INCOME INVESTING ▪ By Eric Uhlfelder

"Baby Bonds" Offer Adorable Yields

CORPORATE BONDS ARE LARGELY THE DOmain of big investors like pension funds and mutual funds. The bonds come in increments of $1,000 and usually change hands in multimillion-dollar chunks, with prices often bouncing around on the news. Luckily, there's an easier alternative: "baby bonds," corporates with a $25 par value. And their yields sometimes top those of regular corporates.

Introduced about 20 years ago, baby bonds mostly trade on the New York Stock Exchange, just like stocks. They even have ticker symbols. You can easily buy, say, $2,500 of the bonds through your online brokerage, and use a limit order to cap your purchase and sell prices.

With about $20 billion of baby bonds outstanding, this is still a tiny corner of the $9 trillion corporate bond market. But yield-starved investors can find plenty to like in the market, with yields several percentage points above those of 10-year Treasuries, now about 2.9%. The yields rise commensurate with the risk you're willing to take. What's more, baby bonds make interest payments four times a year, versus twice yearly for regular corporates.

Bankers conceived of baby bonds to help corporate issuers diversify their bond offerings to the retail market. Various industries have tapped this capital market, including shipping, utilities, communications, retailing, and finance. The bonds are typically senior unsecured, meaning they're senior to other debt and preferred stock in a default but are not collateralized.

Issuers like them because, unlike regular corporates, they are callable after just five years and anytime thereafter. This allows issuers to reduce the cost of their funding if they can subsequently refinance cheaper or cut debt if they no longer need the capital.

In 1998 and 1999, the **Tennessee Valley Authority** issued $1.1 billion of 30-year baby bonds that have three unusual features. One is a variable interest rate that can be reset only downward to reflect falling 30-year Treasury rates. Two, they are noncallable, but investors can cash out at par if an annual reset brings the rate down. (So far, investors have sold $600 million of bonds back to the utility.) And three, interest from these AA+-rated issues is exempt from state and local taxes.

The current yield of the issue due in 2028 (ticker: TVC) is 3.65%. The tax-equivalent yield for a high-income New York City resident is 4.18%. If the bond is held till maturity, that investor would effectively realize a yield of 4.57%.

Lynne Carty

As sometimes happens with baby bonds, those yields also exceed those of the TVA's regular corporates. The TVA corporates due in 2027 carry a tax-equivalent current yield of 3.36% and a yield to maturity of 3.63%.

"With long rates unlikely to fall below their current 2.88% yield, there is little chance the TVA rate resets lower, making this security an attractive play for low-risk investors looking for a bit more than Treasuries offer," says Kevin Conery, an analyst on Piper Jaffray's preferred trading desk.

Some investors like the callable feature because it can have a stabilizing effect on bond prices. But if inflation takes off and rates move sharply higher, especially across the long end of the yield curve, then issuers would be less inclined to call their bonds.

There are some compelling issues available from some surprisingly big names borrowing in this little-known capital space. That's especially so if you're willing to take on some more credit risk.

EBay's 6% exchange-traded bond, rated BBB+ (a moderate investment-grade rating for senior unsecured debt) is currently selling at $26.24, offering a current yield of 5.72%. If the bond is called in 2021, as allowed, investors still end up collecting more than 4% a year. If the bond is held until maturity in 2056, investors would collect 5.70% annually.

Yield hunters may find that baby bond more attractive than **eBay**'s August 2021 regular bond, with a current yield of 2.90%, or its July 2042 bond that's paying 4.64%.

Meanwhile. a large Southern power supplier, **Entergy**, has an A-rated senior-secured baby bond that's currently yielding 5.41%, callable in less than three years, trading just slightly over par at $25.38.

Apollo Investment, a fund-raising and investment arm of one of the world's largest private-equity firms, has a currently callable bond maturing in 2043 that can be purchased slightly above par with a yield of 6.82%. Its BBB- rating is at the low end of investment grade.

The relative obscurity of this asset class can also fuel peculiar behavior in the securities, creating opportunities. Doug Baker, head of preferred securities at Nuveen, says the market often fails to differentiate between baby bonds and preferred securities, most of which don't mature and are lower down the capital structure than bonds. The reasons: Both are generally $25 exchange-traded issues that are retail focused, typically with five-year call features, and have been included together in preferred indexes and exchange-traded funds.

"When dealing with issues from the same company," explains Baker, "we've witnessed a baby bond performing worse than a preferred."

Dividend Payments, page M39

The reinsurer Maiden Holdings was hit by significant reserve charges last year that led to a selloff of its securities. Returns of its baby bond (MHNC; due in 2043) have underperformed its preferred issue by 9%. The much-lower-coupon bond now has a current yield of 9.49%, just below the preferred yield of 9.69%. "Moreover," explains Baker, "this means today's investors can lock in this nearly equivalent high yield for an investment that matures and is more secure than preferred stock."

Barry McAlinden, a senior fixed-income strategist in UBS' chief investment office, says that as rates have increased, baby bonds have generally held up better than corporate bonds. This may be occurring because institutionally owned corporates tend to react more quickly to changing Treasury rates than the $25 retail bonds. He also notes a substantial rise in corporate issuances this year, which has also put downward price pressure on these bonds.

McAlinden adds, "If the Federal Reserve continues to modestly tighten rates and unwind quantitative easing, baby bonds may continue to outperform—especially those whose call dates are helping support their prices." ■

Bond Buying Made Easy

These corporate "baby bonds," which you can buy in $25 increments, carry varying levels of risk and yield.

Issue / Ticker	S&P Rating	Recent Price	Call Date/ Maturity Date	Current Yield	Yield to Call
Apollo Investment / AIY	BBB-*	$25.17	7/2018 – 7/2043	6.82%	Callable Now
AT&T / TBB	BBB	24.87	11/2022 – 11/2066	5.38	5.26%
eBay / EBAYL	BBB+	26.24	3/2021 – 2/2056	5.72	4.19
Entergy New Orleans / ENO	A	25.38	4/2021 – 4/2066	5.41	5.21
Tennessee Valley Authority / TVC	AA+	24.31	NA – 6/2028	3.65	NA

*Fitch Rating, not rated by S&P NA = Not Applicable

Source: Bloomberg