Seeking Alpha α

Preferreds Market Weekly Review: Market Weakness Takes A Break

Oct. 24, 2021 10:11 AM ET | AAIC, AAIC.PB, AAIC.PC...

ADS Analytics
Marketplace Bio

Summary

- We take a look at the action in preferreds and baby bonds through the third week of October and highlight some of the key themes we are watching.
- The preferreds market has bounced back nicely in October with a drop in longer-term Treasury yields.
- We discuss how investors can think about valuing the yield differential in preferreds with and without maturities.
- We also highlight a number of shorter-maturity ideas such as AAIN and OXSQL.
- I do much more than just articles at Systematic Income:

cemagraphics/iStock via Getty Images

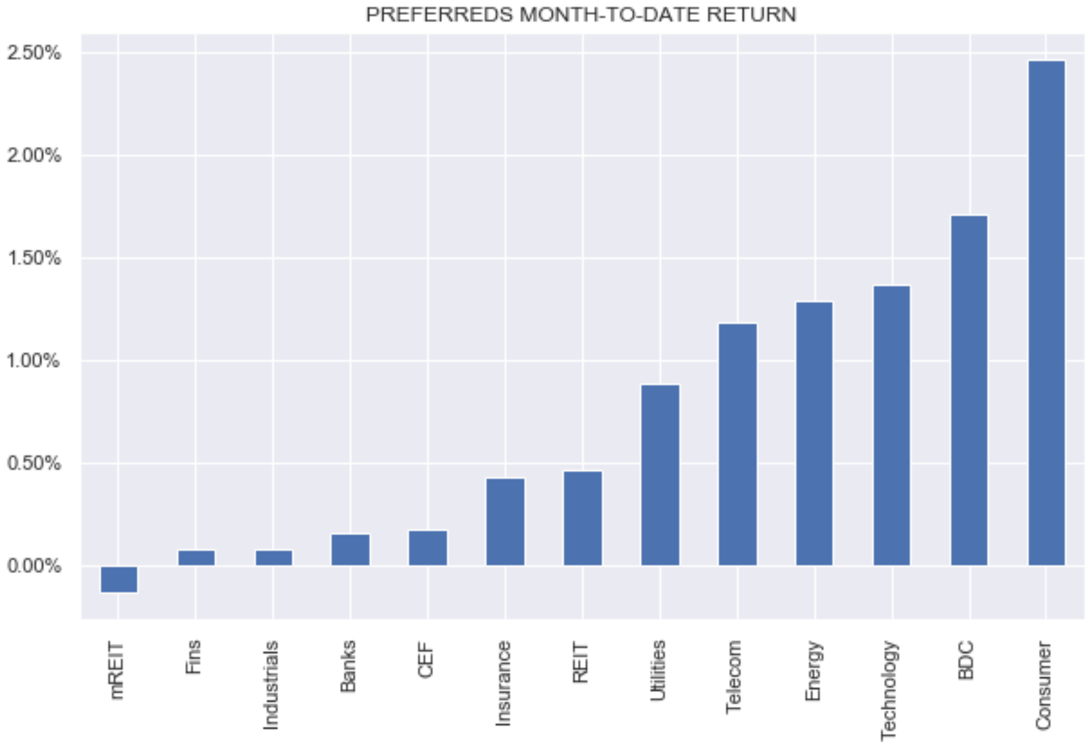
This article was first released to Systematic Income subscribers and free trials on Oct. 18.

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 October. Be sure to check out our other weekly updates covering the BDC as well as the CEF markets for perspectives across the broader income space.

