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Preferreds Market Weekly Review

Jun. 27, 2021 8:54 AM ET | HCDI, HCDIP, OXLC... | 2 Comments | 5 Likes

Summary

- We take a look at the action in preferreds and baby bonds through the third week of June and highlight some of the key themes we are watching.
- The retail preferreds sector continued to deliver decent performance in June despite the volatility in stocks.
- We highlight some new issues as well as securities with different duration profiles.
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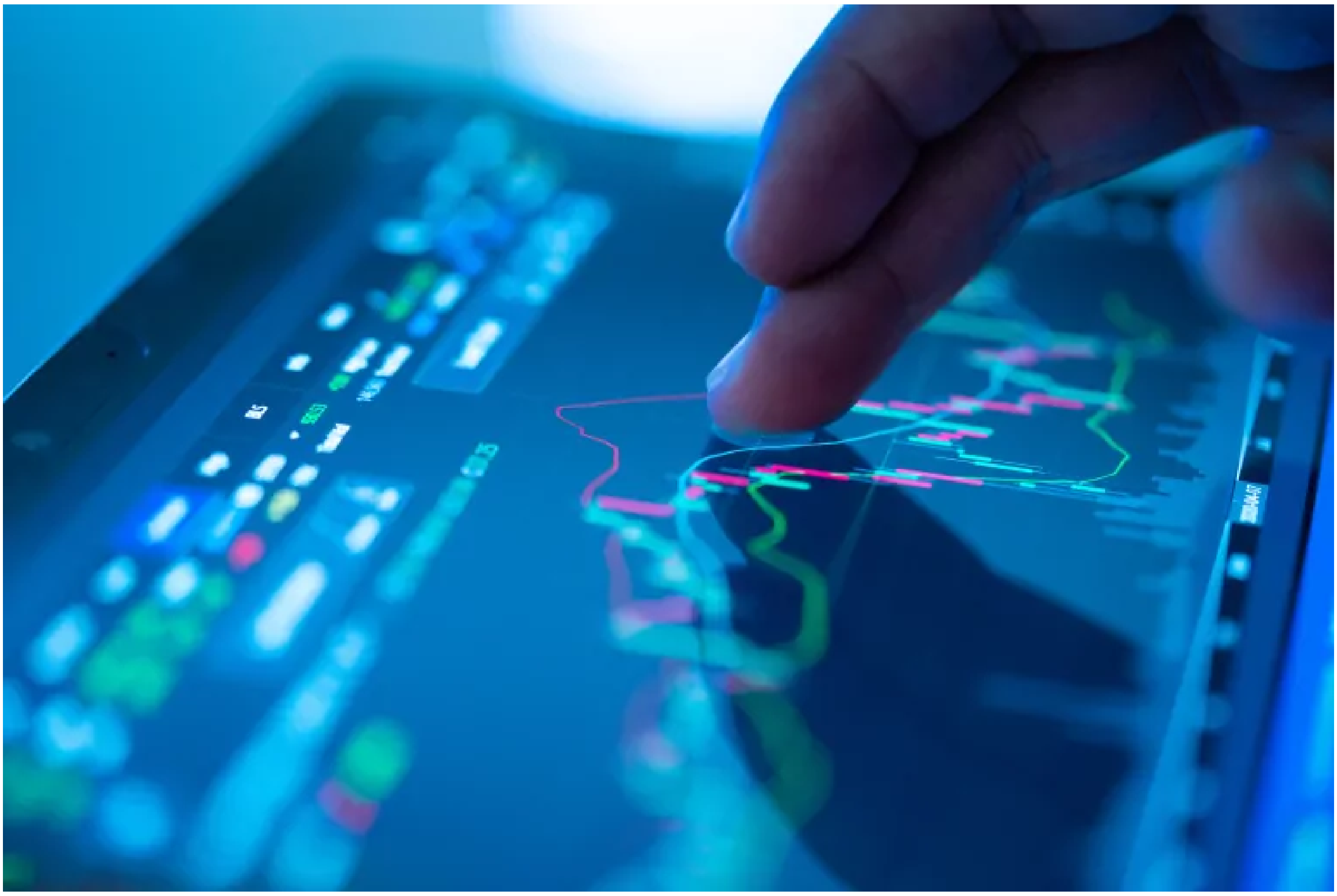


