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Preferred Market Weekly Review: The Attraction Of Below-Par Term Securities

Jan. 23, 2022 9:10 AM ET | KTBA, WFC, WFC.PA...

Summary

- We take a look at the action in preferreds and baby bonds through the second week of January and highlight some of the key themes we are watching.
- The preferreds sector delivered a flat return so far this year, in aggregate - something hard to complain about as most income sectors are in the red.
- We discuss the attraction of allocating to shorter-maturity securities below "par" and highlight some of the confusion surround the WFC-L option conversion communication and recent issuance in the sector.
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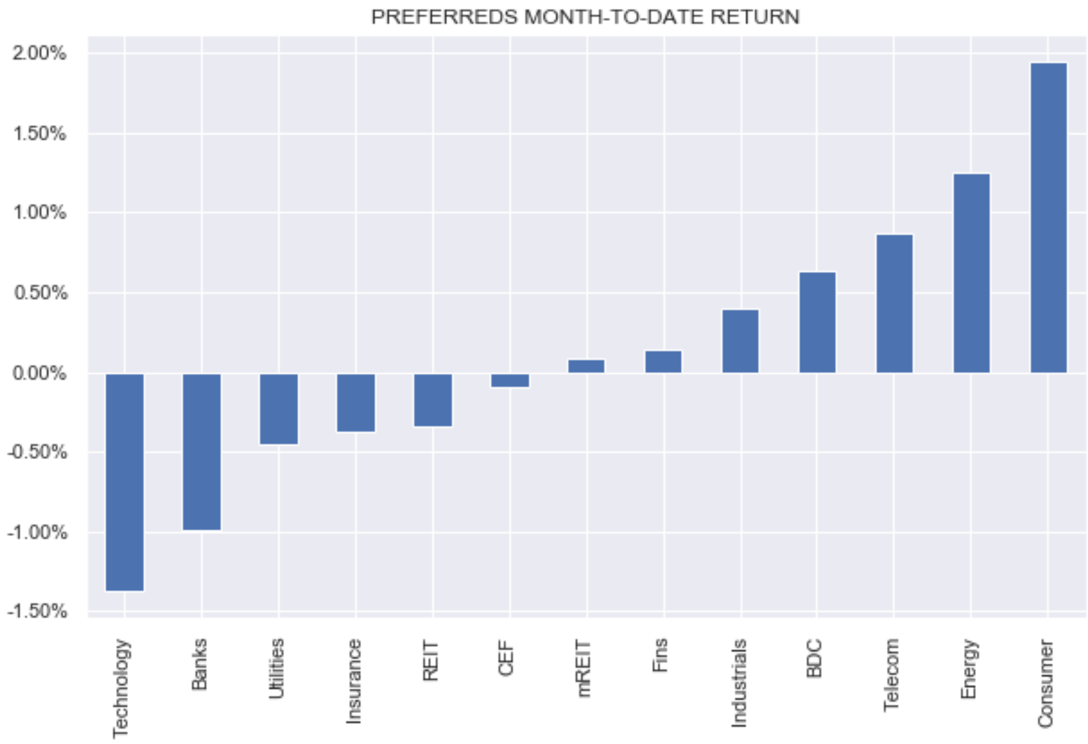
This article was first released to Systematic Income subscribers and free trials on Jan. 16.

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 January. 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

It was a decent week for the preferreds space, with most sectors finished in the green. On a month-to-date basis, the sector is pretty flat, however. Higher-yielding sectors like mREITs and Energy have outperformed, withstanding both the drop in stocks and Treasuries so far this year.



