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Preferreds Market Weekly Review

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Summary

- We take a look at the action in preferreds and baby bonds through the second week of August and highlight some of the key themes we are watching.
- We discuss a frequent question about tracking redemption as well as new issuance and sector moves.
- We remain focused on pinned-to-par securities as well as those in the "middle-yield" space with lower vulnerability to a duration sell-off but higher-quality from a through-the-cycle perspective.
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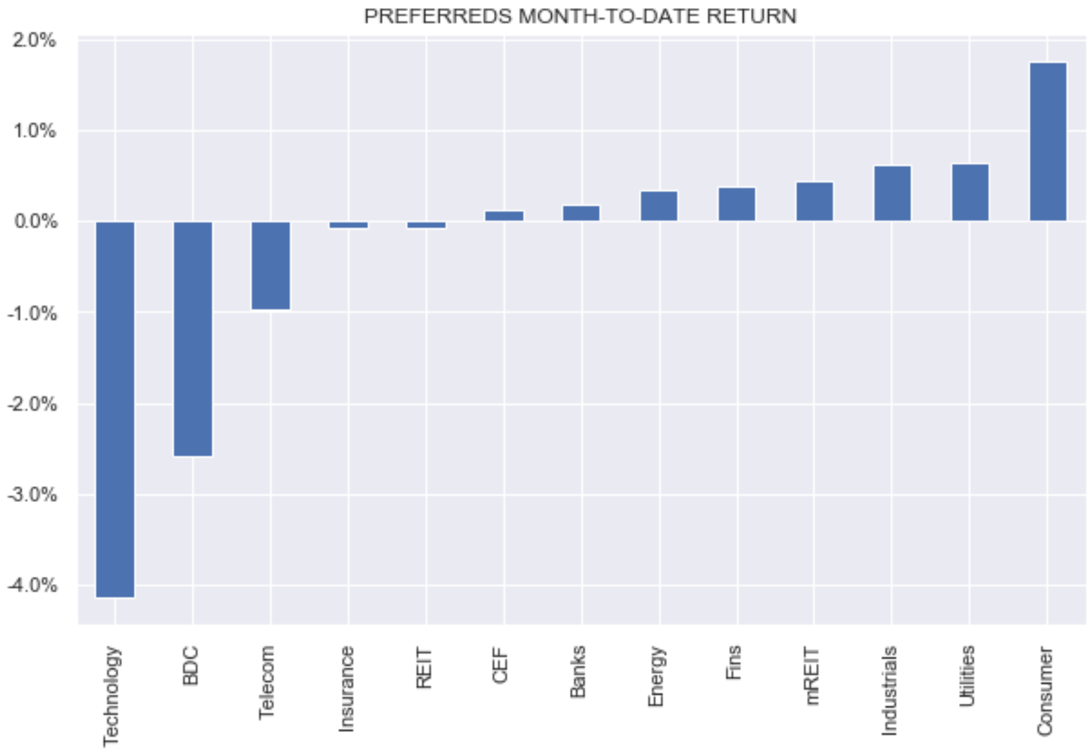
This article was first released to Systematic Income subscribers and free trials on 16-August.

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 week of August.

