The Federal Reserve under Chairman Ben Bernanke, just barely over a year old, has provided us with an opportunity to recall some basics of portfolio management. The Federal Open Market Committee has been on hold for about nine months after a two-plus-year rate hike skein. Treasury rates, which by and large dictate the yields in bank portfolio investments, have ebbed and flowed since the Fed has been on the sidelines, reacting instead to data churned out by economic calendar.

The result is that virtually all bond sectors can now be purchased at prices above and below par. A manager can therefore skew the portfolio to be premium-heavy or discount-heavy. During extended periods of high rates (for example 1999-2000) there were very few premium securities to be found. Low rate periods like 2001 thru 2003 created little opportunity for discount bonds.

Let’s review the costs and benefits of both, and times when they may be beneficial to your portfolio.

### Premiums: When to Buy

It’s been my experience that a community banker is premium-resistant. My guess is that it stems either from a banker’s notion of having to pay more for a bond than one of his peers did (irrational), or from trying to limit his call risk (rational). Either way, there is a time and a place to buy bonds at prices above par—namely, if one expects interest rates to rise.

Premium bonds that have a call feature are also known as “cushion bonds” because they provide a cushion against rising rates. Mechanically, the premium is amortized to the worst case, which is the first call date. The investor should expect that the bond will be called at the first opportunity. If the bond is not called (because interest rates have risen in the interim), at least the yield will rise to that of the coupon, as the book value will be 100.00 forevermore. Table 1 displays a cushion bond.

Amortizing securities have a similar profile. The mere fact that a bond is worth more than par on the purchase date is due to the fact that its coupon is higher than current rates. Borrowers can and will refinance their debt to prevailing rates, given the option.

As a result, if you buy a mortgage-backed security (MBS), adjustable-rate mortgage or collateralized mortgage obligation (CMO) at a
premium, be sure to pay attention to faster prepayment speeds before deciding to buy. Don’t be afraid to make your broker display a range of speeds when considering a purchase.

A final comment on premiums: They also have shorter durations than par or discount securities of identical maturity. Duration is the weighted average period of time it takes to receive all P and I. The higher the I, the shorter the duration, as interest is received early, middle and late on a bond. Shorter durations equal less price volatility, which is a desirable attribute in rising rates.

Discount Nuances

To borrow from “The Color of Money,” money won is twice as sweet as money earned. Buying something at a price less than it originally sold for has a mysterious allure to it. However, I would suggest that a hardware store in Texas putting snow blowers on 50 percent off in January doesn’t make it a good buy.

In other words, the absolute price of a bond doesn’t make it a suitable investment.

Bonds priced below par for reasons of interest-rate movements can, however, be great tools to protect against falling rates. I mention interest rates because price declines due to credit downgrades are another subject for another day. In the meantime, a discount callable is the corollary to the cushion bond mentioned above.

Let’s say you think rates will be falling, and you have net interest-margin exposure to falling rates. A callable security purchased below par will reward the owner if the call is exercised. As the discount is amortized to maturity (again, worst case), any call notice allows the remaining discount to be received immediately, pushing up the yield.

Since the reason a bond is called in the first place is that rates have fallen since it was issued, this bump up in yield will help numb the pain of the bond being taken away. Table 2 shows how this works.

As for discount MBSs or CMOs, I would recommend looking at very slow prepayment speeds before determining whether you like it. Obviously a bond with a purchase price of 99.75 has less extension risk than a price of 93.00, but using 6 percent CPR as your baseline probably will show you how bad something can get.

To recap: Fast prepayments are probably good if you own a security at less than par. And as I discussed in my January column, there are two mortgage-backed securities that will prepay faster than normal—relief pools and Alt-A pools.

Determine Your Needs

Where does this leave us? A good start would be to quantify whether your community bank is exposed to rising or falling rates. If an institution is positively gapped (also known as being asset-sensitive), it will do worse in falling-rate environments. Discount securities can help maintain your bank’s net interest margin. Most, but not all, community banks exhibit some asset sensitivity.

If your bank has a negative gap, like many thrifts did in the 1980s, its margin will get whacked if rates rise. Premium securities will perform better in those situations. In fact, since premiums’ yields rise and fall with general interest rates, they can be considered quasi-adjustable securities.

The ICBA Securities Performance Profile includes an earnings-at-risk calculation that can be very useful for this purpose. The profile displays a bank’s exposure in plus and minus 100 and 200 basis point shocks. I would recommend this analysis to determine whether discounts or premiums are a better fit for your portfolio.

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Table 2

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<th>Date</th>
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<th>Yield to Maturity</th>
<th>Yield to Custom</th>
<th>Yield to Next Call</th>
<th>Yield to Refunding</th>
<th>Yield to Worst Call</th>
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Source: Bloomberg