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Hunt for Yield Leads to a Rare Bond Prize

By Mike Cherney

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Bond investors are looking for pieces of junk among highly rated companies.

Lured by higher yields, some money managers are scouring the market for companies that have been upgraded by credit rating firms from junk status to coveted investment grade.

The hunt is on for a specific type of corporate bond—one that allows the issuing company to buy back the debt after a set period but before the bond's maturity. Because investors don't typically like such uncertainty, issuers pay for the privilege with higher yields.

Those higher yields are looking attractive now as interest rates hit rock-bottom levels. And for investment-grade investors, the added yield is a rare boon.

Usually, callable bonds are confined to companies with junk-rated debt. Such companies seek added financial flexibility, and recent demand for junk bonds has enabled them to sell these bonds relatively easily.

Now, as more companies move up the ratings scale, investment-grade investors are seeking them out.

Investors' scramble in this corner of the approximately $3.5 trillion U.S. high-grade corporate-bond market illustrates the intense focus on garnering higher returns at a time when yields on debt issued by developed countries are very low.

"We thought it was an area of the market that was being overlooked," said Matt Brill, a senior portfolio manager at Invesco Ltd., which manages $790 billion in total assets.

He said his firm recently bought callable bonds sold by oil producer Continental Resources Inc., which Standard & Poor's boosted to investment grade last August. Now, one of Continental's bonds, which matures in 2022 but can be called in 2017, yields 2.519%, according data provider MarketAxess. Mr. Brill said that is an attractive yield compared with similar bonds, such as one from Anadarko Petroleum Corp., which is similarly rated, matures in 2017 with no call option and recently yielded 1.546%.

The size of the market for callable investment-grade bonds is small but could grow, according to Shobhit Gupta, a credit strategist at Barclays. Only 29 of about 5,000 securities in Barclays's investment-grade corporate-bond index are callable, with a value of about $19 billion. Those 29 exclude debt that is callable within one year of maturity at full price and debt that can be called early within the next few months.

More companies could be upgraded from junk to investment grade as the U.S. economy gains steam, expanding the number of bonds available, analysts say. As of May 20, S&P has upgraded nine companies to investment grade this year, including firms internationally.

Barclays analysts have highlighted natural-gas company Chesapeake Energy Corp. and pipeline-company Access Midstream Partners LP as strong candidates for an upgrade.

Part of the reason investment-grade callable bonds yield more is that they don't appeal to all buyers who would normally seek out high-grade debt. Insurance companies and pension funds buy high-grade corporate bonds so that future interest and principal payments offset future liabilities, but a bond that might be redeemed early would make it harder to plan ahead, Mr. Brill said.

"It's just one of those things that makes it a little bit different, and you get paid a little more for it," said Kent White, director of investment-grade research at Thrivent Asset Management, which oversees about $90 billion in total assets and has recently purchased some callable bonds from Continental Resources.

Interest rates are another potential downside. If interest rates rise significantly to the point at which the rate on an outstanding bond is lower than the rates on new bonds, a company may decide not to redeem the bond early. An investor betting on an early call would instead be stuck holding the bond to its maturity, unable to reinvest that money at higher interest rates.

Tom Luster, co-head of investment-grade bonds at Eaton Vance Management, which oversees about $286 billion, said he generally finds that callable bonds "offer little value," but wouldn't necessarily turn down a bond with a call provision if "the benefits of an upgrade are otherwise obvious."

Dave Battilega, who helps oversee the $211 million Aquila Three Peaks High Income Fund, said he has been looking to add to the fund's position of callable bonds from technology provider Fidelity National Information Services Inc., which S&P upgraded to investment grade in January 2013.

A 2022 bond from Fidelity National, which has a 2017 call, recently traded to yield 3.393%. Last month, the company sold brand-new three-year bonds with no call. These bonds now yield 1.500%, according to MarketAxess.

Mr. Battilega said his firm passed on the company's new deal because of the lower yield.

The new bond sale didn't "intrigue me all that much, especially when I have this bond," he said.

Write to Mike Cherney at mike.cherney@wsj.com

FLOYD NORRIS

Looking for a Low Interest Rate? How About Zero?

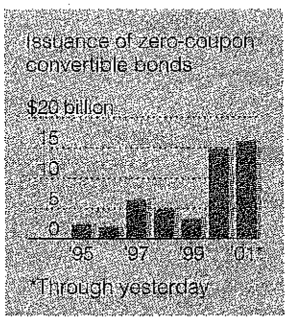
EVEN Alan Greenspan must be surprised by just how low some interest rates have fallen. Can you believe zero percent?

