Seeking Alpha α

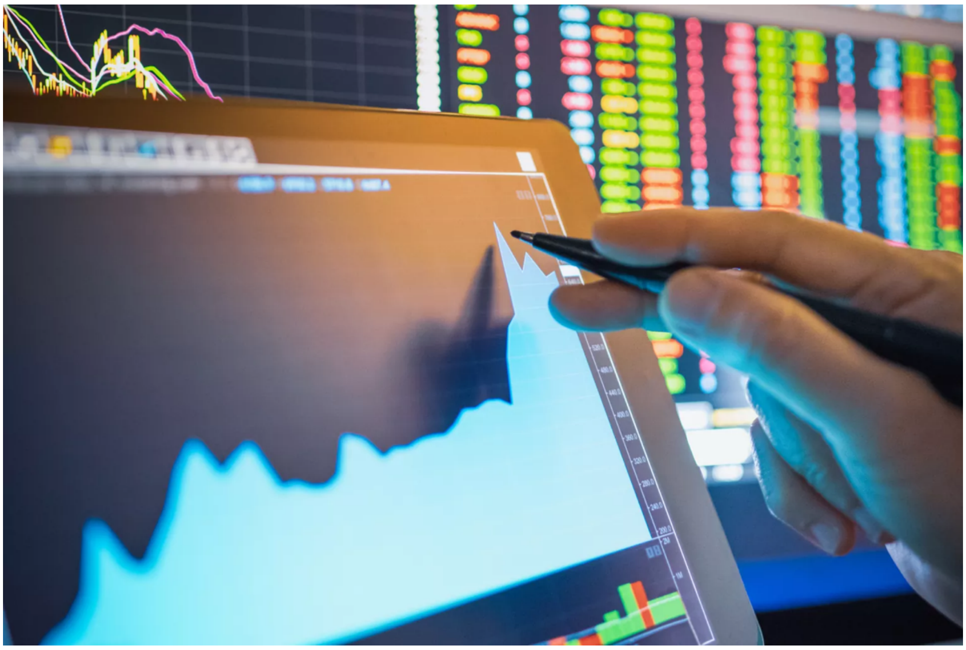
Closed End Funds

Preferreds Market Weekly Review

Jul. 11, 2021 10:59 AM ET | BAC, BAC.PB, BAC.PE... | 9 Comments | 17 Likes

Summary

- We take a look at the action in preferreds and baby bonds through the first short week of July and highlight some of the key themes we are watching.
- We highlight the steep fall-off yield dynamic of callable securities moving past their "par" price level.
- And highlight a few opportunities in WTREP, MFA preferreds and others.



primeimages/E+ via Getty Images

This article was first released to Systematic Income subscribers and free trials on 6-July.

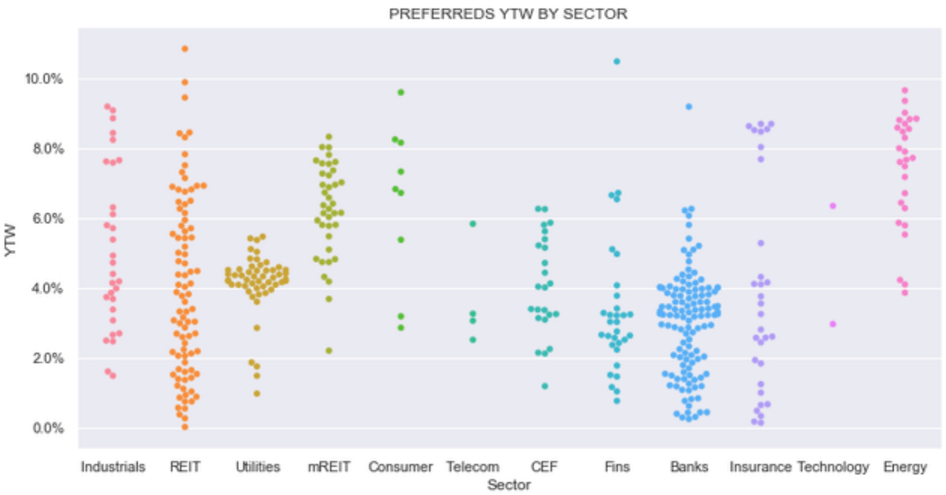
Welcome to another installment of our Preferreds Market Weekly Review where we discuss preferreds and baby bond market activity from both the bottom-up - highlighting individual news and events - as well as top-down - providing an overview of the broader market. We also try to add some historical context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

Market Overview

It was a solid week for preferreds with all sectors posting positive returns. There was quite a bit of noise due to the end of the quarter fund rebalancings which drove some stocks sharply higher.

