Portfolio Management

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Portfolios Morph

Investment securities underwent big changes in the last year

By Jim Reber

If there’s a constant in the world of a community bank investment manager, it’s disappointment. If you buy a bond today and yields go down tomorrow, you wish you’d have bought more; if yields go up, you wish you had bought none. If your overall portfolio has unrealized gains, you lament the poor yields that are available; if you are presented with attractive rates on new offerings, it means you’ve got losses on the balance sheet.

As we embark on our silver anniversary year at ICBA Securities, we would like to convey some data that we’ve gathered about community bank portfolios. The motive is expressly not in the misery-loves-company vein, but rather to share what your peers’ portfolios, sector weightings and yields look like.

I am also pleased that I’ve got two great reference points by which to measure performance: Dec. 31, 2012, and Dec. 31, 2013. That calendar year saw a rise in interest rates and a steepening of the curve, and ironically almost exactly a 100 basis-point shock in the middle of the maturity range. The five-year Treasury note started 2013 at a yield of 0.72 percent and ended at 1.74 percent.

Crowd favorites
Our sample, which I’ve used often in this space over the last nine years, is the Vining Sparks bond accounting client base. Vining Sparks, which is ICBA Securities’ clearing broker, provides this service for about 600 community banks with an average portfolio size of $84 million. The average portfolio is 60 percent larger than it was five years ago.

These portfolios have nearly half their dollars in some type of mortgage security. Fixed-rate mortgage-backed securities (MBSs) comprise 25 percent of the total, fixed-rate collateralized mortgage obligations (CMOs) are 14 percent and floating rate MBS are 10 percent. Right around 20 percent of the investments are in tax-free municipals. The bulk of the remainder, 14 percent, is in government agency bonds.

Stretched out
While the sector weightings are essentially unchanged over the last year, there are two stark differences: duration and market values. On Dec. 31, 2012, the average portfolio had a duration of 2.5 years. (Duration is a major yardstick for investment managers, as it affects cash flow and market risk. The higher the duration, the greater the risk.) One short year later, duration had risen to 4.1 years. So portfolios have, at least in theory, 60 percent more risk than a year ago.

The cause, of course, was the rise in longer-term rates during 2013.

Fun Fact
ICBA Securities will launch its 2014 webinar series, Community Bank Matters, on April 23. The topic will be M&A and Community Bank Valuation Update and the speaker will be Tom Mecredy. Register for each of the five events by visiting www.icbasecurities.com.
buy adjustable rate MBSs or ARMs. Hybrid ARMs, even those which don’t have their first reset date for seven years, tend to have tolerable effective durations because the borrowers whose loans represent the collateral tend to prepay as the first roll date approaches. The general rise in rates over the last year has produced hybrids whose prices are near or even below par.

So there you have a revisiting of the portfolio changes during the last year. By being on top of the changing complexion of your community bank’s investments, you can minimize your disappointments. Avoiding the constant sorrow of portfolio management (with apologies to the Soggy Bottom Boys) can be your milestone accomplishment of 2014.

Something else that’s changed as a result is the unrealized gain or loss. Back in December 2012 the average portfolio was sitting on a 2.4 percent gain. By last December that had swung to a 1.9 percent loss. This roughly 4.3 percent decline is further affirmed by the duration and the roughly 100 basis-point hike in market rates.

**Plug the leak**

Most portfolio managers are now focused on limiting further extension risk. That should not be terribly difficult to do, as most securities that have any seasoning to them have already been repriced to a longer expected maturity.

In the case of callable agencies, which incidentally suffered the largest market value decline of any individual investment sector, anything that came to market prior to November 2013 is now trading at a discount. This means in practical terms that they are expected to not be called, as is reflected by their long effective duration. The discount callable game, in which an investor is rewarded if the bond is ultimately called early, is in progress.

For MBSs, prepayment speeds have slowed to a veritable crawl, so likewise their durations have extended. Nonetheless, not all MBSs are created equally. Collateral with 10- to 20-year finals typically can continue to prepay with some consistency even if interest rates rise. Of course, the scheduled principal repayments will be much greater than for 30-year loans, independent of prepays.

A variation on this theme is to