

>> PORTFOLIO MANAGEMENT

Build a wall

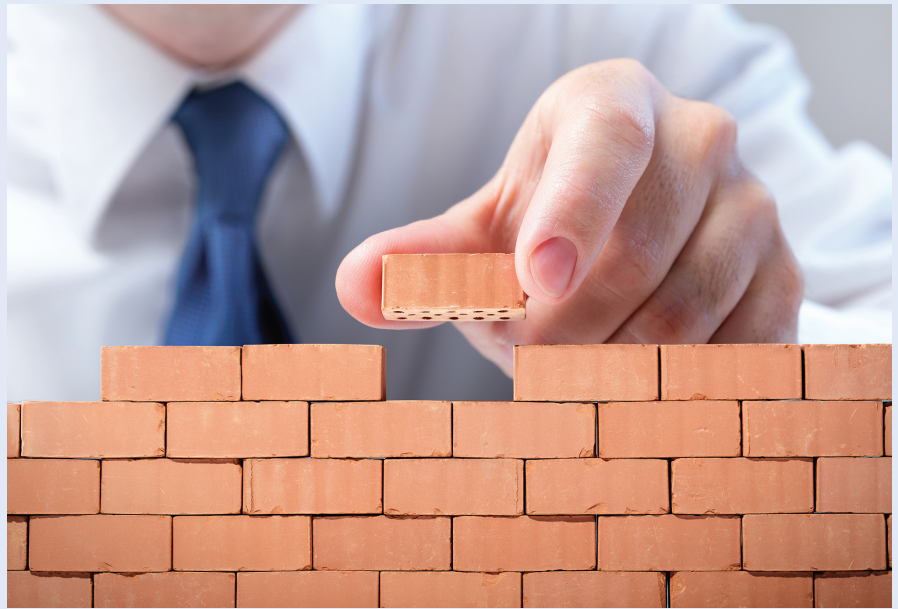
Why it pays to keep your duration in check

By Jim Reber

Now that I've gotten your attention with the title, this investment column does not involve the securing of a certain international border, or the stiffening of one country's immigration policy. In spite of the play these issues received in the most recent national election, the erection of a wholly separate "wall" may be a wise tack for your community bank to take this year.

The bond market saw a retreat in November and December, the likes of which hadn't been seen yet this decade. As of this writing, the middle part of the interest rate curve (roughly three to seven years) is at its highest yields since at least 2011. As luck would have it, this is also the part of the curve in which community banks park most of their investments.

Like it or not, many of the more popular securities with community banks are now priced below par (100.00). This is true whether you bought them last year, probably at a premium, or are considering purchas-



Square one

Effective duration is a measuring stick that estimates how much the value of the investment portfolio will change given an interest rate shock. It should be made available to you before you buy a given bond and also form part of your bond accounting package. Effective duration for a fixed-rate security also is very close to the weighted average period of time it takes to receive all the principal and interest on a bond.

Let's take the three-year Treasury note, for example. The duration is about 2.8 years, which means that the value of that bond will fall about 2.8 percent if interest rates rise 100 basis points (1.0 percent) instantly. It also is roughly the time it takes to get all your money back.

Already at the perimeter

This management of duration would be quite easy if community banks owned bonds that had no uncertainty in their cash flows. Instead, about 80 percent of the bonds in most portfolios have some "optionality," meaning the issuer has the final say-so in the payoff date. And, as you may imagine, the higher interest rates rise, the less inclined a borrower is to pay off the debt early. This means that effective duration will rise during periods like

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ing some at today's discount prices. More likely, you're faced with a combination of both. So, let's review the market assumptions for a collection of investments owned at a discount to ensure we're clear on our risk/reward posture, particularly as it pertains to putting in a stop-out point on your "effective duration."

Webinar series kicks off

ICBA Securities will present the first segment of "Community Bank Matters" on March 21. Rick Redmond of Vining Sparks will discuss balance sheet strategies for 2017. One hour of CPE credit is available. To register, visit www.icbasecurities.com.

Table 1

Bloomberg consensus estimate of prepayment speeds of Freddie Mac Gold 15-year, 2.5% mortgage-backed securities

Date	Base case PSA	Modified duration
11/8/16	229	4.32
11/22/16	194	4.61
12/6/16	164	4.87
1/6/17	158	4.93
1/17/17	148	5.03

Source: Bloomberg

the one we're currently experiencing.

As a case in point, let's take a look at an investment commonly owned by community banks: a 15-year agency mortgage-backed security (MBS). These will pay P&I for 180 months, and some portions of the principal will come back early to the investor if the homeowners that back the pool decide to refinance their mortgages. Since the now-benchmark date of November 8, expected prepayments on those pools have dropped by 35 percent, making the durations extend from around 4.3 years to about 5.0. This is a significant increase in price volatility if we extrapolate it to the entire bond portfolio.

Fortify the flanks

Fortunately for you, a number of investments you may already own have some built-in extension protection. The most obvious of these are floating-rate securities. These can be adjustable-rate

mortgages (ARMs), corporate floaters, or even the agency securities known as "step-ups." Your columnist has long extolled the virtues of Small Business Administration (SBA) 7(a) pools.

If your portfolio's effective duration has seen a drift upward, it should have come as no surprise. Bond accounting services display the "shocked" cash flows and price volatilities in any number of formats. Nor should you feel alone, as all well-managed bank portfolios have some degree of optionality.

The conclusion is to keep your eyes on effective duration, since it can change daily. This will enable you, the successful community banker, to adjust sector weightings as appropriate to keep your risk profile within the wall. **■**



ICBA convention activities

ICBA Securities and its exclusive broker, Vining Sparks, will be front and center at ICBA Community Banking LIVE in San Antonio from March 15 to 18. Visit us in Booth 418 at the Expo, and come participate in our multiple workshops in the Education Zone.