On a year-to-date basis, the sectors in the lead are the usual mix of cyclical high-yielding sectors like Energy, convertible-heavy sectors like Technology, some idiosyncratic stories in the small Consumer sector and mortgage REIT preferreds.

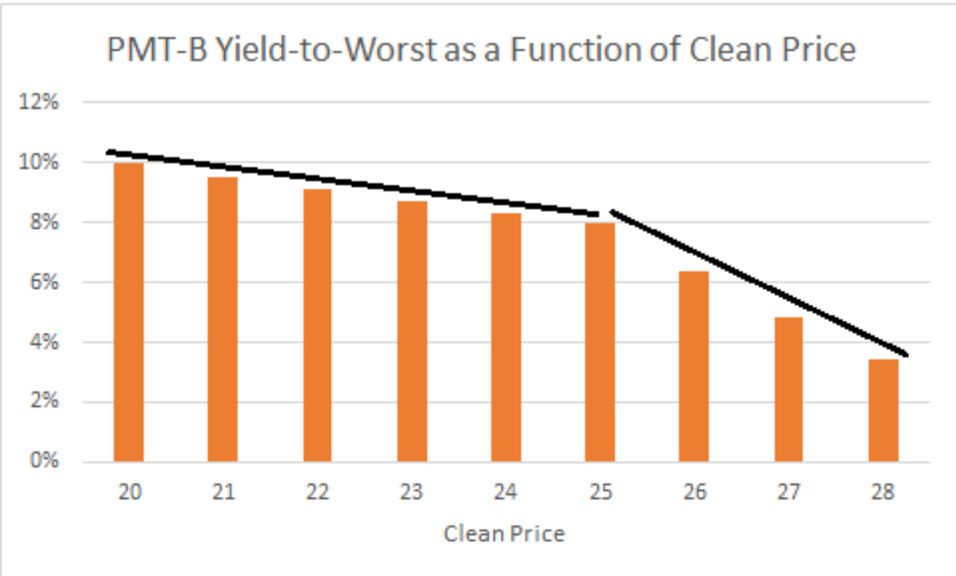
Looking at the YTW available across the different sectors with an eye towards high single-digit levels, Energy remains a key standout along with a handful of stocks in the REIT, mREIT and Insurance space. Higher-quality sectors like Banks, Financials, Utilities, CEFs offer slim pickings for yield-hungry investors.



Source: Systematic Income

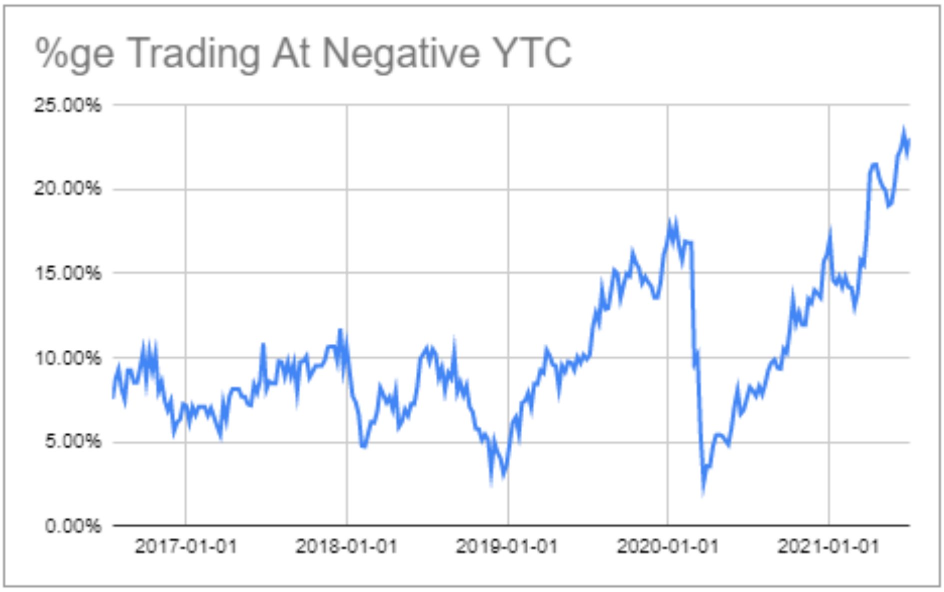
One of the dynamics of the preferreds market we have discussed recently is the sharp fall-off in yields once preferreds start to trade north of their "par" amount. Yield non-linearities as a result of embedded issuer call options are not very intuitive for most investors so the chart below tries to illustrate this dynamic.

