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Fixed Income

Preferreds Market Weekly Review

Jul. 25, 2021 8:42 AM ET | LAND, LANDO, NYMFP... | 16 Comments | 17 Likes

Summary

- We take a look at the action in preferreds and baby bonds through the third week of July and highlight some of the key themes we are watching.
- Given sharply lower Treasury yields, we take a look at the impact of coupon level in driving portfolio durations.
- And have a look at recent issuance and redemptions.
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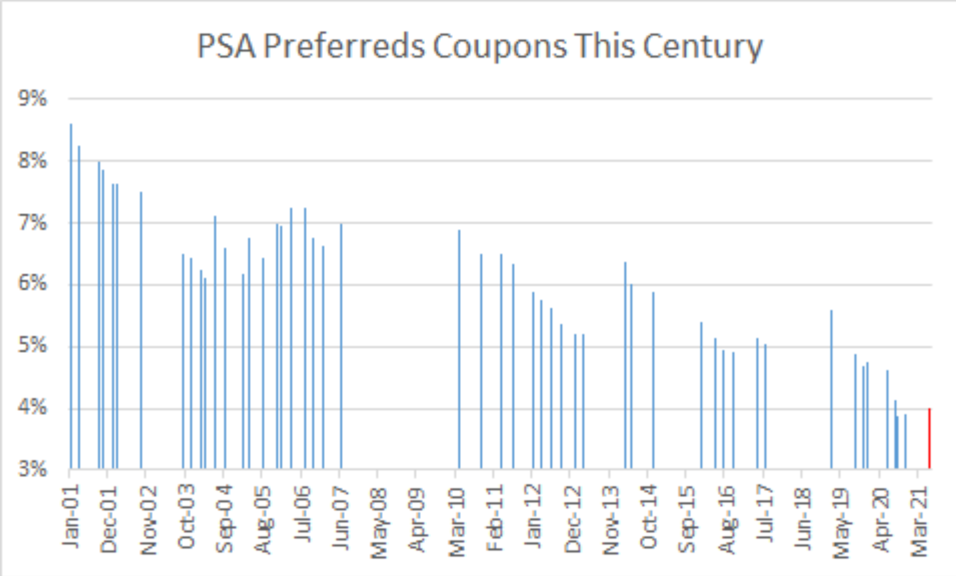
This article was first released to Systematic Income subscribers and free trials on 19-July.

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 third week of July.

Market Overview

It was a wobbly week in the higher-beta income space due to the drop in stocks which a rise in Treasuries was not able to offset. As we discussed in the CEF Weekly Review, nearly all CEF sectors finished lower with the median sector falling around 0.7%. Preferreds remained somewhat more resilient with the median drop of less than 0.3% and about a third of sectors actually finishing in the green. This is a pretty common pattern for preferreds versus CEFs where discounts tend to drive both higher volatility of CEFs and offer less diversification during drawdowns for CEFs over preferreds.

