



Preferreds Market Weekly Review: Managing Libor Termination Risk

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ADS Analytics

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Summary

- We take a look at the action in preferreds and baby bonds through the first week of December and highlight some of the key themes we are watching.
- November wrapped up as the worst month for preferreds since March of 2020 with the first days of December seeing some stabilization.
- We discuss the risk of Libor termination for preferreds portfolios and a few suggestions for mitigating it.
- We also highlight recent issuance in the CLO Equity CEF space as well as taking advantage of heavier-than-usual selling on ex-div dates.
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This article was first released to Systematic Income subscribers and free trials on Dec. 4.

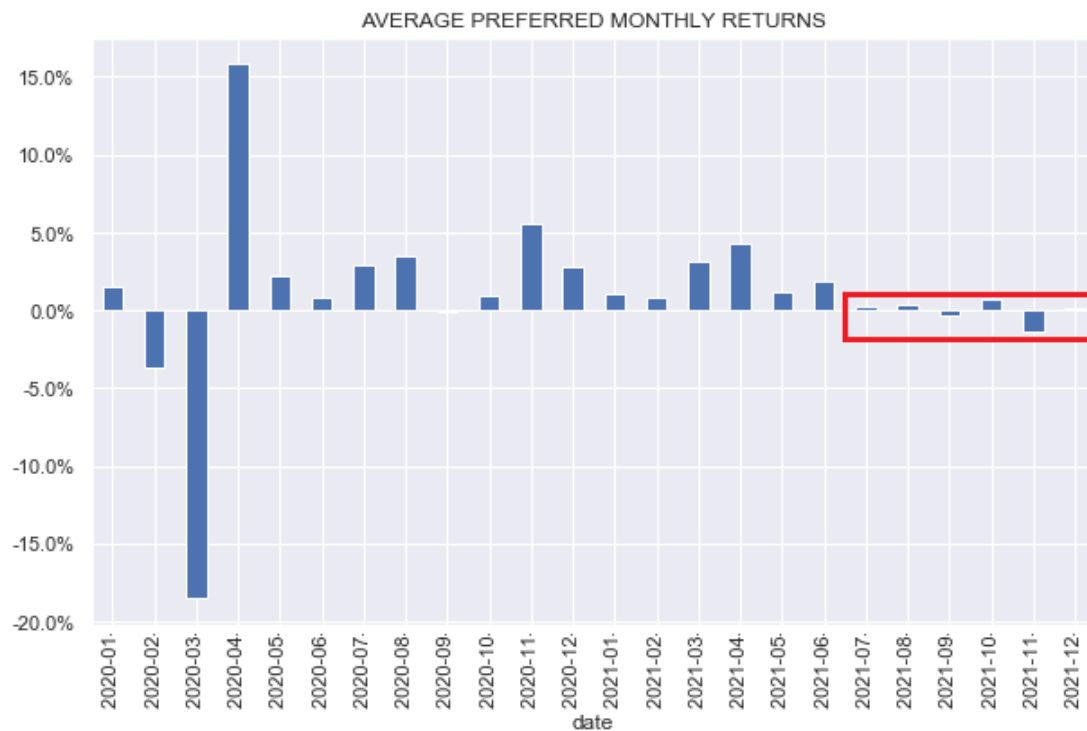
Welcome to another installment of our Preferreds Market Weekly Review where we discuss preferreds and baby bond market activity from both the bottom-up, highlighting individual news and events, as well as top-down, providing an overview of the broader market. We also try to add some historical context 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 December. 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

