Invesco

Investment Insights

Getting a Kick from Premium-Coupon, Callable Bonds

Insights from the Invesco Municipal Bond team

In line with our continuing goal of helping investors earn attractive, yield-driven total returns, the Invesco Municipal Bond team includes premium-coupon, callable bonds in our municipal bond fund suite. Known as “kicker bonds,” these bonds provide a kick in yield once the first call date has passed and may be particularly useful in our shorter duration strategies. While investors appreciate the above-market yields this investing strategy can generate, they may wonder why we are willing to pay a premium to purchase kicker bonds.

How kicker bonds work for you

Premium-coupon, callable bonds offer coupon rates that are higher than the prevailing market rates on bonds with similar ratings and maturities. Because a kicker bond has a higher coupon, a bondholder can command a higher price (a premium) when selling the bond in the secondary market.

Most new bonds with longer maturities come to market with a call feature, typically 10 years after they are issued. This feature gives the issuer the opportunity to call the bond on a specific date and, if market rates have become lower than they were at the time of sale, to refinance at a lower rate. In the municipal market, a call feature is generally a rolling 30-day call. Once the bond reaches its call date, it can be called at any time with 30 days’ notice to bondholders.

A kicker bond kicks to a higher yield if it remains outstanding after its original call date. This occurs because the bondholder — in this case, one of the Invesco Municipal Bond fund portfolios — has amortized the premium to the first call date and, as a result, the book yield kicks up. Once the call date has passed, the attractiveness of the bond to other investors generally lessens. Who would want to pay a premium for a bond that might be called on 30 days’ notice? Not too many investors. So, rather than sell, the bondholder can sit back and collect interest payments for as long as the bond remains outstanding. The Invesco Municipal Bond team believes these kicker bonds can help shareholders achieve their goals for competitive levels of tax-free income.

A useful analogy: Consider a couple who has taken out a mortgage at 5%. If interest rates drop, the couple might seek to refinance at a lower rate; however, the best outcome for the bank that holds the mortgage would be if the homeowners decide to keep paying the full 5%.

Understandably, any bank would be happy to collect an above-market rate on a loan. It follows that another bank would have to offer a premium on the mortgage’s principal before the first bank would consider forgoing future interest payments by selling the mortgage. Investors in municipal securities — whether individuals or mutual funds —are like banks holding mortgages in that both seek to collect highly competitive yields.

Here’s the catch: The municipal market isn’t as efficient as the average homeowner. After a moderate-to-steep fall in interest rates, a homeowner is generally quick to shop around for a lower rate and refinance. Issuers in the muni market rarely move that quickly to secure a lower rate, even when their bonds have call features. As fund managers, we seek to use this market inefficiency to increase the yield potential our funds generate.

Not a Deposit | Not FDIC Insured | Not Guaranteed by the Bank | May Lose Value | Not Insured by any Federal Government Agency

The funds most likely to buy premium-coupon, callable bonds are:

- Invesco Short Term Municipal Fund (ORSTX)
- Invesco Limited Term Municipal Income Fund (ATFAX)
- Invesco Rochester® Limited Term New York Municipal Fund (LTNYX)
- Invesco Limited Term California Municipal Fund (OLCAX)

The Invesco Approach

Historically, premium-coupon, callable bonds have been beneficial to the fund as:

Yields improve
As a group, muni investors tend to be risk averse. They generally prefer to buy bonds with high credit ratings and to know with certainty when the principal amount will be paid back. For this reason, they are less likely to buy a bond with a call feature as it introduces an element of uncertainty into the transaction. They usually take a pass on the callable bonds and instead opt for "bullet bonds," which have a set date for the return of principal. Typically, a bond with a call feature will have a lower price (and higher yield) than a bullet bond that has same coupon, rating, and maturity as the call date.

The municipal bond market is inefficient
In our experience, many callable bonds do not get called at their first call date. If the bonds are not called on that date, these bonds continue to generate tax-free income for the bondholder. The Invesco Municipal Bond team is always looking at a variety of bonds and sectors, and this provides strong insights about which issuers and sectors have a history of ignoring their bonds' first call dates.

The bond's price stabilizes
Once a kicker bond becomes callable, it tends to trade close to par and to be relatively stable in price. Other investors may be jealous of the income these bonds are paying, but most individual investors are hesitant to bid on them; this wariness is justified, given that the bond now demands a premium but could be called at any time. Our shareholders may benefit from the price stability caused by this reluctance.

Our portfolios are large and diversified
Unlike the individual investor who holds a laddered portfolio of 10 to 50 investments staggered with different maturities, each Invesco Municipal Bond fund has many more holdings and usually a larger amount of capital to deploy. While an investor with a small ladder risks having a majority of bonds called in a narrow timeframe, it is far less likely that a large fund would be in similar straits.

Our team also has something that most individuals lack, which is the ability to create highly diverse portfolios by purchasing bonds featuring many different ratings, maturities, call dates, coupons, and issuers. Another advantage our active management team has over the average investor is the ability to monitor the market in real time and react quickly to attractive opportunities.

Premium and the NAV

Understandably, some investors might wonder if purchasing bonds at a premium causes a fund's net asset value (NAV) to decline. As the following example demonstrates, that generally does not happen.

