Bonds have been called. Now what?

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We recently wrote a detailed article explaining bond calls. It was published by AdvisorPerspectives, the leading on-line newsletter for financial advisors.

We received from our Scarsdale Newsletter readers many comments and questions that said yes, I have been subjected to many bond calls: "Please advise what are my options and what are the strategies that I might use to reinvest the cash that I have received as a result of these calls." This article is a response to those requests. We hope you find it of value in these difficult times with low interest rates.

Often when we open *The Wall Street Journal* there is a full-page advertisement which shows a weathervane at the top of the page. If you have more than $500,000, the company promises to tell you which way the wind is blowing and how to invest now.

Unfortunately, hindsight is 20/20, pardon the pun, but the best you can do is to figure out where you personally are today and what your needs might be in the future. Any investing decisions should be guided by your personal situation and how you see your financial requirements going forward. This article will provide some alternatives and strategies for investing in individual bonds: we encourage you to consider how they might fit with your own financial and life needs.

Clarification of Terms

Aside from a default, where you lose some or all of your investment, there are certain built-in risks to investing in bonds. In this article we are concerned with two: the reinvestment risk and the liquidity risk.

Reinvestment risk is the risk of having to reinvest your interest payments or returned principal at a lower rate of return than when it was initially invested. You may be fortunate, and be able to reinvest at higher rates of return. As you may realize, given the current situation of rock bottom interest rates, this risk is of particular concern.

Liquidity risk is the inability to sell your securities currently at a fair price. If there are lots of issuers and more sellers than buyers, you may find that your bonds may only fetch a low-ball price if you need an immediate sale. In March 2020 some investors found themselves in an illiquid market when they wished to sell bonds.

Although any market may have liquidity issues, the municipal market has a number of problems. For example, the municipal market has approximately 20 times more bond issues than the corporate bond market, although the corporate bond market has better data reporting and analyst coverage.[i] Corporate bonds generally trade daily, while many municipal bonds may not trade at all in a given year. Municipal bonds also are mostly callable, having a built-in option for the issuer to buy its bonds back (i.e., redeem the bonds) before the bond's due date. The corporate and treasury bond markets are like a broadloom carpet compared to the oriental rug municipal market.

There are a number of factors that lead to lower municipal liquidity. First, lower tax rates on banks and corporations make the municipal tax-exemption less attractive to them. Second, large scale ETFs that are benchmarked against an index only include issuers of a certain size, which means they hold the most heavily indebted issuers. They do not purchase smaller, better credit issues. Third, mega-funds that hold at least $10 billion in assets and serve 51% of the market must sell bonds when there is a liquidity event. To whom do those funds sell in a market crunch?

We hope to help you think about how you are structuring your bond portfolios to protect yourself from market actions. Here are a number of scenarios and possible solutions for a variety of individual investor situations.

College Grad (CG) – Inflation Protected Securities

College Grad is a recent college graduate who is saving for a car and a house in the future. CG's investment funds are limited at this time. In the past, CG would have invested in a ladder of **Certificates of Deposit** so that cash would be readily available, or purchased short-term tax-exempt municipal bonds if in a high tax bracket. Unfortunately, with interest rates so low, this is not a viable alternative in the current economic environment.

If CG can delay access to his funds for five years or more and he has little cash to invest, CG might consider purchasing an **I-Bond**. The November 2020 through April 2021 I-bond yield is 1.68%. According to the website TreasuryDirect.gov, I-bonds have an annual interest rate derived from a fixed rate and an inflation rate. Interest, if any, is added monthly, and paid to the investor when he cashes in the bonds. I-bonds are sold at face value – you pay $50 for a $50 bond. Maximum yearly purchase per individual is $10,000, with a minimum holding period of 1-year, with penalties for cashing it in before 5-years.

Advantages of I-Bonds include:

1. The income is exempt from state income taxes, but is subject to Federal income taxes.
2. Interest income may be excluded from Federal income tax when used to finance education in very specific cases.

Disadvantages

1. Maximum I-Bond purchase amount is limited to $10,000 per year per individual.
2. I-Bonds must be purchased and held only at TreasuryDirect.gov.