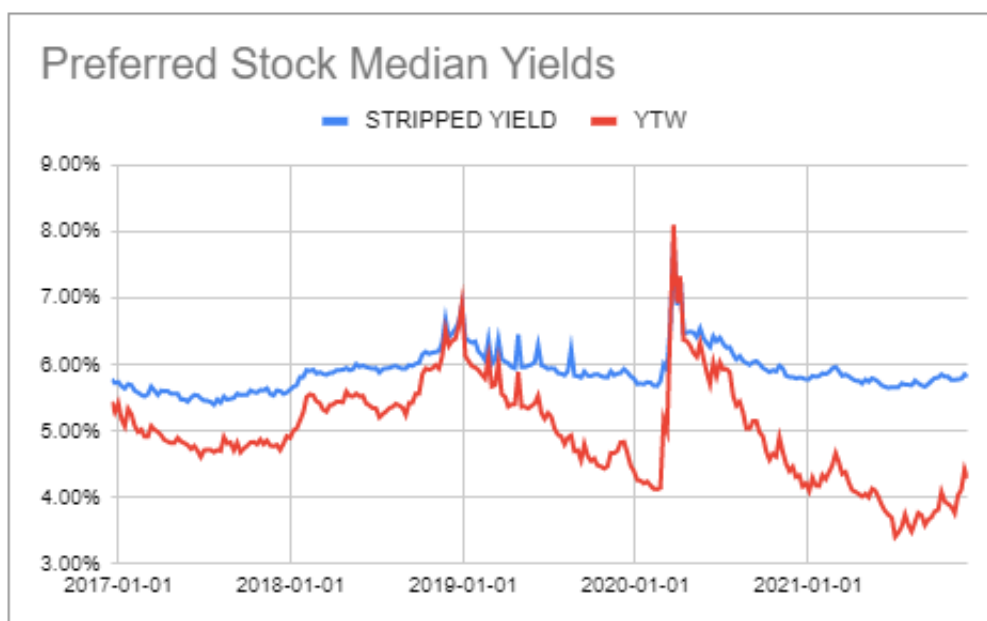
Unlike the previous three down weeks, the preferreds market was flat this past week - a welcome relief from previous weakness. However, even the strong rally in the longer-end of the Treasury yield curve was not able to propel the market forward. A widening in credit spreads took away all the support that the Treasury market provided.

The key theme of the preferreds market is that it has gone nowhere in the second half of the year - highlighted below, after a very strong first half.



Source: Systematic Income

This weakness does have a silver lining - the median yield-to-worst of the preferreds market has risen off its 5-year (and likely historic) low.



Source: Systematic Income Preferreds Tool

If we control for the Treasury yield and plot the differential of the median preferred yield-to-worst to the relevant Treasury yield we see that current valuation is actually fairly attractive, outside of the 1-year post-COVID period when the market was adjusting back to a more normal range.



Source: Systematic Income Preferreds Tool

The action in breakevens (i.e. market-based inflation expectations) has been very interesting. 5Y breakevens marched higher in the first half of the year, took a pause until October and then accelerated higher to around 3.20%.



Source: FRED

Powell appeared to agree with this assessment, throwing in the towel on the word "transitory" and since then breakevens have deflated 0.45% in just a couple of weeks. The market appears to take comfort in the more hawkish stance of the Fed (which oddly coincides with Powell's reappointment). However, it remains to be seen whether the Fed will actually follow through on either an acceleration of the tapering or a faster pace of hikes. Certainly, a worst-case omicron scenario makes this unlikely.

The net result is that the Treasury market appears to be made of Teflon. Treasury yields have not been able to rise due to either inflation surprising to the upside or the Fed surprising to the hawkish side. This has limited any fallout in the preferreds market so far. It is clear that the consensus appears to be for higher yields however the traditional drivers of higher yields keep coming up to the plate and striking out.

Market Themes

The recent hawkish turn by the Fed and the rise in front-end yields in expectation of faster hikes next year is a good opportunity to quickly review LIBOR risk. As many investors know LIBOR will be put out of its misery at some date. That date was supposed to be the end of 2021 but it has been pushed back to the middle of 2023, at least for the more popular tenors like 3-Month.

About 20% of the retail preferreds market is linked to Libor, whether as the current floating-rate or as a part of the Fix/Float feature. The reason all this matters for investors is the risk that they can get stuck with a disadvantageous coupon that does not reflect the market environment.

For instance, imagine a scenario where a preferred goes from a fixed coupon of 6% to a coupon of 3M Libor + 4% in mid-2023. Imagine that the Fed policy rate (and hence Libor which follows the Fed Funds rate fairly closely) is near zero so the coupon on the preferred is about 4%. Now imagine the Fed begins to hike rates at the same time that Libor finally ceases to be published. Investors who thought that the coupon on their preferred would increase roughly in line with Fed hikes may actually see the coupon frozen instead at the previous 4% for the simple reason that Libor is also frozen i.e. its last value is no longer reflective of higher short-term rates.

The scenario where Libor is no longer published is specifically addressed in preferreds documentation by "fallback language" which outlines what to do in case Libor doesn't exist.

