



Do's, Don'ts, and Maybes

A set of simple rules to streamline portfolio management in 2021.

By Jim Reber, President & CEO of ICBA Securities

If my recent aggregate conversations with investment managers are an indication, there is still a lot of seat-of-the-pants decision making going on out there when it comes to portfolio strategies. And I hasten to add this is not a criticism; it's merely an observation. Why should we expect anything else?

Banks are still sitting on a lot of cash. The bond market is giving mixed signals with short rates being anchored at near-zero levels while the Treasury yield curve is its steepest in three years. Bond portfolios still have substantial unharvested gains, and net interest margins are at record lows. PPP 2.0 has been launched, as a new wave of fiscal stimulus is about to be unleashed on consumers and governments.

Given this bewildering set of variables, perhaps we can create a (relatively) simple set of ground rules that portfolio managers can refer to while trying to make sense of it all. I would like to emphasize that "maybe" is the unspoken theme to these guidelines, as every community bank has its own risk/size/earnings/ownership profiles. But here goes:

Do: Stay invested. Cash yields zero, and will remain there for the remainder of the year, at least. A simple bond that yields even 50 basis points (.50%) will probably produce a spread to your cost of funds, and will provide collateral for pledging purposes. An example of a bond that yields 0.50% is a callable agency with a five-year maturity, and one year of call protection ("5/1 callable").

Don't: Keep buying the same old bonds just because. In just the last three years, community bank portfolios have changed tenor significantly. You know that banks own fewer tax-free securities since tax rates were cut in 2017, but did you know that both general market munis, and taxable munis, have picked up the slack? The other big "new" bond sector is multifamily mortgage-backed securities (MBS), which follows...

Do: Take action to normalize your bond portfolio's cash flow. As low as returns (and spreads) are, the cost of eliminating optionality is an all-time low. Case in point: a five-year non-callable agency (aka "bullet") yields about 0.47%, which means an investor surrenders three measly basis points to remove all cash flow uncertainty. In a different sector, MBS, a similar set of dynamics is at play. You've read in this column recently that "prepayment friction" pools which consist of low balance loans can slow down refinance activity. The same outcomes can be achieved with "yield maintenance" provisions on multifamily MBS.

Don't: Worry (too much) about rates rising to the point that your collection of bonds is underwater from a market price standpoint. If your community bank is typical, it will benefit from a general rise in rates. For one thing, since banks own a whole lot of bonds at prices above par, interest rate increases will cause the current bonds' yields to improve. For another, the rest of your bank's earning assets will pretty quickly show some improvement, whether the loan portfolio consists of floaters or shorter-duration fixed rate credits. Community banks' asset/liability positions are built for rising rates.

Do: Stay on top of your portfolio's effective duration, to put your mind at ease about all of the above. We have seen this important barometer of price risk really whipsaw over the last year. At last look, most portfolios had returned to their pre-pandemic durations of around 3.0 years, but that's taken a lot of buying of a lot of longer-maturity bonds to get there. In mid-2020, they had shrunk, on average, to about 2.5 years. That's a 20% increase in two quarters.

Maybe: Invest in some bond education for your staff and you. As the economy (and travel) begins to open back up, there will be a whole range of investment school options available, some virtual, some live, some hybrid. There is also plenty of archival information that's been accumulated over the last year as trade associations, brokers-dealers and consultants have figured out digital delivery channels. So ask around your providers for offerings that may suit your needs.

And by all means, **do** continue your due diligence and documentation of your actions. Investment portfolios have grown remarkably in the last year. They are likely to be a substantial driver of bank profits for the foreseeable future.

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