Portfolio Management

By Jim Reber, ICBA Securities

To the corner office

The bond portfolio fires back a reply to the community bank president.

Dear Community Bank President,

Thank you for your kind letter this past month. It has been a crazy four weeks, which has delayed my response, so I appreciate your understanding. In fact, one of the best things about working so closely with senior management is that you know just as well as I do when things are in flux. It's been a while since a health scare threw the financial markets into a frenzy, but you do remember what happened back in 2003 with the SARS outbreak: My market value first improved in a flight-to-quality rally, then dropped far more than it had first risen after the scare was contained. Who knew this was going to be part of our 2020?

I realize I'd been on the back burner for the past several years, but it wasn't really necessary to apologize for the perceived lack of attention. As long as the senior lenders and quality control folks are doing their jobs, what's good for them is good for the bank and ultimately good for me. I remember a few hiccups back in 2008 when

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several community banks had to write off their investments in certain bonds—bonds!—and that was no fun. Lehman Brothers and agency preferred stock comes to mind. Of course, a lot of community banks had loan issues back in that era, too. I believe I'm correct in saying the entire industry lost money, net, in 2008 and 2009. Glad that era is in our rear-view mirror.

And I know part of the reason I had been fairly idle recently is that our deposit-gathering has been a challenge. That's a universal condition. And I'll mostly let the liabilities section of our balance sheet speak for itself, but have you considered layering in some wholesale funds? I realize there can be a stigma attached to that activity, but, at the same time, we've got plenty of capital. I understand our asset/liability posture is pretty balanced, so it's just possible that you can grab some fixed-rate deposits, lock in your costs and leverage out on the yield curve with loans or bonds. I would be pleased to be of service.

I'm excited about contributing to the community bank's success this year. It's something of a bittersweet period for us bond portfolios when we get back to being in the spotlight, because it probably means that the overall economy has peaked and is at least beginning to show signs of a slowdown. I realize a free-market system has expansions and recessions, so it's part of life, and we've been lucky to have such a great run of economic growth recently. Still, I'm ready for what the near future holds.

I thoroughly enjoy being part of a successful enterprise like our community bank.

You mentioned that bond fashion has changed in the past five years. That's great! I've never been very proud of some of my components anyway. It seems like the bonds that can get called away at any time never perform like you want them to. I hear the term "negative convexity" and some profanity in close quarters quite often. I'd much rather be made up of bonds that can actually rise in value if rates fall. And it doesn't bother me that a new wave of mortgage-backed securities secured by apartments and healthcare facilities is available. If they have the same Ginnie Mae, Fannie Mae or Freddie Mac wrappers, they should be as liquid as the ones backed by single family residences, right? And, just maybe, their cash flows will be more predictable.

Education on Tap

Webinar series continues

ICBA Securities and its exclusive broker Vining Sparks continues its 2020 Community Banking Matters webinar series on April 14 at 10 a.m. CDT. Greg Roll will present Balance Sheet Management and Your Loan Portfolio. Up to one hour of CPE is offered, and there is no cost to attend. Visit ***viningsparks.com*** to register.

I suppose I should address your point about my being nearly 3% underwater in the recent past. Of course I'm going to lose value when rates rise! That's why you've got qualified risk managers to assist you—so that you can make value judgments about the price volatilities in each bond you buy and about me in aggregate. And since you've purposely set my duration at about three years, you know what happens when rates rise 1%—my price is going to drop about 3%. That should have come as no surprise.

While I'm at it, you contended in your letter that when I lost value, my yield didn't improve. That's what's going to happen if you're not sending me any new bonds when rates are rising! I'm asking politely for bonds with positive convexity, thank you very much. With rates across the board being on the low side, it doesn't cost much to buy call protection.

I'm ready when you are to build me back up to my peak size. I thoroughly enjoy being part of a successful enterprise like our community bank. I am also very happy to be the alternative—and complement—to our bank's loan portfolio. It's what I'm here for.

Very truly yours,
The Bond Portfolio

Graduate Banking School in Memphis

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