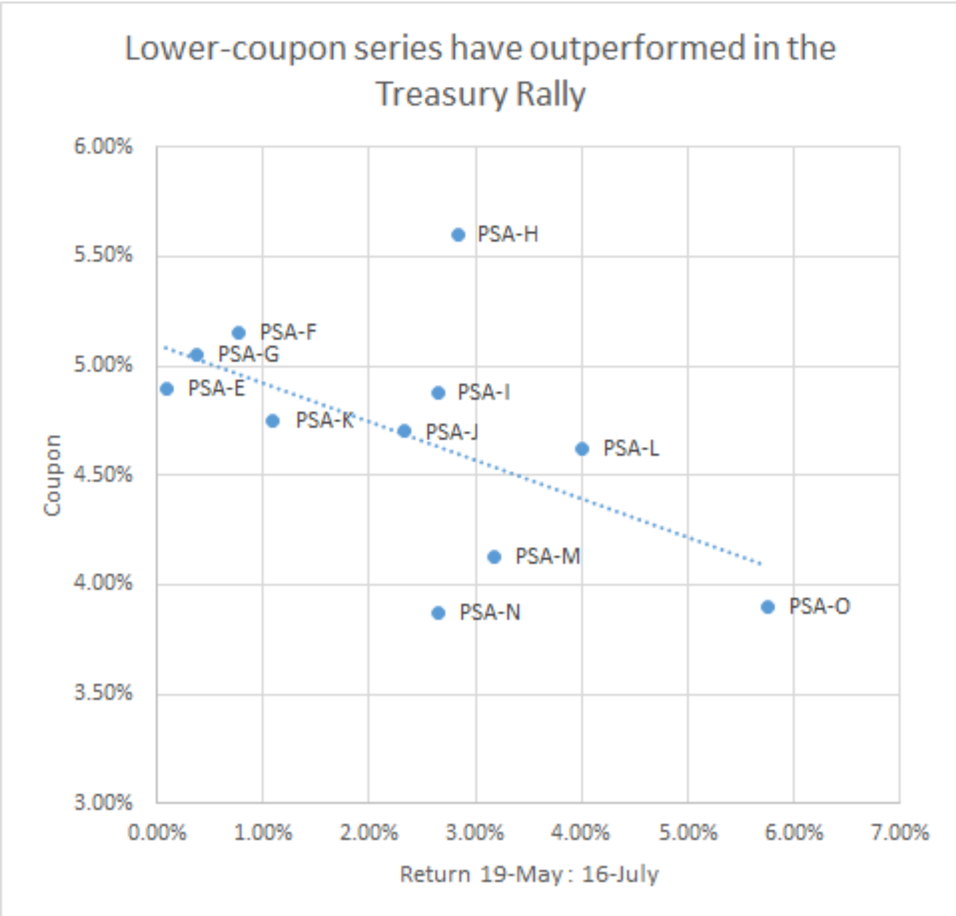
Refinancing in the preferreds space continues apace as issuers take advantage of a low yield environment. This market dynamic can be painful for income investors who now have to find ways to redeploy their capital in an unattractive market environment. If this weren't enough, continued refinancing has another important element for income investors which has to do with the fact that coupon levels have continued to shrink over the last few years. The chart below which shows the coupons of the Public Storage (NYSE:PSA) REIT makes this dynamic very clear.



Source: Systematic Income

Though coupon level isn't usually a very important feature to focus on since preferreds will trade on a yield basis, they do matter a great deal for the stock's duration profile. More specifically, lower coupon stocks have a higher duration or interest-rate sensitivity than higher-coupon stocks. This isn't immediately obvious (to anyone who hasn't wasted years staring at fixed-income price screens) but there are some rules of thumb to remind investors of this fact. The first is the formula for the duration of perpetual securities (which most preferreds can be in practice) and that is *(1+yield)/yield*. Since the numerator is dominated by the *1,* it shows that duration will decrease as the *yield* grows. Another way to think about duration is as the fulcrum balancing the lever of all the cash flows. The higher the coupon the more near-term cash flows there are balancing out the principal with the fulcrum positioned closer to the left of the lever which again makes duration shorter.

To see this in practice, consider the performance of PSA preferreds from the period of 19-May to 16-July when the 10-year Treasury yield fell from 1.68% to 1.31%. The chart shows that lower coupon series tended to outperform higher-coupons series. This makes sense since the lower-coupon series have a longer duration and, hence, are more sensitive to changes in interest rates. The chart isn't perfect as a couple of series are outliers but it's good enough to show how different series of the same issuer can be buffeted by changes in rates.