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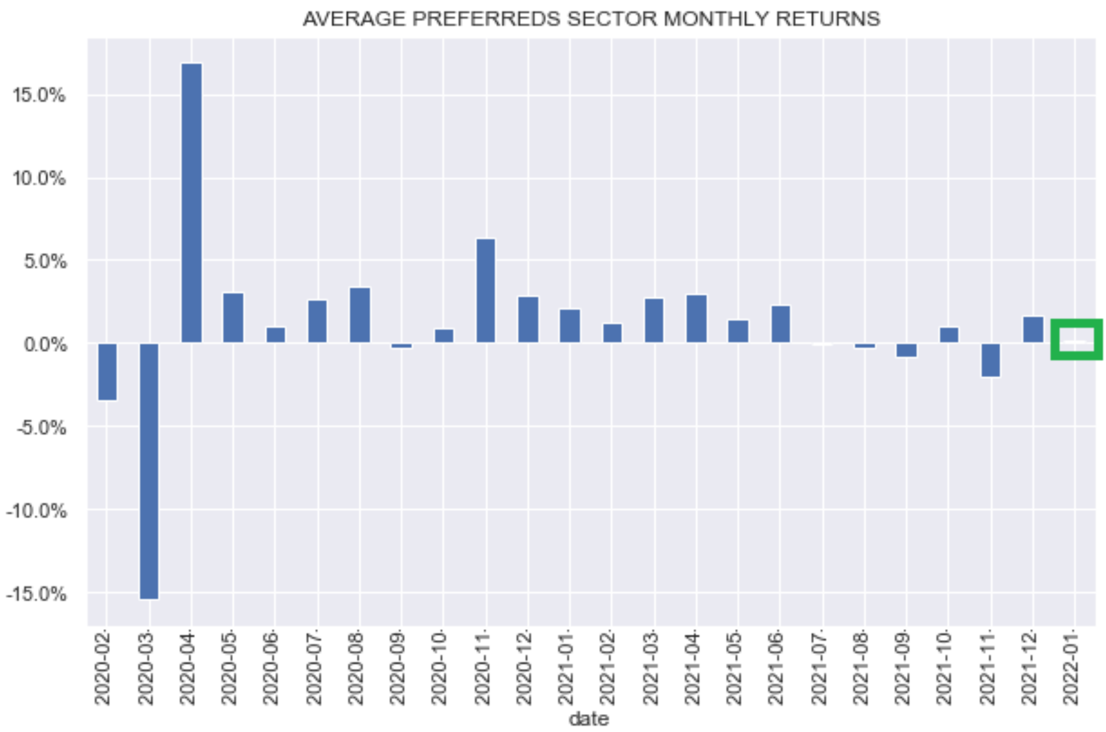
The average preferred is flat for the month (and the year) which is hard to complain about since the broader income space is mostly down.



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Market Themes

We have seen a number of shorter-term securities issued in the last few weeks which is great to see, particularly, in the current market environment of rising longer-term yields which are putting pressure on fixed-income assets, nearly across the board.

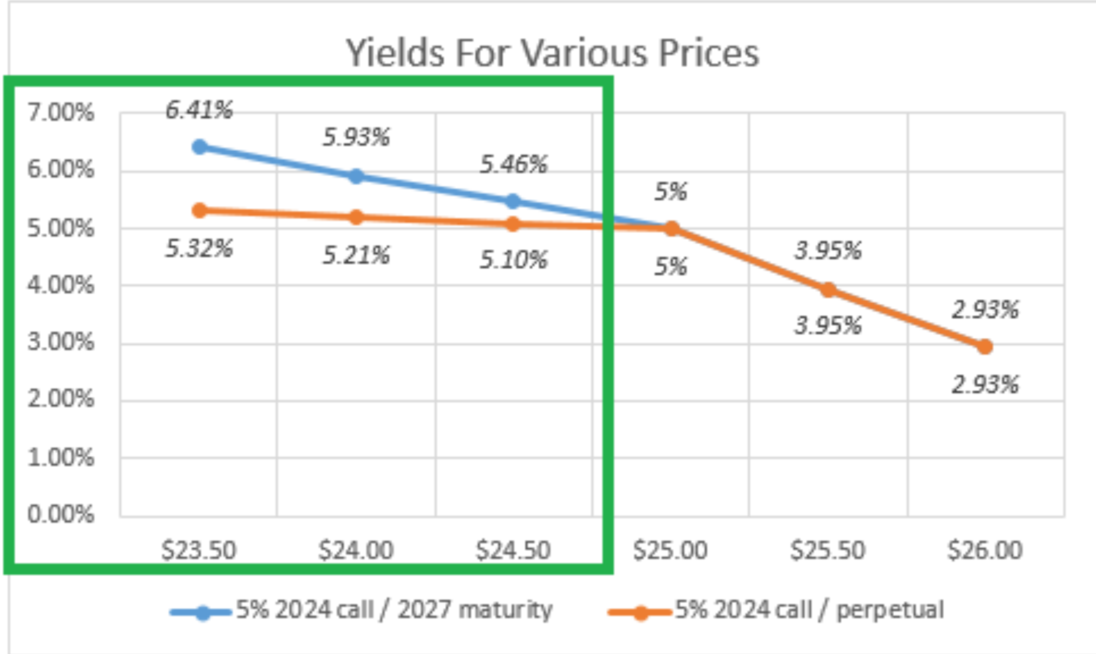
Typically, preferreds are perpetual i.e. they have no maturities while baby bonds are typically issued with very long maturities. A lack of maturity or a maturity that is very long-dated (i.e., 25+ years) can be unattractive because both types of securities feature very long durations. This can prove particularly painful in an environment of sharply rising interest rates, which can hammer longer-duration securities especially hard.

