



Preferreds Market Weekly Review: Choosing Between Common Vs. Preferred Shares

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Summary

- We take a look at the action in preferreds and baby bonds through the third week of November and highlight some of the key themes we are watching.
- The preferreds sector was down this week and is in the red for November so far - a trend we are seeing across the broader income space.
- We discuss our thoughts about choosing between common and preferred stocks of a given issuer.
- And highlight a number of new issues such as OPP.PB, ECCD, NYMGV and others.
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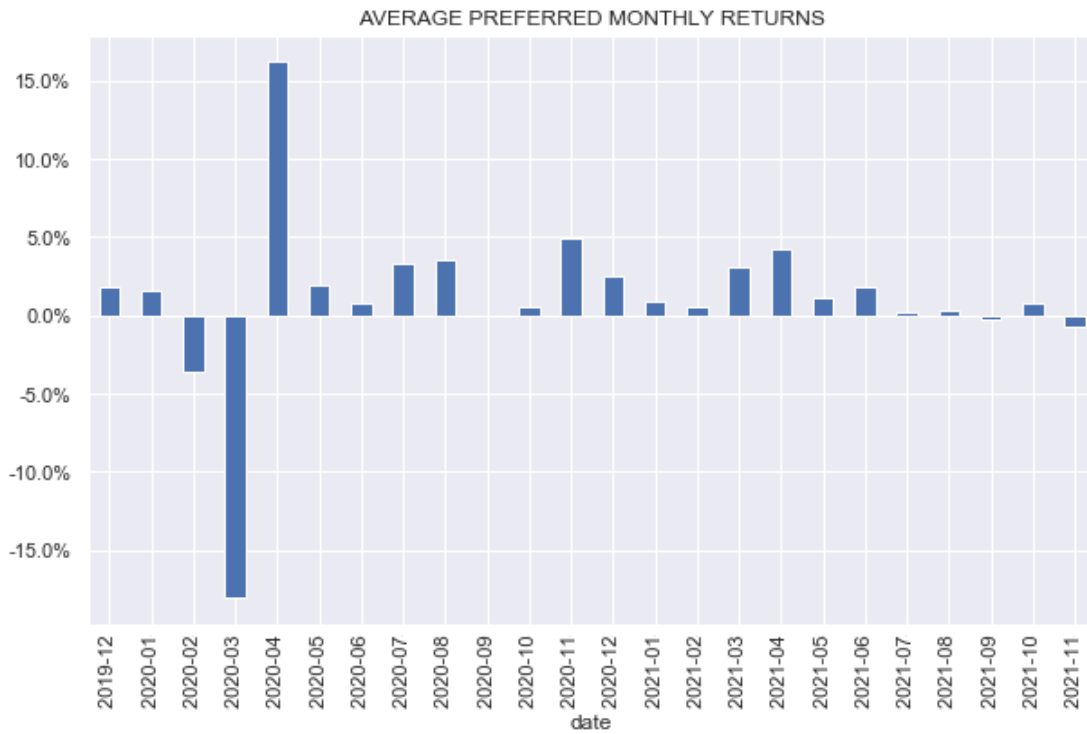
This article was first released to Systematic Income subscribers and free trials on Nov. 20.

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 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.