The EE bond option in U.S. government savings bonds does not yield enough to be considered an option in the Winter of 2020.

Savers – The Barbell Strategy

The Savers are currently faced with low interest rates. They need to save for retirement, but also know they may need cash for future expenditures, like a new house or house upgrade, school expenses and so many other expenses.

In January 2021, current interest rates on cash deposits in a bank are less than one percent, and on money market funds $0.01. The Savers are in a quandary.

The Barbell Strategy of investing in bonds is a possible solution. With this strategy, you create a short bond ladder to earn whatever you can on the cash you may need short term, and invest the rest in long-term bonds to earn a higher interest rate.

Advantages of the Barbell Strategy

1. Access to cash without having to sell any bonds.
2. Earning the higher interest provided by long-term bonds.

Disadvantages of the Barbell Strategy

1. Short-term bonds have a low return.
2. Reinvestment risk on short-term bonds.
3. Liquidity risk on longer-term bonds.

Early Retirees (ER) – Bond Ladder Strategy

ERs face a difficult dilemma. Like Savers, they need an adequate cash flow, the highest interest rate and perhaps some cash available to supplement their income. They fear long-term investments because they believe that if they invest exclusively in long-term bonds, they may be faced with rising interest rates that could result in losses if they need to sell bonds before their due dates.

If you are an ER, then you may have been saving for a long time. If you had invested in bonds, then you may have a bond ladder. We encourage our clients to create a custom bond ladder which can start and end at any point. You could create a 5-year ladder, for example, starting in year 5 and ending in year 10. As the bonds come due, you might reinvest in another set of 5-year bonds. Alternatively, a bond ladder might be 10-years in length or extend out 30-years. The ladder may be evenly populated, with the same face value -cash amount - of bonds coming due every year, or bulge in years that you might expect to need money for some planned expenditure. You may blend the types of bonds and accounts (tax-free and retirement) in your ladder, or the ladder may be composed of only one kind of bond in either a retirement or taxable account. You decide what is required and how you want to structure the ladder(s).

Tax-exempt Municipal Bonds cater to a different market segment than corporate bonds. Corporate bonds generally have higher yields, but sometimes tax-exempt bonds yield more than taxable bonds on an after-tax basis. This is the case in the Winter of 2020-2021. ERs may decide to invest in tax-free muni bonds to reduce their income taxes. They may decide to invest in a ladder of 15 to 30-year tax-free muni bonds that will pay them the highest current return to maximize their yield and cash flow.

ERs may also decide to take a position in **Treasury Inflation Protected Securities (TIPS)**. Taking a position in TIPS is currently suboptimal. The current coupon (without the inflation adjustment) is providing a negative yield. However, if inflation rears up, these bonds may cushion the impact on the overall portfolio. TIPS are very complex instruments. If you want to learn about them, check out our book BONDS: The Unbeaten Path to Secure Investment Growth, John Wiley, 2nd edition 2011.

Advantages of Bond Ladders

1. Spreads out the bond maturities so all the bonds don't come due at one time.
2. Cushions the portfolio against interest rate fluctuations.
3. Provides incremental increases in yield on longer dated bonds.

Disadvantages of Bond Ladders

1. Liquidity: If you wish to sell bonds, the market may not be accessible.
2. Bond calls: Longer-term bonds might be called, more heavily weighting shorter maturities.
3. Reinvestment Risk: As the shorter dated bonds come due, the cash has to be reinvested at possibly lower returns.
4. Credit Risk: The reliability of the issuer may deteriorate.
5. Inflation: May erode the value of the portfolio.

There is no investment that is risk free. You must pick which kinds of risks you are more comfortable entertaining. Having a bond ladder ameliorates some risks because some bonds are always coming due and others being bought. In stock investing they talk of **income averaging. Bond ladders are a similar strategy.** Some bonds are purchased at higher yields and other at lower yields. The point is that you earn a consistent cash flow that can be spent or reinvested.