Let's have a look at fairly typically fallback language by one of the TWO preferreds which is shown in full below. The various fallback steps are highlighted by us.

LIBOR will be the rate (expressed as a percentage per year) for deposits in U.S. dollars having an index maturity of three months, in amounts of at least \$1,000,000, as such rate appears on "Reuters Page LIBOR01" at approximately 11:00 a.m. (London time) on the relevant Dividend Determination Date; or if no such rate appears on "Reuters Page LIBOR01" or **if the "Reuters Page LIBOR01" is not available** at approximately 11:00 a.m. (London time) on the relevant Dividend Determination Date, then we will select four nationally-recognized banks in the London interbank market and request that the principal London offices of those four selected banks provide us with their offered quotation for deposits in U.S. dollars for a period of three months,

commencing on the first day of the applicable Dividend Period, to prime banks in the London interbank market at approximately 11:00 a.m. (London time) on that Dividend Determination Date for the applicable Dividend Period. Offered quotations must be based on a principal amount equal to an amount that, in our discretion, is representative of a single transaction in U.S. dollars in the London interbank market at that time. If at least two quotations are provided, the Three-Month LIBOR Rate for such Dividend Period will be the arithmetic mean (rounded upward if necessary, to the nearest 0.00001 of 1%) of those quotations. **If fewer than two quotations are provided**, the Three-Month LIBOR Rate for such Dividend Period will be the arithmetic mean (rounded upward if necessary, to the nearest 0.00001 of 1%) of the rates quoted at approximately 11:00 a.m. (New York City time) on that Dividend Determination Date for such Dividend Period by three nationally-recognized banks in New York, New York selected by us, for loans in U.S. dollars to nationally-recognized European banks (as selected by us), for a period of three months commencing on the first day of such Dividend Period. The rates quoted must be based on an amount that, in our discretion, is representative of a single transaction in U.S. dollars in that market at that time. **If fewer than three New York City banks selected by us** do not quote rates in the manner described above, the Three-Month LIBOR Rate for the applicable Dividend Period will be the same as for the immediately preceding Dividend Period, or, if there was no such Dividend Period, the dividend shall be calculated at the dividend rate in effect for the immediately preceding Dividend Period.

Source: TWO-A Prospectus

As a quick summary:

1. Use the usual Libor figure published on Reuters
2. If it's not there call up 4 banks in London
3. If no one is picking up the phone call up 3 US banks
4. If no one is picking up the phone there either use whatever was the previous rate

We can summarize this process even quicker by saying that if the Libor rate is not published in its usual place then do a "dealer poll" and if that fails use the previous rate. Dealer poll language is very common in securities documentation and is a typical backstop in case of a dispute or lack of clarity about the pricing of a given market instrument or variable.

This sounds like a pretty good fallback but the problem is it might as well not be there at all. This is because the likelihood that a bank will stick its neck out and quote Libor when Libor no longer exists is nil. People have gone to jail for quoting "wrong" Libor so the chance that a trader at a bank with no upside (banks don't get paid for participating in dealer polls) and full career risk downside will decide to chance it and provide a quote for Libor is laughable.

So we can further summarize the fallback language as "if Libor is not published, use the previous rate". This highlights how investors can get stuck with a coupon on a preferred that does not reflect reality.

Of course, it is possible that Libor goes away in a period where the Fed is bringing rates down. In that case however the issuer is much more likely to simply redeem the security rather than have to pay a rate that is to its disadvantage. When the rate is to its advantage, however, the risk remains that the issuer keeps the security outstanding, harming investors in the process.

What can investors do to mitigate their Libor risk?

First, and most obvious, investors can simply avoid Libor Fix/Float securities. In our view, this is not necessary as a blanket strategy but it can be worth doing for some investors who also like to see income levels remain stable.

Secondly, investors can tilt to securities with longer first call dates i.e. those past, say, 2024 when a standard solution is likely to be in place for legacy Libor securities. This solution can take the form of a broad fallback language override and a safe-harbor from shareholder litigation.

