Day-to-Day Portfolio Management

An approach to time-efficient and effective community bank portfolio management

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Like many jobs, the task of managing the investment portfolio was quite different fifteen years ago than it is now. Back then, most portfolio managers relied heavily on hard-copy portfolio listings, books and tables to look up prepayments, rudimentary yield calculators, insufficient accounting systems, and a host of other burdens which made the job all-consuming. Even so, the job of managing the investment portfolio did not seem disproportionately large or difficult to justify. After all, if one-third of the bank’s assets are held as investments, a substantial investment of time and management effort seemed reasonable – and it was.
Today, many bank Presidents, CFOs, and other upper management members are faced with quite a different situation. Instead of being overburdened with administrative issues, portfolio managers actually have the ability to effectively and successfully manage their investments while allocating amazingly little time to the task. Thanks to technological advances and increasingly knowledgeable community bankers, a portfolio manager who is organized and educated and makes efficient use of outside resources can achieve optimal performance from the portfolio.

Even at banks with billions in the investment portfolio, managing the investments does not need to be a full-time job, thanks to the wealth of resources available to portfolio managers today. That is a good thing for community banks whose executives wear many hats. The investment hat need not be worn all of the time nor does it need to be uncomfortable.

As an outline, in order to efficiently manage the portfolio, it is important to first understand the portfolio’s role and objectives, maintain an organized approach, seek education as needed to stay abreast of current issues, and effectively use outside resources.

**Understanding the Portfolio’s Role**

At all institutions, the investment portfolio plays a combination of roles. In the broadest context, it provides liquidity, balances asset/liability exposure, and generates income. The relative importance of those three roles as well as the extent to which the portfolio can fill those roles varies from one institution to another.

At some institutions, the investment portfolio is 25% of assets or greater. In such cases, it can easily provide liquidity. Instead, management must focus on the income needs of the portfolio as well as balancing asset/liability exposure. At other institutions, the portfolio is as small as 10% of assets. As a result, the portfolio must be kept liquid and is not a significant income contributor or asset/liability balancer.

Portfolio managers must also have a vision for the future. How is the composition of the bank’s balance sheet changing? Growth expectations may alter the demands on the portfolio. Banks should always seek quality loans and core deposits at appropriate interest rates. Competition and the bank’s market will dictate the type and availability of those loans and deposits. Over time, the types of loans and deposits may change, dictating changes in the bank’s investment portfolio.

At most community banks, the portfolio manager is involved in and aware of the institution’s balance sheet and growth plans and their implications for the investment portfolio. While this understanding serves as the foundation for managing the portfolio, it is not an added burden.

**Having an Organized Approach**

Perhaps the most important way to make sure the job of managing the investment portfolio does not become needlessly all-consuming is to have an organized approach. Following a comprehensive yet confined regimen will allow portfolio managers to fulfill regulatory requirements and ensure that their portfolios play their role on the balance sheet while striving for optimal performance.
### Portfolio and Security Checklists

Each portfolio manager should develop a routine which fits the specific institution and portfolio needs. It should also be a routine with which the manager is comfortable. Through the course of a year, events may occur which prompt the portfolio manager to add, even temporarily, certain activities to the schedule. For routine, scheduled tasks, it is ideal to document the completion of each activity. The insert provides an outline to the way some managers schedule their reviews of the investment portfolio. Many of the schedules may be established in policy while others may be personal preference. For example, the frequency with which price volatilities are evaluated, aggregate risk reviewed, and credit risk information updated should be documented in policies. In contrast, the process and frequency for evaluating bond swaps, market conditions, investment alternatives, and peer comparisons will fall to the personal preference of management and possibly the board of directors.

