

# Preferreds Market Weekly Review: Low Coupon Preferreds Struggle

Feb. 11, 2022 12:31 PM ET | ARR, ARR.PC, DX... | 23 Comments | 22 Likes

## Summary

- We take a look at the action in preferreds and baby bonds through the first week of February and highlight some of the key themes we are watching.
- Preferreds continue to struggle in February with rising Treasury yields proving a serious headwind.
- Low coupon preferreds are being hit particularly hard due to their elevated duration profile.
- We also highlight some recent issuance from US Bancorp and CareCloud.
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*This article was first released to Systematic Income subscribers and free trials on Feb. 6.*

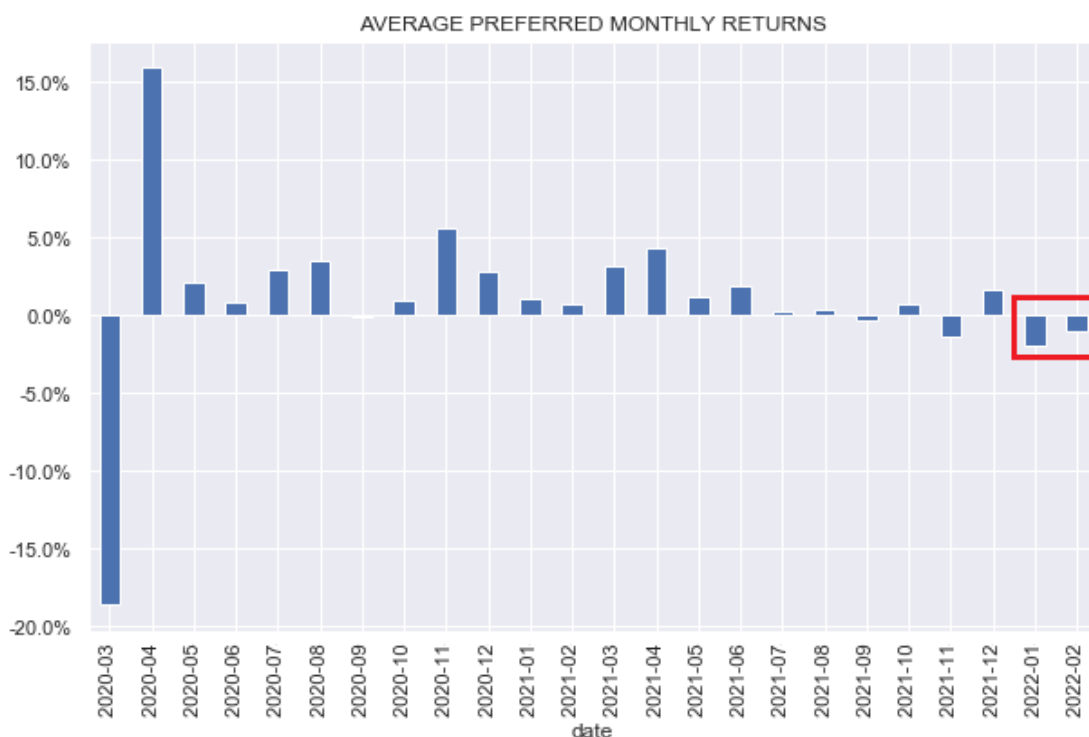
Welcome to another installment of our Preferreds Market Weekly Review where we discuss preferreds and baby bond market activity from both the bottom-up, highlighting individual news and events, as well as top-down, providing an overview of the broader market. We also try to add some historical context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

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 Action**

Most preferreds sectors were down on the week as higher Treasury yields, once again, proved to be a headwind for the sector. Technology and Banks are the underperforming sectors year-to-date - not surprising given the Tech difficulties and the generally higher-quality profile of Bank preferreds and their higher durations.

February is shaping up to be the second down month for the sector this year. The chart also makes clear that preferreds have been trading water since the second half of last year.