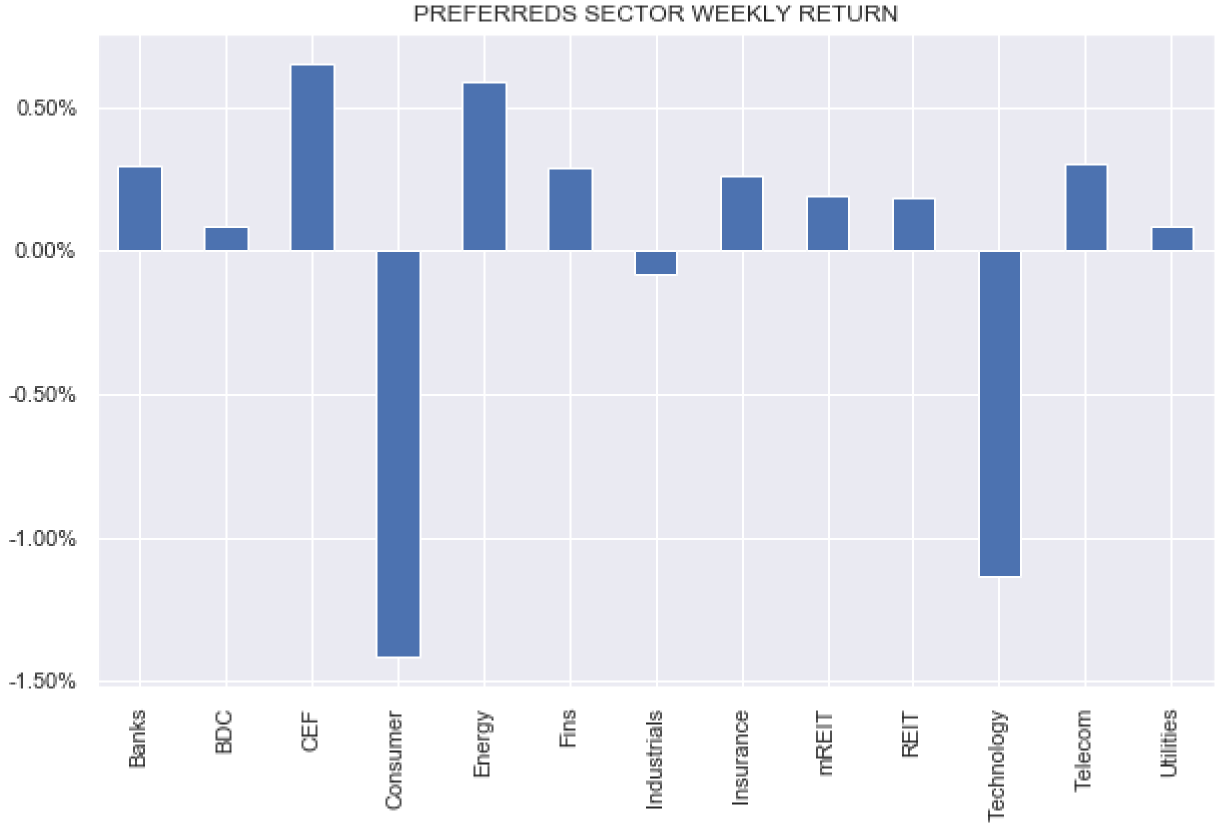
Witthaya Prasongsin/Moment via Getty Images

This article was first released to Systematic Income subscribers and free trials on 21-June.

Welcome to another installment of our Preferreds Market Weekly Review where we discuss preferreds and baby bond market activity from both the bottom-up - highlighting individual news and events - as well as top-down - providing an overview of the broader market. We also try to provide some historical context as well as relevant themes that look to be driving markets or that investors ought to be mindful of. This update covers the third week of June.

