



Climb or Lift?

By **Jim Reber**

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Virtues of ladders and barbells, and when they work best

You may not know it, and you may not care, but your community bank's investment portfolio is probably structured in one of two ways. There are compelling arguments for either structure, and there are times when either can perform very well. I am speaking of the eternal struggle between the ladder and the barbell.

The former is a strategy in which roughly similar amounts of cash flow are produced each month or quarter, over a period of time. It's not uncommon for a 36-month ladder to be in place for a community bank. The ladder, er latter, is a portfolio that has roughly equal amounts of money invested on the short and the long ends of the curve. Let's review the whys and wherefores of both, and also the whens.

What's yours?

A community bank investment portfolio's design, like a

professional career or tastes in clothing, often evolves over time and without conscious purpose. Often the bond-of-the-day ends up in a portfolio with no real cohesiveness. This is not to say that this necessarily creates unwanted risk. However, it can mean an underperforming security inventory, or one that does not complement the rest of the balance sheet.

If you are forced to have a significant amount of dollars invested at money market rates—that is, for less than two years—you may well have a barbell. Community bank portfolios that fit this category are those that have a lot of “hot money” like public funds, or those that have unusually large amounts of fixed-rate loans. This is especially true if your community bank is consistently profitable and can benefit from tax-free income. Many municipal bonds are on the long side of the duration scale.

If, however, your community bank has consistent loan demand, a high percentage of core deposits and is situated in an average growth market, a ladder may be your chosen portfolio structure. I am aware of community bankers who methodically purchase a set maturity or average life of whatever they buy, sometimes just out of habit. This will result in a type of ladder, like it or not.

If you're not sure what you've wrought, how can you tell? A great visual aid is the ICBA Securities Performance Profile. This quarterly report, produced

by the ICBA Securities' investment strategies department, displays bar graphs with your bank portfolio's cash flows over the next 10 years. It also shocks the portfolio in a range of different future rate environments. This report is a complimentary service for all community banks.

Why they work

In baseball terms, the barbell is almost guaranteed to get you on second base. Since community banks really aren't in the rate-forecasting business, this is essentially a no-fuss method of making sure that at least half of your bank's bonds will perform well. Of course, another way to look at this is that you're ensuring that half *aren't* doing well from a yield perspective.

With a barbell, if rates suddenly and unexpectedly rise, the investments that are short can in quick order be reinvested at higher rates. This includes very short maturities, as well as near-resetting floaters and mortgage-backed securities (MBS) that have a lot of principal cash flow. If rates fall suddenly, the longer maturities will sit out there nice and pretty, and can have significant price appreciation. This includes longer-maturity agency bonds with call protection,

longer-average-life MBS and, of course, municipal bonds out past five years to maturity.

Ladders are similarly forgiving in that a certain percentage of the portfolio is available for reinvestment no matter what the rate scenario. While this column (naturally) presumes that the cash flow stays in the bond portfolio, often the proceeds pay down borrowings or are diverted into loans. In essence, a ladder is a storehouse of liquidity and can lessen the need for forced sales of investments.

When to employ

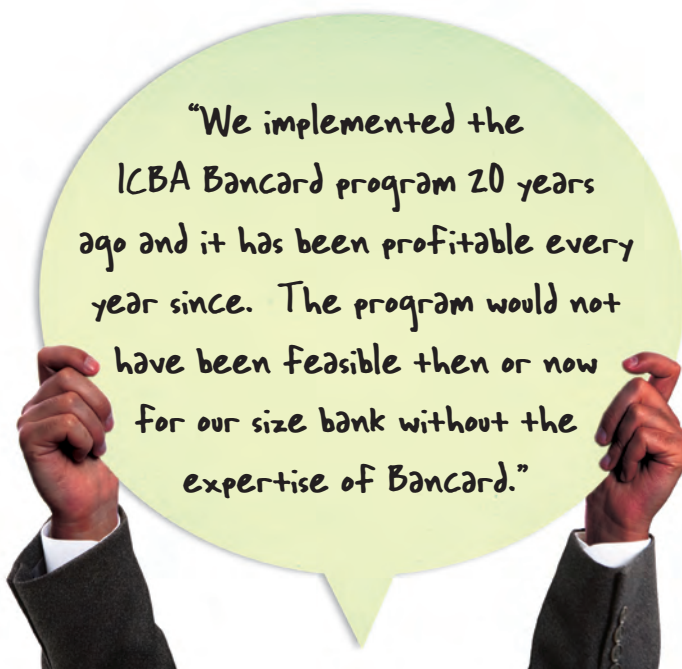
Barbells perform best when the interest rate curve is expected to flatten, and curves are expected to flatten when short rates are very low. The current market is an example of that. Keep in mind that a "normal" Treasury curve

is sloped only about 100 basis points between two and 10 years. Whether short rates rise or long rates fall, you're half happy.

Ladders out-perform barbells when curve steepening is expected. (News flash: Flat curve environments—think circa 2006—are a great time to put dollars further out on the maturity spectrum; 2011 is not a flat curve year.) Still, there's no telling when interest rates will begin to rise in a long-term pattern. Ladders do better as the curve steepens, as the investments scattered in different maturities will appreciate in value, just with the passage of time, due to the "roll down the yield curve" effect.

To conclude: Flat curves spell future steepness—build a ladder. Steep curves portend flattening—build a barbell. Let's break some ground. **13**

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