Agency step-ups can cushion your market values.

We’re trying. We really are. The broker/dealer community is doing its best to create and market investments that stand a reasonable chance of doing well whenever the long-anticipated rise in rates occurs.

But it’s not altruism that causes us to do this. It has nothing to do with the desires of the issuers, primarily government-sponsored enterprises (GSEs). It’s all a function of demand from investors, including the community banking sector.

In response to your asking, the underwriters of new securities have reignited the step-up machine. Step-ups have been around for about 15 years, but in high-rate and flat-curve environments, they garner a collective yawn from investors. The last two years, being the opposite, have brought them back into prominence.

Step-Up Primer
Step-ups have a number of advantages, not the least of which is their relative simplicity. They’re issued by GSEs (Fannie Mae, Freddie Mac and Federal Home Loan banks), have 20-percent-risk weightings, have small bid/ask spreads (synonymous with good liquidity) and are easily pledgeable against advances. Usually there are readily determinable market values.

Another advantage is their breadth of structure. They come in a wide range of maturities, call features, and starting and ending coupons. Step-ups also don’t require the “prepayment speed/tail piece/reinvestment of unexpected cash flows” maintenance that amortizing securities do.

Still another plus is the either/or decision-tree outcome on many step-ups, especially those with European (one-time-only) call features. This eliminates a lot of the guesswork associated with multiple options and makes it easier to build a liquidity ladder.

What To Watch Out For
Whenever I’ve touted a new or popular community bank investment option here, I’ve discussed the downsides as well. Step-ups have relatively few structural flaws, but I’ll try listing some downsides.

For one, be wary of long-stated final maturities (say, longer than seven years) that have coupons that move up less than 1 percent a year. The back-end coupons may appear enticing, but you really set yourself up for the old high-low beating: Low initial coupons create price volatility early on, and investors never realize the payoff because the bonds get called before the fun kicks in.
For another, try to limit the number of steps/call dates. That will make your “buy/not buy” decision much easier. If you have two or three possible outcomes on an investment, it’s that much easier to assess your interest. The vast majority of step-ups have multiple steps and a plethora of call dates. Be sure your broker discloses the yield to each possible call date before you say yes.

Finally, many who have shunned step-ups lately have done so because they can’t stomach the, shall we say, modest starting yields. For an issue with limited call dates and an intermediate maturity, you should expect to start at 2.00 percent or less. In probably the most relevant comparison, this still stacks up very favorably to money-market rates.

**Likely To Perform Decently**

To dissect a live example, consider this: The Federal Home Loan banks recently issued a bond with a 1.75-percent coupon for 18 months, after which it either gets called or “steps up” to a 4.00-percent coupon for 4 1/2 more years. If it steps up, it becomes a “bullet” (noncallable bond) because it has the European option. The yield to maturity is 3.39.

The math shows that a 1.75-percent yield for 1 1/2 years is quite good, as the two-year Treasury yielded about 85 basis points at issuance. Also, the 4.00-percent coupon on the back end is highly callable at the moment, as 4 1/2-year bullets yielded about 3.00 percent. So the current duration is less than two years. (Premium callables with a fixed coupon perform exactly the same way as step-ups do. If your broker and you can’t find a step-up to your liking, ask to see a cushion bond; the analytics will be the same.)

What this illustrates is a security that does a pretty fair job of creating some yield for a short period, with the opportunity for much higher yields if, by the call date, general market yields have also risen. In this sense, step-ups are really floating-rate securities. With your examiners being newly energized about interest-rate risk, these bonds should be seen as a solution, not the problem.

Those of you stubbornly sitting on overnight investments yielding 10 basis points owe it to your portfolio to take a look at well-structured step-ups. Your fellow investors have helped us brokers build these jewels, and you should be able to find one or more that fit your risk-reward matrix.

**Learn More**

*For current offerings and analytics on step-ups and other adjustable-rate instruments, contact your ICBA Securities sales rep or visit icbasecurities.com.*

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