Market Overview

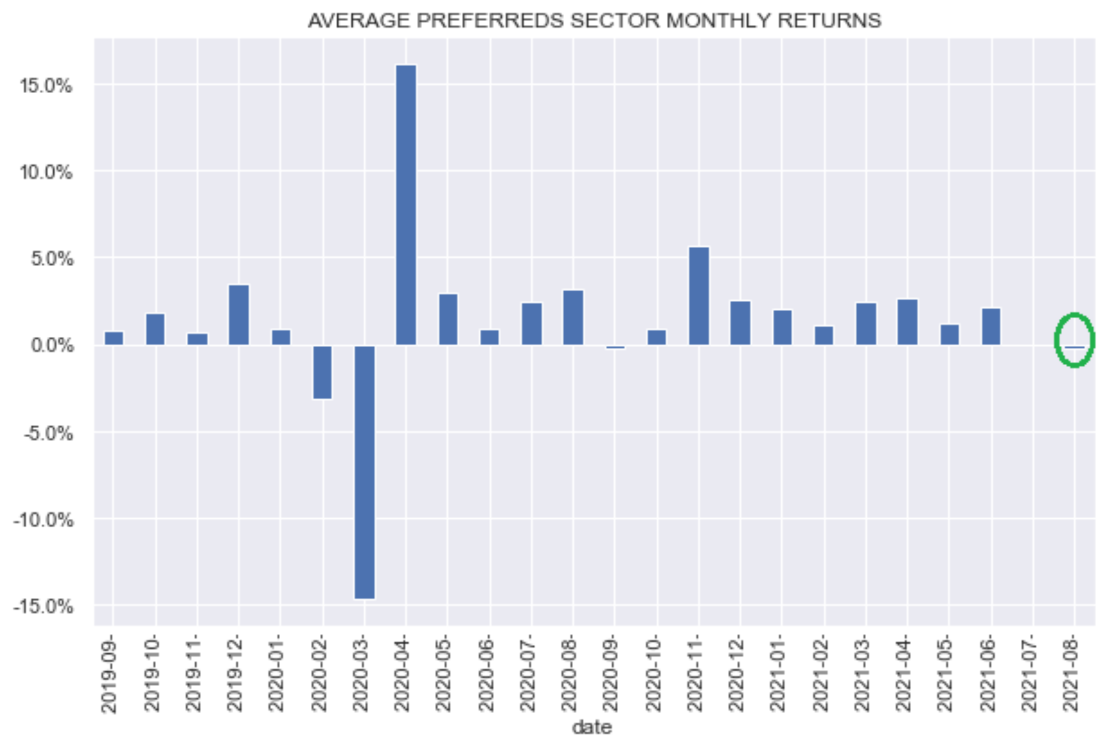
It was not a great week for senior securities which was somewhat surprising given the low volatility across major asset classes this week along with higher stocks and lower 10-year Treasury yields. Most preferreds sectors finished in the red on the week with Consumer and Utility sectors edging higher.

Over the month of August so far, most sectors are up though by a smaller amount than the underperformers are down.



Source: Systematic Income

So far, August is clocking in at about what July delivered - a total return of close to zero which is actually fairly unusual over the last year and a half. This period was supported initially by tightening credit spreads and then by falling risk-free rates. Now with risk-free rates appearing to bounce back from their lows (ironically, just when inflation readings are stabilizing) credit spreads may be too tight to offset their negative impact on preferreds returns. This suggests that we may be looking at flat returns at best into the end of year, particularly in higher-quality, low-coupon preferreds.



Source: Systematic Income

It's fair to say that redemptions have been coming hard-and-fast given the combination of tight credit spreads, low risk-free rates, and many preferreds entering the redemption period with high coupons having been issued more than 5 years ago when yields were much higher than they are now (the initial non-redemption period is typically 5 years).

An important question came up on the chat is how investors can track redemptions of their holdings. Unfortunately, there is no foolproof solution here. As a member of the service highlighted, redemption notices are only sent to record holders of the individual securities which are clearing firms rather than individual investors. Your own individual brokers may or may not let you know of the redemption in a timely manner.

One way to increase your chance of being notified is to use a news aggregator site like Yahoo where you can build a portfolio of securities which will allow you to see the collated list of press releases. Press releases are not required on redemptions but many issuers do post them. A minority, however, insist on tucking the news away into a 10Q.

Finally, a not very serious suggestion is that if you see a currently callable security that is trading above "par" drop in price by more than the usual dividend amount (particularly if it's not on an ex-div date) then it is worth checking to see if it has been redeemed.

Market Commentary

The CLO-Equity focused Oxford Lane Capital Corp (NASDAQ:OXLC) is out with a 6% preferred (OTCPK:OXLNP). Recall they have a 6.75% OXLCM outstanding which didn’t react at all despite trading north of par in clean price terms - suggesting the market doesn't think it is likely to be redeemed. And to be fair, from a leverage perspective OXLC don’t actually have to redeem OXLCM – if they do nothing their leverage will be around 32% which is not far from where it has tended to be. Of course, they could still redeem OXLCM but that would push leverage down to 27% - that’s not crazy low but on the lower side of where the fund has tended to position itself. It’s also possible they just do a partial redemption of OXLCM. If OXLCM trades half a percent lower or so, it would be a nice pinned-to-par hold at around a 6.7% stripped yield as it would have no call price risk.

