Bond Case Briefs

Municipal Finance Law Since 1971

For Whom the Bond Calls.

Like most bond investors, you probably check your online brokerage accounts two to three times a week. You might brace yourself for alerts advising you that another bond or two is being called. You may flinch, wince and may even shout a few expletives. Welcome to the insane world of zero/negative interest rates whose ramifications are painful.

The global drive for yield has broken all the rules: Europeans, Asians and foreign corporations are buying taxable and tax-free municipal bonds like crazy. The tax status is irrelevant; it's the yield that matters. The global demand for all U.S. bonds has been insatiable. You may hate U.S. bond yields but foreign investors find them luscious.

Think about it. If you are a German citizen or the cash manager of a German insurance company and have a choice of investing in a ten-year German bund at 0.02% or a ten-year U.S. Treasury at 1.65%, which would you choose? Asked and answered. Plus, capital flows are a simple click away.

With interest rates grinding lower, it's important to stay on top of your bond positions. A perfect example is municipal housing bonds. These are bonds used to finance multi-family or single family mortgages secured by the payments of the underlying mortgage loans. These bonds raise money for affordable housing. Most states issue such housing bonds. Their credit quality overall is good but there is a downside. When there are mortgage prepayments, unexpended, unused proceeds from the bonds issue—you guessed it—bonds can and will be called. If you paid a premium when you purchased the housing bonds and the bonds get called at par, the yield you thought was locked in wasn't.

Many of my California clients and I own California State Department of Veteran Affairs Home Purchase Revenue bonds. Bonds were state and federal tax exempt, 3.50% due December 1, 2021. When the bond was issued in 2011 it had serial maturities going from December 2013 to the longest dated maturity of December 2028.

As rates have continued to grind down we looked at which bonds have been called and where we stood in the maturity conga line. We were right in the line of fire. Most bonds in the series have already been called. Even though the 2018-2020 maturities are non-callable, they have caveats: Bonds can be called, "from unexpended proceeds at any date prior to their respective stated maturity dates," according to the official statement.

As you can imagine, our bonds were selling at a premium over par value, roughly $110 ($1,100 per 1,000 face value). Brokers' bids varied widely and wildly. The low bid was $107; the high bid was $109.983. What were the odds that our issue would be called at par? Difficult to say. But we've seen other lower coupon housing bonds called. So the old saying, "a bird in the hand…" We sold our bonds at the high premium and let the new owners worry about losing their premium.

Bottom line: Check your bond positions for call provisions—both those that are clearly stated and those that have unusual call features. If you aren't preemptive and sell, then your premiums will vanish. 'Tis the season of low interest rates."

All issuers—taxable, tax free, corporations, government agencies—wish to lower their net interest costs. Calling bonds is one way to accomplish this. Good for them, bad for us bondholders.

FORBES

MARILY COHEN

JUN 13, 2016 @ 12:18 PM

Marilyn Cohen is founder and CEO of Envision Capital Management, Inc., a Los Angeles fixed-income money manager.