

Preferreds Market Weekly Review

Sep. 18, 2021 11:11 AM ET | AAIC, AAIC.PB, AAIC.PC... | 5 Comments | 11 Likes

Summary

- We take a look at the action in preferreds and baby bonds through the second week of September and highlight some of the key themes we are watching.
- There is a clear trend over the last few months of low volatility and much more subdued returns over the earlier trading period.
- Given the expected start of tapering as a first step to rate hikes, we discuss how investors can think about preferred stock reset yields.
- We also highlight some of the stocks that have not run ahead with the rest of the market, offering attractive entry points.
- I do much more than just articles at Systematic Income: Members get access to model portfolios, regular updates, a chat room, and more. [Learn More »](#)



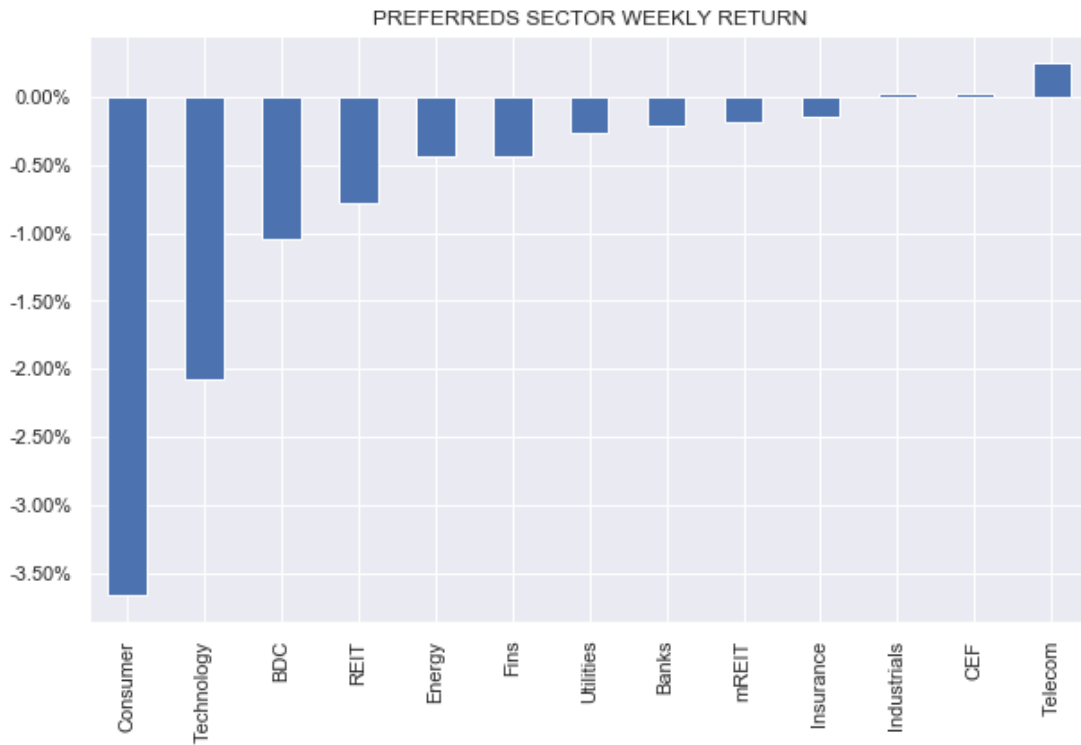
cemagraphics/iStock via Getty Images

This article was first released to Systematic Income subscribers and free trials on 13 September.

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 second week of September.