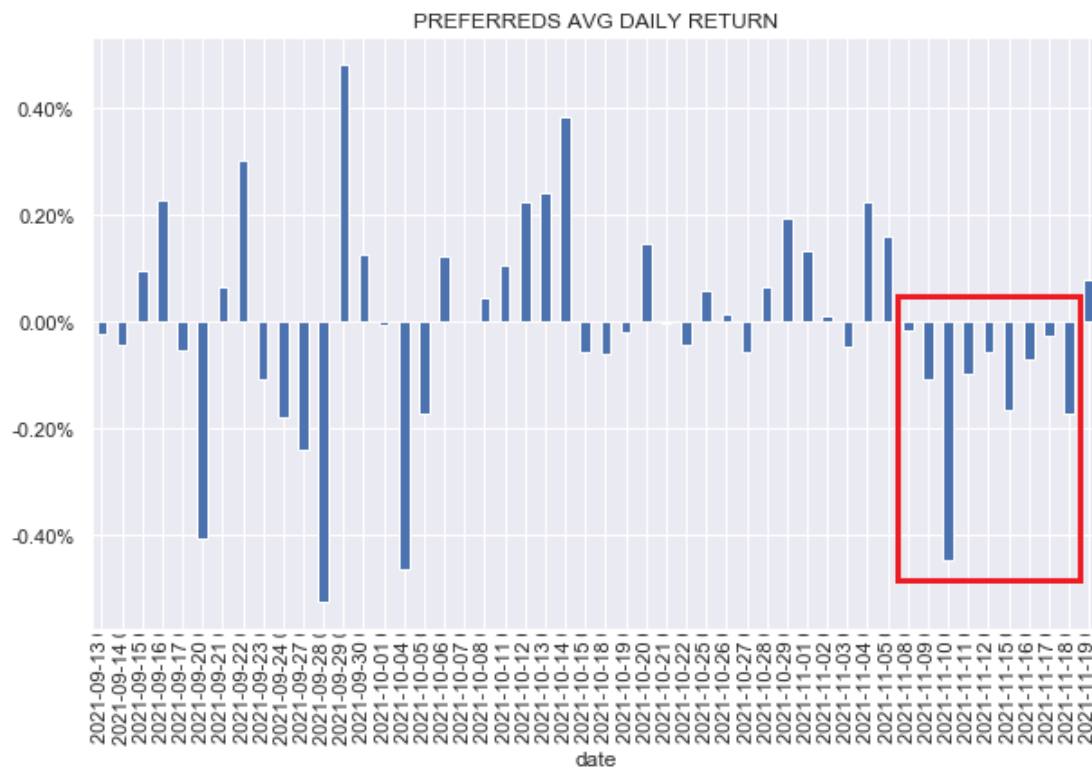
Market Overview

Only one preferreds sector - Telecoms - was up this week with mREITs and Energy outperforming as well. At this point through November it is looking like the worst monthly performance for the sector in 5 months. That said, the absolute size of the drop is fairly marginal and below 1% for the average preferred.



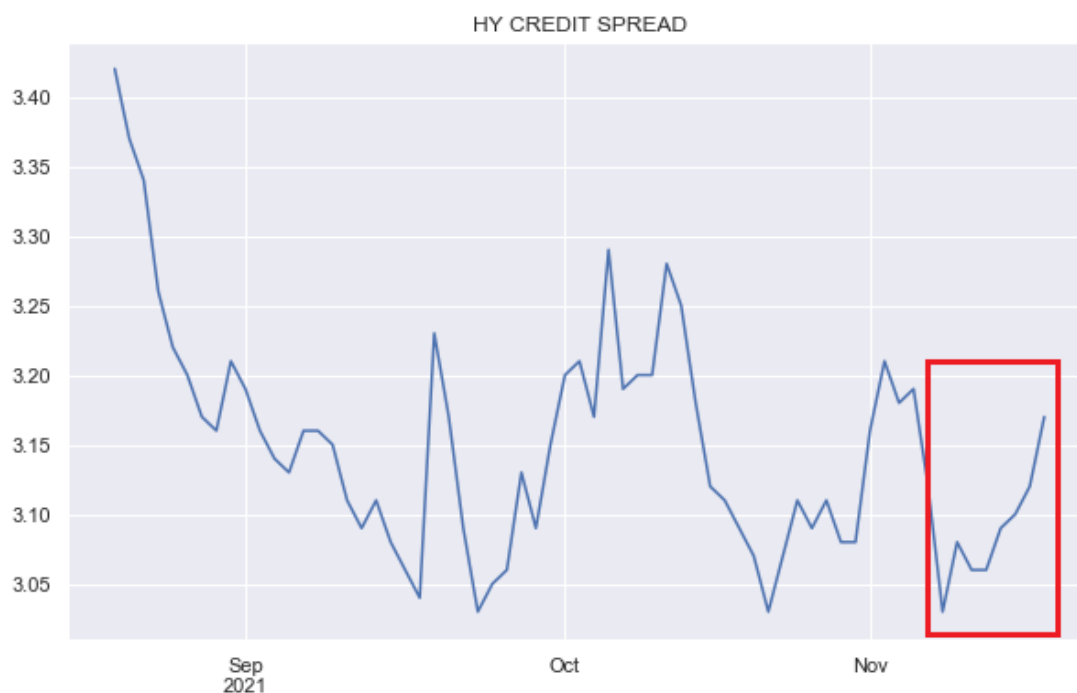
Source: Systematic Income

If the last two weeks felt like a consistent drip lower that's because it was - until Friday the market fell on 9 consecutive days.



Source: Systematic Income

This weakness in the market was in spite of stable or lower Treasury yields and higher or stable stocks. The weakness has come through the credit spread side with the High-Yield corporate bond market also showing weakness which we can see in consistently rising credit spreads below. More broadly, however, the rise has been tepid and credit spreads remain very tight by historic standards.



Source: Systematic Income

Market Themes

Investors who allocate to common stocks often get into heated arguments with investors who allocate to preferreds about the pros and cons of each asset class. Investors who favor common stocks argue that preferreds offer only downside with very little upside with the view that if the common goes bust the preferreds are typically rendered worthless also.

