No Boom Yet For These Babies

Baby bonds are one of the most compelling sources of low-risk income that most advisors haven't heard about.

By Eric Uhlfelder

WITH MANY INTEREST rates now in their eighth year below 1%, advisors remain hard-pressed to find low-risk sources of significant income. Online-only bank accounts may pay 0.90%. Five-year CDs are yielding 1.64%. And 10-year Treasurys recently traded at 1.46%.

Stocks are a superior source of yield. That's a key reason the equity market has been making new highs. But for investors focused on capital preservation, equities are not the right place to park all their money.

We've written about the appeal of preferred stocks. These are dividend-focused securities whose prices move in concert with interest rates. The main drawback of these issues is that most don't mature. So if you need your money in several years, and rates do start moving up, then you may be in for a haircut if you sell.

Securities that get mixed into the discussion of preferreds are "baby bonds." These are exchange-traded debt issued at $25. You can easily buy and sell them online like stock. They mature on set dates. Most important, many are investment-grade senior debt offering attractive yields.

Haven't heard of them?

No surprise. The space isn't very large—only about $25 billion. Few advisors know about them. Financial papers don't write about them. And while big-name brokerages underwrite them, very few cover them. Baby bonds are an obscure asset class, even though from a safety perspective, they rank alongside their traditional $1,000 brethren in the capital structure.

Reaching Retail

Baby bonds were created several decades ago to expand the investor base of creditors to retail investors. Issuers like them because they are flexible debt, with call features that kick in five years after an offering, payable at par; $1,000 corporate bonds, on the other hand, tend to be much more expensive to buy back for the issuer because they are designed for high-end investors and institutions looking for long-term yield plays.

Corporate debt pays interest semi-annually, involving much

Select Baby Bond Investments Ordered By Coupon Yield

ISSUE	TICKER	COUPON	INDUSTRY	PRICE	CALL DATE/ MATURITY DATE	CURRENT YIELD	YIELD TO MATURITY	YIELD TO CALL
Senior Unsecured Debt with no Negative Call Risk								
JMP	JMPC	7.25	Finance	25.27	1/17-1/21	7.17	7.08	5.78
Seaspan	SSWN	6.38	Shipping	25.41	4/19-4/19	6.27	5.78	5.78
EBAY	EBAYL	6.00	Retail	26.85	3/21-2/56	5.59	5.55	4.24
GE	GEK	4.70	Finance	26.59	5/18-5/53	4.42	4.41	1.67
Bonds with Substantial Yields and Negative Call Risk								
Aegon	AEK	8.00	Insurance	27.23	8/17-2/42	7.34	7.22	-0.86
KKR	KFI	7.50	Private Equity	26.45	3/17-3/42	7.08	7.10	-0.76
GS	GSJ	6.50	Finance	25.95	11/16-11/61	6.26	6.26	-9.31

Note: All bonds are senior unsecured debt, except the Aegon issue, which is a lower subordinated issue. Data as of market close, July 29, 2016.

larger issues that trade over-the-counter with wide bid-ask spreads. Baby bonds make quarterly interest payments, trade like stocks and involve issues that typically range in size from $30 million to several $100 million.

Industries raising revenue in this market include financials, shipping, industrials, utilities, energy and retail. And the issuers include some very big names: Goldman Sachs, GE, eBay and Hartford Financial.

A helpful, free website that provides essential data is quantumonline.com. It lists nearly 200 issues, identifying call dates, maturities and yields, along with access to prospectuses.

So what's wrong with them?

Nothing, except that retail investors have poured into baby bonds since late winter, making many expensive. This means that even with many bonds offering attractive yields, new investors have to watch out for negative net returns if the bonds are called. That's because they are trading so much above par. Kevin Conery, analyst at Piper Jaffray's preferred trading desk, suggests buying new issues around par with initial call dates many years out.

Credit risk is largely informed by the health and prospects of a company (and its industry) and rank in the capital structure: senior unsecured down to subordinated debt.

Caveats

Like any investment, advisors need to know the issuer and its industry. They must check the bond's maturity, which can range from less than a year to a century.

Buying above par isn't necessarily a bad thing. Just make sure you can't lose more when the bond is called than you gain on interest collected. Greg Phelps, senior portfolio manager at John Hancock Asset Management, who runs several billion in preferred stock mutual funds (which includes a bunch of baby bonds), says this is a key issue because "more often than not, baby bonds are called at or soon after the initial call date."

As of midsummer, Goldman Sachs had an issue that was trading under $26 with a current yield above 6%. Despite its long-dated maturity, it's callable in November. If that happens, a new investor will be out more than 8.5%.

