



Preferreds Market Weekly Review: Reaching For Yield Is A Tough Gig

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Summary

- We take a look at the action in preferreds and baby bonds through the second week of December and highlight some of the key themes we are watching.
- The market rebounded somewhat in December but remains way off, clawing back its November losses.
- We touch on why reaching for yield in a low-yield environment can cause more problems than it solves.
- And highlight recent action in OXLC and EFC.
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This article was first released to Systematic Income subscribers and free trials on Dec. 12.

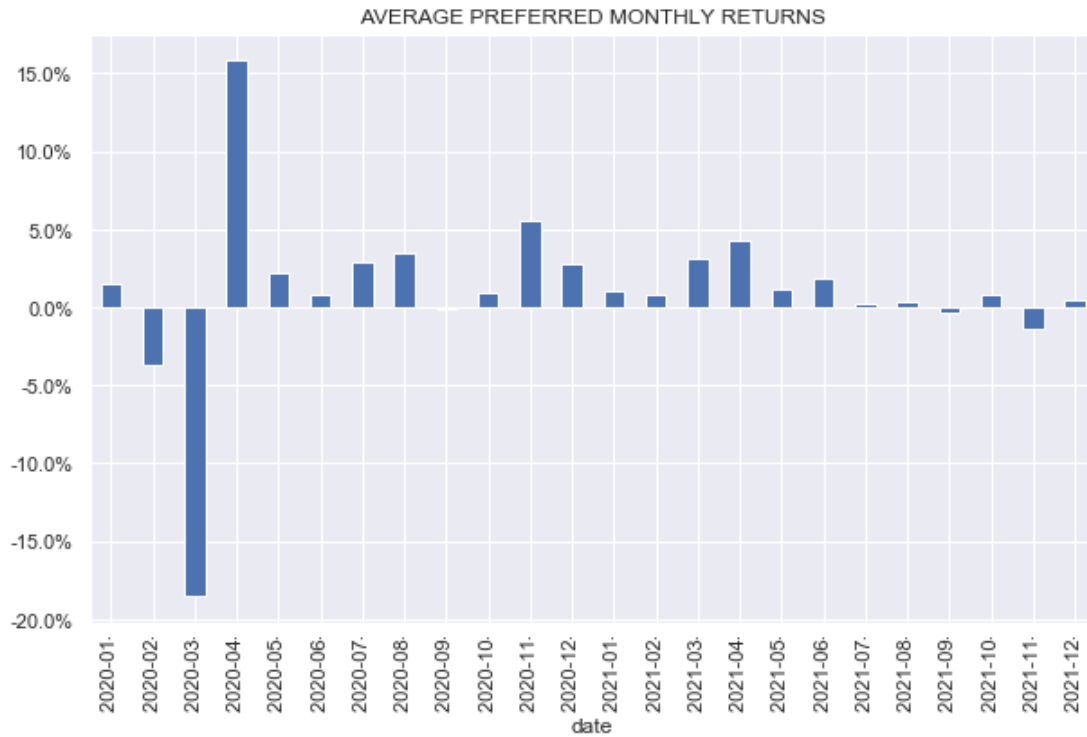
Welcome to another installment of our Preferreds Market Weekly Review where we discuss preferreds and baby bond market activity from both the bottom-up, highlighting individual news and events, as well as top-down, providing an overview of the broader market. We also try to add some historical context 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 second week of December. This will be our last Preferreds Weekly for the year. Happy holidays to all!

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.

