It Just Keeps Rolling

Persistently steep yield curve creates investment opportunity

By Jim Reber

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One enduring image most of us have of this spring’s weather is of the flooding in the Mississippi River Valley. Pretty much any state in its path or its major tributaries has been living through flood warnings and sandbags since March. It does seem like Old Man River just keeps rolling along.

Equally stubborn has been the Treasury yield curve’s steepness over the last three years. This has been both a blessing and a curse for community bank investment managers. The reward for extending maturities is great, as is the penalty for staying short. Yet, you keep being reminded that a steep yield curve reflects investors’ expectations of higher yields in the future.

If the Fed Funds Futures contracts are correct, the first time the overnight rate will actually rise will be late 2012. This means that there may be quarters, not weeks or months, in which the tried-and-true “roll down the curve” strategy can still be beneficial to your investment portfolio.

With the curve’s shape near its record steepness, you may want to put this plan to work.

Recent curve shapes

First, a revisit of Treasury curve fundamentals. Bond market analysts track the relationships of yields at different maturities for a given instrument. Treasury bonds are the easiest to track, as they are the most liquid and visible. Graphically stringing together the yields across the maturity spectrum provides a picture of the yield curve.

The difference in yields of the two-year note and the 10-year bond is a benchmark for research wonks. It is seen as a proxy for what short-term and long-term investors are expecting. A big gap between the two, or “steepness,” indicates longer investors anticipate an increase in inflation, and therefore interest rates.

The 20-year average difference in the two is about 100 basis points, or 1 percent. Since 2009 it has been more than double that, and recently has been in the 250-basis-point range. This is an ideal scenario to invest in bonds that roll down the curve.

Bonds that work

Any debt instrument that does not amortize and does not have call features is perfectly suited to take advantage of this landscape. These are also known as “bullets.” Community banks typically don’t own a lot of these, for the simple reason that they don’t have a lot of yield. Only about 15 percent of bank investment portfolios consist of bullets.
Others can work reasonably well. Longer municipal bonds that have “lockout” (that is, long periods before call dates kick in) fit this description, as do collateralized mortgage obligations (CMOs) with principal being returned in a concentrated period, or “window.” Planned Amortization Class (PAC) CMOs often are structured this way.

Also, agency callables with lockout of roughly half of the final maturity generally perform well. An example of this is a bond with a five-year maturity and two years of call protection. In the vernacular this is referred to as a “five non-call two.”

**Numbers don’t lie**
A comparison of a three-year bullet to a five-year can bring this strategy into focus. Recently, the former was offered at a yield to maturity of about 1.00 percent, with the latter at about 2.00 percent. This is another illustration of the steepness of all fixed-income curves.

We can model the future prices of these and other bonds by assuming certain future interest rate paths. In a year, assuming no change to rates, the three-year bond will actually appreciate by about one-half point, or about $5,000 per $1 million invested. The five-year? Up in price more than a full point, or about $12,000 per $1 million.

So not only is your yield significantly higher, your chances for price appreciation are much greater. The downside, which must be taken into account, is that the longer bond will lose more ground in a truly rising-rate environment. The parity rate hike for these two bonds is about plus 120 basis points over the next year.

This concept deserves more dialogue and analytics than can be displayed here. But if you have liquidity that needs to be put to work, and are feeling queasy over the available yields, the features of medium-term bullets can be an antacid. Rolling down the curve could make for a pleasant cruise in turbulent waters.