Looking at total return to find bonds that outperform

I would like to use this month's Portfolio Management column to talk about a personal shortcoming and how I was able to improve upon it. Like many portfolio managers whom I've spoken with and have gotten to know on a person-to-person basis, I am trying to beat or at least meet broad indices' performances with my personal retirement accounts.

My investment horizon is considered long-term, so I have a relatively high tolerance for risk. As such, I don’t mind being exposed to products that can have significant fluctuations, in expectation of being rewarded over time with risk-adjusted returns that should handily outpace inflation.

Here’s how this topic relates to bank portfolios: You can also manage your bonds to outperform broad fixed-income indices or a sample set of your peers, based on total return characteristics. You don’t even need a Bloomberg on your desk or a Chartered Financial Analyst on your payroll to accomplish this. All that is needed is this column and access to research compiled by ICBA Securities, ICBA’s institutional broker/dealer.

Back to Basics

Total return is a true measurement of performance, whether we’re talking about stocks, bonds, real estate, cattle futures or golf bets. It is not complicated and shouldn’t be feared. It is simply a calculation of income (interest or dividends) plus price change over a stated period. For periods of over a year, the number is usually
stated on an annualized basis.

For example, a stock that pays a 3 percent annual dividend and has grown in price by 4 percent this year has had a total return of 7 percent over the last 12 months. Your bank’s retirement fund manager probably has some online calculators that will help you arrive at these numbers.

Similarly, a bond that has a 5 percent yield (not coupon) and has lost 2 percent in value this year has had an annualized total return of 3 percent. Your broker should be able to tell you prospectively and retrospectively how each of your bonds will do, or have done, as rates change and your holdings roll down the curve.

**Bond Analytics**

ICBA Securities, like many broker/dealers, calculates total return prospects for current offerings on a wide range of fixed-income securities. When we do this, we shock the bonds based on a range of future interest rate paths. Included in our tests are parallel shifts of the rate curve up and down 200 basis points, and, more applicably, “twists” to the curve that project flattening and steepening. It is a rare occasion indeed when the Treasury curve shifts in a parallel fashion.

These findings are in turn condensed into research titled “Products Poised to Outperform.” It is available either by logging onto ICBA Securities’ Web site (www.icbasecurities.com) and going to the “Strategies” link or by requesting the research from your ICBA Securities broker. Our Investment Strategies Department updates this document each month.

Every edition will feature two or three securities which we feel should perform well in the near future and represent reasonable value. It also has a matrix that displays the total return for common agency callables, corporates, mortgage-backed securities, collateralized mortgage obligations and municipals to a one-year horizon. The table displays one page of the matrix from December 2006.

**Your Portfolio’s Results**

If you are one of the 1,500 or so banks that have a Performance Profile compiled by ICBA Securities, we calculate and display your portfolio’s total return in the section titled “Ratios and Financial Comparisons.” Line 63 shows the most recent period’s total return annualized and the prior three full years as well.

**Obtain a Report**

If you would like to obtain the Strategic Insight “Products Poised to Outperform,” contact your ICBA Securities sales rep or Jim Reber at (800) 422-6442 or jreber@icbasecurities.com.

Your high-performing peer group’s results are displayed also. Since the criterion for inclusion in this high-performing group is return on assets and not portfolio yield, a bank could be in the top quartile of its peers based on ROA, but still have a middling yield or total return profile.

The current periods being displayed are the full years of 2003, 2004 and 2005 as well as a portion of 2006. It is interesting to note in many cases that low-yielding portfolios could have had
favorable total return results. If the manager insulated the portfolio against upward rate shocks in, say, 2005 by loading up on ARMs or intermediate-term munis, total return could look very good compared to those with higher yields but more price volatility. In essence, total return is a more complete measurement of performance.

**Advantage: You**

Now that you know your portfolio’s total return results are easily attainable and that virtually the entire spectrum of bank portfolio offerings’ returns are available from your broker, I would encourage you to take advantage of this data as part of your day-to-day management.

Keeping factors such as price volatility and convexity in mind when purchasing can help get you into the top quartile of your peers. Let’s face it: Yield is important, but it is far from the whole story. Rising rate periods like 2004 and 2005 have shone a spotlight on total return, for better or worse.

Armed with all this knowledge, when allocating or reallocating monies to my retirement accounts, I look at, you guessed it, total return. Past performance of broad indices such as the S&P 500 or the Lehman Aggregate Index can be used for comparison. I am therefore able to build and manage a group of assets that I expect to keep me ahead of the game. This can and should be one of your main objectives as well.

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