As we approach the winter holidays you may be thinking about your waistline and how you’ll improve your profile in a social season rife with temptation. Sometimes the “balanced diet, regular exercise” route is just plain hard to travel.

Thankfully, it’s easier to follow a disciplined approach to improve the yields from your community bank’s portfolio-investing routine. Adopting the barbell structure, that tried-and-true method of hedging your bets, might pay big dividends in your bank’s investment portfolio in the coming quarters and years. You could end up being the Charles Atlas of your peers, to the envy of those 97-pound weaklings on the beach.

The Barbell Concept
Barbell investment strategies are as simple as they are effective. Think bench presses. In their purest form, they call for portfolio managers to divide their institution’s investment pie into two nearly equal slices, varying by the bank. The monies are invested in the short end and the long end, in roughly equivalent amounts and at roughly the same time. The pieces are sometimes referred to as “liquidity” and “core” respectively.

Some variables can be injected here. For example, many different investment sectors can be used. If your bank is interested in improving risk-based capital, it can buy Ginnie Mae adjustable-rate mortgage-backed securities (ARM MBS) or Small Business Administration (SBA) pools for its short-term segment; both are zero-percent risk weighted. If your bank is an S corporation and has limited needs for tax-free investments because of its dividend policy, it can use taxable munis, including the new Build America Bonds, for its core sector.

Also, within either segment, you can choose from several types of bonds. Speaking again about the short end, a well-versed manager could use high-coupon “cushion” agencies to improve yields over and above money-market instruments while protecting against rising rates. For the core portfolio, a combination of long planned amortization class (PAC) collateral mortgage obligations, longer-reset hybrid ARMs and 15- and 20-year fixed-rate MBS may be appropriate.

Why This Works
Because no one knows where interest rates are headed, having a large amount on either end of the curve virtually ensures that half the portfolio will do well. A lot of this has to do with how interest-rate curves react to changes in Federal Open Market Committee monetary policy.

When investors in Treasuries become convinced that the Fed-funds rate will rise, they divide into two groups. Short buyers, who are in for roughly two years and less, start demanding higher yields. There is some degree of correlation between the yields on these maturities and Fed funds. If in fact higher rates prevail, these “liquidity” investors will be able to reinvest reasonably soon and at better rates.
The other camp, the long end, which I define here as roughly seven years and longer, actually takes some comfort from anticipated Fed-funds hikes. This is because higher Fed-funds rates are likely to stamp out the risk of inflation, which is much more damaging to the value of “long” bonds than to short ones. As a result, long interest rates don’t rise nearly as much as do short ones, once the Fed begins stepping on the monetary brakes.

Higher short rates + stable long rates = flattening curve. The market values of a bank’s investment portfolio can be fairly constant in such an event if it has enough invested on either end of the barbell.

**Workout Routine**

A very steep yield curve is a pretty good place to start this process. I am going to assume that short-term interest rates, that is, Fed funds, will be up 100 basis points within a year to 1.25 percent. That, coincidentally, is what the futures market currently predicts. If you manage a typical community bank portfolio, you are wondering what its investment sweet spot is because you have about 30 percent of your bank’s bonds coming due in the next 12 months.

An example barbell investment strategy is equal amounts of (1) a low-premium SBA pool, which floats quarterly based on the prime rate and no annual caps, priced to yield prime minus 2.25 percent, or 1 percent today; and (2) a 20-year muni at a premium, priced to yield 4.50 tax-free to a 10-year call date. The muni is an insured and AA-rated general obligation bond.

A year from now, assuming the yield curve flattens by 50 basis points (which is certainly possible), the SBA investment pool will yield about 2 percent and will still have a duration near zero, whereby the muni will have a 6.50-percent tax-equivalent yield, about a 2-percent loss (due to a 50-basis-point rise on the long end) and a tidy 5.5-year effective duration.

The simple averages mean this entire barbell investment strategy has essentially maintained its market value and has seen its yields rise 50 basis points to 4.25 percent, while its average duration is only about 2.8 years. Even a skeptic would have to concede that this would be acceptable performance amid rising rates.

As all good weightlifters know, resistance and repetition are the keys to success. Good luck with your portfolio sculpting.

**Performance Profile**

ICBA Securities’ investment strategists can help you determine, free of charge, the most advantageous leveraging or swap strategies for your community bank’s investment portfolio. Contact your sales rep or visit icbasecurities.com.