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## Market Themes

In an earlier [weekly](#) last August we discussed a few things investors could do to manage their interest rate exposure. The timing was relevant as the 10Y Treasury yield had moved below a level of 1.3% off its then recent peak. It is now trading at 1.93%.

Our playbook in the article was to watch out for low-coupon preferreds and prefer [pinned-to-par](#) preferreds as well as those lagging the market and providing an additional margin of safety.

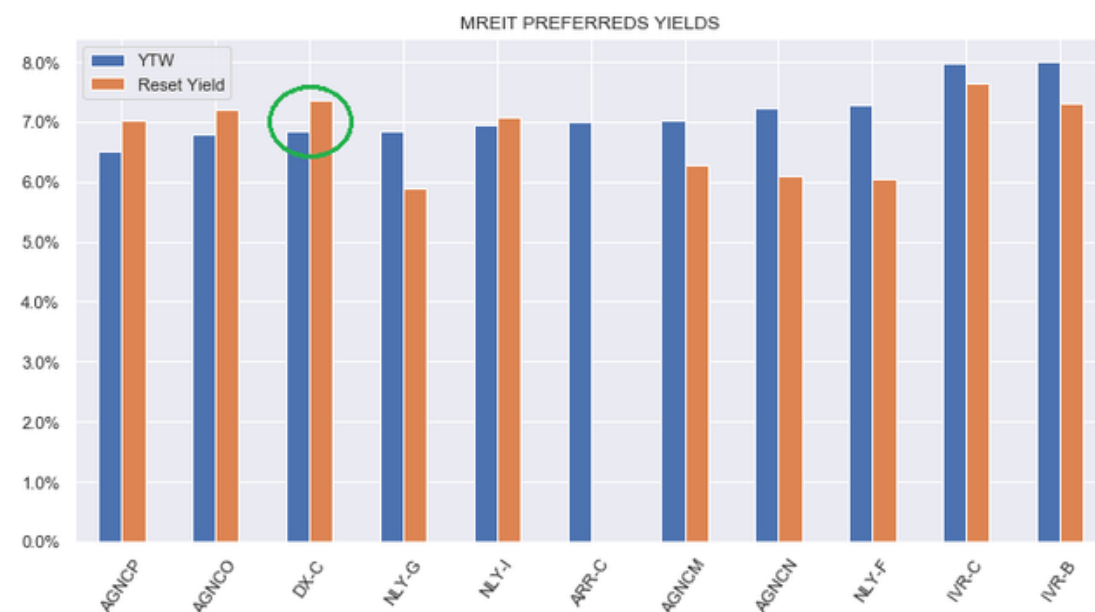
The reasoning for the last two types of securities is obvious, but the first one is less so, particularly for investors new to preferreds and baby bonds. The key point is that credit securities tend to trade in yield terms i.e. very similar securities tend to have similar shifts in yield in response to market conditions. However because credit securities have different coupons, their prices need to move by different amounts in order to generate the same yield moves. Securities with lower coupons need a larger price adjustment and vice-versa.

Let's take a look at how Bank sector preferreds have done since mid-August, before Treasury yields began their latest ascent. We use the Banks sector because it has a large number of decent quality preferreds and it also controls for the credit profile element. The y-axis of the chart shows total return since mid-August and the x-axis shows the coupon of the security.



