Preferreds Market Weekly Review: Yield Optics Misinform Investors

ADS Analytics

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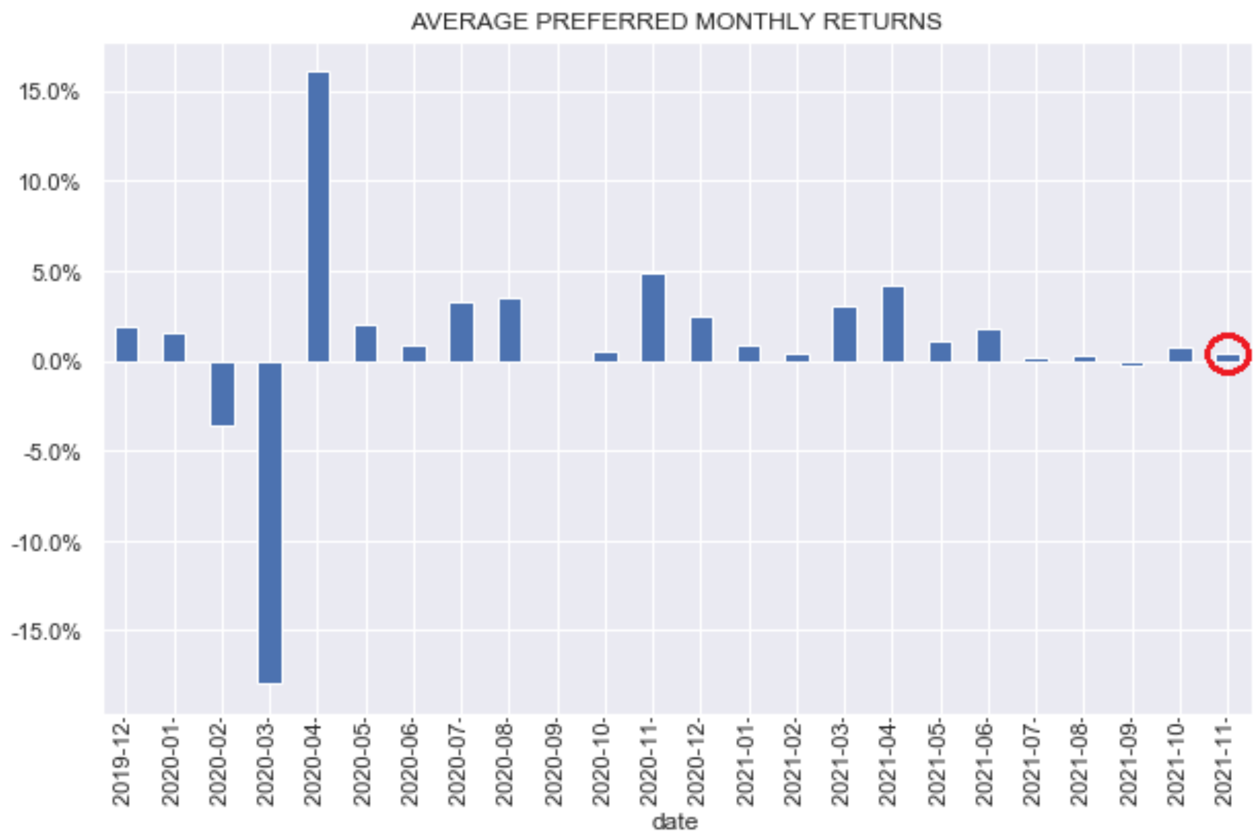
This article was first released to Systematic Income subscribers and free trials on Nov. 7.

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 November. 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

The preferreds market picked up where it left off in October, delivering decent returns in the first week of November, led by the higher-quality, longer duration sectors like Banks, Insurance and Financials.



Source: Systematic Income

The sector benefited from both lower Treasury yields as well as a supportive risk sentiment backdrop. The long bond (i.e. 30Y Treasury) yield has fallen nearly 0.30% off its recent high about a month ago, reversing some of the earlier yield curve steepening. This

dynamic could either be on the back of the market viewing the recent hawkish turn by the Fed as bearish for the broader economy or it could be a technical reversal of the previously sharp move. Given the record highs in equity indices, it suggests that the technical explanation is more likely.