Investors who favor preferred over common stocks argue that the preferred is typically much more resilient than the common in the sense that a bad decision by management will hit the common much more than the preferred. This is because for the preferred to get into serious trouble, management will have to burn through a lot of the equity of the company. And even then they could try to issue additional equity which could actually boost the coverage of the preferred. And in any case, the scenario of the common going bust is fairly rare and so is not a relevant scenario for comparison. Rather, the common getting cut by 25% is much more realistic and would obviously have much more direct impact on the common shares.

Our own view is that there is usually no right or wrong - investors simply have different investment strategies, return expectations and views on risk. That said, we do think that for companies that are wrappers of fixed-income assets such as mREITs or CEFs, there are three guidelines we tend to follow.

For companies that tend to 1) struggle to grow book value, 2) are not trading at attractive discounts to book value and are 3) prone to irreversible deleveraging we tend to favor the preferred over the common. We covered some of this ground [here](#) and [here](#).

We also discuss some of the relevant considerations for investors in the Market Commentary section below for the recent RiverNorth/DoubleLine Strategic Opportunity Fund ([OPP](#)) preferred issuance.

We won't rehash all the points here so let's instead take a look at the agency mREIT sector where we think the preferreds offer a much more compelling investment case than the common.

A good example of why is the following chart which shows the total return performance of the ARMOUR Residential REIT ([ARR](#)) common and preferred stocks. As a starting date we use the first trading day of the earlier preferred we can find the data for.

The chart clearly shows that the common has struggled to overcome a number of deleveraging episodes.



Source: Systematic Income

Even what is considered to be the best agency manager - the AGNC Investment Corp. ([AGNC](#)) has struggled to sustainably deliver the same performance as the preferred while doing so at a much higher volatility.



Source: Systematic Income

These are not unusual cases in the sector - in fact this pattern is true for all agency-focused mREITs (it is also mostly true for hybrid mREITs). Of course, other sectors do boast performance of the common that exceeds that of the preferreds but in their case one of the three criteria that we specified above does not hold. This suggests it's a good idea for investors to consider these criteria when evaluating the investment case for the common vs. the preferred.

Market Commentary

The RiverNorth/DoubleLine Strategic Opportunity Fund ([OPP](#)) is out with another A1-rated preferred – 4.75% Series B ([OPP.PB](#), temporary ticker [OPPBP](#)) with a 4.75% coupon. The fund already has the 4.375% Series A ([OPP.PA](#)) outstanding which was trading close to “par” before the news and fell about a percent, now trading at a 4.47% yield.

As of the last shareholder report OPP ran at 25% leverage which is unusually low for a fixed-income CEF (though there is a bit more embedded leverage from its BDC/CEF/CLO positions). Assuming we end up with \$120m of preferreds across the two series and the fund cancels its credit facility we will get to around 34% leverage which is more in line with the market (though still miles below the sky-high leverage of the PIMCO funds which tend to flirt with a 50% level).

It's odd that the fund took so long to scale up leverage and is now doing this when valuations are at rock-bottom, having missed a huge rally in asset prices. They are also paying 0.38% more on the new preferred so that's not a win either for common shareholders. OPP has a 4.86% NII NAV yield (if we include the preferred dividends) based on the last report which is actually overstated because of its overdistributing mortgage/CEF/BDC debt positions and is probably closer to 4-4.5%.

As a side note, you have to be careful when looking at OPP NII because they don't include preferreds dividends in the interest expense. In short, given a choice between "earning" 4.86% via OPP trading at a 5% premium or 4.75% in the OPP.PB, the preferred looks pretty attractive.

OPP could be more interesting here if it were trading at a decent discount or if it had a history of alpha generation, however, since 2020, the fund delivered an annualized total NAV return of 4.64% which is only marginally above what a typical High-Yield bond ETF has delivered and is below the yield of the OPP.PB.

With the new preferred onboard its NII will move even lower – it's important to understand that whatever assets the fund acquires with the proceeds of the preferred, the NII of these assets will basically go to pay the preferred (4.75% + issuance fees) and the fund's fees, leaving investors in the common just taking the risk on those marginal assets with no compensation for them.

Of course, OPP is a great fund to pitch as a “safe” high-yielder because it has a relatively low volatility and an extremely high 12.5% distribution rate. Obviously, this is all smoke and mirrors – the fund gets nowhere close to either actually earning that rate or delivering a NAV return anywhere close to that level. Investors should, therefore, question the basis for the current recommendation of the common shares in the fund.

In terms of Series A vs. B it makes sense to rotate into B if it continues to trade at a higher yield as it is now. This is because the two preferreds should trade at a very similar yield. OPP.PB will have a marginally lower duration due to its slightly higher coupon so maybe it will end up trading at a slightly lower yield for that reason.