That's the rate the Calpine Corporation, which owns power plants and has been getting rich off California's electricity problems, paid this week when it borrowed $850 million for 20 years. The bonds are convertible into Calpine stock at a 37 percent premium to Calpine's current price.

Another borrower, Stilwell Financial, did not get a zero rate. But Dan Carpenter, an executive vice president of Stilwell, the parent of the Janus mutual funds group, was still happy. "Our combination of a 1 percent yield and a 47.5 percent conversion premium is the best any issuer ever achieved," he exulted last night.

They are not alone. Since Tyco, a rapidly growing conglomerate, started the ball rolling last November, 25 zero-coupon convertibles with yields of 4 percent or less have raised $19.2 billion, according to Thomson Financial Securities Data. Merrill Lynch leads the field, but most other big underwriters are also involved. Over all, including those with higher yields, more zero-coupon convertibles have been issued in 2001 than in any previous year.

How can this be possible? The government can't borrow money at those rates, and its credit is supposed to be better than any company's.



The answer hinges on volatility. The wild swings in stock prices may drive investors crazy, but they also make it cheaper for companies to borrow.

That is because a convertible bond can be seen as a combination of two securities: a bond and a long-term call option to buy the stock. The higher the volatility, the more the option is worth. So an investor pays for the option by taking a lower interest rate on the bond.

At first glance, it appears the company cannot lose. If the share price rises, it ends up selling stock at a price well above the current market price. If the stock price fails to rise, the company has borrowed money at a very low interest rate, so it wins there, too.

There is another neat trick here, one that may lead to misleading accounting. By carefully manipulating the terms of the bonds, companies believe they will not have to include the shares they will issue when calculating per-share earnings, even after the stock price has risen past the conversion price. That appears to conform to the precise wording of accounting rules, but perhaps not with the intent. The rules may need to be updated.

There is, however, one other feature that could yet blow up on a company or two. To make these bonds attractive to investors, they include put provisions allowing the investor to sell the bond back to the company on certain dates. If the stock falls sharply, the company will have to buy back the bonds.

If the company is still in good shape financially, it will be able to borrow other money to repay the bond. But a company could find itself forced to pay billions just when its finances are the most troubled. "As in many financial instruments, it works really well as long as the stock goes up," said Jonathan Glaser, whose JMG Capital Partners has bought several such issues. "If the stock plunges, potentially it's a death spiral."

No one seems very worried about that possibility now. With a recession possible, some creditors are frozen out of the credit markets. But those that can borrow, including some like Calpine that are rated just below investment grade, can get money at rates that are the lowest ever.

Bloomberg

Print Back to story

How $170,000 in Options Moved Clorox Shares $450 Million

By Callie Bost - Jun 12, 2014

Just before 1 p.m. on June 9, 5,700 options tied to Clorox Co. (CLX) were bought on U.S. markets for about $170,000. Traders snapped up the underlying stock and within half an hour, more than $450 million had been added to the bleachmaker's shares.

Ten days earlier, RadioShack Corp., the struggling electronics retailer, jumped as much as 33 percent, adding $40 million to its stock capitalization, after someone purchasing $600,000 in bullish call contracts ignited a rally in the equities. The stock rose to $1.45 from $1.32.

Rallies in companies from Clorox to Molson Coors Brewing Co. (TAP) show how options influence shares and create signals for traders. While equity derivatives have received scrutiny in recent years by regulators looking for evidence of insider advantages, investors scouring screens to turn split-second profits don't have time to think about where their cues are coming from.

"With big trades like these, you see a self-fulfilling feeding frenzy in the underlying stock," Daniel Brady, president of San Francisco-based trading firm Entropy Capital LLC, said in a June 10 phone interview. "People buy the stock and buy the calls and more people buy the stock and the calls."

Smart Money

It's never obvious who's buying options, though investors may believe it's people who have developed special insights into a stock, even illicitly. Years before last week's trades, transactions took place in Clorox contracts prior to takeover announcements by Carl Icahn that are now piquing the interest of federal regulators, a person familiar with the matter said.

"This is where the smart money plays, in the options market," Joe Kunkle, founder of OptionsHawk.com, a Boston-based provider of market data and analytics, said by phone. "You follow the large trades and you can take part in the gains without doing your research."

