Bramshill Investments

September 2024

BRAMSHILL INSIGHTS

Opportunities for Rotational Shifts in the Preferred and Hybrid Market

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Opportunities for Rotational Shifts in the Preferred and Hybrid Market

Preferred (PFD) and Hybrid securities offer investors compelling diversification and income opportunities in today's volatile interest rate environment. There are a variety of different structures within the asset class, and we thus wanted to revisit our current exposure and preferences. The opportunity in fixed-to-float PFDs with large backend resets we highlighted in early 2023 has largely played out as we predicted. Many of those securities have been called or will be called in the next 12 months. We currently see value in fixed-to-reset structures which have higher upfront coupons, longer call protections, and/or idiosyncratic features often creating pricing discrepancies. The PFD/Hybrid asset class is often misunderstood due to the various structures, retail-heavy buyer base, and trading characteristics, thus providing an abundance of alpha opportunities.

The PFD/Hybrid asset class has yields and returns comparable to high-yield fixed income yet these securities are typically issued by companies with stronger balance sheets and investment grade credit ratings at the senior level. Furthermore, having a low correlation with the fixed income and equity markets, today's PFD and hybrid securities have evolved into a distinct and attractive income-generating asset class boasting a variety of structures and serving as a meaningful component of an investment portfolio.

Preferred and hybrid securities are a specialty of Bramshill Investments, differentiating our firm from others in the fixed income investment management arena.

Relative Value Opportunities Across PFD and Hybrid Structures

Investor's wavering preferences coupled with regulatory changes (many stemming from the Great Financial Crisis) have caused several different PFD structures (and more recently Junior Subordinated Hybrids) to be issued over the last decade. These various structures provide investors with many investment options, but confusion often arises on how these securities can play a part in an overall portfolio allocation. This often leads to mispricing, dislocation, and consequentially, opportunities.

The main PFD and Hybrid structures currently available include:

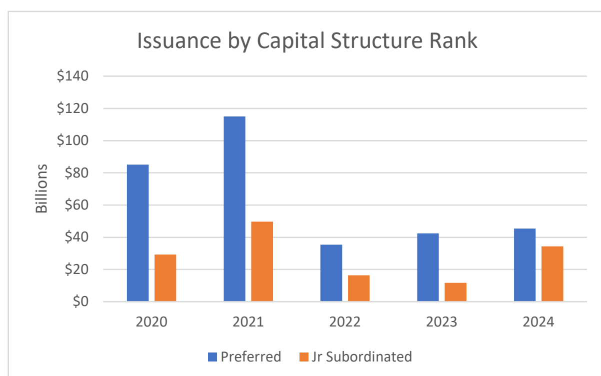
- Fixed Rate Preferreds: Long duration (perpetual) instruments with fixed coupons for life, mostly non-call 5-year securities. Fixed Rate Preferreds are usually issued in $25 par increments, trade on an exchange, and thus, have extremely different trading characteristics and volatility profiles than alternative PFD structures.

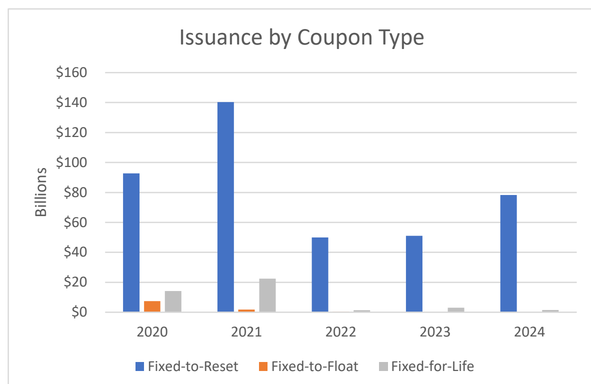
- Fixed-To-Floating Rate Preferreds: Instruments that carry fixed coupons for a non-call period of typically 5 years, and then a floating rate coupon spread over a benchmark such as LIBOR or SOFR. Most of these securities were issued as LIBOR floaters, adding a layer of complexion as LIBOR has terminated. The LIBOR floaters are typically being called, or transitioning to SOFR floaters with an additional spread added to the backend reset in order to compensate investors for the LIBOR/SOFR difference (due to the LIBOR credit component).

