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All Bond Portfolios

An Analysis of Step-Up Fixed Income Securities

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Introduction

We received a request from a newsletter reader to explain securities that pay a fixed rate of interest for a limited time and then a higher rate or rates of interest in subsequent years. This type of security is referred to as a step-up. They may be issued by corporations, federal agencies, or as certificates of deposit.

On January 6, 2017 we received an offer for some step-up certificates of deposit (CDs). At first glance, the step-up CDs appear more attractive than fixed rate CDs – meaning that the step-up seemed to yield more.

Step-ups definitely attract attention. The step-up coupon or initial interest rate may start slightly higher or lower than the current market rate depending upon the competition and the necessity of the issuer. They may have one or more rate increases, topping off at 6 to 8 percent or more before the step-ups come due. At the same time, the step-ups generally have short and frequent calls.

The step-ups may not be better than a fixed income bond. If what drew you to the step-up was those big yield numbers, think again.

Considerations

What are some of the considerations in purchasing these step-up securities?

Interest Rates Have Three Possibilities:

- Stay the Same: Step-ups may be called early if it is in the best interest of the issuer.

- Rising Rates: Buying step-ups is a bet by you that interest rates will be rising and you will reap the benefit - if the issuer chooses not to call them.

- Falling Rates: If interest rates fall, the step-ups will probably be called away since the issuer may then refinance its debt at a lower interest rate. If you had invested in a fixed income security with a defined maturity and call protection, then you may have a higher return.

Liquidity

- Trade liquidity – the ability to sell at a good price is less likely with step-ups because of the possible calls.
- Return of capital – the timing is unknown due to possible calls, which may occur on any interest payment date after the first call, with a notice given 15 days before the call.

Credit Risk for Corporate Step-ups

- Step-ups may lock you in if the credit situation deteriorates.
- A shaky credit situation may be why step-ups are issued.

Description of the Step-Up

Big Bank Certificate of Deposit (CD) Step-Up 84 Months – 7-years
Callable 01/18@100 - Multi-Step Coupon

Step-Up CD Date-	Coupon Rate	Step-up CD Actual Yield to Date	Non-Callable Fixed Rate CDs Actual Yield to Date
01/20/2017 -	2.000%	2018 – 2%	2018 – 1%
01/20/2020 -	3.000%		2020 – 1.6%
01/20/2022 -	4.000%		2022 -- 2.05%
01/20/2023 -	6.000%		2023 – 2.5%
01/20/2024		2024 – 2.813	2024 – N/A

With a quick review it appears that you are getting 2 percent on the step-up in 2017 – an above market rate. In 2020 the coupon becomes 3%, but your yield would not be 3% because the yield would be the aggregate of all the interest accumulations since the date of issuance of the bonds.

At the initial offering, fixed income CDs in 2022 were yielding 2.05% and 2.50% in 2023. If the step-up CDs are not called, the yield on this step-up would be 2.813% in 2024, according to the initial public offering- nowhere near 4% or 6%. What are you missing?

<u>If the Step-ups are Called</u>: In this example, you would make an above market return to the call date in 2018. This may encourage you to reinvest into step-ups, if in your experience the step-ups you bought got called. This

might be considered easy money. Why not make 2% when the going rate is 1%?

Actual Step-Up Yield if Not Called: Not 4% or 6%. Your yield to maturity, assuming that the step-ups are not called early, would be 2.813% for seven years (2024) according to the new issue offering – nowhere near 4% or 6%. This is because the majority of the compounding occurs at the lower rates in the early years (2-3%).

In addition, the lower yields come first and the high yields quoted are for a very short time and at the end of the maturity of the step-ups. Unfortunately, there is not enough time for the higher rates to make much difference in the overall return.

Advantages and Risks of Step-Ups

The expected advantage of the step-up based on the high coupons, is the possibility of above market return based on the time of purchase if interest rates rise rapidly. Even though you won't make 4% or 6%, at the time of sale a 2.813% taxable return might be somewhat better than a fixed income CD purchased to the same maturity date. However, you give up control of how long your investment will be outstanding due to the issuer having the option of calling away the bonds. Here is how the risks stack up.

One disadvantage is *reinvestment risk.* It costs you money to buy securities and you pay for each transaction. If they are called prematurely, you must pay again to purchase new securities. If the issuer calls the bonds, the reinvestment yields may be lower than your initial investment.

You may have *liquidity risk.* You may invest funds that you know you will need short-term, anticipating that the step-ups will be called and they are not. You may also incur *liquidity risk* if you must sell them into an unfavorable market because you cannot hold them to maturity. If they are not listed on an exchange, you will have no way of evaluating the sale price.

You may be comparing apples and oranges. You expect that if there is a lot of inflation, you will be protected as you might be with Treasury Inflation Protected notes (TIPs), by getting a higher yield. As we saw in the example above, the yield is not what it appears to be at first glance. It is probably those 4% and 6% coupons that attracted your attention, not the actual yield-to-maturity. What you see is NOT what you get (WYSINWYG).

Corporate issuers of step-ups may be weak credits. You may incur *credit risk* if the issuer is downgraded, compounding the problem if you need to sell. If the yield is really high on the longer end, it may be that the issuer is an angler fish that might turn into a junk bond in the future.

Thinking Guidelines

How do you protect yourself from believing in something which is not likely to occur?

- When offered a product that immediately seems very attractive, set it aside.
- Think about why this product might appear so much more attractive than other similar offers.
- Set your expectation by reviewing similar fixed income new issues to get an understanding of the current market. Then ask the question: Why is this offering yielding more?
- If you state that you want a return of 6 percent, which is not available on high quality securities ask: Why is this security different from all the other securities?
- Ask if there is any verification of the yield from a third party provider.