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Agents of Good

Agency bonds have super appeal for community banks

By Jim Reber

Maybe by now you've had your fill of prepayments, slowdowns, GWACs, WALAs and WARs. It could be that the additional scrutiny of your community bank's municipal holdings has created some angst. As some community bank portfolio managers' comments indicate to me, maybe interest rate risk concerns are forcing your hand.

For whatever the reason, it may be time to add some weight to your community bank's government agency portfolio.

Debt securities issued by the main government-sponsored enterprises (GSEs)—which include Fannie Mae, Freddie Mac and the Federal Home Loan Banks—have been a staple of community bank portfolios for decades. Historically, somewhere around 15 percent of total investments for community banks consist of such items, so they are a significant contributor to many bottom lines. With interest rates on medium-term investments about 1 percent higher than a year ago, agencies now have the opportunity to perform well as the Fed prepares for its next monetary policy phase.

Simple but effective

The most basic form of a government agency bond is a "bullet," which means that there are no options attached to it. It can neither be shortened (by being called) nor extended (as many mortgage-backed securities have done lately). The investor is guaranteed semi-annual interest payments, plus principal at maturity date. Often, a bullet is so generic that it doesn't yield enough to make an investor interested.

Not so at the moment. An agency bond with the right maturity can both create some noticeable yield, and be situated to maintain its value even if interest rates rise modestly over the next, say, two years. The reason is that the interest rate curve is very steep out to the five-year sector, thanks to the Fed's forward guidance suggesting overnight rates will be near zero for a good while.

For example, a bullet agency maturing in November 2018 today yields about 1.68 percent. If we project its market value in two years by assuming interest rates rise about 100 basis points (or 1 percent), the market price is virtually unchanged. Rates, of course, can rise much more than this, but there is some level of built-in protection.

One and done

Not enough yield? The market has produced a bond that's one step more complex that a bullet, and yields more. And it has upside.

A one-time callable bond that was issued in 2012 or early 2013 is now worth less than its original par price. If you recall the discount callable story (which has been out of circulation for seven years), an investor benefits from a bond being called, if he or she paid less than 100 cents on the dollar for it. The yield to call is enhanced by the discount being realized in a shorter time frame.

An example of this is the Fannie Mae 1.05 percent bond maturing Nov. 26, 2018, and callable one time, Nov. 26, 2014. It came to market at par in 2012 and is now worth about 97 cents on the dollar. Its yield to maturity is 1.75 percent (fully 70 basis points higher than the original investors), and its yield to call is a frothy 5.92 percent.

ICBA Securities will be attending about 25 state community bank affiliate conventions this year. To see our schedule of upcoming events, visit our home page and look for the "Check Us Out" link.

Buying bonds simple (bullets) or complex (secondary market step-ups) issued by your favorite GSEs can now produce some noticeable yield, and have a decent chance to either maintain their value or increase their yield.

Remember that the call is unlikely to occur, but nevertheless is possible.

If, as expected, the bond doesn't get called this November, you are left with a bullet. This will likely cause the spreads to narrow, and the bond will further get some price support. Most bonds have multiple call dates, but I recommend the "European" version, which is one-time only. Be sure to make your broker aware of your preference.

Built for yield

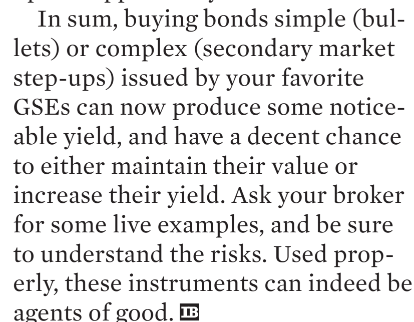
Another item on the agency debt menu is a callable bond that has a series of escalating coupons, which coincide with call dates. These highly popular bonds are known as "step-ups," and while they're not new on the scene, they too are available at levels well below their original par prices. An indication of their widespread acceptance is that more than 100 individual step-up issues came to market last month alone.

As proof that the market for step-ups is efficient, some longer maturity issues now have as much as 10 points of discount. (By "longer," I'm suggesting bonds with more than seven years to maturity.) This is a function of two variables: 1. A bond with a distant maturity date will have more price volatility than a shorter one, and 2. In many cases, the coupon schedule is back-loaded, and the earlier steps just don't keep up with recent rate hikes.

As my earlier comment indicates, I prefer steps-ups that have only one step, or at least limited steps. This will create a much more finite set of outcomes. Of course, a bond with 10 points of discount is really a security that is well out of the money to be called anytime soon.

Recently, an FHLBank step-up was available at price of about 90.31. It was originally issued at 100.00 in February 2013. This bond has a long maturity (2028) and a series of nine coupons ranging from 2.35 percent all the way up to 10.00 percent. The investor has to wait until the last six months of the bond's life to get the fat coupon.

The likely result at this point is for the bond to be called in 2025, when the coupon is scheduled to jump from 3.00 to 3.50. That produces a yield-to-call of 3.57 percent, and any other outcome has a higher return. Of course, many community bank investors won't and shouldn't consider a bond with a 15-year maturity,



but for those who deem it appropriate, the steep discount will create upside opportunity.

In sum, buying bonds simple (bullets) or complex (secondary market step-ups) issued by your favorite GSEs can now produce some noticeable yield, and have a decent chance to either maintain their value or increase their yield. Ask your broker for some live examples, and be sure to understand the risks. Used properly, these instruments can indeed be agents of good. IB

Know Your Call Dates

You can create and view a list of each of your callable bonds by expected call date. This Predicted Call Report is updated frequently so it is a valuable liquidity management tool. Visit ***www.icbasecurities.com***, or contact your sale representative for more information.