

Preferreds Market Weekly Review: A Welcome Flurry Of Reset Issuance

Sep. 26, 2021 8:55 AM ET | HBAN, HBANN, HBANP... | 1 Comment | 3 Likes

Summary

- We take a look at the action in preferreds and baby bonds through the third week of September and highlight some of the key themes we are watching.
- The preferreds market has seen a significant step down in returns despite a supportive macro backdrop due to tight credit spreads, low risk-free rates, and negative convexity.
- CMT reset-rate preferreds have increased in frequency - we discuss why it's worth holding some of these fix-to-float securities in income portfolios.
- Market activity has woken up - we highlight redemptions and new series from Huntington, Vornado, New Residential, and more.
- I do much more than just articles at Systematic Income:

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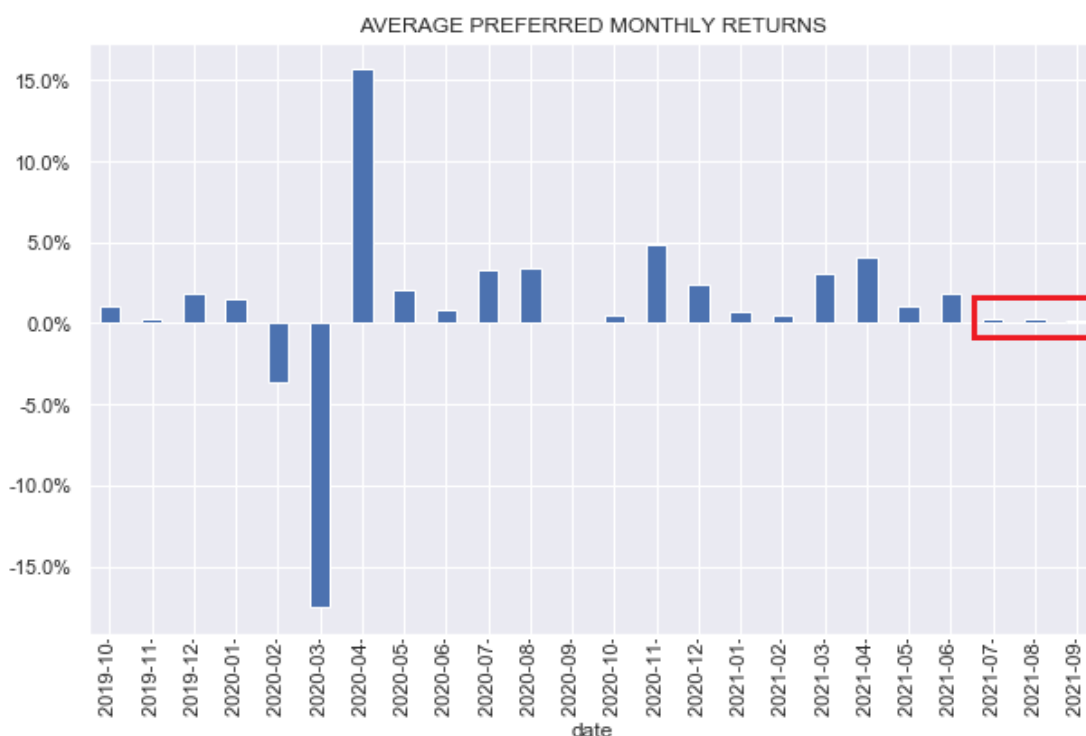
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This article was first released to Systematic Income subscribers and free trials on 20 September.

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 third week of September.

Market Overview

Only two of 13 preferred sectors were down on the week which was quite an achievement in a week that saw both lower Treasuries and stocks. However, that was not enough to deliver convincingly positive returns for the market month-to-date. In fact, the pattern over the last while is the same one we have highlighted in our CEF updates - the last three months have seen a significant step-down in returns from the previously strong pace.



Source: Systematic Income

This dynamic suggests that the higher-quality / lower-yielding sectors like Banks and Financials are going to struggle to deliver quarterly returns much above 1% given their high prices and low yields-to-call. Higher-yielding sectors like mREITs, those with more cyclical exposure such as REITs or convertibles-heavy sectors like Tech should outperform if the market background remains supportive.

Market Themes

As the new issue market has sprung back into action a key trend we are seeing is the increase in the issuance of 5-year constant maturity treasury, i.e. 5y CMT reset preferreds with 3 just in the last couple of weeks.

