Callable US Agency Bonds
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McQueen Financial Advisors

Callable bonds allow the issuer to return the investor's principal at predetermined dates, in advance of the maturity date. On the surface, buying a callable bond may not seem riskier than buying a non-callable bond. However, there are imbedded risks and reasons to avoid callable bonds. Our primary concern is that they expose the buyer to reinvestment risk. When interest rates fall, issuers have a strong financial incentive to exercise their call options. In doing so, investors get their principal back at the worst possible time, after interest rates have fallen.

Callable bonds offer slightly higher yields, but investors are not adequately compensated for the additional risk.

Agency Debt Securities

US Agency issuers offer a wide variety of debt securities across the yield curve. These include Fannie Mae, Freddie Mac, Farm Credit and the Federal Home Loan Bank. Agency bonds can help diversify your portfolio and most of our clients hold them. However, we favor non-callable bonds.

Federal Home Loan Bank

The Federal Home Loan Bank (FHLB) is the largest issuer of long-term US Agency debt with approximately 40% of the total. Starting in 2022, FHLB ramped up issuance of callable debt securities. As of late 2022, approximately 39% of their outstanding debt is callable. This is up sharply from only 8% at the end of 2020. Looking back 15 years, the percentage of callable bonds outstanding has averaged only 15% and has never been close to 40%, as it is now.

"Callable bond investors are not adequately compensated"

Why would the Federal Home Loan Bank sharply increase their issuance of callable bonds? The answer is quite simple. It is widely expected that the Federal Reserve Bank will bring inflation under control in late 2023, then start cutting interest rates. The FHLB has intensified callable bond issuance anticipating that they will call them after rates fall. This will reduce their borrowing cost and reduce the yield to callable bond investors.

With over $600 billion in total outstanding bonds, the Federal Home Loan Bank has great insight into markets and cost-saving opportunities.

Bonds will be called when the financial advantage is with the issuer, not the investor.

Yields

The yield on callable US Agency bonds is often only slightly higher than bullet (non-callable) bonds. The additional yield is simply the cost of an option, which gives the issuer the right to redeem bonds early.

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“This is a trap which should be avoided”

Risk vs. Return
History has demonstrated that the higher rate on callable US Agencies does not compensate investors for the risk of early redemption. The callable bond market is very efficient. At each call date, issuers analyze the yield curve using complex models. Bonds will be called when the opportunity exist for the issuer to refinance at a lower rate. Because the outstanding amounts are large, even a few basis points of yield advantage will result in a call. Of course, this only happens when interest rates fall. Investors are then forced to purchase replacement bonds at lower rates.

Call Structures
Callable US Agency bonds are issued with a variety of structures and call features. Some bonds are callable only one time after a few years, while others are callable semi-annually, quarterly, monthly or at any time. Bonds with short-dated call structures and high call frequency (daily) may offer seemingly attractive yields. However, this is a trap which should be avoided.

It is not possible to out-guess multi billion-dollar issuers at their own game. The most likely outcome is that bonds will be called, forcing reinvestment at lower rates.

Prudent Fixed Income Portfolio Management
In the current interest rate and economic environment, our portfolios are well structured ladders providing a consistent level of liquidity. We anticipate higher market volatility, higher interest rates and continuation of the flat or inverted yield curve. We continue to recommend a structured approach with ample flexibility to take advantage of market uncertainty and volatility.

We suggest the following:
- Remain fully invested.
- Do not try to time the market or wait till yields hit their peak. It’s not possible.
- Do not implement wholesale portfolio changes based solely on the slope and shape of the yield curve or on speculation of what might happen.
- Most callable bonds should be avoided.
- Talk with your advisor about how the yield curve has changed and how higher yields may impact your institution, and which bond sectors represent the best values.