Alternate tracts

A flat yield curve rewards bond buyers who comparison shop.

Let’s look back for a moment to June 30, 2006. The Fed bumped up the rate on overnight borrowings one more time, to 5.25%, with its 17th and final hike of the cycle. You want flat? I’ll show you flat:

Fed funds ......................... 5.25%
One-year T-bill..................... 5.19%
Two-year note ..................... 5.15%
Five-year note .................... 5.09%
10-year note ..................... 5.14%

How many buyers would have preferred a 10-year instrument over, say, a two-year note with little or no immediate benefit? I recall it was less than most, as they say.

And who could blame them, based on how risk-averse investors are wired to be? Certainly, community bankers understand that risk belongs in the loan portfolio. They know the primary purpose of the bond inventory is safety, followed by liquidity and cash flow. It is counterintuitive to buy a longer versus a shorter bond and not be rewarded with a higher return.

It’s well known by now that those brave soldiers who elected to go long in 2006–07 were
happy they had done so by the end of 2008. Fed funds had plummeted to near zero by then and stayed there for seven full years.

As interest rates dropped like a rock, investment yields soon followed. The typical community bank’s investment portfolio yield fell by about 130 basis points (1.30%) between 2006 and 2009, even though average maturities actually increased during that window. Portfolio managers were trying hard to build some duration to stem the cash flow tidal waves that were storming through their balance sheets.

What’s the lesson to be learned? Well, I think it’s been internalized that a flat curve precedes a slowdown in the economy and, eventually, a stimulative Fed policy. Instead, perhaps the message today is there are tools available to help make good decisions about maximizing bang-for-the-buck when picking investments among a stack that have similar yields.

**Yield versus volatility**

It’s time to state for the record that not all bonds today, nor at any other time, yield the same. There are always going to be allowances for liquidity, certainty and, of course, credit quality. It is, however, correct to say that the range of available yields have converged into a tighter stratus than any time in the last decade.

So, an important measure of value—total return—becomes more prominent when faced with an interest rate environment like the one we have in 2019. Total return is the sum to two inputs: yield and price change over a period of time. If a community bank has a bond with a 2.50% yield and its price increases by 1% over the next 12 months, its total return for the period is 3.50%.

**Going dark**

Any collection of investments can be modeled for total return over a range of future interest rate paths, and their results tallied for comparison. You are correct to assume a short bond will outperform a longer one if interest rates rise in the future, as the starting yields will be roughly similar but the price volatility will be less. The opposite is thus: Longer-duration bonds will have higher total returns, given a lower rate horizon.

Many broker-dealers and bond analysts survey the market and compile total return outcomes on tables for investors to utilize. An excerpt of one such table is below. In this example, the darker the square, the higher relative return given that future rate assumption. The darkest squares indicate top-quartile performance among all other bonds in that column.

Market yield barometers have long been available to identify securities that offer relative value. Given the convergence of stated returns in today’s market, and the possibility of the next secular shift being either higher or lower, total return analysis may be a useful alternative tract for portfolio management and measurement.

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**Investment alternatives matrix: 12 month total return**

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<th>Base</th>
<th>25</th>
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<td>2Y Agency Bullet</td>
<td>3.26</td>
<td>2.76</td>
<td>2.52</td>
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<td>2.03</td>
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<td>3Y Agency Bullet</td>
<td>4.19</td>
<td>3.20</td>
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<td>4Y Agency Bullet</td>
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<td>3.77</td>
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<td>5Y Agency Bullet</td>
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<td>7Y Agency Bullet</td>
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Source: Vining Sparks, April 9, 2019