Market Themes

The preferreds sector remains an especially tricky one for investors for two reasons. First is the complexity of the market with multiple series for a given issuer, different coupon types such as fixed vs. fixed-to-float, different first call dates, perpetual vs. term series and more. The second key difficulty is getting to grips with the yields on offer on an individual basis as well as in aggregate.

For instance, unlike municipal bonds, US, developed and Emerging Market investment grade and high-yield corporate bonds, preferred sector yields are not available on such platforms such as FRED or the S&P indices. This makes it difficult to evaluate the attractiveness of the sector relative to other available options across the income sector.

It also doesn't help when research geared for retail investors can lead them astray. For instance, State Street, helpfully, publishes fixed income research with a summary of available yields across various sectors. The trouble is that they misrepresent the yields in the preferreds sector with a suggestion that preferreds yields are not far from 5% whereas in reality sector yields are below 3%. They do this by showing preferreds yields as dividend yields (i.e. stripped yields or current yields) ignoring the much lower yields-to-call in the sector.

Source: Bloomberg Finance, L.P., FactSet as of September 30, 2021. **Past performance is not a guarantee of future results.** US HY Bonds: Bloomberg High Yield Very Liquid Index; Preferreds: ICE BofA Hybrid Preferred Securities Index; EM Hard Currency: Bloomberg Emerging Markets USD Aggregate; US High Dividend Stocks: S&P 500 High Dividend Index; International Stocks: MSCI EAFE Index; US Core Fixed Income: Bloomberg U.S. Aggregate; EM Stocks: MSCI Emerging Markets Index; US Treasury: Bloomberg U.S. Treasury Index; US Large Cap Stocks: S&P 500 Index; US Small Cap Stocks: Russell 2000 Index; International Corporate Debt: Bloomberg Global Aggregate Ex USD >$1B Corporate Bond Index. For fixed income, yield to worst was used while dividend yield was used for equities and preferreds. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

Source: SSGA

Showing dividend yields would make sense for a sector that was either mostly non-callable or mandatory convertible but neither is true of the preferreds sector. And because the average preferred is trading well above "par" it means that not only is its yield-to-call well below its dividend or current yield but it is much more likely to be redeemed as the market is clearly signalling to issuers that most can easily refinance at much lower coupons than their outstanding issues.

Other sources helpfully break down the difference between dividend yield (shown as CY or current yield in the table below) and yield-to-

worst.

INDEX	CY	YTW
BofA Fixed Rate Preferred Index	4.95	2.10
25 Par Preferreds	5.30	2.10
1000 Par IG	4.91	3.01
1000 Par HY	5.33	3.65
USD CoCo	6.09	3.67
US High Yield	5.61	4.04
US Corporate	3.37	2.14
5-10yr. Financials	3.20	2.14

