

Public Investing

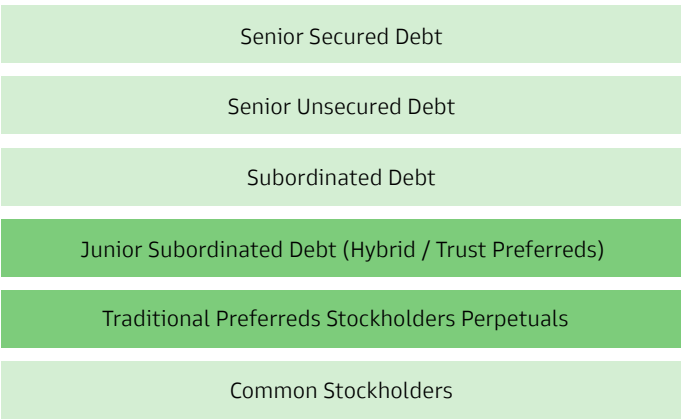
UNDERSTANDING PREFERRED SECURITIES

Preferred securities, also known as “preferreds” or “hybrids,” share characteristics of both debt and equity, and may offer investors higher yields than common stock dividends or corporate bonds. Understanding preferreds is an important first step in determining if they are an appropriate investment.

WHAT ARE PREFERRED AND HYBRID SECURITIES?

Preferred and hybrid securities are typically subordinated and long-dated or perpetual (no maturity date) instruments, typically issued by investment grade companies to achieve regulatory capital or rating agency credit. Banks are the largest issuers in this market given the regulatory requirement to maintain a certain amount of Tier 1 capital.¹

Location in the Capital Structure



Preferred and hybrid securities have priority claims over common equity but are generally subordinated to all other forms of corporate debt. Preferreds are typically rated 2-4 tiers below senior unsecured bonds of the same credit. They can either be a form of debt (junior subordinated debt) or equity (preferred stock).

Preferred securities may have a dividend stopper which gives issuers the right to defer or omit/suspend the coupon or dividend payments on preferreds & hybrid securities.

- Hybrid coupons are typically deferrable and cumulative.
- Preferred stock dividends can typically be suspended and are noncumulative. However, dividend stoppers typically protect holders by restricting payments on securities ranked equal to or junior to the deferred security (such as common stock dividends).

For illustrative purposes only.

1. Tier 1 capital is the predominant form of capital in the U.S. and represents the sum of common equity tier 1 capital and additional tier 1 capital; Common equity tier 1 capital is the most loss-absorbing form of capital. It includes qualifying common stock and related surplus net of treasury stock; retained earnings; certain accumulated other comprehensive income; Additional tier 1 capital includes qualifying noncumulative perpetual preferred stock, bank-issued Small Business Lending Fund (SBLF) and Troubled Asset Relief Program (TARP) instruments that previously qualified for tier 1 capital,² and qualifying tier 1 minority interests, less certain investments in other unconsolidated financial institutions' instruments that would otherwise qualify as additional tier 1 capital. Definitions from Section 2.1 of the FDIC Risk Management Manual of Examination Policies.

2. Qualified Dividend Income (QDI) is similar to ordinary dividends paid on common stock but it can be reported to the IRS as a capital gain rather than income.

3. Dividend Received Reduction (DRD) allows corporations to deduct some or all of the dividend income they receive.

4. Callable securities can be redeemed by the issuer prior to maturity.

5. Source ICE BofAML U.S. All Capital Securities Index as of 12/31/2023.

Sector Composition

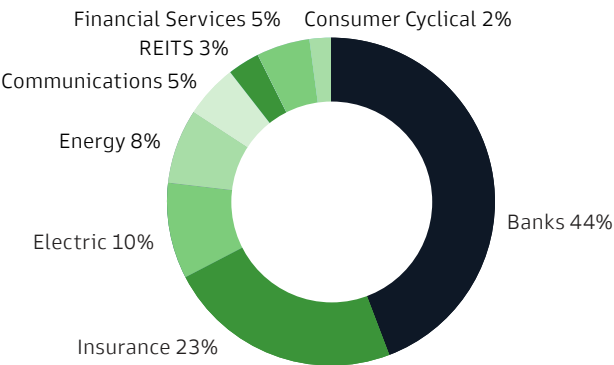
The preferred and hybrid securities market is dominated by financial issuers (approximately 75%) given they are required to issue preferred stock for regulatory purposes.