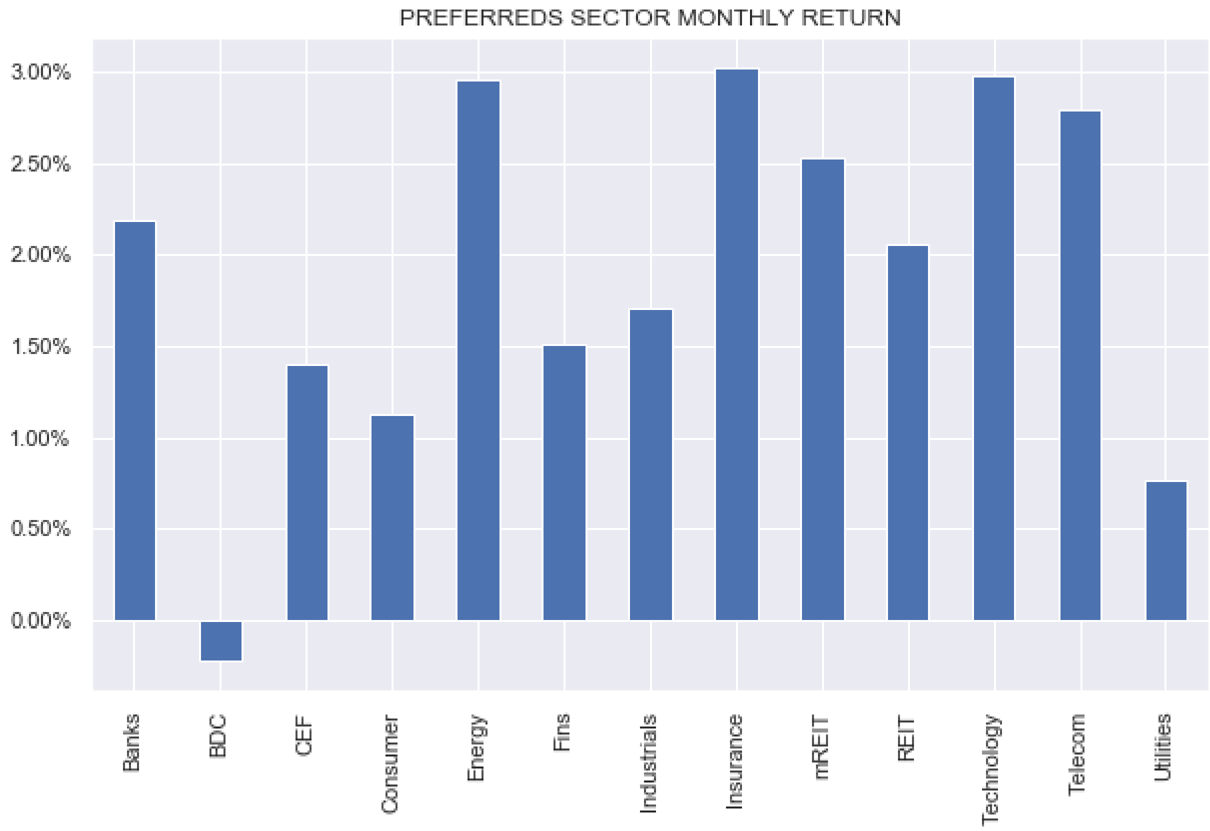
Market Overview

Despite the weakness in stocks, the average retail preferred sector return on the week was wrapped around zero with the median return well in the green.



Source: Systematic Income

In the month, nearly all sectors have so far posted strongly positive returns.



Source: Systematic Income

It's fair to say that the sharp flattening of the 5s30s yield curve was the biggest development across income markets.

Source: Bloomberg

On the one hand, this is odd since inflation has continued to surprise to the upside and the Fed delivered an unexpectedly hawkish signal with the committee signaling two hikes by the end of 2023 and a minority of members expecting hikes in 2022.

On the other hand, the apparently hawkish turn by the Fed suggests that they are unlikely to sit on their hands and lose control of inflation. On the back of this apparent commitment to keep inflation under control, inflation expectations fell back.

Source: Systematic Income

The sharp move in the yield curve suggests that many institutional investors were caught flat-footed in a consensus trade of higher long-end rates on the back of what seemed to be an ultra-dovish Fed and inflation expectations that could only go up.

This development argues for a two-pronged approach to duration exposure. First, it makes sense (as with most assets) to take a value-based approach to duration. Rather than pile in or avoid duration entirely it makes sense to allocate to duration when the market adequately compensates investors for the risk they are taking. It is fair to say that prior to the recent yield curve steepener unwind, duration exposure offered a compelling proposition - the yield curve was very steep, inflation expectations were already very elevated and risk sentiment was very high. This made duration exposure interesting not only from a pure carry and rolldown perspective but that a change in sentiment would likely cause longer-end rates to fall, delivering further gains to duration positions. This is pretty much how events have played out with the long bond yield back to 2% from its yield high of 2.45% this year.

The second prong of our duration approach is to diversify duration exposure via attractive income assets, allowing investors to dial it up or down depending on the market environment. For example, non-callable perpetual securities offer a way for investors to dial-up their duration exposure. Decent-quality candidates here include the 5.75%-yielding A. Schulman 6% (OTCPK:SLMNP), the 4%-yielding Southern California Gas 6% Series A (OTCQB:SOCGP), or the 5.11% yielding Wells-Fargo 6.5% Series L (WFC.PL) - this last one having some, if very low, probability of a mandatory conversion.

