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For rising rates

Evan Lorenz and Fabiano Santin write:

No matter how much you invest in zero percent yields, zero is what you earn. All the capital in creation would avail you nothing more. Now in progress is a survey of the opportunities on offer at today's new and improved yields. On the analytical agenda are bank-preferred stock, shares in a business-development company, closed-end municipal-bond funds and—a touch of the exotic—an option on much higher interest rates many years down the road. Credit risk and interest-rate risk remain, of course. We write for the many who need income.

The banking business would seem to be a natural beneficiary of rising rates. Lending long at floating rates and borrowing short via low-cost deposits, a bank cashes in on fattening net interest margins. Or it seeks to. In this, the Age of Markets, it wrestles for deposits and tussles for assets. It competes even for that ancient staple of bank credit, the secured commercial loan. Pension-fund investors and the managers of collateralized-loan obligations are eager to buy bank-like assets, a.k.a. "leveraged loans," despite vanishing covenant protection and relatively meager yields (*Grant's*, Sept. 7). Thus, in the second quarter, measured year-over-year, growth in bank assets was just half of the 5.4% growth in nominal GDP.

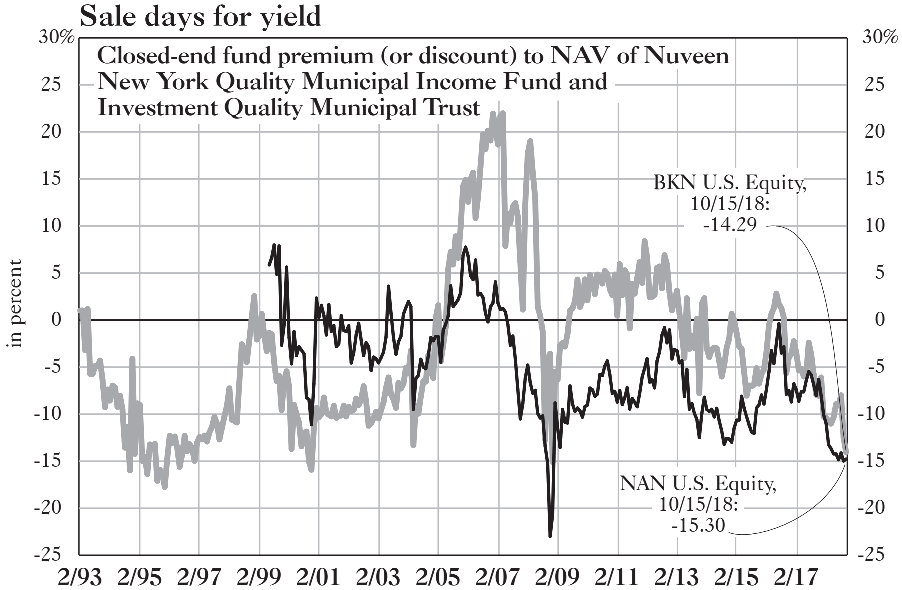
Understandably enough, bank depositors, after so many years of earning nothing, now demand to earn something. Again, in the second quarter, according to the Federal Deposit Insurance Corporation, more than 100% of the 3.9% year-over-year uptick in deposit liabilities stemmed from a bulge in the $9 trillion of interest-bearing deposits (the non-interest-bearing kind showed a slight decline, to $3.2 trillion). The upshot is that, in the three months through June, a 15.2% growth in interest income lagged well behind a 61.6% leap in interest expense.

Taking the banking industry as a whole, Christopher Whalen, publisher of *The Institutional Risk Analyst*, tells *Grant's*, "The average cost of funds for the whole industry right now is a little over 1%. The average earnings on total earning assets is barely 3%. You've got about 2 points of spread. If funding costs keep rising faster than earnings, then you will see net interest margin contract by Q1. How do you think the Street will react to that?" Not lying down.

Which leads us to bank preferreds, or rather back to bank preferreds, a subject we tackled in the issue dated May 4. The shares pay qualified dividends taxed at the long-term capital-gains rate, an attractive attribute for residents in such high-plunder states as California and New York. And while bank net interest margins may well be pinched in coming quarters, America's Dodd-and-Franked banks deploy capital enough to surmount most cyclical contingencies. Besides, the preferreds' high coupons confer some margin of safety against rising interest rates. (Much depends, of course, on the tempo of the upswing. It was slow and deliberate in the two preceding American bond bear markets, those of 1900–20 and 1946–81, but past performance is never the last word on future results.)

Take, for example, the triple-B-minus-rated JPMorgan Chase & Co. Series AA

Sale days for yield



source: The Bloomberg

6.1% Non-Cumulative Preferred (CUSIP: 48127X542). The shares, of which $1.4 billion are outstanding, are callable quarterly, at par ($25.00), starting in September 2020. At $25.47 a share, the Morgan stock yields 5.5% to call, which is equivalent to 7.5% taxable interest income for a tax-bludgeoned New York resident, who may pay a combined rate of as much as 53.5%. If not called next year, the strip yield is 6.1%, or 8.3% on a tax-equivalent basis. JPMorgan's return on equity has averaged 9.7% in the past five years, and the Bank of Jamie Dimon shows a 12% tier-1 common-equity ratio.