Security Features

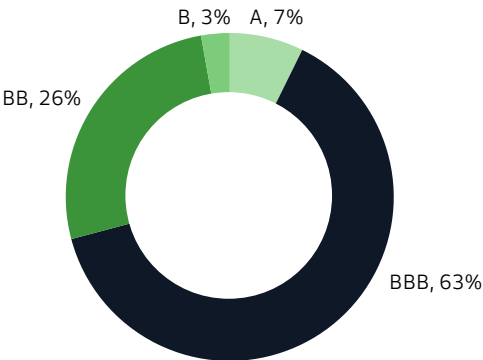
Traditional preferred stock is typically perpetual in nature (no maturity date) and pays fixed or variable coupons and eligible for Qualified Dividend Income (QDI)² and/or Dividend Received Reduction (DRD).³ Hybrid securities are generally long-dated and pay coupons as interest.

Securities are typically callable⁴ and can have either a fixed coupon for life or a variable rate feature.

Sector Allocation (%)⁵



Credit Allocation (%)⁵



PREFERRED SECURITIES ARE OFFERED IN TWO MARKETS

Exchange-traded \$25 par securities are traded on the NYSE (like common stock) and marketed towards retail investors.

- Characterized by more diversified industry representation
- Primarily fixed-rate securities, though some are variable-rate
- Interest-bearing and QDI and/or DRD eligible securities
- Includes senior debt securities

OTC Traded \$1000 Par Securities are traded over-the-counter (like a bond) and marketed towards institutional investors.

- Primarily financial institutions and energy/utilities
- Primarily variable-rate securities
- Interest-bearing and QDI and/or DRD eligible securities

HOW MAY PREFERRED AND HYBRID SECURITIES FIT INTO A PORTFOLIO?

Preferred and hybrids may be utilized in both fixed income and multi-asset portfolios as a diversifier.

- **Income Generation** - Preferred and hybrids may provide higher income than investment grade bonds and similar income to certain high yield bonds. These securities may add income potential to the overall portfolio.
- **Potential Portfolio Diversification** - Preferred securities have demonstrated low correlations¹ to traditional core bonds and may potentially provide attractive diversification benefits within a broad portfolio.
- **Lower Rate Sensitivity** - Variable-rate securities, which are a significant portion of the investment universe, may lower interest rate sensitivity.

INVESTMENT CONSIDERATIONS

Improving Credit Fundamentals - Regulatory changes since the 2008 Global Financial Crisis (GFC) have increased banks' capital and liquidity requirements. Banks participate in annual stress tests and are subject to regulatory approval for dividend increases/share repurchases.

Potential for Higher Income - Preferred and hybrid securities may offer higher yields due to their subordinated stature to senior bondholders, and potential QDI.

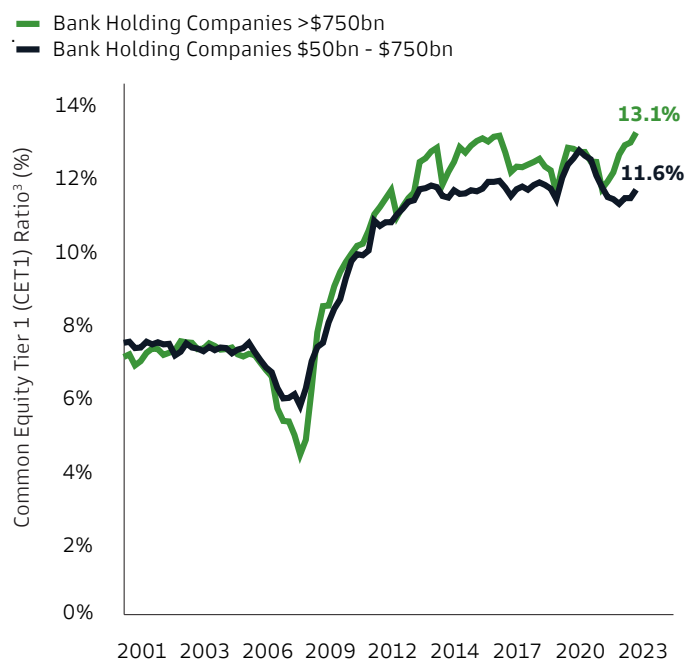
Attractive Relative Value - Preferred and hybrid securities are currently trading at spreads that are historically attractive versus senior investment grade bonds or US Treasuries.

