The Federal Reserve began lowering Fed funds rates in December 2000 and dropped them to their current level of 1.0 percent in July of 2003—their lowest level since 1954. It’s instructive to examine the differences between high-performing portfolios during high interest rates (December 2000) and during low rates (December 2003).

The information in this month’s column is based on the 500 community bank portfolios in the ICBA Securities and Vining Sparks bond accounting systems.

Table I on this page shows the differences in effective duration between portfolios in the high-performance versus the low-performance quartile. Note that the high performance portfolios have lengthened slightly from 4.3 years to 4.6 years, while the low performers are back to where they started in 2000 at 2.8 years.

Table I also shows the tax-equivalent-yield differences between the portfolios in the high performance quartile and those in the low performance quartile. Note again the dramatic changes in the tax-equivalent-yield differences—from 0.9 percent in December 2000 to 2.3 percent in December 2003. This is because low performance portfolios tend to have shorter durations than do high performance portfolios. Shorter portfolios lose yield faster in falling rates as their investments get called or mature more rapidly than those in the longer portfolios.

Allocation Differences

Table II on page 96 shows the changes that have occurred in the high performance portfolios over the past three years. The primary changes are in the reduction of fixed-rate mortgage-backed securities, from 41 percent to 34 percent, and the increase in tax-free securities, from 21 percent to 27 percent.

Table III on page 96 shows much more dramatic changes in the low performance portfolios. Floating-rate mortgage-backed securities rose from 4 percent to 40 percent and, in a trend opposed to that of the high performers, tax-free securities dropped from 9 percent to 3 percent.

Many high-performing portfolio managers are in asset-sensitive banks, so their interest margins are expected to increase as rates rise.
cent. Callable agencies dropped from 34 percent to 14 percent as they were called in, and some of the cash was either moved to other types of securities or held in Fed funds sold positions.

Table IV on this page compares the compositions of the December 2003 high performance and low performance portfolios. There are several significant differences. The high performance portfolios have more fixed-rate mortgage-backed securities and fewer agencies than do the low performers. However, the big differences are in floating-rate mortgage-backed securities (12 percent versus 40 percent) and in tax-frees (27 percent versus 3 percent). The low performers appear to be playing defense with their floaters, while the high performers appear to be playing offense with the higher yielding, longer duration tax-frees.

Analyzing the Trends
Reaching conclusions at this point in the rate cycle is like the joke about the guy who fell from atop the Empire State Building. As he passed the 40th floor, he was heard to say, “So far, so good!”

The longer-duration portfolios will continue to out-yield the shorter-duration portfolios, but they will lose market value more rapidly when rates begin to rise. High yielding portfolios are outperforming the shorter, lower yielding portfolios by 23 percent—or $230,000 for each $10 million invested. Keeping their powder dry and waiting for rates to rise has cost the low-yielding portfolios more than $500,000 per $10 million invested since rates started falling in late 2000.

Many high-performing portfolio managers are in asset-sensitive banks, so their interest margins are expected to increase as rates rise. Their strategy is to let the investments make higher yields today, knowing that when rates rise, their longer duration portfolio yields will not rise as fast as will the yields on shorter portfolios. However, since the bank is asset sensitive, the overall margins will increase anyway.

This is a strategy that recognizes that the investment portfolio is not a separate entity but an integral part of the bank. It is designed to perform well in low rates when the bank’s margins are squeezed, and can be expected to recover more slowly when rates rise and when its performance is not as essential to the overall profitability of the bank.

C.J. Pickering is president of ICBA Securities, a member of NASD and SIPC in Memphis, Tenn. Reach him at cj@icbasecurities.com.