Ebb and Ebb

Drop in bond prices has not been uniform

By Jim Reber

This month’s column happily begins with not one, but two trite admonitions: “Be careful what you wish for—you just might get it.” And “those who do not learn from history are doomed to repeat it.”

You may have had the opportunity to notice that market rates have “improved” since May. That’s the way bond salesmen acknowledge that the value of your community bank’s investment portfolio has dropped. Or tanked. Or cratered.

While it’s likely that most of your bank’s securities have gone down in price in the last four months, the drop has been anything but consistent. There are a lot of factors that determine a true market value of a bond, and some of these variables can counteract the others. For example, an unusual or small issuer of a municipal bond can have a high relative price because of its scarcity. A different investor, however, can believe that the same issue should be valued lower because of a perceived lack of liquidity.

Duration review

The yardstick for measuring the price risk in a given investment is its duration. Duration in its most basic definition is the weighted average period of time for cash flows to be received. Cash flows include principal and interest. The stated interest, as we shall see, can have a major impact on the duration.

There have been refinements of the original duration model to account for floating-rate securities. In the case of floaters, such as adjustable-rate mortgages (ARMs), a more relevant gauge is the effective duration. Effective duration accounts for cash flows, the window until the security can reset next and any rate caps that are present in estimating how much price volatility is embedded.

If there is a lesson that can be applied in any rate environment, which has been crystallized this spring, it is that greater cash flows will result in lower price volatility. This applies to corporates, municipals, agency debt and all variety of mortgage-backed securities.
ICBA Securities can calculate any community bank's price volatility by individual line item in a Portfolio Value at Risk report. This complimentary report can be updated monthly. For more information, visit www.icbasecurities.com, or contact your ICBA Securities representative.

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result in lower price volatility. This applies to corporates, municipals, agency debt and all variety of MBS. Your bank’s bond accounting provider should be able to calculate all of your bank’s effective durations in a variety of interest rate shocks. Now is a good time to revisit the reports to see how the risk profiles have changed. And your broker is always a good resource to discuss which bonds create the right duration profile for your community bank.