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Dividend Strategy

Preferreds Market Weekly Review: Our Lower Beta Playbook For Elevated Volatility

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Summary

- We take a look at the action in preferreds and baby bonds through the fourth week of November and highlight some of the key themes we are watching.
- Preferreds are having a tough November - the worst month so far since March of 2020.
- We discuss our approach to allocating to securities that are likely to be more resilient through market drawdowns.
- And highlight new securities from Granite Point, First Republic Bank and Eagle Point Credit.

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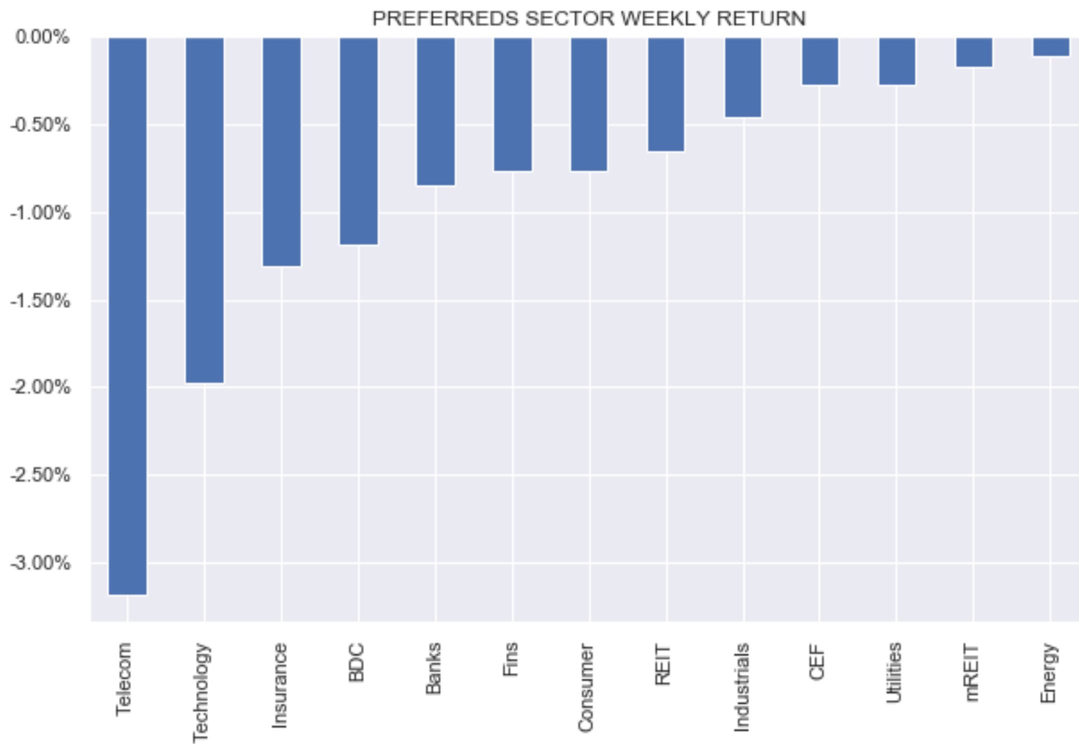
This article was first released to Systematic Income subscribers and free trials on Nov. 29.

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 fourth 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.

