



Portfolio Management By Jim Reber, ICBA Securities

Shucking convention

No surprises here. Adjustable rate securities have performed as hoped since 2016.

“It was a bold man that first ate an oyster.”
—Jonathan Swift, 1702

“It was a bold investor that purchased floating rate securities three years ago.” —Jim Reber, 2019

The first statement we accept as avuncular truth. The second invites scrutiny. After all, as 2016 dawned, it appeared we had entered an interest rate environment that would have lent itself to short-term securities. The Fed made its

first adjustment to overnight rates in Dec. 2015, moving fed funds up to 0.50%. It was poised to do more of the same.

The backdrop, however, offered less clarity. Although GDP averaged 2.9% in 2015, it had begun tailing off in the second half of the year and was up only 0.4% in the fourth quarter. Core inflation was also well under 2%. So, it was altogether uncertain that rising rates would in fact prevail in 2016.

Add to that an interest rate curve that was still quite steep throughout the year. This ensured that short-term investments would yield a lot



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

less than longer ones, at least at the outset. Finally, it wasn't cheap to buy floating rate bonds back then. Newly issued adjustable rate mortgage-backed securities (ARMs), even those that didn't actually float for 36 to 60 months, came to market with 103.00+ prices.

Remember also that deposits were still cheap but becoming harder to find, and loan demand had returned full force. Investment portfolios were at best holding steady, if not shrinking. A busy portfolio manager could be excused for not focusing on adjustable rate securities.

Up to date

It turns out that 2016 wasn't the year for interest rates to break out. The Fed hiked rates only once, and that was in December. Anything out on the yield curve barely budged. The 2-to-10 slope actually steepened by 3 basis points (0.03%). So do floating-rate buyers now wish they hadn't thrown caution (and yield) to the wind by being conservative?

As we may now have entered an idle phase in the current monetary policy drama, and it's been nearly four (!) years since the first rate hike of the cycle, we have some documentation about the performance of our investment holdings during this period. While the current level of short-term rates is still far below a typical stopping-off point, we have seen a relatively typical yield curve shape for the latter stages of a tightening policy.

ARMs have legs

As one example of a security that could be owned by your bank, let's examine Fannie Mae pool BM4569. It's known as a "Mega," which is a pool-of-pools, most of which came to life in 2011. These pools each had a "5/1" structure, meaning they had a fixed rate for five years, after which they began to adjust annually. So, the surviving loans (which are about 12% of the originals) have been free to float for about three years.

During this time, the pass-through coupon on this security has risen from 3.08% to 4.48%. Some portion of the collateral loans will reset every month, with the "weighted average roll" date about six months out. As this seasoned pool is now fully indexed, it will continue to stay on market. These current floaters have retained their value, as the coupon rate listed above is quite attractive in today's market. These pools can command market prices in the 104.00 range.

Glad they did

Other floaters that have stayed on market include true money-market alternatives, such as collateralized mortgage obligation (CMO) floaters. These will reset monthly, with

Education on Tap



Sector snapshots

ICBA Securities' exclusive broker, Vining Sparks, publishes its Weekly Sector Update each Monday. It provides commentary and current market analysis on each community bank investment sector, including ARMs, SBAs and CMOs. To receive yours, contact your Vining Sparks sales rep or visit viningsparks.com

Busy July for state conventions

ICBA Securities will attend, sponsor and speak at six ICBA state affiliates' annual conventions this July. For a calendar of our upcoming appearances, visit icbasecurities.com/seminarswebinars

no annual caps. Most of these have enjoyed their coupons improving from the low 1% to the low 3%. And, of course, prime-based adjusters, namely Small Business Administration (SBA) pools, have moved lock-step with fed funds through what is now nine rate hikes totaling 2.25%.

So the question remains: Have those who invested in floating rate securities several years ago been rewarded or punished for being conservative? The ARM example above

Have those who invested in floating rate securities several years ago been rewarded or punished for being conservative?

certainly demonstrates that yields will improve, and prices can be relatively insulated against rising rates, with floating rate instruments. SBAs and CMO floaters have been even more responsive to general rate changes. I would contend that adjustables have done their job through this part of the interest rate cycle.

Sometimes, being bold—whether in one's gastronomic or investment choices—pays off. ■