Guide to Bond Investing: Callable Bonds

This article touches on the distinguishing features of callable bonds and guides you through the basics of callable bond investment.

- **What is Callable Bonds?**
  Callable bonds can be redeemed or paid off by the issuer prior to the bond's maturity date. The bond issuer has the option, but not the obligation, to buy back (call) the bonds from the bond holders at a defined call price to term after an initial non-call period.

- **Why Issue Callable Bonds?**
  The primary reason that companies issue callable bonds rather than non-callable, "bullet maturity" bonds is to protect them in the event of interest rates drop. Another reason for companies to issue callable bond is that it send a strong positive signal to the market about the quality of their business.

- **What are the Odds of being Called?**
  In a rising interest rate environment, bonds are less likely to be called and investors should expect to hold bonds until maturity; while in a decreasing interest rate environment, bonds are expected to be called and investors face the risk of losing current income.

- **Investing in Callable Bond**
  With callable bonds, investors are taking the risk that issuer may redeem their bonds prior to the stated maturity date. However, to compensate investors for the reinvestment risk and unknown final term of investment, callable bonds generally offer higher yields than non-callable comparable alternatives.

What is Callable Bonds?

A distinguishing feature of callable bonds is they can be redeemed or paid off by the issuer prior to the bond's maturity date. There are three primary types of call features and the most common one is optional redemption, others are sinking fund and extraordinary redemption. For optional redemption, the bond issuer has the option, but not the obligation, to buy back (call) the bonds from the bond holders at a defined call price to term after an initial non-call period. A call schedule is determined at the time of issuance and bonds may only be called on specific dates or at any time after the non-call period depending on its call options (see Table 1).

Table 1: Forms of Call Options

American Call	Known as "continuously callable", issuer has the right to call a bond at any time starting on the first date the bond is callable until maturity.
European Call	Known as "one time only call", issuer has the right to call a bond only once on a predetermined date.
Bermuda Call	Issuer has the right to call a bond on interest payment dates only.
Make-Whole Call	Issuer has the right to call the bond prior to the stated maturity date at par plus "make whole premium". The call price is based on a comparable Treasury plus a predetermined yield spread; therefore, neither the call price nor the yield to call can be predicted.

Source: iFAST Compilations

Why Issue Callable Bonds?

The primary reason that companies issue callable bonds rather than non-callable, "bullet maturity" bonds is to protect them in the event of interest rates drop. An issuer may choose to redeem a callable bond when current interest rate drops below the issuance rate of the bond. That way the issuer can restructure their debt profile by repaying the bond and refinance at a lower interest rate. This is especially crucial for a declining interest rate environment. Without callability, issuer that issue bonds at a high interest rate could find itself locked into a high rate and continued to finance its debts at the old, higher rate. Callable bonds allow issuers to hedge against possible decreases in future interest rates and give them the options to refinance when interest rates are low. Another reason for companies to issue callable bond is that it send a strong positive signal to the market about the quality of their business. Companies that are confident about their business and believe that their credit quality will improve in the future often issue callable bonds; as soon as market realizes their better values, they can simply call the old higher rate bond and replace it with a lower rate bond due to lower borrowing cost from their improved credit quality. On the contrary, companies with credit quality that is likely to deteriorate in the future will issues non-callable rather than callable bonds to lock in a fixed financing rate.

What are the Odds of being Called?

The direction of interest rate not only is an important factor in the fixed income space, but also plays a crucial role in determining the odds of early redemption (see Table 2). In most

circumstances, calls occur in a lower interest rate environment; when the time to maturity has diminished to a point on a yield curve where rates are lower. In a rising interest rate environment, bonds are less likely to be called and investors should expect to hold bonds until maturity; while in a decreasing interest rate environment, bonds are expected to be called and investors face the risk of losing current income.

Table 2: Interest Rate Effects on Callable Bonds

Direction of Interest Rates	Effect on Callable Bonds
Increasing	• Bonds are less likely to be called. • Investors should expect to hold till maturity. • YTM comparable or higher than non-callable bonds to compensate risk of call. • Higher coupon callable bonds are less sensitive to rising interest rate
Decreasing	• Bonds are likely to be called. • Investors face reinvestment risk in the lower interest rate environment. • Investors face the possibility of losing current income. • YTC* is usually higher than the return offered on comparable shorter-term non-callable bonds.