We use the PMT 8% Series B (NYSE:PMT.PB), trading at a price of $27.51 and clean price (ex-accrued dividend) of $27.27 as an example. As the price of the stock moves from a low level towards "par" of $25 the yield of the stock falls gradually. However, once the stock moves north of "par" the yield falls at a much faster clip. This dynamic has to do with the fact that the yield-to-worst is a conservative calculation and takes the lowest values of stripped yield (coupon / "par" amount) and yield-to-first-call (all-in yield assuming the issuer redeems the stock at "par" on the first call date). North of "par", each penny of appreciation in the clean price comes out directly out of the investor's yield which is what explains the acceleration in the drop of the yield past "par".



Source: Systematic Income

Of course, in many cases, the yield-to-worst is too conservative and the stock can remain outstanding past its first call date even if trades above "par". In addition to insider and regulatory reasons, this often has to do with the fact that refinancing an existing preferred carries significant costs. That said, the high rate of redemptions over the last few months does highlight that this is a real issue that investors need to be mindful of. Nearly a quarter of the retail preferred market is currently trading at negative yield-to-call.



Source: Systematic Income Preferreds Tool

Market Commentary

The New York Mortgage Trust is redeeming NYMT 7.875% Series C (NASDAQ:NYMTO) and refinancing with the NYMT 6.875% Series F (OTCPK:NYMFP) - permanent ticker NYMTL. Apart from the expected lower fixed coupon, NYMFP is a fixed-to-float security, based off SOFR.

Among the four series of the issuer, NYMT 7.75% Series B (NASDAQ:NYMTP) remains tempting as a pinned-to-par option at a 7.73% yield (no call price risk, assuming the usual notice period). NYMT Series D (NASDAQ:NYMTN) is also compelling at a 7.59% YTW and is the series we currently hold in the High Income Portfolio. The newly-issued NYMFP is not super-compelling - it has the lowest YTW of the four series (we're ignoring the negligibly negative YTW of NYMTP), decent but not longest call protection, decent but not highest floating spread. It is only compelling for investors who worry about the uncertainty around Libor and who also want some call protection (investors who don't need call protection have fixed-rate NYMTP as the more obvious choice).

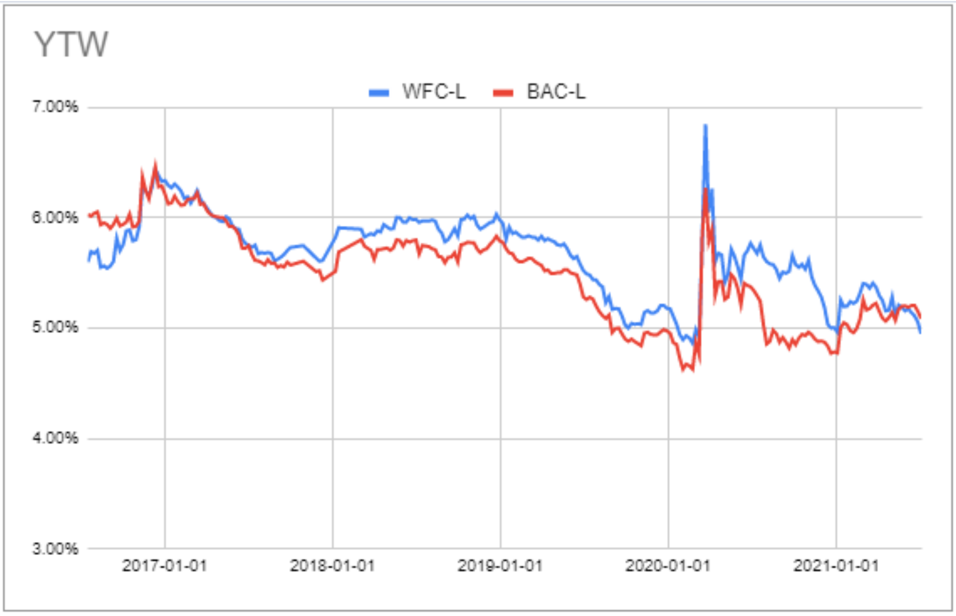
STOCKS	NYMTP	NYMTN	NYMTM	NYMFP
Clean Price	25.07	25.51	25.48	25.20
Type	Fix	Fix/Float	Fix/Float	Fix/Float
Float Index		3mL	3mL	SOFR
Float Spread		5.70%	6.43%	6.13%
Current Coupon Type	Fixed	Fixed	Fixed	Fixed
Current Coupon	7.750%	8.000%	7.875%	6.875%
Call Date	2018-06-04	2027-10-15	2025-01-15	2026-10-15
Maturity				
Stripped Yield	7.73%	7.84%	7.73%	6.82%
YTC	-0.28%	7.59%	7.26%	6.70%
YTM				
YTW	-0.28%	7.59%	7.26%	6.70%
Reset Yield		7.81%	7.76%	6.13%