Source: UBS

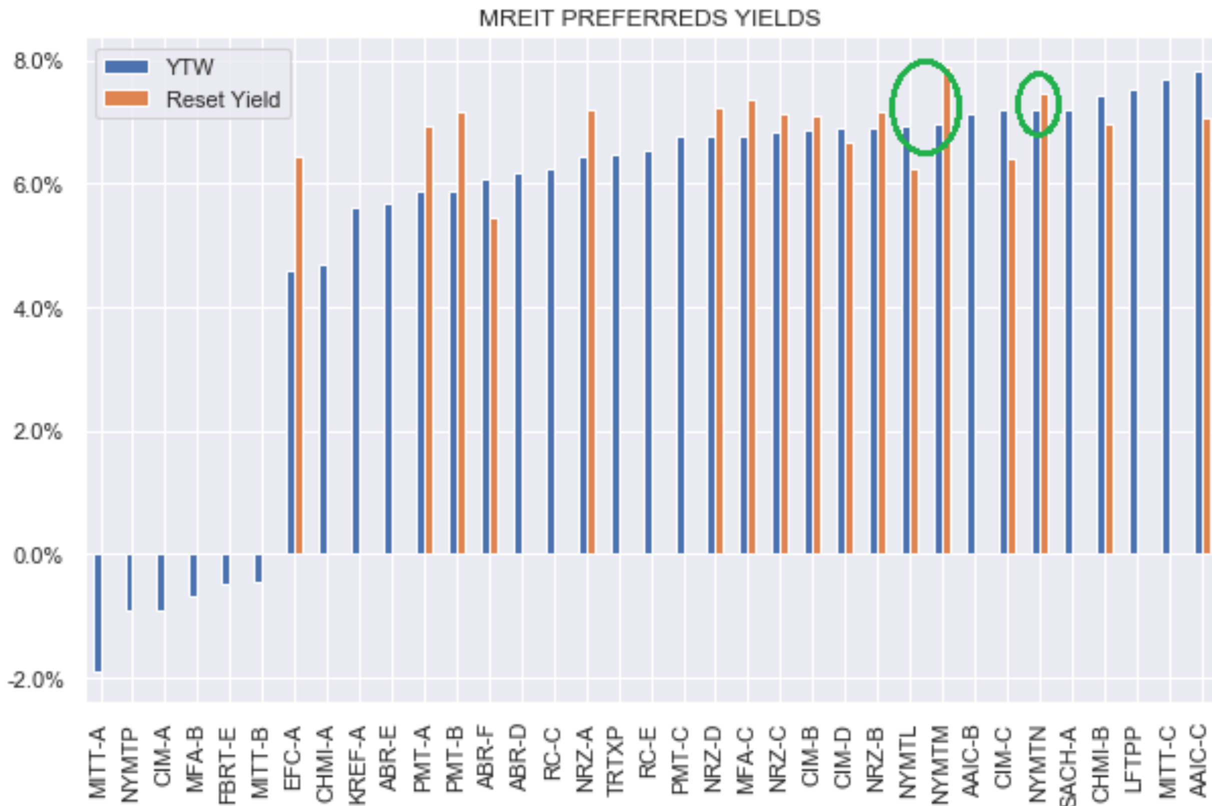
Investors can also confirm the yields on offer across the aggregate sector and sub-indices from sources like Nuveen or Spectrum. The takeaway here is that investors needs to be on the lookout for what looks too good to be true. They can also put their intuition to work - the preferreds sector is higher-quality (going by credit ratings at least) than the high-yield corporate sector and so should certainly not trade at a higher yield than high-yield bonds. And while it is true that the duration profile of the preferreds sector can be longer than that of corporate bonds (and hence, requiring a higher yield, all else equal) due to their potentially perpetual nature, the fact is most preferreds are trading to first call which means their durations are relatively short, at least at current valuations (durations can extend if prices fall).

Market Commentary

This week saw further earnings from the mREIT sector which remains one of our areas of focus on the service.

