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Time out for trivia

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Q’s and A’s to enlighten portfolio management

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By Jim Reber, ICBA Securities

If you’re a sports fan (and I know you are), and you’re also of a vintage that has recall back several decades, you may have heard of Todd Donaho. Donaho was the self-proclaimed “commissioner of sports trivia” as the host of *Time Out For Trivia*, a popular live call-in show that ran on the USA Network on weekday evenings from 1985 to 1990. The commish would fire off questions in rapid-fire succession to phone-in contestants, who hoped to win prizes ranging from telephones to grills. Players would compete at their own peril, as Donaho would often ask “boneheads” who guessed incorrectly to “take a hike.” Nonetheless it was a winning formula, and by cable TV standards *TOFT* had high ratings.

What does this have to do with community banking? Hang with me as I pose a series of my own questions relating to community banks, which I hope you will view as more helpful than trivial. Even better: Your author supplies the answers, so there’s no risk of nationally-broadcast humiliation. As Donaho himself would exhort, “Who’s playing *Time Out For Trivia*?”

**Question:** If you buy a callable bond, are you long or short a call option?

**Answer:** You are short. Mechanically, you have simultaneously bought a bond and sold an option. The issuer has done the opposite and owns the right to take the bond away from you at designated dates in the future. Most callables have periodic call features (e.g., quarterly) but some are callable one time only. The aggregate value of the series of options translates into the additional yield over and above a non-callable “bullet.”

Question: Why is Average Life always longer than Effective Duration for a given bond?

Answer: Average Life is the weighted average period of time to receive your principal, whereas Effective Duration is the weighted average period of time to receive principal *and* interest. Average Life is more relevant for amortizing securities such as mortgage-backed securities (MBS). Since interest is received periodically (as well as early and late) in the life of a bond, the weighted average time period is less than for principal alone. Average Life is more useful for calculating portfolio cash flows and liquidity; Effective Duration is a standard for measuring price volatility.

**Question:** If you sell the guaranteed portion of an SBA 7(a) loan, what are the total proceeds?

**Answer:** There are two sources, and a third element that bears mentioning. First, the proceeds include the principal plus the premium paid by the buyer. If the guaranteed portion is $250,000 and the bid is 108.00 (which isn’t unusual), the total is $270,000 of which $20,000 is gain, and booked on sale date (not settlement date). Additionally, SBA mandates that the seller retains 1% of the interest flow from future payments as servicing income. Finally, the entire amount of the unguaranteed portion, principal and interest, is retained by the original lender.

**Question:** Why does the inflation gauge consumer price index (CPI) usually come in higher than the Fed’s preferred measuring stick personal consumption expenditures (PCE)?

**Answer:** It’s a two-pronged answer. First, the basket of goods for both indices (which is very deep—more than 80,000 items) changes over time as new products enter the market, some disappear, and others’ popularity rise and fall. PCE is quicker to adjust the basket to reflect what you and I actually consume. Which brings us to the second prong: Informed consumers will prefer cheaper goods to more expensive ones, given suitable substitutes. Since PCE mirrors more quickly what our new basket of goods actually holds, it tends to be several tenths of a percent lower than CPI.

**Question:** Why do straight pass-through MBS use the prepayment model conditional prepayment rate (CPR), while their first cousin, collateralized mortgage obligations (CMO) use the model known the Public Securities Administration (PSA), when estimating how a given security will perform?

**Answer:** At one point in the distant past, examiners decided that PSA was more accurate in predicting how a cohort of mortgages would prepay, so that became the standard. PSA is in fact derived from CPR and is an attempt at refining prepayment estimates based on the age of mortgages in a pool. These standards (set in the 1980s at the dawning of the mortgage derivative market, and in *TOFT*’s heyday) have been relaxed, even though CPR/PSA information is still calculated and available for all manner of mortgage securities. Best practices can still call for documenting and modeling how a pool would perform using both methodologies.

So there you have our trip down cable TV lane, compliments of the venerable USA Network. As the commissioner of sports trivia himself would sign off, “Feeling tremendous, I might add.” And if you’re so inclined, you can view some classic episodes of *TOFT* on YouTube.

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*Jim Reber (*jreber@icbasecurities.com*) is president and CEO of ICBA Securities, ICBA’s institutional, fixed-income broker-dealer for community banks.*

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**Upcoming webinar**

ICBA Securities’ exclusive broker Stifel will present its Quarterly Bank Strategy webcast on Nov. 16 at 1 p.m. Eastern. Several presenters will comment on current market conditions and opportunities, and up to 1.5 hours of CPE are offered. To register, contact your Stifel sales rep.