Update for Quarter Ended August 31, 2019

By almost any measure, 2019 has been a banner year for fixed-income (including the types of preferred and other income securities purchased in the funds) – fueled primarily by significantly lower interest rates but also tightening credit spreads. Our market has continued to benefit from investors' appetite for yield, along with limited new issue supply and favorable technicals.

Market expectations of lower rates have been ahead of Federal Reserve policymakers most of the year. Two much-anticipated rate cuts finally arrived in the third calendar-quarter – a 0.25% cut in the fed funds rate on July 31 and another 0.25% on September 18. These moves, along with some signs of weakness in recent U.S. economic data, have continued to keep market expectations biased toward even lower rates. For context, yields on 30-year Treasuries were 3.30% on November 30, 2018, and 1.97% as of the end of the fiscal quarter. Yields on 10-year Treasuries were 3.0% and 1.51% over the same periods. Interest rates in many foreign markets remain in negative territory as global economic conditions continue to be lackluster. Even Greece has some negative-yield debt outstanding today!

In this environment, long-duration assets have outperformed materially. The Barclays-Bloomberg Long U.S. Credit index was up 11.4% in Q3 alone, bringing total return to 26.8% for the period matching our fiscal YTD. This compares to results for the Barclays-Bloomberg U.S. Aggregate index (intermediate duration) of 4.1% in Q3 and 11.1% fiscal YTD.

The preferred market in which the funds invest, on average, is more intermediate duration given the predominance of fixed-to-float structures. Even though prices have increased, preferred and other subordinated securities continue to offer extra yield over comparable senior-debt of similar issuers. In other words, these securities have largely kept pace with the move but still offer healthy subordination premium relative to senior debt. Embedded call options result in negative convexity as prices move higher, so the Funds' bias toward longer call protection has proven valuable.

Credit quality of financial issuers continues to be a bright spot, particularly in the U.S. A weakening economy could eventually result in earnings pressure, but for financials this should be isolated to earnings and not be a threat to capital. Loan losses could tick higher from recent historical lows, but the banking system is in very good shape to weather a storm. Similarly, insurers face headwinds from low investment yields, but underwriting generally remains sound (and data to better assess risk is expanding rapidly) and liabilities have adjusted over the past decade to accommodate low rates. As has been the case for some time, the global picture is not quite as good – but even so, financials stand

above most non-financial companies given continued regulatory oversight and increased levels of common-equity capital.

The move in long-term interest rates has been impressive, but short-term rates have also moved lower – and that directly benefits the Funds' cost of leverage. After reaching a high in January, 2019 around 2.5%, 1-month LIBOR (the Funds' benchmark for leverage rates) was 2.1% as of quarter-end and has continued slowly moving lower. Leverage costs reset monthly, so benefits of lower short-term rates accrue rather quickly. There is no question some of this benefit will be offset by risk of reinvestment at lower rates over time. However, call protection allows for asset levels to reset more slowly than leverage costs – meaning we should see a net benefit to distributable income over the near-term.

Risks to our otherwise positive outlook center primarily on a reversal of this year's decline in interest rates, but that likely results from better-than-expected economic data – which should be good news for credit. Alternatively, a weaker economy could put pressure on spreads (which have narrowed across fixed income this year) that would likely affect preferred and other subordinated securities as well. Longer-term, however, we believe the funds continue to be well positioned to provide attractive levels of income – much of which is tax-advantaged – to shareholders.