APPLETON PARTNERS, INC.

# IS IT TIME TO KICK THE KICKERS? A LOOK AT PORTFOLIO TRADEOFFS AND CONSIDERATIONS

At face value, "kicker" bond yields are appealing, yet we urge advisors and investors to be cognizant of risks and recognize that these bonds will not trade like non-callable issues when rates turn. . . We see no need to punt on "kickers" unconditionally yet feel that investors ought to take a close look at what they own.

## THE NATURE OF KICKERS

Risk and reward tradeoffs are an inherent element of portfolio management, and advisors and investors face many such decisions in today's seemingly endless "lower-for-longer" era. With the 10Yr AAA municipal curve yielding 1.03%, the search for tax-exempt income is intense, yet some seemingly attractive options have the potential to introduce unwelcome exposure if the landscape changes.

Traditional means of reaching for yield involve credit decisions and curve positioning, although bond structure is also an important factor. As we work with clients, a common inquiry concerns our view of "kicker" bonds. "Kickers" are premium bonds characterized by a shorter call date relative to the bond's longer stated maturity. These structures price to the call date and trade at lower dollar prices than longer call or non-callable alternatives due to valuation on a yield-to-worst basis. This produces a yield advantage relative to comparable issues with tighter call to maturity spreads, or shorter-dated, non-callable bonds. Steeper yield curves increase yield-to-call and yield-to-maturity differentials.

Like most aspects of investing, there are no "black and white" answers; our potential appetite for such bonds is driven by the nuances of a particular issue as well as client specific risk considerations and portfolio objectives. Before delving more deeply into "kickers", a brief look at bond calls offers useful context.

## THE ECONOMICS OF BOND CALLS

Callable bonds grant issuers the option to redeem a bond on the call date or at maturity. Such decisions often depend on the yield at which new debt can be issued at the time that option is considered. If prevailing market conditions allow for issuing new debt at a lower yield than original issue, debt can be economically refinanced. Retiring bonds by exercising a beneficial call provision is advantageous for the issuer as coupon and maturity payments will be reduced. On the other hand, should market yields exceed an outstanding bond's original issue yield that bond is less likely to be called and more likely to trade to maturity.

From the standpoint of an investor, if interest rates increase to a point where the math no longer makes sense for the issuer to call a bond, principal repayment extends from the call date towards the maturity date. Because these payments are now discounted over a longer period at a yield greater than the coupon, the price of the bond falls accordingly. This is known as extension risk.

## FAVORABLE "KICKER" SCENARIOS

As an illustration, let's look at three California General Obligation bonds:

| As of 11/30/21 | Non-Callable Bond | Short Call | "Kicker" Bond |
|---|---|---|---|
| Coupon | 5% | 5% | 5% |
| Price | $112.95 | $112.83 | $112.24 |
| Maturity Date | 10/1/24 | 10/1/26 | 10/1/34 |
| Call Date | NA | 10/1/24 | 10/1/24 |
| YTW | 0.41% | 0.45% | 0.62% |
| YTM | 0.41% | 2.19% | 3.78% |
| Duration | 2.67 Yrs. | 2.67 Yrs. | 2.66 Yrs. |

The "kicker" bond with a much wider maturity/call spread offers a meaningful yield advantage given greater call uncertainty, yet all three currently have essentially the same duration and are offered by the same high-quality issuer. The "kicker" bond's appeal is understandable.

Source: Bloomberg, Investortools Perform

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## FAVORABLE "KICKER" SCENARIOS

Duration-neutral "kickers" often outperform in flat or falling interest rate environments due to their incremental yield or "carry". These structures are priced to their call date, and in benign rate environments the probability of a call is reduced. In such scenarios, "kickers" will typically behave similarly to a non-callable "bullet" maturity bond, and investors benefit from greater yield that compensates for the presence of a call option.

Interest rate volatility, not simply nominal levels, may also impact a "kicker" bond's performance expectations, as callable bonds are essentially bonds with an embedded option. Therefore, a decline in rate volatility expectations would likely boost "kicker" performance. Conversely, as volatility increases call uncertainty also does and a callable bond's price will likely decrease even if yields remain flat.

## BEWARE OF EMBEDDED RISKS

Despite what has been a cyclical declining interest rate cycle, periods in which "kickers" may underperform are far more common than many realize. Although "kicker" bonds that remain far away from their call date may be able to offset the effects of a modest rate increase with incremental income, more substantial rate increases can be problematic, particularly for bonds closer to their call date.

Extension risk is a concern should yields rise sufficiently to force a bond to price to maturity rather than the call due to a reduced likelihood of a call being exercised. When rates rise, "option-adjusted duration," a calculation that factors in a bond's call option relative to its maturity, increases. This adjusts for the probability of that call option not being exercised and can cause effective duration to diverge considerably. Longer duration bonds generally underperform shorter duration bonds as rates rise. Therefore, "kicker" bond prices are likely to decline faster than non-callable bonds, as their effective duration increases along with interest rates due to the change in option-adjusted duration.