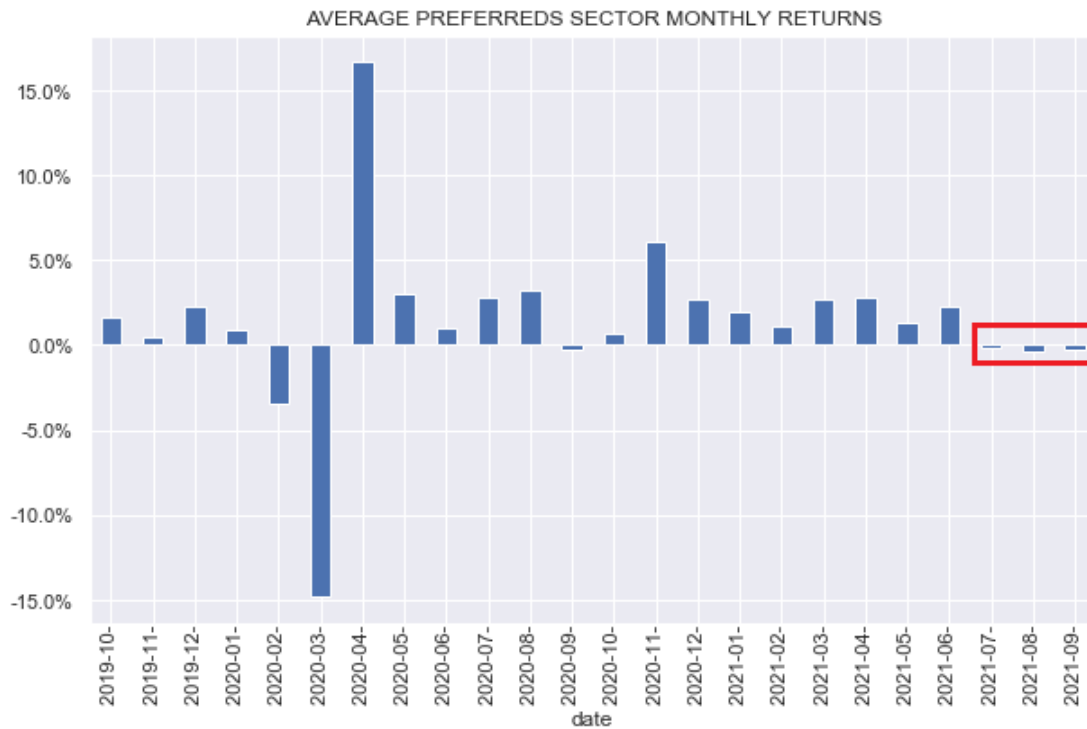
Market Overview

It will come as little surprise that most preferreds sectors were down this week on the back of lower stocks and Treasuries - a relatively rare combination these days. Over the month of September, most sectors are still in the green, however.



Source: Systematic Income

If we look at monthly trends over the last couple of years, there is a clear pattern of 1) unusually stable returns over this July, August and September and 2) a clear step-down in returns from the very healthy pace since the end of the drawdown in March of 2020.



Source: Systematic Income

It is clear that very tight credit spreads, low risk-free rates and negative convexity are all playing a role here. The latter factor has to do with stock prices bumping up against their "par" levels or strike prices, driving yields-to-call to low levels and making it difficult for them to keep rallying. Elevated inflation readings, labor market hiccups and likely tapering set to begin over the next 3 months are likely causing many investors to question the risk/reward on offer.

Market Themes

An important question came up on the service about how to think of reset yields for fixed-to-float stocks, i.e. the dividends after the redemption date if the stock fails to be redeemed by the issuer and whose coupons switch from fixed to floating-rate. This is a genuinely difficult question and what makes some preferred stocks hard to analyze even outside of any fundamental credit issues. It is particularly relevant now as many stocks are approaching the end of their fixed-coupon periods and the Fed is looking to start tapering its asset purchases, the first step on the way to eventual policy rate hikes.

There are a few ways to approach this question. Investors who have a firm view of where Fed policy rates are going to be over the next 5 years or so can simply use their assumptions, add floating spreads (and whatever Fed Funds/Libor basis looks sensible to them) and estimate the yield of a given stock post-redemption.

The rest of us can use a scenario based approach to this question. Here we run through some of these scenario yields.

- **Stripped yield** is the yield figure under the assumption that the security will remain outstanding in perpetuity.
- **Yield-to-call** or YTC assumes the security will be redeemed on the first call date.
- **Yield-to-worst** or YTW is the minimum of stripped yield and yield-to-call and should be used ahead of the other two unless investors have a firm view on redemption.
- **Reset yield** is the yield of the stock assuming Libor will reflect current market expectations on redemption date and is just the floating coupon using Libor forwards and the stock's floating

spread divided by current price.

- **10Y Yield** assumes that the stock will only be redeemed after 10 years and is useful because it combines periods of fixed coupon and floating-rate coupon, providing a kind of averaging of the two.
- **ZIRP yield** assumes that Libor stays at zero (it is around 0.11% now) and, typically, is a kind of worst-case yield scenario.

The **AGNC** set of preferreds provide a good test case for thinking about reset yields.

