 2013	December 31, 2013	2.51%	3.04%	0.53%	-3.06%
February 2, 2015	June 10, 2015	1.68%	2.50%	0.82%	-0.04%
July 8, 2016	December 16, 2016	1.37%	2.60%	1.23%	-4.16%
September 7, 2017	November 8, 2018	2.05%	3.24%	1.19%	-1.29%
<b>Average</b>					<b>5.26%</b>

Source: Bloomberg, REIT Preferred Shares – Wells Fargo Hybrid & Preferred Securities REIT Index. Please see disclosures for indices used. Past performance is not a guarantee of future results.

## How do REIT preferreds stack up against other non-traditional fixed income investments, in terms of returns, volatility and relative value?

*Compared to a leveraged loan or other non-traditional bond strategy, how do REIT preferreds look?*

In our current investment environment—characterized by a historic multi-year bull run in bonds—many savvy asset allocators are seeking effective means to diversify exposure within the fixed income portion of their portfolios. As such, many investors are exploring “non-traditional” fixed income opportunities, including US high yield, leveraged loan, “core plus” and unconstrained bond strategies.

REIT preferreds, which are often an overlooked slice of the non-traditional fixed income market, stack up competitively against the other alternatives.

REIT Preferreds vs. Non-traditional Fixed Income			
10 years as of June 30, 2019			
	Annualized Return	Standard Deviation	Correlation to REIT Preferreds
REIT Preferreds	11.29%	6.92%	1.00
All Preferreds	8.38%	6.77%	0.84
US High Yield Bonds	9.24%	6.32%	0.59
Leveraged Loans	6.17%	3.98%	0.55

### What about REIT preferreds vs. US high yield bonds?

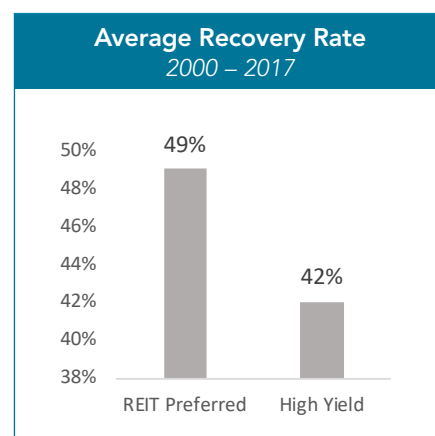
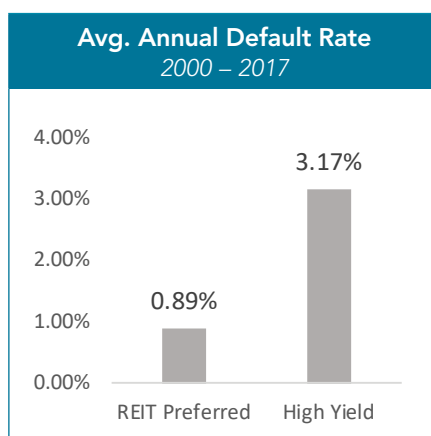
We believe it's worthwhile to take a closer look at REIT preferreds compared specifically to US high yield bonds. REIT preferreds are well-positioned for three key reasons: The ability to generate competitive returns with comparable volatility, the potential for better credit quality, and attractive relative value.

First, over the long term, REIT preferreds have delivered a similar return to high yield—and, depending on the time period analyzed, have exhibited similar standard deviation characteristics.

Annualized Returns as of 6/30/19				
	5-year	10-year	15-year	Since Inception (1/31/00)
High Yield	4.70%	9.24%	7.58%	7.17%
REIT Preferreds	6.31%	11.29%	7.53%	9.32%

Standard Deviation as of 6/30/19		
	High Yield	REIT Preferreds
Since Inception (1/31/00 – 6/30/19)	9.17%	11.29%
Post-Crisis (12/31/09 – 6/30/19)	5.05%	5.26%
Pre-Crisis (1/31/00 – 6/30/07)	5.73%	4.13%

Second, as illustrated below, credit losses associated with REIT preferreds have historically been lower relative to high yield investments with a better recovery rate. In fact, in 2018 there were no defaults within the REIT preferred market.



Lastly, REIT preferreds offer attractive relative value. As noted below, high yield bonds have a tighter spread to its average compared to REIT preferred securities.

