Callable Bonds

Corporate and municipal bonds can be **callable**, which means the bond issuer has the right — not the obligation — to redeem the bond prior to maturity at a set price. The call feature can be exercised after a specified period of time, allowing the issuer to pay off their debt early. This is typically done if interest rates fall, and the bond issuer can re-issue their loan at a lower interest rate.

If called, the investor receives the bond's face value plus any accrued interest, and no further coupon payments are made. Some callable bonds can be called at an amount higher than the original face value, sometimes referred to as an **optional redemption feature**. Generally, the earlier in a bond's lifespan it is called, the higher its call value. For instance, if a bond has a 20-year maturity, but can be called in 10 years, it may have a call price of 102, which means the investor would receive $1,020 for each $1,000 in face value of their investment.

Call provisions benefit the issuer, and such provisions may require the issuer to pay extra yield to compensate investors for the inclusion of this benefit. Callable bonds can have different variations, and the offering document will outline specific terms, such as the set points by which the bonds can be called.

The Relationship Between Interest Rates and Callable Bonds

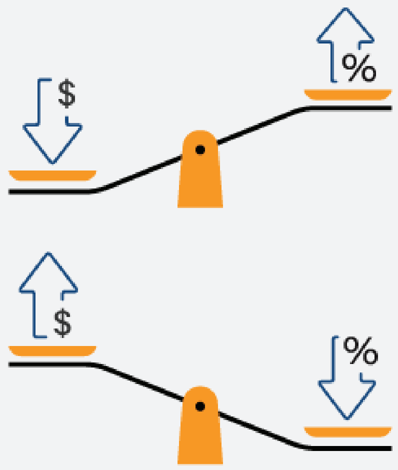
Understanding the inverse relationship between bond prices and interest rates is important to grasping how callable bonds work.

Similar to refinancing your home, if interest rate rise, a bond issuer generally will not call its bonds early because they would be forced to reinvest in a higher interest rate environment, thus costing them more money. Conversely, when interest rates decline, it is advantageous for an issuer to call their bonds early and issue new bonds at lower interest rates.

Suppose you purchase ABC Bond with a 10-year maturity at a face value of $1,000 that is paying a 6.00% annual coupon. At maturity, the investor would receive their initial $1,000 plus $60 interest annually for 10 years, totaling $600.

However, suppose the bond is callable in five years at 101 and interest rates drop to 3.00%. The bond issuer could refinance their debt and call the bond early, paying the investor $1,100 plus the final coupon payment of $60. The investor would forgo any future coupon payments, receiving only $300 total interest over the life of the investment.

Inverse relationship between bond prices and interest rates



Yield to Maturity vs. Yield to Worst

Investors should take two yield calculations into consideration when evaluating callable bonds. **Yield to maturity (YTM)** is a measure of the total return an investor receives over the course of a bond's life, and accounts for factors including the coupon, selling price, and par (redemption) value. If a bond is callable, the effective yield may be lower, which is known as a bond's **yield to worst (YTW)**. Since YTW uses the callable date, rather than years until maturity in its calculation, it is always less than YTM and always should be considered when purchasing bonds.

Advantages of investing in callable bond

- Typically pay higher coupon or interest than comparable non-callable bonds.
- Attractive investment if investor believes interest rates will rise or remain steady.
- Generally less risky than investing in stocks.

Disadvantages of investing in callable bond

- Loss of future income payments if the interest rates decline and the bond is called.
- Investors are forced to reinvest in a lower interest rate environment if bonds are called.
- Potential returns are generally lower when investing in bonds vs. stocks.

Other Features

Call protection is the period of time the bond issuer cannot redeem the bond. The bond issuer must specify the exact terms of the call option, including the timeframe when the bond can be called and at what price.

An **extraordinary redemption** feature allows the issuer to call the bond prior to maturity if a specific or unusual event occurs, such as a catastrophic weather event that damages or destroys the underlying funded project.

A **sinking fund redemption feature** allows the issuer to redeem a specific portion of the bond issuance by adhering to a predetermined schedule. Some of the bonds are callable, allowing the issuer to pay off parts of its debt early.

Speak with your financial advisor to learn more about callable bonds.

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