Source: Systematic Income Preferreds Tool

The Algonquin Power & Utilities Corp 7.75% convertible preferreds are trading with their permanent ticker (AQNU). These equity units are fairly unusual as they are made up of two parts - a 2024 mandatory convertible for which it pays 6.57% per year and a corporate unit paying 1.18% for a total of 7.75%. As the company is Canadian there is a potential tax angle in the US and Canada. The breakeven on the conversion is $15 on the common which is now trading at $15.03 on the NYSE. Everything is in USD in this one - the AQNU and the conversion. The units were rated BB+ by S&P. For investors who don't mind the Canadian and conversion angles it's worth a look at a 7.71% stripped yield.

We added the SiriusPoint 8% Series B (OTCPK:SRSPF) to the Core Income Portfolio. SRSPF is a new preferred from SiriusPoint rated BB+ by S&P and Fitch with a 2026 call date. It has unusual provenance being a refinancing of a preferred held by institutional investors due to the recent merger with Third Point Reinsurance. Because it's a Bermudan issuer, you have to watch out for a foreign security fee some brokerages will try to claim that they shouldn't. The stock traded as low as $27.12 when first highlighted, however, it is now approaching $28 which has tended to be the standard behavior for attractively priced securities. At the current price of $27.85 the yield of 5.27% still looks attractive versus its rating. The reset coupon of 5-year CMT + 7.298% is also very attractive though it's unlikely to see the light of day given where the stock is trading now (as it's very likely to get redeemed before it floats).

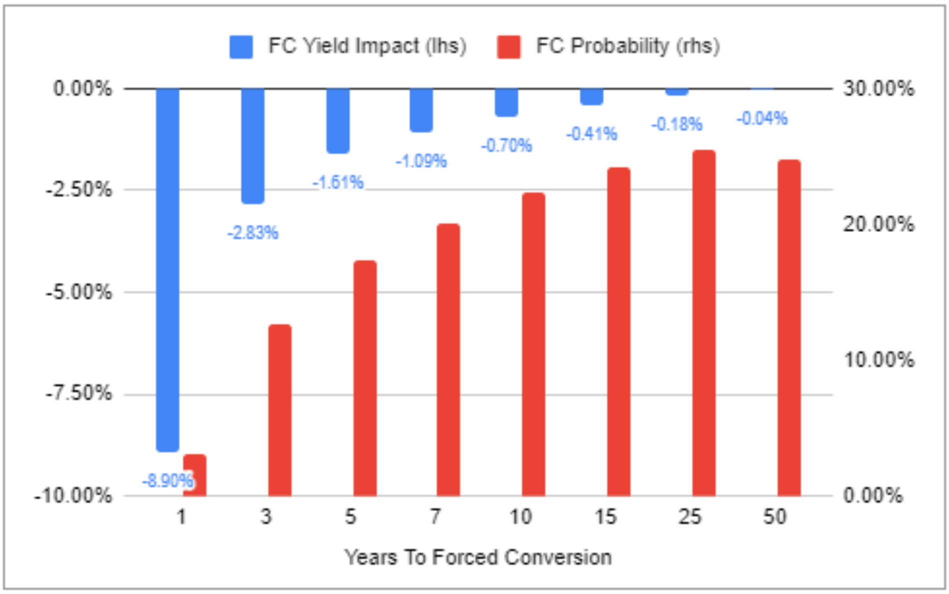
A pair of bank preferreds that we follow: WFC 7.5% Series (NYSE:WFC.PL) and BAC 7.25% Series L (NYSE:BAC.PL) have diverged recently. Historically, WFC.PL has tended to trade at a higher yield. Presumably, this was because of the additional regulatory constraints and lack of confidence in management due to the account fraud scandal. This relationship has shifted with BAC.PL moving to trade at a slightly higher yield despite obvious changes in fundamentals and the marginally higher rating profile of BAC.PL. BAC.PL is currently trading at a 5.09% yield while WFC.PL is trading at a 4.95% yield.