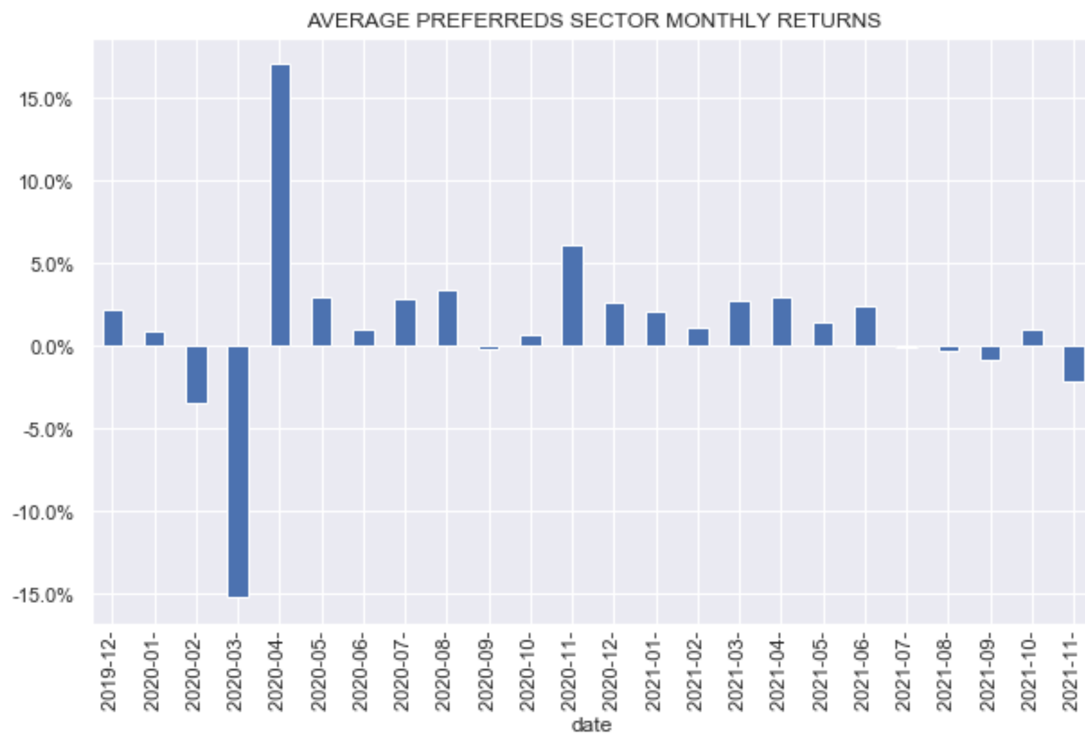
Market Overview

Given the price action elsewhere, it's not a surprise that all preferreds sectors finished in the red this week. The convertible-heavy Tech sector underperformed as did Telecoms, though that was primarily due to a severe drop by COMSovereign (COMSP). Energy outperformed as did the lower beta CEF and Utilities sectors along with mREITs which is supported by a number of lower-beta pinned-to-par preferreds in that sector.



Source: Systematic Income

November is shaping up to be the worst month in preferreds since March of last year. Interestingly, out of the three main macro asset class drivers of preferreds: Treasury yields, stocks and credit spreads, two of the three are either stable or stronger (10Y Treasury yields are lower from the end of October, stocks are mixed (Nasdaq is up, S&P is flat and Dow Jones is a bit lower)). What is driving negative performance so far is the fact that credit spreads are significantly wider. Credit spreads are trading near historic tights so the price risk for preferreds is clearly asymmetric from here - something we have been stressing over the last few months.



Source: Systematic Income

Market Themes

An occasional market drawdown, while painful, brings its own rewards. Specifically, it provides a real stress test for a given portfolio which can be used to improve its resilience in the future.

This highlights why it can make sense to build a portfolio as much from a top-down perspective, i.e. by focusing on the overall risk profile of its holdings, as bottom-up, i.e. by focusing on individual opportunities available in the market.

Our playbook for maintaining resilience in senior security (i.e. preferreds / baby bond) portfolios is driven by four allocation tilts.

First, we like to hold an allocation to a number of **niche systemic sectors** such as CEF and agency mREIT preferreds, BDC baby bonds and CEF preferreds. The niche tag refers to the fact that these sectors are often overlooked by investors and the systemic tag refers to the fact that these securities are, in essence, portfolios of other securities.

This means that their performance tends to be driven by systemic market drivers rather than idiosyncratic drivers. In other words, it is very unlikely that a security in these sectors delivers a big negative surprise to investors while the rest of the market is doing just fine. On the other hand, with non-systemic securities (i.e. securities issued by, say, "normal" companies e.g. widget makers), investors are taking both systemic and idiosyncratic risk. These sectors have outperformed the broader senior security market in the recent drawdown period which is something we would expect.

Sector	1D PX RTN	1W PX RTN	1M PX RTN
Banks	-0.4%	-0.8%	-1.6%
BDC	-1.2%	-1.2%	-7.3%
CEF	-0.1%	-0.3%	-0.6%
Consumer	-0.4%	-0.8%	1.1%
Energy	-0.4%	-0.1%	0.0%
Fins	-0.8%	-0.8%	-1.2%
Industrials	-0.2%	-0.5%	-1.1%
Insurance	-0.5%	-1.3%	-2.5%
mREIT	-0.3%	-0.2%	-0.2%
REIT	-0.5%	-0.7%	-1.7%
Technology	-1.2%	-2.0%	-2.9%
Telecom	-1.9%	-3.2%	-6.5%
Utilities	-0.3%	-0.3%	0.7%
AVERAGE SECTOR	**-0.6%**	**-0.9%**	**-1.8%**
AVERAGE PREFERRED	**-0.4%**	**-0.7%**	**-1.1%**

