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Up with Coupons

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Larger interest payments can build a floor under your bond prices

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By Jim Reber, ICBA Securities

Up with People, which readers of a certain age may remember, was an organization that had a run of popularity in the 1970s and ‘80s by promoting wholesome values and positive thinking. Its delivery channel was through song and dance performances, often in large arenas and stadiums. Up with People provided the halftime entertainment for five Super Bowls between 1971 and 1986, though in recent decades it has been relegated to the dustbin of a bygone era. Today’s attitudes toward pop culture, it seems, have little room for this squeaky-clean message; *The Simpsons* had several episodes featuring a snarky knockoff, “Hooray for Everything.”

More salient to the current environment, at least pertaining to community banking, is a simple-to-execute investment strategy: Up with Coupons. This tactic can be employed at any time, and in any interest rate scenario. The reason we’re talking about it today is that it could well be utilized to both limit the price volatility and normalize the cash flows of your bond portfolio. As we’ve seen, market values have been on a one-way trip in 2022, and putting a floor under your investments may strike some as a good idea.

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Moving target

If we look back just a year, we would see a totally different rate landscape. It was nearly impossible to buy a bond, particularly an amortizing security, which had a price as low as 100.00, much less at a discount. So, going “up in coupon” would seemingly have heaped an additional pile of prepayment risk onto the portfolio, at a time when mortgage refinancing was setting its own world records.

For example, in June 2021, a 15-year agency mortgage-backed security (MBS) with a 1.0% coupon would have cost about 100.00, so if your bank purchased that security back then, your book yield will forevermore be 1%. A similar bond with a higher coupon, say 2.5%, would have cost about 104.50. Its resultant yield would have been totally a residual of the prepayments, over which an investor has little control. Many a portfolio manager opted for the lower coupon, given the need to stabilize the shrinking net interest margins.

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MBS shakeout

Today, of course, we have a completely different set of dynamics; foremost is the lower prices for all things in the bond world. The 15-year 1.0%’s are now worth around 86 cents on the dollar, for a decline of about 14%. The 15-year 2.5%’s are down in price “only” about 10%. This demonstrates how premium (up-in-coupon) pools will experience price compression in low rate environments, like the bond market of a year ago. When a market sell-off occurs, the price declines will be less acute for the higher coupon cohorts.

Another factor is that average lives, and effective durations, will remain shorter for the higher coupon securities. Using very recent speeds of our two model pools as examples, the 1.0% bond now has an expected average life of almost six years, while the 2.5% is around four years. This is part of the reason that the higher coupon’s price has declined less than the cut coupon pool. But to be clear, neither of these are expected to have much prepayment activity in the near future, as the collateral for both is plainly out of the money to be refinanced.

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Discount munis: Buyers be alert

Let’s shift investment sectors, but stay on message. The tax-free municipal segment of a bank’s collection of bonds is an important determinant of overall performance. There are specific rules that apply to tax-frees purchased at prices below par that you may have forgotten, since “discount munis” was an oxymoron for most of the last four years.

The Internal Revenue Code states that a tax-free bond that came to market either at a par or premium price, which is subsequently purchased in the secondary market at a discount, is subject to capital gains tax to the extent the yield is attributable to the discount. For example: a bond with a 3.0% coupon that came to market at par, and is now priced at a discount to yield 4.0%, will be taxed at the capital gains rate on the 1.0% incremental market yield.

The upshot is a muni priced to yield 4.0% may *not* yield 4.0%, given its coupon and original price. Your brokers can and should walk you through all the ramifications of these matters, which have some subplots that space does not allow to discuss here. The easiest work-around? You guessed it: up-in-coupon bonds. Munis that have higher stated rates, which today mean fours and fives, have built-in cushions against falling prices, and avoidance of capital gains tax liabilities.

Ultimately, multiple applications of this strategy suggested here can make life better for your community bank. Limited price volatility? Probably. More predictable cash flow? Likely. Up with income? Most expectedly.

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

[Sidebar]

New ICBA Securities Directors

ICBA Securities has added these four leadership bankers to its Board of Directors: Tommy Bates, ICBA Chairman, Legends Bank, Clarksville, Tenn.; Aza Bittinger, Community Bankers Association of Ohio, Columbus, Ohio; Blake Heid, First Option Bank, Paola, Kan.; and Craig Wanichek, Summit Bank, Eugene, Ore.