- Fixed-To-Reset Preferreds: Instruments with a fixed coupon for 5 or 10 years, at which time they are either called or the coupon "resets" to a spread over duration-matched Treasuries. Once reset, these coupons are fixed for 5 years again until the next reset date in which the coupon would reset again. These PFD structures became more prevalent in 2019/2020 as concerns around the cessation of LIBOR caused investors (such as Bramshill) to pressure underwriters to develop a new structure.

- Junior Subordinated Hybrids: Instruments with a defined maturity, a 5- or 10-year call date, and a fixed coupon that resets at a given spread over treasuries at the call date. This has become an increasingly popular structure for utility and midstream issuers who in the past have tended to issue PFDs for supplemental capital needs. Moody's recently updated their criteria to be more closely aligned with S&P and Fitch - these structures now receive 50% equity credit if the security has a final maturity of at least 30 years, and currently has less than 20 years to maturity, and allows for optional coupon skips. This structure offers issuers the ability to protect their credit ratings to a greater degree than in the past. Recent deals continue to enjoy broad -based participation due to final maturity, index eligibility, call date aligning with loss of equity treatment, and more than twice the spread of 10yr senior paper.

As noted above, structure issuance often depends on market conditions and the resulting investor preferences based on those conditions. As highlighted in the chart below, the breakdown of new issuance by structure has shifted significantly over the past year, as the current high interest rate environment has influenced issuers to shy away from fixed-for-life issuance in favor of fixed-to-reset structures.





Varying Rate and Credit Regimes Cause Drastic Differences in Security Features Even Within Similar Structures:

To complicate matters further, even within the same structure type, there can be significant differences across securities based on the market environment at issuance. During the period of 2020-2021 the US Treasury 10-Year Note average yield was 1.16%. During this era of low rates, PFD and Hybrid issuance was characterized by low coupons at relatively wide spreads. For example, several regional banks and utilities issued Fixed-to-Float and Fixed-to-Reset PFDs with coupons in the 4.75%-5.75% range. However, due to being issued at wider spreads, these securities had back-end resets with spreads of 375-500 over 5-year US Treasuries. This essentially meant that investors received less current income but had lower extension risk given the higher reset. In contrast, securities being issued in today's environment have opposing features. Recent issuance has seen more attractive coupons in the 6.5-7.5% range, however given today's tighter spread environment these often come with backend resets inside of 300 bps. We believe that many of these securities have significant extension risk and thus have a higher risk, higher return profile than their lower coupon predecessors.

Distinct Issuance Attributes Create Opportunities – Where We See Risk and Where We See Value

In early 2023 we highlighted the attractive attributes of several seasoned securities which after the fixed income rout of 2022, had traded down from par into the high-$80s/low-$90s price range and were now trading at attractive yields to short calls. More specifically, we highlighted C 5% PFD. In our March '23 note, we stated:

> As can see from the Bloomberg screen below, if this bond is called (our base case), an investor receives 8.56% annualized to the '24 call. This is a spread of 369bps over Treasuries and significantly higher than the 5.89% yield on the PFD index. If this bond is not called, it will float at SOFR (currently 4.55%) +381, which currently equates to an 8.36% coupon (trading at a discount). We find the limited downside risk (a significantly lower Fed Funds rate) well worth the upside optionality and protection. These are the type of securities that we are targeting and believe they offer extremely strong risk to reward ratios with a built-in margin of safety.

