In February 2002, I discussed the historical evidence that interest rates could fall for at least 18 months following the recession that ended after third quarter 2001. History also suggested that it could then take another 12 months for rates to rise by 1.0 percent.

Now 26 months after the 2001 recession, short-term rates remain at 45-year lows. However, history also shows that in 1989, 1994 and again in 1999, fed funds rates rose by 300 basis points, 300 basis points and 200 basis points, respectively, each in 12 months.

So, what steps can a community banker take to plan his or her bank’s portfolio in the face of extremely low rates with little sign of near-term relief, but with the specter of rapidly rising rates when they do begin to rise? The dilemma is whether to accumulate and sit on the bank’s cash and wait for higher rates, or to invest now and risk market-value losses when rates rise. Let’s consider some of the market’s underlying characteristics and suggest some investment strategies.

Underlying Characteristics

Although short-term rates have fallen over 550 basis points since the highs of 2000, the 10-year Treasury is still within 200 basis points of those highs. In other words, the intermediate-range portion of the yield curve moved down about one-third the move of the short-term range.

One result of the way that rates moved down since 2000 is that the yield curve is very steep. Over the past decade, the 10-year Treasury has averaged a spread of 119 basis points over one-year. At press time, the 10-year Treasury was 312 basis points over the one-year—almost 200 basis points steeper than historical averages.

The steep yield curve suggests that the market is already anticipating higher rates, so longer-term rates may not move up as much as short-term rates when the Fed does raise the fed funds target. The fed funds target rate, for example, would have to be raised by 200 basis points just to bring short-term rates back into historical equilibrium with the 10-year trend.

As described in previous Portfolio Management columns, a major key to successful investing in today’s environment is to select securities that have either floating-rate characteristics or that have relatively high cash flows that can be reinvested as rates rise. The following are some of the more popular securities being purchased at this time:

- Five-year cushion agencies;
- Five-year step-ups agencies;
- One-year Ginnie Mae ARMs;
- Hybrid ARMs (rates reset in three, five or seven years);
- Five- and seven-year balloons; and
- Ten-year amortizing mortgage-backed securities.

These types of securities offer relatively high yield, relatively low market

For More Information

CBA members are invited to call (800) 422-6442 for the following complimentary information:

- 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 more detail;
- Independent Banker reprints showing the effects of investing now in the face of rapidly rising rates; and
- Expanded discussion of the Portfolio Yield Forecaster. (See box on page 98.)
price volatility and cash flows or floating rate coupons that allow community bankers to earn decent yields now while preparing for potentially rapidly rising rates in the near future.

Restructuring Opportunities
Bank investment portfolio restructuring usually takes place at year-end or at the beginning of a new year. Many banks take bond swap losses at yearend 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.

With year-end 2003 rates down dramatically, there are losses and gains in the portfolio.

Either strategy will shift additional income into future years. The bond swapping opportunities may be even better in 2003. With year-end 2003 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, with the steep yield curve, 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.

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Portfolio Yield Forecaster
One of the more complex jobs in budgeting is determining investment roll-off and the investment portfolio’s resultant loss/gain in overall yield. Fortunately there is a new tool (complimentary to ICBA members) that projects maturities, calls and prepayments based on analyses of each of a bank’s individual securities.

The yield forecaster projects monthly and annual roll-off principals, roll-off blended yields, reinvestment rates, remaining balances and the blended yield of remaining balances. This information takes a lot of the guesswork out of trying to determine what the bank’s portfolio yields will look like for up to two years in the future.

Call CJ Pickering or Mark Evans at ICBA Securities at (800) 422-6442 to order this valuable, complimentary system.