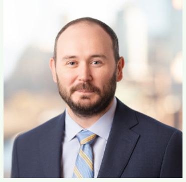
TAXABLE BONDS

AUGUST 2026

UNDERSTANDING PREFERRED SECURITIES: FEATURES, BENEFITS, AND RISKS



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Preferreds can offer investors attractive, tax-efficient income while providing meaningful portfolio diversification. Those potential benefits also come with credit, interest-rate, and liquidity risks. At GW&K we seek to mitigate those risks through active security selection, rigorous fundamental research, and disciplined portfolio construction. In this Q&A, Portfolio Manager Brian McArdle and Client Portfolio Manager Michael Wands discuss the potential benefits and risks of preferred securities, how they can fit within an investor's portfolio, and GW&K's approach to investing in the asset class in our multi-sector bond strategies.

What are preferreds, and why do companies issue them?

Perpetual preferreds are a type of "hybrid" security that shares some of the characteristics of both debt and equity securities. Preferred securities are issued by corporations and typically pay regular dividends. They have priority over common stock but are generally subordinate to debt holders in the event of an issuer liquidation.

Companies issue preferreds to raise capital for regulatory or capital expenditure needs. Banks are the largest issuers in this market given the favorable capital treatment that they receive, though other types of companies, including utilities, energy, and insurance companies, will issue preferreds as a way to meet rating agency debt/equity targets.

Preferreds are generally perpetual securities, like common stock, and pay a regular dividend that may be fixed or floating. While they do not have maturity dates like typical bonds, they are generally callable. They are typically rated several notches below senior unsecured bonds from the same issuer. Because preferreds sit lower in a corporation's capital structure, they generally trade at wider spreads than the company's unsecured corporate debt.

How can preferreds fit into an investor's portfolio?

Preferreds can be used in fixed income or multi-asset portfolios, and may offer investors an attractive combination of income, tax-efficiency, and diversification. Potential benefits include:

- **Income generation:** Preferred securities typically offer higher yields than traditional corporate debt issued by the same company due to their subordination, providing additional income to a client's portfolio.
- **Reduced interest-rate sensitivity:** Preferreds are typically callable and often issued as fixed-to-floating-rate securities — dividends are fixed for a preset period and reset at regular intervals. This structure can make them less sensitive to interest-rate moves.

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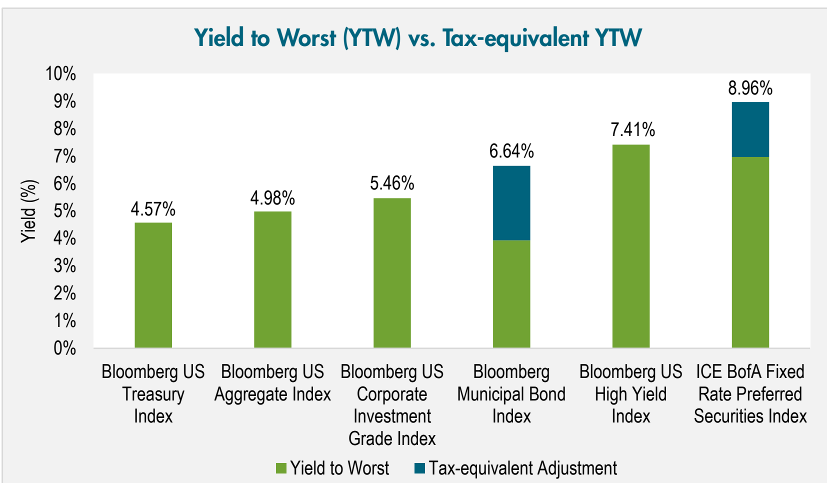
- **Preferential tax treatment:** Preferred dividends can be treated as qualified dividend income (QDI), meaning these payments may qualify for a lower tax rate than ordinary income, like interest payments for traditional corporate bonds (**Figure 1**).
- **Potential portfolio diversification:** As hybrid securities with both bond and equity-like features, preferreds have historically exhibited low correlations with traditional bonds and less volatility than common stocks, so may provide diversification benefits within a client's portfolio.

FIGURE 1

Preferreds May Offer Investors Tax Benefits



Sources: GW&K Investment Management, Bloomberg, and FactSet.
The tax assumptions used are a dividend tax rate of 23.8% (20% plus 3.8% Affordable Care Act (ACA) surtax), and an interest income tax rate of 40.8% (37% marginal plus 3.8% ACA surtax). Data shown as of July 31, 2026.

What other factors should investors consider?

While preferreds offer several advantages, investors should also understand how certain features of these securities can impact their value or performance. Preferreds are subordinate to traditional corporate debt, so investors should be compensated for potentially higher losses in the event of a company liquidation. In addition, during periods of market stress, like we saw during the 2008 financial crisis and the pandemic selloff in 2020, the market may begin to price a preferred less like a short-term callable debt security and more like a perpetual equity security. This is known as extension risk and can negatively impact the pricing of preferreds. Understanding the structural components that vary across the asset class is key to managing and mitigating these potential risks.

How does GW&K use preferreds in fixed income strategies?

At GW&K, we've historically used preferreds within our actively managed bond strategies to take advantage of their attractive yield and diversification benefits. Our approach is grounded in bottom-up fundamental research. As a result, we typically invest in preferreds issued by investment-grade financial institutions with strong balance sheets, robust governance, solid

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credit metrics, and diversified revenue sources. By investing further down the capital structure in these high-quality financial companies, we're often able to capture a meaningful yield advantage relative to their unsecured corporate bonds.

From a technical standpoint, there are many factors that drive price movements in preferreds beyond changes in interest rates and credit spreads. New issuance trends, interest-rate volatility, and the likelihood of these issues being called can all have a meaningful influence on their risk/return profiles. These complexities create an opportunity for active managers like GW&K, as we closely monitor the sector and actively seek to capitalize on resulting market dislocations.

GW&K has been managing taxable bond portfolios for clients for more than three decades. We aim to take advantage of the relative valuation among distinct bond sectors and the increased opportunities to generate income and capital appreciation in changing market environments. Our selective and opportunistic long-term investing style seeks to capture attractive risk-adjusted returns over time.

Learn more about our firm and fixed income capabilities.