Higher Credit Ratings than High Yield Market - The majority of preferred and hybrid securities are rated near investment grade, and issued by investment grade companies.

FUNDAMENTAL IMPROVEMENT IN THE FINANCIAL SECTOR

Since the GFC, banks are required to hold significantly more capital, including common equity, following the signing of the Dodd-Frank Act in 2010, and may be subject to increased regulatory scrutiny and higher capital requirements as part of the Basel III² endgame proposals. ■

Capitalization Has Significantly Increased Post GFC



Source: Goldman Sachs Asset Management, Bloomberg (includes 14 representative banks). Chart: Bottom left: Federal Reserve Bank of New York. As of Q3 2023.

1. Correlation describes the relationship between two variables. Diversification does not protect an investor from market risk and does not ensure a profit. Past correlations are not indicative of future correlations, which may vary.
2. Basel III is an internationally agreed set of measures developed by the Basel Committee on Banking Supervision in response to the financial crisis of 2007-09. The measures aim to strengthen the regulation, supervision and risk management of banks. Source: Bank for International Settlements.
3. Common equity tier 1 capital (CET1) is widely recognized as the most loss-absorbing form of capital, as it is permanent and places shareholders' funds at risk of loss in the event of insolvency; CET1 and Tier 1 Common Equity Ratio compares a bank's capital against its risk-weighted assets to determine its ability to withstand financial distress. Definitions from Section 2.1 of the FDIC Risk Management Manual of Examination Policies.

DISCLOSURES

Equity investments are subject to market risk, which means that the value of the securities in which it invests may go up or down in response to the prospects of individual companies, particular sectors and/or general economic conditions. Different investment styles (e.g., “growth” and “value”) tend to shift in and out of favor, and, at times, the strategy may underperform other strategies that invest in similar asset classes. The market capitalization of a company may also involve greater risks (e.g. “small” or “mid” cap companies) than those associated with larger, more established companies and may be subject to more abrupt or erratic price movements, in addition to lower liquidity.

Investments in fixed income securities are subject to the risks associated with debt securities generally, including credit, liquidity, interest rate, prepayment and extension risk. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. The value of securities with variable and floating interest rates are generally less sensitive to interest rate changes than securities with fixed interest rates. Variable and floating rate securities may decline in value if interest rates do not move as expected. Conversely, variable and floating rate securities will not generally rise in value if market interest rates decline. Credit risk is the risk that an issuer will default on payments of interest and principal. Credit risk is higher when investing in high yield bonds, also known as junk bonds. Prepayment risk is the risk that the issuer of a security may pay off principal more quickly than originally anticipated. Extension risk is the risk that the issuer of a security may pay off principal more slowly than originally anticipated. All fixed income investments may be worth less than their original cost upon redemption or maturity.

High-yield, lower-rated securities involve greater price volatility and present greater credit risks than higher-rated fixed income securities.

Preferred and hybrid securities are junior to an issuer's senior debt instruments; therefore, they are subject to more significant credit risk than those senior debt instruments.

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The ICE BofAML U.S. All Capital Securities Index is a subset of the ICE BofA Merrill Lynch U.S. Corporate Index including all fixed-to-floating rate, perpetual callable and capital securities. Indices are unmanaged. Investors cannot invest directly in indices.

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