Characteristics of C 5% PFDs on 2/28/23 highlighted above:

1) Graphs | 2) Yield & Spread | 3) Pricing | 4) Description | 5) Custom | 6) Calls

C 5 PERP (172967MG3)
Spread 368.90 bp vs 2y T 4 5/8 02/28/25
Price 95.000 G.P. 97.375 99-16 7/8 18:37:28
Yield 8.565 Call 4.876 S/A
Wkout 09/12/2024 @ 100.00 Contributed Yld 3 3
Settle 03/03/23 03/02/23

Spreads		Yield Calculations	Workout	Maturity
11) G-Sprd	362.5	Street Convention	8.565	6.987
12) I-Sprd	344.0	Equiv 1 /Yr	8.749	7.109
13) Basis	-259.9			
14) Z-Sprd	331.4			
15) ASW	321.8	*Risk calculations done to the end of the		

Coupon Schedule

Fix Coup...	Pay Date	Frequency
5.0000	03/12/2...	2.0000
5.0000	09/12/2...	2.0000

Coupon Method F USD SOFR (vs. FI...
Default Swap curve is used for projecti...
Benchmark Float Frequency 4
SOFR - O/N 4.5500 %d
+ 381.30 (bps) spread
Assumed Cpn 8.3630 %
First Floater Fix Date 09/12/2024 to
Maturity Date 03/12/2171

Source: Bloomberg

This investment thesis came to fruition as Citigroup recently announced the call of this security at its first call date of 9/12/24. We expect several other to be called in the upcoming year (albeit at still attractive YTC levels). With that said, we believe this investment thesis has mostly seasoned as highlighted by the 8.56% annualized return on the C 5's. We now see new and better opportunities, driven by multiple key changes within the PFD market.

First, the spread environment has meaningfully changed, and now subordinated and preferred paper is being issued at relatively higher coupons, but with resets in the 200-300 range. The current income on these structures is attractive, given the high coupon. Secondly, as mentioned earlier, changes to rating agency criteria have influenced non-financial issuers to bring junior subs to market rather than PFDs. These junior subs have been issued at greater volumes recently and while the back-end resets are not attractive, and thus carry extension risk, several securities are still more likely to be called by issuers given the fact that they lose equity treatment at call date.

While we have found some of these new issues attractive, we also find some to carry higher levels of risk for which investors are not being compensated. Here we highlight a few examples.

Attractive:

a) **Higher coupons with larger back-end resets** – there are some notable securities that were issued in a high rate, wider spread environment. One example is the below ET 8% Junior Subs which were issued to help fund a redemption of $25 par PFD securities, influenced by the aforementioned Moody's equity credit realignment. 10yr ET senior unsecured paper was trading near 150 basis points over Treasuries, roughly 30 basis points higher than today's levels. As a result, these came with an attractive +402 reset over 5Y US Treasuries. These offer very strong current yield, and would have an attractive coupon upon reset, offering solid protection against extension risk in case these are left outstanding. These have rallied over $6 points since purchase earlier this year, however, we still find attractive based on the characteristics mentioned above.

1) Yield & Spread | 2) Graphs | 3) Pricing | 4) Description | 5) Custom | 6) Calls

ET 8 05/15/54 (29273VAX8)
Spread 257.29 bp vs 5y T 4 07/31/29
Price 106.849 G.P. 109.004! 101-18 11:42:31
Yield 6.223919 Call 3.651043 S/A
Wkout 02/15/2029 @ 100.00 Consensus Yld 6 6
Settle 08/22/24 08/22/24

Spreads		Yield Calculations	Workout	Maturity
11) G-Sprd	255.2	Street Convention	6.223919	7.555605
12) I-Sprd	286.8	Equiv 1 /Yr	6.320762	7.698323
13) Basis				
14) Z-Sprd				
15) ASW		*Risk calculations done to the end of the		
16) OAS		fix coupon period - 05/15/2029		

Coupon Schedule

Fix Coup...	Pay Date	Frequency
8.0000	05/15/2...	2.0000
8.0000	05/15/2...	2.0000

Coupon Method F US Govt RV Spline...
Default Swap curve is used for projecti...
Benchmark Float Frequency 2
H15T - 5 YR 3.7000 %
+ 402.00 (bps) spread
Assumed Cpn 7.7200 %
First Floater Fix Date 05/15/2029 to
Maturity Date 05/15/2054

