



Portfolio Management

By Jim Reber, ICBA Securities

Give and take

How to profit from buying and selling bonds simultaneously.

As we approach year-end, once again it's time to go into the attic and reach not for the holiday decorations (although there's nothing wrong with that), but the bond management archives. If there has been a theme of the "Portfolio Management" columns in this magazine this year, it's that community bankers have been able to, or have had to, employ some strategies they haven't been able to, or needed to, for the better part of a decade.

Along with the holiday traditions that many community banks observe and celebrate come investment activities that naturally occur right around year-end. This may include some minor, garden-variety window dressing to demonstrate ample stores of liquidity, but it could also be time to execute a more ambitious, strategic repositioning of the bond portfolio.

We'll review the reasons that community

banks would consider such trades, and remind the portfolio managers of the costs, benefits and guidelines for such actions.

Season for the reason

It's timely to be thinking about a bond swap, because banks' annual earning numbers are coming into focus. By far the busiest month for the simultaneous purchase and sale of bonds is December, and the second busiest is January. We'll go into the reasons for that shortly.

For a community bank to begin considering a transaction, its management team is acting on at least one of these four motives:

■ **Cashing in gains:** Banks that are falling short of projected income goals may choose to selectively dispose of a few bonds, at gains, to achieve such goals. They also may be projecting that gains will be smaller in the



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

future, if they expect interest rates to keep rising.

- **Realizing losses:** If projected earnings are ahead of pace, especially due to one-time or non-recurring events, securities that aren't performing well may be sold at losses to effectively defer income. This is almost always a smart cash-flow strategy, and your tax accountant will be pleased with you.
- **Duration altering:** Asset-liability management is the motivation here. The bond portfolio has always been the easiest portion of the balance sheet to tweak for interest rate risk purposes. An asset-liability profile that shows exposure to falling rates would suggest that an extension swap is appropriate. If a profile indicates risk in a rising rate scenario, a duration-shortening swap may be in order.
- **Sector reweighting:** This column has often mentioned the makeup of a high-performing bond portfolio. If one's sector weightings are too heavy in, say, bullet agencies or corporates, and a recasting of some dollars can quickly bring the makeup in line with a more desirable portfolio, some sector swapping can be of value.

A given swap can fall into more than one category. For example, if a bank is ahead of its profit goals and is exposed to falling rates, it could potentially sell some short taxable securities at a loss and reinvest into longer taxable or, better yet, tax-free bonds. The result would be less asset-liability exposure, deferral of income, improved book yield and better sector diversification. That adds up to a 4-point play for the home team.

Sales candidates

There are several variables to consider in identifying bonds that the portfolio



Enterprise and Third-Party
Risk Management
Software and Services

Vendor Management | Business Continuity Planning
Cybersecurity Assessment | Enterprise Risk Management
Findings Management | Contract Management

ncontracts.com



manager could sell. For one, if a bank is interested in gains, it should look primarily to the taxable portion of the inventory. Just as losses defer income, gains cause immediate recognition, which also accelerates income tax liability. This condition is further aggravated if the bonds sold at a gain are otherwise tax-free.

This brings us to the concept of a tax swap. Any bond sold at a price less than its carrying (or “book”) value is considered an ordinary loss, deductible in arriving at taxable income. If the proceeds are then reinvested into tax-free securities, the period of time to make up that original loss is lessened. The investor will only be hit with the net-of-tax loss, but 100 percent of the reinvestment earnings are tax-free. So don’t be too quick to look at your muni portfolio for gains.

Also, don’t forget about assets other than bonds that can be sold. Many community banks own portfolios of performing, non-conforming loans, which have an actively traded secondary market. High-quality jumbo mortgage loans in particular can be quickly liquidated. And government-guaranteed loans, such as SBA 7(a) loans and FmHA guarantees, can be sold servicing retained, often at substantial gains.

Consider these

Portfolio managers should pay close attention to the “take-out yield.” Take-out yield can go by several names (such as market yield and give-up yield), but its definition is the yield that the buyer of your bonds will earn. The reason it’s important is that the take-out yield is the benchmark reinvestment yield that must be met or exceeded for a swap to have economic value. A bank may still elect to execute a swap even if the take-out yield is not improved upon, as long as some other objective is achieved. An example would be a duration-shortening swap that reduces exposure to rising rates.

The classification of Available for Sale (AFS) versus Held to Maturity (HTM), as mandated by Financial Accounting Standard 115, must be considered as well. For some of the holdout investors who still put some or all of their bonds into HTM, the ability to sell may be severely limited, depending on the attitude of the external auditor. I would recommend prior consultation with the auditors if the bank wants to take this route. And I absolutely would recommend classifying all future purchases as AFS to provide maximum flexibility.

As the new year approaches

Now, a word about current market opportunities. As the year-end draws near, and yields are at or near highs from the last decade, most community banks have losses in their portfolios. Many, in fact, don’t own a single bond at a gain.

Education on Tap



Investment column library

For access to “Portfolio Management” columns dating back to 2001, visit icbasecurities.com/independentbankerarticles/ to see the ICBA Securities website archive. Included are several years of columns by ICBA Securities president emeritus C.J. Pickering.

Webinar series for 2019

ICBA Securities and its exclusive broker, Vining Sparks, will again host an eight-part webinar series, “Community Banking Matters.” It will feature eight different speakers on a variety of balance sheet topics of interest to community banks. Look out for an announcement about the calendar and topics early in 2019.

Coupled with the banking industry’s strong performance in 2018 (partly the result of tax reform), most community banks have the opportunity to take some losses and defer income to future periods.

Another challenge for portfolio managers at the present is the availability of liquidity. The replacement of “bullet” securities with amortizing bonds like mortgage-backed securities can potentially improve the take-out yield, increase cash flow and come close to matching average durations. It is also true that the flatness of the yield curve will make it necessary to have some duration extension to “beat the take-out,” but many community banks are well-balanced from an interest rate risk standpoint.

Your broker should create full documentation of the costs and benefits of a particular swap transaction well before the play is put in motion. I strongly recommend that a portfolio manager review, analyze and critique the data in the swap analysis before executing any swap. And don’t be afraid to take a retrospective look at the swap to see if it performed as modeled.

Finally, if 2018 isn’t the year to execute a bond swap, perhaps 2019 is the perfect time to do so. One advantage of taking a loss early in a fiscal year is that there is almost a full year to be earning higher income from the reinvestment bonds. In many cases, the full loss can be recouped before the next year-end. All of which would help ensure that 2019’s business year is merry and bright. ■