Independent Banker

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Portfolio

[tag] Portfolio Management

[hed] **Returns, in total**

[dek] A wide range of market prices requires analysis.

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If your duties at your community bank include bond portfolio management, you may have noticed that your holdings’ market values are all over the table. In another consequence of the last 12 months’ volatility, bond-buying in 2023 presents a rare opportunity to buy liquid, predictable government-guaranteed bonds at variety of prices. This includes premiums, discounts and even par (100.00). In some recent periods, (e.g., 2021) there weren’t many bonds available at prices below par, and in others (e.g., 2022) none could be found at premiums.

Of course, your current security inventory still contains unrealized losses, but at least you have a chance to choose some bonds that are set up to perform well in rising <i>*or*<i> falling <i>*or*<i> stable rate environments. This is what happens when the 5-year Treasury note’s yield rises and falls over 80 basis points (.80%) in a two-month window, like it did in February and March. If you’re able to spend some money here in mid-2023, there are some nuances and tools available that you’ll want to consider as you’re looking at current bond offerings.

**[subhed] Shopping lists**

Many (learned, experienced) community bankers I know tend to review a series of quantitative factors when analyzing potential investments. These include the traditional metrics such as stated maturity, issuer name, coupon, price (premium, par or discount) and, of course, yield. This analysis will also include a future price projection given certain interest rate shocks. Since a given bond is worth par on possibly only two days of its life, those being pricing date and maturity date, most everything a community bank buys will be at prices either above or below par.

The reason that matters when comparing one bond to another is that these premiums and discounts will have an impact on their projected future values, given a certain change in rates. Bond math is clearly not linear, and even more so when an investment is stress-tested with a book price that’s nowhere near par. Let’s review the benefits of buying bonds at both discounts and premiums.

**[subhed] Discount versus premium**

I’ve made the case that investors like the sound of a bond that’s priced below 100 cents on the dollar. It has the ring of a bargain, or (even better) a superior position to the unfortunate investor who paid par when first issued. This of course requires buyers to ignore the fact their own portfolio has recently dropped in value. Whether you realize it or not, bonds priced below par tend to perform best when rates fall, particularly when there’s some kind of a call option attached, which applies to about 80% of bonds owned by community banks.

The opposite occurs when a bond is priced over 100 cents on the dollar. Premium bonds, which requires buyers to accept that the original owners paid less for the same bonds, will do better if rates rise. The above-market coupon rates will help to keep the duration from extending and possibly even cause yields to move higher since premium investments are sometimes referred to as “quasi-floaters.”

**[subhed] Valuable tool**

The good news is there is a standard measuring stick to augment some of the numerical features mentioned above: Total Rate of Return (TRR). Total return takes into account three variables: yield, change in price and horizon date. It’s a much more complete standard than yield, and the primary risk in a bond—price volatility—is embedded in the calculation. (You can calculate TRR on virtually any financial instrument, including equities, as well as commodities.)

For example, if you are offered a security at a price of 93 cents on the dollar, priced to yield 5.25% to maturity, and a year from now its market value has risen to 95 cents, your total return for that period will be 7.25%. The typical set of offering documents that brokers provide will include a price volatility table, which usually includes projections assuming immediate and parallel rate shocks. Feel free to ask for a Total Return Analysis (TRA) screen from your brokers. TRAs are easy to read and can provide valuable data for your decision making.

Finally, most full-service firms, including ICBA Securities’ endorsed broker Stifel, produce TRR matrices that are frequently updated and readily available, for some pre-purchase analysis. So make life easier on yourself, and help improve the performance of your bond portfolio: Adopt total return analysis as part of your due diligence as you consider premium versus par versus discount purchase opportunities.

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[sidebar] Education on tap

**Virtual bond school scheduled for June**

ICBA’s Securities’ endorsed broker Stifel will host a virtual portfolio management series June 13–15. Topics include bond basics, investment product detail, and portfolio building. Up to four hours of CPE are offered. To register, visit <i>***icbasecurities.com***<i>

Product selection analytics

The Stifel Strategies and Analytics Group produces the popular Investment Alternatives Matrix that calculates Total Return on a wide range of bonds that may be suitable for community banks. To receive your complimentary copy, contact your Stifel sales rep.

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