Although a larger amount of preferreds is a credit negative if the fund goes ahead and gets rid of its \$20m facility that will mostly be a wash since the credit facility is higher up in the capital structure and gets repaid first ahead of the preferreds. The preferred also has redemption provisions relating to asset coverage so that eventually the fund has to redeem the preferreds if coverage remains below 200% which is a nice feature to have and is above what the Investment Company Act of 1940 asks for.

In bigger picture terms, A1-rated equivalent US corporates are trading at a yield sub-2% - yes they do have maturities / lower duration versus OPP-B which is perpetual but the 7s/30s Treasury yield differential (roughly equivalent to the duration difference between A-rated corporate bonds and OPP.PB) is only 0.5% so when you adjust for the duration difference you are looking at maybe 2.35% in corporate bond yields versus 4.75% for OPP.PB at “par”.

Of course, the worst-case scenario is quite a bit worse for OPP.PB than it is for a basket of A1-rated corporate bonds so the risks are clearly not identical. That said, the yield pick-up of OPP.PB over similarly-rated corporate bonds is still very attractive.

Gabelli Utility CEF (NYSE:[GUT](#)) is redeeming its Series A preferreds ([GUT.PA](#)). The stock was trading near \$27 prior to the news which will wipe off more than a year's worth of dividends. It's been callable since 2008 so it's curious why Gabelli waited so long to redeem. In an earlier [article](#) we showed that the combination of high-coupon preferreds and low-dividend assets means equity-focused CEFs like Gabelli basically have zero or negative income which strains the definition of what an "income investment" really means i.e. if a fund has negative NII but an 8% distribution rate is it an income asset or not?

mREIT NYMT is issuing 7% Series G (NYMGV temporary ticker, NYMTZ permanent ticker) to redeem ([NYMTP](#)). Looks like this will be a fixed-rate preferred which is nice because there aren't many fixed-rate preferreds in the sector. That said, [NYMTM](#) has a spread over Libor of 6.429% so the worst case scenario is it will have a coupon of around 6.50% if/when it floats - not far off the 7% of the G.

CREDIT-FOCUSED MREITS	STRUCTURAL						MARKET					
	Call Date	Type	Current Coupon	Float Index	Float Spread	Float Floor	Clean Price	Stripped Yield	YTC	YTW	Reset Yield	ZIRP Yield
AVERAGE ISSUER							7.34%	5.97%	6.67%	7.02%	6.38%	
NYMTM	2025-01-15	Fix/Float	7.875%	3mL	6.429%		25.32	7.77%	7.42%	7.42%	7.99%	6.35%
NYMTN	2027-10-15	Fix/Float	8.000%	3mL	5.695%		25.77	7.76%	7.36%	7.36%	7.51%	5.53%
NYMTL	2026-10-15	Fix/Float	6.875%	SOFR	6.130%		24.47	7.03%	7.39%	7.03%	6.32%	6.26%
NYMGV	2027-01-16	Fix	7.000%				24.45	7.16%	7.52%	7.16%		7.16%

Source: Systematic Income Preferreds Investor Tool

NYMTM will float in 2025 so the breakeven versus G is just two hikes i.e. if the Fed hikes more than 2x then NYMTM will have a higher coupon than G and vice-versa. Two hikes doesn't feel like a high bar for the Fed, so NYMTM looks more attractive than G in any "normal" Fed hike scenario.

Of course, there is always the risk we see another recession and by the time NYMTM floats, Libor is back at zero in which case NYMGV will be more attractive at current prices. Overall, the appeal of G is in the relatively long call period and its fixed-rate. CLO Equity CEF Eagle Point (NYSE:[ECC](#)) is issuing another preferred – 6.75% Series D (ECCD). The fact that ECCB just became redeemable is probably not a coincidence.

It also highlights why tilting to the highest stripped yield preferreds from relatively commercial / frequent issuers doesn't make a ton of sense. Eagle Point obviously don't like leaving money on the table (if nothing else because they hold a lot of the common) and they were able to issue ECCC at a 1.25% lower coupon than ECCB so holding ECCB made very little sense as its yield has been in low single digits for some time.

ECCD will have no maturity which is a trend we have begun to see in the CLO CEF preferreds space with the Priority Income Fund recently issuing a perpetual preferred. Unlike the broader preferreds space, most CLO CEF preferreds have maturities which is one reason they are attractive. Removing the maturity does result in a higher yield investors would receive otherwise at the expense of a much longer duration profile.

Stance And Takeaways

The kind of weakness that we have seen in the last few weeks across a few names, if not in aggregate, in the preferreds space is opening up opportunities in the market for patient investors ready to deploy dry powder. Another potential source of returns is relative value opportunities both between preferreds and CEFs of the same issuer as well as across different preferred series of the same issuer some of which we have been highlighting in these updates. Taking advantage of these alpha opportunities in a timely fashion can keep income portfolio returns ticking along, in excess of what are still fairly low overall yields.

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

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This article was written by