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CALLING THE CALLS ON MUNICIPAL BONDS AND HOW TO USE CALLS TO SEEK HIGHER YIELDS

Investors can get hurt by bond calls, particularly when they buy premium bonds without knowing all the calls in advance. And, while most calls are well advertised, there are some that are not so easily detected. You should be especially vigilant, because issuers are often trying to exercise any and all calls possible when interest rates have dropped-whether hidden or well advertised. However when you know all calls they can be used to seek higher yields, both to the call date and to the maturity. This article shows you how.

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So let's take a look at the various types of calls to get a better understanding of the pitfalls as well as the opportunities for gain.

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ORDINARY CALLS

During high interest rate periods almost every issuer tries to get short call features on its debt obligations. But, while some succeed in issuing bonds with various types of short calls, most can not because if the call features are too short, the buyers won't go for it. So to sell their bonds, most issuers are forced to give longer call protection to investors than they would like to–usually 10 years.

There is a continuous supply of bonds that fall into the time period where ordinary calls can be exercised. But even the issuers that gave buyers longer call protection are not totally shut out of the refinancing market when rates are lower. It's true that, unless the call provisions allow for it, issuers can't call in their higher cost debt. But there are other types of refinancing they can use–even for bonds with total call protection as we will explain later.

Some types of calls could spell bad news for the investor, while other methods of refinancing–particularly advance refunding–could result in gains for bondholders. So here's what you should know about the various types of calls and refundings to protect yourself and to help you maximize your return.

HOW CALLS CAN HELP YOU OR HURT YOU

Before we review the various types of calls let's take a quick look at bond arithmetic to gain a better understanding of how calls can be either harmful or beneficial to bondholders. It is important to remember that bond prices are derived from the yield to maturity and not vice versa. That is the key, and the first step to understanding bond arithmetic.

On a discount bond the yield to maturity is the total of the annual coupons over the life of the bond, plus the annualized appreciation rate over the life of the bond. So, if your original yield to maturity was based on an annualized appreciation over a ten year period and your bond is called in five years, you have essentially doubled the annual rate of appreciation and therefore greatly increased your yield. That's why any call on a discount bond can result in a gain for the bondholder.

It is with premium bonds that one has to be more careful. Because with a premium bond the yield to maturity is the total of the annual coupons over the life of the bond, minus the annualized amortization rate of the premium over the life of the bond. So anything that accelerates the amortization rate, such as an early call, reduces your yield. But early calls on premium bonds can only hurt when you don't know about them prior to purchase. Because the proper way to price a premium callable bond is to compute the yield to the worst case scenario—taking all calls into account.

SPECIAL REDEMPTION CALLS

Many municipals and particularly revenue bonds are issued with call provisions that allow the issuer to buy back the bonds at a certain point in time, usually 10 years after the date of issue, and often at a premium price such as 102. With this type of call protection, bondholders are assured of their income at least up to the call date. But some bonds—particularly most Housing Finance issues—have what they call extraordinary call provisions in addition to the standard 10 year call features.

The extraordinary call provisions, or special redemption features as they are often called, are there to protect the issuer, because whenever the issuer is unable to sell any or all of the mortgage money it raises by selling the bonds, it can use the unexpended funds to buy back some or all of the bonds at par. For example, if an issuer is able to place only $90 million out of a $100 million mortgage money pool, the $10 million it has left over will be used for an "extraordinary call" on the out-standing bonds—by random lot.

But with Housing Finance Agency Bonds, the fact that an issue has been around for more than 24 months doesn't protect you either. Because the issuer may also make random lot par calls from the proceeds of prepaid mortgages whenever home-owners are able to take advantage of refinancing at lower rates. The underlying mortgages are about 2% higher than the interest rate on the bond issue that was used to raise the money. And mortgage rates usually have to fall about 2% for significant refinancing to occur, so whenever mortgage rates fall below the coupon rate on your housing finance bond there is a good chance your bond will be redeemed at par.

There is another fairly common type of municipal bond called “Certificates of Participation” or COPS. All of them (except those from Texas) have special redemption clauses, because the funds to pay this type of debt must be re-appropriated annually, even though many of them are general obligations. And while it seldom happens, in the event of a non-appropriation, the bonds must be redeemed at par. So at the very least, be sure to know when you’re buying a “Certificate of Participation.”

SINKING FUND CALLS

Many revenue bonds, in addition to having ordinary call provisions—usually 10 years from the date of issue—also have "sinking funds" that are used to retire debt by calling in bonds. Sinking fund calls are usually done by random lot, and sometimes apply to only one maturity of an entire issue. The bonds are sunk at par and these calls can and do often occur prior to the first ordinary call provision date.

Sinking fund provisions are most common with the various types of revenue bonds. And sinking Fund calls take place in all types of markets because they're mandatory, so the extent to which they take place is dependent upon the bond indenture rather than the interest rates climate. If you buy a bond at par that is subject to a sinking fund call, it is somewhat like playing Russian roulette: if your bond is called when rates are low you will be forced to reinvest at the lower rates, but if it is called when rates are high you'll be able to cash your bond in early and get a higher-yielding bond.

If you buy a secondary market bond that is subject to a sinking fund call and you pay a premium for it, be sure you know when the sinking fund starts, and how active it is, because if it is suddenly sunk on you, it could result in a loss, unless the sinking fund was taken into account at the time of purchase.

If you buy a bond at a discount you can only gain from a sinking fund call and the sooner the sinking fund call occurs, the more substantial your gain will be.And with a discount bond, the presence of an active sinking fund will help protect your principal if bond prices fall, because in essence a sinking fund shortens the average life of your bond and short bonds protect your principal better.