Source: Bloomberg

b) Securities with longer call protection – Citigroup recently issued a Fixed-To-Reset non-call 10 year PFD. Citigroup was the first of the Big 6 US Banks to issue this structure with 10 years of call protection. Financial PFDs have recently been issuing with backend resets in the 250-300 range. While we feel these structures hold extension risk for non-call fives (especially in a Fed cutting environment) we feel a security such as this with 10 years of call protection and a 7% coupon more than compensates for extension risk. We favor the Citi 7% with a longer call protection of 10 years vs. JPM and WFC's recent issuances with only 5 years of call protection. Additionally, Citi continues to simplify and streamline their business, which we believe bodes well for the credit.

1) Graphs | 2) Yield & Spread | 3) Pricing | 4) Description | 5) Custom | 6) Calls

C 7 PERP (172967PM7)
Spread 269.40 bp vs 10y T 3 ⅞ 08/15/34
Price 104.000 G.P. 104.525 100-17 14:28:30
Yield 6.504 Call 3.810 S/A
Wkout 08/15/2034 @ 100.00 Contributed Yld 3 3
Settle 08/27/24 08/27/24
Spread Quoted

Spreads		Yield Calculations	Workout	Maturity
11) G-Sprd	269.4	Street Convention	6.452	6.709
12) I-Sprd	316.2	Equiv 2 /Yr	6.504	6.766
13) Basis	-163.2			
14) Z-Sprd	306.9			
15) ASW	314.6	*Risk calculations done to the end of the		
Calculate OAS		fix coupon period - 08/15/2034		

Coupon Schedule

Fix Coup...	Pay Date	Frequency
7.0000	11/15/2...	4.0000
7.0000	08/15/2...	4.0000

Coupon Method F US Govt RV Spline...
Default Swap curve is used for projecti...
Benchmark Float Frequency 4
H15T - 10YR 3.8100 %
+ 275.70 (bps) spread
Assumed Cpn 6.5670 %
First Floater Fix Date 08/15/2034 to
Maturity Date 11/15/2172

Source: Bloomberg

c) Idiosyncratic features such as a coupon floor – as noted above, we believe subordinated securities with lower backend resets in many cases are not compensating investors for the risk. However, these risks can be ameliorated by specific features such as coupon floors. One such example is D 6.875% which has a low reset spread of only +238bps. However, it has a coupon floor of 6.875%, offering significant protection if we shift to a lower rate environment. Therefore, even if rates decline, structures such as these will continue to provide strong current income. Dominion is a business that has been highly focused on delevering their balance sheet and selling non-core assets. Structures like these, issued by solid investment grade rated issuers, make for very attractive uses of capital.

1) Yield & Spread | 2) Graphs | 3) Pricing | 4) Description | 5) Custom | 6) Calls

D 6 ⅞ 02/01/55 (25746UDT3)
Spread 219.27 bp vs 5y T 4 07/31/29
Price 104.64 G.P. 105.041(101-20¼ 12:19:55
Yield 5.828257 Call 3.635508 S/A
Wkout 11/03/2029 @ 100.00 Consensus Yld 6 6
Settle 08/22/24 08/22/24

Spreads		Yield Calculations	Workout	Maturity
11) G-Sprd	218.7	Street Convention	5.828257	6.619715
12) I-Sprd	251.6	Equiv 1 /Yr	5.913178	6.729266
13) Basis	-199.7			
14) Z-Sprd	244.8			
15) ASW	251.1	*Risk calculations done to the end of the		
Calculate OAS		fix coupon period - 02/01/2030		