There is a common argument that fix-to-float securities are a kind of fool's gold in that you take the downside of lower rates (as many fix-to-float holders experienced in 2020) without having any upside since the stock would just be called away if rates rise significantly higher.

There are a couple of problems with this view. First, it's not at all obvious that a fix-to-float stock will be called away if rates rise. This is simply because higher rates also imply a higher-yield environment for issuers. So, an issuer who calls away a floating-rate stock and wants to issue a fixed-rate stock will be forced to pay the going rate in the market which is now presumably higher than when they issued the stock they just redeemed. It's not like they can go back in time to a lower-rate regime and issue then. If they have spare cash on the sidelines, then they don't have to refinance the redeemed stock but then, presumably, that cash cannot be used for working capital purposes, new investments, etc.

The second issue here is that from the perspective of the investor, having a stock redeemed is far from a bad outcome. If the alternative is that higher rates leave the investor holding income securities well below "par" that surely feels like a worse outcome than being given "par" with an ability to now reinvest that capital at higher yields. Clearly, the redemption is a win for the investor, not a loss.

There is another misconception about fixed-to-float or floating-rate securities which is that because they have low duration (particularly, the Libor-flavored ones) they are immune to changes in interest rates. In some sense, this is surely correct. From a leveraged perspective (say a bank desk) whose cost of capital is roughly Libor, any changes in Libor do not translate into higher or lower income levels since they are cancelled out on the balance sheet. In other words, a security that pays Libor + 2% will deliver the same return to the bank regardless of where Libor is because any increase in security income from higher Libor will just go out the door in higher funding costs and vice-versa.

However, retail and institutional investors are typically unleveraged so consider this thought experiment of a 4% fixed-coupon Series A and a Libor + 2% Series B with the same maturities when Libor is at 2% (hence, both securities have a 4% coupon) and both securities are trading at the same price (not surprisingly as they have the same coupon and the same credit risk). Now imagine Libor goes to zero - the coupon of Series A remains 4% while the coupon of Series B is now 2%. Anyone who thinks that Series B will continue to happily trade at the same price as Series A despite having half the coupon of Series A needs to check the batteries on their [HP-12C](#) and a few other things.

The key point for income investors is that they are highly leveraged to interest rates and that a back-up in rates can deliver losses and make it difficult to reinvest at the newly higher yields. Fix-to-float securities mitigate that kind of exposure by either allowing the investor to participate in higher yields or by having the security redeemed, allowing the investor to redeploy the principal amount at higher yields. With the 5-year Treasury yield trading sub-1% the risk between lower and higher rates feels asymmetric.



Source: FRED

In our view, it's worth having some Libor / SOFR as well as CMT fix-to-float stocks, particularly for investors concerned that rates may be headed higher. This is because we don't really know what the shape of the yield curve is going to look like. It is certainly possible that the front-end of the curve will move higher as the Fed hikes rates but the back-end of the curve stays mostly where it is, i.e. the curve inverts, perhaps because the market views the hikes as macro-negative. This will benefit Libor-linked stocks over CMT-linked stocks. And vice-versa, the Fed could stay put because of macro worries while longer-term Treasury yields move higher due to persistent inflation which will benefit CMT-linked stocks.

Market Commentary

Looks like the preferred market is finally waking up from a hiatus that covered both August and the first half of September. Three official or expected redemptions so far from Southern Co. 5.25% Notes ([SOJB](#)) ([SOJE](#) looks best of the remaining two bonds at a 3.55% yield). There was also a redemption of Vornado 5.7% Series K ([VNO.PK](#)). It's not clear why it took them so long to stop paying 5.7% despite being cross-IG rated. The new 4.45% Series O ([VNOOV](#)) looks best at a 4.45% yield.

