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Speculating for income

There's no investment income to be had. That is the fact. At least, there's none that answers the description of natural, organic, unleveraged and secure. For U.S. dollar-denominated yields in excess of, say, 3%, one must settle for the hothouse variety of yield, the kind grown in debt.

So income-producing gimmicks are the items on the agenda. The securities under review are the types once known as a businessman's risk—you pay your money, you take your chances. Each affords some protection against rising rates. We are willing to forego protection against falling rates. They have been slipping for 34 years and 10 months.

Benjamin Graham and David Dodd described bond selection as a "negative art." As the upside in fixed-income investing is inherently limited, one must bank on the downside. We take the great thinkers' counsel to heart. What's wrong, not what's right, is a running theme of the essay now in progress.

What's wrong with bonds today is the frenzy to own them. Conveniently, you can trade the concept of What's Wrong with Bonds in a liquid ETF. The iShares International Treasury Bond ETF (IGOV on the NASDAQ exchange), heavy-laden with Japanese government debt, is that security, and it yields a princely 0.17%. And wouldn't you know that it's returned 9.9% in the year to date (*not*, principally, from coupon income)?

"Investors are buying bonds for capital appreciation and stocks for income," sagely observes James Abate, chief investment officer at Centre Asset Management (he was so quoted in a July 11 MarketWatch story). "The world has turned upside down."

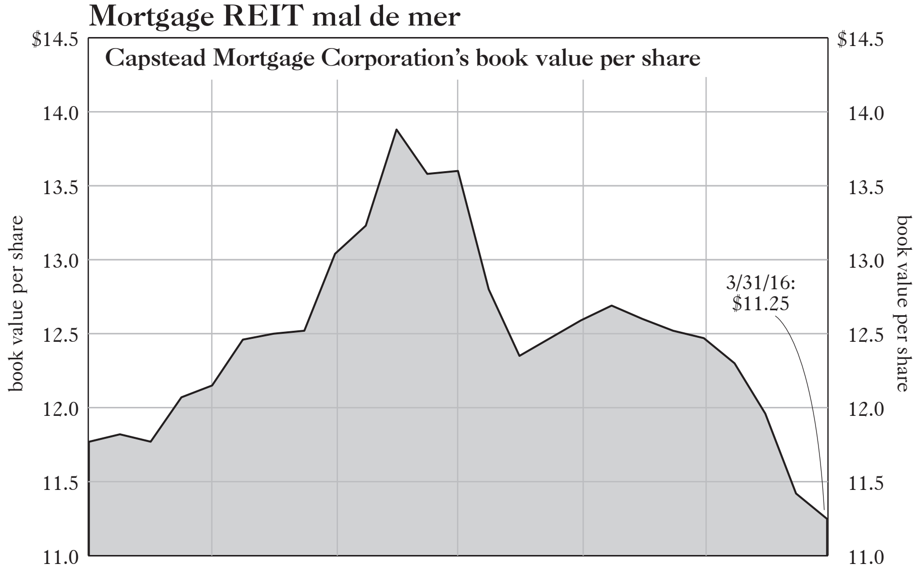
Will it ever turn rightside up? January 2017 puts on IGOV are quoted at a $98 strike; they're priced at $3.30 with an implied volatility of 10.3%. The put-holding bond bear would make money if the shares, now quoted at $98.46, traded below $94.70. They began the year at less than $90.

But we were talking about income. In the *Grant's* spotlight are fixed-to-floating bank-issued preferred shares, a mortgage real-estate investment trust specially attuned to the risk of rising rates, a commercial mortgage REIT and a certain closed-end bond fund. Not one could be confused with a long-dated 6% Treasury bond, which, as you will have noticed, happens not to exist.

Fixed-to-floating preferreds pay semiannual dividends. The payouts are discretionary, non-cumulative and subordinated to the other interest owed by the issuing institutions, among which are four American money center banks. The preferreds are usually callable, even if nominally perpetual. The call date is typically five or 10 years after the IPO.

For instance, JPMorgan Chase's 7.9% Series I perpetual callable preferreds (trading over-the-counter under the CUSIP 46625HHA1) pay that 7.9% dividend every six months

Mortgage REIT mal de mer



source: The Bloomberg

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until the April 2018 call. If uncalled on April 30, the shares start paying quarterly dividends based on a rate of Libor (currently 0.73%) plus 3.47%.