This is why we find some of the recently issued shorter-term securities quite attractive. Apart from their shorter-duration profile these securities have a related benefit which is that they become more attractive more quickly when their price moves below "par" or the usual $25 liquidation preference. This is because their maturity means the below-par price will move back up to par on maturity, unless the security defaults, providing an additional gain to investors.

We can quantify this additional gain in overall yield terms. The chart below provides the intuition, comparing how a perpetual security (i.e. one without a maturity) behaves relative to a term security when their prices move below "par".

The orange line shows a 5% coupon security having a 2024 call date and no maturity. The blue line shows a 5% coupon security with a 2024 call date and a 2027 maturity.

At prices above "par" the yields of the two securities are identical, being driven by their 2024 call date. However, at prices below "par" the yields of the two securities diverge, with the term security moving out to a significantly higher yield. For example, at a price of $24, the term security (blue line) will provide a 4% tailwind spread out over 5 years into its 2027 maturity while the perpetual security has no such benefit.



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Two recent bonds we would keep an eye on are the CLO Equity CEF notes - the OXLC 5% 2027 notes (OXLCZ) - the model for the blue line in the chart above - and the ECC 5.375% 2029 notes (ECCV). Although the headline coupons of these notes aren't going to blow anyone away, they can become much more attractive very quickly if their prices start to fall below $25.

Market Commentary

The SEC rule is creating some weird dynamics in preferreds and bonds such as the 7% BellSouth Certificates (OTC:KTBA) - a BellSouth bond repack (the company was absorbed by ATT). The underlying bond is the BellSouth 7% 2095 which is trading at a 4.6% yield and is BBB rated. At the same time, KTBA is trading a touch below a 7% yield which is weird because it just holds the 4.6% yielding bond with additional no option overlays at all from the looks of it. The differential simply has to do with the fact that KTBA is pretty much impossible to buy (via a retail broker at least). Presumably, this won't last forever and the SEC might get their finger out eventually and realize that they've made a chunk of the retail market unbuyable. If / once they fix the problem, something like KTBA, which is just one of many examples, will look very attractive.

The Wells Fargo 7.5% Series L (NYSE:WFC.PL) came up on the service due to a confusing corporate action option conversion communication. Basically, there are 2 conversion options in this stock. First, holders have an ongoing option to convert the stock into 6.3814 shares of WFC - if you do this you get $357.74 in exchange for a share that is now worth $1479 so it's not something anyone would want to do. The second option is held by the issuer where they can convert the preferred into the common if the common trades above $203.72 for 20 out of 30 consecutive days. If this happens, the preferred is converted into common worth at least $1300 (6.3814 x $203.72). That's not a great scenario for the preferreds holders. Thankfully, the common has to rally 363% for this to happen and with the common trading where it was in 2015 that seems a distant proposition. Investors who are very worried about this prospect should hold some of the common as a hedge. We continue to hold WFC.PL in a number of income portfolios - in our view it remains the most attractive bank preferred, trading at a 5.09% yield.

The CLO Equity CEF ECC is offering new 5.375% 2029 notes (ECCV). ECCY or ECCB might get redeemed on the back of this issuance. It's interesting that this new note might is coming out at a higher yield than the recently issued 5% 2027 OXLCZ notes (both ECC and OXLC are both CLO Equity CEFs). OXLCZ is a 2027 maturity and so should have a slightly lower yield though not by 0.375%. It may simply be the case that the market agrees that OXLC notes have much higher asset coverage than ECC notes - something we have been highlighting - making them more attractive, all else equal.

Overall, we continue with a barbell allocation in preferreds, focusing on higher-yielding parts of the sector, such as a number of mREIT preferreds while also allocating to shorter-maturity and pinned-to-par securities to manage duration exposure in an environment of rising rates. The two recent CLO Equity CEF baby bond announcements (OXLCZ and ECCV) are part of this strategy. We have already reallocated from OXLCL to OXLCZ, picking up about 0.75% in yield while shortening the maturity by 4 years.

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This article was written by

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