



# Guard Your Flanks

Investing on the peripheries improves your portfolio chances

By Jim Reber

**C**ommunity bank portfolio managers have now had a full quarter to digest the rapid spike in interest rates earlier in 2013. The upshot is a mixed bag of results:

- » investment portfolio yields have finally quit falling;
- » liquidity has somewhat dried up, thanks to a substantial decline in mortgage-backed security (MBS) prepayments and, to a lesser extent, deposit runoff;
- » market values have gone from a net gain to a net loss; and
- » average durations have extended.

The factor that should be of most concern to a portfolio manager is the last one. Duration extensions have myriad implications, and in a rising rate environment they are mostly negative. A very real positive, however, is that a strategy has emerged that allows a community bank to greatly limit its future duration creep and at the same time invest in securities that have very recently been repriced downward.

## Duration matters

Not all duration extensions are bad. For example, the trillions of dollars invested in MBSs in the last five years have almost all been priced above par. As prepayments slow, the book

yield will rise. This is the “cushion” in a cushion bond, which is an investment with imbedded call options purchased at a price above par.

But it's also an unwelcome development for a community banker who is depending on the cash flow from the investment portfolio to fund burgeoning loan demand or deposit runoff. And a corollary to duration extension is a decline in market values. So having to mine the portfolio for securities to sell at a gain has suddenly

become, shall we say, ambitious.

Better perhaps to purchase securities that have virtually no extension risk, if in fact an investor is concerned about (or exposed to) continued rising rates. The remainder of this month's column will be discussing such items. In fact, we're talking about a combination of two similar and yet very different bonds.

## Backed by Uncle Sam

A regular reader of this column has



## SBA 7(a) Assistance

Holtmeyer & Monson, a Preferred Service Provider of the ICBA, assists community banks in packaging, closing and selling SBA 7(a) loans. For more information on this lucrative lending opportunity, contact Arne Monson, president at (800) 340-7304 or [amonson@holtandmon.com](mailto:amonson@holtandmon.com) representative.

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## Barbell in Action

Equal amounts invested in both the floating and the fixed-rate pools will effectively hedge a portfolio's bets. A recent analysis of this strategy used the following two securities:

1. SBA 7(a) pool 521826, priced at 113.375, and
2. SBA DCPC 2013-20 E1, priced at 94.500.

The averages of the two pools create an investment profile that is more than acceptable to most community bank investment goals. Using what we believe are conservative estimates for prepayments, the average yield (today) is 2.11 percent, the average duration is only 3.4 years and the average book price is about 103.59. That earns an investor fully 130 basis points over the Treasury curve, without sacrificing one iota of credit quality. The

spread has widened out dramatically since spring, as the curve has steepened markedly.


Several additional benefits include the ability for half of the investment (the floaters) to move up in yield quite quickly, whenever Prime changes, and for the other half (DCPCs) to have yield enhancement via prepayment penalties, which are a standard feature and which are passed through to the investor.

For the moment at least, there is some expectation that the short end of the curve will remain tethered near zero for quarters to come. The natural extension of that notion is for a steep curve to prevail for a while. That is the ideal environment in which to buy "near and far" for the community banker who is prudently seeking risk-adjusted returns.

been inundated by Small Business Administration (SBA) recommendations. Well, here are several more. The SBA offers two main security options. Both of them have timely payment of principal and interest guaranteed by the federal government and are therefore 0 percent risk-weighted.

Floating rate pools, also known as 7(a)s, adjust based on the Prime rate (which is perfectly correlated to Fed Funds). Their popularity is enhanced by the fact that they reset very frequently (monthly or quarterly) and have no caps or floors, either periodically or lifetime. Their durations will only be about three months.

The distant cousin is Development Company Participation Certificates (DCPCs), which are fixed-rate pools that amortize over

10- or 20-year periods. DCPCs are collateralized by debentures issued as part of the SBA's 504 program financing. They will have long-ish durations, especially the 20-year pools, although prepayments are typically very slow, so the chances of extension are remote. 

## Long and Short

ICBA Securities can calculate the costs and benefits of adding an SBA barbell to your community bank's investment portfolio. For more information, visit [www.icbasecurities.com](http://www.icbasecurities.com), or contact your ICBA Securities representative.