



Total Return

A combination of factors determine every bond's ultimate performance

By Jim Reber

During my 20-plus years of dealing with community bankers, either as an investment strategist, sales rep or business-development manager, I have come to understand that certain buzz words fall on deaf ears. As a consequence, supply-siders, like your bank's brokers, tend to avoid using them during a sales pitch.

It's ironic, therefore, that one of those terms should actually be embraced by community bank

investment managers, and should be used to begin the discussion of what's suitable for their bank's portfolio. I hope I don't lose my audience here, but that phrase, with all its lack of glamour, is "total return."

Let's revisit the composition of total return, and consider some suggestions as to how you can incorporate its benefits into your own investment management routine.

Professionals' benchmark

What is total return? We only need

three ingredients to make the calculation. They are 1.) tax-equivalent yield, 2.) market value as of a beginning date, and 3.) market value as of an ending date.

With the typical community bank investment, each of these variables should be easily attainable. Which is another point to be made: Total returns can be computed on any number of financial instruments, including stocks, commodities and life insurance products.

Simply put, total return measures



the income received from an investment, plus or minus the change in value for that period. The return is usually annualized if we're looking at less than a 12-month period.

Let's take the S&P 500 index for example. In all of 2014, it had simple price appreciation of 11.39 percent. On top of that, the basket of stocks that comprise the index paid an average of 1.95 percent dividend; the sum of those two is 13.34 percent. Because those dividends were received throughout the year, we have to factor in some compounding for reinvesting, and this adds roughly another 34 basis points. So your total return, if you owned the index, arrives at 13.68 percent for 2014.

For the asking

Whenever you are bond shopping, consider asking your sales reps to show you the total returns for several different bonds. As stated before, this should be relatively attainable either through proprietary modeling or using the TRA function on Bloomberg.

Either of these calculations should show the total return under a range of future interest rate paths. To be sure, the "up-rate" scenarios are the more pertinent, as interest rates are still on the low side, and the up-rate environments produce a drop in market prices, so they present worst-case outcomes.

You will also want to define your horizon date of measurement, although many models default to a one-year window. There's certainly nothing wrong with looking at multiple horizons.

Performance in sharp relief

Let's take a look at two example bonds, which hopefully will give you a how-to guide for your bank's next (and maybe all future) purchases. For

the sake of simplicity, we will take two bonds of equal credit quality, and with no imbedded options. (Callable and amortizing investments can certainly be modeled under total return scenarios, but their comparison to non-callables is another subject for another column.)

Freddie Mac has issued a global bullet with a stated rate ("coupon") of 0.875 percent which matures March 7, 2018. Fannie Mae has outstanding a global bullet with a 1.75 percent coupon, maturing June 20, 2019. A recent yield on the former was 1.28 percent, and the latter 1.68 percent.


Let's look forward one full year. If we assume rates are up 100 basis points at that time, the total return on the Freddie Mac would be exactly 0.01 percent. What this means is that the yield for the year would be precisely equal to the price decline. Overall, an investor would have broken even.

In contrast, the Fannie Mae bond shows a negative 1.60 percent total return. This makes sense, as the longer maturity will have a larger price decline if rates rise. The additional 40 basis points of yield is not enough to allow the longer bond to keep up.

This is not the end of the story, however. For one, remember that the longer bond will outperform the shorter one if rates fall, or if rates don't move. For another, most models assume that spreads remain stable over time, and that's rarely the case in practice. For yet another,

it's assumed the shape of the curve doesn't change, which is another unlikely event.

Still, more and more successful portfolio managers utilize the TRA screen and similar models in comparing bonds. It can also be a useful tool in measuring overall portfolio performance.

My suggestion is to keep your eyes and ears open when your broker discusses total return. It may be the difference in creating high performance for your community bank's investment portfolio. 



Comparison Shopping Made Easy

Vining Sparks produces an Investment Alternatives Matrix each week. This document calculates total return on dozens of bonds popular for community banks.

For a copy of the report, contact your Vining Sparks sales rep or visit www.viningsparks.com.

Balance Sheet Summit

ICBA Securities' exclusive broker Vining Sparks announces the 2015 Community Bank Conference, a symposium for community bank financial managers. The event will be held at the Drake Hotel in Chicago, May 4-5. For more details, go to www.viningsparks.com/realinsight.