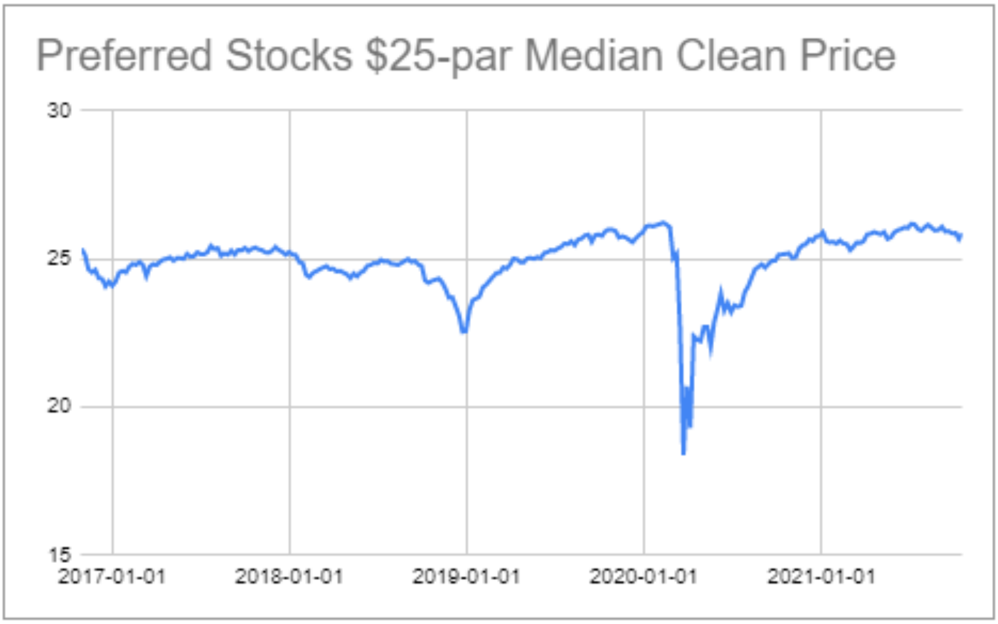
Market Overview

In contrast to the price action in September (and the preceding few months for that matter), October has delivered good news to investors. All preferreds sectors were up in the third week of the month. On a month-to-date basis all but mREITs are up also though even mREITs are off only marginally. Lower longer-term (if not 10-year and shorter term) Treasury yields along with tighter credit spreads have provided a tailwind for the retail preferreds market.



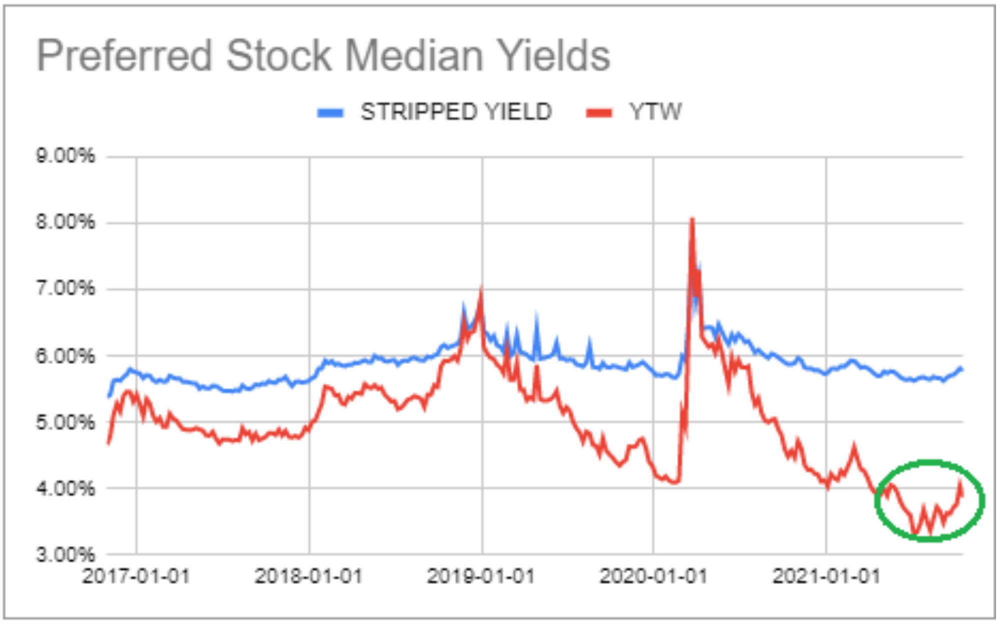
Source: Systematic Income

The recent uptick, however, has not erased the previous drop. The median clean price is about $0.30 off the recent high around $26.15 or so a few months ago.



