Portfolio Management

By Jim Reber, ICBA Securities

Reconstruct, don't deconstruct

Record-low yields create an opportunity to strategize on the fly.

Have you ever purchased a bond when the 10-year Treasury note yielded sub-1%? If you have, it was after March 4 of this year. In fact, you couldn't have purchased a bond when the 10-year was under 1.10% until March 2. Or when the 10-year was under 1.25% until Feb. 28. You get the picture.

This is not to suggest that your timing was bad or that your bond portfolio was ill-prepared for the ferocious rally that took place in February and March. It is, however, a fact that community bank investment cash flows, which certainly picked up noticeably in the second half of last year, have seen, or will see, another wave of "liquidity." We could wax about spreads widening in market rallies (which they have), or suggest yet again that call protection is cheap (which it is), but this column will instead proffer ways that this unexpected liquidity can be thoughtfully reinvested without the need for

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

detailed bond-swap analytics. In fact, many community bank investment portfolios now have the ability to be rebuilt to the owner's liking, courtesy of the record bond market yields of 2020.

How much is there?

Since it takes several months to feel the true effects of a more than 100-basis point (1%) rally on a collection of investments, coupled with unprecedented Central Bank intervention, the final tally isn't yet here. Luckily, we have recent history to give us a guide. The Federal Open Market Committee (FOMC) cut rates three times from July to Oct. 2019, and when it signaled to the market in June that it would "act as appropriate," rates declined all through the summer. The volume of bonds that were called more than doubled between June and August, and interest rates are much lower now than they were then.

For the record, all bonds called by the government-sponsored enterprises (GSEs) in June and August 2019 were $21.8 billion and $45.7 billion, respectively. Similarly, prepayment speeds on 30-year 3.5% mortgage-backed securities (MBS) between August and October 2019 (which accounts for the lag in refinance turnaround) more than quintupled. So, get ready for some reinvestment opportunities.

High-performance features meld

Any seasoned community banker has by now learned that one of the more enduring characteristics of a high-yielding portfolio is the sector weight given to tax-free munis; that is, the more munis, the greater the likelihood that the portfolio will be in the top quartile of its peers. That still stands today, although the yield differential has shrunk. The

COVID-19 RESOURCES

ICBA has compiled expert guidance on how to respond to the COVID-19 pandemic. Check the ICBA Crisis Response & Preparedness webpage.
icba.org/crisis-preparedness

impact of the 2017 tax reform is still shaking out, but we've learned that the difference in the tax-equivalent yields between Quartiles 1 and 4 are at a decades-long low, as the table (see below) demonstrates.

What this also likely means for future portfolios is that substitutes to longer, tax-free instruments could become critical determinants of outperformance.

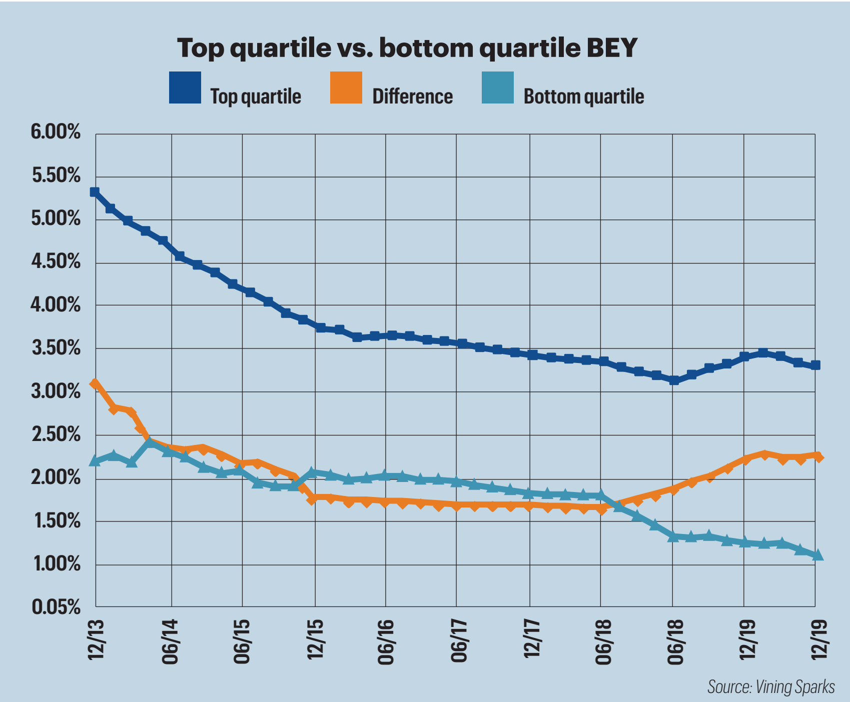
It will take some patience and discipline to strategically layer in the right mix of maturities.

Build-out and compare

If your bond portfolio does have some meltdown due to bonds being called and/or prepaid, ask your brokers to show you alternatives, including high-quality corporate bonds with lockout.

Recently, this column has discussed various multifamily MBS, some of which have absolute call protection, as well as taxable munis. Your brokers can keep you up to date on which of your investments are likely to be called, as well as the expected cash flows in general for the portfolio.

It bears mentioning that the sudden rally has likewise caused effective durations to fall, probably to levels that are shorter than desirable. It will take some patience and discipline to strategically layer in the right mix of maturities, as most everything available will have, shall we say, modest yields. The good news



Next: Customers are clamoring for cybersecurity education

Education on Tap

Webinar series continues

ICBA Securities and its exclusive broker, Vining Sparks, host the next segment of their 2020 Community Banking Matters webinar series on May 12 at 10 a.m. CDT. Rick Redmond will present The End of LIBOR, which should appeal to a wide range of community bankers. Up to one hour of CPE is offered, and there is no cost to attend. To register, visit ***viningsparks.com***

No mysteries for management

Vining Sparks' proprietary model Performance Architect can quantify the impact of a variety of alternative investments on the prospective balance sheet and income statement of any community bank. For a demonstration, contact your Vining Sparks sales representative.

for portfolio managers is that most full-service brokers can now model the impact of a new set of investments on a community bank's entire financial landscape, including ROI/ROE, margins, interest rate risk, capital and liquidity, before even pulling the trigger.

Careful reconstruction of your portfolio can help your securities stay in, or arrive in, the top echelon of its peers. ■

COMPLIMENTARY EDUCATION—AT HOME

Register at *Independent Banker*'s Webinar Events Center to access presentations on topics like compliance, cybersecurity and account acquisition. ***tinyurl.com/ibwebinars***