Negative Yield Bonds

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INTRODUCTION

Bond Definition

Bonds are debt instruments issued by corporate or governmental entities (each, an "**Issuer**"). Bonds consist of loans from investors in exchange for the Issuer's agreement to pay a specific rate of return to the investor for a specified period of time.

Bond Yields

The return (or "**yield**") on a bond involves a complicated calculation that takes into account the amount of income generated by the bond (the "**coupon**"), the price paid at the time of purchase, the time period that the bond will pay interest to investors, any realized gain or loss of principal by the investor when the bond is retired, and the reinvestment value of the coupon over the period of time that the bond pays interest.

Call Features

A bond Issuer may reserve the right to repurchase or retire ("**call**") their outstanding bonds prior to the stated maturity date. This is known as a call feature or call provision. When bonds are initially issued, the Issuer may establish a schedule for when the bonds may be called and the specific call prices for each call date.

Since an investor's yield takes into account the period of time a bond pays out interest and any gain or loss of principal, an Issuer's decision to call the bond will affect the investor's yield. As a result, it is crucial that bond investors be aware of any potential call features that could affect their overall return before they invest in a bond.

Required Call Disclosure

Securities regulators require that investors be informed of the worst-case scenario when purchasing a bond. Brokerage firms, therefore, are required to calculate both the yield-to-maturity and the yield to each in-whole call to determine which scenario would result in the lowest overall return for the investor. Brokerage firms are then required to disclose the lowest of the yield-to-maturity or yield-to-the-call to potential investors prior to their decision to invest as well as disclosing the lowest yield on their trade confirmation.

NEGATIVE YIELDS

As noted above, based on a number of variables (i.e., price paid, time held, interest generated, etc.), an investor's yield may vary from what is quoted at the time they purchase a bond. In rare cases, some investors may elect to invest in a bond that is quoted at a negative yield.

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One Strategy

In a low interest rate environment, and in very limited circumstances, certain investors may seek to invest in older, higher coupon bonds with short call dates that are selling at small premiums to their face value. The investment strategy is positive only if the bonds remain outstanding until the interest earned exceeds any loss of principal paid when the bonds are called or mature.

It should be noted that the success of this strategy is by no means guaranteed and requires significant amounts of research by the investor and their Financial Advisor.

Research Required

Investors who wish to purchase bonds at a stated negative yield must be well-informed as to the potential consequences if the bonds get called by the Issuer prior to the date at which the interest earned offsets any loss of principal (the "**breakeven**" date). Certain conditions must apply for this strategy to be successful:

- Investors need to be aware of the call history of each offering to help them make an assessment as to whether the bonds might be called in whole or in part in the near future. In addition, investors need to be fully informed as to what the existing call features are.
- Investors need to be aware of the breakeven date after which a bond sold at a negative yield will begin to generate a positive return if it is not called. To ascertain this date, investors, with the assistance of their Financial Advisors, should calculate out several succeeding calls to determine when the income earned on the bonds would offset any loss of premium paid thereby resulting in a positive return to the investor.
- Premiums paid by the investor, when kept at a low enough level in relation to the worst-case call feature, will generally limit the downside.

IMPORTANT RISK CONSIDERATION

Potential for loss of principal

Based on a number of market factors that could affect a bond's yield (i.e., early call, default, etc.), there can be no guarantee that employing this strategy will result in a positive return for the investor. Anyone considering this strategy needs to be fully cognizant of the risks it entails, including the potential for loss of principal invested.