Other senior securities allow investors to dial down their duration exposure. CEF preferreds and baby bonds are often issued with relatively short maturities. Decent candidates here include the 2024 maturity OXLC 6.75% (OXLCM) which is currently callable and is trading at no call price risk at a 6.64% YTM and the 2024 maturity RSF 5.875% Series A (RMPL.P) which is also currently callable and has low, if any, call price risk and a 5.71% YTM.

Market Commentary

Ready Capital (NYSE:RC) is redeeming Series B (RC.PB) and Series D (RC.PD). Given these two series are paying much higher coupons than the recently issued Series E (OTCPK:RCPPP) and that the RCPPP size is almost exactly equal to the sum of the redeemed series, it's not a big surprise. Any price impact due to the redemption should be small as the clean prices were close to "par" for both. After the redemption, the equity/pref coverage of RC will be 11.8x which is very high for the sector and makes the 6.26% yield on the Series C (RC.PC) actually reasonably attractive. This is particularly as the stock doesn't have the negative convexity of callable series – this one is convertible and non-redeemable. In other words, when comparing RC.PC to callable preferreds you can't just look at the yield – the lack of callability is worth quite a lot to holders.

To partially offset a tough redemption environment, the following new securities began trading recently.

The **Harbor Custom Development 8% Convertible Series A** (HCDIP) - a small home builder - opened weak and is now trading at a 8.49% yield. Above a common price of $7.65 (for 20 out of 30 consecutive trading days), the company can convert the preferred into common stock. At the current common and preferred prices, this is not particularly worrisome. More relevant is that the company is operating at a loss and the trend of the stock price is not favorable. A strong housing market, however, can lift many boats so this one may be worth a look for investors with a higher risk tolerance.

The **Presidio Property Trust 9.375% Series D** (NASDAQ:SQFTP) - a small REIT which bills itself as a contrarian real estate investor - is also trading below "par" at a 9.61% yield. Unsurprisingly, at that yield, the company is also running at a net loss.

Priority Income Fund (unlisted CLO Equity CEF) is issuing a new 6.125% Series I (OTCPK:PRIIP). Good news is that the coupon is marginally higher than the previous Series H (PRIF.PH), issued just a few weeks ago. This is also what we saw with Public Storage – another prolific issuer which had a higher coupon on its most recent series. This new series is the best looking of the large suite of this issuer.

The table below compares various preferreds and bonds that allocate to the CLO Equity space in whole or in part.

Source: Systematic Income

It's always worth comparing both bonds and preferreds together as well as CEFs and non-CEFs. In this case, the Oxford Square Capital Corp. (OXSQ) – a BDC - runs a very similar portfolio to the XAI Octagon Floating Rate & Alternative Income Term Trust (XFLT) which is a CEF so it's worth comparing them side-by-side rather than within their own sectors which are not at all similar to these unusual portfolios.

In our view, the OXLC 6.75% 2031 Notes (OXLCL) is an obvious standout here with very high asset coverage and one of the highest YTWs. For a lower risk profile (i.e. more senior loans/less CLO Equity in the portfolio) it's worth keeping an eye on the OXSQ 5.5% 2028 Notes (NASDAQ:OXSQG) or the OXSQ 6.5% 2024 Notes (OXSQL) with the latter being a pinned to par option.

Elsewhere in the sector OXLCM as a pinned-to-par option and looks tempting at a 6.78% YTM (it's trading just below "par" and is currently callable). This one doesn't quite fit the textbook risk/reward since you can have OXLCL at a 6.04% yield and pick up an additional 5x of coverage (i.e. OXLCL has 8x asset coverage while OXLCM has around 3x). At the same time, OXLCM is a 2024 maturity versus OXLCL of 2031 and as a pinned-to-par security should be slightly more resilient to rising yields than OXLCL.

Takeaways

The preferreds sector has remained resilient so far in June despite some ructions in stocks. The unwind of the popular yield curve steepener has supported valuations of long-duration assets. This dynamic highlights the fact that a naive approach to duration exposure can fail to deliver the expected result. Diversifying across both longer and shorter-duration assets with a value-approach in mind can allow investors approach fixed-income assets on a firmer footing.

This article was written by

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Disclosure: I am/we are long OXLCL, SOCGP, WFC.PL, SLMNP, OXSQL. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

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