OXLNP itself is trading right around par and currently has the third highest YTW of the CLO Equity preferreds (i.e. OCCI, PRIF, OXLC, ECC funds). The most attractive of the preferreds bunch is the OCCI 6.125% Series C (NASDAQ:OCCIO) which has a 6.21% YTW - the highest in the sector and a relatively short 2026 maturity (OXLNP is a 2029 maturity). One thing that investors looking at the sector often miss is the capital structure element which has a huge impact on the risk profile of a given preferred. All else equal, a preferred with no debt ahead of it is much more attractive. OCCI is the only company in the sector that doesn't have any debt in the capital structure which is a big plus for preferreds holders. For investors happy to settle for a lower yield, our view remains that the OXLC 6.75% 2031 bond (NASDAQ:OXLCL) remains the most attractive security in the broader sector though the yield is less exciting now at 5.26%.

A new 6% Telephone and Data Systems preferred started trading (OTCPK:TDSLL) – B/Ba3-rated and has already rallied about 2% above "par" when we first highlighted it as a potential switch for the holders of TDS 6.625% Preferred (TDS.PU). TDSLL is trading at a 5.56% yield - still more attractive than the 4.86% yield on TDS.PU. Both series have a first call date in 2026 and TDS.PU is more likely to be redeemed due to its higher coupon. A new Public Storage (BBB+) preferred was priced at 3.95% (PASQV) and is trading at a 3.89% yield. We don't expect a strong move higher as the 4% (NYSE:PSA.PP) is trading at $25.22 clean and a 3.80% yield. Both still offer value against the rest of the suite (third highest YTW is 3.20%) but the low coupon / higher duration profile of these two recent new series is a risk given where risk-free rates are.

One way to fit this high-duration / decent quality security in an income portfolio is to specifically add it as an attractive yielding macro hedge. If the recovery stalls here rates will probably move even lower and the decent quality of the stock means it's going to be able to digest a sell-off better than most preferreds. You can hold something like (NASDAQ:VCLT) - an ETF holding long duration investment grade corporate bonds with a lower duration and lower yield (around 3% SEC yield) or you can hold PASQV at a 3.89% yield and even longer duration. The longer duration element is a benefit here because you don't have to hold as much of PASQV as you would of VCLT to get the same bang for the duration buck, leaving more of the portfolio in higher-income assets.

BDC Gladstone Investment Corp. (NASDAQ:GAIN) will have a new 4.875% 2028 bond (GAINZ). At par, the yield is a lot better than the 4.17% YTM and 2.88% YTW of their other bond 5% 2026 bond (NASDAQ:GAINN). The sector median YTW is just 1.85% so this is a welcome addition. The recently launched PSEC preferred (PSEC.PA) has been trading very weak – now at just $23.87 clean price and 5.6% yield. It continues to look pretty good for a BB / Ba2 rating. In their rating note, Moody's has highlighted the company's low leverage, strong liquidity management, and a history of profitable operations. Many investors don't have a high view of the common but that's largely beside the point for preferreds holders who aren't looking for upside and who don't need the managers to be superstars but, rather, just half-decent risk managers.

The new Triton 5.75% preferred (TTRNV), BB-rated with a 5.43% yield started trading. It looks the best among the other 4 preferreds which range from 4.64% to 5.37% yield. The company's unsecured debt is investment-grade – the company was upgraded one notch from BB+ at the end of March. You get a good market environment for the firm with shipping costs rising rapidly (China partly shut the world's third largest port) against relatively high leverage and a cyclical profile. The new preferred has a lower coupon than the second-highest yielding series which lowers the likelihood of immediate refinancing and it also has an additional year and a half of call protection.

Stance And Takeaways

Despite 10-year Treasury yields backing up close to 0.2% from recent intraday lows there has not been a lot of movement in the senior security space. Apart from the pinned-to-par space that we have discussed in previous updates, we are also focused on the middle-quality preferreds that should prove more resilient than the low-coupon high-quality series or the low-quality series that may be vulnerable through the cycle, once the current period of easy fiscal and monetary policies comes to an end.

In particular, we like the BB+ rated Algonquin Power & Utilities Corp. converts (NYSE:AQNU), at a 7.6% yield, (NASDAQ:BPYPM) from Brookfield Property Partners, rated BB+, at 6.34% yield, non-callable LBRDP at a 5.98% yield which is basically a portfolio of Charter Communications stock and a strong balance sheet, Qurate Preferreds QRTEP (BB- Fitch) at a 6.75% yield with a 2031 maturity and the non-callable SLMNP from a Lyondell subsidiary at a 5.83% yield.

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This article was written by

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Disclosure: I/we have a beneficial long position in the shares of SLMNP, AQNU, OXLCM, LBRDP 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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