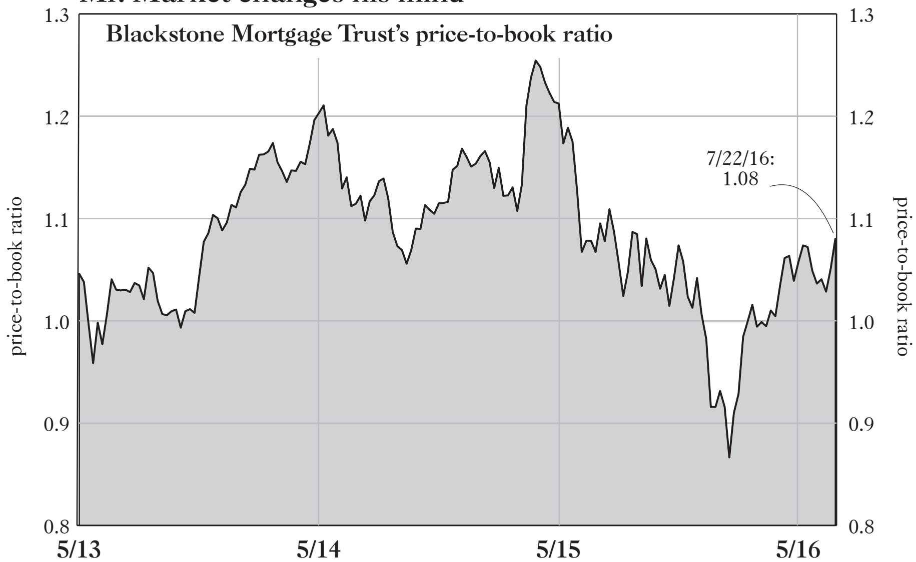
Many preferreds are quoted on the Big Board in dollar amounts rather than relative to par (usually a $25 par for listed shares). The Morgan issue has a par value of $1,000. It's quoted on Bloomberg at a "clean price" of 103.97 to yield 5.5% to call. Thus, a single preferred share would cost the buyer $1,039.70 before accrued interest. After accounting for progress toward the next dividend date, the price would ratchet up to $1,059.22.

Preferreds are the red-headed stepchildren of a capital structure. They rank senior only to the equity, and the ratings agencies judge them a notch or so inferior to their parent's creditworthiness. While JPMorgan Chase carried a long-term issuer rating of A-minus, the 7.9% preferreds are appraised triple-B-minus (by S&P in both cases).

"You can get a current yield close to 6%," a fan of the preferreds, speaking of the fixed-to-floating field in general, tells colleague Alex Hess. "And if inflation goes up and rates go up, that fixed-to-float feature protects them"—as long as the lift-off is not so quick and powerful as to induce a call. "Libor, back before the Fed raised the funds rate for the first time, was selling at 0.24%," our aficionado continues. "Once they raised, it shot up and now it's at 0.73%. Conceivably, we'll be looking at a Libor rate in four years of at least 2%." Add that to a typical spread above Libor that the preferred shares pay, and you have a floating-rate instrument that yields upwards of 6%.

Adverse outcomes are easy to imagine. Rates might fall, not rise. Or rates might rise too fast. As to the latter possibility, imagine that the preferred holders get their long-awaited upside lurch in rates and inflation. "Imagine," Hess adds, "that Libor reaches 7%. The JPMorgan Chase Series I preferred holders, once content with their 7.9% coupon, are ecstatic—their yield is set to rise to Libor plus those 347 basis points, or to 10.47% per annum. The bank's funding costs shoot up, too, even faster than the yield on its assets. Come the April 2018 call, JPM elects to rid itself of its most expensive capital and trains its eyes on that very preferred."

Mr. Market changes his mind



source: The Bloomberg

At this point, the preferred holders are kicking themselves not once but twice, as they have missed a wonderful rally in bank stocks—that is, the common stocks. In 2009, net interest margins for FDIC-insured institutions averaged 3.49%. By the first quarter of 2016, that average had dwindled to 3.10%. The deterioration is duly reflected in the performance of bank equities. While the S&P 500 has climbed by 6.1% this year, the bank component of the S&P index has fallen by 8.9%. Bank of America and Citi change hands at double-digit percentage discounts to book value. BofA, Citi, JPM and Wells Fargo are quoted at between eight and 12 times trailing net income; on average, the four yield 2.2%. Certainly, the share prices have room to run if rates rise and net interest margins fatten.

On, now, to Capstead Mortgage Corp. (CMO on the Big Board), a mortgage REIT constructed to weather a rise in interest rates. The trouble is that mortgage rates have not risen (though Libor has), and Capstead has cut its quarterly dividend three times, to 23 cents a share from 34 cents a share, since the end of 2014. In 2011, the company was earning an interest margin on its mortgage portfolio of 168 basis points. At last report (there was be an update on July 27, the day after we went to press), that spread had shriveled to 90 basis points.

When we last looked in on the company (*Grant's*, Feb. 12), CMO was quoted at 81% of book to yield 11.2%, and Andy Jacobs, the long-serving CEO, was still at the helm. Jacobs and Capstead unexpectedly parted company on July 14. The company declines to say anything more than that CFO Phillip Reinsch, who has been on the payroll since 1993, is running things now. Whatever the reason for Jacobs's departure, the yield-hungry market has taken the news in stride. The shares are quoted at 89% of book value and yield 9.2%. Since the shakeup, they've actually managed a little rally. They are no longer a bargain, an observation with wide applicability these days.

Capstead bears risks common to all mortgage REITs. Thus, the company's long-term capital of $1.4 billion supports assets of $14.1 billion, while the interest-sensitive American mortgagee can (and does) refinance whenever the arithmetic allows it (thereby depriving the investor of the mortgages that he or she would rather keep or, in a time of rising rates, sticking that investor with the assets that he or she would just as soon lose).

