

» PORTFOLIO MANAGEMENT

Strength Up the Middle

Intermediate-term securities gain appeal

By Jim Reber

To some of you, the subject of this month's column may have become unfamiliar over the last five years. Ironically, if you had been paying heed to many brokers' advice, and structured your community bank's investment portfolio as they suggested, you would have had little use for these items.

A change in the direction, or at least the pace, of the domestic economy since December has put these

themselves by flattening, and barbells perform pretty well in a flattening-rate environment.

Better than expected

So what's a community banker supposed to do with his or her beloved five-year Treasury note? Well, given the lack of a bond market sell-off so far this year, plus the fact that the curve is flatter than it has been recently, maybe those bonds that mature out in the "belly" of the curve still stand a good chance of performing well.

Case in point: The five-year note issued in May 2014, which is now effectively a three-year note, has rarely been

worth less than par in its two years of existence, even though the Fed hiked rates in December. Over the last year, the interest rate curve has already flattened by 70 basis points, so perhaps some of the fun of the barbell is now behind us.

Our new best friends

As the curve has flattened, and rates are still quite a bit lower than anyone would have projected at this point, I want to be clear that we are

not recommending a go-for-broke escalation of your bank's maturities. Instead, we are suggesting that bonds that have minimal cash flow and built-in extension risk may be built for this seemingly range-bound scenario we're facing.

Two simple, traditional bonds that fit these criteria are a five-year bullet agency and a 10-year tax-free muni. As of this writing, a five-year bullet yields around 1.40, at a spread over the curve of about 17 basis points, which is higher than for most of 2015. Its market value would only decline about 0.5 percent (0.005) if rates rise 50 basis points in the next year. And, if the curve steepens, it could be worth more than that.

For the 10-year muni, remember that tax-frees have only about two-thirds of the price volatility of taxables, so you have the risk profile of about a seven-year Treasury. Its yield is about 1.70 percent, for a tax-equivalent of about 2.40 percent. That is extremely attractive relative to a 10-year Treasury note.

Non-amortizing amortizing bonds

Last month's column featured

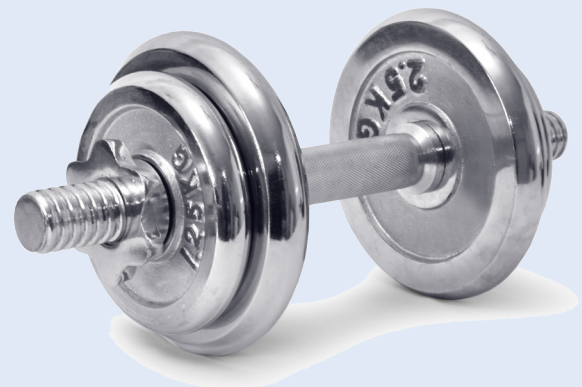
ICBA VOICE

Jim Reber (jreber@icbasecurities.com) is president and CEO of ICBA Securities, ICBA's institutional fixed-income broker-dealer for community banks.



investments back on the "maybe" list for purchasing.

To be candid, I'm glad to own up to the fact that Vining Sparks, ICBA Securities' exclusively endorsed broker, has been recommending a "barbell" configuration for at least this decade. This has been seen as justified by the fact that we've had (a) interest rates near zero at the short end of the curve, and (b) a steeper-than-normal curve for the better part of a decade. Steep curves correct



Takeaway: Investments with maturities from three to seven years have become more compelling in the last three months.

delegated underwriting and servicing bonds and Freddie Ks, both of which are mortgage-backed securities that have multifamily properties as collateral. They will usually have 30-year amortization periods with balloon dates in seven years, and they also have stringent prepayment penalties. The result is an average life of about six years and principal cash flow that is decidedly back-loaded.

Another security whose cash flow is limited until maturity is an SBA Development Company Participation Certificate, or a DCPC, security. (See this column in the September 2015 issue of *Independent Banker*.) DCPCs are securities backed by loans on small-business facilities. These, like the multifamily bonds, are fixed-rate, and they usually have a 20-year amortization period, with no balloon. What they do have is a prepayment penalty for the first 10 years, and semiannual interest payments. These too result in average lives at the outset of about six years.

To conclude, the recent reshaping of the interest rate spectrum is cause to consider some possibilities that have been in mothballs for a while. Investing in the belly for a portion of your community bank's portfolio has some compelling benefits. If your bank's investment portfolio has its flanks guarded by a barbell, perhaps strengthening your middle is a compelling strategy. ■

Webinar with Free CPE in May

ICBA Securities' webinar series "Community Banking Matters" continues on May 17 at 10 a.m. (Central time). Rick Redmond, director of balance sheet strategies for Vining Sparks, will present "Capital Market Solutions and A/L Management."

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