Tool Time! The popular 1990s sitcom Home Improvement featured a show within a show, in which the host, played by Tim Allen, would create knickknacks using simple handyman’s techniques. And, of course, power tools. Lots of them.

For those of you who are responsible for running your community bank’s investment portfolio, the early spring may be a good time to sweep up the sawdust and get back to such building fundamentals. Most community bank portfolios already have some semblance of a “ladder” in place, however flimsy, and the current yield environment makes it very inexpensive to reinforce the framework with just a little bit of handiwork.

Ladder defined
A ladder, in portfolio vernacular, is a structure in which a series of maturities are intentionally placed to ensure that a certain amount of cash flow will be received over time. The ladder can be very well-defined and intractable or more imprecise depending on the types of bonds purchased. The more definite the cash flow, the lower the yield—probably.

The reason for the fuzziness is that most bonds owned by a community bank, about 80 percent of them, have some type of an option attached. The most visible examples are callable agencies, which are instruments issued by Freddie Mac, Fannie Mae or the Federal Home Loan Bank, and which can be repaid early or “called” by the issuer. The reason a call will be exercised is very logical: The borrower can refinance its debt at a lower cost. In other words, market rates have fallen.

In addition, virtually all mortgage securities have irregular cash flow. Principal paid by the borrowers whose loans collateralize the securities is passed through to the investor. This includes scheduled principal, which is very easy to calculate, and prepaid principal, which is much less predictable.

So the estimated cash flows from the collection of bonds owned by a typical community bank are usually dependent on interest rates. The lower rates go, the more cash created by the portfolio. An exception to this is a portfolio that has no callability (i.e., one that consists exclusively of “bullets”). Most investors put up with the aggravation of inconsistent cash flow because of the additional yield that accompanies bonds with call options.

When they work
While it’s true that predictable cash flow gives comfort to bankers (and regulators and investors and ...), there is another benefit that can accrue. When the interest rate curve is steep, the market value of the bonds in the ladder can greatly improve, or at least be insulated against declines, just by the passing of time. The last three years have witnessed steep curve environments. Market barometers like Fed Funds Futures are expecting the curve to remain steep for several more years.

Let’s assume that today you would like to buy a four-year bond yielding 75 basis points (0.75 percent). One year from now, if rates do not move, that bond will have appreciated in value by around a half of a percent. That’s about $5,000 for every $1 million invested. This would not happen if the curve were flat, or even if it were just less steep. So the current shape to the curve itself will help the performance of a ladder.

Wield the hammer
Attention hardware shoppers! It’s now very cost-effective to add rungs

Cash Flow Monitor
ICBA Securities has interactive tools on its website to monitor expected cash flows in your bank’s investment portfolio. Visit www.icbasecurities.com or ask your ICBA Securities sale rep for more information.
to the ladder that are virtually certain to remain in that cash flow slot. This is the by-product of having low absolute yields, which both makes the likelihood of further bond market rallies less likely and has compressed the entire incremental available yield out of market rates.

Let’s look at some examples. Currently, a five-year agency bond that has a continuous call date in a year (a “5-1 American”) would have a yield of about 1.25 percent. This means that the investor would have certainty of only one year, after which the issuer has the right to take the bond away on any day.

However, if you were to buy additional call protection by staying with the five-year maturity but going to a two-year call, the yield will only drop to about 1.21 percent. And you can make it a one-time-only call, which is much preferred by conservative investors, without it costing you virtually anything.

Finally, the ultimate in call protection is a bullet. Five-year bullets yield about 1.15 percent at the moment, meaning that the investor (you) only give up 10 basis points for a workshop full of call protection. Higher yield environments have seen that give-up in the 40 basis point range.

As we now know, one of the advantages of investing at these paltry rates is that the cost of cash-flow certainty is very low. Another is that the steep curve will help support market prices by the “roll down the curve” effect.

To sum up: Ladder building can be a productive project for community bankers this spring.