### Securities Transaction Report

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<thead>
<tr>
<th>Trade Date</th>
<th>Compliance</th>
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<tr>
<td>Settlement Date</td>
<td>Officer Executing Transaction</td>
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<table>
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<tr>
<th>Purchase</th>
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<td>Sector(Agy/Tsy/Corp/MBS...)</td>
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<td>Description of Security</td>
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<td>CUSIP Number</td>
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<td>Coupon Rate</td>
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<td>Call Date</td>
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<td>Purchase / Sale Price</td>
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<td>Average Life (if MBS/CMO)</td>
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<td>Original Face</td>
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<td>Current Factor</td>
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<td>Ratings &amp; Outlook Moody’s</td>
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<tr>
<td>Ratings &amp; Outlook S&amp;P</td>
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<td>Price Change (%) +300</td>
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<tr>
<td>Was this transaction part of a swap?</td>
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</tbody>
</table>

### Documentation

- Is additional supporting documentation available and attached?
- Has Prospectus/Official Statement been ordered (CMOs, Corporates, Municipals, Pfd. Stock, etc.)?
- Attached Screens: Description, yield table, Price vol
- Credit risk items - attached Screens from Bloomberg
- Security Description (DES), Issuer Info. (ISSD), Credit Profile (CRPR), Income Stmt (CH2), Balance Sheet (CH3), Current News (CN) 1st Page, Financial Analysis (FA)

### Reason(s) for Sale Transaction:

- Generate liquidity
- Clean up odd lots
- Reduce liquidity portfolio
- Reduce maturity concentration
- Excess price volatility
- Increase yield
- Ride the Yield Curve
- Tax swap item
- Projected poor total return
- Credit Quality Concerns
- A/L Balancing
- Other (Describe)

### Reason(s) for Buy Transaction:

- Fill Hole in maturity ladder
- Increase rate sensitivity
- Diversify into different instruments
- Provide a pledgeable investment
- Ride the Yield Curve
- Short duration
- Provide cash flow predictability
- Yield
- Tax planning
- Provide good total return
- A/L Balancing
- Leverage Transaction
- Other (Describe)

### Maintaining Files

For regulators, accountants, and the bank’s needs, documentation for investment securities must be maintained and accessible. Checklists can help make sure the right documentation is obtained and retained. See example above.

A file should be retained on each investment security. A checklist can assist in not only making sure the correct documents are obtained but also can serve as a reminder as to why a security was bought or sold. The file can prove very useful, especially since some regulators’ questions come years after a purchase is made.
DEVELOPING A ROUTINE

DAILY
• Review Treasury yield curve & changes
• Brief market update
• Scan economic report results

WEEKLY
• Review projected cash flows, looking for gaps, shortfalls, or excesses
• Scan the coming week’s economic calendar

MONTHLY
• Evaluate market prices, price changes, and gains/losses for concerns
• Review bond accounting reports, reviewing book yields, prices, amortization/accretion
• Scan portfolio

QUARTERLY
• Review portfolio and individual security price volatility (+/- 100, 200, 300)
• Review duration shocks (+/- 100 & 200)
• Review ratings on corporate & municipal bonds rated below AA-
• Conduct other-than-temporary impairment assessment of securities as well as disclosure table and text (utilizing bond accounting report as source for table)
• Complete call report securities section using corresponding bond accounting report
• Review asset/liability exposure and assess whether balance sheet shifts are needed to alter risk profile.

ANNUALLY
• Review investment policy
• Review ratings on corporate & municipal bonds rated AA- and higher
• Reassess approved broker list

OTHER EVENTS WHICH MAY TRIGGER ACTIONS
• Material credit downgrades or upgrades on debt issues owned
• Bond swap or other investment opportunity which merits consideration
• Unexpected FOMC actions or significant shifts in expectations
• Economic or political upheaval in key regions
• New FASB or regulatory guidance impacting portfolio or balance sheet management
Market News

While it is important for portfolio managers to stay abreast of market conditions including interest rates, economic data, and the Fed, doing so does not need to be all-consuming. In fact, it can be done in just a few minutes a day. ICBA Securities, at www.icbasecurities.com, provides the following resources for staying up-to-date on market conditions and influences:

- **Newsletters** – *The Market Today* provides a daily market commentary, yield curve, and economic recap. *The Market Review* is a weekly publication summarizing the prior week’s happenings. It also includes yield and spread information on the products in which banks invest and a look at the coming week’s economic calendar. *FOMC Newsbreak* provides an immediate update on the policy announcements following each FOMC meeting. All three are available via email or the ICBA Securities’ website.

