Independent Banker

Portfolio — Portfolio Management

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[tag] Portfolio Management

[hed] What we hoped for?

[dek] Community bankers wished for higher rates in 2022. And now…

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I confess an affinity for Casey Stengel. The legendary manager of the New York Yankees in the 1950s, during which his teams won seven World Series titles, could politely be referred to as garrulous. Casey also had a way of mangling the English language that came to be known as “Stengelese.” Many of his comments are transportable to other walks of life, and some have appeared in this column over the last 17 years. Now that we’re well into the 2022 baseball season, I’d like to dust off another of the Old Professor’s quotes and attempt to maneuver that back to bond portfolio management: “There are three things you can do in a baseball game. You can win, or you can lose, or it can rain.”

[subhed] Praying for rain

If your duties include managing you community bank’s collection of bonds, it might be said that your goal at the end of the quarter, or year, or career is to end in a tie. By that I mean the portfolio has a reasonable risk-adjusted return, and the attendant unrealized gain or loss is purely a sidebar. It’s simple enough to calculate the return over a period of time, the standard being tax-equivalent yield. It’s easy to compare your bank’s returns with your peers’, as the call report contains enough information for reporting agencies, including bank regulators, to make that information public.

It’s also simple to quantify the risks associated, especially since credit risk is assumed to be confined to the loan portfolio. The major remaining risk is price volatility, and you will recall the primary means of measuring that is duration. Duration is essentially the weighted average period of time until your bonds reprice, one way or another. Your bank’s bond accounting provider will calculate the effective duration each period and estimate how that would change if rates rise or fall.

[subhed] Unrealized = unfinished

Which brings us to the third rail of many investment committees’ measuring sticks: gain or loss in the market value of the holdings. I have long contended that the net change in market values of a collection of bonds gets far too much attention from community bank management. This is especially so since the end of the Great Recession, which was the last time there were any real impairments to bond holdings. In the past 14 years, gains or losses have been purely the result of changes in interest rates.

We also remember just a couple of years ago, when bond prices were soaring while equities plummeted as the COVID-19 pandemic swept across the globe. Portfolio managers knew intuitively that this was not in the longer-term best interest of the bank, as yields and earnings were on the way down. It made perfect sense then, as now, to posture the overall balance sheet to benefit from rising rates, which it was hoped would one day again prevail.

[subhed] Ducks on the pond

Now that day has arrived, it seems that community bankers are again consumed with the drop in their portfolio’s market values. Let me quickly and pointedly state that managers <i>*should<i>* be aware of their price volatility posture, and also of the current gain or loss (which in mid-2022 is a loss). But, in true bond portfolio tradition, let’s remind ourselves that this is a zero-sum game, at least as it relates to the market values. Rates are at their highest since 2018, and the last time portfolios were underwater for any length of time, overall yields rose noticeably. (See table.) Perhaps this illustrates the “playing for a tie” metaphor.

Given that overall rate risk exposures are stilted toward benefiting from this landscape, the suggestion is to keep the eyes on the market values and use some of the liquidity that many banks have been warehousing. Could rates move up from here? Absolutely. The Fed’s strategy for winding down its balance sheet is far more aggressive than it was last time around, and the mountain is much higher.

The message of this column is that 2022 will likely be remembered as a good time to have purchased fixed income securities. This primarily is the residue of the attention paid to creating balance sheets that would benefit from higher rates. As Casey himself opined, “Never make predictions, especially about the future.”

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[sidebar] Education on tap

2022 webinar series continues

ICBA Securities and its exclusive broker Stifel Financial present the next installment of the 2022 Community Banking Matters webinar series on June 14 at 10 a.m. Central. The topic is “Mortgage Market Update and Opportunities.” To register, visit **stifel.com**

Quarterly bank strategy webinar

Marty Mosby, Stifel Financial’s director of bank advisory and strategic services, will discuss the community banking industry’s advantages and challenges at his next webinar on June 23 at 10 a.m. Central. Visit icbasecurities.com to register.