

Cushion Bonds – Increased Potential Return With Less Risk

By: Ian McAbeer, CFA

Fixed income investors and financial advisors face a dilemma in the current environment; either invest in short-term bonds and earn virtually nothing in return, or invest in longer-term bonds and risk significant losses in the event that future interest rates rise substantially. The cushion bond - a callable bond trading at a premium to par value - offers the potential for higher return in a low rate environment, while providing protection against the potentially damaging consequences of future rate increases.

Most investors know that bond prices move inversely to changes in interest rates (i.e. when rates increase, bond prices fall). Most investors may also be aware that long-term bonds are more sensitive to changes in rates than short-term bonds. However, most investors do not fully appreciate one of the biggest factors that may reduce a given bond's sensitivity to changes in interest rates - an embedded call option.

The call option feature of a bond is the most significant characteristic that may reduce interest rate sensitivity because it is the only feature that can actually accelerate the maturity date of a given bond. The call option allows the issuer of a bond - a corporation or municipal agency - the right to call back the bond at a fixed price, typically at par value or slightly more. Thus, if interest rates decline after original issuance, the issuer may repurchase the bonds at a fixed price and subsequently reissue new bonds at lower prevailing market rates. Obviously, the call option embedded in such bonds is a benefit to the issuer, not the investor.

A callable bond can therefore be viewed as a combination of a non-callable bond, plus a call option. Yet, while the *investor* owns the bond, the *issuer* owns the call option. In other words, the investor has effectively sold the call option to the issuing agency, and therefore the call option has negative value to the bondholder as it reduces the overall market value of the callable bond. Formulaically, this can be expressed as follows:

- Value of Callable Bond = Value of Noncallable Bond - Value of Call Option

So, why do callable bonds represent an opportunity in the current market environment? Well, over the past couple of years as interest rates have declined, investment-grade bonds have generally appreciated in value, but much less so for callable bonds. As rates declined, it became more likely that many such bonds would be called by their issuers at or near par value, so these bonds simply could not appreciate in price to any meaningful degree. Referring back to our formula, this means that the value of the call option increased significantly as interest rates fell, dampening any overall increase in the value of the bond itself.

For the same reason, if rates begin to rise in the coming year or two, these callable bonds are less likely to lose much value because they are already trading at levels that are relatively close to par. Such callable bonds, which have coupon rates that are higher than current market rates and trade at slight premiums to par value, are known as "cushion bonds" - the name being derived from the fact that these bonds are not as sensitive to overall changes in interest rates; they do not appreciate very much when rates fall, nor do they depreciate very much when rates rise. Thus, these bonds can *cushion*, or buffer, a fixed income portfolio against the affects of changing interest rates.

In fact, at extremely low levels of interest rates as we have today, callable bonds can exhibit a condition known as *negative duration*, in which the value of the embedded call option becomes more sensitive to change in interest rates than the bond itself, and the overall value of the callable bond can actually *increase* when interest rates rise. This condition is the opposite of the conventional relationship between price and yield of a bond, and holds true only at very low rates, where the coupon rate on a bond is substantially higher than the prevailing market rate. The result is that investors may have a unique opportunity in the current environment to invest in cushion bonds, offering the potential to earn a rate of return that is superior to owning short-term bonds while exposing their investments to lesser risk in the event that interest rates increase substantially in the next year or two.

Blackhaw Wealth Management is an independent financial advisor in Austin, Texas. As an independent financial advisor, our firm works with private clients and foundations to develop, implement, and manage investment portfolios.