There are three certainties a bank portfolio manager faces: death, taxes and a security inventory that has a concentration of purchases in a low rate environment. And if the third condition isn’t as much of a given as the first two, consider this: Of the approximately 1,500 banks each quarter that use a Performance Profile created by ICBA Securities and its broker-dealer, Vining Sparks, less that one out in five score higher than a 1 (out of a possible 3) on the “Market Timing” segment.

A score of 1 means that more than 80 percent of the current portfolio was purchased in the third or fourth quartile of yields looking back seven years. Those banks that score a 1 generally will face an uphill climb in getting the security inventory’s yields to improve once the Fed embarks on a tightening cycle. To wit: The 500+ banks that use ICBA Securities for their bond accounting have seen their yields improve only 16 basis points from June 2004 (date of the first Fed hike) through June 2005, despite the fact that the yield on Fed Funds rose a full 125 basis points during that time.

Opportunity Arrives
Now, finally, it appears some relief is in sight. The graph below illustrates that we are in the second quartile of yields looking back to 1999, using the two-year Treasury as a benchmark. (Bank portfolios currently have a duration of about 2.5 years.) This example bank is fairly typical in that 2001 through 2003 is the period of the vast majority of its purchases.

Notice also that the remaining periods of “first quartile” yields are at the far left of the graph, which means that they will be rolling off of the chart in another year or so. That may well cause current yields to vault into the top quartile, prospectively.

What this all means is that today appears to be at least a reasonably good time to buy securities. And for bond investors who have been waiting for the ideal time to purchase (and in essence out-guess the market), remember that not all bonds are created equal when it comes to purchase.
to price risk. Let’s look at several strategies that can improve your “market timing” results.

Limit the Callability
If one were to define the single biggest factor that causes most banks to have poor market timing, it would be “optionality.” That is, the issuers of most debt securities have built in their right to take their debt back early, if it’s to their advantage, or to leave it outstanding, if that is a better alternative. Callable agencies are the most visible example of this sector. Those of us who were involved in bond management in the 2001 through 2003 period know exactly what happens when rates fall: Callable bonds get called.

Also, those mortgage-related securities with “imbedded” options, primarily residing in a homeowner’s right to prepay his mortgage, experienced an avalanche of prepayments in those years, the likes of which were unprecedented. These mortgage prepayments occurred in spite of an individual borrower being (theoretically at least) an inefficient option holder.

So it follows that, if a portfolio limits the chance that it can be involuntarily converted to cash it should be able to add reasonable amounts of securities in any rate environment. Examples of such securities include one-time callable agencies, preferably at a discount, bullet munis and well-structured PAC CMOs with tight payment windows.

Build a Solid Ladder
Creating a predictable series of cash flows regardless of rate shocks can ensure certain monies can be reinvested as rates gradually rise, thereby improving a chance of buying in a higher quartile. What creates predictable cash flow?
cycle. The average lives of such pools are rarely over four years.

**Artificial Induction**
A third way to improve timing is to finance purchases in high-rate environments using one of two techniques. The first is the tried-and-true bond swap in which some current securities are sold and others simultaneously purchased. The advantage of this strategy is obvious; the downside is that your sales will almost certainly result in losses, which may or may not be good, and the reinvestment bonds will usually have to be longer in duration to make economic sense.

The second technique is to finance purchases through a series of wholesale borrowings, the most popular being FHLB advances. The upside is that bonds are purchased at attractive yields, but the downside in this case is threefold:

1. The borrowing will certainly be made in a high-rate environment;
2. If the asset “goes away” before the borrowing, by virtue of being called or prepaying, the bank will likely have a negative spread on reinvestment; and
3. High-rate environments usually occur during flat yield curves, so attractive spreads from such an arbitrage are unlikely.

Most banks have consistently been cash rich during low rate cycles and cash poor during high-rate environments. However, it’s important to point out that absolute rates are at a four-year high.

As near-future securities purchases are made, it behooves the portfolio manager to be mindful of the predictability and availability of the cash flows from these purchases. Doing so can ensure future high performing yields, resulting from the boost achieved by favorable market timing.

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