



# Covering the Spread

Bond investments' incremental yields can reward, penalize

By Jim Reber

**T**he Spread. What does that mean to you? In the context of a sporting event, it's the expected margin of victory. If we're talking about investing in a stock or a mutual fund, it's the difference in what you get if you're selling (bid) or buying (ask). Gastronomically speaking, it's something that you smear on a cracker with a knife. And here in late fall, it could refer to the diffusion of germs or a virus.

For community bank portfolio managers, the spread is friend and foe, a benefit and a detriment, something that can make or cost your bank

significant income. For virtually every community bank in the country, it's a fact of life, which makes it curious that it is largely misunderstood.

Given its importance in determining how an investment, and by extension an entire portfolio, performs, it's time to review what The Spread is and how it changes during rising and falling interest rates.

## Spreads in bond land

Spread in the context of this column is the incremental yield over and above a risk-free asset to which an investor is entitled. Community banks that have no reason to consider the implications of spread are those that either own no bonds or own only U.S. Treasury securities. We can probably count those on two hands. Because Treasury securities are viewed as the benchmark from a liquidity and safety standpoint, they are also the lowest yielding.

Anything a community bank owns or produces, including its loans, is priced to yield a "spread" to a comparable maturity Treasury. The amount of the spread is determined by these four variables, in order of influence: safety, maturity, liquidity and optionality.

The first three are probably logical enough to a community banker so as to be internalized. The final item, optionality, relates to how certain an investment is to be repaid at a designated time. For a bond that has no call options (a "bullet"), there is no

question about when the principal is repaid: at maturity. For a bond that has one or multiple call dates, the yield on the bond will be higher to compensate the buyer for this uncertainty.

## Why widen? Why narrow?

A given investment will very likely see its market price change during its life due to both changes in the risk-free rate (i.e., the Treasury yield curve) and the market's perception of the safety, liquidity and optionality of the bond. Dramatic examples are Fannie Mae or Freddie Mac equity and debt in 2008.

The preferred stock of both agencies, rated Aa3 in early 2008, was reduced to junk status in September of that year when the agencies were placed in the conservatorships in which they still reside. The price of the equities went from more than 100 cents on the dollar to under 3 cents in less than seven months. Ironically, because the debt issued by the agencies was perceived to be enhanced by the takeover, to almost an obligation of the federal government, spreads narrowed and prices rose on the outstanding borrowings.

More commonly, spreads will widen when interest rates fall, and will do the opposite as rates rise. The rationale is that the very reason rates are falling is that the economy is sliding into a period of recession, and credit risk on borrowers is greater. An ancillary effect is that for bonds that



can be refinanced, such as callables or mortgage-related securities, the risk of refinance is greater, and an investor demands incremental compensation.

### **Some of these bonds ...**

So how do you find bonds whose market spreads do not widen, or even shrink, after your community bank buys them? First, buy bonds whose credit quality won't deteriorate. That should be easy to do, because virtually all ICBA members have an investment policy that requires very high-quality, investment-grade securities, most of which are obligations of a local, state or federal government.

A more practical application is to buy bonds whose remaining life will shorten with the passage of time. Although that sounds simple in theory, plenty of bonds out do not have these attributes—namely, many mortgage securities, particularly collateralized mortgage obligations (CMOs) that have very little priority to cash flows. These so-called support or mezzanine classes can see their average lives extend, depending on mortgage refinance activity levels, and their spreads widen dramatically. Which is bad news for your bond's market price.

### **... are not like the others**

At the other end of the risk/reward spectrum are those bonds that roll down the yield curve. These bonds can neither be called nor extended by changing market rates. The best example is a bullet agency, but well-structured CMOs, corporates and municipal bonds with a long non-callable period also exhibit this characteristic.

How to find them? Most broker-dealers can produce a report or a spreadsheet that will quantify the amount of spread that your bank's preferred investments will produce. You will notice that the shorter the maturity, the smaller the spread. For example, at the present, a five-year CMO will produce a spread of about 63 basis points (0.63 percent) above a five-year Treasury note; a three-year

CMO is spread at about 0.48 percent over a three-year note. The narrowing of spreads helps maintain your market value in times of rising rates.

So as you consider your purchases, be sure to have your brokers create an expected horizon price for you, given

your chosen rate forecast at a specified future date. The TRA or HZ1 screens on Bloomberg both can quantify your outcomes. Armed with this detail, you can build a collection of investments for your community bank that keeps it from being spread eagled. <sup>13</sup>