Source: Systematic Income Preferreds Tool

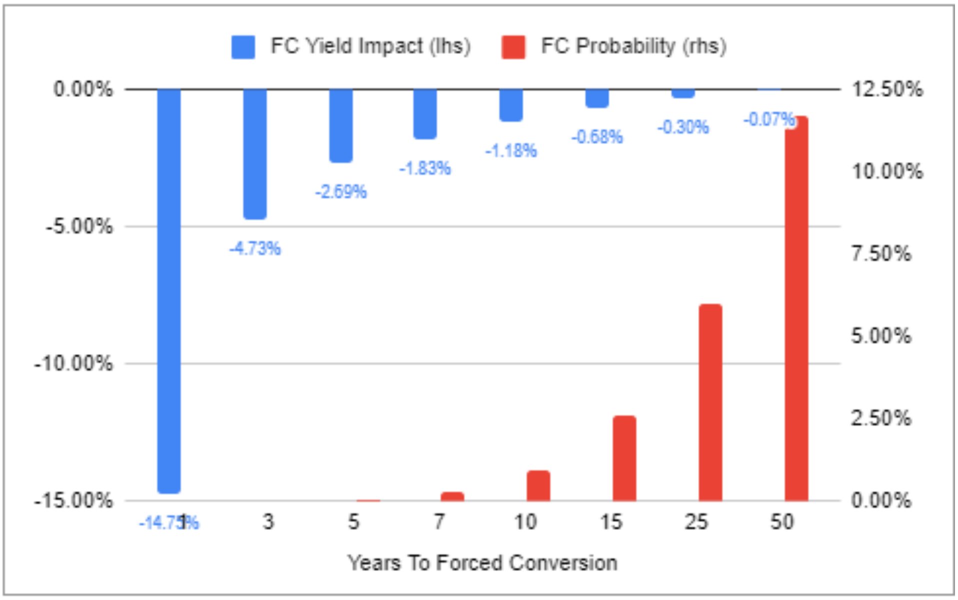
It is true that WFC has had a stronger 2021, however, that appears to be due to its larger sell-off in 2020. If we look at returns since the start of 2020, BAC comes out ahead. Our view is that this dynamic has to do with the convertibility provision of the two preferreds. In short, BAC.PL is much closer to its conversion, being "only" 58% away from the conversion (measured as the required return in the common to hit the level where the issuer can force conversion) versus WFC.PL which is 350% away from the conversion. Because the conversion happens at $1300 for both preferreds this would be a negative outcome for preferreds holders. The hit varies from 9% for BAC.PL to 14% for WFC.PL.

Without getting too much into the weeds - we can quantify the expected value of this conversion impact by estimating the probability of the conversion across different time periods based on the stocks' volatilities and distance to the conversion "strike" using basic options math. For example, to quantify the fair-value yield "cost" of the potential conversion we can calculate the probability of the conversion and its impact on the stock's lifetime yield. A shorter time to hit the conversion strike is less likely (red bars) but extracts a greater impact (blue bars) on the stock's lifetime yield and vice-versa. If we sum up the products of the yield impacts and their probabilities we come up with a number of 0.18% for BAC.PL. This represents the cost of the potential conversion in yield terms as of today.



Source: Systematic Income

Running the same numbers for WFC.PL we see that while the impact of the conversion is greater (due to the higher price of WFC.PL relative to the conversion strike), the probability of hitting the conversion strike is much lower. The resulting yield cost for WFC.PL is only 0.01%.

