Portfolio Yield Projections

Historical data can be helpful in projecting future portfolio performance.

by C.J. Pickering and Randy Wade

It has been a little over two years since the end of the 2001 recession, so the current recovery period is longer than history suggests. Also, as mentioned in this column, when rates do start up, they could go up rapidly. In 1989, 1994 and 1999, within 12-month periods, Fed funds rates jumped up 300 basis points, 300 basis points and 200 basis points, respectively. Conclusion: History suggests that Fed funds rates could move up rapidly sometime during the 2004-2005 time frame.

Using history and current investment portfolio yields as guides; some rather simple assumptions can be made about the future of community bank portfolio performance under rapidly rising rates.

Historical Perspective

The duration of the average community bank portfolio usually falls within a 2.5- to four-year range—2.5 years when rates are low up to four years when rates are high. Graph I shows the relationship between the three-year Treasury and average portfolio yields from December of 1997 through June of 2003. Note that changes in direction of portfolio yields lag changes in direction of the three-year Treasury by two- to three-quarters. Conclusion: Average portfolio yields change direction (up or down) about two- to three-quarters after three-year Treasury rates change direction.

Referring again to Graph I, points A, B and C represent the high and low portfolio yields while points E, F and G represent the high and low three-year Treasury rates.

From points F to G, Treasury rates dropped 5.02 percent while portfolio yields dropped 2.51 percent. Portfolio yields dropped about half as fast as did Treasury rates.

From points E to F, three-year Treasury rates rose 233 basis points. However, since there was a quick drop in Treasury rates from points D to E and a rapid recovery, it can be argued that a more reasonable comparison would be from points D to F. The reason: Portfolio yields are built over time and the portfolio yields from points A to B are more related to the period prior to point D than to the very short period starting at point E.

Given this argument, the portfolio yield rise of 0.51 percent from points A to B was about half that of the Treasury rate rise of 1.01 percent (points D to F). Conclusion: Average portfolio yields tend to move about half as far as Treasury rates.

Graph II shows the historical relationship between community bank cost of funds and portfolio yields historically lag rises in Treasury rates.

Rises in community bank cost of funds and portfolio yields historically lag rises in Treasury rates.

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yields. Note: As rates rise and fall, the spread between the two remains fairly constant. Since 1998, the average cost of funds has varied by a little over 200 basis points, portfolio yields have varied by 250 basis points, but the spread between the two has averaged 2.7 percent and has remained within 35 basis points of that average. Conclusion: the spread between high-performance portfolio yields and the cost of funds remains relatively constant at around 2.7 percent.

Average portfolios are relatively short (2.8 year duration). Prepaying fixed-rate Mortgage-Backed Securities and Collateralized Mortgage Obligations make up about 34 percent of these portfolios, and adjustable rate MBSs and CMOs make up an additional 19 percent. Conclusion: MBS and CMO cash flows will allow the purchase of additional securities as rates rise.

What it All Means
Short-term rates could rise rapidly within the next year and a half. Risks in community bank cost of funds and portfolio yields have historically lagged the rise in Treasury rates.

Community bank portfolios contain a large proportion of MBSs and CMOs with cash flows that can be reinvested as rates rise. Portfolio yields are expected to rise about half as much as the rise in three-year Treasury rates. (Note: Graph I shows that portfolio yields did not

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Yield Forecaster and Other Helpmates
CBA Securities has a new tool to help community bankers project their investment portfolio’s investment yields. This system takes into account the following:

- Each individual security in the bank’s portfolio;
- Projected maturity, call and prepayment rates for each security; and
- Projected monthly reinvestment rates.

This information can be used to project roll-off cash flows and yields and reinvestments to project the bank portfolio’s future monthly yields.
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take as big a nose dive (2.5 percent from points B to C) as did Treasuries (5.0 percent from points F to G). Therefore portfolio yields will not need to rise as much as Treasury rates to return to equilibrium.

History suggests then that three-year Treasury yields could rise by 200 to 300 basis points within the next year and a half and that average bank portfolio yields could rise by 100 to 150 basis points after a two- to three-quarter lag.

As always, the conclusions outlined in this article are based on historical data. Nonrecurring events may skew projections. Hopefully, this information can be used to assist in the budgeting process. However, it should not be viewed as infallible (like weather forecasting, being in the ball park some of the time seems to be acceptable).

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