Bankruptcies, conservatorships and excessively volatile credit markets have portfolio managers increasingly searching for investments that offer the safety of principal and liquidity with only a tertiary, at best, concern for yield. Small Business Administration (SBA) pools have always been a safe harbor in times of volatility. SBA pools offer the full faith and credit of the U.S. government; uncapped, adjustable coupon rates keeping them in step with changing market rates; and yields well above alternative short-duration investments.

In addition, the spreads available in SBA pools are currently wider than their historical levels, thus removing much of the premium exposure typical to these investments (see Chart I). So, if you had previously dismissed SBAs because of yield concerns, or if improving your risk-based capital ratio has appeal, please read on.

**Safety of Principal**

Since 1984, more than $50 billion of SBA pools have been created. They are composed of loans to small business customers and are guaranteed by the U.S. government, and therefore have a zero percent risk weighting. Because of this explicit guarantee, SBA pools have the same credit quality as U.S. Treasury obligations (as do Ginnie Mae securities, which were covered in October’s Portfolio Management column). Portfolio managers focused primarily on safety of principal can take comfort in owning any of these products.

**Minimal Price Volatility**

There are two aspects of SBA pools that limit their price volatility: the lack of credit risk and adjustable coupon rates.

Credit deterioration has been a significant catalyst in much of the market turmoil over the past 12 to 15 months. As a result, the liquidity of most fixed-income sectors has been dramatically reduced, causing significant price volatility and the inability to sell securities when needed. For example, yield spreads on 15-year, agency-issued mortgage-backed securities (MBSs) have widened 139 basis points since the duress began in the summer of 2007. In that same period, spreads on SBA premium 10-year weighted average maturity (WAM) pools have widened just 71 basis points. This variance is even more pronounced when comparing SBA pools to other riskier asset classes like some corporate debt or mortgage derivatives.

Additionally, the uncapped, adjustable coupon rates on most SBA pools allow them to keep pace with current market yields. This point is particularly germane when investing during periods of low interest rates. Adjustable-rate SBA pools generally have a three-month floating coupon rate that
adjusts at a fixed spread to the prime rate. Prime is an excellent index for many investors because of how well it correlates to alternative product yields: Fed Funds, money market funds, investment pools, commercial paper or London interbank offered rate (LIBOR) floaters. Chart 2 illustrates the correlation of the prime rate to some key indices.

**Yields Have Improved**

The yield available in SBA pools varies from structure to structure with particular emphasis on the amount of premium paid. Investments priced within one point (1 percent) of par typically offer a slight spread over the Fed Funds target rate, while premium pools offer more spread. The spreads on par-priced pools have widened, offering premium-averse buyers a unique opportunity in this sector. However, the spreads in premium products have widened also (see Chart 2) and continue to be much wider than par-priced pools, offering an equally unique opportunity.

Like other MBS-type securities that are prepayable, the premium risk must be considered when paying premiums for SBA pools. However, the premium risk has been more easily projected in the past with SBA pools because their prepayments have been more consistent and much less sensitive to changes in interest rates than their MBS counterparts. These loans require considerable effort to refinance, thus hindering the economic value of refinancing.

Still, the question can be raised as to why an instrument that has zero credit risk has gone down
in price relative to U.S. Treasury obligations. The answer, in a nutshell, is liquidity. While the SBA market has reasonable depth, and bid/ask spreads are comparable to agency MBS markets, the fact that the pools are not fully fungible and have uncertain (albeit fairly predictable) cash flows means that they will yield more than Treasury obligations. And, since the current market is beset by liquidity issues, all product spreads have widened. This is most likely a temporary situation.

Diversify and Conquer

SBA pools stand out as an excellent alternative to money market funds in terms of yield. While the yield on these instruments will not currently be as attractive as longer duration, fixed-rate alternatives, the benefits of owning uncapped, floating-rate securities will be evident when rates rise. And for the masses of investors simply looking for strong credit, the full faith and credit of the U.S. government is reassuring. The spread widening in the SBA sector has removed some of the premium exposure in these pools, leaving them as even more attractive investment options. For more information regarding the value in SBA pools, please contact your account representative.

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