Let’s Play Ball

Cover the bases in the portfolio investment game

Keep your eye on the ball. Have you ever had a coach offer that advice? I have for years, in a multitude of sports, and still can’t quite pull it off.

As the new baseball season is upon us, I thought it would be timely to point out the benefits of keeping one’s eye on the ball, as it were. In this case, the “ball” is the various sectors of your community bank investment portfolio.

In this still-young year, the different pieces to the puzzle that is your bond portfolio have moved in varying directions, and for various reasons. The fixed-income market in general has been affected by an avalanche of news, real and proposed policies, and some rational and irrational assumptions. (Of course, it would have been considered irrational a year ago to think that Fannie Mae and Freddie Mac would be nationalized.)

If we review the performance of the more popular sectors of a typical community bank’s investment portfolio over the last six months, it’s hoped you can be brought up to speed on what is attractive and what isn’t. Maybe you’ll even be able to more efficiently build your portfolio, through near-term purchases or through bond swaps (which work well in a lot of cases at the present).

On-Deck Circle
For all the rhetoric that Treasury securities elicited in 2008, there isn’t a lot of relevance that attaches to banks. Less than 1 percent of bank portfolios are composed of Treasuries. The price/yield movements of Treasuries are even less pertinent when spreads widen and tighten dramatically, as they have over the last year. Just the same, the shape of the curve is worth mentioning.

The normal difference in yield between one-year and 10-year Treasuries is right at 100 basis points. Anything wider than, say, 150 basis points would qualify for a steep curve. Steep curves, you may recall, are inexact predictors of rising rates, especially on the short end.

For 2008, the one-to-10 difference averaged 187 basis points and had ballooned out to 228 by March 2009. (See Chart 1.) This would seem to suggest that it’s time to run for cover, and buy short or adjustable rate products. That is, unless you choose to read further.
Rounding First

Next to Treasuries, the most simple of all securities are government agency non-callable debt securities, which also are known as "bullets." Because they are just a baby step removed from Treasuries, it’s useful to examine their additional yield, or "spread," to discern investor sentiment.

At the time of Fannie Mae’s and Freddie Mac’s takeover last Sept. 7, one could buy a three-year bullet at a spread to the curve of about 80 basis points. That spread ballooned to around 190 basis points for a brief time in late 2008 as the market was trying to assess the true support that then-Treasury secretary Henry Paulson was throwing behind them.

As investors began to gradually convince themselves that there was tangible credit enhancement from the Treasury, coupled with the Federal Reserve’s active investing in GSE debt in early 2009, spreads have gradually tightened. By March 1 of this year, spreads were back down to about 65 basis points.

It’s worth noting that the 10-year average for three-year bullets is only 40 basis points, so spreads are still historically wide.

Heading for Third

The mortgage securities that are issued by these same agencies have some differing dynamics that affect them. The most tangible of these is prepayment risk. Typically, as rates fall (and prices rise), spreads on mortgage-backed securities (MBS) will widen to compensate an investor for the increased risk that a lot of principal will be dumped in his or her lap at just the wrong time.

This time around, in the aftermath of Fannie’s and Freddie’s takeover, spreads widened to levels not seen in many years. Flight-to-quality was the main cause. These spreads remained enormously wide until the Federal Reserve announced it would buy up to $50 billion in Fannie/Freddie/Ginnie Mae MBS in the first half of 2009.
To put this in context, total GSE origination for this period will be roughly half of what the Fed intends to buy. In other words, supply will be greatly lessened.

As of March 2009, a typical 30-year MBS had a spread to its average life of about 140 basis points, which is very near its 10-year average. This is the case even though the Fed’s activity cut the spread advantage by about 50 percent from the levels seen at the start of 2009. This is still an environment that can make sense in leveraging strategies.

**Head-first Slide Into Home**

I would be irresponsible if I didn’t mention municipal securities. In brief, most bank-qualified munis are insured by one of a handful of private insurers. In the good old days of 2007 and earlier, these insurers all had AAA ratings assigned to them by Moody’s or Standard & Poor’s.

These insurers (examples: MBIA, FGIC, AMBAC) have been substantially downgraded by the agencies as they have posted huge losses in recent quarters, thanks to non-muni exposure. This has placed a renewed focus on the “underlying” rating of a given muni, or the credit quality irrespective of any insurance.

The insurer debate, with the general illiquidity in credit instruments in late 2008, caused even high-quality munis to trade at enormous yields. Actually, there were all-time record spreads in longer maturities at the end of the year.

The “January effect” was felt with a vengeance early this year. General lack of supply and general strong demand forced yields much lower. For example, 20-year AAA rated munis were available at 7.00 percent tax-equivalent yields in December 2008, and at 6.00 percent on March 1, 2009. This occurred in an environment in which the 20-year Treasury rose in yield by 90 basis points in that same period.

**Play ball!**

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