Another option is the triple-B-plus-rated Northern Trust Corp. Series C 5.85% Non-Cumulative Preferred (CUSIP: 665859872). The Series C shares, of which $400 million are outstanding, are callable quarterly, at par ($25.00), beginning in October 2019. At $25.00 a share, the stock yields 6.1% to call, which is equivalent to 8.4% from taxable interest income to a maximally taxed New Yorker. If not called, the strip yield is 5.8%, or 8.0% on a tax-equivalent basis. Northern Trust has posted an average return on equity of 10.7% over the past five years; it shows a 13.2% tier-1 common-equity ratio.

The triple-B-rated Charles Schwab Corp. Series C 6% Preferred (CUSIP: 808513402) constitute preferred specimen No. 3. The Series Cs, of which $600 million are outstanding, are callable at par ($25.00) each quarter starting in December 2020. At $25.42 a share, they're priced to yield 5.5%, which, to match, an affluent New Yorker must find a fully taxable yield of 7.5%. If not called, the strip yield is 5.9%, or 8.1% on a tax-equivalent basis. Charles Schwab has earned an average of 12.8% on its abundant equity over the past five years; its tier-1 common-equity ratio stands at 19.3%.

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Like banks, business-development companies beat the bushes for creditworthy borrowers. The ideal BDC lending candidate is large enough to weather a recession but not so big as to issue its own junk bonds. It's the kind of company that turns the heads of private-equity acquirers. Until 2014 or 2015, a BDC could lend at wider credit spreads and on better covenant terms than a big bank could to a larger, though perhaps no more creditworthy, borrower. The competition unloosed by a decade of ultra-low interest rates has shaved the BDCs' underwriting advantages.

Mindful of this unwanted company, our friend Solar Capital Ltd. (SLRC on the Nasdaq; *Grant's*, July 27) is looking beyond customary BDC commercial credits. De-emphasizing middle-market loans (they made up 34.4% of total investments in the second quarter, down from 55% a year earlier), it's concentrating, instead, on market segments that it judges to be less crowded or for which it believes it has developed a particular expertise: asset-based lending (32.3% of the Q2 portfolio), lending against capital equipment (19.8%) and lending to the life-sciences industry (11.6%).

As of June 30, Solar's $1.8 billion portfolio was invested in first-lien loans (83.4% of the total), second-lien loans (14.7%) and equity and equity-like securities (1.9%). At quarter-end, nonperformers were nil. Solar has been cutting exposure to second liens, which fell to 14.7% of the portfolio on June 30 from 19.3% on March 31. Floating-rate loans made up 78.2% of invested assets at the end of the quarter.

Nothing to fear from rising rates with Solar, at least not in the context of immediate dividend payouts. Management estimates that a 100 basis-point rise in the London inter-bank offered rate would boost annual net investment income by $0.14 per share. For reference, Solar paid a $0.41 per share dividend, which was covered by $0.45 in net investment income, in the most recent quarter. The shares, quoted at a 5% discount to net asset value, are priced to yield 7.9%.

Most BDCs have a poor track record compounding equity: The 44 constituents of the S&P BDC Index eroded net asset value per share by 2.5% year-over-year in the second quarter; as a result, the index trades at 91% of book value. Solar expanded its book value per share by 0.6% in the second quarter and has managed to increase book by 6.3% since its initial public offering in 2010. Golub Capital BDC, Inc., another BDC with a stellar record in book-value accretion, trades at a 14% premium to NAV. By the numbers, then, compared with other strong BDC underwriters, Solar may be counted a bargain.

Complying with the Investment Company Act of 1940, BDCs could borrow no more than the sum total of their equity. That changed on March 23, when President Trump affixed his signature to the Small Business Credit Availability Act of 2018. So doing, the former New York leveraged real-estate speculator cleared the way for BDCs to borrow twice as much as before. On Aug. 2, Solar's board of directors duly approved an expansion in allowable leverage.

But it's no lunge for leverage that will cause third-quarter borrowing to jump sequentially to 0.65 times equity from 0.5 times equity. The change rather stems from Solar's choice to wind up a pair of joint ventures, with Pacific Investment Management Company, LLC (Pimco) and Voya Financial, Inc., and bring back on its own balance sheet the first-lien loans that had resided with the JVs.

Solar tells *Grant's* that debt will rise to no more than 1.25 times equity. "We now have substantial dry powder to take advantage of not only rates increasing, but, hopefully, spreads increasing as typically happens when rates increase," says CEO Michael Gross.

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The upward heave in interest rates has left closed-end muni funds—leveraged structures largely invested in longer-dated bonds—trading at their widest discounts to net asset value since the financial crisis (*Grant's*, Aug. 10). "You've got a bias against long bonds, and you've got a bias against leverage," John Mousseau, paid-up subscriber and chief executive officer and fixed-income director of Cumberland Advisors, tells *Grant's*. "People want to get out of leverage when the perception is that it's going to hurt them."