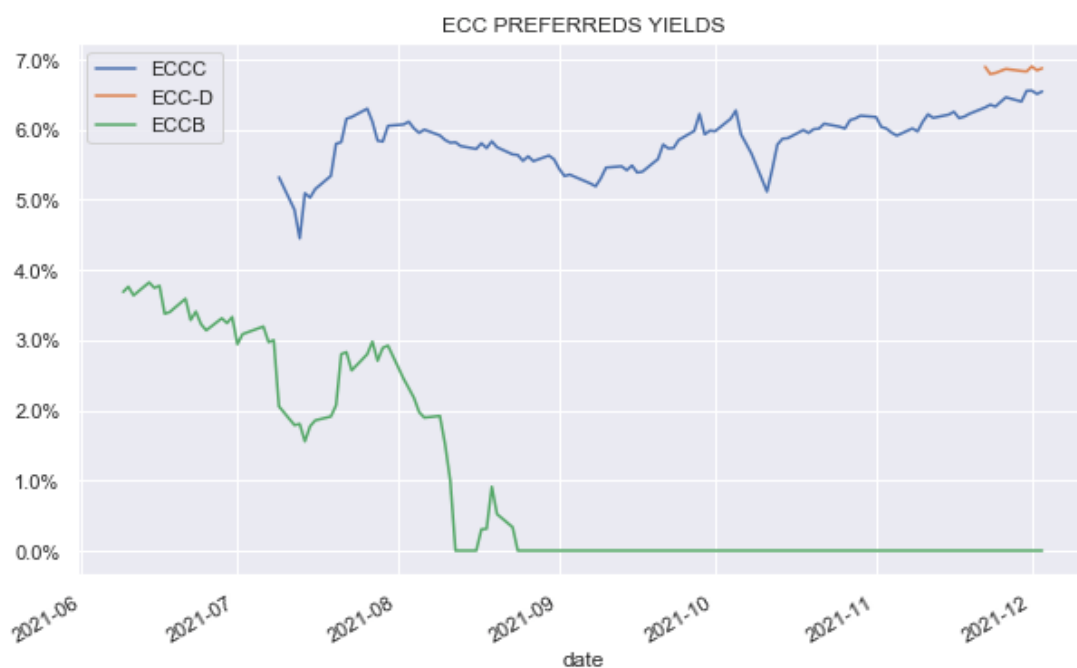
Thirdly, investors can tilt to more frequent and sophisticated issuers. For instance, mREIT issuers fit the bill and they are also incentivized not to be seen as screwing over their preferreds shareholders. This means they are unlikely to play games with Libor and leave shareholders in the lurch. It might be worth avoiding unsophisticated and infrequent issuers or Pink Sheet No Information securities whose issuers may not be bothered sticking it to investors.

Libor risk may very well end up a nothingburger. Currently, the market expects the Fed to already be at its terminal rate for this hiking cycle when Libor is expected to go away by mid-2023. That said, a lot of asset allocation is about minding small risks and preventing own goals rather than hitting home runs so it may be worth quickly scanning the portfolio for the issues that fall into the buckets mentioned above.

Market Commentary

Schwab will start charging \$6.95 for OTC trades which is certainly annoying. A recent Preferreds [weekly](#) described how preferreds start trading - initially in the OTC market and then on the exchange. This means that if you want to buy a recently launched preferred (say within the first week or so) you would have to pay this fee. It will be interesting to see if other brokers follow suit - some are likely already doing this.

The CLO Equity CEF Eagle Point Credit Co ([ECC](#)) is doing a 50% partial redemption of ECC 7.75% Series B ([ECCB](#)). ECCB has tended to trade at a very low YTW in the past year and a negative YTW since about mid-August. The chart below shows the yields of the three preferreds of the fund. The chart is clipped at zero (i.e. not showing the negative yields of ECCB) for clarity.