PRE-REFUNDING CALLS

Any substantial drop in interest rates can create a situation in which bondholders with high-coupon issues might suddenly find their bonds are pre-refunded (i.e. already called for the earliest possible future call date as set forth in the bond indenture). The pre-refunding of an entire issue occurs when municipalities have issued bonds that gave investors a period of call protection—say ten years from the date of issue—and because of that, the issuers now find themselves unable to take full advantage of the lower rates by calling in the old bonds and issuing new ones. So they do the next best thing. They bring out a new issue at the lower rates and invest the proceeds from the new issue in U.S. Treasuries, to be held in an escrowed account for the specific purpose of paying off the old issue at the earliest possible call date.

The issuer benefits if it is able to get a higher rate on the taxable Treasuries than the tax-free rate it pays out on the new issue. And they use the interest differential they earn to help reduce the more expensive interest rate cost on the original issue. The original issue bonds are commonly called pre-refunded bonds, and they become tax-free bonds backed by the U.S. Treasury.

From a bondholder's point of view, it is very important to know if any of your bond holdings have been pre-refunded because that is the day they will mature. Pre-refunded bonds usually wind up with short maturities and a call premium bonus, so if you know that your bonds are already pre-refunded you may wish to consider trading them in now to take a profit and get another longer term bond with more yield.

Any Stoever Glass representative will be happy to check your bonds to see if any of them are already pre-refunded or are likely to be pre-refunded.

ESCROWED TO MATURITY

Issuers can lower their interest costs even on bonds that have no call features or special redemption provisions by doing almost the same thing they do when pre-refunding an issue. They might take advantage of the taxable versus the tax-free interest rate differential by arbitraging. Issuers bring out a new lower-cost tax-free issue and put the proceeds into an escrowed account of the higher yielding taxable Treasuries—which are then used to secure the retirement of their older issue at maturity. Once again, the benefit to the issuer is that it can use the extra interest earned on the higher yielding Treasuries to help make payments on its previous high cost obligations.

In the process bondholders are rewarded with what many experts consider to be the "best of both worlds." Their escrowed bonds go up to the highest quality, giving them a sudden price gain, and yet their bonds are still not subject to an early call. So the bondholder can either hang on to the highest quality bond purchased at a low price, or sell it at a profit and buy another bond.

As you can see, there are various ways of losing or gaining from calls. To protect yourself and maximize your profits, you must know all calls and all of the other redemption provisions of your bonds prior to purchase. We'll be happy to help you with these thorny problems. Just call any Stoever Glass account representative.

HOW TO USE CALLS TO SEEK HIGHER YIELDS KICKER BONDS

There is a fairly common type of bond that provides some extra yield for investors who find them suitable. They're callable premium bonds, which are priced to give a yield to the "call date" which is higher than comparable bonds maturing on that date. And since callable bonds are always priced to the call date that produces the cheapest dollar price to the buyer, the yield to maturity is always much higher if the bond isn't called. They're commonly referred to as "kicker bonds" because the yield to the call kicks up to a higher yield to maturity. The only disadvantage is that since they are callable, they are not suitable for people who want their bonds to mature on specific dates. However, for investors who are satisfied with a maturity range rather than specific maturities, kicker bonds represent some of the best values in the bond market. Because it is possible to find bonds which have the call date and the maturity fairly close together – five or six years apart for example. So they're ideal for investors who like current income bonds in the short to intermediate maturity range.

If some of your bonds are called you still have a better yield than you could have purchased with the same maturities as your call date. But it is unlikely that all of the bonds in a portfolio of this type will be called, and whenever that happens your yield automatically kicks up. The net result will be a portfolio of higher yields – slightly higher than comparable maturities for those that are called and a much higher yield to maturity than non-callable bonds of the same maturity.

SUNKEN TREASURE

Bonds with sinking funds can also net you much higher tax-free returns when coupled with the proper strategy and sufficient expertise.

Common to many long term revenue bonds, sinking funds require that the issuer

begin to retire bonds prior to maturity. In this way sinkers are a little like call features, except that calls are at the option of the issuer, while sinkers follow a mandatory retirement schedule. The amount of bonds to be sunk at par (100) each year is specified at the time the bond is issued and must be carefully adhered to.

And since we know the final maturity, the number of bonds originally issued and the mandatory sinking fund schedule, we can easily check the average life of the issue on our Bloomberg system. In fact we can also send you the Bloomberg print out, which will verify the average life as well as the various yields. So bonds of this type can be priced to a predictable average life, and they usually yield more to the average life than other bonds in the same maturity range.

There is one catch, however. Investors who buy bonds priced to the average life must invest in a quantity that is large enough to make the "average life" valid. Sinking funds are done by random lot, so if you have ten or twenty bonds out of a $300,000,000 issue you could be unlucky and have the majority of your bonds sunk early. That could result in a loss of principal because sinking fund bonds which are priced to the average life, usually have negative yields to the first few sinking fund dates. So the larger the amount of a sinking fund bond you can buy, the more assurance you have of approximating the average life, and with it a higher yield to maturity.

Occasionally bonds with sinking funds can be bought and sold the same way callable "kicker bonds" are, but this is more difficult because they are usually priced to the average life as indicated above. However we do manage to pick up some "sinker kickers" from time to time.

SPECIAL REDEMPTIONS SPECIAL PRICES

Since they are subject to special redemption, Housing Finance Agency Bonds, traded in the secondary market, often have much higher yields than other bonds of similar maturities and ratings. So you can use the possibility of a special redemption to your advantage, because as with everything else, knowledge reduces risk. For various reasons, some Housing bonds have less risk of redemption than others, so a knowledgeable trader can use the threat of redemption to get you a higher yield with a very worthwhile risk-reward relationship.

Although the above information and statistics are not guaranteed, they have been obtained from reliable sources and are believed to be accurate.