I wouldn’t take umbrage to an investor commenting that it’s easy for a broker to make recommendations, since the broker doesn’t have to live with the consequences. I know I wouldn’t, because I’ve had community bankers say that very thing to me on a number of occasions. And I must agree with the notion.

So I am going to walk the plank, figuratively, and go on record as to what I believe makes sense for community bank portfolio managers in the current investment environment. Before I do, however, I would like to acknowledge that community banks have a multitude of needs and objectives, not to mention limitations. Therefore, I will attempt to suggest securities and strategies that would fit the majority of ICBA members.

Long and short of it
My recommendations have had a consistent theme: “barbells.” Buying roughly equal amounts of short and long bonds will outperform a collection of serial maturities (or “ladders”) with roughly the same average duration. This advantage is due to the current shape of the yield curve, as most of the yield out to the seven-year part of the curve is concentrated out beyond four years. This is a situation that has existed for months, and could well persist as the Fed continues to suggest that overnight rates may be stuck near zero for some time.

What to buy on the short end, with the one-year Treasury yielding all of 12 basis points? We still like Small Business Administration floaters. SBAs are unique in that they float based on Prime, have short reset periods (usually 90 days) and no caps. This allows their yields to stay on-market. As of this writing, SBAs have yields anywhere from 50 basis points up to about 100 basis points. The difference is a function of stated final maturities—longer equals more yield—and the amount of premium paid.

There are a few specifics about SBAs that can protect the investor from prepayments, which is really about the only risk in this product. For one, the larger the number of loans in a pool, the more dispersed an investor’s prepay risk. For another, the investor can and should review the loan list (available from the offering broker) that makes up a pool. This will help identify whether an inordinate amount of the pool is concentrated into just a few, or even just one, large loan.

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Also, remember that newly hatched pools probably have several years of built-in prepay protection, as small-business borrowers tend to stay on schedule for a while after origination. Seasoned pools begin to show prepay activity after, say, 24 months.

Munis matter
SBAs very effectively address the short end of the barbell. For the anchor on the long end, I enthusiastically suggest municipal securities. And it doesn’t matter if your bank has net operating loss carryforwards or is a Subchapter S corporation that distributes earnings. Taxable munis, an example of which is a Build America Bond, fit that bill.

For community banks, the issue with munis is arriving at the suitable maturity. The muni curve, as usual, is very steep, particularly out past 12 years. One way to protect against rising rates and the consequent drop in price for a long maturity is to buy a bond with a large coupon. These “cushion” bonds maintain their value much better than ones with prices near par.
So you may be wondering how to match-fund such an animal. Federal Home Loan Bank advances require collateral, and retail deposit maturities are almost always under 36 months. Perhaps a suitable alternative would be for your community bank to issue callable CDs. With the value of a call option being so low, it costs just a few basis points to give you the hammer to redeem an issue early, if that suits the community bank’s needs.

As an example, as of this writing, it is possible to issue 10-year brokered CDs with a maturity of 10 years, with the issuer’s option to call them within a year, at an all-in cost of about 2.50 percent. Cushion municipal bonds of very high quality that would give an investor a spread over cost of funds of well over 100 basis points are available, and that’s just for Subchapter C corporations. Spreads for S corporations would be much higher.

Mortgage bargains
I’d be remiss if I didn’t mention several mortgage-backed securities that seem to have value. The 20-year sector has been one of our favorites for several months as that maturity has been unaffected by the Fed’s quantitative easing policy; Chairman Ben Bernanke is focused solely on 15- and 30-year pools. We like coupons of 3.0 percent or 3.5 percent. The advantage may dwindle as the “tapering” of quantitative easing begins.

Ginnie Mae 15-year pools are also available at historically low “pay-ups.” Ginnie Mae pools trade at higher prices than identical maturity and coupon Fannie Mae or Freddie Mac pools, owing to their superior credit quality. That premium has dwindled as the Fed has temporarily inflated the prices of Fannie/Freddie pools through quantitative easing. The result, happily, is that a 0 percent risk weighting costs little at the present.

So there you have it. Barbells, starring SBA pools and longer maturity municipals, funded by callable, brokered CDs and complemented by strategically selected mortgage-backed securities, are what I’d be buying. We will revisit my suggestions in the future to see how I would have fared.