- **Current Market Rates and News** – Throughout the day, yield curves are updated on the ICBA Securities’ website. In addition, news applicable to the financial markets is available intra-day. Both are provided by Reuters.

- **Spread & Rate History** - By reference to the Graphs/Rates sector of the website, a bank can readily view historic spreads for most every type of security that a typical bank portfolio would purchase. The latest spreads are also included each week in *The Market Review*. Next, these spreads to the curve can be parlayed onto the Treasury market table mentioned in the previous paragraph, and it becomes very quick and easy for an investor to determine “right now” yields that are available for purchase, with no other phone calls or analyses necessary.

Staying “Up to Speed”

Education, and more to the point self-education, is another important requisite for effective portfolio management. Education also can be seen as a necessity in several different arenas, such as new accounting and regulatory pronouncements, and also hard research on new bond products and strategies.

A constant obstacle to staying up-to-date on accounting pronouncements, regulatory rulings and general fixed income research is really two separate issues operating in concert: one, the sheer volume of information that is disseminated, and two, the fact that a number of different sources are producing it. The ICBA Securities website has a resource that can be very effective in streamlining the process of finding and retrieving all pertinent data.

The Customer Support Area contains a Research Archive. An example of the Customer Support Area is displayed at the top of page A7. In it you will find all of the following:

- Bond Research Reports
- Recent Newsletters
- Strategic Insights on Accounting and Regulatory Issues
- Sample Investment, A/L and Liquidity Policies
- Links to FDIC, OCC, FFIEC, OTC and FHLB websites
Here is a real example of the Archive’s usefulness: Let’s say you are contemplating a sale of bonds classified as Held to Maturity (HTM). The literature that controls this activity dates back to 1994, and may not be easily located in your files. The “Accounting/Regulatory” link will take you to all literature ICBA Securities has published, sorted by topic, including “FAS 115.” By following the link you can access the applicable research, view it, and print it.

The same holds true for product research and policy templates. Often times a visit from regulators (or the threat thereof) requires a portfolio manager to get files in order, whether that means fixed income documentation or the updating of policies. Again, by reference to the Research Archive, you can access the relevant information, and capture it for your own use.

Since the Archive is continuously updated, it can be regarded as a genuine tool to support the institution’s education needs, without having to subscribe to any number of trade journals or newsletters.

### Tapping Outside Resources

One of the greatest challenges facing community banks is that the increasing complexity of financial products (whether loans, securities, or even deposits), of competition, and of customers is increasing the demands on management talent and time. Fortunately, at least in the investment arena, a vast array of resources has been developed over the past fifteen years, thanks to advances in automation and computer modeling. Many of these services are available at little or no cost from securities firms and others with vast resources and ready access to the computer models, data, and personnel needed.

### Keeping Control While Tapping Outside Resources

Banks have access to a number of outside resources which support the management and reporting of the investment portfolio. These resources are available without giving up control of the portfolio. Many are available free-of-charge. Those that do entail costs are almost certainly far less expensive than the staff time required to perform the tasks internally. In addition, by outsourcing functions like bond accounting and asset/liability modeling, the bank benefits from the expertise of professionals who work with hundreds of banks.

