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Fixed Income

Preferreds Market Weekly Review: Niche Sectors Remain Resilient

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Summary

- We take a look at the action in preferreds and baby bonds through the last week of September and highlight some of the key themes we are watching.
- The exchange-traded preferred market finished lower for the third month in a row due to a combination of headwinds.
- A number of niche senior security sectors such as mREIT and CEF preferreds have remained resilient during September which we continue to be overweight.
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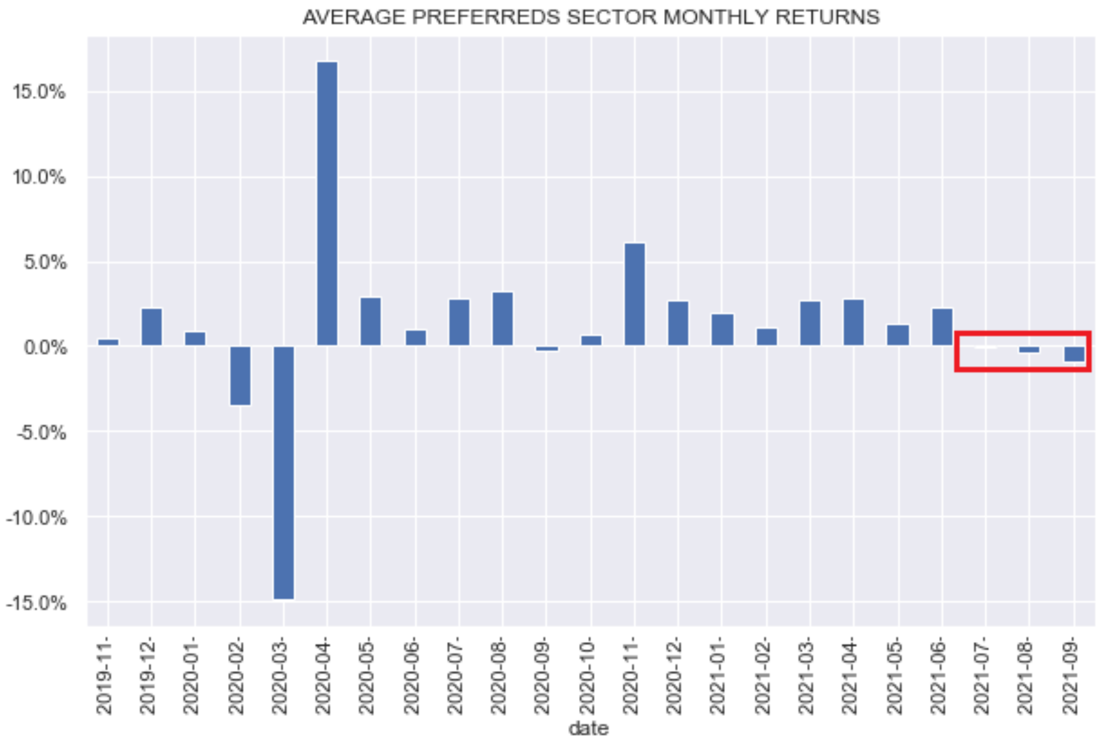
This article was first released to Systematic Income subscribers and free trials on October 4th.

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 last week of September.

