



Calling All Investors

Different option types can dictate bond yields and performance

By Jim Reber

Since spring has arrived for most of us, maybe our thoughts can turn to some midyear vacation spots. Actually, vacation spots are never far from my thought progression. It's just that the subject matter of this column happens to conjure images of places most of us would rather be (not that there's anything wrong with Main Street, USA).

I would like to talk about agency bonds with options both foreign and domestic. Most community banks own some. About 14 percent of the typical ICBA member's investment portfolio consists of these items, so they are a major contributor to the bottom line. They have a high degree of liquidity and are easy to transfer and pledge. Also, because their principal doesn't amortize, their cash flows are much more straightforward than they are for mortgage securities.

However, as investors in these items have continually asked for more yield, the financial engineers who create bonds have found ways to (potentially) enhance their returns. These bond-builders' medium is optionality, and there is more raw material on their construction sites than ever before.

So come along as we tour the far-flung, the exotic and the domestic

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versions of call options. You'll return with a reinvigorated sense of wizened investing.

Callable mechanics

As we board, let's review how callable agencies work. Originally, the government-sponsored agencies financed their activities by borrowing money for a stated term. These types of loans, which had no call features, are still being used today for about 10 percent of the total outstanding balances. They are generically known as "bullets." They also have the lowest yields of any agency debt.

Soon buyers began clamoring for higher returns, and they eventually struck a deal with the borrowers: The

debtors could repay their debt early, on one defined date in the future, and they would pay a few basis points more for the privilege. These one-time callables have what is known as a European call option.

Next on the tarmac, with incrementally higher coupons, were bonds that featured the mellifluous acronym AIPD, or any interest payment date. This in effect means every six months, and has long been the favorite of bonds issued by the Federal Home Loan Bank system. These have been given the tag of a Bermuda option.

Still more yield was the need for a certain number of buyers, so another version was rolled out which gave

the borrower the right to prepay the loan on any business day after the initial “lockout” period ended. Since one can contend that the higher yields make these bonds cheaper than the first two examples, it makes sense that this structure would carry the label of an American option (although I know some bankers who have other adjectives to describe these continuously callable gems).

More recently, investors asked for a combination of the first two bonds, in which the borrower could prepay the loan on more than one occasion, but at some date the loan became non-callable. This middle-ground callable has what is known as a Canary option, ostensibly because the Canary Islands are situated between Europe and Bermuda. And you thought advanced finance was complicated.

Shop and compare

So the question for investors becomes, Which version is best? There is no doubt that the day a callable is purchased, the one with the most call dates will have the highest yield. Here’s an example from earlier this year.

On March 19, the FHLBank issued a four-year note with a European call (in two years). It had a 1.50 percent coupon and was priced at par. The same day, Freddie Mac issued a four-year note with an American call (beginning in six months). It had a 1.70 percent coupon and was also

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priced at par.

The value of these two bonds will move in tandem for about six months, until the first call date arrives for the Freddie Mac bond. After that date, they will still be about the same if market rates rise; if rates are stable, or if they fall, the FHLBank issue will see its price increase, unlike the Freddie. This is due to the fact that the Freddie Mac bond is eligible to be repaid any business day. The result is its market value will never again be over par.

What is interesting is that the bond with the higher coupon, and more call dates, will outperform the other if neither bond gets called. They both mature in four years, and one has a higher yield. This is what would happen in a protracted rate-hike environment.

Your best option

Tell me if you’ve heard this before: Diversify, with a bias toward owning bonds with fewer call options. A community bank portfolio with some European, some Bermudan and some American features will approximate the yield of the general agency market

over time. This is especially so if some parts of the portfolio are purchased in the secondary market.

The main benefit of buying a bond after it has been initially settled is that the market has taken some of the guesswork out of the optionality. If, for example, you are offered a bond at 102 cents on the dollar that was worth 100 cents a few months earlier, it is clear that the first option is in-the-money to get called. A bond being worth a less than 100 is a great indication that it may be around for a while.

As you contemplate your metaphorical travels through the wonders of the callable agency lands, keep this brochure handy. Buying new and seasoned issues, with a variety of different call features, is the best strategy for arriving at your preferred destination. **IB**

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