REIT	Stripped Yield	YTC	YTM	YTW
SECTOR AVERAGE	6.16%	2.96%		3.60%
VNO-L	5.29%	-2.16%		-2.16%
VNO-M	5.05%	2.02%		2.02%
VNO-N	4.87%	3.29%		3.29%
VNOOV	4.45%	4.47%		4.45%

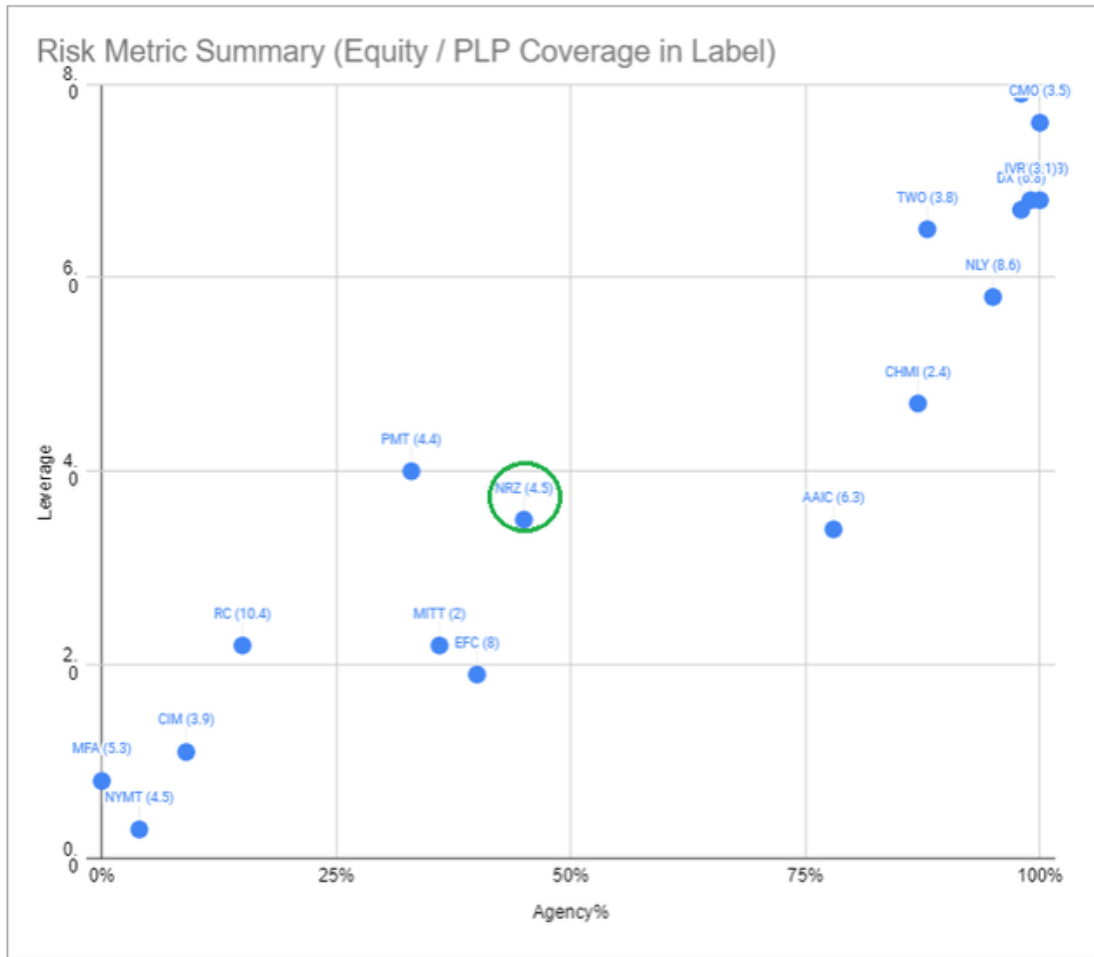
Source: *Systematic Income Preferreds Investor Tool*

Huntington Bancshares 5.875% Series C ([HBANN](#)) will be redeemed (HBANP looks best of the remaining series at a 3.98% yield, including 3 institutional series). The 3 HBAN institutional preferreds are interesting in that two have very long call periods, one being in 2030 and all have pretty attractive CMT fixed-to-float profile though they are unlikely to be actioned but they do provide some protection in case rates blow up. As typical, the yield variation between the institutional is more narrow / rational than the one in the retail space.

Banks	Stripped Yield	YTC	YTM	YTW
SECTOR AVERAGE	5.13%	2.83%		2.90%
446150AL8	5.51%	3.45%		3.45%
446150AT1	4.72%	3.15%		3.15%
446150AV6	4.06%	2.77%		2.77%
HBANM	5.49%	2.47%		2.47%
HBANP	4.40%	3.98%		3.98%

Source: *Systematic Income Preferreds Investor Tool*

mREIT New Residential Investment Corp. ([NRZ](#)) is out with a new preferred 7% Series D (NYSE:[NRZ.PD](#)), currently trading at a 7.04% yield. Unusually it is not trading at the highest YTW – A and B are trading at slightly higher yields but NRZ.PD does have one advantage which is the 5y CMT fix/float structure. This makes it more compelling despite a slightly lower yield. Overall, it's an MSR-heavy portfolio though majority is held in agencies. Coverage should drop to about 4x after the issuance and with leverage of about 3.5x and half the portfolio in agencies, it looks OK within the mREIT sector but not a slam dunk. NYMTN and AAIC-C look more attractive, in our view, with stronger metrics and higher yields.