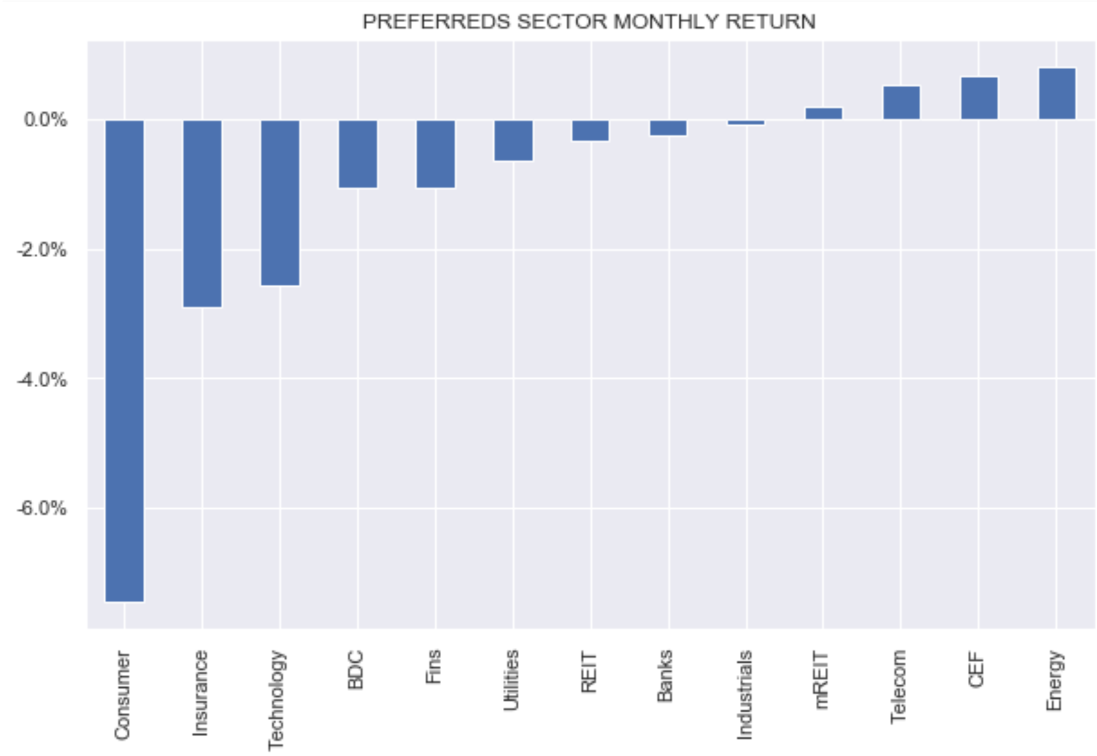
Market Overview

The preferreds exchange-traded market finished lower for the third month in a row as higher Treasury yields, weaker stocks and already-tight credit spreads served as sector headwinds.



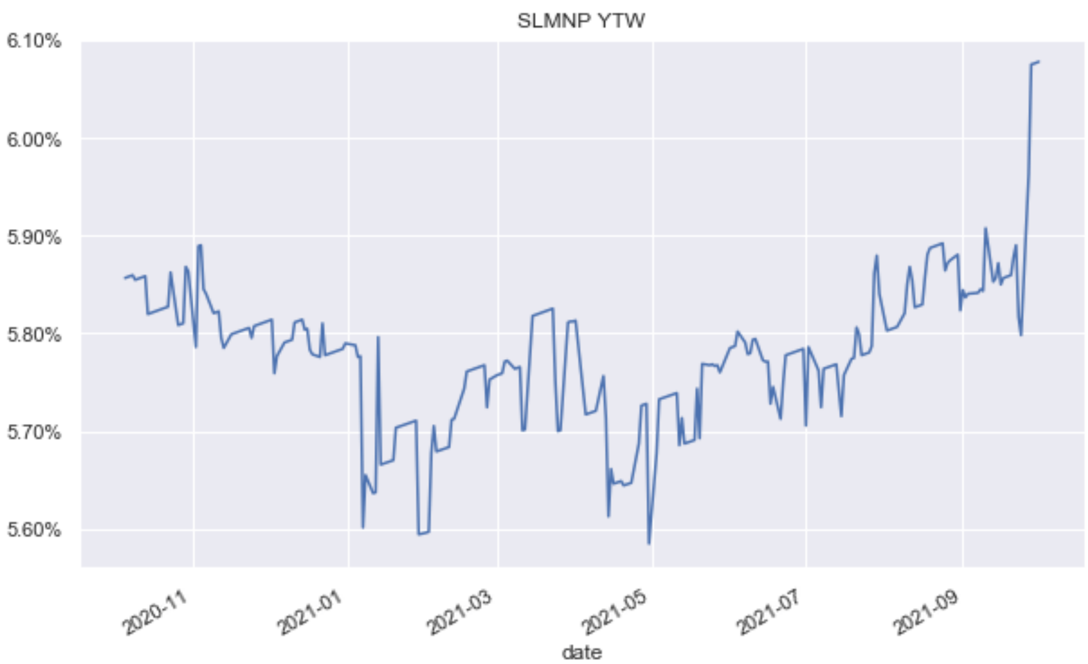
Source: Systematic Income

Only four sectors finished in the green with Energy outperforming which reflected the sector's ability to take advantage of the rising oil price.