Even quite nominal upward rate moves can begin to lengthen a bond's option-adjusted duration, adding unwanted interest rate sensitivity when it hurts the most, and decreasing it in falling rate environments when investors likely welcome duration. Furthermore, increases in option-adjusted duration can begin occurring well before the point at which the yield equals the coupon rate, particularly for bonds with shorter calls.

It also bears emphasizing that, despite a long secular bull market, tax-exempt investors have faced meaningful rate spikes on at least four recent occasions.

10 Year AAA Municipal Yield Curve % (1/1/10 – present)


Source: MMD

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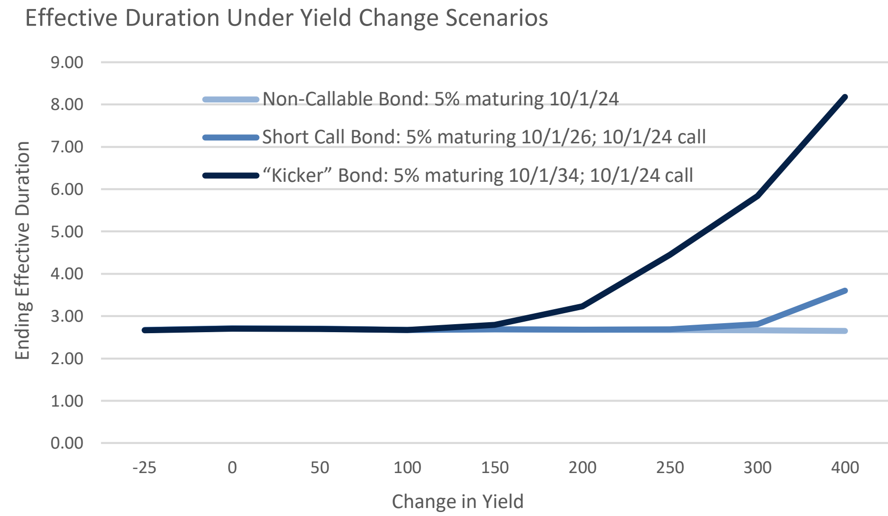
With the case for transient inflation increasingly vulnerable, and the Fed slowly transitioning away from its highly accommodative stance, we see potential for increased bond volatility. Should this occur, it may impact the value of callable bonds. Stated differently, the yield advantage afforded by "kicker" structures can quickly evaporate on a total return basis should rate pressures accelerate.

Consider the three previously referenced California GOs priced to 10/1/24, one a "kicker" with a much longer stated maturity, a short call bond, and a non-callable bond maturing at that same time. Assuming various instantaneous rate shocks illustrates the extent to which option-adjusted duration can be impacted by rising rates, particularly bonds with shorter calls.




Source: Investortools Perform, Appleton Partners

## WHEN IS CAUTION WARRANTED?

At Appleton, our inclination to avoid short call/long maturity structures aligns with our tax-exempt investment philosophy. We seek to carefully manage volatility in an asset class sought after for portfolio stability and tend to avoid bonds that may add significant price variability. We also emphasize total return and rarely hold bonds to maturity. More broadly, we strive to outperform in rising rate markets given the defensive role municipals play in most of our clients' asset allocation strategies and the historically negative correlation between rates and riskier asset classes.

Furthermore, valuation is everything and we (usually) concur with the adage that "there are no bad bonds, only bad prices". Today's conditions are characterized by low nominal yields and tight spreads, a dynamic that reduces the margin for error. Sustained demand has driven many "kicker" premiums down to what we believe are unattractive levels. Given where rates are situated and with still muted longer-term expectations, the markets are treating many "kickers" as if they were non-callable bonds of the same maturity, valuation that seemingly overlooks embedded risks.

Even though we do not anticipate rates rising dramatically anytime soon, richly valued bonds with significant extension risk could be attractive sell candidates. While the current carry is attractive, holding with an intent to optimally time future sales may prove problematic. At face value, yields can be enticing yet we urge advisors and investors to be cognizant of risks and recognize that these bonds will not trade like non-callable issues when rates turn.

## THE DEVIL IS IN THE DETAILS

Nonetheless, we are buyers of certain "kicker" bonds when prices are attractive, and their characteristics fit a client's needs. Those that appeal to us usually possess relatively short time frames between maturity and call dates.

The suitability of any bond is fundamentally a function of a client's goals and risk appetite, and "kickers" must be analyzed in the context of an overall investment strategy. For example, our Long Municipal strategy is likely to be better positioned to accommodate a riskier and higher yielding "kicker" structure than Intermediate. Alternatively, investors looking for incremental yield who are willing to accept greater interest rate risk may be better off with non-callable, longer maturity bonds.

An investor's liquidity needs are also paramount. Liquidity is a risk that is far less easily modeled than quality and duration. Scenario analysis can tell you what a bond should be worth, but not what concession an investor will demand during a rate shock. Therefore, the extent to which an investor can ride out pockets of volatility or hold to maturity is an important factor when evaluating "kickers".

Ultimately, our investment decisions are based on the needs of individual clients, a bond's characteristics, and relative value at a given point in time. We see no need to punt on "kickers" altogether yet feel that investors ought to take a close look at what they own.

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