Source: *Systematic Income Preferreds Investor Tool*

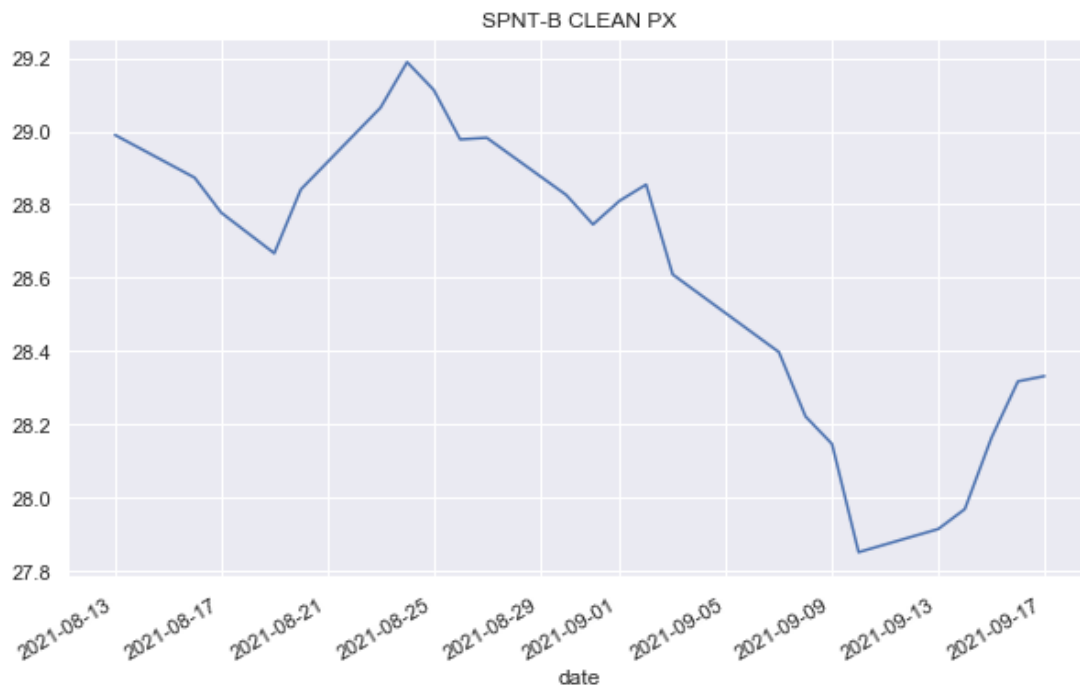
Series A preferred from Western Alliance Bank (WALPV), Ba1 (BB-equivalent) rated, started trading, rising quickly above \$26 and currently trading at a 3.35% YTW. This one also has a 5y CMT fix-to-float feature so can act as an interest rate risk diversifier in the portfolio if rates start moving up.

The CLO Equity fund OFS Credit Co. ([OCCI](#)) - an issuer of two public (and 2 private) preferreds - 6.875% 2024 Series A ([OCCIP](#)) and the 6.125% Series C ([OCCIO](#)) - reported financials as of July. What is very striking is how quickly the company has increased its share count. They nearly doubled the number of common shares in the fund from just six months ago through a combination of at-the-market sales, DRIPs and PIK distributions (i.e. paying shareholders in mostly new shares rather than cash).

The combination of organic NAV increase through price appreciation and equity issuance has driven leverage significantly lower and it looks to be around 33% (slightly overstated as about 10% of the portfolio is cash). This suggests that OCCI may not redeem OCCIP, although they probably should just refinance it as they were able to issue 0.75% below what they are paying on it. It also means that if you can snag OCCIP close to par in clean price terms (currently at \$25.46) it would be a nice pinned-to-par position with the stripped yield in OCCIP 0.8% higher than the YTW of OCCIO.