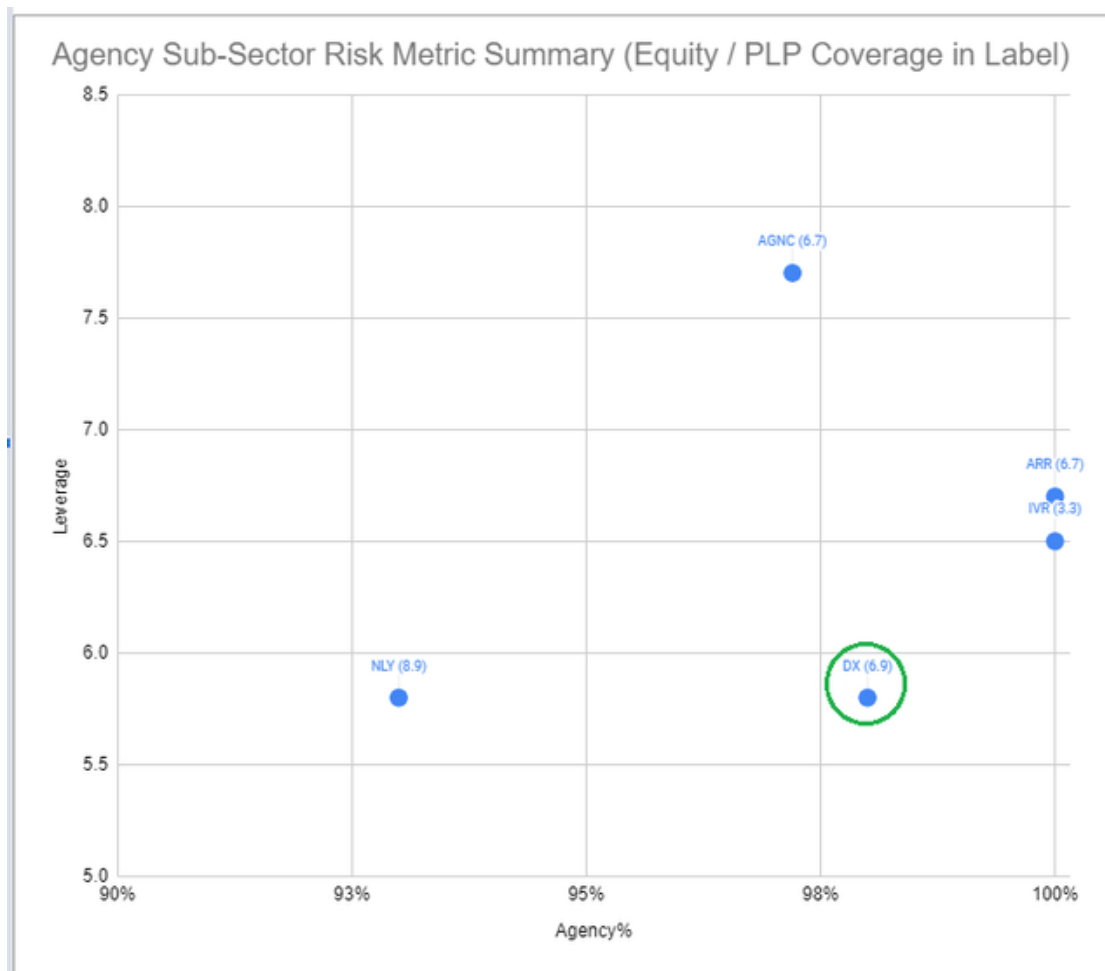
mREIT Dynex Capital (DX) reported Q4 results. Book value moved 2.3% lower - a common theme in the mREIT space and leverage ticked lower to 5.8x - the company has continued to reduce leverage for about a year. Equity / preferreds coverage stayed pretty flat at 6.9x and the 25bp MBS basis sensitivity fell to 11.5%.

The Dynex Capital 6.9% Series C (DX.PC) remains the most attractive higher-quality agency-focused preferred (i.e. within the AGNC, NLY, ARR, DX population). Stripped yield is among the highest and, very importantly, spread over Libor is the highest in the agency-focused space which, combined with the decent price level, means the reset yield (i.e. the yield if the stock is not redeemed on its first call date) is attractive. The first call date is also fairly long in 2025 which avoids any near-term coupon stepdowns and provides a measure of call protection.



