

Mind the cap

Rate caps on bonds affect their performance.

By Jim Reber



This year will very possibly be one in which a nuance in bond investing gets exposed. It seems to me that, of the many variables and moving parts an investor must consider during the prepurchase phase, the interest rate cap is one that can be overlooked. If by the end of 2018 there are indeed another three bumps to the fed funds rate, we could begin to see rate caps in stark relief.

You'll recall there are two types of rate caps: periodic and lifetime. Some

variable-rate investments, owned by community banks, could have one, both or neither. The periodic variety is the maximum rate change between adjustment periods, and the lifetime cap defines the ceiling on the rate for the lifetime of the bond. Let's take a look at how caps stack up and important factors to consider.

Moving up slowly

For many community banks, the sector with the most restrictive caps is the type of government agency bond known as a step-up. These bonds have a stated coupon for a stated period, after which they will either be called by the issuer (Fannie Mae, Freddie Mac, FHLB) or their interest rate

will rise. There can be structures in which there is just one step for the bond's life or (more commonly) multiple steps.

For the "multi-steps" in particular, these gradually higher coupons can be quite restrictive. It's not unusual to see a structure that has a 25 basis point (0.25 percent) annual step, which provides almost no relief in a rapidly rising rate environment. So don't be lulled into liking a step-up that has attractive end-of-life coupons without providing more current yield protection. Recently there have been fewer step-ups issued, as a flattening yield curve makes

it more difficult to build them out to be attractive relative to traditional callable agencies.

Sooner and later

Adjustable rate mortgage (ARM) securities can be a mixed bag for community bank investors. The notion of having a security whose yield will fluctuate along with general market rates sounds attractive to many a risk-averse portfolio manager, and they provide good cash flow and liquidity, so those boxes are checked as well.

However (have you noticed that word appears often in columns discussing bonds?), investing in ARMs has several limitations. First, they come to market with a fixed-rate window that can vary from three to 10 years, which means they don't float for a while. Next, when they do begin to float, many pools experience

a lot of prepayment activity, and the remaining balances that do adjust to market rates can be smaller than hoped.

Then there's the cap issue. ARM pools issued by Ginnie Mae have 1 percent periodic caps, and that, historically, has been inadequate to keep up with a tightening phase by the Fed. This time around, the Fed has been slow in bumping money-market rates, so perhaps Ginnie Mae pools will be able to stay near market. For many investors, the preferred labels for ARMs are those issued by Fannie and Freddie, which have 2 percent periodic caps.

Lifetime caps are likewise more generous for Fannie and Freddie, versus Ginnie. They generally will be 6 percent above the initial, day-of-issue coupon. Ginnie's caps are usually 5 percent over the start rate. However (there it is again), Fannie/Freddie pools usually come with higher prices as a result of the higher caps, so that will need to be accounted for as well.

Free floaters

Then there are those floating-rate securities that have little or no caps. Collateralized mortgage obligation

2.66%

Projected yield on CMO floater 2017-69 EF by December 2018. In January 2018, that was 20 basis points above the 10-year Treasury note

(CMO) floaters are true money-market instruments in that they float monthly, based on the 30-day LIBOR index. They have no periodic caps, so they'll keep your yield on market, unless they start bumping up against the lifetime rate ceiling. In the last decade or so, most CMO floaters have been created with lifetime caps in the 6.0-6.5 percent range, which has been sufficiently high to keep the bonds floating and the prices stable.

If you want a totally uncapped bond, you have a choice of one: SBA 7(a) pools. They float based on prime, and most reset each calendar quarter. Since 2015, these instruments have seen their yields improve by 125 basis points, which mirrors the rise in fed

funds. Because of the short reset period and lack of caps, their market values are remarkably consistent even after applying substantial rate shocks.

So, short-duration investors, there is your recap(!) of the various ceilings that are built into floating-rate instruments. Be sure to have your broker explain the periodic and lifetime caps on any adjustable-rate securities you're considering. They're likely to be a factor in the performance of your portfolio in the very near future. ☐

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Interest rate caps on selected securities

Type	Common index	Periodic cap	Lifetime cap	Reset period
Step-ups	N/A	.25% to 2.0%	Determined by market; could be 9.0% or higher	Depends on structure; ranges from quarterly to biennially
FNMA/FHLMC ARMs	1-year Treasury	2.0%	6.0% over initial rate	Annually
GNMA ARMs	1-year Treasury	1.0%	5.0% over initial rate	Annually
CMOs	3-month LIBOR	None	6.0% to 10.0%	Quarterly
SBA 7(a)s	Prime	None	None	Quarterly

Source: Vining Sparks