As it is, OCCIO is probably the most attractive not-currently-callable CLO Equity preferred in the sector at a yield a bit below 6%. The Priority Income Fund series do trade at higher yields but they have a credit facility and debt ahead of the preferred in the capital structure which makes them less attractive.

Reinsurer SiriusPoint ([SPNT.PB](#)), BB+ rated by Fitch and S&P, came up on service as it had a fairly sharp drop as the chart below shows.

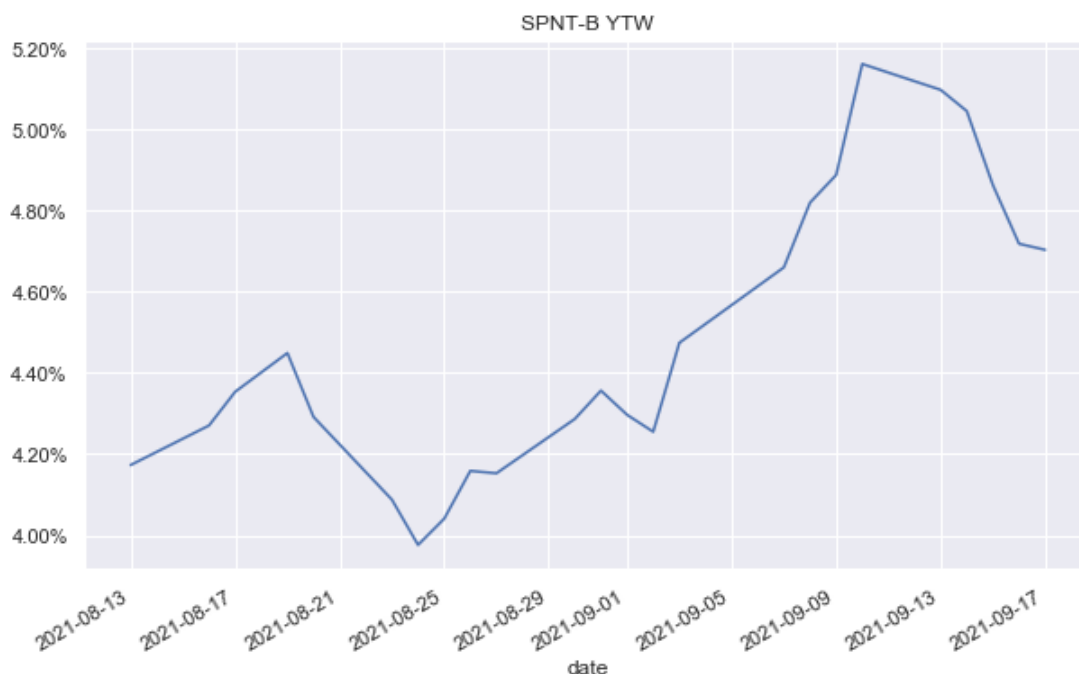


Source: Systematic Income

The stock, basically, did a round-trip from where it began trading (unusually at \$27 due to its enormous coupon for its quality) rose to close to \$30 before moving back to trade only about 2% higher, ex-recent dividend, from where it began). It has unusual provenance being a refinancing of a preferred held by institutional investors due to the recent merger with Third Point Reinsurance.

We have held the stock in the Core Portfolio since the end of June when it was still trading below \$28 - about \$1 below the current price if you include the dividend that was accrued and paid out last month. It did come off a lot recently but that just seems a reversal of a huge unsustainable run-up. It rallied about 11% straight up after its IPO so a 4-5% reversal makes sense in that context. Though the yield is not attractive as it was when we added it, it still looks attractively priced relative to the broader preferred market at a 4.7% yield.

Our view has been that acquiring the stock at a yield of close to 5% was very attractive given the investment-grade rated issuer and the rating on the preferred just one notch below investment-grade. Median YTW of securities rated BB- to BB+ are not far off 3% so a near 2% yield advantage is attractive.



Source: Systematic Income

The 5yCMT reset coupon is attractive as well, although it's unlikely to see the light of day given the very high likelihood the stock will be redeemed. However, if rates do somehow blow up then it provides a decent way to make sure you don't get stuck with a low-coupon perpetual.

In addition to the floating-rate element, the high coupon also lowers the duration on the stock relative to other recent new issues all of which have much lower coupons and are typically fixed-rate – two features which cause their durations to be much higher than that of SPNT.PB.

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

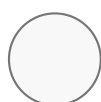
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