About 5,700 Clorox calls expiring in July with strike prices as high as $95 were purchased in the two minutes after 12:46 p.m. in New York on June 10, according to Trade Alert LLC, a provider of options-market data. Shares of Oakland, California-based Clorox jumped after the transaction, rising as much as 4 percent, the biggest increase since September 2011.

RadioShack, Coors

On May 29, about 20,000 RadioShack calls expiring in October with a strike price of $1.50 were purchased at 10:25 a.m., according to New York-based Trade Alert. The stock then surged, reaching $1.75 a share in the biggest intraday advance since at least 1980. The shares finished up 9.9 percent at $1.45.

An options trade on June 10 in Molson Coors sparked the biggest rally in 10 months in the stock. A trader bought 2,000 January $75 calls around 10 a.m. and more than 11,000 calls changed hands in the first 30 minutes of the day, according to a note from Trade Alert. The maker of Coors Light and Molson Canadian rose 5.4 percent to $70.71 by the close.

Aileen Zerrudo, a spokeswoman for Clorox, and Merianne Roth, a spokeswoman for RadioShack, declined to comment on the options trading. Colin Wheeler of Molson Coors also declined to comment.

Debate about whether options market trades can be exploited profitably in equities has raged for years. A 2006 study by Massachusetts Institute of Technology professor Jun Pan and Allen M. Poteshman of the University of Illinois found that stocks with bullish options signals, such as low put-call ratios, beat those with negative signals by more than 1 percent a week.

Chat Rooms

Traders are paying more attention to options volume as it gets easier for analysts to study transactions and distribute the information through chat rooms, news feeds and e-mail blasts.

"We've seen a surge in options-focused trading and commentary in chat rooms, which may amplify the effect of unusual options flow," Henry Schwartz, president of Trade Alert, said by phone. "It's definitely become easier to watch options flow technology and broker's platforms have evolved to the point where options flow that used to be well under the radar is now quickly caught by traders who specialize in that."

Another way options influence equities is that market makers need to hedge the buying and selling of puts and calls with transactions in the underlying stock, according to a 2014 paper by Jianfeng Hu of Singapore Management University.

Market Makers

"One big challenge for options market makers is that once someone trades against them, they need to hedge, and their counterparty also knows that," Hu said in an interview yesterday. "Potentially, the counterparty can front-run their transaction in the stock market, which is very dangerous, particularly in large trades. So market makers must constantly adjust their hedging."

Spending $10,000 each to buy RadioShack, Clorox and Molson Coors shares in the minute after the options trades would have generated almost $1,000 in profit if the positions were sold at the end of the day, according to data compiled by Bloomberg.

In some cases, options trading has represented activist investors building up a stake in a company they plan to take over, according to Trade Alert's Schwartz. Other times traders are speculating a company is a good buyout candidate.

"It may be rumors, but it might also be the activist buying calls before his announcement," Schwartz said by phone June 3. "It's not uncommon at all. Most traders accept it as one of the drivers of activity. I don't think it surprises anybody."

Icahn Calls

Investigators are reviewing large option trades in Clorox before Icahn's attempt to buy the company in July 2011, as well as trading by golfer Phil Mickelson and sports gambler William Walters in Dean Foods Co. in 2012, according to a person familiar with the matter. None of the three men has been accused of any wrongdoing.

More than 16,000 calls to buy shares of Clorox changed hands on July 11, 2011, the most since October 2010 and 10 times the number of puts to sell, as the shares rose 2.8 percent.

Icahn has said that he has "never given out inside information" and isn't aware of the probe. He added that he "never purchased" or was "involved in any way with Dean Foods," and that he never spoke to Mickelson.

"I have done absolutely nothing wrong," Mickelson said in a statement, adding that he is cooperating with investigators. Walters told the Golf Channel that he's not involved in insider trading.

Exaggerated Effect

Shares bought by market makers could have an exaggerated effect on stocks during periods of low trading volume, according to Brady of Entropy Capital. About 5.4 billion shares on average have changed hands on U.S. exchanges each day in June, 18 percent below the average daily trading volume through May this year.

Trading in Clorox shares surged to 4.8 million on June 9 after volume hadn't exceeded 1 million shares in any day since May 14, according to data compiled by Bloomberg.

"If there was more liquidity in the underlying stock, those kinds of trades would be absorbed more in the marketplace," Brady said by phone.

