

Callable & Callable Step-Up Securities

HOW TO BEAT INTEREST RATE AND CREDIT RISK

There are always risks associated with investing and the current investment climate is even more fraught with peril than normal. A number of cross currents or risks that will effect an investor's investment decisions in coming months are roiling the U.S. financial markets. Interest rate risk: the prospect of higher interest rates, and credit risk: the effect a change (negative) in the financial conditions of an issuer, are two of the recurring themes that can have a dramatic impact upon an investor's portfolio.

Recent economic reports indicate the U.S. economic recovery will be sluggish at best and, when coupled with the prospect of low inflation, will likely keep the Federal Reserve from raising rates until later this year. This near-term prospect of steady rates combined with the possibility of higher rates in the future-interest rate risk-might make investors feel the safest bet is to keep money on the sidelines in anticipation of this move higher in rates. An investor choosing this passive approach versus one who adopts a more proactive strategy must realize, however, that there is an opportunity cost to waiting. This "do-nothing" approach puts pressure on the investor in the future to find higher-than-market investment rates in an attempt to play catch-up to the proactive investor. As for credit risk, the hit parade of companies reporting problems such as disappointing earnings and accounting shenanigans continues to grow. Investors are hesitant to put money to work for fear of a ratings downgrade wreaking havoc upon their portfolio. This only provides investors with more reasons to wait,

and again this passive approach costs them money in the long run.

Very seldom are there "magic" products that can mitigate all investment risks, but callable and callable step-up bonds issued by U.S. Government Sponsored Enterprises (GSEs), such as the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) as well as FDIC insured Certificates of Deposit (CDs), come close to fitting this bill. These high-quality securities provide an investor with protection from credit risk, offer very competitive yields, and in the case of step-ups, a coupon that increases as rates rise.

GSEs and FDIC insured financial institutions routinely issue callable and callable step-up securities as a way to achieve a great deal of flexibility in managing their balance sheets. Once the initial non-callable period has expired, the issuer has the option to call the debt according to the term of the particular security's call provision. This means that as interest rates decline, the issuer can call the bonds and replace the securities with less expensive liabilities. This is very beneficial to these institutions that have interest rate-sensitive assets on their books, such as mortgage-backed securities and other loans that prepay principal as interest rates fall. Thus the ability to call these liabilities prior to maturity is a very important asset/liability management tool for these institutions. Issuers will exercise their call when they determine that it is cheaper to issue a new security rather than make interest payments on the outstanding debt. There is no simple way to predict precisely when a call will occur, but it is sufficient to



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say that when interest rates decline the probability of a security being called increases significantly.

Callable and callable step-up securities have been very popular with individual investors due to their attractive yields, high credit quality and the variety of maturities available. The step-up feature also is a good way for investors to receive some protection from higher rates, as the coupon increases on a predetermined schedule if the security isn't called. Recently, however, a Financial Consultant asked: "Why are the yields so much higher on callable and callable step-ups than on non-callable issues? Am I missing something?" The answer to the first question is that in investing in callable or callable step-up securities, an investor in effect sells a call option, the ability to call the issue prior to maturity, to the issuer. The receipt of this call option provides the issuer with an extremely important asset/liability management tool and, hence, it has considerable value. So as an incentive for investors to purchase this debt and assume the uncertainty of principal repayment, issuers will compensate them by paying higher rates than that available on non-callable debt. As for missing anything, investors should realize that in taking advantage of the higher yields on callable and callable step-up securities they are also assuming the uncertainty of maturity risk. This means that due to the call feature and changes in interest rates, a bond's ultimate maturity could be as short as the first call or as long as the stated final maturity. The willingness to accept the uncertainty in the timing of ultimate principal repayment, however, will provide investors

in callable and callable step-up securities with higher rates of return in a stable to rising rate environment.

The following chart depicts how a callable step-up security works. The issue has an initial coupon fixed for three years, and the coupon increases every three years if the security isn't called. In this case, the initial coupon is 5% and the final coupon is 8%. The internal rate of return (IRR) shows the effective yield of the issue to each of the respective call dates.

In choosing to invest in callable and callable step-up securities, it is important for investors to note the following characteristics:

- The initial and subsequent calls aren't guaranteed; they are subject to the level of interest rates. A security with a 10-year maturity, non-callable for one year, shouldn't be viewed as a one-year investment. As a general rule of thumb, a 10-year callable structure should have an effective duration of three to five years depending upon interest rate cycles, and a 15-year callable bond should have an effective duration of five to eight years.
- The direction of interest rates will also determine how the securities trade in the secondary market. Investors should realize that in a rising rate environment, the issue will have the price volatility of its stated final maturity, while in a falling rate environment the security will have the upside potential of its shortest possible call date. For example, a 10-year maturity, non-callable for one year, will have the price volatility of a 10-year note if rates rise, but only the upside potential of a 1-year note if rates fall.



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- The United States government does not guarantee GSEs such as FNMA and FHLMC either directly or indirectly. However, both issues carry Aaa ratings by S&P, are well capitalized, and carry lines of credit with the U.S. Treasury that have never been tapped. Thus they are deemed to be very creditworthy institutions. Also, their heavy involvement in the housing industry, an essential element of the U.S. economy, increases their importance as ongoing institutions.
- The CDs issued by the United States and its territorial financial institutions are fully insured by the Federal Deposit Insurance Corporation (FDIC) up to \$250,000. The U.S. government in 1933 established the FDIC to insure deposits and promote safe and sound banking practices. The insurance on deposits up to \$250,000 provides investors with a very high level of protection from credit risk. In the event a financial institution fails, however, investors should expect a delay of two to six weeks for FDIC reimbursement.

Prior to October 3, 2008, the standard insurance coverage amount was up to \$100,000 per depositor per insured bank. The Emergency Economic Stabilization Act enacted on

October 3, 2008 temporarily increased the basic limit on deposit insurance for all account ownership categories from \$100,000 to \$250,000. This increase is effective from October 3, 2008 to December 31, 2009. After December 31, 2009 account ownership categories for which the deposit insurance limit was

\$100,000 prior to October 3, 2008 will revert to the \$100,000 limit.

Callable and callable step-up securities issued by GSEs or FDIC insured financial institutions are excellent investment alternatives for investors as they face the challenges presented by the current investment climate. In making the decision to purchase these securities, investors can take comfort in knowing their portfolio will contain high quality, secure products that offer very attractive returns, and that their portfolio will provide some protection against interest rate and credit risk.

Financial Consultants and their clients can access additional information on FDIC Insurance Coverage at these links:

- FDIC home page: <http://www.fdic.gov/index>
- Read more about FDIC insurance online: www.fdic.gov/deposit

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