



Portfolio Management

By Jim Reber, ICBA Securities

Counter intelligence

Your next best bond purchase may surprise you.

In the pantheon of bond portfolio management no-nos, there are venial sins and there are cardinal sins. Some of these are determined by one's own experiences, some are theoretical and some are promulgated by your friends, the examiners.

An example of an investment error that was learned by harsh lesson is the \$18 billion hit that community banks took in September 2008 when the two housing GSEs, Fannie Mae and Freddie Mac, were placed into receivership and their Preferred Stock became worthless (cardinal). A “thou-shalt-not” of the second order is to pay large premiums on securities that can prepay or

be called away in the very near future (venial). And your regulators will be quick to comment on a set of investments that have long average lives or durations, with commensurately high price risk. Some examiners would place excessive price risk in the “cardinal” category.

Typical profile

As 2019 develops, there are several risk-management variables that are either outside the norm for community banks or have evolved since late last year. Among the former is that banks in general have fully positioned their balance sheets to take advantage of rising rates. Stated another



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way, the typical community bank is now exposed to falling rates.

Two pieces of evidence support this. First, for the 300-plus institutions that utilize Vining Sparks for their rate risk monitoring, the average user has positive Earnings at Risk (EAR) and Economic Value of Equity (EVE) postures, and very little Capital at Risk (CAR).

Secondly, the average investment portfolio's effective duration, another common risk yardstick, was 2.97 years as of December 2018. This is a historically low number, the least it's been in six years.

So as community banks have insulated themselves from further rate hikes, the Federal Reserve has adopted a "patience" refrain. The bond market is now anticipating maybe one additional rate increase before the end of 2019. Longer-termed maturities' yields have fallen noticeably since last December.

Portfolios have been recast

If a community bank investment manager decides that he or she needs to maintain or even increase the portfolio's duration, here's another curveball: Since tax reform became effective in 2017, community banks have shrunk their tax-free municipal holdings. Munis have long been the preferred vehicle for locking in some yield on the long end of the duration spectrum. But as tax-frees' yields are not what they used to be, banks are trying to figure out the optimum mix of their investments.

Some institutions have recently decided to take positions in a historically verboten sector: 30-year fixed-rate mortgage-backed securities (MBS). Before you conclude this would be the commission of a cardinal sin, please read on. Their risk-return profiles are potentially not much different than munis, especially for C corps, and they provide much-desired diversification to boot.

The current mix of price, yield, supply, risk and need behooves the informed investment manager to consider cutting against the grain when creating a productive securities portfolio.

Education on Tap



New investment commentary available

Vining Sparks, ICBA Securities' exclusive broker, recently published a Strategic Insight, 30-Year MBS: Tax Reform and Relative Value. For your copy of this report, contact your Vining Sparks rep or visit viningsparks.com

Webinar series continues

ICBA Securities and Vining Sparks present the next segment of their 2019 webinar series, Community Banking Matters, on April 16 at 10 a.m. CDT. Katharine Bray and Dan Stimpson of Vining Sparks will discuss "Balance Sheet Strategies for 2019." Free CPE is available. To register, visit icbasecurities.com

This may not be for your community bank. If an institution is exposed to rising rates, and many still are, longer-durated assets are not your friend. Still, it's worthwhile to take a dive into comparing a muni to a 30-year MBS.

Munis vs. MBS

As of this writing, a standard muni with an AA rating and a 15-year maturity or 10-year call structure will produce about a 3.5 percent tax-equivalent yield for a C corp bank. A new 30-year MBS with the right mix of coupon and premium can match that yield. Here's the kicker: The MBS probably has lower price risk. Of course, either option will lose value as rates rise, but a mortgage security with a 4 percent coupon or more will probably have an effective duration of about four years, versus seven years for the tax-free. As we've learned, less is more when discussing price risk.

Finally, you'll recognize that these are two very different investment choices. If your community bank is in fact exposed to falling rates, the monthly cash flow from the MBS won't help matters. Supply and liquidity for MBS are superior to tax-frees, as 88 percent of the entire mortgage market consists of 30-year loans. There are differing factors for pledgability and risk weighting to consider.

In sum, the current mix of price, yield, supply, risk and need behooves the informed investment manager to consider cutting against the grain when creating a productive securities portfolio. Counterintuitive need not be counterproductive. ■