Portfolio Management

By Jim Reber, ICBA

Spreads thin

As yields rise, incremental yields on your favorite bonds narrow.

There are precious few rules that can be relied upon in the real world of community banking. You veteran bankers out there have firsthand experience with booms and busts over the last quarter century or so, in which lending decisions and marketing strategies that seemed like a good idea at the time didn't quite pan out as hoped.

It appears strategic initiatives will continue to be fraught with uncertainty. Nonbank lenders, fintech, AI and regulations all are forcing community banks to consider the type of institutions they want to be in the future. "Game theory in practice," as I've heard it described.

So, as a counter to these intangibles and uncertainties, I offer several bits of certainty that exist today and will exist decades from now. First is the immutable rule that interest rates move in the opposite direction of bond prices. The second is that spreads narrow as rates rise. This column will review and expound on this second tenet of portfolio management.

Spreads reexamined

The term "spread" has many uses. It's one thing to use it in the context of an athletic event vis-à-vis Las Vegas, and quite another to describe the application of peanut butter to a Ritz cracker. In

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the investment world, it is the additional yield an investor earns over and above a benchmark. For community banks, the benchmark is almost always the term structure of the Treasury curve.

There are a number of variables that determine the amount of spread an investor earns on a given bond, and each variable is an attempt to quantify the amount of risk. There are three primary risks that any bank assumes when purchasing a bond: credit, liquidity and reinvestment.

Risk premia embedded

The most obvious reason a bond issued by anyone other than the U.S. government yields more than a Treasury note is that it has a lesser credit profile. In the case of bonds issued by an agency of the government or a state or local government, the credit quality is minimally lower than a Treasury issue, but it's lower nonetheless. And, as an economy improves and business activity increases, the expectation is that borrowers' ability to repay their debts on time also increases, so some credit risk premium is sifted out, resulting in a narrowing of spreads.

The other two risks, liquidity and reinvestment, tend to be more stable over time than credit risk, but they, too, can contribute to a narrowing of spreads as rates rise. For example, reinvestment risk, which some analysts refer to as "call risk," is assumed to decline in higher-rate scenarios, because the borrower has little incentive to repay the debt early (if that's a right he or she owns). Further, if the bond is called by the issuer, the investor can potentially reinvest the proceeds in a favorable (i.e., high) interest rate environment.

Recent reactions

The table at right demonstrates how much spreads have narrowed across a wide range of popular investments since mid-2017. While it's true that spreads tend to decline due to embedded risks shrinking as rates rise, there are two more factors at play in some of these bond sectors.

Most obvious is that tax reform late in 2017 caused tax-equivalent spreads to decline dramatically. Another factor is the limited supply in both the municipal and mortgage arenas, which has had the effect of supporting the price of bonds in those sectors.

In the end, shrinkage of spreads has multiple implications. One is that, even though the value of the portfolio has declined this year, it would have been worse had all the bonds been invested in Treasurys. Just as "spread" has numerous uses, so does a thinning of spread have myriad outcomes for the community bank portfolio manager. ■

Treasury yield spread snapshot

	4/7/2017	3/9/2018	3/29/2018	4/6/2018
Agency bullet				
2 yr	10	4	8	8
5 yr	12	13	11	11
10 yr	40	30	30	30
Agency callables				
3/1 yr	27	19	22	23
5/1 yr	32	40	47	46
10/1 yr	68	80	94	102
5/2 yr	23	30	37	36
10/2 yr	57	70	84	92
Muni				
5 yr	48	-16	-1	-3
10 yr	86	42	57	54
15 yr	146	90	99	96
CMO vanilla				
2 yr	49	30	35	35
5 yr	67	49	60	65
10 yr	73	60	64	75
MBS				
15 yr	56	43	45	45
30 yr	75	67	72	70

Source: Vining Sparks

Education on Tap

Bond Management 101

ICBA Securities and Vining Sparks will present the 2018 Bond Academy Oct. 22–23 in Memphis, Tenn. This entry-level school will explain bond basics and best practices for portfolio management. Up to 18 hours of CPE credits are available. Registration opens this summer.