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Portfolio

[tag] Portfolio Management

[hed] Performance? Simple

[dek] Some of the least complex bonds now have attractive returns.

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“I have the simplest tastes. I’m always satisfied with the best.” —Oscar Wilde

“Simplicity is the sign of true greatness.” —Vince Lombardi

I’m guessing this is the only column ever to appear in *Independent Banker* that contains thoughts from both a 19th-century Irish playwright and a 20th-century football coach. That’s, ahem, simple enough. The trick will be to explain how this pertains to bond portfolio management in the next four minutes.

Community bankers tend to favor securities that have less, rather than more, complexity. Some of that is due to internalizing that risk belongs in the loan portfolio. Some is the result of examiners having ideas about the suitability of certain investments for community banks. Some is that a collection of generic securities probably has greater liquidity and can be more easily converted to cash, if necessary.

What’s implicit in this conversation is many investors are willing, within reason, to sacrifice yield to achieve other objectives. However, in 2023, a number of securities that fall into the non-complex category are also among the higher yielding; specifically, government agency bonds. So with the ability to achieve two objectives at once, let’s take a closer look at this unique opportunity.

[subhed] **Conditions met**

When certain investment sectors seem to offer more value than usual, a typical explanation is there is an imbalance of supply and demand. That’s partly at play here, but there’s more to it. Government agency bonds are one step removed from the benchmark securities for the entire financial universe, those being U.S. treasuries. Agencies are obligations of your favorite government sponsored enterprises (GSEs), primarily Fannie Mae, Freddie Mac and the Federal Home Loan Bank. Their balances do not amortize; their only variability is if they are called early; and around 10% of agencies have no call features at all and are commonly known as “bullets.”

Why are their yields now higher than many mortgage-backed securities (MBS), and even municipal bonds? Let’s start with the inverted yield curve. At the moment, the two-year treasury has 90 basis points (0.9%) more yield than the 10-year. Many community bank portfolios have average durations in the “belly” of the curve, between, say, three and seven years. So their preferred maturities have a head start over longer ones.

Concerning supply, the Fed still owns a pile of MBS, over 20% of the market, and doesn’t yet seem compelled to unload them on the market, which is probably good for community banks. The shorter municipal bonds out there, five years and less, continue to be gobbled up by nondepositories, making the muni curve, as usual, positively sloped.

Finally, with the big run-up in yields last year, the agencies with call features are much more likely to be at some point “in-the-money” to be redeemed early, and investors have demanded compensation in the form of yield, today, so spreads are unusually wide, today.

**[subhed] Add yield, deduct risk**

For portfolio managers with money to invest now, you likely can find an array of shorter investments that have nice risk/reward profiles. The trick is to lock down these yields for the period of time that fits the bank’s needs. Three-year treasuries have been hovering around 4.25% recently; three-year bullets have about 10 basis points more, and a three-year callable gets almost another full percentage point in yield, which at the moment means around 5.5% to maturity.

Contrast this with a 15-year “current coupon” MBS. These have 15-year stated finals and will have 180 separate monthly P&I payments until they mature. They have around 5% yields, and average lives initially around five years. A quick comparison by the seasoned community banker sees the callable agency having less price risk and more yield. It also is more predictable; the only variable is whether the call option gets exercised or not.

There are, of course, more factors to consider than just yield and term; sector weightings and cash flow are examples. Another legitimate consideration is interest rate risk. This column has presupposed that the banker prefers shorter bonds, when in fact the longer option may be more appropriate. Still, agency bonds may deserve a look as an alternative to more sophisticated products without sacrificing yield.

That leaves us to close with a famous quote from the most pragmatic of investors, Warren Buffett: “Whether we’re talking about socks or stocks, I like buying quality merchandise when it is marked down.”

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[sidebar] Education on tap

Live Community Bank Conference series

ICBA Securities and its exclusive broker Stifel are presenting half-day conferences in several locations in upcoming months. We will be in Boston May 2; Kansas City, Mo., May 10; Denver June 21; and Atlanta June 27. There is no cost to attend, and CPE credit is offered. To register, visit <i>***icbasecurities.com***<i>

**Banking school in May**

ICBA’s endorsed banking school, Barret Graduate School of Banking, hosts its 51st session in Memphis, Tenn., from May 21–26. ICBA’s chief learning and experience officer Lindsay LaNore and ICBA Securities president/CEO Jim Reber are members of Barret’s faculty. For more information or to register, visit *barretbanking.org*

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