Alternatives To Short-Term Bonds

Digging into an obscure asset class may be the only source of attractive short-term yield that isn't likely to go south on investors as interest rates rise.

By Eric Uhlfelder

SINCE THE FEDERAL RESERVE BANK LOWered overnight interest rates to virtually zero nearly seven years ago, it's been next to impossible to find attractive yields that aren't risky. Today, bank accounts are paying 10 basis points, two-year Treasurys 77 basis points, CDs maybe a bit more and investment-grade corporate bonds 2%. With the Fed getting ready to ratchet up rates, principal risk to debt instruments is very real, and bond prices have already begun falling.

Stocks have been a decent dividend alternative. But after six-plus years of a bull run, and with markets being whipsawed, a serious pullback wouldn't surprise.

The one asset class, however, that provides attractive annualized yields—with a likely protection against price decline due to interest rate risk—is high-coupon preferred shares and $25 "baby bonds." Many that were issued in the aftermath of the financial crisis are very likely to be called in the near future.

Advisors don't know much about these alternatives because there is very limited brokerage coverage and because there is virtually no discussion of this short-term strategy. But for clients who are keeping healthy cash balances in personal accounts and retirement accounts, certain preferreds and baby bonds can be thought of as cash-like alternatives.

Kevin Conery, Piper Jaffray's preferred desk analyst, thinks many issues are likely to be redeemed soon after their call date is reached "because they probably can be refinanced at lower coupons and due to their loss of their Tier 1 status triggered by stiffer regulatory policies that have been put in place." Likelihood of redemption can also reduce volatility.

How To Search

QuantumOnline.com is a superb free data source of all things preferreds. UBS Wealth Management Research maintains a useful preferred database to start the search, including annualized yield-to-call returns, which is the first metric in determining if a preferred may be a compelling short-term play.

Yields are not worth chasing if they come with credit risk. But assessing riskiness has become more challenging since the financial crisis because rating agencies have aggressively downgraded preferreds in contrast to their senior debt ratings.

Deutsche Bank's Contingent Capital Trust 8.05% preferred has a junk rating. "But the likelihood of Germany's flagship bank missing payments on its preferreds is very low," says Greg Phelps, senior portfolio manager at Manulife Asset Management, who runs $3.5 billion in preferred funds.

Select Preferreds And Baby Bonds

Company	Ticker	Industry	Price Aug. 24, 2015	Call Date	Est. Annualized Rate of Return Until Call
Seaspan Pref. C 9.50%	SSW-C	Shipping	25.00	Jan 2016	11.71%
JMP Senior Notes 8.00%	JMP-B	Brokerage	25.00	Jan 2016	9.79%
First Republic Bank Pref. A 6.70%	FRC-A	Bank	25.38	Jan 2017	5.84%
Endurance Specialty Holdings Pref. B 7.50%*	ENH-B	Insurance	25.95	Jun 2016	4.33%
Deutsche Bank Capital Trust V 8.05%	DKT	Banking	27.88	Jun 2018	3.87%
KKR Senior Notes 8.375%	KFH	Specialty Finance	26.55	Nov 2016	3.21%

*Calculation based on data before shares went ex-dividend on 27 August 2015.
Source: Fidelity.com and Quantumonline.com

Kevin Conery adds that eventual removal of the preferred's Tier 1 status will also encourage an early call. German 10-year sovereign yields of 64 basis points and the euro zone still in a slump suggest an early call is possible for this high-coupon security. If redeemed in June 2018, this preferred would generate a net annualized yield of 3.87%.

On the shorter end of the call spectrum, iconic private equity shop KKR has a Baby Bond with an 8.375% coupon that's callable in little more than a year. If held until then, its net annualized return is 3.21%. Despite the firm's reputation and record-setting second-quarter earnings, the security is rated "BBB"—two notches above junk.

To determine if an investment makes sense, first check the credit quality of the company's senior unsecured paper, see how much debt is outstanding and if maturities are sensibly dispersed. Read analyst reports and scan for news about the company. If any findings disturb, move on.

Some preferreds and baby bonds are not rated. That could be a red flag. But not necessarily. Management may have opted not to pay for a rating when it has an established reputation, especially for smaller issues, and if underwriters anticipated sufficient demand for the security.

Don't be turned off with the security selling over par with a near-term call. That's normal. To determine if it's a good deal, count the number of dividend payments due by the first call date, subtract the market price premium over the call price, then annualize the gain over the remaining period until call. Remember, buying above par produces capital losses that can shelter other profits. (Note: The accompanying table was made in August. If a security's next payment's ex-date has passed, the minimum return calculus will have changed.)

Two Types

Perpetual fixed-rate preferreds and baby bonds are exchanged-trade securities, designed to reach retail customers. Both are callable, typically several years after they were issued.

There are basic differences between the two securities. Baby bonds are senior to preferreds, bond issuers cannot suspend quarterly payments without defaulting, and they do mature. Most preferreds don't.

Advantages of preferred dividends include being taxable at a lower qualified rate. And they are sometimes paid with capital, which defers tax liability until the security is sold. (For short-term yield plays, avoid preferreds that can be converted into equities or whose coupon can become a variable rate.)

