Nuveen’s Baker: Look Beyond Yield To Find Opportunity In Preferreds

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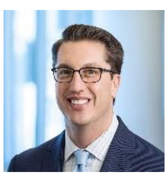
Chuck Jaffe, in this episode of The NAVigator podcast interviewed Doug Baker, head of preferred securities at Nuveen. Read the Q&A below as Doug says that while it is relatively common now to find preferreds with yields above 7 percent, the real opportunity for investors at the moment comes from looking beyond the yield. He says that preferred prices right now are at 'meaningful discounts' that are uncommon in the preferred industry, creating attractive entry points, particularly on preferreds with adjustable coupon rates. He also discusses how the banking crisis, interest rate environment, and inflation picture are impacting the preferred market now.



Doug Baker

The podcast can be found on AICA’s website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Doug Baker, head of preferred securities at Nuveen is here, and if you prefer closed-end funds, we’re about to have some fun now on The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry from users and investors to fund sponsors and creators. If you’re looking for excellence beyond indexing, The NAVigator’s going to point you in the right direction. And today we’re moving in the direction of preferred securities with Doug Baker, a portfolio manager for the preferred securities strategies team at Nuveen, which has $1.1 trillion in assets under management and which you can learn about at Nuveen.com. And if you want to know more about closed-end funds, interval funds, and business-development companies in general go to AICAlliance.org, the website for the Active Investment Company Alliance. Doug Baker, welcome to The NAVigator.

DOUG BAKER: Chuck, it's good to be here.

CHUCK JAFFE: Because preferreds are something that people who love them really do love them, and other people are like, "Wait, they kind of scare me. I don't know them," give us basics on preferreds in closed-end funds and the investment outlook that we've got right now in a higher rate environment.

DOUG BAKER: Sure, absolutely. So we're very constructive on the preferred asset class, and I think a couple things to highlight, first, preferreds are typically issued by highly rated companies, primarily banks, insurance companies, utilities. That's one of the things I think that gets lost most in the preferred story, is that the issuers are high quality, and that catches a lot of people by surprise given that the yield within the category is as high as it is. So today it's not uncommon for us to find preferreds that are yielding north of 7%, and on top of that, another benefit, oftentimes this income is tax-advantaged, not tax-free but tax-advantaged. For many of the structures in our space the distribution is considered qualified dividend income, and for certain investors that provides a tax-advantaged income stream versus say, interest from a regular bond, which oftentimes is taxed as ordinary income.

CHUCK JAFFE: In terms of where the market is now, how the market for preferreds has kept up with both inflation and interest rates, people are looking for yields that are going to outstrip inflation but they're also waiting to see what the Fed does next. Where are preferreds in that portion of the curve in the cycle right now?

DOUG BAKER: Within the preferred category you can put together a strategy that is either very long duration or very short duration, it all depends on securities selection. So for example, it's not uncommon to find preferred strategies with durations of only around two or three years for example, if it owns the right structures and still generating yields in that 7% type of range. Now where we think there's the opportunity is beyond the yield. Today on average you'll find that preferred prices are at meaningful discounts, I would say on average about nine to 10% discounts, and that has been uncommon in the preferred category. History we tended to see preferreds trade around par or at premium, so we think that's an opportunity as far as today for an entry point. And then also, a lot of the securities in our space have coupons that are adjustable to some degree, and so in a rising-rate environment, if you choose the right security structures, you can also benefit from your coupons increasing as interest rates have increased over time. And in a lot of our strategies we like to focus on those structures, and as a result today we're actually seeing the income generated from our strategies increasing over time as the Fed has continued to raise interest rates.

CHUCK JAFFE: What does that do for the yield curve? When you hear "yield curve", you're thinking Treasuries.

DOUG BAKER: Right.

CHUCK JAFFE: But you're also going, "Wait, hold it. It's about long duration versus short duration." And when it comes to preferreds, these are typically long-dated securities, so you got some duration risk, where are we on the duration risk side of things? And what are the other risks? Obviously you talked about the fact that there are certain industries, you're kind of buying into a few things right now and one of them is the financial sector, and we do have this banking situation that is not fully resolved, so let's talk about the risks.

