Independent Banker

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Portfolio

[tag] Portfolio Management

[hed] Collateral advantage

[dek] A variety of MBS pools can spread your risk.

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As many community bankers are still picking up the pieces from their bond portfolio’s meltdown last year, it occurs to me that the breathtaking rise in rates has created at least one byproduct that is both unusual in frequency and tangibly beneficial for future performance.

Portfolio managers continue to embrace mortgage-backed securities (MBS) for several reasons. One is that they are loan surrogates. Since community banks are lenders by definition, the monthly cash flows are well understood and a nice fit for the balance sheet and interest rate risk.

Each MBS pool is backed by hundreds, if not thousands, of conforming mortgages that have been underwritten to uniform standards. This allows securities to be compared with one another and for prepayment histories on given cohorts to be a basis to project future behavior. This also is one reason for the terrific liquidity in the pass-through market.

What’s come to light in the wildly volatile 2022 is that borrowers’ rates can change in a hurry. In fact, they more than doubled last year. “Current coupon” pools are those new securities priced nearest to par (100.0) on issue date each month. They increased at an alarming pace last year and hit levels not seen since 2003.

For example, in January 2022, the current coupon on 30-year agency MBS was all of 2%. By April, it had squared to 4%. When mortgage rates peaked in October, a par MBS issued by Fannie Mae or Freddie Mac was all the way up to 6%.

[subhed] **The opportunity**

There have been several lengthy periods recently in which an investor in the mortgage market was limited to buying bonds with a small range of coupons. For the past 15 years or so, “small range” has been synonymous with “low.” In nine of those years, fed funds was anchored at 25 paltry basis points. Although there isn’t a high degree of correlation between overnight rates and 30-year mortgages, when money-market yields are “accommodative” (Fed-speak), it’s not likely that longer rates are historically impressive.

So as community bankers try to set up their bond portfolios to take advantage of what’s available, there is now a wide range of options. One time-tested strategy is to diversify. (In fact, when is that *not* a good idea?) Sometimes that means issuer name, weighted average maturity (WAM) or even age of the pools. This time around, it can also mean coupons.

**[subhed] Spread the wealth**

Let’s say you’re in the market for 15-year stated final MBS, and you ask your favorite brokers to show you several examples. There currently is a supply of securities with pass-through rates ranging from 1.5% up to 5%. Each incremental bump in rate will, of course, have an increase in price. Another piece of good news related to this is that even the higher coupons have only modest premiums, especially compared with 2021. If investors are unsure of their favorite flavor, they can buy several different structures, thereby guaranteeing they will be pleased with at least some of the new purchases. (A pessimist might say they’ll be guaranteed to be <i>*displeased<i>* with some, but I’m going with the affirmative.)

What also is clear is that an MBS with a below-market coupon will look very different from a “current coupon” in terms of prepayments, average lives, price volatility and, yes, yield. Currently, a 15-year 2% security is priced around 9 points below par, and the lifetime prepayment speed on the entire cohort is well under 10% annually, which is very slow. (It may be helpful to know that the average homeowners’ mortgage rate was 3.39% at the start of 2023.) One can expect these low coupons to continue to prepay very slowly, producing minimal monthly cash flow in the near term.

If buyers are so inclined, they could layer in some 15-year MBS with, say, 4.5% coupons, which, at present, are at a slight premium. Because the borrowers’ rates will at some point be “in the money” to refinance, these pools will have shorter average lives than the discount pools and, quite possibly, higher yields. However, most relevant is that the portfolio will now be insulated against both rising and falling rates, and average risk/reward metrics of the multiple pools would probably beat any one security currently available.

Today’s lesson is that the debris of last year has created a simple-to-apply strategy of buying an historically wide range of coupons and, in effect, hedge your interest rate bets. Doing so can turn the collateral damage of 2022 into your collateral advantage of 2023.

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[sidebar] Education on tap

2023 webinar series continues

ICBA Securities and its exclusive broker Stifel present the next installment of the 2023 Community Banking Matters webinar series on March 23 at 12 p.m. Central. The topic is “Solutions for a Challenging Environment.” To register, visit <i>***icbasecurities.com***<i>

**Bond Academy registration open**

There are still some slots available for the ICBA Bond Academy on April 17­–18, 2023, in Memphis, Tenn. Up to 11 hours of CPE credit are available. The event is hosted by ICBA Securities and its exclusive broker Stifel. For more information or to register, contact your Stifel sales rep or visit <i>*icbasecurities.com<i>*

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