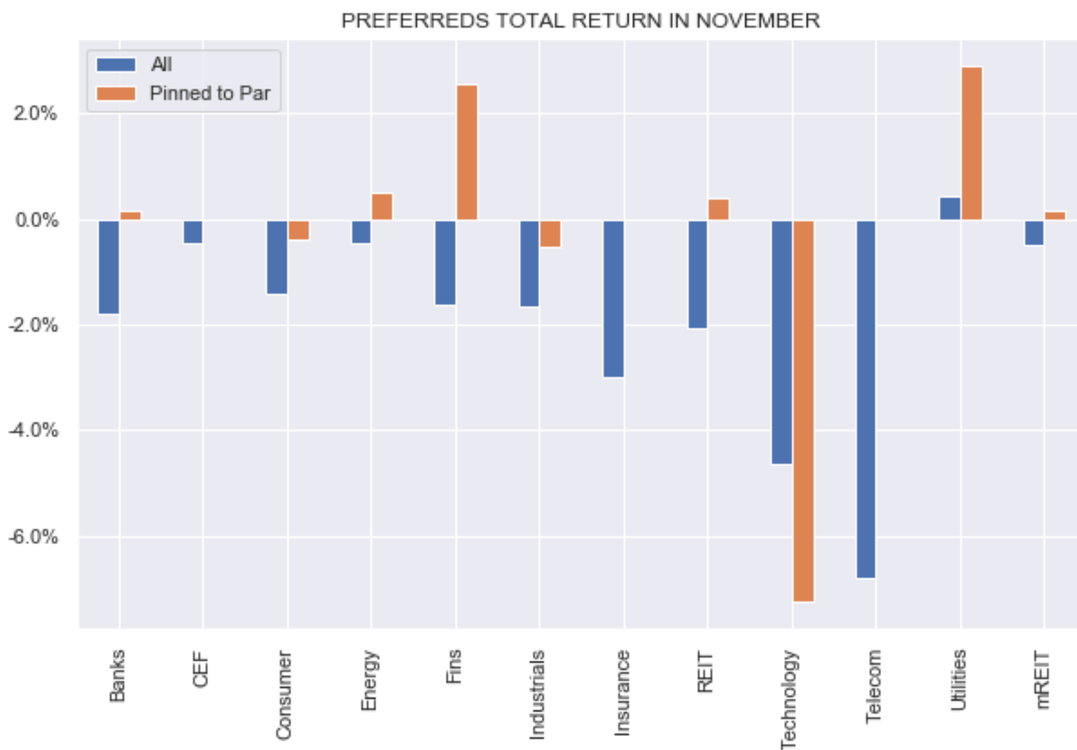
Source: Systematic Income Preferred Tool

In the agency mREIT sector, we like the Dynex Capital 6.9% Series C (DX.PC), trading at a 5.89% YTC and a 6.95% Reset Yield (based on Libor forwards as of its Apr-2025 redemption date). Although the stock's current yield of 5.89% is not the highest in the sector, its spread over Libor is the highest. The combination of a high spread over Libor, a relatively long call date and a clean price well above "par" (itself an indication of a higher probability of redemption) means the stock is less vulnerable to the risk of persistently lower short-term rates in its sector while having some potential upside to higher short-term rates as well. DX has below-average leverage and above-average equity coverage in the sector.

We also like **long-duration / high-quality preferreds**. These include securities such as the two $1000 "par" bank preferreds Wells Fargo 7.5% Series L (WFC.PL) and the Bank of America 7.25% Series L (BAC.PL), trading at yields of 5.16% and 5.07%, respectively. We like the WFC preferred here despite the lower yield as it's much further away from potential conversion.

Although these securities are not totally invulnerable, as the COVID drawdown showed, their long-duration profile allows them to be supported by the drop in Treasury yields while a higher-quality profile means they are relatively less exposed to wider credit spreads. The near 0.20% drop in the 10Y Treasury yield over the last two days highlights that a partial allocation to long duration securities can be helpful for income portfolios.

Thirdly, we continue to favor **pinned-to-par securities** which have tended to be more resilient during periods of drawdowns. The chart below shows the performance of preferreds in November split between pinned-to-par securities in the sector (orange bars) and the entire sector (blue bars). In all but one sector, pinned-to-par securities had lower drawdowns and even managed to rally in 6 of the sectors.



Source: Systematic Income

In this part of the market, we like the Eagle Point Credit 6.75% 2027 Notes (ECCY) at a 6.73% YTM, Chimera 8% Series A (CIM.PA) at a 7.99% yield and Pitney Bowes 6.7% 2043 Notes (PBI.PB) at a 6.73% yield, all with no call price risk (i.e. no loss in case of immediate redemption).