Following is a breakdown of the common services banks utilize from outside sources:

**Free of charge**
- Web access to portfolio details & reports
- Monthly investment securities reporting
  - Market pricing
  - Price volatility
  - Duration and duration shocks
  - Cash flows
  - Predicted calls
- Quarterly board / management reports
  - Color reporting packages
  - Scenario cash flows
  - Price volatility
  - Duration and duration shocks
  - Simplified asset/liability modeling

**Nominal charge**
- Bond Accounting
  - Monthly accounting reports
  - Quarterly FASB disclosures & call report
- Asset/Liability Modeling – Simulation Model
  - Quarterly reports including NIM and EVE simulations
  - Customized assumptions including growth / budget assumptions
Tapping outside resources can greatly reduce the staff time needed to manage the investment portfolio and the entire balance sheet while maintaining complete control. Following are some examples of the most-frequently utilized outside resources:

**Bond Accounting**

It is common for a third-party source to charge a nominal fee of around $2 per position per month to provide a fully automated list of securities, including a menu of reports that fit the institution’s specific needs. These services have become much better at calculating factors such as P&I payments due, amortization/accretion, journal entries, true yields, and effective durations. It would be difficult to not justify the cost of an outsourced bond accounting model. Example reports are displayed at the top of this page.

In addition to just investment accounting calculations, third-party bond accounting services typically provide:

- Details needed for general ledger entries for interest income, amortization/accretion, etc.;
- Data required to complete call report fields for investments, including schedule RC-B; and,
- Information required for financial statement tables covering other-than-temporary impairment (EITF 03-1 and FSP 115-1).

The cost for top-quality third-party bond accounting pales in comparison to the staff cost for a bank to perform their own bond accounting.

**Investment Reporting**

Whether the bank utilizes a third-party for bond accounting or not, comprehensive investment reports are readily available at no charge, putting in the portfolio manager’s hands all of the tools and reports needed to manage an investment portfolio ranging in size from $10 million to $10 billion or more.

**Quarterly Reporting & Board Reports**

For banks which utilize the ICBA Securities Performance Profile, much of the most-used investment securities data is immediately available online at www.icbasecurities.com. The Profile is a comprehensive review of the bank’s investment portfolio, including its cash flows, price volatility and liquidity. ICBA Securities will load your bank’s security inventory onto your page of the website whenever you to have secure access whenever you desire.

As an example of one of the many benefits of having ready access to your portfolio let’s assume a bank is interested in realizing some strategic losses on its bond portfolio. Currently, the banker will typically phone one or more of his or her brokers and ask for some ideas, and some bids, and then calculate respective gains.
and losses. This process can create some logistical issues as it relates to timing and communication.

Now, however, by going to the “My Portfolio” link in the Customer Support Area, you can see your portfolio detail, bond-by-bond, including market values and Gains/Losses as of the previous month end. You can also sort the bonds by any of the sixteen columnar headings. This last feature is particularly valuable, as it can sort, say, by amount of Gain/Loss or by book yield, in either ascending or descending order. This can help highlight in our example which bonds have the greatest losses, or alternatively which are the lowest yielders. Below are examples of these screens.

**Monthly Investment Reporting**

Monthly or quarterly reporting, whether internal or public, whether required by policy, auditor or regulator, can also be easily accomplished using third parties. Some of this data is again available from a typical bond accounting service. Other information, such as specific data about a particular bond, can be had from proprietary software provided by a broker/dealer or money manager. The “My Portfolio” link from the website has a set of reports that a manager can request and print as often as needed.

An example of an investment report that is sure to be of great assistance to a manager is the “Value at Risk.” This again shows bond level detail, including price percentage changes in +/- 300 basis point swings and can likewise be sorted by any of the column headings. The benefit of this detail is that it can identify outliers, or at least those bonds which have the greatest susceptibility to price decline, as well as ensuring compliance with the bank’s investment policy.

Further, any report under the “General” heading in the My Portfolio link will allow the user to view all of the details about a given position, simply by clicking on the CUSIP number. “All of the details” includes its purchase date, book price, yield, market price, and stress-testing data such as price percentage changes and actual horizon prices.

Much of the information on these reports is updated in our bond database frequently, as often as weekly. Examples include a 5-Year Cash Flow Ladder, a Scenario Call Report, and a Maturity/Redemption Report, among others. The report menu also has a feature that allows the user to download the portfolio detail to an Excel spreadsheet.

