## BRAMSHILL INVESTMENTS
March 2023

# MONTHLY INSIGHTS

## Attractive Investment Grade Preferred's With 400+ Back-End Resets

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# Attractive Investment Grade Preferred's With 400+ Back-End Resets

### Opportunities in the Preferred Market

Preferred securities (PFDs) offer investors compelling diversification and income opportunities in today's volatile interest rate environment. We see specific value in fixed-to-reset and fixed-to-float PFDs which have coupons that adjust higher at future dates if rates rise. PFDs are an asset class that is often misunderstood due to the various structures, retail heavy buyer base, and trading characteristics, thus providing an abundance of alpha opportunities.

With yields and returns comparable to high-yield fixed income, credit quality nearing that of investment-grade credits, and low correlation with the fixed income and equity markets, today's preferred 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 securities are a specialty of Bramshill Investments, differentiating our firm from others in the fixed income investment management arena.

### Relative Value Opportunities Across PFD Structures

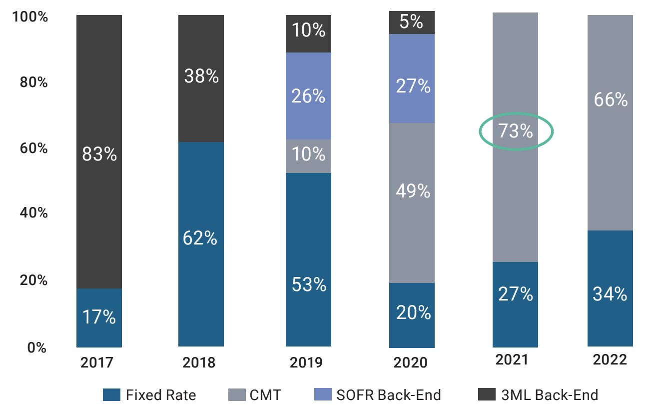
Investor's wavering preferences coupled with regulatory changes (many stemming from the Great Financial Crisis) have caused several different PFD structures to be issued over the last decade. These various structures provide investors with many investment options, but confusion often arises on how these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

The main preferred structures currently available include:

- Fixed Rate Perpetual Preferreds: Long duration instruments with fixed coupons for life. Most are non-call 5-year or non-call 10-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.
- Perpetual 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 complexity as LIBOR is set to terminate. The LIBOR floaters are typically being called, or transitioning to SOFR floaters with an additional spread added to the back-end reset in order to compensate investors for the LIBOR/SOFR difference (due to the LIBOR credit component).
- Fixed-To-Reset Preferreds: Instruments issued with a fixed coupon for 5 or 10 years, at which time they are either called or the coupon "resets" to a spread over a matched duration treasury. After resetting, these coupons are fixed for another 5 years until the next reset date at which time 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.

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 dramatically over the years.

**US Bank Preferred Issuance By Structure**




Source: Bloomberg Finance L.P., J.P. Morgan, Morgan Stanley as of 12/31/22

### Different Structures Lead to Different Returns

While the nuances between the three main PFD structures may seem moderate, the return profile tells a different story, and thus highlights the investment opportunities. Similar to bonds, yields of preferred securities and interest rates are highly correlated. A rising rate environment brings increased interest rate risk, as well as increased price volatility for investors in long duration, fixed-for-life preferreds. In the grid below, we highlight four PFD securities, each containing a different structure. For comparative purposes, we highlight three PFDs from JP Morgan and one Charles Schwab issue (as JPM did not have any Fixed-to-Reset PFDs outstanding in 2022). All of these PFDs have similar investment grade ratings (BBB), and did not have any impactful credit issues in 2022. Thus, the total return differences are purely from the differences in the security structures. These total return differences highlight the type of opportunities that can be found across the PFD asset class.

| Ticker | Structure | 2022 Total Return | Rating | Float Details |
|---|---|---|---|---|
| JPM 4.2% PFD | Fixed-for-Life | -27.42% | BBB | Fixed |
| JPM 6.75% PFD | Fixed-to-Float | -1.86% | BBB | nc'24, L+378 |
| JPM 4% PFD | Fixed-to-Float | -11.04% | BBB | nc'25, S+274 |
| SCHW 5.375% PFD | Fixed-to-Reset | -5.22% | BBB | nc'25, T+497 |

The JPM 4.2 PFDs are Fixed-for-Life. In late 2021, we warned about the dangers in these low coupon, long duration securities. In 2022, we fortunately avoided these structures, however, even we were surprised with the speed and depth of the sell off. Many fixed for life perpetual PFDs finished 2022 down more than 30% while this specific security suffered a -27.4%

total loss. In contrast, the JPM 6.75% PFD held in very well (considering a year that saw the Bloomberg US Aggregate Index down more than -13%), losing only -1.9% in 2022. This security benefitted significantly from a short call date ('24), a healthy +378 back-end reset off LIBOR, and an above market upfront coupon (6.75%). The 3rd security listed is a JPM 4% PFD that is also fixed-to-float. However, this security finished down approximately -11% as it has a weak back-end reset (only S+274), which is off a lower benchmark rate (SOFR), and a lower upfront coupon (4%), which made this security less attractive and more vulnerable to the rate sell off. Finally, the SCHW 5.375% PFD is the type of structure we currently prefer, characterized by an above market back-end reset (T+497 over 5Y treasuries). While this security has a high probability of being called due the T+497 back-end reset, it sold off in 2022 due to the historic move higher (+327 bps) in 3Y treasury rates.