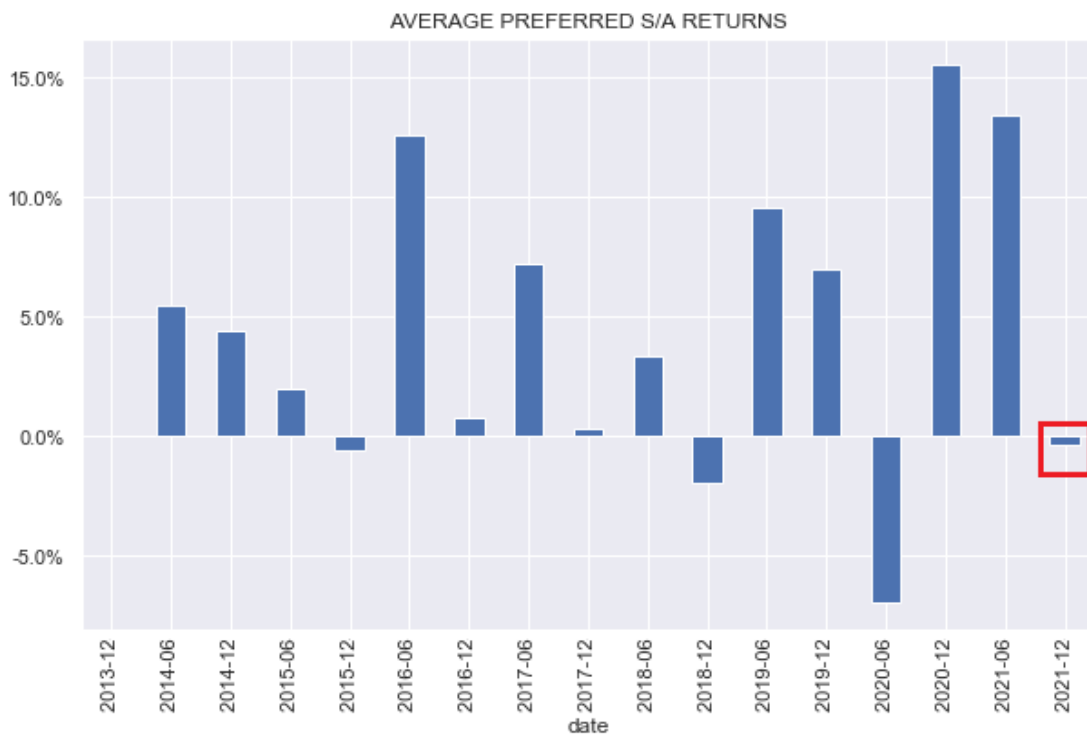
Market Overview

The preferreds market staged a nice recovery in the last week and so far in December. However, it is unlikely that we will see a reversal of all the losses accrued for November at the current pace.



Source: Systematic Income

The second half of the year has been disappointing for preferreds investors with a negative total return for the exchange-traded market. A negative total return is well off the positive double-digit pace for each of the two preceding semi-annual periods.