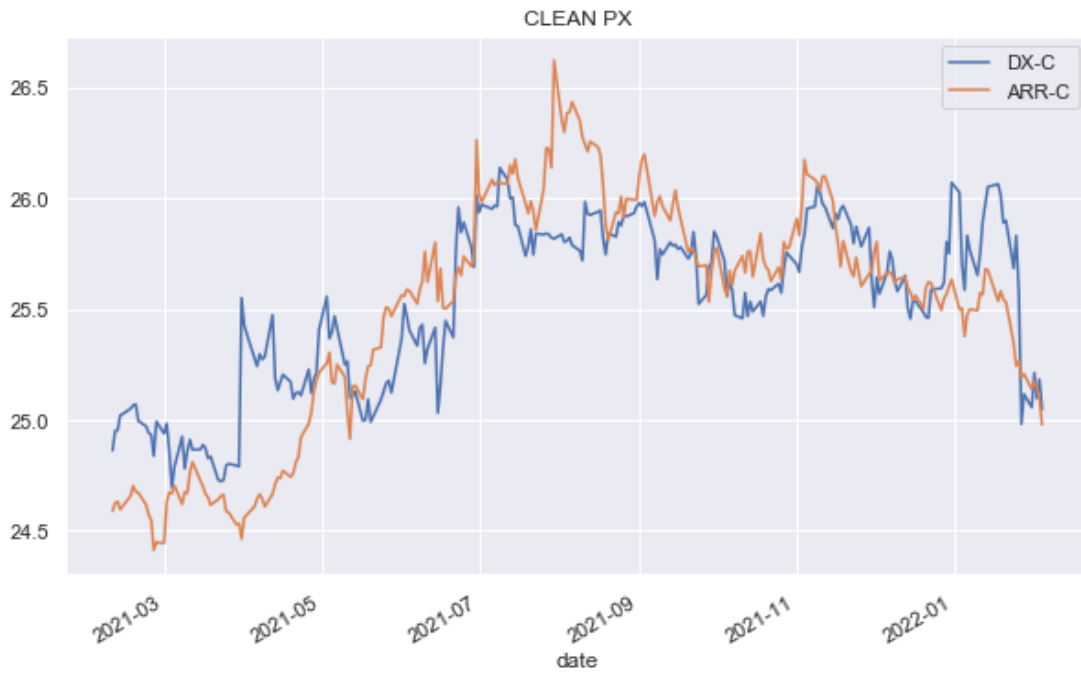
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From a portfolio credit perspective, DX.PC has the combination of a very high agency allocation, the lowest leverage in the agency-focused subsector and the second highest equity / preferreds coverage level. DX.PC is trading at a 6.84% yield-to-worst (up to the first call date) and a 7.35% Reset Yield (based on Libor forwards as of the first call date).



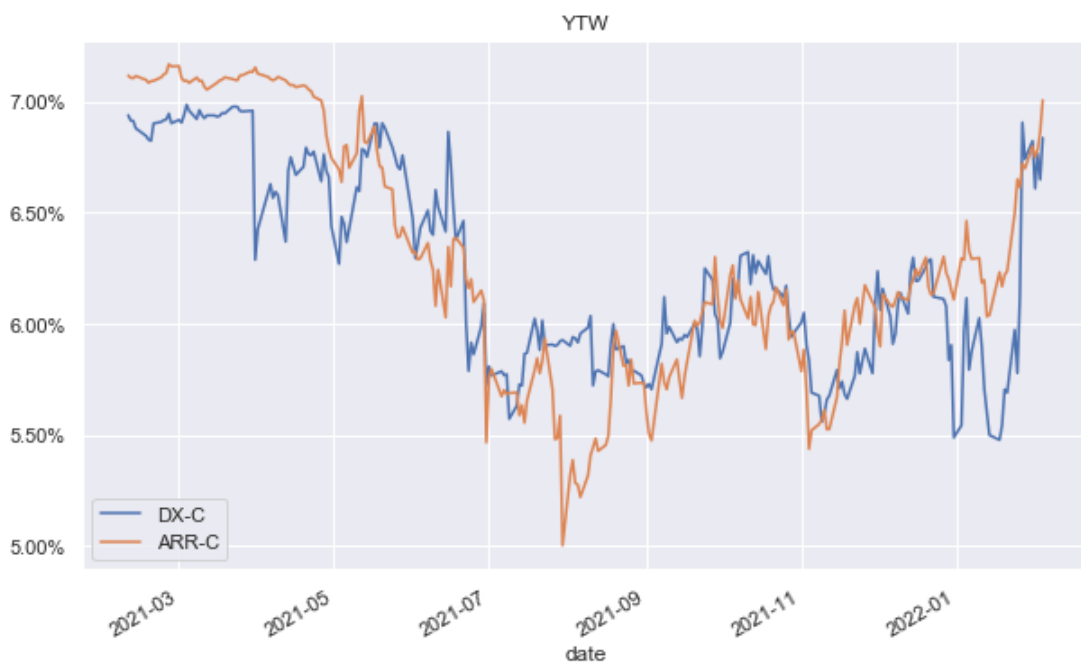
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Apart from DX.PC, we also like the Armour REIT 7% Series C ([ARR.PC](#)) in the agency-focused mREIT subsector. Prices of both have come off around 4% from their 2021 peak levels which has significantly boosted their yields by close to 1.5% because the strongly negative pull-to-par headwind has mostly gone away.