Source: Systematic Income

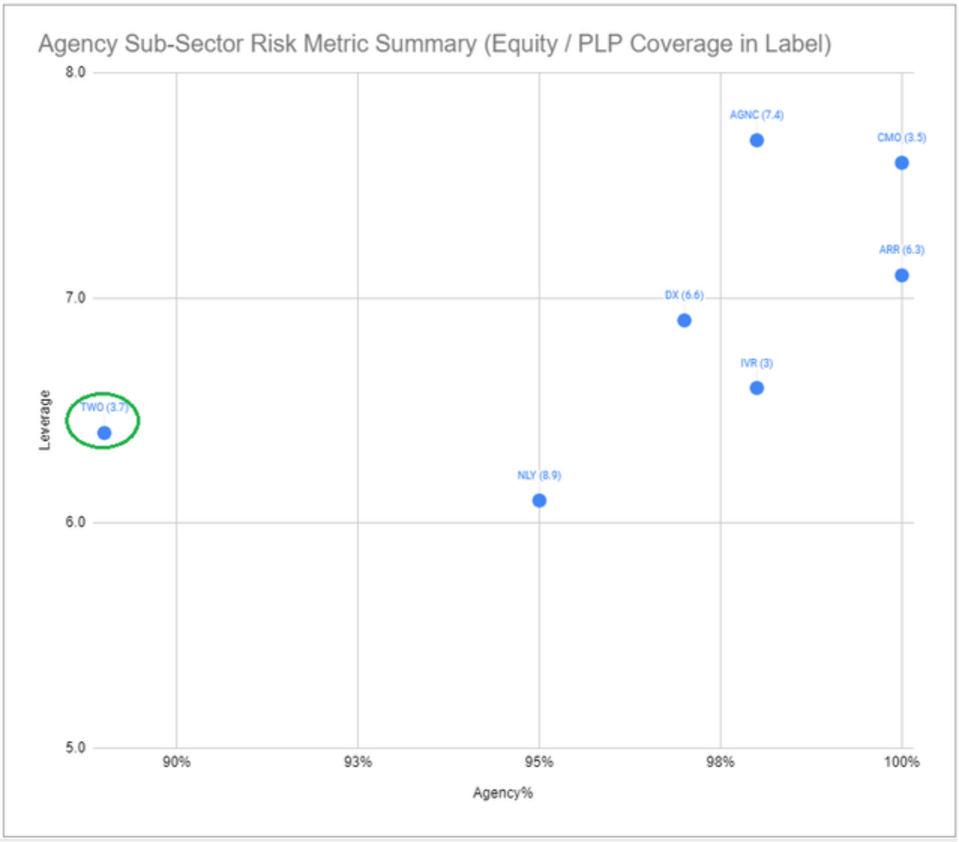
The upshot here is that Treasury yields are at oddly low levels which bear little resemblance to the actual state of the economy. If we do see another sustained trend in yields over the coming months, it's much more likely to be for higher rather than lower yields unless we are willing to seriously entertain the likelihood of negative yields. The takeaway is that investors should cast an eye over their holdings to ensure they are comfortable with the individual series of any given issuer in their portfolio and opportunistically reallocate to higher-coupon series as one way to mitigate the duration of their portfolios.

Market Commentary

A public offering from the agency-focused mortgage REIT Two Harbors (TWO) came across our screen the other day with the stock falling nearly 10%. We often see investors treat certain market or company events as being either all good or all bad for any shareholder of a company whether common or preferred. The reality is more nuanced. This dynamic highlights why investors have to be careful in distinguishing the interests of common shareholders (who don't particularly want new common issuance and its likely dilutive and negative market impact) and preferreds shareholders (who do want new common issuance as it will increase asset coverage of preferreds). This can make the preferreds of a number of companies relatively attractive even if their common are not particularly compelling. The chart below, which is fairly typical of the mREIT sector, makes this point.

Source: Systematic Income

TWO preferreds remain attractive in the agency-focused mREIT space with yields just below Invesco Mortgage Capital (NYSE:IVR) preferreds which have much worse fundamentals. TWO does have relatively low agency allocation in the sector as well as middling coverage (as of Q1 which should now be higher for Q2) but leverage is relatively low as well. TWO 7.625% Series B (TWO.PB), trading at a 7.32% YTW with a long call protection period of July-2027 is our pick in the TWO suite.



Source: Systematic Income Preferreds Tool

A few months ago CLO Equity CEF OFS Credit Co. (OCCI) issued a new preferred - the 6.125% (OCCIO) just as the 6.875% (OCCIP) series became callable. However, from what we can tell OCCIP hasn't actually been redeemed yet which is weird because 1) OCCIP has a much higher coupon than where OCCI can issue (as evidenced by OCCIO) and 2) failing to redeem OCCIP pushes the fund's leverage to very high levels. As of April, OCCI had a quarter of its assets in cash – presumably ready to pay off OCCIP but they haven't done it yet. It seems implausible that they don't redeem OCCIP and fully invest the new cash they got from OCCIO because that would push their leverage to 50% at which point they would have suspended common distributions per 1940 Act rules and yet they haven't done it.