Source: Systematic Income

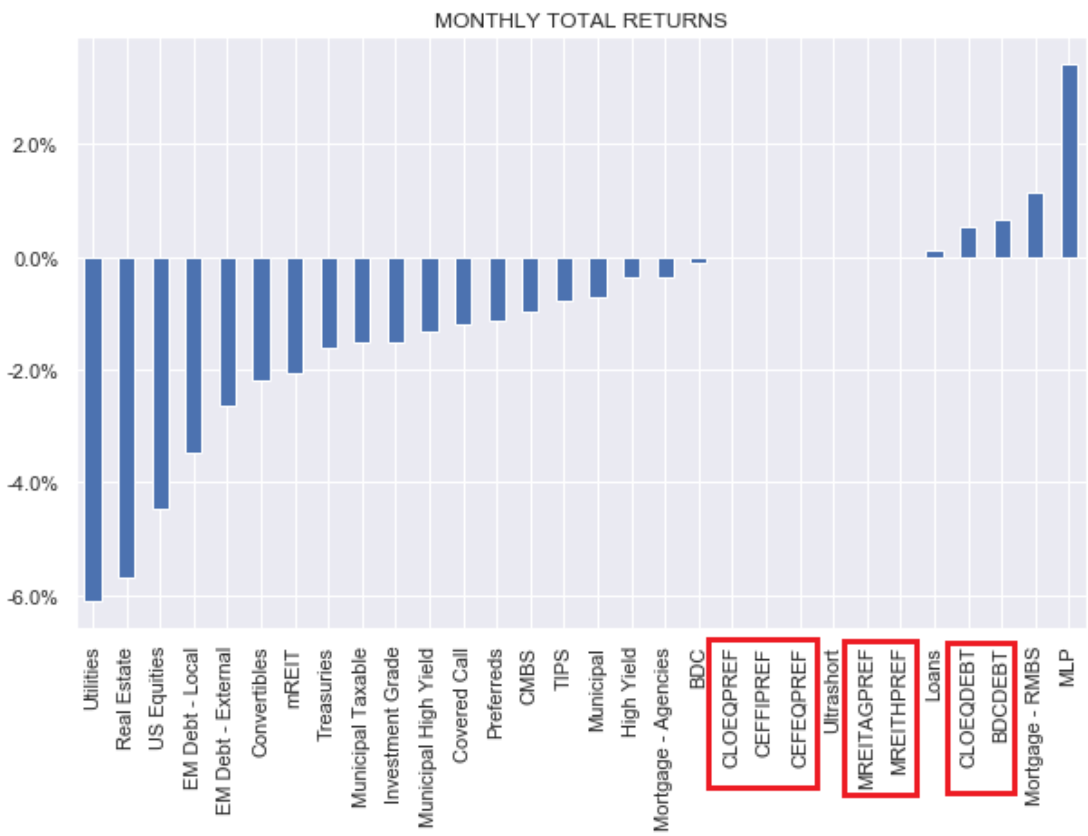
Continued market weakness is due, in some part, to the continued volatility stemming from the SEC 15c2-11 rule which is meant to limit the publishing of quotes by brokerages for issuers with incomplete current financial information. However, in practice, this has limited the ability of investors to buy shares of issuers that are caught up under the rule, correctly or not. The resulting unbalanced supply and demand picture (limited buys vs. unlimited sells) as well as some investors hoping to exit holdings that may be caught up in the rule has caused some stocks to significantly underperform the broader market. This can present an opportunity for investors who are still able to purchase shares in these stocks and are happy to hold them through potential liquidity challenges in the future. We see value in the A. Schulman 6% (OTCPK:SLMNP), now a non-convertible, non-callable perpetual of a Lyondell subsidiary which has risen to trade above a 6% yield.



Source: Systematic Income

Market Themes

If we take a look at the broader income space returns in September, we see that despite the market finishing lower in aggregate, there were quite a few sub-sectors that remained resilient. These tended to be niche preferred and baby bond sub-sectors and are highlighted below.



Source: Systematic Income

These are:

- Fixed-income, equity and, CLO Equity CEF preferreds and baby bonds
- Hybrid and Agency mREIT preferreds
- BDC baby bonds

About a year ago we highlighted these sectors as ones that are likely to maintain a measure of resilience due to a combination of factors. These factors include a significant presence of pinned-to-par securities, lower liquidity in some sub-sectors such as CEF preferreds which can be an advantage for "polite" market drawdowns, their niche position which likely leads them to be held by investors with greater conviction and their higher-yielding profile which allows them to absorb rises in Treasury yields better than lower-yielding securities.