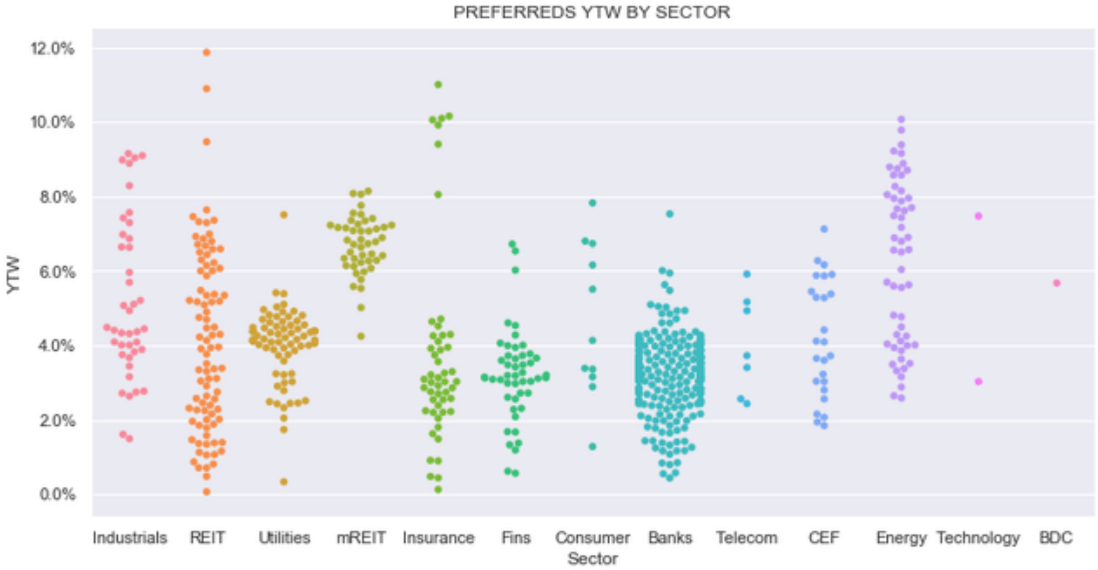
Source: Systematic Income Preferreds Investor Tool

At the same time, the median yield-to-worst is around 0.75% higher than the recent low - providing some breathing space for investors who are looking to put new capital to work or to reinvest dividends.



Source: Systematic Income Preferreds Investor Tool

Pockets of high yield remain in the Energy sector, the mREIT sector and parts of the CEF space (particularly in the CLO Equity CEFs) as well as REITs and Industrials.