A few redemptions hit recently. The investment-grade rated insurer RenaissanceRe (NYSE:RNR) Series E (RNR.PE) is being redeemed (the recently issued RNR.PG keeps moving higher – now at a 3.64% yield which is still not bad for an IG-rated preferreds but not super exciting). A less cyclical industrial-focused REIT Rexford Industrial Realty (NYSE:REXR) Series A (REXR.PA) is also being redeemed on its first call date. Rexford Series B (REXR.PB) remains outstanding at a 2.99% yield which is decent risk/reward but also hard to get excited about. CEF Special Opportunities Fund (NYSE:SPE) Preferred (SPE.PE) was redeemed at $25. The stock was convertible by holders to about $29 but investors who failed to convert got given $25 instead which our four-function calculator shows is worse than $29.

Prospect Capital (NASDAQ:PSEC) is out with their first preferred (OTCPK:PSECP) with BB/Ba2 ratings from S&P and Moody's, trading at a 5.38% yield. There are not a lot of other BDC preferreds to compare to with - just the unrated GAINL trading at a -2.7% YTC which has been callable for about a year. PSEC has a baby bond (PBC) which is rated two notches higher and is trading at a 1.2% YTC with a call date at the end of 2021. The other two baby bonds have been redeemed recently. Giving up two rating notches in order to pick up 4.2% in yield seems like a good trade. Separately, the median YTW of the BDC baby bond sector is 2.05%, and even though only the PSEC bonds are rated, it's unlikely that the quality of the other bonds is so high as to warrant this yield differential. The preferred is also an interesting alternative for investors in credit CEFs who worry about the discount volatility of CEFs. The median covered yield (net investment income yield on price) of the loan CEF sector is 5.62% or about 0.2% higher than PSECP. What investors gain by giving up this 0.2% in yield is 1) avoiding the potential discount volatility of CEFs, 2) moving up in quality – the average holding quality of loan CEFs is B+ vs. BB of PSECP, 3) avoiding distribution cuts, 4) avoiding potential for deleveraging. All-in-all PSECP doesn't look half bad in the broader loan space.

Sunstone Hotel (NYSE:SHO) REIT is out with the 5.7% Series I (OTCPK:SNSHP) to redeem SHO.PF. There is one other series trading – the 6.125% Series H (SHO.PH). SNSHP looks a better option here with a similar stripped yield but a significantly higher YTW of around 5% vs. 4.5%.

First Republic Bank is out with an investment-grade rated 4% Series M (FRBSV). The typical new issuance pattern applies here – FRBSV has the lowest stripped yield in the 5 series suite but the highest YTW. An investment-grade security at a 4% yield is not half bad in the current environment when the High Yield corporate index yield is sub-4% (yes, durations are different in this comparison but the point stands). The farmland REIT Gladstone Land (NASDAQ:LAND) preferreds came up on the service. The issuer has two existing series with YTWs of around 3.2-3.5% (LANDO) and (NASDAQ:LANDM) and appears to still be offering a 6% Series C via the myipo.com website which was described in more detail here. Ignoring the illiquidity issue (if you buy Series C you have to wait till it moves to the exchange to sell it, though you can always sell it back to LAND at $22.5), the fair value of Series C is around $27.25 (to get us back to a YTW of around 3-3.3%) which is quite a bit higher than the $25 offer price.

The 8.5% Watford Holdings (WTREP) was delisted – most likely scenario is we get a new ticker and it pops back up OTC (unless redeemed). We might get a price dip, though this is likely to be bought by retail given the high stripped yield of around 7.7%. Prior to delisting the stock traded right around $25 in clean price terms, hence, having no call price risk. Separately, there was some confusion about a "dividend increase" for WTREP. The key thing to understand is that fixed coupons have a DCC or day count convention of 30/360 which means you always get the same coupon (as a month is always considered to have 30 days with 360 days in a year) whereas floating-rate coupons typically have an actual/360 convention where the numerator depends on the number of actual days in the month and so because WTREP is paying a floating-rate coupon, i.e. Libor + X, its actual cash dividend will typically vary a tiny bit quarter to quarter.