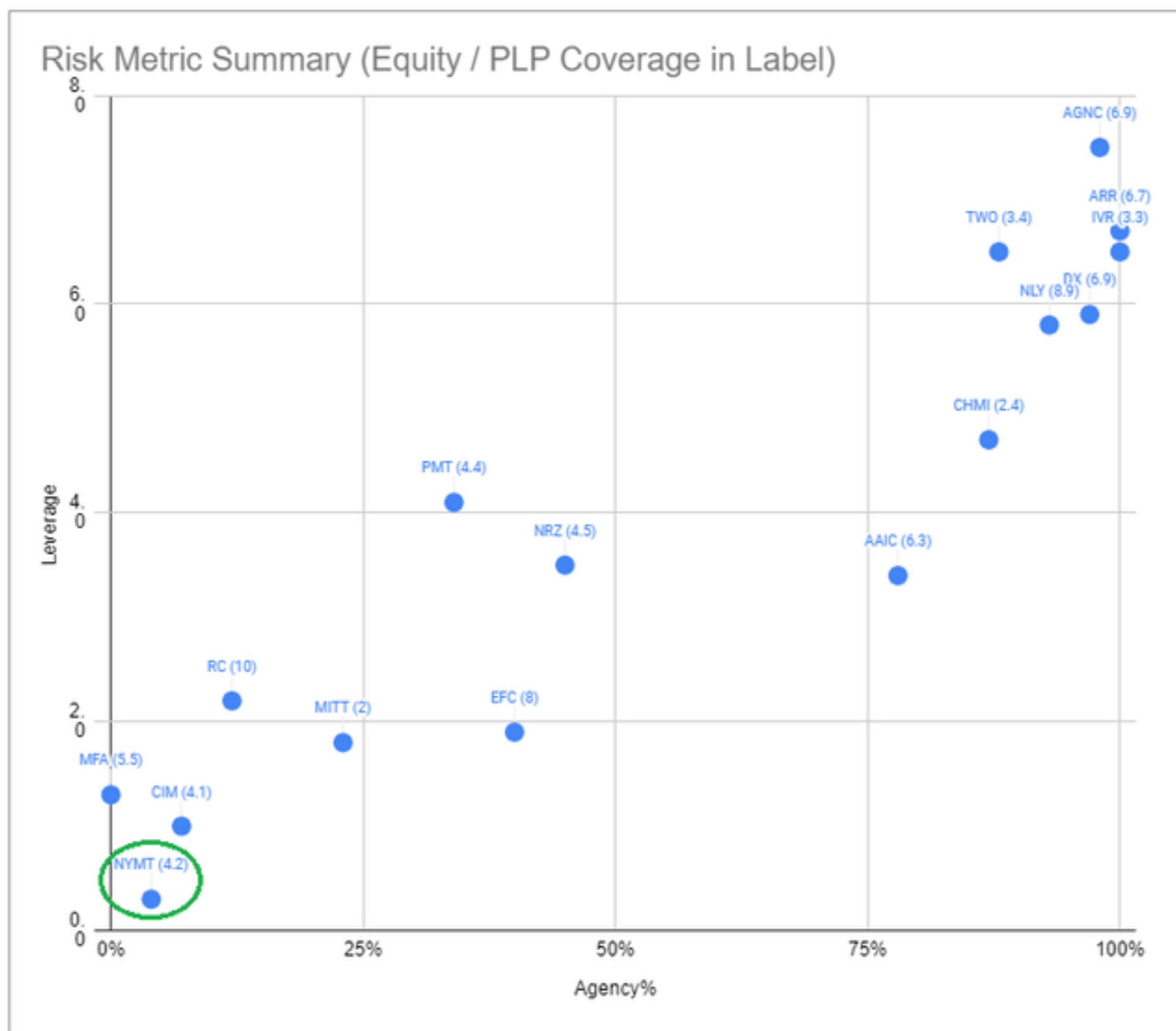
New York Mortgage Trust (NYMT) book value held steady and stockholders equity rose marginally. However, equity / preferreds

coverage fell to 4.2x from 4.5x due to a net increase in preferreds liquidation preference (Series C was refinanced with a higher liquidation preference of Series F). NYMT remains attractive in the hybrid mREIT space for a few reasons and not just because its preferreds are on the higher-yielding side in the sub-sector.



Source: Systematic Income Preferreds Tool

On the fundamental side, its leverage is very low at 0.3x (the lowest in the hybrid sub-sector and down from 1.5x in Dec-19).



