Why Are All Your Bonds Being Called?

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Change happens whether we like it or not. It happens in our individual lives and in the lives of those around us. Forces push and pull at society, changing social and business relationships. The standard black telephone made way for innovation. Now cell phones and other means of communication let us go anywhere while staying in touch. We are no longer tied to the stationary phone – the land line. One business cannibalizes another.

In the year 2020, lower coupon bonds are cannibalizing higher coupon bonds. Munch and crunch – 5% coupons are replaced with coupons in the ones and twos. This results in reduced income streams and greater risk for long-term investments.

As a result of the COVID-19 pandemic, the phrase, "pulling forward" has been used a lot in business commentary, coupled with the word '"demand." Companies are forced to sell today's goods or service at the expense of future revenue. This concept might apply to a company like Peloton. Stay-at-home workers are buying Peloton bikes so that they can exercise at home, while otherwise they might have gone to exercise at the gym, delaying such a purchase.

Demand pulled forward funeral services at Service Corporation International, America's biggest death-care company[i]. It had 12,000 customers in the last quarter, many of them elderly. Increased demand came as states saw an increase in mortality among people infected by the COVID-19 virus, who might otherwise have lived longer.

How are bonds pulled forward?

Bond issuers often have the option to "call" or redeem long-dated bonds before their maturity date. The issuers pull forward the repayment of the debt, in order to refinance at a lower interest cost.

The issuers pull forward the redemption date of the bonds, which then creates demand for future new issuers. This article describes how and why issuers generally demand one or more call provisions when they sell bonds.

Understanding bond yields and how they are affected by calls

Before you can understand how bond issuers can pull forward the redemption dates for bonds, it is important to focus on the basic language describing bond values. The basis for comparing one individual bond to another is based on time value of money calculations called the yield-to-maturity (YTM) together with the yield-to-call (YTC). The YTC is also sometimes called the yield-to-worst (YTW). The yield-to-worst describes the lowest yield that you could earn on the bonds. Generally, this occurs if a bond is called at its first call date.

In the time value of money calculation, it is assumed that it is better to have the money now then get paid later. Because of the delay in returning the money, the borrower makes interest payments to compensate the lender for the use of the money.

When you purchase a bond, you are told the following:

- Present value – the price you pay for the bonds;
- Fixed interest rate – what percentage you will be paid annually;
- Optional call date – when a bond can be redeemed prior to its due date; and
- Final maturity date – when the bonds come due and your money is returned to you.

You can calculate the future value of the investment by putting this information into a handheld financial calculator. The number that is returned is the YTM if you used the maturity date or YTC or YTW if you used the call date.

If bonds are continuously callable there is no way to calculate your return. Your bonds could be called the day after settlement. Depending upon who is advising you, you might purchase bonds that you think are not-callable, only to find out that there is a sinking fund that pre-maturely retires some of your bonds. In either of the above cases, you might end up with a negative yield.

These calculations do not take into account the fluctuating value of the bonds, which will be redeemed at par or face value. Thus, if you purchased a bond with a face value of $10,000, it will pay $10,000 when it is called or comes due, whether you paid more, less or the exact same amount as the face value at the time of purchase.

These calculations are different from calculations used to determine the price or NAV of mutual funds and ETFs, which are not time-value—of-money calculations. Total returns for bond funds and exchange-traded bond funds are combinations of interest payment and changes to the price of bonds in the portfolio. Though bond funds are equally affected by early call dates as holders of individual bonds, the bond fund or ETF holder is not aware of how the funds are being impacted by issuers pulling forward the redemption dates of the bond portfolio holdings.

What are the types of calls?

There are numerous ways that bond redemptions can be pulled forward. Municipal bond issuers use all of them, but tend to make the most use of the first four items below. Corporate bond issuers tend to use the last three, though they often have a fixed call as well, which is a favorite of municipal issuers.

- Fixed call – Call set at the time of issuance. For example, a bond with a maturity of 10/15/2040 might have a fixed call on 10/15/2030, after which the bonds are callable at any interest payment date.
- Pre-refunding – Call that transforms a possible fixed call into a permanent call generally at the first call date. For example, if a bond had a maturity of 10/15/2040, it may be pre-refunded to a fixed call date of 10/15/2030, which now become the final due date.
- Extraordinary calls – For a variety of possible reasons outlined in the prospectus, the bonds can be called at any time.
- Sinking funds – Calls dates requiring a redemption of a fixed number of bonds a few years before the final maturity, established at the date of issuance.
- Make-whole call – A redemption of bonds at par, plus a penalty paid to the bond holder based on Treasury bond yields. If you have purchased the bonds at a premium, you may lose some or all of the premium you paid.
- Mandatory tender – Bonds with a short call and a long maturity – usually corporate issuance. Bonds are called, the interest rate adjusted, and the bonds are put back to the bond holder, with a new call period.
- Optional tender – Bond issuers offer an incentive to encourage bond holders to sell their bonds to the issuer early – usually corporate bonds.

