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# Less can be more

A guide to owning bonds at prices below par.

By Jim Reber



It's interesting to consider the relationship between the price of an object and its perceived value. One of the most basic tenets of economics is that buyers prefer lower prices to higher, and sellers prefer the opposite. Ultimately, the agreed-upon price arrives at the

intersection of supply and demand.

On the other hand, behavioral sociologists tell us that, at least for certain goods and services, buyers want to pay up. I suppose cut-rate brain surgeons or attorneys can give me pause. Some consumers limit their housing choices to certain ZIP codes and wouldn't have automobiles of certain makes. I know of otherwise rational individuals who simply won't dine in restaurants that advertise.

It should be reassuring, then,

to portfolio managers that the type of investments suitable for community banks contain very little subjectivity in regards to their quality. Most bonds owned by depository institutions have some type of government guaranty attached and are considered 20 percent or even zero percent risk weighted by the FDIC. But this doesn't mean their value can't fluctuate. In fact, on balance, bond portfolios owned by community banks are now worth less than their book values.

### First time in a long time

The gradual strengthening of the U.S. economy and the Federal Reserve's preemptive strike against inflation have pushed nominal yields to levels not seen in years. On the short end, it's been a full decade since we have been here. This, of course, means that all existing bonded debt has dropped in value, and new issues are coming to market with higher stated coupons.

As of Dec. 31, 2017, the average community bank bond portfolio had an unrealized market loss of 0.5 percent. That number almost certainly grew in the first quarter as rates across the maturity spectrum increased. Since the Fed is still into the current tightening phase, and it's unwinding (slowly) its \$4.5 trillion balance sheet, we probably have a ways to go.

As you're rediscovering the joys of buying investments at newly reduced prices, there are a couple of thoughts to keep in mind as you shop. One is that your portfolio's duration and average life are subject to extension, so be sure to keep your eyes on these measures of risk. Another is that the lower the coupon (and probably

price) of an investment, the more out-of-the-money any embedded options are.

### Exempli gratia

One simple example is to look at a callable agency bond that was printed in 2017. Fannie Mae issued a five-year bond in October 2017 with a 2.25 percent rate that has a first call date in April 2018. Original owners of that bond, who paid \$100 at the launch, now have an unrealized loss in that position. Recently, its market value was about \$97.75, so a new investor would earn about 2.77 percent to maturity. Its "modified duration," which takes into account the call features, is now 4.2 years, which means all pricing models are projecting that it will be around until 2022. If it were to be called

**2.46%**

Average tax-equivalent investment portfolio yield for the 400-plus community banks that utilize Vining Sparks' bond accounting services, as of Dec. 31, 2017

early, and this is Fannie Mae's decision, the new owner would have a windfall, as the yield to the call date would be enhanced.

Mortgage securities are similar but not identical. A 15-year pool with a 2.5 percent rate, issued by Fannie Mae or Freddie Mac, also has a current price of around \$97.75. What that tells an investor is that the loans behind the pool are not subject to much refinance activity at the

Community bank investment portfolios	
December 31	Unrealized gain (loss), % of portfolio
2012	2.40
2013	(1.87)
2014	0.73
2015	0.30
2016	(0.72)
2017	(0.50)

Source: Vining Sparks Bond Accounting Population

moment, so there will likely be very little principal cash flow in the early going. Hence the longer duration. Again, if prepayments were to pick up, the bond's yield would improve, thanks to the discount price.

### Tax-free discount alert

Here's one reminder of caution to be exercised when buying bonds at a discount. In the land of tax-free securities, there are several different rules that come into play. In particular, if a given municipal bond is purchased at a price below par, and it was not originally issued at a discount, capital gains tax liability can accrue to the new investor. To be sure, the amount of the tax can be minor if the discount is small, but make sure to have your broker quantify for you the extent of any capital gains hit.

Finally, I wouldn't despair if your portfolio is several percentage points underwater. This just means that you're in good company with the other 5,700 community banks in the country. You can also inform your investment committee, board and examiners that portfolio earnings are now on the way up, thanks to higher market yields. Buying popularly priced investments does not make one a bottom feeder. ■

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ICBA VOICE

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