	Purchase	Year 1	Year 2	Year 3	Year 4	Year 5
Cash Flow	($1,020)	$50	$50	$50	$50	$1,050
Distribution		$30	$50	$50	$50	$1,050
Book Cost	$1,020	$1,000	$1,000	$1,000	$1,000	$1,000

Let's say we purchase a $1,000 par value, 5% coupon bond with a 5-year maturity to a 1-year call at a price of $1,020. The general assumption is that the NAV will fall over the first year by 2% (the premium), and the bond's price will tend to move to par as the call date approaches; the NAV should remain stable in a stable-rate environment. This is true because we do not pay out $50, the full distribution, during the first year. Instead, we would distribute $30 in income and the other $20 would go toward the NAV.

If the bond gets called at the first possible time, there would be no NAV depreciation and $30 of tax-free income, or a yield of 3% during the holding period.

The strategy “kicks” if the bond doesn’t get called. For example, if the bond remains outstanding for a full year after its initial call date, we will pay out the entire 5% coupon to our shareholders as tax-exempt income. Better yet, if this hypothetical bond never gets called, we’ll pay out 5% tax-free for three additional years.

During this time, few investors will be interested in paying much more than par for the bond — after all, it could get called away at any time with 30 days’ notice — so the bond’s price should remain close to par. If the bond remains outstanding, it will exhibit the low price volatility of a 30-day bond. Concurrently, shareholders may benefit from the bond’s above-market coupon.

Keeping real examples under wraps?

While we would love to provide a current example of a premium-callable, coupon bond that is generating higher-than-market income for our funds, that would not be to our shareholders’ advantage. Why? Because we don’t want to shed light on any issuer that should set a call date on an existing bond and refinance its debt at a lower rate. What’s good for the issuer — eliminating high interest payments on our funds’ holdings — would not be in our shareholders’ best interests.

While our funds’ annual and semiannual reports don’t specifically spell out which bonds are kicker bonds, they do include a list of holdings, including the coupon, par amount, effective and final maturity, and price of each holding.

What are the risks?

Individual investors and funds do take on some risks by investing in kicker bonds:

Call / Distribution risk
By holding bonds that are currently callable, you run the risk that the bonds are called out of your portfolio, which would place downward pressure on future distributions. This becomes more likely when rates have dropped significantly because such rate changes give an issuer a greater incentive to lower its payments by refinancing existing bonds.

The downward pressure exists because a bond that has “kicked” and is already providing above-market-rate levels of tax-free income isn’t easily replaced. If interest rates have dropped sharply, the market is not likely to offer many bonds with equally attractive coupons; however, we believe this risk can be diversified by holding a large number of bonds. For example, Invesco Short Term Municipal Fund (ORSTX) usually holds more than 700 different bonds as an attempt to diversify this risk.

Extension risk
When rates rise, it is possible that our premium-callable, coupon bond will be priced at a discount (in other words, priced to the final maturity, not the call date). This will happen when the prevailing rate, or yield, for a bond rises above the bond’s coupon. Once this occurs, investors will no longer be willing to pay a premium for it because it no longer offers more interest than does a bond selling at par. Additionally, the bond now has a longer duration and is likely to face greater price volatility.

We believe this risk can also be lessened by diversification. Our funds hold a large number of bonds with varied credit ratings, final maturities, coupons, and call dates. This may help to reduce the chance that all, or even a large percentage, of our bonds will flip to a discount at the same time.

The takeaway

Premium-coupon, callable bonds play a vital role for our funds because they typically trade like short bonds and exhibit less volatility than their final maturities would suggest. Additionally, they may provide our funds and shareholders with higher amounts of tax-free income than would bonds with shorter maturities. We’ve used this unique strategy for many years and believe it truly benefits our funds.

A premium-coupon bond has a coupon rate higher than the prevailing interest rate for that bond maturity and credit quality.

Duration is a measure of a bond fund's price sensitivity to changes in interest rates.

Amortization is an accounting treatment that reduces the cost basis of a premium bond.

Book yield is the percentage of interest income over the average amortized cost of a bond during a specified period.

A credit rating is an evaluation of the credit risk of a debtor, which predicts their ability to pay back the debt.

About risk

Municipal securities are subject to the risk that legislative or economic conditions could affect an issuer's ability to make payments of principal and/ or interest.

Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa.

An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

If interest rates fall, it is possible that issuers of callable securities will call or prepay their securities before maturity, causing the fund to reinvest proceeds in securities bearing lower interest rates and reducing the fund's income and distributions.

All or a portion of the fund's otherwise tax-exempt income may be subject to the federal alternative minimum tax.

Income exempt from regular federal income tax may be subject to the US federal alternative minimum tax, as well as state and local taxes.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

Invesco does not provide tax advice. Investors should always consult their own legal or tax professional for information concerning their individual situation.

The opinions expressed are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

Diversification does not guarantee a profit or eliminate the risk of loss

Before investing, investors should carefully read the prospectus and/or summary prospectus and carefully consider the investment objectives, risks, charges and expenses. For this and more complete information about he fund(s), investors should ask their financial professional for a prospectus/summary prospectus or visit invesco.com/fundprospectus.