



## Call Features: Don't Get Caught Off Guard

May 23, 2005 | By [George D. Lambert](#)

[Callable bonds](#) - because they carry the risk of being cashed in early - often have a higher [coupon rate](#). Although this may make callable bonds more attractive, call provisions can come as a shock. Even though the issuer might pay you a bonus when the bond is called, you might still end up losing money. Plus, you might not be able to reinvest the cash at a similar rate of return, which can disrupt your portfolio. Here we look at how a call can cause losses, what to look for in a callable bond and how to prepare for the possibility of your bond being [called](#).

### How You Can Lose Money

Let's look at an example to see how a call provision can cause a loss. Say you are considering a 20-year bond with a \$1,000 face value that was issued seven years ago and has a 10% coupon rate with a call provision in the 10th year. At the same time, because of dropping interest rates, a bond of similar quality that is just coming on the market may pay only 5% a year. You decide to buy the higher-yielding bond, whose purchase price is \$1,200 (the premium is a result of the higher yield). This results in an 8.33% annual yield (\$100/\$1,200).

Suppose that three years go by, and you're happily collecting the higher interest rate. Then the borrower decides to retire the bond. If the [call premium](#) is one year's interest, 10%, you'll get a check for the bond's face amount (\$1,000) plus the premium (\$100). In relation to the purchase price of \$1,200, you lost \$100 in the transaction. And once the bond is called, your loss is locked in.

### Municipals Not Immune

Now you may think that this problem may occur only to investors who buy high-yielding corporate [junk bonds](#). Wrong.

In Feb 2005, New York City began calling in \$430 million of its AAA-rated bonds. Their goal was to reduce interest expenses by replacing old bonds that paid 6-8% with new ones paying 3-5%. It was estimated that this move caused these seemingly high-quality bonds to lose \$50 million in total market value. And for those individual bond owners who had bought the bonds at a premium, the loss was 15% or more of their investment.

### What to Look For

When you are buying a bond on the [secondary market](#), it's important you understand any call features, which your broker is required to disclose in writing when transacting a bond. Usually call provisions can be inspected in the issue's [indenture](#).

When analyzing callable bonds, there isn't necessarily one bond that is more or less likely to be called than another of similar quality. The main factor that causes an issuer to call its bonds is interest rates (we look at this more below). There is one feature, however, that you want to look for in a callable bond: [call protection](#). This means there's a period during which the bond cannot be called, allowing you to enjoy the coupons regardless of interest rate movements.

Before buying a callable bond, it's also important to make sure that it in fact offers a higher potential yield. Find bonds that are non-callable and compare their yields to callable ones. However, locating bonds without call features might not be easy. According to Thomson Financial, about 78% of new municipal bonds sold in 2004 are callable.

Finally, don't get confused by the term 'escrow to maturity'. This is *not* a guarantee that the bond will not be redeemed early. This term simply means that a sufficient amount of funds, usually in the form of direct U.S. government obligations, to pay the bond's principal and interest through the maturity date is held in [escrow](#). Any existing features for calling in bonds prior to maturity may still apply.

### Don't Wait until Interest Payments Stop

If you own a callable bond, remain constantly aware of its status so that, if it gets called, you can immediately decide how to invest the proceeds. To find out if your bond has been called, you will need the issuer's name or the bond's [CUSIP](#) number. Then you can check with your broker or online at: <http://www.moodys.com/> (the service is free but requires registration).

### Be Prepared

As we mentioned above, the main reason a bond is called is a drop in interest rates. At such a time, issuers evaluate their outstanding loans, including bonds, and consider ways to cut costs. If they feel it is advantageous for them to retire their current bonds and secure a lower rate by issuing new bonds, they may call their bonds. If your callable bond pays at least 1% more than newer issues of identical quality, it is likely a call could be forthcoming in the near future.

At such a time, you as a bondholder should examine your portfolio to prepare for the possibility of losing that high-yielding asset. First look at your bond's trading price. Is it considerably more than you paid for it? If so, it may be best to sell it before it is called. Even though you pay the capital-gains tax, you still make a profit.

Of course, you can prepare for a call only *before* it happens. Some bonds are freely callable, meaning they can be redeemed anytime. But if your bond has call protection, check from what date the issuer can call the bond. Once that date passes, the bond is not only at risk of being called at any time but its premium may start to decrease and the issuer might not pay any more interest. You can find this information in the bond's [indenture](#). Most likely there will be a schedule stating the bond's potential call dates and its call premium.

Finally, you can employ certain bond strategies to help you protect your portfolio from call risk. [Laddering](#), for example, is the practice of buying bonds with different maturity dates. If you have a laddered portfolio and some of your bonds are called, your other bonds with many years left until maturity may still be new enough to be under call protection. And your bonds nearer maturity won't be called because the costs of calling the issue wouldn't be worth it for the company. While only some bonds are at risk of being called, your overall portfolio remains stable. (For more on this strategy, see [The Basics Of The Bond Ladder](#).)

### Summary

There is no way to prevent a call. But with some planning, you can ease the pain before it happens to your bond. Make sure you understand the call features of a bond before you buy it, and look for bonds with call protection. This could give you some time to evaluate your holding if interest rates experience a decline. Finally, to determine whether a callable bond actually offers you a higher yield, always compare it to the yields of similar bonds that not callable.

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