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Ebb and Ebb

Drop in bond prices has not been uniform

By Jim Reber

This month's column happily begins with not one, but two trite admonitions: "Be careful what you wish for—you just might get it." And "those who do not learn from history are doomed to repeat it."

You may have had the opportunity to notice that market rates have "improved" since May. That's the way bond salesmen acknowledge that the value of your community bank's investment portfolio has dropped. Or tanked. Or cratered.

While it's likely that most of your bank's securities have gone down in price in the last four months, the drop has been anything but consistent. There are a lot of factors that determine a true market value of a bond, and some of these variables can counteract the others. For example, an unusual or small issuer of a municipal bond can have a high relative price because of its scarcity. A different investor, however, can believe that the same issue should be valued lower because of a perceived lack of liquidity.

Duration review

The yardstick for measuring the price risk in a given investment is its duration. Duration in its most basic definition is the weighted average period of time for cash flows to be received. Cash flows include principal *and* interest. The stated interest, as we shall see, can have a major impact on the duration.

There have been refinements of the original duration model to account for floating-rate securities. In the case of floaters, such as adjustable-rate mortgages (ARMs), a more relevant gauge is the *effective duration*. Effective duration accounts for cash flows, the window until the security can reset next and any rate caps that are present in estimating how much price volatility is embedded.

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Side-by-side

So in putting this model into motion, the bond market's recent history gives us a great case study. Interest rates on virtually all maturities longer than two years rocketed higher in the 60 days between May 6 and July 5. Community bankers were stunned to see their market values for the June 30 call report. This is where the duration metric was exposed by the harsh light of summer.

We can evaluate two seemingly comparable bonds to see how this played out. A staple of many community banks' investment portfolios is a 15-year, fixed-rate mortgage-backed security (MBS) issued by either Fannie Mae or Freddie Mac. The stated rate, or coupon, attached to such securities makes a tremendous difference in price movements, even though the two securities have identical stated maturities.

The graph on page 59 indicates that higher coupon bonds fared much better than did lower ones. In the case of MBS, there are really two factors at play: 1) the interest portion, being greater for the 4.0 percent bond, means more cash flow to reinvest, and 2) more importantly, the loans that collateralize the pools are based on a much higher borrowers' rate (Gross WAC). It's widely expected that the 2.0 percent pools will have only token prepayment activity, while the 4.0 percent will continue to have some noticeable paydown.

Rules to invest by

Please do not interpret the graph as an endorsement for all bonds with high coupons, to the exclusion of those with lower coupons. There can exist some needs by community banks to keep premiums at a minimum. There can also be legitimate asset/liability exposures that are addressed by longer-duration investments. Coupon diversification is another possible benefit.

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If there is a lesson that can be applied in any rate environment, which has been crystallized this spring, it is that greater cash flows will result in lower price volatility. This applies to corporates, municipals, agency debt and all variety of mortgage-backed securities.

15-Year Mortgage-Backed Security Closing Prices Over 60 Days

(from May 2 to July 5, 2013)

15-Year mortgage-backed security with 2% coupon

15-Year mortgage-backed security with 4% coupon

Closing Price

108.00
106.00
104.00
102.00
100.00
98.00
96.00
94.00
92.00
90.00
88.00

5/2 5/10 5/17 5/24 5/31 6/7 6/14 6/21 6/28 7/5

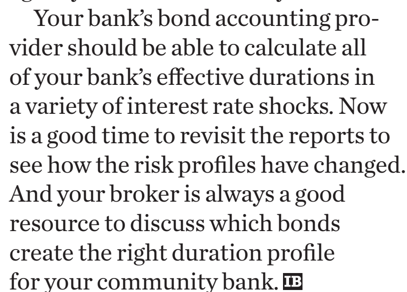
Month and Day

Source: ICBA Securities

Value at Risk

ICBA Securities can calculate any community bank's price volatility by individual line item in a Portfolio Value at Risk report. This complimentary report can be updated monthly.

For more information, visit ***www.icbasecurities.com***, or contact your ICBA Securities representative.



result in lower price volatility. This applies to corporates, municipals, agency debt and all variety of MBS.

Your bank's bond accounting provider should be able to calculate all of your bank's effective durations in a variety of interest rate shocks. Now is a good time to revisit the reports to see how the risk profiles have changed. And your broker is always a good resource to discuss which bonds create the right duration profile for your community bank. IB