It seems there is never a perfect time to restructure a bank investment portfolio. When interest rates are high, the existing portfolio securities are underwater and a makeover would require substantial losses on any securities sold. When rates are low, many of the existing portfolio securities have unrealized gains, but market rates are low and reinvestment alternatives are low-yielding as well.

However, today's market does offer some attractive alternatives for some bank portfolios. For example:

- Many portfolios include securities with unrealized gains or small losses;
- The yield curve is very steep and offers higher yields for relatively small average life extensions; and
- Securities with cash flows will normally outperform single maturity and callable securities in rising-rate markets.

What It Means
ICBA Securities' consulting CPAs and CFAs recently analyzed a portfolio made up almost entirely of single maturity and callable agency securities. Although this is not unusual, it does signal room for improvement since the average high performance portfolio has 48 percent of its investments in amortizing mortgage-backed securities and an additional 26 percent in tax-free municipal bonds.

Graph A compares the investment allocations of high performance portfolios to the example portfolio before and after the portfolio restructure.

CONCENTRATION IN ANY SINGLE TYPE OF SECURITY CAN CREATE PROBLEMS.
llio makeover. Before the makeover, the portfolio had about 28 percent and 49 percent of its funds in single-maturity and callable agencies, respectively. During the makeover, 38 percent of the portfolio was reallocated. Mortgage-backed securities were increased from 11 percent to 50 percent of the portfolio, and tax-free municipal bonds were increased from 11 percent to 28 percent (fixed and floating combined). Several characteristics in Table A were affected.

<table>
<thead>
<tr>
<th>Portfolio Makeover Example Table A</th>
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<tbody>
<tr>
<td><strong>BEFORE</strong></td>
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<tr>
<td>Portfolio Yield</td>
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<tr>
<td>Change in Overall Yield</td>
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<tr>
<td>Change in Marginal Yield</td>
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<tr>
<td>Effective Duration</td>
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<td>Price Volatility</td>
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</table>

(Yields on the bonds that were swapped improved by 56 basis points, while effective duration increased by six months and price volatility increased by 1 percent with rates up 300 basis points.)

**Major Upgrades**

In rising rates, a single-maturity or callable agency will pay back 100 percent of its principal at maturity and none of its principal prior to that date. One of the primary benefits of mortgage-backed securities is the fact that they produce continuous cash flows that can be reinvested as rates are rising.

Graph B shows two years of quarterly cash flows both before and after the portfolio makeover. In the Before case, with no change in rates, many of the callable securities will be called and the funds will have to be reinvested during the low-rate cycle. However, when rates begin to rise, the callables will extend to maturity and cash flows will drop by an average of 60 percent. Cash flows range from $12 million in the third quarter if rates remain stable, to less than $1 million in the fourth quarter if rates rise by 200 basis points.

In the After case, the mortgage-backed securities’ cash flows are much more stable and will be reduced by an av-
average of only 23 percent when rates begin to rise. Cash flows range from a high of $5 million in the third quarter to a low of $2 million in the fourth quarter, regardless of rate fluctuations. This is a much more balanced quarterly cash flow and permits investment “dollar-cost averaging”—the investment of money each and every quarter to reduce the potentially damaging effects of investing substantial portions of the portfolio during dips in market rates. The increase in cash flows during rising rates and the addition of floating rate mortgage-backed securities also improves the bank’s interest-rate risk profile by making it more asset-sensitive. In this low rate environment, making the balance sheet more asset-sensitive increases the bank’s net margins and profitability when rates begin to rise.

Conclusions
There are plenty of securities that make sense for community bank portfolios, including single-maturity and callable agencies. However, significant concentration in any single type of security can result in a portfolio with some of the inherent problems discussed above. Now is a good time to think about restructuring a poorly positioned portfolio. Interest rates are low, there are potential sales profits in the portfolio, the yield curve is steep and some attractive alternatives are available.

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