Discount Magic

Bonds priced below par have an upside potential

By Jim Reber

There is an entire crop of community bank investment portfolio managers who have never pondered this possibility: purchasing a bond at a price below par. Well, your opening may have arrived.

With interest rates on an almost nonstop trip downhill since 2007, virtually all new and outstanding bank-suitable investments have seen their prices grind inexorably higher. That is, until March of this year.

Take the five-year Treasury note for example. Between March 6 and March 21, the rate on this benchmark rose every day except one. That was 10 out of 11 days in which the price fell, which in this case aggregated 1.5 percent. While that may not sound like a big change compared to, say, stock prices, it created a world of opportunity for community banks.

**Good versus bad discounts**

Before we begin, I should acknowledge that the vast majority of bonds available today, and those which your community bank currently owns, are priced at premiums (that is, above par). If your portfolio looks like the average community bank’s, its book value is around 102 cents on the dollar. This is the residue of the aforementioned long-term trend to lower rates.

Around mid-2009, most community banks owned bonds that were valued at prices well below par. That was due to two related, but separate, issues. First was the fact that liquidity dried up for all but the most liquid securities—in essence, anything other than Treasuries. Even bonds issued by the government agencies saw their market yields soar as widespread deleveraging took place, and the Federal Reserve had not yet launched its “quantitative easing” campaign.

The second reason is that a number of bonds truly deteriorated in terms of credit quality. Private label mortgage-backed securities (MBS), particularly the lower priority segments, are the best example. Many of these were collateralized by subprime or nonconforming mortgages that, as we now know, were built with default in mind.

So, the example of the former demonstrates that normal changes in market rates of interest could cause your prices to fall. This is a typical consequence of everyday investing, and is not a cause for undue alarm. The second example is a different story. This column addresses the former (“good”) discounts.
Cushion your fall
A discount callable can protect your margins against falling rates. The implied expectation of a bond whose market price is below par the day it’s purchased is that it will not be called. The worst-case outcome for a bond at a discount is that it never gets called.

That may be perfectly acceptable for you, the investor. Oftentimes, the decision to buy a callable versus a non-callable bond is the additional yield delivered by the callable; the yield enhancement that accrues from the call feature is viewed as simply a bonus.

As an example of a recently available discount callable, our friends at Fannie Mae issued a new five-year note with two years of call protection, with the call feature being one time only. The market vernacular for this is a “5-2 European.” The original price was par, and the coupon is 1.00 percent.

Within a month of issue, the price had fallen to about 98.9. This pushed up the yield to maturity to 1.22 percent, and the yield to call to 1.58 percent. From this one example, we can see that a call, if exercised, will actually improve your outcome. Recall too that a drop in market yields is what precipitates a call being exercised.

Diversify your holdings
If rates gradually increase in the next couple of years (not that I’m predicting anything), you will be presented with more opportunities to buy bonds at below-par levels. There will be a day when MBS are available at discounts, which will greatly limit the prepayment risk that exists in most community bank portfolios.

For the time being, though, let’s be reminded that bonds at premiums help protect us against rising rates. A callable bond priced above par is known as a “cushion bond,” as it softens the yield impact if an option is not exercised. Over time, a well-managed investment portfolio should contain some investments at both premiums and discounts. Such a position can create some yield magic regardless of the whimsies of interest rates.