**Asset/Liability Management**

A/L modeling is an area in which the pendulum has swung back and forth between outsourcing and in-house work over the past twenty years.
Today, almost all community banks rely on outside resources to either provide asset/liability modeling reports or to provide investment data to drive internally-run models.

Efficiencies with technology now allow more customization and lower cost, so that a relatively small bank can have access to a third-party model that is expandable as the bank’s A/L profile changes. This access is either via a model that is run in-house or at a service bureau, with the physical transfer of data being generally through electronic means.

For most banks under $1 billion in assets, obtaining A/L modeling reports from a third-party is the most efficient way to obtain accurate, appropriately sophisticated reports and tools for managing the institution’s interest rate risk. Institutions over $1 billion in assets usually need to purchase a system and run the model in-house. The greatest cost of running a model in-house is the heavy demand for both staff time and expertise.

For smaller institutions, the above-mentioned Performance Profile may prove sufficient. The study contains a “Risk Management” section which calculates an asset/liability gap using a unique Earnings at Risk model and quantifies rate risk on 3 bases: Percentage asset/liability mismatch, earnings shrinkage or improvement, and change in Net Interest Margin (on an ROA basis). Please see the example on the right. It is calculated using rate shocks of +/-100 and 200 basis points. This model can be very accurate, and suitable for many community banks, provided the bank’s practices regarding loan and deposit repricing are accurately reflected by the Earnings Change Ratios (ECRs)
used in the model. Customized ECRs can be calculated as desired.

Once the Performance Profile is completed, the entirety of the report is loaded into the website for you to access and review on-line, and/or print, at your convenience. Several years’ worth of Performance Profiles are available on the site for ease in comparison or for trend analysis. The studies are accessed by clicking the “Performance Reports” link on the Customer Support Area, and following the page to the desired analysis, sorted in chronological order.

For institutions in the middle, including those with $200 million or more in assets, those with more complex balance sheets, or those with a desire for more sophisticated modeling via a simulation model, third-party sources are invaluable. Like bond accounting, outsourcing to a service bureau can be the least expensive and most efficient way to obtaining comprehensive, sophisticated asset/liability reporting. Doing so frees management to drive the assumptions and business plans of the model without getting mired in the details.

As an example, ICBA Securities’ Risk Manager service provides quarterly asset/liability modeling utilizing the Darling Consulting Group’s BASIS model. An example of the model’s output is shown above. It simulates both income and the economic value of equity (“EVE”). Current and historic Risk Manager reports are available via the ICBA Securities’ website.

For those institutions who are struggling to decide how to approach interest rate risk management, a previous edition of this insert entitled “Pick Your Path” outlines the options and trade-offs.

Conclusion

It is perhaps ironic that the task of running a liquid, safe, profitable portfolio should take less time and effort today than it did 10 years ago, with increased complexities in products, additional reporting requirements and stepped-up regulatory oversight. It should now be clear that a number of services exist that can reduce the work load for a community bank manager. Even better, most of these services are available free of charge.

More accessible accounting and regulatory literature, more transparent market data, and faster transfer of information can allow “highest and best” decisions to be made in a fraction of the time it previously took. And, importantly, much of the decision-making can be done without requiring the input of interested third parties, namely vendors or brokers. The use of some of the services discussed herein can produce greater efficiency, and therefore profitability, for a wide range of financial institutions.

Don’t fall into the trap of assuming that the job of managing an investment portfolio should be all-consuming. Don’t assume that there is a correlation between the time spent managing investments and results. Effective time management and utilization of outside resources can allow a portfolio manager to achieve outstanding performance while also adding value to other areas of the bank. Even though investments may comprise one-third or more of the balance sheet, they do not require a similar devotion of the institution’s management time and resources.

About the Authors

Jim Reber is President and Mark Evans is Director of Investment Strategies for ICBA Securities, a member of NASD/SIPC.
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