Source: Systematic Income

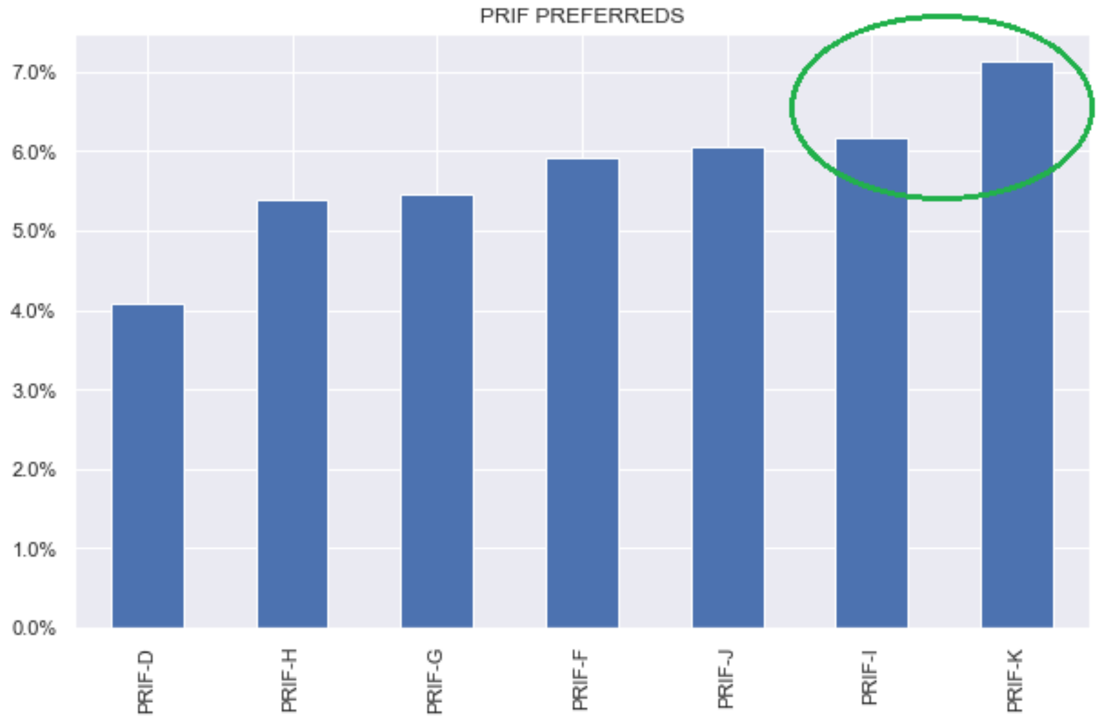
Market Themes

The preferreds market is unusually complex in the income space. Embedded issuer call options, fix-to-float structures and presence or absence of maturity makes it difficult for investors to compare securities to each other.

In this section we briefly take a look at the impact of maturity on the fair-value yield of a given security. The motivation for this is the recent issuance of the Priority Income Fund 7% Series K (NYSE:PRIF.PK). The Priority Income Fund is an unlisted CEF which primarily holds CLO Equity securities. The fund is unusual in that it is a frequent issuer and has a large number of outstanding preferreds.

A key difference between PRIF.PK and the other PRIF series is that PRIF.PK is a perpetual preferred while the other series have maturities. In fact, PRIF.PK is the first series in the PRIF suite that has no maturity. This may sound odd since few preferreds have maturities. However the CLO Equity sub-sector is unusual in that all but one stock - PRIF.PK - have maturities, 14 in all. So what is unusual for this sector is actually a lack of a maturity.

So how should investors think of PRIF.PK in the context of the PRIF suite of preferreds as well as the broader CLO Equity sub-sector? The chart below shows the yields-to-worst (i.e., the minimum of yield-to-call and stripped yield) of the PRIF suite.



Source: Systematic Income

The chart shows that PRIF.PK, unsurprisingly, boasts the highest yield which is around 1% higher than the second highest yield. Since all the other PRIF series have maturities, it is fair to say that PRIF.PK currently offers about a 1% yield pick-up over the highest-yielding series with a maturity.

The key question for investors is - is 1% sufficient compensation for a lack of a maturity. In other words, investors can buy PRIF.PI at a 6.14% yield and a June-2028 maturity or buy PRIF.PK at a 7.13% yield and no maturity.

There are a couple of ways to think about this question. One way to think about it to say that most preferreds investors are probably very long duration as it is, since very few preferreds have maturities. Therefore, it makes sense to remain allocated to some of the few preferreds with maturities and avoid PRIF.PK since that would be doubling up exposure to PRIF (if the investor is already holding, say, PRIF.PI) without the benefit of mitigating duration risk. This approach is arguably more relevant for investors who worry more about potential rise in yields.