Complexity risk is another hazard of mortgage REIT investment. Capstead's brand of adjustable-rate mortgages add a separate layer of complexity. ARMs do not reset as soon as rates rise; the elapsed time to reset varies. As of March, 58% of the company's ARM portfolio was on course to reset in an average of 6.2 months, the remaining 42% in an average of 41.8 months. There are other moving portfolio parts, including the frequency at

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which rates reset and the movement in the interest rates against which the ARMs adjust. Nor should one overlook the risk that interest-rate hedges misfire. Such elements contribute to the sometimes volatile fluctuations in book value that make for mortgage REIT mal de mer.

For all its mechanical complexity, Capstead has given a good long-term account of itself. In the past 10 years, its shares have generated a total return of 16% a year, most of which stemmed from dividend income (out of 341.8 percentage points of total return, price movement contributed 43.1 percentage points). Annaly, the biggest mortgage REIT, produced annual 10-year returns of 11.4%, more than 100% of which stemmed from dividend income; the grand total price change over the period was minus 11%. A sustained period of rising rates would likely burnish Capstead's record.

Blackstone Mortgage Trust (BXMT), a longtime *Grant's* favorite among leveraged income-producing vehicles that are riskier than they seem, invests in senior commercial mortgages. It borrows at Libor plus 2% or so, invests at Libor plus 4¼% and manages to generate a trailing-12-month return on equity in excess of 10%. How? Why, debt: It uses a little more than $3 in financial leverage for every dollar of equity employed.

Blackstone admits it can't compete with banks and insurance companies in lending to fully tenanted trophy buildings. It lends, instead, to the sponsors of buildings that have just lost a big tenant or are otherwise in transition. "If you take a 95%-leased building in Manhattan, they wouldn't be able to compete for that," says a knowledgeable source. "But if a 30% tenant left, and it became 65% leased, then a lot of lenders can't handle that the current cash flow has been temporarily disrupted and isn't reflective of its ultimate cash flows or ultimate value. And that's where they come in."

In exchange for the risk, Blackstone earns a higher rate than the banks and insurers do on their blueblood loans. Its goal is to lend no more than 65% of quoted real-estate value, another form of risk mitigation. At the end of the first quarter (we go to press just before release of second-quarter results), Blackstone's $9.3 billion in mortgage assets was apportioned 45% to office buildings, 20% to hotels, 14% to manufactured housing. New York accounted for 21% of building value, followed by California at 13% and the United Kingdom at 11%. Floating-rate mortgages predominated, at 79% of the portfolio.

"Our credit facilities," Steve Plavin, CEO, told dialers-in to the first-quarter earnings call, "are term-matched or long-term. They are currency- and index-matched, limited-recourse, and we have no capital-market space mark-to-market provisions."

Then came Brexit. July 26 brought news of a 14% post-Brexit markdown in the value of a major residential development at Earls Court in Central London and of the forced offering (by Aberdeen Asset Management) of an office building in Hammersmith, West London. Maybe the second-quarter conference call, slated for July 27, has clarified Blackstone's UK exposures.

BXMT has rallied along with everything else in the world. At 1.1 times book value, 12 times earnings and yielding 8.7%, the shares aren't the bargain they were in February (*Grant's*, Feb. 26). They are an OK speculation on yield in an unyielding market.

It happens that another Blackstone income-producing entity, the Blackstone/GSO Strategic Credit Fund (BGB on the Big Board), also yields in excess of 8% (8.5% to be exact). We'll give this one wide berth.

BGB is a closed-end fund. As of the first quarter, senior secured loans filled 72% of its portfolio, junk bonds 26%. Borrowed funds were equivalent to 32.8% of net assets. The loans paid an average spread to Libor of 5.7%, the average bond coupon was 8.6%.

Credit risk is one thing, leveraged credit risk something very different. And leveraged credit risk—with a 20% exposure to high tech, no less—is what BGB has to offer. Nearly 30% of the fund's assets were rated Caa1 or lower by Moody's, according to material presented by the sponsor. Liquidity risks complement the others. To quote the BGB prospectus: "In general, the secondary trading market for senior secured loans is not fully developed. . . . To the extent that a secondary market does exist for certain senior secured loans, the market for them may be subject to irregular trading activity, wide bid/ask spreads and extended trade-settlement periods."

Why would anyone partake? Basis points of income are the new grains of gold (soon to be supplanted, we expect, by the old grains of gold). The investment zeitgeist was neatly captured by the *Financial Times* in a July 21 story about the refusal of American investors to abandon the marginally higher-yielding money-market funds that the SEC is trying to regulate out of business.

"For now," the paper reported, "the higher yields on prime funds are proving too tempting at a time when investors are keen for returns on their cash against a backdrop of near record-low interest rates." Just how tempting? The so-called prime funds yield 0.27%; government funds, 0.16%. It's a temptation in keeping with the treacherous times. Then, again, in which other times can we choose to live?

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