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Avoiding the Call Pitfall

By Eric Jacobson | 11-15-1999

The hardest thing about working for Morningstar is politely trying to convince family and friends that while investing isn't rocket science, it can't be digested into hot tips that can sustain you until retirement.

So you can imagine how much harder it gets when one of those relatives asks for a quick and dirty explanation of how bonds work. I can usually get through the interest-rate-sensitivity part with some brevity, but people just don't seem to care much when I try to explain the call options embedded in most bonds and how important they are.

The call options built into many bonds, however, are critically important to understanding how bonds, or bond funds, are going to perform.

Take individual bonds. Let's say you've got a high-quality corporate or municipal bond. You believe you got a pretty good deal on the price, including a high yield. Now you're ready to hang on for the next 30 years collecting interest payments.

Things might not go so smoothly if the bond comes with a call option, though. If it's callable in 10 years, for example, and the issuer (be it a municipality, a corporation, or whoever) can issue new bonds with lower interest rates when the call date rolls around, there's an excellent chance that issuer will call the bond. In that case, the bondholder is forced to give up the bond in exchange for a predetermined call price.

That can be particularly frustrating because any bond likely to be called at some time in the future is also likely trading at a premium right now. (A bond's premium is the difference between its par value and its higher market value.) As a premium bond approaches an imminent call, however, its market price moves closer and closer to par. What's more, if the issuer chooses to call a bond because the issuer can sell new bonds with lower rates, it's probably because interest rates have fallen. So unless you're willing to buy a bond with more credit risk, you're likely to be forced to go out and buy new bonds with lower rates.

Of course, there are ways to fend off the devilish call. If you don't want to risk losing a bond's premium, you can sell the bond at a profit and reinvest the money in another bond

(or bonds) with a call date that's further away. Doing so will offer protection against an imminent call, but will also mean a longer term to maturity.

If that seems like a bother, then mutual funds are a great way to go. Most fund managers have the advantage of being able to run a big pool of bonds, thereby avoiding having too many become callable at once. And because bond trading isn't nearly as easy as stock trading, a fund manager is also in a much better position to buy and sell bonds at more opportune times and prices.

So, when it comes to calls, what should you watch for when buying a bond fund?

Don't be lured by an unusually fat yield. In addition to a number of reasons you might want to be suspicious of a fund with a bigger than average yield, those with unusually large yields may be chock-full of bonds with high interest rates and may be subject to calls in the near future.

If a fund doesn't move much when interest rates do, make sure you understand why. This is the flip side of item number one. The same bonds that trigger the first flag are likely to be relatively insensitive to interest-rate shifts, but may also be callable in the near future.

If numbers one or two raise a flag, find out the manager's approach to handling bond calls. Some funds (particularly muni funds) buy a lot of callable bonds. There are a lot of ways to manage calls, however. Some funds will wait for a bond to rise to a tall premium and then sell, thereby capturing a gain. That may trigger some tax liability and hurt a fund's current dividend rate, but such funds usually make a point of trying to earn strong total returns. Many also work hard to figure out whether a particular bond appears to be trading cheaply given its call features, or if it isn't likely to be called.

Other funds prefer to hold out as long as they can without selling high-yielding bonds, but still try to unload them well before they're called.

Still other funds don't want to distribute capital gains of any kind to shareholders and may therefore hold most of their bonds as long as possible, even if that means allowing them to be called.

In general, however, most open-end bond-fund managers avoid having big chunks of bonds become callable around the same time. Spreading out those calls means that fund investors need to worry less that dividends--which are always going to fluctuate with market interest rates--aren't likely to shoot up or down dramatically.

If that still sounds intimidating, at least there's a silver lining in the cloud. Anticipating if bonds are or are not going to get called is an art that good fund managers can practice to benefit shareholders. Some of the best, such as Clark Stamper of Davis Tax-Free High Income VMPAX, or Ron Fielding of Rochester Fund Municipals RMUNX (a New York muni offering), have compiled terrific results in just that way.

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