The other way to think about is in more quantitative terms. This requires us to estimate differences in duration between the two securities. For a back-of-the-envelope estimate, the duration of PRIF.PI should be roughly around 5.5 (driven by its mid-2028 maturity) while the duration of PRIF.PK should be around 15 based on the formula for the duration of a perpetual security.

Once we know the difference in durations we can then see what the market is charging for longer-duration securities over their shorter-duration counterparts. The Treasury bond market, for instance, charges around 0.6% for this.

However, PRIF preferreds are far from the quality of US Treasuries so we need to add a credit spread differential as well by looking to the high-yield bond market. Historically, this additional credit spread differential has been on the order of 0.5-1% or so. Adding the two we get to a number of around 1.35%. In other words, PRIF.PK should yield roughly 1.35% more than PRIF.PI as the compensation for its longer duration profile. Currently, PRIF.K offers around a 1% premium over PRIF.PI.

An important caveat in this analysis is that we are ignoring the impact of the issuer redemption option on durations. For example, PRIF.PI has a June-2024 first call which is much shorter than its June-2028 maturity. And because the stock is roughly "at-the-money" i.e. its $24.95 clean price is close to its redemption price of $25, the likelihood of redemption prior to its 2028 maturity is quite high. Once we take this into account we can see that the duration estimate of 5.5 is actually the upper limit and the option-adjusted duration is closer to 3-4.

The same is true for PRIF.PK which has a first call date in Sep-2026 though it is currently a bit out-of-the-money with it clean price about 2% below its redemption price, making it somewhat less likely it will be redeemed on the first call date. That said, the likelihood is far from zero which means, again, that our previous duration estimate of 15 is really its upper limit and its option-adjusted duration is closer to 8-10 or so.

What does this mean for investors? At current duration estimates PRIF.PK is arguably fairly priced. However, based on worst-case duration estimates the yield premium of PRIF.PK is a bit too low. Investors who worry about higher yields and, especially, wider credit spreads, should probably go with the worst-case duration estimate because higher yields will push the prices of these preferreds lower which will push their embedded options further out-of-the-money. This will, in turn, cause their durations to extend for the simple reason that the issuer will be much less likely to redeem the series. This suggests that investors worried about a sharp rise in rates should either stick with PRIF.PI or wait for a larger yield premium of PRIF.PK.

Stance And Takeaways

Capping duration exposure is a key focus for many investors in the market. As highlighted above, the number of exchange-traded senior securities in the market with relatively short maturities is fairly small. Few preferreds have maturities and many baby bonds have very long maturities which means they tend to behave as though they didn't have one.

So rather than pick from a handful of senior securities with short durations many investors choose to allocate to credit CEFs (which, apart from the preferreds and taxable muni sectors) tend to allocate to assets with durations in the mid-single digits. And to further boost yields, CEFs either use additional leverage and/or simply distribute more than their underlying yields with the hope to make up the gap through alpha.

The main difficulty in this CEF strategy, however, is that CEFs are highly sensitive to sharp rises in Treasury rates - something we have highlighted in our CEF weekly updates. So, while the drop in NAVs from higher rates can be fairly benign, the widening in discounts can often double or triple the drops in NAVs, leaving investors with assets that, for all sorts and purposes, behave like very long duration assets.

This is why we continue to see value in allocating to shorter-maturity senior securities which remains part of our playbook (A, B, C, D, E), in addition to pinned-to-par as well as higher-yielding securities in preferreds and baby bonds specifically.

In this sub-sector we currently see value the mREIT Arlington Investment Corp 6% Notes (NYSE:AAIN) with a 2026 maturity and trading at a 5.43% yield and the BDC OXSQ 6.5% Notes (NASDAQ:OXSQL) with a 2024 maturity and trading at a 6.45% yield (with small call price risk as it is currently redeemable).