



Spillover Effect

External events can impact your muni bond portfolio

By Jim Reber

What were you doing on Dec. 19, 2010, and July 18, 2013? If your community bank owns a sizable amount of municipal bonds, chances are you have a clear recall of your activities and whereabouts on those dates.

It has long been Vining Sparks' recommendation to its community bank clients that their investment portfolios contain a healthy allocation of high-quality municipal bonds. Vining Sparks, ICBA Securities' exclusively endorsed broker, tells us that community bank investment portfolios containing a 30 percent or higher allocation of tax-free investments typically are in the top quartile of their peers' yields, with a relatively benign risk profile.

However, another variable in the creation of a top-quartile collection of bonds is the ability to act during periods when market disruptions temporarily create value. Below is a recounting of the recent past that could conceivably reoccur within the near future.

Unique subset

Bond strategists often compartmentalize securities into two major groups: taxable and nontaxable. One major reason is that munis, unlike taxables, can be subject to "headline risk." When an exogenous event that affects the municipal debt market hits the media, often the entire category can see its market values plummet and stay depressed for weeks, months or even quarters, even though munis are uniquely local in nature.

This is what happened on the TV

news magazine "60 Minutes" one Sunday in December 2010. A securities analyst predicted a "spate" of defaults in 2011, and immediately muni bond funds started seeing net withdrawals, including many high-grade issues. It took the better part of six months before the selling ran its course.

Muni rallies

Broker-dealers everywhere were pointing out the oversold condition of the muni market in both late 2010 and late 2013. Happily, the market prices of the bank-qualified sector rallied dramatically after both sell-offs, which in retrospect was precisely what they should have done.

Between December 2010 and December 2011, muni market values jumped about 4.4 percent, while taxable bonds improved about 1.0 percent. Similarly, from December 2013 to December 2014 munis' market values rose more than 4.5 percent, while taxables' market prices improved about one-third as much.

Pays to be choosy

So what's to be done with this story? There are two main takeaways that your community bank can capitalize upon.

The first is that the structure of a given muni bond can give it a much better chance of performing well in a sell-off, whether it's due to a market disruption or a legitimate spike in market rates. The following attributes will prove to be your friend:

» strong underlying credit ratings;



» high coupon (usually 3.5 percent or higher); and
 » initial call date about half the time period to maturity.

The second is that it can be beneficial to keep some powder dry to jump on a buying opportunity in the muni world. A community bank portfolio can contain a ladder of agencies or an inventory of floating rate investments, both of which should out-yield fed funds and can be liquidated quickly and efficiently when the value train arrives.

The headline effect that has occurred twice in recent memory could well produce an encore performance. If your community bank is prepared, its bond portfolio could actually emerge better off for it. ☐

Webinar This Month

The 2015 Community Banking Matters webinar series concludes on Dec. 9. Jim Reber will present a workshop titled "Portfolio Checklist for Year-End, and the New Year" at 10 a.m. (Central time). It offers a CPE credit hour.

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