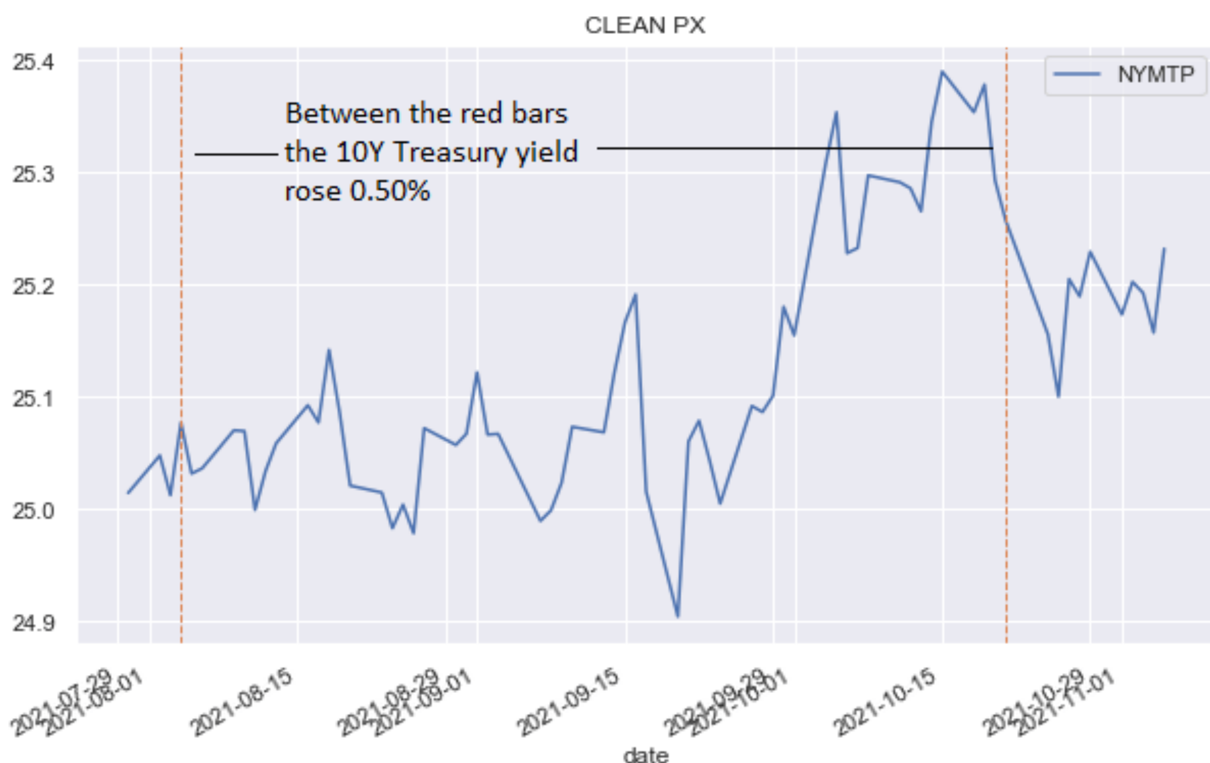
Source: Systematic Income Preferreds Tool

The percentage of marked-to-market borrowings is also very low at 51% (and much lower than pre-COVID) in the sector – only MFA is lower. This makes it difficult for the company to get into a negative feedback loop of lower prices leading to margin calls leading to forced sales leading to lower prices and so on leading to an eventual default. Coverage is only a touch below sector median of 4.4x. The agency allocation is low, however, if we stress test its current portfolio, it comes out with one of the stronger stress equity / preferreds coverage ratios - a metric available in our Preferreds Tool.

In the NYMT preferreds suite, the NYMT 8% Series D (NYMTN) is

attractive for its decent 7.19% YTW, long first call date in 2027 (i.e. not having to worry about what Libor or its replacement is going to do for 6 years) and strong reset yield of 7.45% (i.e. the yield of the stock based on its floating-rate coupon post first call date). NYMTN is currently trading at a near $26 clean price but occasionally moves down towards $25. Last time we highlighted the stock about a month ago this happened and when it does the yield moves up closer to its 8% coupon so it is worth watching.

The NYMT 7.75% Series B (NYMTP) at a 7.68% stripped yield and only a bit of call price risk is a good pinned-to-par option. The stock is a lower volatility NYMT preferred and, along with many pinned-to-par preferreds, snoozed through the recent 0.50% rise in the 10Y Treasury yield, even managing to rally somewhat in the process.