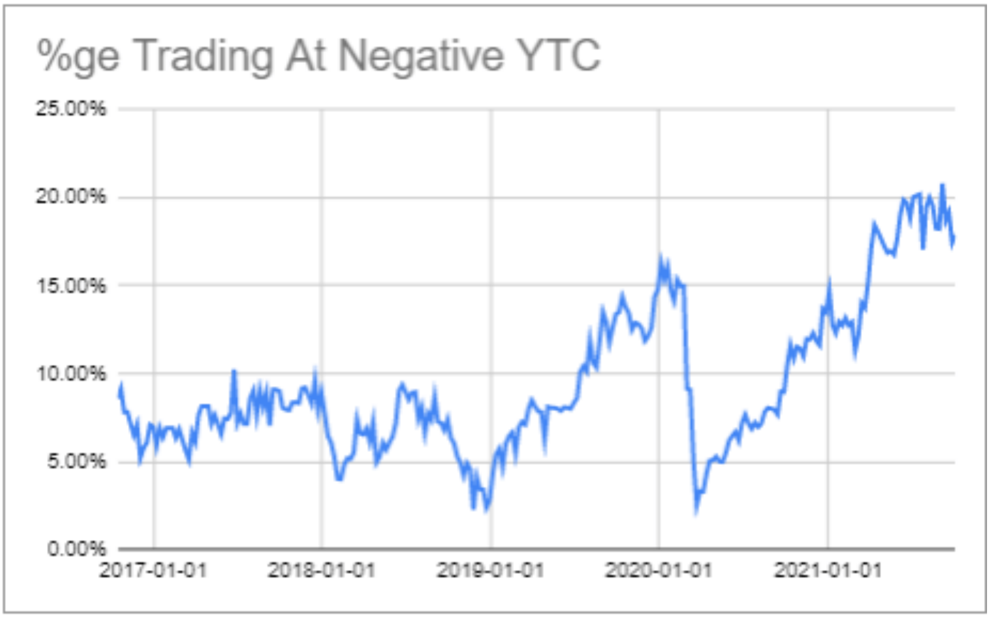
Our income portfolios remain overweight these sectors and have taken advantage of their resilient profile. We continue to find value in the mREIT Arlington Asset Investment Corp (AAIC.PC) trading at an 8.27% yield and discussed in more detail here, the CLO Equity Priority Income Fund 6.125% Series I (PRIF.PI) trading at a 6.17% yield, the BDC OXSQ 6.5% 2024 Notes (OXSQL) trading at a 6.12% YTM with roughly half a percent of call price risk so care has to be taken on the entry.

Market Commentary

Although the median $25-"par" clean price has started to roll over as we can see from the chart below it remains at an elevated level around $25.85 - more than 3% above the liquidation preference.

Source: Systematic Income Preferreds Tool

This presents a serious headwind not only for securities with call dates in the future, but especially, for securities that are currently callable. The chart below shows that close to a fifth of the market is trading at a negative yield-to-call which for currently callable securities analyst we define as the instantaneous drop to $25 from their current clean price i.e. a security trading at $26 clean has around a -4% YTW if redeemed immediately. This is slightly overstated as it ignores the notice period during when the coupon will continue to accrue but it is not overstated by very much - perhaps half a percent.



Source: Systematic Income Preferreds Tool

The recent redemption of the Banco Popular 6.7% stock (BPOPN) provides an interesting example. The stock was trading close to $29 at the time of the redemption which ended up being a -12% move on the day or more than 2 years' worth of coupons.

Obviously, given where yields are, some higher-coupon preferreds are trading at very high prices. A preferred that is trading well above "par" is a signal from the market that the issuer should be able to refinance at a much lower rate which is precisely what many have done. Investors who keep holding these preferreds are making an implicit bet that the market is wrong and that the preferred will keep being outstanding. That bet is wrong most of the time. Tracking this *call price risk* can be tricky for individual investors without access to dedicated tools as it requires knowing the first call date of each holding as well as the current traded price (ideally, the clean price as exchange-traded securities trade dirty or with the accrued included in the price). We track call price risk in our Preferreds Tool on the service.

Separately, it seems there is a view out there that quarter ends are particularly auspicious days for income investors who are overweight senior securities because lots of senior securities pay at quarter-end. And because most senior securities pay quarterly, the dividend amounts tend to be chunkier than those in funds so they are more noticeable. So if there is a mark-to-market loss in the portfolio through the month (as was the case for most investors in September) the big pay date "saved the day" and pushed many portfolios back in the green.

The reason some investors take this view is only because most brokers have curiously bad systems (e.g. Schwab and apparently Vanguard and Fido). Specifically, they don't accrue dividends in the portfolios over time but hit the portfolio with the entire dividend when it comes in, causing a big spike in the account's value. This obviously does not reflect the reality.

The better brokers correctly take dividend accruals into account over time as they come in and when those dividends pay out, the accrual disappears resulting in no big single spike in the account value.

Another side effect here is that the worse brokers will show a mark-to-market loss, all else equal, on an ex-div date as the price of the security drops by the amount of the dividend that falls away (plus/minus some market noise). This is obviously wrong - the account doesn't actually drop in value - that dividend is now accrued so the broker should show no move in the security overall (again, plus/minus market noise) but many will show a loss on the ex-div date and then a gain on the pay date whereas neither date should show much mark-to-market as the ex-div price behaviour, payment and accrual should offset each other. The reality is that dividends accrue regularly over time and the account doesn't jump in wealth on the dividend payment date just because the broker can't be bothered to properly accrue the dividend in the account. This is probably obvious to most but worth emphasizing as it can lead to some misconceptions like there is free money to be made with dividend capture.

This article was written by

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Income investing across BDCs, CEFs, ETFs, preferreds, baby bonds and more.

Disclosure: I/we have a beneficial long position in the shares of AAIC.PC, SLMNP, OXSQL 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.