Coupon Schedule

Fix Coup...	Pay Date	Frequency
6.8750	08/01/2...	2.0000
6.8750	02/01/2...	2.0000

Coupon Method F US Govt RV Spline...
Default Swap curve is used for projecti...
Benchmark Float Frequency 2
H15T - 5 YR 4.4890 %
+ 238.60 (bps) spread
Assumed Cpn 6.8750 %
First Floater Fix Date 02/01/2030 to
Maturity Date 02/01/2055
Floor 6.875%

Source: Bloomberg

High Levels of Risk:

On the downside we have avoided securities that are issued at tight spreads without some extension risk protection as mentioned above. If front end yields moved significantly lower and the curve normalized, structures with low/tight resets could eventually start pricing in the change of coupon and trading to an extension price. Furthermore, if spreads (which are currently near multi-year tights) widen significantly, structures trading at tight spreads could see negative price actions. We highlight a few examples below.

a) Fixed-for-Life PFDs - The below chart shows the spread of Fixed-for-Life PFDs compared to 30yr Treasuries over the past 10 years. We can see that spreads are 2 standard deviations away from the mean, suggesting that this security structure is rich relative to the historical norm and thus has little room for error. Though as a whole we are comfortable with taking some duration risk, we find that the implied credit risk of fixed-for-life preferreds given spread levels make this structure unattractive. If long end rates stayed constant and credit spreads just widened back to the average level over the past decade of 274bps, this could equate to approximately 20% in price loss. We see better opportunities elsewhere.

Source: Bloomberg

b) Fixed-to-Reset structures issued at tight spreads with <5 years of call protection - several recently issued structures have low back-end resets given the tight spread environment. We forecast that issuers will seek to call subordinated paper when the reset spread is greater than 1.75x their senior unsecured spreads. With senior unsecured spreads hovering at historic lows of 100bps, many of these issues seemingly have low extension risk. However, if senior unsecured spreads were to widen out to 150bps or greater (a likely scenario in an economic slowdown) many PFDs that reset in the 250-275 range suddenly pose significant extension risk.

CONCLUSION

It continues to be a very exciting time to invest in fixed income. Nominal yields across many of our asset classes have reached levels we have not seen in many years. The complexity across structures in the PFD market continue to create opportunities. We find ourselves favorable on higher coupon securities with long call protections, securities issued during pockets of volatility with favorable back-end resets, and unique structures that protect against extreme rate volatility and tight

credit spreads. In contrast, we find ourselves cautious in many areas of the market as we believe lower rates and curve normalization could substantially change the risk/reward prospect of many recent issues.

APPENDIX

Advantages in Execution

At Bramshill, we view the US PFD and Hybrid market to be an asset class that is highly differentiated from other fixed income areas in that it offers a variety of structures, uncorrelated returns, and, in addition, numerous liquidity outlets to transact.

There are two par amount price structures with which preferred securities are typically issued.

- Preferreds of $25 par structures, trade on the New York Stock Exchange. To transact, an investor can work with an OTC PFD desk in order to move large blocks or can try to discreetly work with custom algorithms on the exchange.
- $1000 par structures, are traded over the counter by institutional market makers and investment banks from their investment-grade trading desks, crossover desks, or electronic bond trading platforms such as MarketAxess, where both "buy-side" and "sell-side" investors directly participate. Furthermore, we have developed algorithms to automatically execute at levels if there are sell-offs during volatile markets.

Due to a variety of structures and an eclectic investor base, the Preferred asset class can provide a great deal of investment opportunities in different market environments and volatile regimes. Due to our multi-decade relationships, speed of capital, execution capabilities, quantitative modeling, and research analysis teams, we believe Bramshill maintains a competitive advantage in this asset class which will continue to serve our clients well over many different market cycles.

About Bramshill Investments

Bramshill Investments is an alternative fixed income asset manager with over $6.51 billion in assets under management as of August 31, 2024.

Founded in 2012 and headquartered in Florida, with offices in California and New York, the firm offers alternatives to traditional fixed income investment management featuring a variety of strategies across various debt and fixed income markets and specializing in preferred securities.

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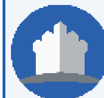

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