HAPPY RETURNS

Investment principles of top bank portfolio managers

By Karen Epper Hoffman

Community bank institutional investment portfolio managers have been put through their paces the past several years. It could arguably be deemed a feat of investing prowess and market prescience to not only manage well in this market, but thrive in it.

Yet that is exactly what many community banks have accomplished. Despite the challenging bond investing market with historically low levels of interest rates, tight spreads, poor commercial loan growth and a flattening yield curve, institutional investment portfolio chiefs at a wide range of community banks have managed to strengthen their banks’ liquidity and buoy their balance sheets, according to James Plunkett, director of investment product strategies at Vining Sparks, the exclusively endorsed investment broker for ICBA Securities, ICBA’s institutional fixed-income broker-dealer for community banks.

“All investment environments have their challenges,” Plunkett says, “but this one [since 2008], especially so.” Independent Banker interviewed a few of successful community banks investment managers, all of which statistically have an investment yield that puts each of them in the top quartile of their peer institutions, with a high degree of risk-adjusted return. In addition to having a high-yielding portfolio, these investment managers have managed the tricky challenge of balancing on the risk-reward tightrope without necessarily buying into a lot of long-maturing investments, according to Jim Reber, president and CEO of ICBA Securities.

High Performer
Greg Steverson successfully manages a $100 million institutional investment portfolio for Ledyard National Bank in Norwich, Vt.
Greg Steverson, executive vice president, chief operating officer and chief financial officer for Ledyard National Bank in Norwich, Vt., says the bank has taken a very “tactical” approach in how it has managed its investment portfolio, relying on it for earnings as well as liquidity over the past seven years. The $440 million-asset community bank manages a $100 million bank investment portfolio, a portfolio Ledyard National has beefed up in recent years as the bank has made calculated moves to invest and then reinvest, with an eye toward counterbalancing trends in other areas of its balance sheet.

Having a supportive board of directors, which has supported Ledyard’s need to invest in other sectors, has allowed Steverson to allocate funds to other areas at opportune times, such as corporate securities, bank-owned life insurance, low-income-housing tax credits and municipal securities. The bank’s division, Ledyard Financial Advisors, has $1 billion under

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—GREG STEVERSON, LEDYARD NATIONAL BANK
management, which has helped broaden Steverson’s perspective as he looks for opportunities to invest money for the bank. This broader perspective is a result of the bank’s wealth advisory business.

He says that taking a deeper dive on investment analysis also has been critical to the bank’s investment success.

In essence, these steps have collectively allowed Ledyard National Bank to be more tactical in managing its institutional investment portfolio, allowing the bank to enjoy higher returns while recognizing the risks of investing money in a more complicated fixed-income environment.

City Bank in Lubbock, Texas, is another community bank that has grown its investment portfolio—now at $325 million—in recent years to put balance sheet liquidity to work, according to Mikella Newsom, the bank’s chief risk officer. The $2.4 billion-asset community bank has a small municipal bond portfolio and has more recently expanded its short-term agency bonds and mortgage-backed securities, Newsom says.

The barbell approach
Community bank portfolio managers who have fared well in the recent environment say they have paid close attention to the yield curve—migrating from buying the three- to four-year bonds that perform well in a steep-yield curve to the “barbell strategy” of investing that plays better as the yield curve flattens. In a barbell-influenced bond portfolio, banks are typically investing more in both short-term (less than three-year) bonds and long-term bonds, while steering farther away from the intermediate-length maturing bonds, according to Plunkett.

First Option Bank in Osawatomie, Kan., has grown its investment portfolio to include a diversified range of municipal bonds, all bank-qualified and tax-free, which is more conventional and low-risk, according to the bank’s chief operating officer and chief financial officer, Jeremy Smail. As the $285 million-asset bank’s loan-to-deposit ratio has dropped from 92 percent to 50 percent in recent years, First Option has quintupled its investment portfolio from $30 million pre-financial crisis (when the bank was in the bottom quartile for its investment portfolio) to a robust $150 million nowadays.

Among other strategies, the bank has moved away from “bullet” investments—those where the investor picks a maturity date. The bullet strategy is more passive—a set and forget for bond investments—that works in contrast to the barbell investing, which is favored in this market.