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Both are trading at yields-to-call around 7% which is pretty attractive given their agency-only portfolio and high equity / coverage levels.



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These two also make an attractive combination as DX.PC is a fix-to-float security while ARR.PC is fixed-rate which provides some diversification for short-term interest rates.

The investment-grade rated US Bancorp 4.5% Series O (USBOV) has started trading at a 4.56% yield. It's the highest yield of the US Bancorp preferreds and is fixed rate so there is no floating-rate element to worry about. The yield is fairly attractive for what is one of the highest-rated preferreds.

Also in the Banks sector, the 4.875% Morgan Stanley Series L ([MS.PL](#)) - another fixed rate preferred - looks attractive at a 4.96% yield though with a lower rating. Historically, investors have tended to go for non-investment banking risk (i.e. MS is an IB whereas US Bancorp is not) however the post-GFC experience and 2020 drawdown may have changed that calculation as investment banks have significantly derisked over the past decade and have been able to drive significant revenue growth in the 2020 market environment. Our top pick in the Banks sector remains ([WFC.PL](#)) at a 5.38% yield and with no issuer call.

CareCloud - a healthcare Tech company – is issuing 8.75% Series B ([MTBCO](#)). They will be partially redeeming the 11% ([MTBCP](#)). As you would expect for someone issuing at 8.75% the company is loss-making net of preferred dividends. Income trajectory has been very strong over the last few years and the lower-coupon preferred refinancing will improve this picture as well.

Around 15% of MTBCP will be redeemed. MTBCP is trading at \$25.55 so if you are holding at that price today then about 15% of your shares should be redeemed at \$25 – likely with some accrued but let's assume worst case of no accrued – so you lose 2% on the 15% of the holding. However, you are still clipping 11% on the rest of the position - that means that you break even after a couple of weeks on the entire position.

MTBCP might be an interesting pinned-to-par hold and the large yield differential between the two series means that MTBCP will be more resilient than MTBCO (though with no upside) and it also means it's unlikely to be long for this world. In short, MTBCP might be worth a small position however it does require some conviction for a sizable holding.

## Stance & Takeaways

Paradoxically, the relatively mild drawdown of the preferreds sector this year has made a big impact on yields on offer. This is because as securities fall back towards "par" or their liquidation preference, their yield improves dramatically as the negative pull-to-par headwind fades away. This is not something you see in the CEF space that, despite a harder fall, has seen a smaller yield pickup. For this reason we view preferreds as a fairly attractive space while keeping an eye out for very interest-rate sensitive securities. Term securities such as (NYSE:[ECCV](#)), high coupon preferreds such as ([WFC.PL](#)) and fix-to-float securities, particularly those with floors such as ([GPMT.PA](#)) or Treasury resets such as ([NRZ.PD](#)) offer reasonably attractive lower-duration opportunities at present.

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

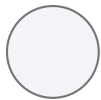
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