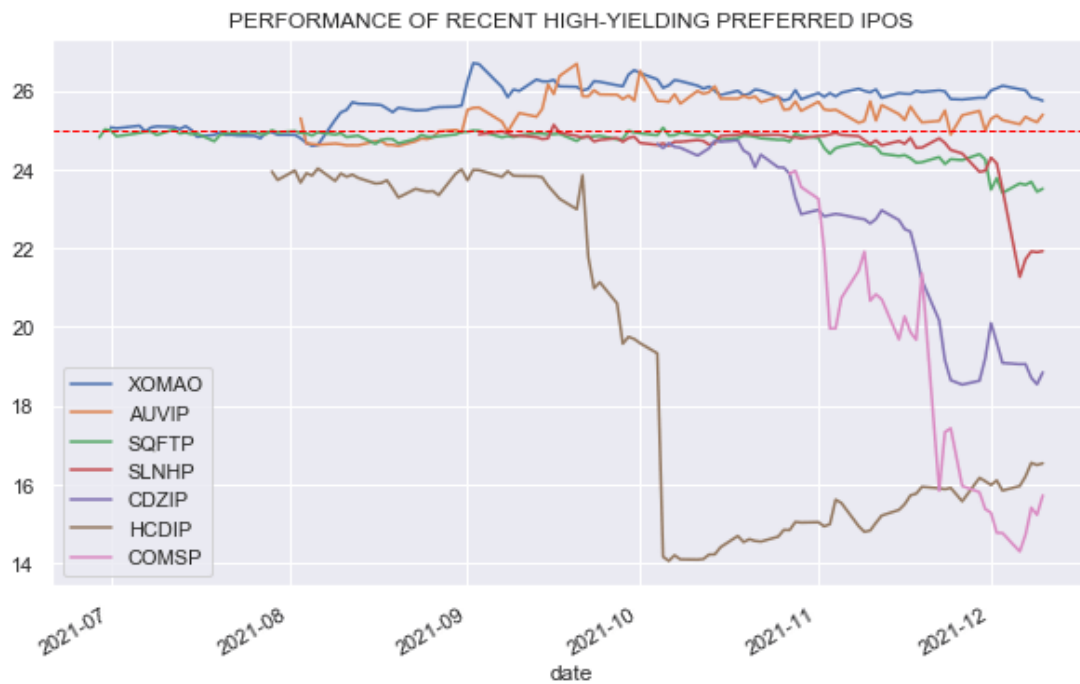


Source: Systematic Income

Market Themes

A negative total return for the broader market, paired with fairly low yields, is likely driving some investors further out the risk curve. A number of high-yielding preferreds have come to the market in the last few months and it is instructive to see how they have performed so far since their IPO, particularly as the market performance over the second half has been much less stellar than over the first half of the year and we have seen a few wobbles in risk sentiment.

The chart below shows the prices of preferreds that IPO'd in the last 6 months at yields in excess of 8%. What the chart shows is that the performance of these stocks has been poor in aggregate, with 5 out of the 7 falling well below the \$25 liquidation preference with 3 currently trading below \$20.



Source: Systematic Income

What this dynamic highlights is that chasing yield in a fully-valued market may not always be the right strategy for income investors. This is particularly true of companies with low or negative income, unproven business models or a non-preferreds shareholder friendly posture. And it's doubly true for stocks in which investors have low or no conviction.

Our mantra for the second half of a typical investment cycle is to focus on avoiding losers as much as it is in picking winners. This is for two reasons. First, avoiding losers can often be easier than picking winners. And secondly, the payoff of any one preferred is typically highly asymmetric with much larger downside than upside which means that playing good defense can make a difference between a positive vs. negative total portfolio return for the year.

Market Commentary

The CLO equity fund Oxford Lane Capital ([OXLC](#)) has continued to regularly sell stock at-the-market to grow assets and take advantage of the stock trading at a premium to NAV. In terms of senior securities, it is tempting to think that ATM issuance is just gravy for the preferreds; however, that misses the point that borrowings themselves do not remain static.

Additional equity issuance is good for senior securities, all else equal, as it lowers leverage and increases equity/preferreds coverage. However, the fund is not just going to issue common shares and keep its financing static – it will issue additional senior securities as well to keep leverage at more-or-less the same level. OXLC leverage has tended to be right around 30% for years despite massive common issuance for the simple reason that the fund has continued to issue new senior securities: both preferreds and debt.

In fact, if anything, the position of the preferreds has worsened considerably in the capital structure because OXLC has issued a sizable amount of unsecured debt which now stands in front of the preferreds. This highlights that investors need to understand both the amount of leverage and the composition of the capital structure of a given fund in order to gauge the quality of a fund preferred rather than be sidetracked by ATM issuance of the common stock.

In the OXLC capital structure, the OXLC 6.75% 2031 Notes ([OXLCL](#)), trading at a 4.85% YTW (and a 6.17% YTM), remain our favorite pick given its double-digit asset coverage. We also like the pinned-to-par 6.75% Series 2024 ([OXLCM](#)) trading at a 6.36% YTM (with some call price risk so care should be taken on new positions).

mREIT Ellington Financial (NYSE:[EFC](#)) is issuing a 6.25% Series B (NYSE:[EFC.PB](#)) preferred. The company has Series A ([EFC.PA](#)) outstanding which is trading at a 5.21% YTW and a 6.55% Reset Yield (2024 first call date). EFC.PB will have a reset rate of 5Y Treasury yield + 4.99%, resetting every 5 years.

EFC.PB is more attractive than EFC.PA on 2 fronts – first, the reset yield will be higher if rates stay where they are now whereas the EFC.PA coupon will step down from 6.75% to 5.3%. And secondly, the YTW of EFC.PB will be substantially higher assuming it opens around par of 6.25% vs. 5.21%.

In terms of credit metrics, EFC has maintained one of the highest equity / preferred coverage levels at 9.2x and this will move lower to 4.7x with the new issue. This begs the question of whether the yield of EFC.PA should move lower to reflect the significantly lower coverage and the obvious answer is yes.

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

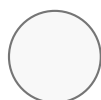
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