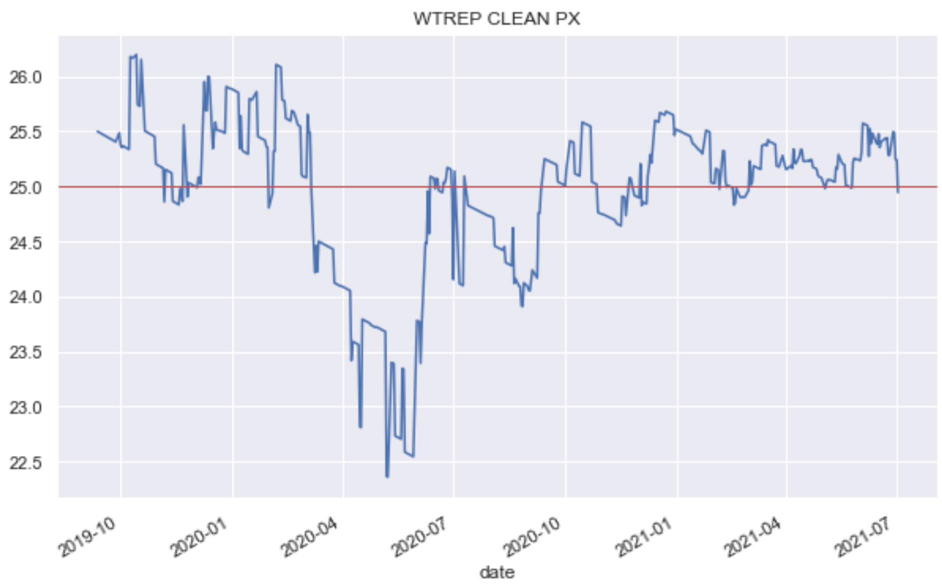


Source: Systematic Income

In other words, all else equal, BAC.PL should trade at a yield that is 0.17% higher than WFC.PL. And because the BAC common has outperformed that of WFC it makes sense for its yield to underperform WFC.PL since the likelihood of the BAC.PL conversion has increase relative to the WFC.PL conversion. It is true that the speed of the adjustment has been faster than our estimates suggest however this pattern of overcorrection is not atypical in markets.

A couple of news items hit this week for watchers of the Watford Holdings Preferreds (NASDAQ:WTREP). Arch Capital alongside Kelso and Warburg Pincus announced the completion of the Watford Holdings acquisition. WTRE is now going to deregister and delist both its common and preferred. This suggests that the stock may get redeemed shortly or, failing that, it will move to trade OTC.

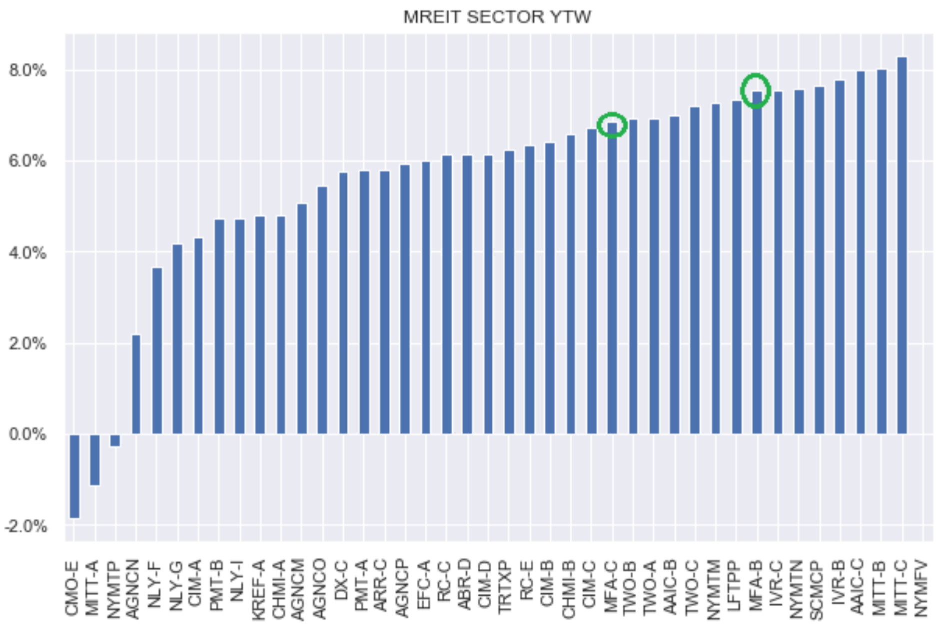
This may have pushed WTREP a touch below its clean price which offers a decent low-risk entry point as it carries no call price risk.



Source: Systematic Income

The obvious issues with WTREP holding here are 1) delisting of the stock can make it harder to trade and 2) it remains very likely to get redeemed. The recent selling that pushed the stock through "par" could be a clue that it's getting redeemed or maybe just that someone can't hold a delisted security. The currently outstanding Arch Capital preferreds have stripped yield closer to 5% and YTC of sub 1% which suggests that the ~7%+ WTREP yield may not make a whole lot of sense to keep outstanding.