Source: *Systematic Income*

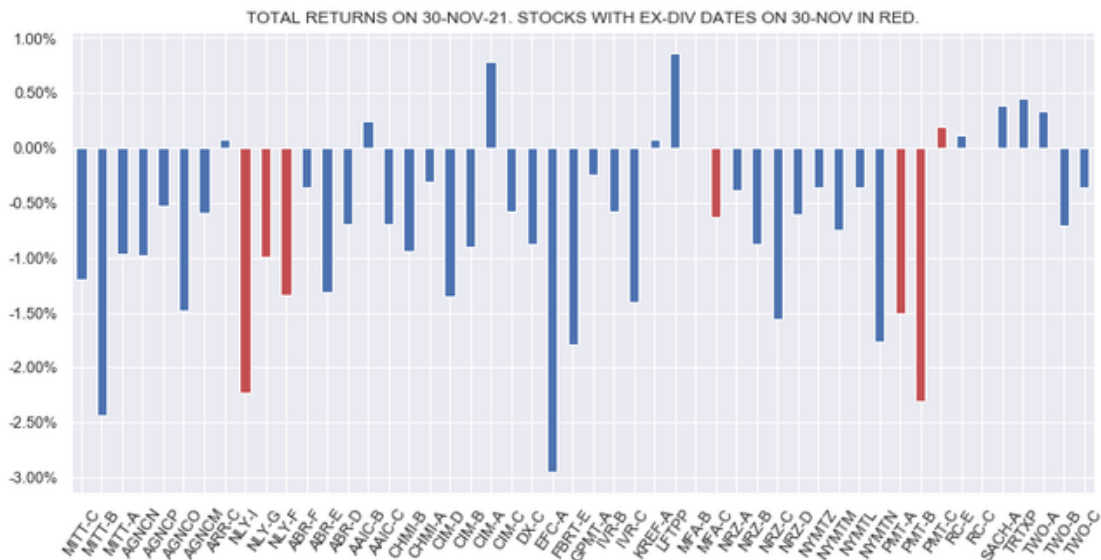
The ECCB first call date was at the end of October and the fact that fund was able to issue Series C (ECCC) at a coupon of 6.5% - 1.25% below that of ECCC - was a very strong indication that ECCC was not long for this world. However, it seems that many investors continued to hold ECCB for which they not only generated sub-par returns for half the year (they could have held ECCC that offered a yield of 3-7% higher) but they actually managed to generate negative returns over the last three months.

Now is a much better time to get into ECCB than it has been for some time. When we first flagged this idea the stock was trading right around \$25 clean price, offering a yield of 7.75% - a full 1% above that of ECCC. And consider that the 6.75% Series D (ECC.PD), which has no maturity, is trading at a yield close to 1% lower than ECCB which has a 2026 maturity. ECCB also currently has by far the highest yield in the CLO Equity CEF preferreds sector.

ECCB still looks attractive at a \$25.08 clean price with fairly negligible call price risk. The likelihood that ECC will do an immediate redemption of the other half of the preferred is very low. And shares acquired now should no longer be "locked up" and eligible for redemption. We wouldn't chase it above a clean price of \$25.25 at which point call price risk becomes more significant.

Also in the CLO Equity CEF preferreds space the OFS Credit Co ([OCCI](#)) is issuing a 5.25% 2026 Series E (NASDAQ:[OCCIN](#)). The coupon is by far the lowest in the sector (and not far off EICA which is mostly CLO debt). One reason for that is that OCCIN will have a 2026 maturity unlike two recent issues from ECC and PRIF which are perpetual. OCCI also has no debt in the capital structure - the only such fund in the sector which makes the preferreds the most senior security (nothing is stopping OCCI from issuing debt but so far they haven't). In our view there are more attractive term securities from a risk perspective that also trade at higher yields. See our previous Preferreds weekly which discussed our low beta playbook for some ideas.

One interesting dynamic that is worth flagging is that preferreds tend to see weakness on their ex-div dates. For instance, the chart below plots total returns (price action + owed dividend) of the mREIT preferreds sector for 30-Nov. Stocks highlighted in red are those that had an ex-div date on 30-Nov.



Source: Systematic Income

The median return of stocks with an ex-div date on 30-Nov on the same day was -1.17% and the median return of stocks without an ex-div date on 30-Nov was -0.66%. This underperformance of stocks with an ex-div date on the same day looks like people were playing dividend capture games (i.e. buy before the ex-div date and sell on the ex-div date to capture the dividend). The fact that all of these stocks except for one had negative total returns suggests that they are not successful, at least not for the majority of the players. This suggests that taking the other side of ex-div motivated selling (i.e. adding to a position on the ex-div date) can generate additional alpha.

In the mREIT sector a few stocks are trading at decent entry points. One worth highlighting is the Franklin BSP Realty Trust ([FBRT.PE](#)) - the former CMO.PE which merged with Franklin BSP Realty Trust, trading at a 7.55% yield (about 0.12% below the level when it first highlighted but still attractive).