Portfolio Management

By Jim Reber, ICBA Securities

Fill the middle

Investment ladders could benefit from the next yield curve shift.

The "middle." What does that mean to you? On a baseball team, it's a term that refers to the defensive players in a line from the catcher out to the center fielder. Physiologically, it's an obtuse reference to one's abdominal/waist/hip area. Related to that, it's the reward in a jelly-filled donut. Politically, it's currently a vacuum, but formerly it was occupied by moderates on either side of the aisle. And geographically, it's the center section of the Volunteer State of Tennessee, the site of ICBA LIVE 2019.

For investment portfolio purposes, the middle often means the segment of the yield curve or a collection of bonds that span from, roughly, two to seven years. If community bankers had been taking heed of the suggestions they've received from brokers and advisors over most of the past decade, they would have invested less in the middle and more on the flanks. It may be time to consider an alternative.

A weighty matter

In review, portfolio structures usually take on one of two general structures: a "barbell" or a "ladder." Barbells have a concentration of bonds that will reprice in the very near future, and equal dollar amounts that will mature in the

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relatively distant future. Ladders don't have aggregates on the edges; instead, they have most of their positions in the medium-term, or middle, with some degree of structure.

Barbells were quite popular from the beginning of the Great Recession until the past year or so. They produce reasonable returns if rates are stable, and more so when the yield curve flattens. Such was the case from 2016 to 2018, as short rates rose about 200 basis points (2.0 percent), and longer ones only about 50 basis points. The floating-rate segment's yield kept pace with money market rates, and the fixed-rate portion didn't experience an acute drop in value.

Next time around

Whether or not the Federal Open Market Committee FOMC switches postures in 2019, the next secular shift in the shape of the yield curve will almost have to be a steepening. This is where the ladder comes in. A collection of bonds with defined maturities in the intermediate portion of the maturity spectrum will likely gain value if short-term interest rates fall faster than longer-term rates, as we saw happen in the 2007–2008 launch of the last recession.

A yield curve that shifts by having short rates fall faster than longer rates is termed a "bull steepener" by bond analysts. This is the norm, but there are recent exceptions. In the 2013 calendar year, overnight rates stayed unchanged (at near zero), while seven-to-10-year yields rose about 125 basis points. (It is worthy to note that the shift almost exactly reversed itself the following year.) The 2013 experience is known as a "bear steepener" and is not beneficial for a ladder structure, although it is something of a black swan.

Ladder prospects

If you decide it's time to revisit the tried-and-true ladder approach, where do you begin? The simplest approach (and most banal) is to buy a series of bullet agency bonds with differing maturities. There is total certainty to your outcome, if you hold the bonds until they mature.

Your first alternative would be one-time callable agencies, which would require some surveillance by the portfolio manager but at marginally higher yields.

Otherwise, structured mortgage-backed securities (MBS) that provide some likelihood of principal return in the middle years of the ladder could be the answer. Examples of these would be multifamily MBS like DUS bonds, Freddie Mac K-Deals, or Fannie Mae ACES. An investor could select a given pool that has a short-stated final of well under 10 years, and little or no principal cash flow until maturity. (These products were featured in this column in April 2016.) More traditional MBS that are well-seasoned and have little prepayment expectations (i.e., low-stated coupons) will work too. At the moment, 15-year MBS that are three or more years old with a coupon rate of 2.50 percent or less fit this description.

In the end (or the middle, as it were), recasting segments of your bond portfolio to mature in the intermediate portion of the maturity spectrum could have some merit in 2019 and beyond. If and when the yield curve steepens, a ladder will create a solid basis for investment performance. ■

Education on Tap

Webinar series continues

ICBA Securities and its exclusive broker, Vining Sparks, have announced the next segment of their 2019 webinar series, Community Banking Matters, for May 14 at 10 a.m. CDT. Greg Roll presents "Balance Sheet Management and Your Loan Portfolio." Free CPE is available. To register, visit ***viningsparks.com***

A site near you

Jim Reber and associates from Vining Sparks will be speaking at numerous community bank events throughout the summer. To view the current calendar, visit ***icbasecurities.com/seminarswebinars***

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