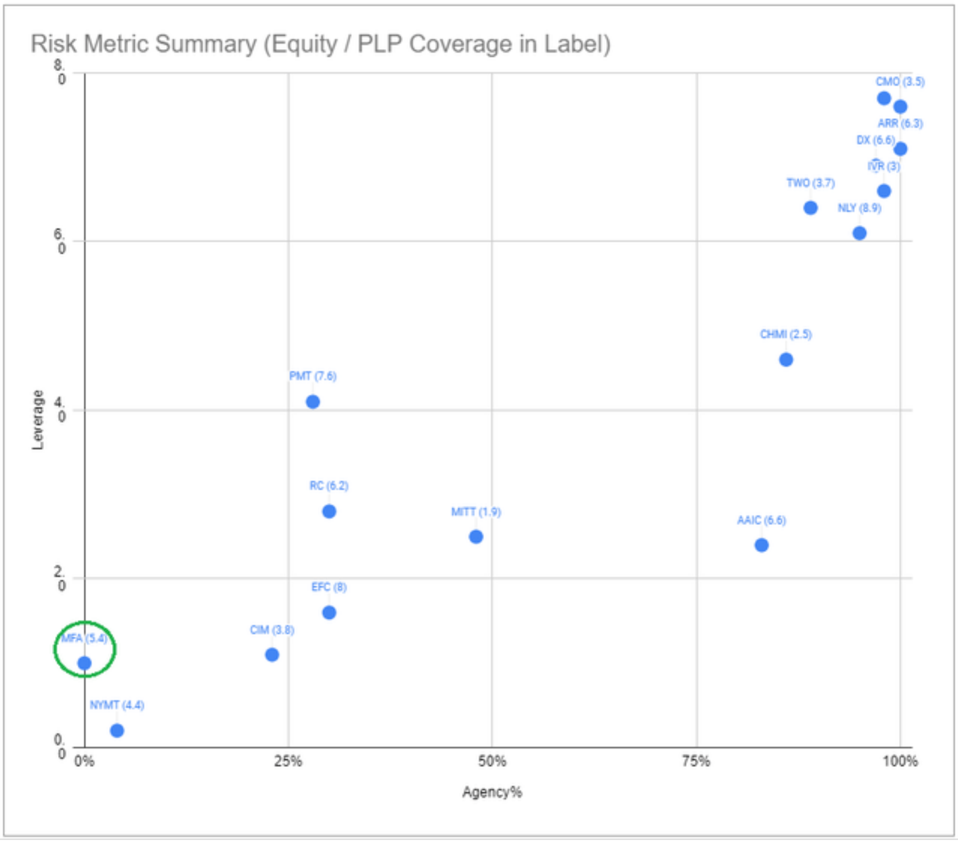
In the mREIT preferreds sector the MFA Financial (NYSE:MFA) preferreds are beginning to look attractive relative to the rest of the mREIT sector. The chart below highlights the two series within the broader sector.



Source: Systematic Income

Agency-focused mREITs have struggled to maintain book value this year due increasing TBA financing costs and agency spreads that have nowhere to go but wider. In contrast, hybrid mREITs have done well due to the continued mark-to-market gains on their loans and releases in reserves. The reason this is important is that this dynamic helps grow company equity and improve coverage of the preferreds. This is precisely what has happened to MFA.

At the same time, the risk metrics are favorable as well. Although the portfolio is light on agency holdings, leverage is low at around 1.0x and coverage is quite high at 5.4x.



Source: Systematic Income Preferreds Tool

The yields of the two series have lagged the strength in the sector since Q3 of last year. This is despite the fact that leverage has ticked lower and equity / preferred coverage has been stable.

Source: Systematic Income

MFA have continued to source financing via securitizations which has 4 benefits. First, it has lowered overall interest expense. Secondly, it is non-recourse (i.e. holders of securitized debt only have a claim against the assets included in the securitization rather than the credit of MFA itself). Thirdly, it is non-mark-to-market and cannot kick off the negative feedback loop of margin calls and asset sales. And fourthly, it has a side benefit of distorting the leverage figure that MFA reports. MFA reports leverage as defined by overall borrowings which includes the non-recourse financing provided by securitizations. This has the impact of overstating the actual economic / recourse leverage of the company (1.6x versus 1.0x) - which is the number that is released by other mREITs. This, arguably, keeps the preferreds yields higher than they should.

