Year-end Planning

Now is a great time to rethink your bank portfolio’s objectives

by C.J. Pickering and Mark Evans

Regardless of the level or direction of rates, the fourth quarter of the year is the time that bankers plan for the coming year and execute year-end strategies. Now is the time to review your bank’s investment portfolio, assess how well it is serving its role and make needed adjustments. In addition, this is the time to execute specific strategies that benefit your bank this year or position it for the coming year.

In February 2002, this column discussed historical rate movements following the past six recessions. The column showed that rates continue to fall for an average of 14 months following a recession and that it takes, on average, an additional year or so for rates to rise 1.0 percent.

As this article is being written in early August, the December fed funds contracts are being traded below 1.75 percent. Perhaps history is repeating itself and rates could take at least 14 months (until around year-end 2002) to hit bottom and that they could rise no more than 1.0 percent by year-end 2003. There is no question that rates will rise, but history and current events suggest that it may be a while before they rise substantially.

The dilemma is whether to sit on your bank’s cash and wait for higher rates or to invest now and risk market-value losses when rates rise. This month’s column attempts to balance your bank’s risk-reward profile by investing now in securities that will cash flow or which can be liquidated without significant losses after rates rise.

Using the August rates, one-year, two-year and three-year agencies were at 1.79 percent, 2.31 percent and 2.94 percent, respectively. Investing in a one-year agency would give a yield of 1.79 percent and, one year later, would require a two-year reinvestment rate of at 3.52 percent to break even with a three-year investment of 2.94 percent.

Here’s the math:

- 3-Year Option = 3 years x 2.94% = 8.82%
- 1-Year + 2-Year Option = (1 years x 1.79%) + (2 years x 3.51%) = 8.82%

In other words, keeping money in very short-term investments while waiting for rates to rise to more at-

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<th>Securities with Comparable Price Risks</th>
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<td>CMO PAC, 5 year average life in base and rising rates</td>
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Source: ICBA Securities
Restructuring During Low Rates
Portfolio restructuring can help meet your bank’s changing needs. For example, in today’s market, it may make sense to move your bank toward a more asset-sensitive position. A more asset-sensitive bank will make more money when rates do begin to rise.

Bank investment portfolio restructuring usually takes place at the beginning of the year or at year-end. Many banks take bond swap losses at year-end if the year promises to be exceptionally profitable or exceptionally unprofitable. Exceptionally high profits can help pay for getting rid of low yielding bonds while exceptionally low profits may be an opportunity for “piling on”; that is, dumping all the bad news into one year to increase profits in subsequent years. Either strategy will shift additional income into future years.

The bond swapping opportunities may be even better in 2002. With year-end 2002 rates down dramatically, there are losses and gains in the portfolio. This means that losses from low yielding bonds can be covered with gains from higher yielding bonds, and the replacement investments can have an overall higher average yield than the investments that were replaced.

It takes a little work, but the payoff can be substantial.

C.J. Pickering is president of ICBA Securities, and Mark Evans is director of investment strategies of ICBA Securities, a member of NASD and SIPC and at 775 Ridge Lake Blvd. in Memphis, Tenn. 38120

Learn More
ICBA members are invited to call ICBA Securities at (800) 422-6442 for the following complimentary information:
• A complete research report on year-end planning;
• A Performance Profile that assesses how well your bank’s portfolio is performing its role;
• Current market conditions, bond yields and price volatilities;
• Bond sale candidate identification;
• Recommended suitable replacement investments and analyses;
• Eight-page Independent Banker reprint explaining bond swap mechanics in detail; and
• Independent Banker reprint showing rate movements following each of the past four recessions.

Now is the time to review your bank’s investment portfolio, assess how well it is serving its role and make needed adjustments.

Floating rate coupon and short-term securities can be sold with relatively little loss in value when rates go up.

Attractive levels, can only break-even with a longer-term investment strategy if rates move up rapidly in a short period of time—an event which history does not support. It could happen, of course, but a more historically supportable scenario is for rates to move up more gradually.

Investing Longer
So far the argument has been against staying very short and waiting for rates to rise. However, at some point in time rates will rise, so investing long will expose your bank to market value risk. The trick will be to get a decent current yield with an acceptable market value protection.

Floating rate coupon and short-term securities can be sold with relatively little loss in value when rates go up. Graph I shows the relative risk-rewards of some example securities with price volatilities comparable to those of two- and three-year Treasuries.

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