Stance And Takeaways

As highlighted above, we are keeping an eye on lower-coupon series to keep duration exposure under control given how far Treasury yields have fallen. Another way to partly mitigate interest rate sensitivity is through pinned-to-par preferreds and bonds where we find value in the NYMT Series B (NYMTP) trading at a 7.74% stripped yield, RSF Series A (RMPL.P) trading at a 5.82% stripped yield and OXSQ 2024 Notes (OXSQL) trading at a 6.49% stripped yield, among others.

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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 NYMTP, WTREP, OXSQL, RMPL.P 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.

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Jimmy Grisham

Yesterday, 1:34 AM

Comments (327) | + Follow

@ADS Analytics

Thanks for the excellent and timely update. I took advantage and grabbed some NYMTP today at 25.10. I had money sitting in an ultra short ETF making 0.5% and now its in a pinned to par preferred getting just under 7.75% I already had a large position in NYMTN, so the "P" was a good addition. I have more than enough of fixed-to-floating so the traditional fixed preferred was welcome. Pinned-to-par seems to be the sweet spot now. I own CMO.pE, MFA.pB, NYMTP, and DBRG.pG (called). Gotta expect a call or two, but the yields are great. Investment grade preferred at 4% and a premium does not appeal to me. Thanks again for the nudge.

Reply Like

Cuip99

26 Jul. 2021, 9:09 AM

Comments (5.52K) | + Follow

Good article but I wish the author would spell out his acronyms at least once. That is usually good grammar practice even though the acronyms may well be considered standard language to the regular user. I am not regular, ergo would like to know what they, the acronyms, mean.

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cbinvest1000 26 Jul. 2021, 9:03 AM

Comments (2.95K) | + Follow

Which is of the most highest quality and best yield?

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0xfc 25 Jul. 2021, 2:51 PM

Comments (3.72K) | + Follow

Thank you ads. More preferred hit the market in the last several days. Jpm, wfc, etc..

Reply Like (1)

Ron1634 25 Jul. 2021, 4:30 PM

Comments (413) | + Follow

@0xfc - I am thinking about it. But you got to accept a 4% yield in this low-interest environment.

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0xfc 25 Jul. 2021, 4:48 PM

Comments (3.72K) | + Follow

@Ron1634 Yes, that is true. IG are 4-4.35 right now. When interest rates went down recently the newest of new issues are lower then just a couple of months ago but one does have to buy some stronger new issues to balance out the weaker choices. Also yield to worst and yield to maturity have to be taken into account with existing issues.

On the plus side on the first day of trading they often go for a bit less then par. I guess just don't buy all at once. Layer in over a 4-8 month period so hopefully you catch some nicer IG issues at 4.6% or what have you.

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Ron1634 25 Jul. 2021, 4:54 PM

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@0xfc - This is the way I look at it. On a preferred that I consider very safe as is JPM, USB, and even WFC, a 4% yield is more than 10X better than what I get in a savings account.

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See More Replies

Greg_Maryland 25 Jul. 2021, 2:13 PM

Comments (1.24K) | + Follow

Nice note. Thanks for sharing.

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vinyl1 25 Jul. 2021, 1:42 PM

Comments (2.2K) | + Follow

With preferreds, yield to call is really important right now. You need 6 to get 4 in a 4-year window if you pay a $2 premium. Of course, it's entirely possible that rates will go up in the next four years, and your 6 will get you more than 4. because the issuer won't call - one more year, 4.4, two more years 4.7, and so on.

Reply Like (1)

NewToThis2015 25 Jul. 2021, 10:52 AM

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Pebblebrook Hotel Trust issued a new preferred series (H) and is redeeming their series C and D shares with the proceeds. The series H shares pay 5.70% and closed at $25.30 on Friday. *(edited)*

Reply Like (1)

Ron1634

25 Jul. 2021, 4:35 PM

Comments (413) | + Follow

@NewToThis2015 - The parent company - PEB, has serious cash-flow problems. Looks like they could eliminate the div there 1st and then preferreds come next.

Reply Like (1)

Ron1634

25 Jul. 2021, 8:52 AM

Comments (413) | + Follow

As usual, Thanks for the write-up

Reply Like (2)