



# Defense! Defense!

Portfolio investing with an eye on future interest rates

By Jim Reber

**A**t the recently concluded National Basketball Association playoffs, home crowds could be heard chanting the familiar “Dee-fense! Dee-fense!” exhorting their heroes to throttle the opponent’s offense. Community bank portfolio managers can also employ this strategy, without inhibiting their ability to score. The technique is the old tried-and-true method known as rolling down the curve.

This is a maneuver that has proven useful for a number of years, as it doesn’t require unique securities or hard-to-accomplish yield environments. In fact, only one variable has to be in play: a positive slope to the intermediate part of the yield curve.

Happily, such a condition exists about 97 percent of the time. In fact, the opportunity is so widely accessible that community bank portfolio managers often lose track of it. As we are entering a phase of the credit cycle in which deposit-gathering and lending become more normal (hopefully), leaving perhaps fewer dollars to be invested in the investment portfolio, rolling down the curve can serve as a significant cushion.

## Curve dynamics

In defining what constitutes a “steep” versus “normal” versus “flat” curve, bond analysts like to compare the yields on the two-year and 10-year Treasury note. These two data points represent short and long investors’ expectations for inflation. The average gap between the two over the last decade has been right around 150 basis points, or 1.5 percent.

If inflation is expected to fall, long-term buyers become more aggressive, and become more willing to accept

lower yields. This causes the curve to be flatter than normal. The 10-year yield can actually be lower than the two-year yield for short periods of time, which is a condition known as “curve inversion.”

Normally, longer investors demand higher yields, which results in a positive slope. This compensates these buyers for the additional price risk they assume, as well as increased opportunity risk. Most of 2013 has seen the average slope to be right in line with historical averages, so our two- to 10-year curve has a normal appearance.

## Works right now

While recognizing that all yields are in a trough at the moment (and have been for several years now), we can still demonstrate the benefits of this strategy. A simple comparison of two recent investments tells the story.

A community bank purchased two non-callable agency bonds (bullets) in August 2012. One was a FHLMC (Federal Home Loan Mortgage Corporation) bond that matures in August 2015, and the other was a Federal Home Loan Bank issue that matures in May 2018. The first, which was about a three-year bond when purchased,

yields 0.44 percent, and the second, which was roughly a six-year bond, yields an even 1.00 percent. So the positive slope of the curve gives the longer bond a 56-basis-point head start.

Today, the 2015 bond has an unrealized gain of about 0.15 percent, while the 2018 one has a gain of about 0.45 percent. This is solely due to the slope to the curve. While that may not seem like much, what it represents is additional cushion against rising rates. And remember that the longer bond has more than twice the yield of the shorter one.

## Strategy applied

I have no better idea about the future path of interest rates than you do, or than 7,000 other community bankers do. What we can quantify today, beneficially, is the advantage of purchasing certain securities to achieve maximum performance from what the interest rate curve is giving us. That now includes bullet agencies placed in strategic maturity buckets.

As this example illustrates, interest rates simply running in place cause certain securities to show appreciation in value. This opens up another world of possibilities for community bank portfolio managers. Bullet agencies make excellent swap candidates due to their liquidity and their low market yields.

Do not be lulled into thinking that a ladder of bullets is a head-in-the-sand portfolio structure. By paying attention to incremental yields on investment, and to total return profiles, you can actually create some income with your bank’s portfolio while appearing to be conservative.

As many an NBA fan knows, sometimes offense is created out of good defense. **IB**

## Bond School

ICBA Securities’ investment school, the ICBA Bond Academy, will be held in Memphis on Oct. 21-23. The seminar will teach attendees how to build and manage a successful community bank investment portfolio.

For more information, visit [www.icbasecurities.com](http://www.icbasecurities.com) or contact your ICBA Securities representative.

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