AGENCY-FOCUSED MREITS	STRUCTURAL					MARKET						
	Call Date	Type	Current Coupon	Float Index	Float Spread	Clean Price	Stripped Yield	YTC	YTW	Reset Yield	10Y Yield	ZIRP Yield
AVERAGE ISSUER												
AGNCM	2024-04-15	Fix/Float	6.875%	3mL	4.330%	25.73	6.68%	5.68%	5.68%	5.27%	6.23%	4.21%
AGNCN	2022-10-15	Fix/Float	7.000%	3mL	5.110%	25.87	6.76%	3.79%	3.79%	5.24%	6.45%	4.94%
AGNCO	2024-10-15	Fix/Float	6.500%	3mL	4.993%	25.58	6.35%	5.69%	5.69%	6.22%	6.64%	4.88%
AGNCP	2025-04-15	Fix/Float	6.125%	3mL	4.697%	25.04	6.11%	6.07%	6.07%	6.27%	6.64%	4.69%

Source: *Systematic Income Preferreds Tool*

For investors who think that all of the series are likely to get redeemed (not a crazy thought as all are trading above "par" in clean price terms), then **AGNCP** looks most attractive at the highest yield (gauged by its highest YTW).

For investors concerned about getting stuck with a step-down in coupons - there is certainly something to worry about. All of the stocks feature floating spreads that are well below their current fixed coupons and all are also trading within sight of "par" which means that a small drop will signal to the market that the issuer is now less likely to redeem.

In this case it is worth consulting the reset yield and here AGNCP also looks best. This may seem odd since it has only the second highest floating spread in the set, however, because its call date is the furthest away, it takes advantage of a higher Libor forward level since the interest rate curve is upward sloping. In addition, its relatively low clean price provides another yield boost. All in all, this pricing fits into our intuition that Libor in 2025 is likely to be higher than Libor in 2022.

If Libor does not rise in line with market expectation but instead sticks close to its zero bound, then the ZIRP yield shows that ANGCP will lose out relative to the other series but not by very much - 0.25% versus the highest ZIRP yielding series. And don't forget that while AGNCP ZIRP yield is lower than that of [AGNCN](#), it will enjoy a much higher fixed coupon for two and a half years from the point when AGNCN floats, giving it a 1.13% yield advantage over that time (AGNCP YTW less AGNCN ZIRP yield) which goes a long way to pay for a 0.25% lower yield in the "worst-case" zero Libor scenario.

The existence of these different scenario yields does not provide all the answers. Specifically, it is useful to know the likelihood of redemption for any given security - this likelihood is clearly different for different series. This likelihood can inform investors whether they should mostly rely on current YTW (which assumes redemption will happen), the reset yield (which assumes redemption will not happen) or the 10Y Yield (which assumes redemption will happen but only after 10 years).

The basic rule of thumb is you want to compare the floating-rate coupon to the current fixed coupon. The lower the floating-rate coupon is below the fixed coupon, the more likely the issuer is to keep the stock outstanding simply because the interest rate it has to pay will move lower from current levels. What adds complexity here is that we don't know what the floating-rate coupon is going to be across time because we don't know what Libor (most fixed-to-float stocks use Libor as the base rate though this is less common for new issues given Libor is going away at some point) is going to be. Using reset yield as a reasonable proxy, in the absence of firm market views, is not a bad idea and can provide some guidance of which scenario yield is more or less useful for any given series.

Market Commentary

There has been little action in the senior security new issue market over the past two weeks. One of the new recent IPOs was the Agree Realty 4.25% Baa3 (lowest IG Moody's rating) Series A (ADCDV), rallying to \$25.40 and trading at a 3.91% yield. In our view, the Public Storage 4% Series P ([PSA.PP](#)), trading at a 3.79% yield looks more attractive, being ahead by 3 rating notches.

A number of securities on our watchlist have not rallied with the rest of the market or have reversed their previous rallies. In particular, we like AQNU – the convertible BB+ rated Canadian utility which has moved back below "par" and looks attractive for a 7.75% yield. The mREIT Arlington Asset Investment Corp 6.75% 2025 Notes ([AIC](#)) which are currently callable and trading at a 6.56% YTM look attractive, although the entry point matters on these to minimize call price risk. The BB-rated K1 issuer Brookfield Property Partners 6.25% ([BPYPM](#)) have traded back down and look attractive at a 6.31% yield - the highest in the 4 series suite. The PennyMac mREIT 6.75% Series C (PMT.PC) continues to trade below "par" and at a significantly higher yield relative to its two other series at a 6.81% yield.

Check out [Systematic Income](#) and explore our **Income Portfolios**, engineered with both yield and risk management considerations.

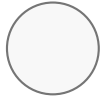
Use our powerful **Interactive Investor Tools** to navigate the closed-end fund, open-end fund, preferred and baby bond markets.

Read our **Investor Guides**: to CEFs, Preferreds and PIMCO CEFs.

Check us out on a no-risk basis - [sign up for a 2-week free trial!](#)



This article was written by



ADS Analytics

5.1K Followers

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 BPYPM, AIC, PMT.PRC 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.

11 Likes

5 Comments

Comments

Sort by

Newest

