Busting myths

Sometimes, old investment axioms just don’t add up.

Airing for 13 years, MythBusters was a popular cable TV show that investigated, in a lighthearted but scientific manner, such burning issues as just how hard it is to find a needle in a haystack, or whether a parachute made of duct tape actually works.

On occasion, bond investing can be based on assumptions/canons/practices whose origins are hard to pinpoint. Or worse, whose purposes are hard to document. Or still worse, whose benefits are hard to quantify.

This month, we will try to address some of these notions and examine whether the myths supporting them have merit. One or more of these may be present in your own portfolio, as community bankers often ask me about them. And for the record, please don’t jump out of an airplane with a duct-tape parachute to break your fall.

**Myth:** Portfolios with incremental call risk have higher yields

**Fact:** They rarely do

The day you purchase a bond, your broker can
demonstrate that those with call features will have higher yields than those without (“bullets”). It follows that if no bonds ever get called, you’ve done yourself a favor. Over time, however, the majority of call options are in fact exercised by the issuer, which means that you’ll gradually reinvest those moneys into, you guessed it, lower-yielding replacements.

About the only time that you’re better off buying a lot of callables versus bullets is when rates slowly but consistently rise after you’ve made your purchases. But that doesn’t mean you’re happy then, either, because it means your portfolio will be underwater.

**Myth:** Bonds purchases with discount prices outperform those with premiums  
**Fact:** It depends  
The discount/premium conundrum plays out most visibly with amortizing investments like mortgage-backed securities (MBS). When such bonds are purchased at prices above or below par, your ultimate yield will be a function of the prepayment activity (aka “speeds”) of the pools. If your book price is 96.00 and prepayments exceed expectations, your yield is enhanced.

Faster speeds are the residual of lower interest rates. As we know intuitively, rates don’t travel in a linear path, or even in one direction. So, over an intermediate horizon of, say, four years, your collection of bonds will likely be subject to different stages of a rate cycle. Higher interest rates favor bonds purchased at premiums. So usually, the hedge-your-bet strategy is to own some bonds at prices both above and below par.

**Myth:** Revenue bonds have higher yields than general obligation bonds  
**Fact:** Usually, yes  
Before I get blown up by this proposition, let me hurriedly add that I’m not suggesting you junk your credit standards. It’s just that there are enough investors in municipal bonds, both retail and institutional, who insist on general obligation (GO) backing. That means there is almost always additional yield to be had in a revenue bond of a like maturity and rating.

But a word to the wise: Make it a practice to purchase revenue bonds whose income streams are derived from essential services. Examples are water and sewer projects, utilities or lease revenues from schools that are ultimately backed by ad valorem property taxes.

**Myth:** Investment ladders perform better than barbells in falling rate environments  
**Fact:** Probably  
Ladders are built through a series of purchases with defined, staggered maturities, which should ensure predictable cash flows over an intermediate-term horizon. Barbells, on the other hand, are built through a series of purchases of both very short and relatively long maturities, with little attention paid to the belly of the curve.

Assuming falling rates, the ladder’s cash flows will do two things that are desirable. 1. They will keep most of the money tied up and invested, and 2. the bonds will appreciate in value. Some of the improvements in prices are courtesy of a steepening curve, which almost always accompanies a falling rate scenario. Barbells, while likely not subject to a decline in value, will see a more noticeable drop in yield.

Perhaps these issues aren’t as weighty as whether you can hold the lever on a live grenade for two hours. But then again, you can’t meet your earning goals with a live grenade. Happy myth busting!