Treasure Quest
Layering of MBS products yields myriad benefits

By Jim Reber

I feel like a teenage spelunker these days. Lately, in writing these monthly Portfolio Management columns, I have been looking high and low for hard-to-find sanctuaries of value, not unlike a Boy Scout on a field trip into a cave. And just as many of those expeditions likely turned up plant life, rock formations and even wildlife that I didn’t know existed, perhaps community bank portfolio managers haven’t used these products (yet).

The word “derivative” can cause community bankers to break out in a cold sweat. But proper use of these products that are built with enough structure can improve a number of different parts of the balance sheet. Your regulators’ own guidance states as much. Last month’s column discussed certain derivatives that have superior cash flow characteristics in comparison to standard mortgage-backed securities (MBS) pass-throughs.

Further, certain types of adjustable-rate mortgage (ARM) pools can also create a profitable yield/risk tradeoff. With virtually all mortgages trading at substantial premiums, there is an increasing need to build in some cushion against prepayment risk. Selectively choosing specific MBS will help create this buffer zone.

Floater dynamics
If a community banker makes a determination to buy truly floating rate securities, he or she is simultaneously deciding to buy (today) a low-yielding instrument. The banker may have arrived at this conclusion by considering a number of factors. For one, his or her bank could be liability-sensitive. For another, the institution could have a fair amount of “hot” money that could leave at any moment. Still another could be the desire to have a “barbell” structure to the portfolio, in which roughly equal amounts of dollars are invested short and long.

True floaters will have a near-term reset period (less than a year) and will have no, or liberal, periodic caps. GNMA ARMs, for example, meet the first criterion but not the second; they reset annually but have a 1 percent periodic cap, which causes them to “stop out” in most rate-volatile situations.

Collateralized Mortgage Obligation (CMO) floaters are hypersensitive, at least in the near term. They will float based on the money market index known as 1-month LIBOR, and they have no periodic caps. They also can be found at prices very near par, which may be a relief to premium-laden portfolios. Their downside? Life caps, which today can be in the 6.50 to 7.00 percent range.

New-age balloons
Community bankers who have been in portfolio management for 15 years or longer will recall the balloon product that was quite popular in a previous era. These pools were issued by Fannie Mae and Freddie Mac and had the all-important maturity date in either five or seven years. The cash flow and resulting average lives fit very well into a community bank’s investment box.

Fast forward to the 21st century: There’s no product. Investors have had to make do with the next best thing, which is still pretty good—hybrid ARMs. These items have an initial fixed-rate period of five, seven or 10 years, after which they convert to an annual ARM. So, the cash flows for the fixed-rate period, and their effective durations, actually mimic the balloons very well.

Barbell + ladder = bases covered
Floaters these days yield in the 60-basis-point range. So, you retort—give me one reason why I should like them. I’ll give you three:

1. It’s a “pure” yield, as floaters have a very short payment delay and the market prices tend to be very near par;
2. LIBOR is highly correlated with Fed Funds, so your yield goes up as soon as the Fed decides to tighten; and
3. The five-year Treasury note, as of this writing, yields only 71 basis points.

Hybrid ARMs for the moment are structured such that their initial starting rate is higher than the reset rate, which is not the norm. The prospect of closing out a loan ahead of time, paying refinancing costs and graduating to an immediately higher rate likely will place a ceiling on prepayment speeds. What the investor of such pools is likely left with is an instrument that has current yield of about 1.60 percent and an effective duration of only about two years.

Both products will have monthly principal payments from the outset. This will allow something of a cash flow ladder to be created, which, for better and worse, creates the ability to reinvest proceeds in the near term. Add in the fact that both floaters and hybrids are either 0 percent or 20 percent risk-weighted and easily pledged, and the story begins rounding neatly into shape. You may want to join an expedition this fall for a mortgage collection that creates reasonable value, great structure and additional diversification.