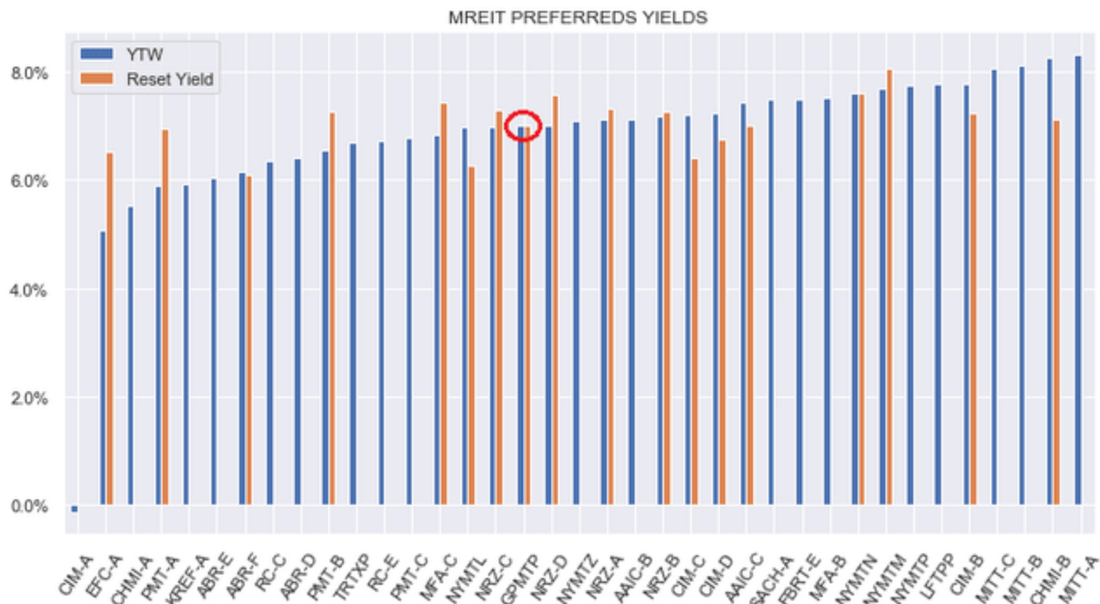
Fourthly, we like **shorter-maturity securities** which can protect against both rising rates and elevated market volatility due to their lower durations and a generally lower sensitivity to market gyrations. For example, a 1% rise in yields has a 2% price impact on a security with a duration of 2 and a 10% impact on a security with a duration of 10. Keep in mind that most preferreds have durations north of 20 due to their perpetual nature. Among others, we currently like the Arlington Asset Investment Corp. 6.75% 2025 Notes (AIC) at a 6.81% YTM which also happen to be pinned-to-par.

Market Commentary

The Granite Point Mortgage Trust 7% Series A (NYSE:GPMT.PA) started trading right around "par". Granite Point primarily holds senior first mortgage loans against Office (46%) and Multifamily (27%) properties. Hotel and retail exposure makes up 23.7% of the portfolio.

GPMT.PA has a Fix/Float structure with a floating-rate coupon of SOFR + 5.83% on its first call date in Nov-2026. However, that also comes with a floor of 7% meaning the current 7% fixed coupon can only go up (if SOFR rises above 1.17% - or about 4 Fed hikes).

This is how the stock looks in the hybrid mREIT preferreds sector.



Source: Systematic Income

The preferred looks very attractive with coverage north of 10x - the highest across the entire mREIT sector and relatively low recourse leverage of 1.4x. The company's performance was unusually strong over Q1-20 with only a 6% drop in book value which was the smallest drop in the sector. The company's financing profile is fairly robust with only about a third of its financing in mark-to-market instruments. The portfolio proved resilient in the COVID shock and there were no impairments, non-accruals or maturity defaults through Q2-20. Current book value is about 6.5% below its Dec-19 level which is also very strong for the hybrid mREIT sector. This combination of decent yield, high coverage and book value resilience is an unusually attractive combination in the sector.

Investment-grade rated 4.5% (FRCDV) from First Republic Bank is now trading at the highest yield of the suite at 4.55% and fairly high for an IG-rated issue. FRCDV has the longest call protection period with the first call date in Dec-2026. All FRC preferreds are fixed rate.

Banks	Stripped Yield	YTC	YTM	YTW
SECTOR AVERAGE	5.29%	3.99%		4.11%
FRC-K	4.39%	5.81%		4.39%
FRC-H	5.08%	3.59%		3.59%
FRC-L	4.47%	5.54%		4.47%
FRC-M	4.40%	6.21%		4.40%
FRCDV	4.55%	4.75%		4.55%
FRC-I	5.30%	3.08%		3.08%

Source: Systematic Income Preferred Tool

The perpetual ECC 6.75% Series D (NYSE:ECC.PD) from a CLO-Equity focused CEF is now trading at a 6.86% yield. The stock opened pretty weak which makes a lot of sense since the coupon offers only a 0.29% yield pick-up over the ECC Series C (ECCC) which has a 2031 maturity. ECCD has roughly double the duration of ECCC at about 16 vs. 8. At current pricing, ECC.PD offers a 0.40% yield pickup at 6.86% vs 6.46% vs. ECCC which still feels too low. The yield differential in Treasuries is about 0.50% for the same duration differential and that does not even include the additional credit spread compensation.