Other reasons bonds are called

While bonds have always been called to improve an issuer's flexibility and financial situation, we are seeing some calls for purposes that are unusual for high quality issuers.

"Scoop and toss"

When a municipal bond is issued, it is supposed to fund a particular project. Bonds are issued to fund a variety of construction projects that need long--term financing for long-term benefits, such as the construction of sewer mains or water pipes, roads and bridges, municipal buildings, schools, hospitals and many other large projects.

In what is known as "scoop and toss," bonds are refinanced for the same project and maturities are extended. Often when this is done it reflects a deteriorating financial condition of the issuer. In the current uncertain world, it is being done to take the pressure off issuers, such as colleges and stadiums that have suffered from the impact of COVID-19.

For example, State of Virginia's Democratic legislature has voted to rework the budget and continue to pay its state-funded colleges and universities at previous levels. The colleges are unable to open fully and must also teach remotely. This is impacting their revenue streams. In the fall of 2020, the VA state government allowed the universities to refund outstanding bonds and add two years to the back end of the deals – like refinancing your home mortgage and extending the length of time you have to pay back your loan. This will provide the universities two years of cash flow relief so they can better weather the impact of COVID-19.[ii]

In this scenario, the colleges and universities call in the outstanding bonds and reissue new bonds paying a lower interest rate with longer maturities. Say goodbye to 4% and 5% coupons.

Other issuers are doing the same thing. For example, the North Texas Tollway Authority is faced with an unanticipated decline in traffic as people started working from home and stopped traveling. In October 2020, the North Texas authority refunded bonds. Since interest rates are unusually low, the issuer was able to achieve significant savings, and buy the authority breathing room in the hopes that the unpredictable decline in traffic will be reinvigorated over the next couple of years.

The outstanding bonds are called in, bond holders paid off, and the issuer floats new bond issues to refinance the outstanding bonds at lower interest rates. This is in effect a tax on bond holders who find themselves reinvesting in bonds at lower and lower rates of interest. Who said there is no wealth tax?

"Cut cash cushion"

Companies, such as telecom giant AT&T, beer brewer Anheuser-Busch, InBev SA and oil company BP PLC, rushed out to raise cash early in 2020 in response to the threat of the coronavirus on their businesses.[iii] Toward the end of 2020, they saw that the world economic situation has stabilized and they do not need so much cash.

The issuing companies often use optional tender offers to buy back their outstanding debt – offers that you should ignore unless you are given a premium to give up your bonds or you need the cash. Sometimes the tenders are mandatory, in which case you have no choice. Issuers can also exercise call provisions – those calls you may have ignored when you bought the bonds thinking they will never exercise them.

The Federal Reserve has bought corporate debt, and the European Union ramped up its purchases of debt obligations in the fall of 2020. The Federal Reserve released its minutes on October 7, 2020, showing its intention is to keep interest rates low for a long period of time. That will result in an extended period during which issuers will call in their bonds and issue new ones at lower rates.

The advisor's options

It is very disheartening to see 5% coupon bonds being called that you may have purchased at par or a low premium and replaced with a 5% coupon purchased at a high premium and a lower yield. However, the key to investing long-term is to keep your principal safe. By investing in long-term projects that are vital to the survival of our nation, you can align your investing with the needs of the country.

If interest rates do rise, as they will at some point in the future, you will be able to reinvest your interest payments at higher returns. In stocks they call this dollar--cost averaging. It applies equally to bonds.

We are always in the midst of uncertainty caused by one factor or another. Today it is COVID-19, wildfires, diseases, recessions and elections. Every challenge is an opportunity for someone. We do not know the turmoil of tomorrow or how to benefit from it. However, we do know that we need to keep our principal safe and live to play another day.

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[i] Overheard. *The Wall Street Journal. 9/30/2020.*

[ii] Shelley Sigo. "Virginia plans 'scoop-and-toss' deals for higher ed pandemic relief,"*The Bond Buyer.* September 20, 2020.

[iii] Anna Hirtenstein. "Companies Cut Cash Cushions to Buy Back Debt,"*The Wall Street Journal.* October 7, 2020.