Among the most compelling preferreds is the Seaspan Series C. It has a 9.5% coupon. It's cumulative, which means if dividends ever get suspended, they must be paid off in full before the common share pays a penny in dividends. It's callable in January 2016. At a price of $25, the net return as of that date would be 4.75%.

If it's not redeemed by January 2017, the divided gets bumped up by 25%. That would produce a coupon of nearly 12%. The point of this feature was to convince investors this preferred should be thought of as a short-term bond. Only outright corporate failure would likely prevent the company from calling the preferred and paying all accrued dividends.

What Could Go Wrong?

This strategy relies on targeting well-managed firms with decent financials. But stuff happens. When non-cumulative preferreds miss dividend payments, they will not be made up and dividend suspension will send their prices significantly lower.

For baby bonds, one missed single payment means default and a sharp rise in future borrowing costs. Preferreds that miss dividends may suffer the same consequences. Accordingly, most firms will do everything possible to make these quarterly payments.

Firms will miss payments only when there's a corporate meltdown that typically results from an internal financial scandal, a long-term shock to their respective industries or rapid deterioration of the economy.

Are any of these scenarios possible? Always. Likely over the next 12 to 30

continued on page 87

Mentoring
continued from page 63

not generated a single penny. I gave him a chance to change his mind."

When Liddell had been presented with the same opportunity himself years earlier, he chose the 40% option. "I learned so much from the guy I was working for," he says. Before a year was out, Liddell had generated more than $250,000 of business, of which he took home just 40%. "I chose the lower pay, but got so much more out of it," he asserts. "I was motivated by watching him, wanting to show him what I could do to earn his trust, and I was happy to be affiliated with someone who showed me the ropes."

What he learned from this experience is that junior people are motivated more by the desire to succeed than by the desire to earn more money. "Reward junior executives for a job well done by taking them to your country club or favorite restaurant and letting them know, 'I'm here to celebrate you tonight,'" he says. "Those simple things that you would do for your own family are what really count."

A Professor-Student Relationship

In many ways, the relationship between a senior and junior advisor should not be that of boss and employee, he says. Liddell prefers a professor-student relationship. "As the professor, you have to have a curriculum. You have to know where you plan to take these people. You have to educate them because they don't know it all in advance and aren't going to learn it through osmosis," he says.

This educational arrangement should last at least 18 months, he holds, and sometimes as long as twice that. "By that time, the student should understand why he or she is partnering," he says.

That may sound like a long journey, but it's not entirely a one-way street. Professors often learn from their students, Liddell points out. A young person might help the senior advisor with technology and social media, for instance. "It may not be acceptable in corporate America for a trainee to outdo a superior, but you should always be open to taking advantage of the younger person's talents," he says. "If you don't allow the student to impress the professor, you could be losing out." FA

Investors Become Bankers
continued from page 80

ranging from 5.99% to more than 22%, depending on their credit rating. Accredited investors participate with minimums of $50,000 spread across $500 pieces of loans, to ensure diversification.

"We charge a 1% servicing fee, but all the coupon goes to the investor," Periu says. "Performance can vary; there will be some defaults, but we feel we price the risk accordingly. Historically, we're yielding about 12%."

Another potential concern is fraud committed by would-be borrowers, which was discussed in Congress during a House Small Business Committee hearing on peer-to-peer lending in May. One of the companies that spoke at that hearing was Funding Circle. "Fraud is something we combat every single day, and it's a big focus in the industry," Periu says. "We make sure we do a lot of identity verification, pulling information from third parties, tracking the location bases of things like cell phones and IP addresses as we underwrite the loans and make lending decisions."

Periu and other P2P lenders don't believe higher interest rates will cause a mass exodus of P2P lenders back to traditional fixed-income vehicles. "Given the shorter-term nature of our loans, when interest rates eventually start to rise we should be able to adjust our rates in tandem," Periu says. "For now, though, fixed-income yields remain low and investors continue to look for higher-yielding products with reasonable risk-adjusted returns."

Given the growing role of institutional investors in the space, P2P lending is increasingly being referred to as "marketplace lending" to better reflect the growing diversity of lenders. "The industry's pioneers were concerned it would become just another institutional game, so the major players such as Lending Club banded together with companies such as ours to ensure the true individual peer investor will always have a seat at the table in peer-to-peer lending," says Bo Brustkern from NSR Invest.

And as NSR, along with companies such as Funding Circle, Direct Lending, Money360 and others continue to reach out to financial advisors, they hope to attract their share of peer investors. FA

Short-Term Bonds
continued from page 82

months? Given generally benign economic conditions: not so much.

Would healthy issuers not redeem shares at the first opportunity?

Sure.

Joe Jolson, CEO of the boutique brokerage firm JMP Group, says there hasn't yet been internal discussion about calling his firm's 8% baby bonds this coming January—the initial call date. JMP issued the bonds several years ago to finance investment opportunities, and he says not all of the proceeds of the $46 million have been deployed.

Firms will not disclose their plans to call until close to the call date. But according to Greg Phelps, "If a firm can save 100 basis points or more by issuing a lower-paying coupon, it typically does so, especially if rates are likely to rise over the longer term."

On the bright side, if high-coupon securities are not redeemed on the initial call date, every additional quarterly payment improves the total return of the investment.

But if one decides to stay on board after the initial call date has passed, be mindful that the investment thesis has then changed, and the purpose and risks of holding the security must be re-evaluated. FA