Source: iFAST Compilations
*YTC = Yield to Call

Before investing in a bond, investors should always be aware if there is a call provision and if so, when and under what circumstances the bond can be called. With callable bonds, investors are taking the risk that issuer may redeem their bonds prior to the stated maturity date. And if the bonds are called, which generally happened when interest rates decline, investors may have to accept lower income payments as bond proceeds are reinvested at lower coupon rates. However, to compensate investors for the reinvestment risk and unknown final term of investment, callable bonds generally offer higher yields than non-callable comparable alternatives.

Investing in Callable Bond

Many investors use callable bonds within a total return strategy, with a focus on capital appreciation as well as income stream, as opposed to a buy and hold strategy focused on income and preservation of principal. Callable bonds are not suitable for investors interested in steady income and predictable returns. For this type of investors, callable bonds present an uncertainty and too much reinvestment risk. The term of the investment may be shorter than expected and the option to call the bonds belongs to the issuer and not the investor. If the bonds are called prior to maturity, the interest payments will stop and investors may have to reinvest proceeds at lower yields. When deciding whether to invest in callable bonds, investors should check for the call premium, call date, yield-to-call, yield-to-worst and other key factors before making an investment decision. The amount of extra yield and the call protection period should be commensurate with the investor's investment objectives. Moreover, since calls are not mandatory and cannot be forecasted with certainty, investors should analyze multiple scenarios that compare earnings for different call dates.

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This article is not to be construed as an offer or solicitation for the subscription, purchase or sale of any bonds. No investment decision should be taken without first viewing a fund's prospectus. Any advice herein is made on a general basis and does not take into account the specific investment objectives of the specific person or group of persons. Past performance and any forecast is not necessarily indicative of the future or likely performance of the bond. The price of the bond may fall as well as rise. Opinions expressed herein are subject to change without notice.

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Bonds are mainly for medium to long term investment, not for short term speculation. Bond investments are not bank deposits and involve risks, including the possible loss of all principal amount invested. It is the issuer's responsibility to pay interest and repay the principal of bonds. If the issuer defaults, the holder of bonds may not be able to receive the interest and principal invested. The holder of bonds bears the credit risk of the issuer. All pricing is indicative only and bond prices do fluctuate when market changes which may cause loss of principal, and that there may not be a secondary market for bonds. Factors affecting market price of bonds include, and are not limited to, fluctuations in interest rates, credit spreads, and liquidity premiums. Investors investing in bonds denominated in non-local currency should be aware of the risk of exchange rate fluctuations which may cause a loss of principal. Investors should refer to the respective Credit Rating Agencies (Moody's, S&P or Fitch or others as the case may be) for their rating definitions, methodology in evaluating the creditworthiness of the issuers and how the ratings are assigned. Rating agencies may change their ratings at short notice. A change in rating may affect the price of securities outstanding. Each prospective investor should consult independent professional advisers before making any investment decision based on your particular circumstances, in particular, in determining the suitability and accessing the investment risks of any securities or other financial instruments.

Key risks of investing in bonds

- Credit risk - bonds are subject to the risk of the issuer defaulting on its obligations. It should also be noted that credit ratings assigned by credit rating agencies do not guarantee the creditworthiness of the issuer;
- Liquidity risk - some bonds may not have active secondary markets and it would be difficult or impossible for investors to sell the bond before its maturity; and
- Interest rate risk - bonds are more susceptible to fluctuations in interest rates and generally prices of bonds will fall when interest rates rise.

Key risks of investing in high-yield bonds

- Higher credit risk - since they are typically rated below investment grade or are unrated and as such are often subject to a higher risk of issuer default;
- Vulnerability to economic cycles - during economic downturns such bonds typically fall more in value than investment grade bonds as (i) investors become more risk averse and (ii) default risk rises.

Bonds with special features

Some bonds may contain special features and risks that warrant special attention. These include bonds:

- That are perpetual in nature and interest pay-out depends on the viability of the issuer in the very long term;
- That have subordinated ranking and in case of liquidation of the issuer, investors can only get back the principal after other senior creditors are paid;
- That are callable and investors face reinvestment risk when the issuer exercises its right to redeem the bond before it matures;
- That have variable and/or deferral of interest payment terms and investors would face uncertainty over the amount and time of the interest payments to be received;
- That have extendable maturity dates and investors would not have a definite schedule of principal repayment;
- That are convertible or exchangeable in nature and investors are subject to both equity and bond investment risk; and/or
- That have contingent write down or loss absorption feature and the bond may be written-off fully or partially or converted to common stock on the occurrence of a trigger event.