Retirees – Non-Callable Bonds

Retirees may want to have a bond ladder or a barbell depending upon their financial circumstances. They may also decide to purchase only non-callable bonds to have a more predictable of cash flow. For this purpose, some retirees purchase **Treasury bonds** because they are non-callable. Aside from being the best credit, the interest income is exempt from state and local income tax, but is Federally taxable.

Another alternative is to purchase **tax-exempt municipal bonds** and build a ten-year ladder. Some longer municipal bonds are non-callable, but the usual call protection is a

maximum of ten years. The tax advantage of these bonds is that they may be free of Federal, state and local income taxes.

Why build a short ladder? Some retirees want to know that their heirs won't have long to wait for the bonds to come due. We would argue that the heirs would be happy with short-term bonds you purchased at long maturities for the higher income. When you live a long time, your individual long bonds will transform into shorter maturity bonds – bonds are **the only investments that actually self-liquidate**.

The Consumer: Bullet Strategy

Another strategy is to purchase bonds to come due at specific times to fund specific investment purposes. You may know that you will need cash in a specific year, for example to fund college expenses. You are looking for the return of capital at that time. This is a **bullet** strategy for investing.

There are three ways to set up a bullet strategy. You can purchase:

- Taxable bonds or tax-exempt municipal bonds maturing in any year
- Non-callable zero-coupon bonds that don't pay interest, purchased at a discount to face value
- Non-callable coupon bonds, bonds that pay current interest

If you chose to invest in any of the above, you will have returned to you the face value of the bonds in the year that the bond is called or comes due.

Advantages:

- Known cash amounts as bonds come due in each year selected
- Safety of the amount invested in high quality bonds
- Zero-coupon bonds pay their face value at maturity

Disadvantages:

- Low interest rates on bonds maturating in ten years or less
- Lost opportunity of higher interest rates compounding or providing more cash flow from callable, longer-term bonds
- Zero-coupon bonds pay no current interest and compound at their yield-to-maturity.

The Investor – The Premium Bond Strategy

The Investor knows that markets fluctuate and that whatever market scenario we are facing currently will not last. At the beginning of 2021, interest rates picked up a little from 2020 rock bottom historical lows. Interest rates on the longer-end of the yield curve were higher than the short end: a choice of a little more than 1% on a ten-year Treasury

or tax-exempt municipal bond and over 2% to maturity on tax-exempt municipal bonds maturing 25-years or longer.

The risk of purchasing long-dated bonds is that inflation will eat away at the value of your investment. While this is a real issue that cannot be dismissed, we suggest that the outcome can be ameliorated by investing in high coupon premium bonds. A premium bond is one that is selling for more than its face value. Premium bonds provide a generous cash flow that can be used for living expenses, or reinvested at the prevailing interest rate. If interest rates have risen, the high interest rates will provide the equivalent of dollar cost averaging.

Advantages of Premium Bonds

- Better cash flow to support current life style
- More cash for reinvestment in inflationary times

Disadvantages of Premium Bonds

- Possible consumption of premiums
- Reinvestment risk

We believe that bonds should form a cornerstone of any investment plan. We are in an historical period of very low interest rates. However, we know that we don't know what the financial situation will be in the long term or even in the short term.

The Speculator

The speculator is not happy with bond yields. Speculators believe that they have to earn more on their investments than a plain vanilla investor. They might choose dividend paying stocks, preferred stocks, closed-end funds, real estate investment trusts (REITS), master limited partnerships (MLPs) and the ETFs that hold these assets. While we could write about these investments, this article is already too long. If you are interested in our comments, please let us know.

Our Recommendation

We are currently recommending longer-term bond investments, at least with a part of your portfolio, because that is where there is some additional yield. We like to cushion the impact of the longer maturities by purchasing higher coupon bonds that pay more cash flow. Most investments are viewed on what is the cash-on-cash return, at least for a period of time. **Premium bonds** cost more to purchase, but provide a better cash flow to be consumed or reinvested at higher rates – if they materialize. There is no perfect solution, only the best solution for you at this current moment.

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[i] Segall, Bryant and Hamill. "Managing Municipal Bonds in an Increasingly Illiquid Market," *Advisor Perspective.* 12/15/2020. Sponsored content