Because low stock market volatility has depressed options prices, investors are buying more calls to hedge or replace equity holdings in their portfolios, according to Michael McCarty, managing partner at New York-based Differential Research LLC. Market makers, who must sell the contracts to interested buyers in order to meet demand, are buying the stock of the company being traded to neutralize their positions, McCarty said.

"That's why you're seeing these big trades and the stock moving immediately," McCarty said by phone on June 10. "There are lots of participants in the market whose priority is to minimize pain."

To contact the reporter on this story: Callie Bost in New York at cbost2@bloomberg.net

To contact the editors responsible for this story: Lynn Thomasson at lthomasson@bloomberg.net Jeremy Herron

<u>Options for a Young Financier</u>

Lisbeth Kaufman
Stern MBA
2015

Buy a put and sell a call when you think the price will fall
A put you sell, a call you buy, if you think it will be high
Go try.

FLOYD NORRIS

Dell's Share-Price Bet Cost It $1.25 Billion

GAMBLING on their own stock prices is not something companies often advertise they are doing. But for some companies, particularly technology companies, it was a popular strategy in the 1990's. Now it is coming back to haunt them. The costs are not showing up in financial statements, but they are huge.

In **Dell Computer's** last fiscal year, which ended Feb. 1, it bought back 69 million shares for $3 billion. That means it paid an average price of more than $43 a share. When you consider that Dell's average share price during the year was about $25, you begin to wonder whether Dell had a truly incompetent trader.

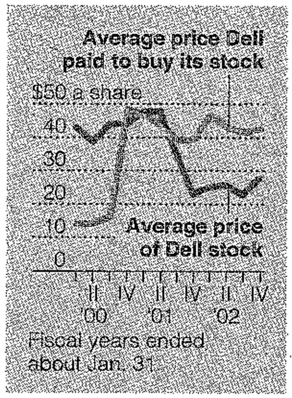
The problem was not with Dell's trader, however. The company was locked into paying high prices because it had gambled on its share price. Had it not done so, the shares it bought last year could have been bought for $1.25 billion less. That number is just a bit larger than Dell's net income for the year.

That cost is not in the financial statements. Under accounting rules, the money a company makes, or loses, in trading its own stock does not affect reported profits. So there is nothing improper in Dell's not recording an expense. But that is still a lot of cash.

Here's how Dell's strategy worked: It entered into complicated options transactions that assured it a lot of money if the stock rose and that would cost it dearly if shares fell. To get a bit more specific, it bought call options, giving it the right to buy Dell shares at a preset price. It got the money to buy those options by selling put options, which gave the buyer the right to sell stock back to Dell at preset prices. The strategy worked well when Dell's price was rising, but now it is costing Dell a lot.

More important, Dell has a lot of risk in the 51 million put options that are still outstanding, with an average exercise price of $45 a share, far above Dell's current $25.42 price.

Dell does not have to put the value of that obligation on its balance sheet because it has the right to pay it off by issuing enough shares to settle its obligation. But in fact it intends to pay the cash, and as such the obligation is as real as any debt.



If Dell's stock price stays just where it is, those options would cost Dell $1 billion. Their current fair value is more than that because of the time value of options.

Just how much more they are worth is something that Dell could compute and disclose, but does not. As it happens, it will soon have to do so. In March, the Emerging Issues Task Force, a part of the Financial Accounting Standards Board, ruled that such fair values must be disclosed. Sam Lynn, a standards board expert on this rule, said that the interpretation took effect immediately, meaning Dell's next quarterly report must tally up the bad news.

Dell made those options transactions to help in its repurchase of shares to offset the dilutive effect of the shares it issues to executives and employees when they exercise stock options. Figures provided by Dell show that from 1997 through the summer of 2000, while Dell's stock was strong, the strategy worked well, enabling Dell to pay well below market prices when it bought back stock.

But then the gamble started getting costly, and it appears that someone at Dell realized what the risks really were. It stopped placing new bets on its stock price in the fall of 2000, but the ones still on the books will be around until mid-2003.

A footnote: Dell's disclosures are a bit sloppy. The figures Dell provided me showed that it repurchased 69,054,919 shares last year. But the annual report says the number was 68 million. Dell says it rounded each quarter's repurchases to the nearest million, and then added up the rounded numbers. Someone should buy Dell a computer with a good spreadsheet program.