Phelps advises to watch for periodic sell-offs, as we saw at the beginning of the year, which can quickly send prices below par, creating buying opportunities.

Baby bond yields are often set at fixed rates. But some pay floating rates, based on a set spread over LIBOR. And some bonds start off with fixed rates and then transition over to floating. While this feature can reduce yield, floating rates are not necessarily a negative thing. In fact, they reduce a bond's volatility because its price doesn't need to fall for the bond to adjust to rising yields.

Just as they could with any other bond, issuers could default, leaving investors with non-performing paper that's worth a lot less than what they paid.

Credit ratings may guide investors away from this risk. Most existing issues' ratings range from "AA+" to "BB." Some issues are not rated. That doesn't mean they are lousy buys. Some companies simply don't want to pay for a rating if they have a well-established reputation and if underwriters think they can easily dispose of these bonds.

But investors must always do their homework to determine if the issuer will likely be around and paying during the life of the bond.

Investments

As the select list of bonds below shows, there are various opportunities. During the beginning of the year there were lots more. JMP, one of the last remaining boutique brokerage firms, saw its 8% (Series B) bond sell off below $20 in mid-February. Now it's trading at $25.35. Since it's now callable month to month, a new investor could stand to lose more than 6% if the bond gets called next month. JMP Series C is now a safer bet (see table).

Dutch insurer Aegon has an 8% bond, which was also traded around $25 in late

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Baby Bonds

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winter. Now it's well above $27. Though its initial call date is still 20 months out, buying now could result in a fractional loss if the insurer decides to call this high-coupon security.

Seaspan is regarded by many industry observers as among the best-managed container ship leasing firms in the industry. But the firm has gotten nicked by the slowdown in world trade and its major reliance on China. Still, its 6 3/8% bond due in April 2019 may be worth a look. Trading above par, the bond's current yield is still over 6% and if held until maturity (there's no call feature), an investor stands to walk away with an annual return of 5.74%.

A baby bond for eBay due in 2056 is currently yielding 5.6%. If called in March 2021, the annualized return would be 4.22%.

Let's compare this with eBay's 4% $1,000 corporate bond due in 2042, which is yielding 4.45%. That's not much higher than the baby bond's yield to call. And if held to maturity, the more expensive corporate bond yields about 90 basis points less than the longer-term baby bond. The baby bond appears to be more attractive.

As Daniel Kelsh, senior fixed-income strategist at UBS Wealth Management, puts it, "especially in this higher-valued environment, it's more essential than ever to do the math to identify opportunities and risks with baby bonds."

This is not quantum mechanics. So when the next sell-off comes, crunching the numbers will be a worthwhile thing to do. FA

RSF Social Finance

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process. No big bank was going to give them a loan."

Many of RSF's borrowers share traits with Revolution Foods in that they create impact in several ways, fostering improvements in the environment, education and nutrition. Another recipient, RecycleForce, is an Indianapolis-based e-waste recycler that doubles as a job-training program to rehabilitate formerly incarcerated individuals.

"Their activity provides e-waste recycling services to a community that they did not have before," Shaffer says. "They provide an added benefit in that the recidivism of program participants is about 20%, compared to a national average between 70% and 80%."

RSF also offers access to grants, loan guarantees and subordinated debts, providing borrowers with integrated capital opportunities to help them grow. RSF's financing offers investors lower returns than other debt, says Shaffer, but also poses lower risk than many other fixed-income investments, offering 90-day liquidity.

"Direct investments are lower risk from a fundamental standpoint and they come with lower volatility," Shaffer says. "We have a 2% loss rate over 32 years in the portfolio, and we have some longtime clients supporting that."

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—Don Shaffer

Shaffer and RSF did have to reconsider some investments. For example, the firm had been a major early investor in Generation Investment Management, the firm founded by former U.S. Vice President Al Gore and David Blood, and had pumped $5 million into the organization, but decided to sell its stake because it wanted a more direct relationship with its investments.

"We decided categorically that we needed to exit any position where we can't and don't know what's going on," Shaffer says. "This is not to judge people at publicly traded companies or on Wall Street. It really isn't a 'holier than thou' thing, but we wanted to model and reimagine how we could use the financial system to change the world."

Even so, RSF still has legacy private equity holdings, and is experimenting with green bonds, including issuances by SolarCity, the solar power system provider slated for a potential merger with Tesla Motors. Stepping back, Shaffer is elated with the rise of impact, green and socially responsible investing in recent years.

"There's certainly a move towards socially responsible behavior in general, not just investing," Shaffer says. "Look at the local food movement: Now it's not just people in artisanal or boutique communities like Berkeley who want to know where their food comes from and want to connect with the people who are producing their food. I see what's going on with capital right now in a similar way." FA