But as the portfolio managers point
out, a stable investment in the community is still an evergreen for their business. For example, Newsom says that City Bank has done well with buying Texas municipal bonds, which perform well and offer solid protection because most are backed by the State of Texas Permanent School Fund. On the other hand, shrewd community banks are largely dismissing investments that had once been seen as a core part of most portfolios pre-crisis. A case in point: Steverson says Ledyard National will rarely if ever buy pass-through mortgage-backed securities, which in essence would put the bank in competition with the Federal Reserve.

Typically, more reward is only achieved at the cost of more risk, as community bank portfolio managers know all too well. This has meant upping their overall risk tolerance to a certain degree in some cases, but being careful about what kind of risk they are willing to take on and where. “Bankers are facing balance sheet pressures from two directions—buying more bonds than budgeted and not enough lending,” says Plunkett. “But the fact that the environment is tougher doesn’t mean you can take a lot more risk.”

At First Option Bank, Smail says that the investment portfolio carries more interest rate risk than it previously had, but not a lot of credit risk. As he puts it, it’s a case of “managing the process, not so much trying to eliminate all the interest rate risk.”

Newsom also says that City Bank indeed takes on lower credit risk in its portfolio. The financial crisis has given the bank more to invest and has altered the shape of the portfolio, she says. “But our strategy is to not try to time the market.”

Conversely, Ledyard National is taking on more credit risk, as it allocates more investment to corporate and especially municipal bonds, with an eye to maintaining a steady state of risk from quarter to quarter, if not from year to year. “Our approach is really managing that risk by taking a more sophisticated approach to analysis than we used to do,” Steverson says.

**Balancing soft lending**

In an overall sense, First Option Bank’s investment portfolio has played an increasingly important function in shielding its entire balance sheet against diminished loan growth and the prospect of rising interest rates. Smail says using the barbell approach—with a significant focus on long-term municipal bonds, balanced by shorter-term assets and...
What Makes a Portfolio High Performer?

Jim Reber, president and CEO of ICBA Securities, suggests that these policies can help lift your community bank’s investment portfolio into the top quartile of its peers:

» Purchase all the high-quality, bank-qualified municipal bonds that your bank’s tax status and interest-rate-risk posture permit.

» For taxable securities, limit the amount of callability. Portfolios with a high degree of optionality will force a bank to purchase a lot of bonds in low interest rate environments.

» If your community bank does purchase bonds with call options (about 80 percent of community bank investments are in some way callable), make sure those bonds have above-market coupons. Premium bonds will be more forgiving in a rising rate environment.

» The best bang-for-the-buck mortgage securities are hybrid adjustable-rate mortgages. Keep your eye on the initial reset dates, and actively manage your investment positions.

investments—has been paying off for First Option Bank. But more importantly, he says, it has been crucial for him and his investment managers to watch their portfolio more closely and consider different sectors within the correct risk category.

“Reviewing more frequently is so much a part of our success,” Smail says. “Previously, we’d review our
investments quarterly, or even twice a year. Now it’s monthly.” Coordinating regularly with his peers on the bank’s lending side is another part of the process. “I don’t manage the loan side of the bank,” she says. “But I am more involved in the process.”

Similarly, Newsom keeps abreast of City Bank’s lending status. The bank offers short-term loans for agricultural production, as well as commercial real estate, and a few mortgage loans, which City Bank in turn sells on the secondary market. As chief risk officer, Newsom meets with the bank’s chief lender and other executives weekly.

The factors that have created this investment environment have pushed community banks to consider embracing different investment approaches, incorporating more than one set of parameters, and generally changing their more traditional strategies to managing their investment portfolio, according to Plunkett. “Smart bankers are saying ‘I want the greatest amount of yield with this amount of price exposure on rates,’” he says. And with that in mind, those banks are taking a broader focus, analyzing the change in the shape of the yield curve over time, and becoming much more diversified than they previously were.

“Of course, they have to make sure that they are taking as much risk as is appropriate to the bank, and that the diversification of investments is there,” Plunkett says. “In the end, this environment will create portfolio managers who are much more solid than ever before.”

For Smail, the experience has underscored that bankers should not try to guess rates. “If we had listened to every interest-rate-rising rumor we have heard over the past three years, we would have been hurt, badly,” he says.

For First Option, the keys have been to truly consider all the markets, plan a good diversity of investments and stick with the overarching strategy. “There will always be a bond that doesn’t perform the way you thought it would,” Smail says.

Meanwhile, Newsom’s tried-and-true mix of credit and municipal bonds has paid off for City Bank. “We just know what works for our bank,” she says.

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