## Different Return Paradigms Create Opportunities – Where We See Value

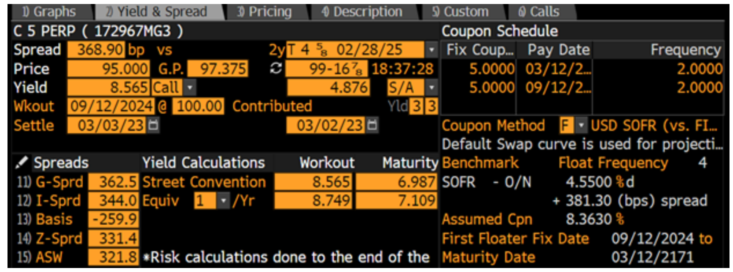
Before highlighting what we find attractive, we'll first examine where we see risk in the PFD market. As of 2/28/23, the ICE BofA Core Fixed Rate Preferred Securities Index yield was approximately 5.89%, after rallying almost 9% to start 2023. At this yield level, investors are picking up only 38bps over the Bloomberg US Corporate Bond Index. This is historically tight as the 10-year average spread is north of 125bps. It makes little sense to us, why investors would take the significant rate and credit risk found in the fixed-for-life PFD market, when compared to the higher quality and shorter duration, investment grade corporate bond market. Furthermore, when comparing the fixed-for-life PFD index to high yield, at 5.89% it yields an eye popping 274bps less than the Bloomberg Corporate High Yield Bond Index at 8.63%. This spread has historically averaged around 54bps, again, showing why from a relative value perspective the fixed-for-life PFD index does not appear attractive at this time.

**Historical Spread of Bloomberg HY Index YTW – PFD (P0P2) Index YTM**


Source: Bloomberg

While the index level shows little value in our opinion, we currently see significant relative value in short call, fixed-to-float, and fixed-to-reset structures, which trade at a discount to par. These structures typically have lower current coupons due to being issued during a much lower rate environment. However, if not called, they reset or float at spreads >350bps over the benchmark. In addition to targeting higher back-end reset spreads, we also favor the shorter call (<2 years) structures. While there is much debate about the path and longevity of future Fed rate hikes, the prospective market is currently pricing in a 5.45% Fed Funds rate by the summer of 2023. Furthermore, this rate is expected to stay elevated well into 2024. Thus, a PFD that is trading at a discount, offers significant upside to the short call based on the assumption that the security will be called due to a sticky Fed Funds rate. In the screen below, we highlight an example of one of these PFD structures. The below security is a C 5% PFD, callable 9/12/24, and if not called it floats at SOFR +381. As seen in 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 PFD is not called, it will float at SOFR (currently 4.55%) +381, which currently equates to an 8.36% coupon (trading at a discount). If SOFR (which closely follows Fed Funds) is higher as expected, the coupon would obviously be higher as well. 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 we are targeting and believe they offer extremely strong risk to reward ratios with a built-in margin of safety.




Source: Bloomberg

In conclusion, it is a very exciting time to be investing in fixed income (finally). Nominal yields across many of our asset classes have reached levels we have not seen in many years. However, we find ourselves cautious in many areas of the market as we believe higher front-end rates are coming, which will in turn pressure credit spreads which are still generically too tight. This leaves us searching for individual securities where spreads are wide enough to provide a cushion against risk off moves, and floating rate coupons, which benefit from rising front-end rates. While the PFD index is unattractive, certain structures within the PFD market give investors just this opportunity.

## Advantages in Execution

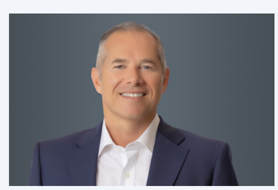
At Bramshill, we view the US preferred securities market to be an asset class that is highly differentiated from other fixed income areas in that it offers a variety of structures, uncorrelated returns, and, in addition, numerous liquidity outlets to transact. There are two paramount price structures with which preferred securities are typically issued.

1. 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.

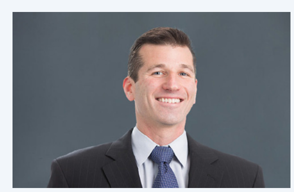
2. $1000 par structures, are traded over-the-counter by institutional market makers and investment banks from their investment-grade trading desks, crossover desks, or electronic bond trading platforms such as MarketAxess, where both "buy-side" and "sell-side" investors directly participate.

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, execution capabilities, quantitative modeling, and research analyst 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.

### Contributors:



**ART DEGAETANO**
Founder & Chief Investment Officer
32 years experience



**DEREK PINES**
Sr. Managing Dir. & Portfolio Manager
24 years experience

## About Bramshill Investments

Bramshill Investments is an alternative fixed income asset manager with over $4.41 billion in assets under management as of February 28, 2023.

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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## Firm Annoucements

**Bramshill Director Nominated for Irish 40 Under 40 Awards**

We are thrilled to announce Bramshill Director Patrick Murray, MBA has been nominated for the 2023 Irish 40 under 40 Awards.