



# High-End Investing

**Steepness of the curve,  
high quality make DCPCs attractive**

**By Jim Reber**

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Small Business Administration (SBA) floating rate pools have grown in popularity among community bank portfolio managers since the world began changing in 2007. In the past three-plus years, many portfolio managers have not just dipped their toes into the SBA waters; they've gone cannonball into the deep end. And thus far these floating rate pools have performed very well.

For one, SBA loan prices, which took a dive in the first half of 2009 as poolers nationally were unable to finance their inventories, have recovered handsomely—even though many bankers regard these instruments as cash alternatives. Also integral to the rise in prices is the continued good behavior of the borrowers behind the pools. Stated another way, prepayments have slowed every year since 2007, and 2011 started out with a continuation of this trend.

So it appears that these investments, which float quarterly or monthly based on the prime rate and have full faith and credit backing by Uncle Sam, have some appeal. Something else they have is premium risk. It's beyond the range of this column to discuss prepayment implications, but

bankers know intuitively that paying 108 to 112 cents on the dollar for an amortizing instrument has its perils. One way to control the premiums paid on SBA pools is to purchase these floaters' fixed-rate brethren, Development Company Participation Certificates, or DCPCs.

**Why buy?** DCPCs are zero percent risk-weighted and generally amortize to 20-year maturity schedules. They are collateralized by a collection of loans, which can number in the hundreds for a given pool. The loans are guaranteed by the U.S. government and are used to finance machinery, equipment and real estate.

Since DCPCs have a fixed rate, the premiums that result from recently issued pools are often modest. This may be a welcome respite for SBA 7(a) buyers. Another nicety is that most pools have prepayment penalties for the first half of their lives, and these pass through to the investor. This can enhance your yield substantially, although in practice it usually simply limits prepayment activity.

The limited ability to prepay commercial real estate loans is another plus for DCPCs. Many investors see these as alternatives to Planned Amortization Class (PAC) CMOs. Or, with some portfolio managers uncomfortable with the short-term prospects of the municipal bond market, these pools have become their go-to choice for the long end of the portfolio barbell. Which, incidentally, is a structure ICBA Securities is recommending.


**What to protect against.** When you invest in SBA floaters, you accept a low yield today (around 1 percent) in return for the ability to rise in the future. A related benefit to this short-term exposure is that market prices tend to be very stable. The duration of an SBA floater is only about 90 days.

Fixed rate DCPCs are quite the opposite. Their average lives are about seven years at the outset, so they are clearly on the long end of the maturity spectrum for a community bank. Further, because prepayments are insignificant and defaults tend to run only about 5 percent per annum, the average life doesn't shrink quickly. Also, DCPCs pay principal and interest semiannually, so the cash-flow aspects are unique. The result is that your investment stays on the books for a long time.

This is good if long-term interest rates fall, which the shape of the Treasury curve isn't predicting to happen anytime soon. So be prepared for some price volatility, and you may want to keep some gas in the tank to buy more of these items when rates move higher. This opportunity presented itself in the last two months of 2010.

**Here's your reward.** Slow, predictable prepayments that fixed-rate SBA pools produce can be an antidote to premium/prepayment risk elsewhere in the bond portfolio. Many mortgage-backed securities (MBS) pools issued by Fannie Mae or Freddie Mac prepaid surprisingly slowly in the last half of 2010. An uptick in housing prices could precipitate an avalanche of MBS cash flow, even if mortgage rates don't retreat to their November levels.

We haven't mentioned yields yet. Most new DCPCs with modest premiums have yields in the 3.60 percent range as of this writing, which is nearly 60 basis points higher than six months ago. This is partly the effect of having an average life on the absolute steepest part of the curve. These yields also assume no enhancement from prepayment penalties, which would provide an additional boost.

Experienced portfolio managers have been pleased to discover SBA DCPCs. They offer diversification from other, better-known instruments from the standpoint of cash flow and premium exposure, and there are no higher credit quality debt instruments on earth. You may want to follow many other community bankers and trade up a segment of your bank's portfolio into a collection that can offer superior value. 

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