In the $3.9 trillion tax-exempt bond market, "people" generally refers to individual investors. They are the direct holders of $1.6 trillion in state and local securities and the indirect holders (through mutual funds and ETFs) of another $954 billion's worth. Individuals are slow to change their minds, but, when something or someone flips the switch, they can change en masse.

Of course, there are other kinds of people in the market—professional managers of municipal-bond portfolios, for instance, and they, too, can exhibit herd-like behavior. The Tax Cuts and Jobs Act of 2017, which reduced the top marginal corporate-tax rate to 21% from 35%, has given an institutional investor good reason to sell the tax-advantaged bonds that, since the tax cut, have become significantly less advantageous. Financial institutions, sizable holders of long-duration munis, have therefore slashed their holdings by $30 billion, or 5%, since the end of 2017. It may not sound like much in the context of $3.9 trillion, but average daily turnover is reckoned to be on the order of as little as $11 billion. Liquidity is not the outstanding characteristic of the muni market.

Relative attractiveness is, for munis, as it is for most other assets, the consideration that impels a decision to buy or sell. For instance, on a pre-tax basis, 30-year Treasurys and long-duration investment-grade corporates pay 3.34% and 4.86%, respectively. Since a New York resident faces a marginal rate of 40.8% on federal securities and 53.5% on other non-exempt fixed-income securities, the after-tax return on the 30-year Treasury drops to 1.97%, that on a long-duration corporate to 2.25%—and a typical junk-rated bond yield of 6.4% shrivels to 2.97% after governments take their bite. Compare and contrast, for instance, the 3.18% double-A-plus-rated, intermediate duration (8.5 years) yield on the town of Bethlehem, New York 3s of Dec. 1, 2028.

Since its 1999 inception, the Nuveen New York Quality Municipal Income Fund (NAN on the Big Board) has traded at an average of 5.4% discount to NAV. Today that discount is 15.3%. The fund has an average effective leverage-adjusted duration of 11.35 years and pays a tax-free yield of 4.75%—it's the equivalent of a corporate bond yielding 10.2%. With assets of $730 million (mostly apportioned to bonds rated single-A or higher), NAN employs leverage equal to 39% of assets.

High-income Californians may ponder BlackRock's California Municipal Income Trust (BFZ on the Big Board). Compared with an average 3% discount to NAV since its 2001 launch, the fund changes hands today at a 15.9% discount. Its leverage-adjusted duration is 10 years and it yields 4.68%, equivalent, for a fully-taxed resident of the Golden State, to 10.19% from corporate bonds. It holds $789 million in assets (mostly single-A- and higher-rated bonds) and uses leverage equal to 42% of assets.

The happy inhabitants of less rapacious states have more flexibility in choosing a closed-end muni fund. The Investment Quality Municipal Trust (BKN on the Big Board), for instance, has traded at an average discount of 0.7% since inception in 1993 but is on offer today at a 14.3% discount. Its leverage-adjusted duration is 12.4 years and its dividend yield is 5.4%, equivalent to a 9.1% yield from Treasurys (a rate last available in 1990). It holds $428 million in assets (mostly rated single-A and higher) and deploys debt equal to 39% of assets.

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Institutional investors have access to bespoke options with which to lay down a long-term bet on much higher interest rates. They have the necessary documentation to implement such a trade—it's called an ISDA (short for the International Swaps and Derivatives Association) master agreement. You, Ms. or Mr. High Net Worth Individual, may not possess an ISDA, but you might have an in with your bank or broker. The particular trade we're talking about is a 10-year forward 20-year swaption.

Yes, it seems like the thing that a prudent person would instinctively reject because it sounds like trouble. Certainly, it sounds complex, though that it is not: "This is allowing you to go short (or sell, for a lack of a better word) the 20-year Treasury, but you have the right to sell it at, say, a 4.5% yield 10 years from now." The speaker is Harley Bassman, age 59, recently a portfolio manager and strategist at Pimco and now the author of financial commentary at ConvexityMaven.com. He proceeds: "So you are buying an option to pay the 20-year rate (to sell the 20-year Treasury or swap rate) 10 years from now. All you do for that is pay some fee up-front."

For a $10 million notional payer swaption with a 4.5% strike price on the 10-year forward 20-year rate, an investor would write a check for $367,640. He could lose that and only that. If the 20-year swap rate rose to 6% from today's 3.28%, the option would be worth $1.7 million in a decade. Two facts, beyond the option's long duration, make this an interesting trade: The forward-swap and volatility curves are extraordinarily flat by historical standards.

"Now," Bassman explains, "usually what happens is, when you buy insurance protection, you have two things going against you: One, you usually have higher volatility going against you. In equity-land, the VIX front month might be at 14, but the six-month VIX or the nine-month VIX are higher. If you want to buy a one-year or two-year option, you are not buying at 14, you are buying at 20. And, you usually have negative carry where the forward rate is higher than the spot. The 10-year forward-swap rate [3.27%] is actually below the spot rate [3.28%].

"I own this trade in my PA," Bassman concludes. "Do you know what I view it as? The Bassman family insurance policy."

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