



Bang for the Buck

Risk/reward dynamics of portfolio investing have changed recently

By Jim Reber

“An ounce of prevention is worth a pound of cure.”

“If it ain't broke, don't fix it.”

“A basis point of yield is worth a basis point of risk.”

At the risk of being trite, I would like to point out that the aforementioned well-worn axioms have contained more than a morsel of utility for community bankers over the years. Now, a confluence of variables has set the third precept on its ear.

What has changed in the portfolio management world is the series of

events known as quantitative easing, or QE in Federal Reserve parlance. This is the ongoing effort by the Fed during the Great Recession to generally bring down long-term interest rates and create sufficient liquidity to ultimately spur lending. As the ramped-up borrowing hasn't yet taken flight, the effect on community bank investment portfolios has been significant.

Yields down, spreads shrink

The primary objective of the initial QE in early 2009 was to bring down “spreads.” In this case, spreads mean the incremental returns available over a risk-free asset (i.e., Treasuries). If we state that a bond has a spread of

2013 Webinar Series

ICBA Securities will be producing a webinar series in 2013 exclusively for ICBA members and the 34 state community bank associations that endorse the ICBA Securities program. Watch your email or visit www.icbasecurities.com for topics, dates and times.

50 basis points, we mean that its yield is one-half percentage point over a comparable maturity Treasury issue.

In late 2008 and early 2009, spreads widened out dramatically on all securities, due to a combination of illiquidity and risk aversion, rational or otherwise. As the Fed stepped in and began buying bonds in the open market, spreads began to shrink back to more normal levels.

The Fed is now on to QE3, or the third edition of this market-support initiative. Spreads are at historic lows, which is beneficial for the value of bonds already in a community bank's inventory—but not for new purchases.

“Hockey stick”

Adding to the conundrum faced by community bank portfolio managers is the fact that short-term investment yields really don't improve until maturities reach, say, five years. Currently, the difference in a one-year Treasury and a five-year is about 65 basis points (0.65 percent). The 10-year average is right at 100 basis points. After that point, yields do improve on the curve, causing some bond analysts to liken the shape of the yield curve to a hockey stick.

Portfolio investors looking for



In today's market, bankers need to assume well over a basis point of risk to receive a basis point of return.

relative value have had to go into seven-, 10- or even 15-year maturities to see some semblance of absolute yield. But there are other techniques that can be employed to improve a portfolio's total return profile.

Where's the value?

Under normal circumstances, a bond investor will be paid a higher yield to take on more risk. The easiest way to see this is to compare the coupon on a non-callable bond to one that has a call feature. This "call risk" is embedded one way or another in about 80 percent of securities in a typical community bank portfolio.

A very simple security for banks to own is a five-year bullet agency. Today, that bond has a yield of about 90 basis points (0.90 percent). For many community bankers, this is not an appealing yield. So most bankers will buy a bond that can be called away at the issuer's whim at some date specific in the future.

A five-year bond that can be called away in two years yields about 93 basis points today. In other words, you only receive 3 measly basis points of additional yield to have the possibility of that bond being liquidated three years early—which is exactly what will happen if interest rates don't go up from here.

To answer the question "Where's the value?" we arrive at this cataclysmic conclusion: Bankers need to assume well over a basis point of risk in today's market to receive a basis point of return. Bullet agencies, low premium mortgage-backed securities and municipals with long call-period lockouts have a better chance of relative performance than in higher-yield environments.

When will this situation right itself? You'll need to ask the voting members of the Federal Open Market Committee. Quantitative easing promises to keep bang-for-the-buck paradigms out of sync for 2013, and perhaps beyond. ■

Market Outlook

ICBA Securities produces a weekly recap of the bond market that includes a table of available yields and spreads each Friday. To receive *The Market Outlook* newsletter via email, contact your ICBA Securities sales rep.

Or, visit www.icbasecurities.com.

EXTREME PERFORMANCE

- MILLIONS SETTLED DAILY - NON BROKERED
- UNLIMITED FUNDING & INVESTING
- NO PAPERWORK - REGULATOR FRIENDLY



National CD Rateline
WWW.CDRATELINE.COM
1-800-246-0005