Dividend Yield Spread		
	REIT Preferred Stock	High Yield Bonds
6/30/19 Yield	6.56%	5.87%
6/30/19 Spread	456	387
Historical Spread		
Pre-Financial Crisis*	365	517
Post-Financial Crisis**	462	487
Weighted Avg. Spread	411	503
Variance to Average	45	-116

*Source: Bloomberg.*

*\*Pre-Financial Crisis (1/31/00 - 6/30/07). \*\*Post-Financial Crisis (12/31/09 - 6/30/19).*

**Past performance is not a guarantee of future results.**

## Conclusion

REIT preferreds are a unique market with several idiosyncratic features. As we've shown here, this often-overlooked investment can offer a reliable source of income and the opportunity for higher risk-adjusted returns, thanks to its relatively inefficient market structure. As with all investments, however, the benefits come alongside certain compromises—in the case of REIT preferreds, the typical tradeoffs are bouts of volatility, interest rate sensitivity, and limited liquidity. ○

## INDICES USED:

**REIT Preferred Stocks** – Wells Fargo Hybrid & Preferred Securities REIT Index.

**All Preferred Stocks** – Wells Fargo Hybrid & Preferred Securities Aggregate Index.

**S&P 500** – S&P 500 Total Return Index.

**U.S. High Yield Bonds** – Bloomberg Barclays US Corporate High Yield Total Return Index.

**U.S. Investment Grade Bonds** – Bloomberg Barclays US Corporate Total Return Index.

**10-Yr U.S. Treasury** – Bloomberg Barclays US Government 10 Year Term Index Total Return.

**10-Yr U.S. Treasury Yield** – US Treasury Yield Curve Rate T Note Constant Maturity 10 Year.

**Corporate Bonds** – Bloomberg Barclays US Corporate Bond Index.

**REITs** – MSCI U.S. REIT Index.

ONE CANNOT INVEST DIRECTLY IN AN INDEX.

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Mutual fund investing involves risk. Principal loss is possible. The fund can make short sales of securities, which involves the risk that losses in securities may exceed the original amount invested. The fund may use leverage which may exaggerate the effect of any increase or decrease in the value of portfolio securities or the Net Asset Value of the fund, and money borrowed will be subject to interest costs. Investments in smaller and medium companies involve greater risks such as limited liquidity and greater volatility. Investments in foreign securities involve greater volatility and political, economic and currency risks and differences in accounting methods. These risks are greater for emerging markets. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investment by the Fund in lower-rated and non-rated securities presents a greater risk of loss to principal and interest than higher-rated securities. The Fund may use certain types of investment derivatives such as futures, forwards, and swaps. Derivatives involve risks different from, and in certain cases, greater than the risks presented by more traditional investments. Investments in asset backed and mortgage backed securities include additional risks that investors should be aware of such as credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. To the extent that a Master Limited Partnership's (MLP's) interests are all in a particular industry, the MLP will be negatively impacted by economic events adversely impacting that industry. The risks of investing in an MLP are generally those involved in investing in a partnership as opposed to a corporation. Exchange Traded Funds (ETFs) are typically open-end investment companies that are bought and sold on a national securities exchange. When the Fund invests in an ETF, it will bear additional expenses based on its pro rata share of the ETF's operating expenses, including the potential duplication of management fees. The risk of owning an ETF generally reflects the risks of owning the underlying securities it holds. Rule 144A securities carry the risk that the trading market may not continue and the Fund might be unable to dispose of these securities promptly or at reasonable prices and might thereby experience difficulty satisfying redemption requirements. The risk exists that the market value of Initial Public Offering (IPO) shares will fluctuate considerably due to factors such as the absence of a prior public market, unseasoned trading, and the small number of shares available for trading and limited information about the issuer. The purchase of IPO shares may involve high transaction costs. IPO shares are subject to market risk and liquidity risk. The Fund is non-diversified, which means that there is no restriction on how much the Fund may invest in the securities of an issuer under the 1940 Act. Some of the risks involved in investing in Real Estate Investment Trusts (REITs) include a general decline in the value of real estate, fluctuations in rental income, changes in interest rates, increases in property taxes, increased operating costs, overbuilding, changes in zoning laws, and changes in consumer demand for real estate.

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