The MFA 7.5% Series B (NYSE:MFA.PB) fixed-rate stock is tempting here at a 7.54% yield though it is currently callable. The stock has no call price risk as it is trading below "par" in clean price terms. Investors who desire call protection can have a look at the MFA 6.5% Series C (NYSE:MFA.PC) trading at a 6.87% yield with a 2025 call date and a 3mL+5.345% reset coupon.

Stance And Takeaways

Our stance in the sector remains to tilt away from passive ETFs or CEFs and to identify idiosyncratic opportunities in individual securities with a particular focus on attractively priced new issuance (before the market has a chance to revalue it higher), opportunities in existing preferreds with favorable risk / reward as well as pinned-to-par securities.

Check out ***Systematic Income*** and explore our **Income Portfolios**, engineered with both yield and risk management considerations.

Use our powerful **Interactive Investor Tools** to navigate the closed-end fund, open-end fund, preferred and baby bond markets.

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This article was written by

ADS Analytics
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Author of **Systematic Income**
Income investing across CEFs, ETFs, preferreds, baby bonds and more.

Disclosure: I/we have a beneficial long position in the shares of AQNU, SRSPF, MFA.PB either through stock ownership, options, or other derivatives. 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.

17 Likes

9 Comments

Comments (9)

Sort by Newest

Bobbie B

Yesterday, 8:48 AM

Comments (2.14K) | + Follow

If one buys a preferred share that is selling at $26 which is above the call price of $25 and gets 7.5% yield(based on a $25) price, you can sell it well before the call in the open market. Doesn't this mitigate the risk of losing your yield when it is called?

Reply Like

ADS Analytics

Yesterday, 9:59 AM

Marketplace Contributor Premium Comments (1.4K) | Following

Author's Reply @Bobbie B If you buy at stock at $26 today with a 7.5% stripped yield and it is redeemed in a year's time at $25 then your yield is not 7.5% but ~3.5%.
ADS

Reply Like (1)

Steve Fischer Yesterday, 6:10 PM

Comments (661) | + Follow

@Bobbie B Do you think you should be giving stock advice? If so might i and you if you're honest direct you to the comments you made about SMLP just a month or so ago when it was at $20.70 with a book of about $120. In CAPs you claimed it was on a destructive path down. - today it closed at $37.65.

Reply Like

Greg_Maryland 11 Jul. 2021, 4:18 PM

Comments (1.23K) | + Follow

Interesting note.
If is interested in AQNU they should also check out DCUE. Similar yield and conversion terms. Based on Dominion Energy.

Reply Like (1)

Bill Stevenson 11 Jul. 2021, 1:39 PM

Premium Comments (149) | + Follow

Thanks for the write up. Preferreds are a vastly under-covered area of the market. Being very new to this area of investing, any information I can get is very helpful.

Reply Like (2)

Raven27936

11 Jul. 2021, 5:47 PM

Comments (47) | + Follow

@Bill Stevenson Contributor Scott Kennedy who also writes under Colorado Wealth Management, both on Seeking Alpha does articles on REIT Preferreds occasionally as well as Rida Morwa who also covers Baby Bonds. Some of Rida's favorites are Non-callable aka "Broken" Preferreds suchas RLJ-A & CEQP.PR. *(edited)*

Reply Like

Bobbie B

Yesterday, 8:46 AM

Comments (2.14K) | + Follow

@Raven27936 What is a "broken" preferred?

Reply Like

Raven27936 Yesterday, 1:12 PM

Comments (47) | + Follow

@Bobbie B It means they most likely will never be called; in RLJ-A (Cumulative Convertible $1.95); but the company did a 1:10 reverse split a couple of years ago; so now in order to convert it has to trade @ 130% of $89.09 for the company to force a conversion. Common Stock RLJ currently trades for $14.45 (owns 103 hotels in 23 states).
CEQP.PR case; only certain circumstances can it be called otherwise its Non-callable; they just amended this as the parent company just Internalized Management this would normally trigger the company if having to buy back the Pref but due to liquidity they decided to ask all the preferred shareholders to vote to ignore this rule (they recv the OK from the SEC to pay out a token dividend of .0125 cents per share voted). Parent Company is an Midstream MLP (pays K-1); also noted all Dividends paid out in the Preferred at UBTI (unrelated business taxable income; anything over $600 in dividends/yr you will possibly have to file separate state income taxes) so I don't own enough shares to trigger this.
(edited)

Reply Like (2)

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