Marked improvement

Falling rates mean higher bond prices. Be careful with that.

As this year has progressed and the mindset of fixed-income buyers nationally and globally has changed direction and picked up momentum, the reckoning in some cases seems wildly erroneous. Here are a few tidbits:

- Austria’s 100-year bond, issued in 2017 at par, was worth more than double that recently.
- In the U.S., the long bond went below 2% for the first time ever.
- More than $17 trillion in debt globally had negative yields in August.
- The U.S. 10-year note launched in Nov. 2018 has risen by more than 14% since.

We could go on and on. Many of these metrics sound like we’re reading Babe Ruth’s or Wilt Chamberlain’s career statistics. They’re hard to believe.

But unless you own the Austrian 100-year bond or are long a bunch of U.S. 10-year notes, your community bank’s portfolio doesn’t have as much appreciation, or as low of a yield, as some of these statistical outliers. And for that, you can be glad.

Closer to home

As we enter the final lap of the year, portfolio managers often take stock of the bank’s earnings projections to see if any “tweaking” is needed. Since we know the bond portfolio is by far the easiest part of the balance sheet to liquidate, it makes sense to start there. You’re likely to find that you have a gain (no surprise) and that it’s broad-based (somewhat of a surprise). Many times, recently, community banks have discovered that the only bonds they own at net gains are their tax-free munis.

Not today, however, as most taxable bonds are above water, too. This includes all manner of mortgage securities, and possibly callable agencies as well, particularly if the agencies were initially purchased at discounts. Since banks’ average maturities have gradually declined in the past year as rates have fallen, the room for price appreciation has also shrunk, but still it’s not unusual to see a community bank portfolio with a 2% unrealized gain. That is a historically large position.

Can pay to be choosy

The recent distribution between taxable and non-taxable is relevant is that the economic benefit of taking a gain on a tax-free bond is more limited. If one properly accounts for the tax liability that falls out from a sale at a gain, the true cost of selling that bond, as reflected in the “take-out yield,” is probably quite high.

In fact, the take-out yield is always the best place to start when considering bonds that are candidates for sale: the lower, the better. Again, in the current environment, some old rules of thumb might be suspended, such as the expectation that the shorter bonds will have the lowest takeout. With the curve inversion that existed for much of 2019, it’s possible that some intermediate-life investments are the best sale options.

Give and take

While your current unrealized gain posture may make for easier conversations during investment committee or board meetings, there are also some best practices if your community bank is considering some strategic liquidations. The first is to have your broker quantify what the “after” portfolio will look like, including prospective yields, cash flows, durations and sector weightings. It’s axiomatic that taking gains will likely result in your remaining yield being lower.

It’s also time to remind ourselves that your tax consultant will usually advise against the acceleration of income tax liabilities, all things being equal. While issues like Alternative Minimum Tax (AMT) aren’t applicable anymore, a seller of bonds at gains could still be sacrificing short-term cash flow in exchange for current income. And that may be fully acceptable to the stakeholders.

Education on Top

2019 webinar series concludes

The final segment of the 2019 ICBA Securities webinar series Community Banking Matters will take place on Nov. 5 at 10 a.m. CST. Tom Mecredy, manager of the Vining Sparks Community Bank Advisory Group, will present M&A and Community Bank Valuation Update. Free CPE is available. Visit icbasecurities.com to register.

Archival footage

ICBA Securities’ exclusive broker Vining Sparks maintains a library of webinar recordings that address a range of community bank topics. Included are a Bond Basics series, replays of Community Banking Matters and a catalog of the quarterly Economic Outlook webinars. Contact your Vining Sparks sales rep or visit viningsparks.com for more information.

Speaking of time, if your institution has decided to take some gains in the current year, today is a good day to pull the trigger. Liquidity in the bond market, even for the safe, highly saleable and price-discoverable investments that community banks own, tends to dry up as we approach the end of the calendar year. Although you can count on the market’s efficiency to return shortly after New Year’s, that doesn’t help you in 2019.

So, you’ve got options. Sitting tight is always one of them. If taking some gains off the table, especially on securities you’re not committed to in the long term, is in your best interest, the rate environment and yield curve have delivered an early Christmas present.

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