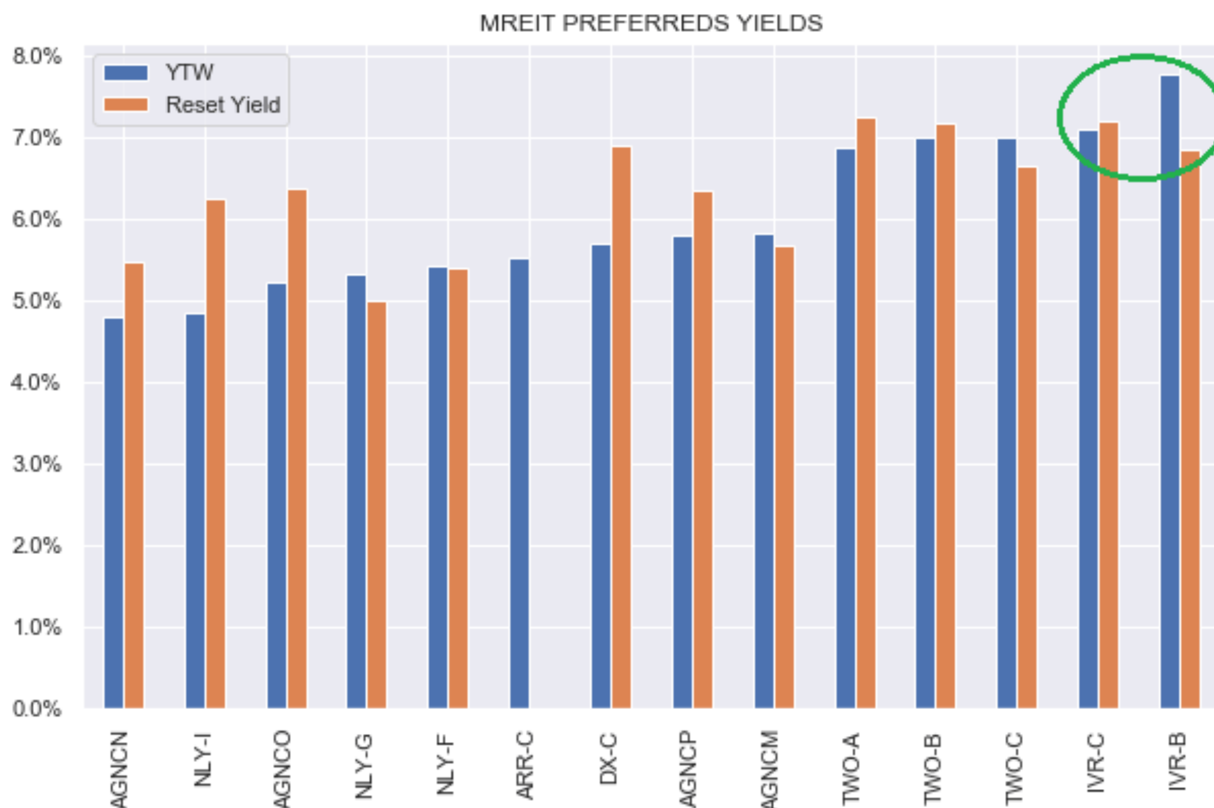
Source: Systematic Income

The downside is that it can get called away any time. It is currently trading at a $25.23 clean price and well worth watching when it gets

close to $25 at which point it is very attractive. NYMTP is also fixed-rate and so could be less of a concern for investors worried about policy rates remaining low and the negative impact this could have on fix-to-float preferreds.

Chimera Investment Corp. (CIM) had a great quarter with book value increasing 7.6%. This has pushed up equity / preferreds coverage to 4.1x from 3.9x. Leverage also ticked lower to 1.0x from 1.1x. The agency allocation fell to 7% from 9%. Overall, it's a good result for preferreds holders. CIM metrics remains pretty attractive – it has the third lowest leverage and coverage pretty close to the median. The current valuation of the preferreds is on the rich side, particularly relative to NYMT but the CIM 8% Series A (CIM.PA) is worth watching as a potential fixed-rate pinned-to-par option with a current stripped yield of 7.91% (and around half a percent of call price risk).

