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Gravity Defied

An investment whose price can rise with interest rates

By Jim Reber

Have I gotten your attention with the headline and subhead? I want to assure you this is not a house of mirrors nor a playful prank. Nor is it some kind of disingenuous spin. Instead, it may interest you to know that your community bank may already own some of these investments.

I am speaking of the Adjustable Rate Mortgage (ARM) pools issued by two government-sponsored enterprises, Fannie Mae and Freddie Mac. Although they do not exist in huge quantities (only about 3 percent of new originations these days are adjustable), there's enough for you and your community banking brethren to find and purchase.

On their face, they fit a community bank portfolio's needs very well. Liquidity is excellent, they're highly pledgeable, and they carry a 20 percent risk weighting. Another characteristic is that they have short effective durations. What sets them apart from most all other bank-suitable investments is their risk/reward profile.

ARM Analysis

ICBA Securities' exclusive broker Vining Sparks allows you to manage your community bank's investment portfolio interactively through a private portal. Included with access to the portal is the ability to sort and view your bank's ARM portfolio by reset date.

For more information, contact your Vining Sparks sales rep or visit ***www.icbasecurities.com***.

Hybrid primer

It has been a while since we discussed hybrid ARMs in this space, so we should first review their structure. These investments begin life as fixed-rate mortgage securities that pay monthly principal and interest on a 30-year amortization schedule. At some date in the future, usually three to 10 years, they will convert to annually floating instruments. (You can pick your preferred reset date.)

While these have both annual and lifetime caps that can affect how adjustable they are, the fact that they will reset to a market rate in the near future make them coveted by investors looking for high-quality, short-term investments. Their relative lack of supply and short durations can cause their market price to rise once they become true floaters.

A note on this second point is that ARMs issued by Fannie Mae and Freddie Mac have more generous caps than do pools issued by Ginnie Mae. This allows the current coupon to stay more in line with current rates, and increases the chances of a more stable market value.

Exempli gratia

At their issuance, hybrids will have a market premium of 2 to 4 percent, depending primarily on the length of time until the "roll." For example, a new pool that has seven years until its first adjustment will have an effective duration of about three years. As time passes, and the roll date approaches, its duration will fall and possibly its price will rise.

Fannie Mae pool AL2633 is a case in point. It will reset for the first time in March 2016 after coming to market as a five-year hybrid in 2011. Currently the market price of this bond is about 107 percent of par; back when it was hatched it was worth roughly 103.

Why the increase in market value? The shorter the effective duration, the lower the yield demanded by investors. As we have learned, the lower the market yield, the higher the price.

Other side of the coin

It's time for some qualifiers, and some reminders. First, higher prices for shorter bonds require that the yield curve has some slope. Back in 2007, when everything a bank would purchase yielded the same, regardless of maturity, there was little price improvement for bonds that shortened up by the passage of time. If we face a flat curve again, hybrid ARMs won't see price increases like those discussed here.

Second, although the theme of this column is that hybrid prices have something of a floor underneath them through the passage of time, do not think that they won't have a noticeable dip if rates spike while there are some years left before the initial reset. The effective duration provided by your broker will help you estimate the expected volatility.

Third, the psychology of a borrower with a hybrid ARM loan is such that he or she may well prepay it as it gets closer to the roll date. There is evidence that the length of the "lockout," or fixed-rate horizon, mirrors the borrower's expected time of ownership. So hybrid ARMs often see faster prepayment activity through seasoning.

This can leave less on the books to benefit from a market price hike.

Still, as community bank investment managers continue to search for the right mix of risk and reward, it is worth noting the market dynamics of seasoned hybrid ARMs. Paying close attention to your roll dates and rate caps could conceivably set up your bond portfolio for some seemingly gravity-defying market values as we enter a new phase of the interest rate cycle. IB

Webinar This Month

The 2015 Community Banking Matters webinar series continues Oct. 7. David Visinsky with Vining Sparks will present "Balance Sheet Management and Your Loan Portfolio" at 10 a.m. (Central time). One hour of Continuing Professional Education credit is available.

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