» PORTFOLIO MANAGEMENT

Shop talk

A community banker asks the questions you've been wondering about.

By Jim Reber

"Jim Reber speaking."

"Hi Jim, this is Charlie Brown with Community Trust Bank. Do you have a minute?"

"I sure do! How can I help?"

"I've got a question that's been on my mind, and I can't figure this out. I also don't want to ask this in front of other bankers. The bank's investment portfolio has an average life of about four years, but an effective duration of about two years, at least according to your bond accounting summary. What causes this difference?"

"Charlie, what you're telling me is that you own some floaters."

"Yes, I do. How did you know this?"

"Average life is an estimate of the time for all of your principal to be paid back to you. This includes the face amount of your agencies, corporates and munis, and an average period for your amortizing bonds like mortgage-backed securities [MBS], collateralized mortgage obligations [CMOs], and SBA [Small Business Administration] pools. Effective duration, on the other hand, is an estimate of how long it will be until your portfolio reprices, either due to a maturity or an adjustment to the rate. When a portfolio has a big difference in the two, it's usually the result of owning a lot of floaters."

"OK, Jim, that's starting to make sense. But on the same bond accounting summary, Vining Sparks estimates that my effective duration will increase when rates rise. Actually, it jumped up quite a bit in the fourth quarter of 2016. Why did that happen?"

"The other part of the answer is that effective duration also accounts for optionality. Most of your bonds have some uncertainty as to when your money's coming back to you. Take your callables, for example. Last October, a lot of your callable bonds would have been called at the earliest date, if rates hadn't spiked 50-something basis points, or 0.5 percent, in two months. Since your callables are not, at the moment, in danger of being called, all of our models are estimating that they'll be around for a while. And that causes an extension in your duration."

"But I don't want my bonds to extend on me. I've got loan demand I'm trying to fund. How can I get around this?"

"First of all, Charlie, every single community bank in the country struggles with this. Somewhere around 80 percent of all the bonds in all the investment portfolios have some optionality to them. This means you'll get your money back sooner when rates are low or falling, and later when rates are high or rising. So if you're asking why you decided to create this countercyclical cash-flow profile, I have a one-word answer for you: 'Yield.'"

"So you're telling me I'm greedy?"

"Heck no. In fact, if your bond portfolio had no optionality, you'd have an awful return compared with your peers. It's the management of the cash flows that makes the risk/

ICBA VOICE

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

reward equation worthwhile. That's why there's an MBS market and a callables market. But since you asked, I have a suggestion: Have a quarterly analysis of your cash flows compiled. Most full-service brokers offer this for free. Make sure your cash-flow ladders are shocked for different rate scenarios. This way, when you're buying more bonds, you can see if you've stockpiled enough liquidity for the near term, or if you have to do some backfilling in certain months or quarters."

"All right, Jim, back to the effective duration theme. By far, the longest maturities in my portfolio are my munis. But the reports you send each month tell me that their duration is actually less than my MBS and my agencies. How does this work?"

"The tax-free market does not work like all the other bond sectors. Because the coupons on munis are effectively after tax, they only react about two-thirds as much to a change in rates as do the taxables. Extrapolating that results in lower price volatility. Which is exactly what you want in a rising rate environment."

"Now that you've brought up rate shocks, can you help me out by telling me where rates are going to be a year from now?"

"Charlie, pardon me for waxing technical, but no way, no how." IB

Education on tap

Mortgage-backed securities

Vining Sparks, ICBA Securities' exclusively endorsed broker-dealer, has published a Strategic Insight, "The Intriguing Path of MBS Spreads." This research report, written by James Plunkett, director of investment product strategies, explains the history and some misconceptions of the mortgage-backed securities market. For your copy, contact your Vining Sparks sales rep or visit *viningsparks.com*.

James will also present the next segment of our popular Community Bank Matters webinar series on August 15. He'll discuss "Mortgage Market with a Focus on CMOs." One hour of CPE credit is available. To register, visit the Vining Sparks website.

Average community bank investment portfolios
As of June 30, 2007, and June 30, 2017

	% of total		Tax-equivalent yield		Unrealized gain (loss) % of par		Effective duration		Effective duration +200 bps	
Sector	**2007**	**2017**	**2007**	**2017**	**2007**	**2017**	**2007**	**2017**	**2007**	**2017**
Treasuries	1	2	4.23	1.07	(0.73)	(0.12)	1.3	1.3	1.3	1.3
Agencies	29	12	4.80	1.64	(1.82)	(0.25)	2.5	2.4	3.3	3.1
Fixed-rate MBS	23	31	4.90	2.35	(3.50)	(2.30)	3.8	3.8	4.0	4.9
Adjustable-rate MBS	8	4	5.69	1.51	(1.07)	(0.28)	1.8	1.0	3.2	2.4
Agency CMOs	12	12	4.88	2.17	(2.18)	(0.34)	3.2	3.1	3.7	4.6
SBAs/other floaters	4	6	5.69	1.99	(0.20)	0.25	1.1	0.5	4.2	0.4
Asset-backed securities	4	1	5.74	2.92	(1.84)	0.45	3.7	3.1	4.3	3.2
Corporates	2	4	5.56	3.01	(1.41)	0.54	1.9	2.3	2.4	2.3
Tax-free municipals	18	28	6.02	3.60	(0.85)	1.68	4.3	3.9	5.5	4.9
Totals	**100**	**100**	**5.21**	**2.53**	**(1.93)**	**0.35**	**3.1**	**3.2**	**3.9**	**4.1**

Source: Vining Sparks