Agency-focused mREIT Invesco Mortgage Capital (IVR) book value increased 1%. Leverage fell to 6.5x from 6.8x and coverage increased to 3.3x from 3.1x due to the increase in book value and additional common share issuance. The two IVR preferreds trade at the highest yields in the agency-focused mREIT sub-sector.



Source: Systematic Income

This is for a good reason. IVR was hopeless in managing itself through the 2020 market shock and saw its book value drop 69% despite not having a particularly risky portfolio. The result was that its equity / preferreds coverage is the lowest in the sub-sector at 3.3x (TWO is not far behind at 3.4x as of Q2). On the plus side, the company sold out of its entire non-agency allocation and has become a pure agency house so it has tied itself to the mast so to speak from a risk perspective - an admission that it did not handle its non-agency allocation gracefully the last time around so it just won't mess with them in the future.

Relative value between the two series goes back and forth. We previously highlighted the 7.5% Series C (IVR.PC), however, it has just been bid up and the 7.75% Series B (IVR.PB) looks more appealing at a 7.76% YTW to its end-2024 first call date. The preferreds reset yield is 6.85% based on current Libor forwards so

investors prioritizing dividend stability should be aware of this, possibly tilting to IVR.PC which has a much longer Sep-2027 first call date as well as a reset yield that is actually higher than its YTW at 7.20% versus 7.09%.

Source: Systematic Income

We highlighted earlier that IVR.PA was likely to get redeemed which would boost the coverage of the remaining series which is what has happened. Our view remains that the low coverage of the preferreds means the company is likely to redeem IVR.PB in 2024, though unlike IVR.PA, it is a fix-to-float and does have other drivers of redemption than just the size of the preferreds in the capital structure.

In our view, even if the coupon of IVR.PA is lower than its current fixed coupon, IVR could still redeem the stock for the simple reason that even paying 5.5% - 6.5% rather than 7.75% doesn't make sense in the context of the yield the company can generate in the agency space given financing rates available on agency repo which are not far from zero.

Elsewhere, Qurate Retail (QRTEA) - the issuer of the Qurate Retail Group 8% Series A (QRTEP) - took a dive, falling close to 30% on the back of disappointing earnings and despite a special $1.25 dividend (vs. $8.22 common close yesterday) – the company paid a similar special last year. Overall it's not a great look – the quarter saw a 7% drop in revenue and a 60% drop in income year-on-year and management will pay out a $500m dividend and have bought back $120m of the stock 30% higher than where it is trading now.

There are obvious pressures on the business model – supply and shipping constraints as well as people going back to in-store shopping. General view of management quality is not great (there is a sense that the large dividend is there to pay insiders who own nearly 10% of the company), though there is a new CEO coming on board. Equity has gone down from $4.97bn in Dec-19 to $3.4 since Dec-19 which is not a great trend for the preferred (though it's been more stable from Sep-20 figure of $3.7bn when QRTEP was issued).

On the plus side, after the special dividend, equity / preferred coverage will be around 3.7x which is not bad (the company treats the preferreds as a liability – presumably because of the mandatory redemption feature which you have to add back to equity to avoid double counting). The behaviour of the stock is as though it's going bust which is pretty unlikely – their interest coverage (interest expense / EBIT) is still 2.4x even after a bad quarter and will move higher as they have redeemed some debt. Relative to the Sep-19 quarter both income and revenue in this past quarter were higher. QRTEP fell about 1.5% yesterday and right now has a yield of about 7.13%.

QRTEP has a 2% allocation in the High Income Portfolio – it was added close to a year ago below "par" and is trading at a clean price of around $106 currently. It can be redeemed in 2025 at $104 with

an amortizing profile into the 2031 maturity. The preferred was rated BB- by Fitch at issuance and Fitch has recently affirmed the parent rating at BB. It's worth waiting to see if it gets sold down towards par where it would be attractive to add.