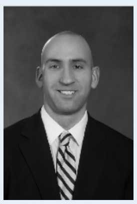
RAYMOND JAMES

September 12, 2022

Bond Market Commentary

Fixed Income Solutions

Making Sense of Callable Bonds



DREW O'NEIL
Director
Fixed Income Strategist

Owning bonds with call features is common for investors with a fixed income allocation consisting of individual bonds. As with any feature of securities you own, it is important to understand how those features work and how they could affect you and your investment portfolio. In today's commentary, I will provide a refresher course on traditional call options and how to think about them in your fixed income portfolio.

If a bond has a traditional call option, it means that the issuer has the option to redeem (or "call") the bond prior to its stated maturity at a pre-determined date and price. For example, if a bond matures in 10 years but is callable in five years at par, the issuer will have the option to redeem the bond in five years at par. Typically, an issuer will choose to exercise the call option when they are able to issue new debt at a lower rate than the outstanding bonds. This could be due to a range of factors, but usually an issuer will be able to issue debt at a lower rate either because the their overall credit quality has improved or because general yield levels are lower than they were when the debt was originally issued. Think of it as refinancing a mortgage: if you are currently paying a 7% rate on your mortgage and you can refinance today at 3%, you will likely take advantage of that option because it will save you money. The same logic applies to a corporate or municipal issuer, if they can reduce their interest expenses by calling in bonds and reissuing at a lower rate, they are likely to do so.

So how should you think about call options when it comes to owning a portfolio of bonds? It all comes down to understanding the risk/reward tradeoff that comes along with calls. Oftentimes, a bond with a call option will offer an investor more yield than an identical bond without the call option. You are earning additional yield for taking on the risks that come along with owning a callable bond.

For example, consider two 10-year bonds priced at par with one of them being non-callable and the other being callable in two years. If the callable bond is yielding 4.25% and the non-callable bond is yielding 4.00%, as an investor you have to weigh the risk/reward based on your own personal situation as to whether you want to purchase the non-callable bond and know for certain (barring a default) that you are going to earn 4% for the next 10 years, or if you want purchase to the callable bond that offers a higher yield with the understanding that the bond might be redeemed two years from now. The risk in the callable bond is that yields are lower two years from now and the issuer calls the bond, meaning that you now have money to reinvest in a lower yielding environment. So you might earn 4.25% for two years, but then (hypothetically) have to reinvest into a bond yielding 2.50%. Compare this to the non-callable bond, where you could earn 4.00% over the next 10 years, regardless of what interest rates do. Neither bond is "better" than the other, but there is a give-and-take that comes along with the differing features. Some investors might purchase the callable bond hoping that interest rates fall and the bond gets called, because their investment timeline is only two years and by purchasing the callable 10-year bond, they are able to earn a better yield than if they were to simply purchase a 2-year bond. The risk in this strategy is that interest rates rise, and while they had hoped the bond would be redeemed in two years, it will likely remain outstanding for a period longer than the two years they had hoped for (this is known as extension risk).

This is a simplistic example, but shines some light on the different ways to view a callable bond. Beyond a basic decision like the one outlined above, there are other ways to "use" callable bonds in your portfolio, which depending on your individual situation may or may not apply. A few common strategies are briefly summarized below.

- If you own bonds that are callable in the next few years, you might consider extending out on the curve now to lock in higher levels of income for a longer period of time. If the bonds you own have a higher-than-market coupon rate or if you are of the belief that yields will fall between now and your bond's call date (making the first scenario likely), there is a decent chance your bonds will get called. The attractive intermediate and longer-term yield levels that are currently available mean it might make sense to sell the near-term callable bonds and reinvest into bonds with either a longer call date or into non-callable longer-term bonds.

- A popular portfolio structure/strategy in the municipal space is to purchase longer maturity, high-coupon (think 5%) bonds that have short to intermediate call dates. The idea is that due to the high coupons, there is a higher likelihood that the bonds will be redeemed at their call dates, yet due to the longer final maturity the investor can likely earn a higher yield-to-call than they would be able to earn if they had simply purchased a shorter term portfolio of non-callable bonds. This strategy comes with the extension risk mentioned above, which may or may not be a concern depending on your unique situation.

- A kicker bond is a high-coupon bond priced at a premium with a short call date and a longer maturity date. These bonds will have a lower yield-to-call than yield-to-maturity. While these bonds will typically get called, if the bond doesn't get called, the yield "kicks" higher the longer it remains outstanding, allowing you to realize additional yield.

- As opposed to municipal bonds, which for longer maturities are almost always issued with a 10-year call, corporate new issues can sometimes come with much shorter call dates, typically ranging from three months to two years. If your portfolio allows for flexibility on when your bonds are redeemed and principal is returned, purchasing intermediate or long maturity bonds with near-term call dates can be a way to earn additional yield relative to a non-callable bond (noting the tradeoffs mentioned in the example above).

The current interest rate environment is offering very attractive yields relative to recent history, which is creating many strategic options for investors. As described above, it may be possible to improve earnings or risk profiles through favorably structuring call features. Contact your financial advisor to discuss these options.

RAYMOND JAMES®

INTERNATIONAL HEADQUARTERS: THE RAYMOND JAMES FINANCIAL CENTER
880 CARILLON PARKWAY // ST. PETERSBURG, FL 33716 // 800.248.8863 // RAYMONDJAMES.COM