DOUG BAKER: So let's talk about interest rate risk. We do acknowledge that there is interest rate risk, or duration risk, within the preferred category, but it will depend meaningfully upon the security structures that you own. So for example, here in the US the preferred market can be broken down into two broad categories, there's a $25 par exchange-traded structure that a lot of people are familiar with, that being the preferred that most people think of, that's about half the market today. But a lot of that paper is fixed-rate coupon paper, and it pays this fixed-rate coupon, same fixed rate, over the entire life of the security. Whereas on the thousand dollar par side of the market, which not as many people are familiar with, what you find is a lot of the coupon structures on that side of the market, they may start paying a fixed-rate coupon but typically there's some sort of adjustable feature to that coupon in the future, and that greatly brings down the interest rate sensitivity or the duration. So for example, if we look broadly at the $25 par index today, the average duration there is about 7 ¾ years, compare that to the thousand dollar par side of the market, the duration there because of the coupon structures is closer to three years. So even though the securities on both sides of the market tend to have long-dated maturities, and actually a lot of them are perpetual, the difference in coupon structures can help you manage the interest rate risk profile that you have as an investor. Now the next risk you brought up is probably one of the reasons why we have an opportunity today, we have a lot of exposure to financial services, and specifically banks and insurance companies. Now we're in the camp today here at Nuveen that the worst is behind us as far as the banking sector is concerned, as far as additional insolvencies, and so with that outlook we also will acknowledge that preferreds are probably going to be volatile for a while because the headlines, we're not done yet. But for those that can stomach a little bit of elevated volatility over the next several weeks, maybe even the next several months, we think that today is a great entry point given the discount prices, given the wide credit spreads, and also super attractive tax-advantaged yields within today's interest rate environment. So there is risk there, we think we can manage the interest rate risks, and as far as the financial service related risk, we think the work is behind us, especially when it comes to the bank sector.

CHUCK JAFFE: Can you give us an example? Maybe taking it from the financial services sector, where, "Here's a preferred security, here's how it works."

DOUG BAKER: Oh, absolutely. So if we were to look at let's say, Citi, so all the large banks are going to have several different preferreds outstanding. Citi for example, pull one up here right now, this Citi, and actually it's a floating-rate preferred today, it originally had a 5.9% coupon on it, it was a structure that we called fixed to floating-rate structure. So it originally paid a 5.9% coupon, which still doesn't sound great by today's standards, but this was a nice coupon in a lower interest rate environment, and we got that coupon until the first call date. And if Citi redeemed the security, well, we'd get our par back, our proceeds, and we'd go re-invest. This one they chose not to redeem. So what is it doing today? Well, today it's paying a floating-rate coupon at three-month LIBOR plus 423 basis points. So if we look at three-month LIBOR today, it's roughly a 550, a 5.5%, to that we would add 423 basis points, that's almost a 9.75% floating-rate coupon for a large bank like Citi. Oh, and by the way, that coupon is also QDI. So these are the types of opportunities that we're seeing in the preferred space, and to be honest, probably yield levels that we haven't seen really for close to a decade in many instances.

CHUCK JAFFE: Quickly, for those who don't want to get lost in the jargon, QDI is about qualified dividends. Explain the extra benefit there quickly.

DOUG BAKER: Sure. So qualified dividends or dividend income is taxed by the IRS at the capital gains rate, so for a lot of folks that's going to be 20%, you would also add to that the Medicare surtax, which is 3.8%. So for a lot of folks, for a distribution that is deemed to be qualified dividend income or QDI, typically the maximum tax rate's going to be about 23.8%. Now we compare that to the highest marginal federal tax rate for individuals, roughly around 40.8% today, and you can see that there's quite an advantage for generating income that's deemed to be qualified dividend income from the IRS perspective. And so for example, in this Citi example that I just used today, if we have a 9.75% coupon and we use those different tax rates to adjust it to a taxable equivalent yield, that comes out to something closer to 12.5%. So really a significant advantage on a taxable equivalent basis when you're generating your income through something that's deemed to be qualified dividend income versus ordinary income.

CHUCK JAFFE: And lastly, we've talked a little bit about the big picture and where things are, but no reason if the Fed is not going to suddenly change its interest rate picture, et cetera, to see any significant changes. I mean, the fact is the credit markets, barring the banking situation turning into a crisis, are such that we would expect this to be relatively stable for the foreseeable future, correct?

DOUG BAKER: I mean, that's our outlook, and to be honest, we're not fighting the Fed on this one. They're explicitly telling us that we're going to have elevated rates for a while here, and the recent labor statistics and the recent pricing information and consumption information supports that. So yes, we are of the same opinion that we're going to be in this elevated rate environment for a while, and we think our securities are going to benefit from that.

CHUCK JAFFE: Doug, this has been great, we appreciate the time. We've benefited from our time with you, thanks so much for joining me on The NAVigator.

DOUG BAKER: Chuck, it was great to be your guest, I appreciate it.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, I'm Chuck Jaffe, and you can check out my show on your favorite podcast app or at MoneyLifeShow.com. To learn more about interval funds, closed-end funds, and business-development companies generally go to AICAlliance.org, the website for the Active Investment Company Alliance, on Facebook and LinkedIn @AICAlliance. Thanks to my guest Doug Baker, portfolio manager and head of preferred securities at Nuveen. Learn about Nuveen and its many closed-end funds with preferred securities at Nuveen.com. The NAVigator podcast is new every Friday, follow along on your favorite podcast app to make sure you don't miss an episode, and we look forward to bringing you more closed-end fund talk next week. Until then, happy investing everybody.

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