

# Yield enhancer, or gimmick?

**Callable securities present risk and reward.**

**By Jim Reber**

Most representatives of the broker-dealer industry have been suggesting to their customers, especially community banks, that their collection of bonds could be situated to perform pretty well in 2025. You can be forgiven for rolling your eyes if you've heard this. And I get it: Persistently stubborn inflation forced the Federal Reserve to hike rates, and now to keep them elevated, for the foreseeable future. This, of course, has kept the market values of your portfolio depressed for what is going on three years now.

While it's true that portfolio yields are now at a multiyear high, they haven't kept pace with your cost of funds. Some banks have a negative spread between their investments and their deposits, and that does not help net interest margins. However, there could be an unrecognized upside to your bond portfolio if you own certain securities—namely, callable bonds at a discount.

## **The talk of the town**

The good news is that most banks now own at least some bonds at prices below par. That was not the case prior to the Fed boarding the good ship Rate Hike in early 2022. At that point, portfolios had a dreadful makeup: low yields (well under 2% tax equivalent), long durations (well over four years), and high book prices (nearly 103.00). Thanks to the prolonged period of high rates, yields are now approaching 3%, and book prices are near par (100.00).

It's also worth noting that most bonds owned by banks have embedded call options. This gives the issuers—or borrowers—the right to pay the debt back early if they so choose. Somewhere around 80% of all the bonds in all the community bank portfolios have some kind of call features. While that sounds enormous or even egregious, consider that virtually all loans are also redeemable at the borrowers' pleasure. That's why management of call risk is a major focus for asset/liability committees.

## The rundown

This may be painfully obvious, but we're going to review how a bond that's redeemable early, when purchased at a price below par, has some latent upside. Although rates pretty much ran in place in 2024, there are plenty of seasoned bonds issued in 2020–21 still available at deep discounts.

Two of the most common varieties are agencies and mortgage-backed securities (MBS). Agencies are callable in full, so they're easier to analyze. If an investor buys a bond at say, 97 cents on the dollar, the worst case is for it to *not* get called. If it ever does, the discount price adds to the yield to the call date, and the investor reaps an income windfall. One other item to note: the worst case is still better than the yield to maturity on a non-callable "bullet" bond.

MBS are similar but not identical. The principal on a mortgage bond is returned to the investor in a series of monthly payments. Investors receive a pro-rata share of all the principal repaid and *prepaid*, from all the loans in an MBS pool. If a security is purchased at the 97.00 price mentioned above, and some homeowners decide to cash in their chips early, the bank receives its share at 100.00, and that too is a yield enhancement. Unlike an agency, over time some mortgages will prepay early regardless of current market rates, as certain life events occur in any rate environment.

## Worth it?

Investors are guaranteed of uncertainties regarding cash flows in a callable-heavy portfolio. It requires the manager to constantly review the upcoming call dates, as well as variables such as current versus seasoned coupons. It's worth asking: Are callable bonds worth the trouble?

I believe the investors have spoken, and their answer is "yes." There are times when non-callable portfolios outperform those with lots of optionality, namely in falling rate scenarios. That's why high performing portfolios in 2025 have large doses of the ultimate non-callable bonds, those being treasury notes. But in rising rate environments, callables are the winner. Here's some free advice for those shopping for callable agencies: the yield give-up for buying a bond that's callable one time only ("European") versus periodically ("Bermudan" or "American") is quite modest; in many cases less than 10 basis points (0.10%) to maturity.

Add to that the current opportunity for a head start by insisting on deeply discounted bonds that were launched in the 2020–21 era, and you've got built-in upside. That sounds to your correspondent like a yield enhancer—and most assuredly not a gimmick.

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## January economic webcast

ICBA Securities and its exclusive broker Stifel kick off their 2025 webcast calendar with the quarterly Economic Insight Live on Jan. 30, at 1 p.m. Eastern. Stifel chief economist Lindsey Piegza, Ph.D., will present. Up to one hour of CPE is offered. For more information and to register, contact your Stifel rep.

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