Independent Banker

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Portfolio Management by Jim Reber

**Echoes of holidays past**

**Year-end is a good time to reflect on past investment performance.**

**The investment portfolio** as a component of a community bank’s overall franchise, is in some respects like your cousin’s husband—Mike, in my case. You know he’ll always be around for important events, doesn’t make much of a fuss and, if needed, is glad to help move furniture for your kids. Colorful and gregarious he may not be, but that’s a blessing in itself.

This holiday season, you’re liable to see Mike and realize that he’s been around through good times and bad. In the spirit of the season and given that bond portfolios have seen a dramatic turnaround in virtually all-important metrics since 2018, we are taking a look back at the more significant year-end portfolio milestones. And please forgive your columnist if he sounds nostalgic. Investment portfolios are, in fact, in very good shape as we approach 2020.

**Benchmark date**

Many bond market analysts use 2007 as a starting point for the so-called “modern era” of portfolio management. It was that June that the Fed, under Ben Bernanke’s chairmanship, began cutting rates aggressively to immunize a sickly economy against a global slowdown. In just six months, overnight borrowing rates fell 100 basis points (1%).

More importantly for community banks, yields across the middle part of the maturity spectrum fell further. The yield on the 3-year Treasury note, which approximates the average duration in community bank bond portfolios, fell more than 200 basis points (2%) in that same six-month window.

Like we have seen in just the last couple of months, bond prices rose a lot in a hurry, as did cash flows. By the end of 2007, the typical bond portfolio was about break-even from a market value standpoint, after being nearly two percentage points underwater that June. Durations plummeted, falling from 3.1 years to 2.7 in just six months. Tax-equivalent portfolio yields hadn’t yet fallen much, but that ship had sailed: We’ve never again approached the 5% or more returns that were commonplace in that era.

**The worst of times**

It’s been said—at least by some of my relations—that you can choose your friends, but you can’t choose your family. This again has some application to the bond portfolio. Unless you are ultradisciplined and buy no investments with any type of option embedded, you will have more to invest in lower-rate environments than when yields are juicy. Very few portfolio managers choose to buy exclusively noncallable debt, as investors are generally paid to take on optionality risk. That’s not the case in rapidly moving markets with lots of volatility.

Such an example was the second half of 2013. Chairman Bernanke made several public comments that quantitative easing (QE) would eventually have to wind down, and the Fed would have to quit buying up all the treasuries and mortgage-backed securities (MBS) that it could get its hands on. The result was the Great Taper Tantrum of 2013, in which bond yields rose a lot, even though the Fed didn’t raise rates and actually kept buying bonds throughout the year.

When the carnage was tabulated in December 2013, bond portfolios still yielded a relatively paltry 2.62%, which is less than today, even though average durations were a bloated 4.1 years. And, oh yes, they were about 2% underwater again. I might as well remind you that banks weren’t making much money then either, as annual returns on assets (ROAs) were barely 1%.

**Par is your friend**

Today, most community bankers seem pleased with the condition of their balance sheets, including the bond portfolio. Their collection of investments yields produces income of around 2% more than their cost of funds, which is in keeping with long-term trends, and durations are on the short side at less than 3 years. So, there’s no indication of “reach” for yield.

Also, banks own less of what historically has been the key moneymaker among their bonds: tax-free munis. This is due to tax reform in 2017, which has made tax-equivalent yields less enticing, even as it has improved after-tax earnings for corporations. Since 2016, banks have shed roughly one-fifth of their tax-frees and replaced them mainly with MBS. This is evidence of community bank portfolio managers being both informed and proactive, especially considering that long-term net margins are being maintained.

This column has recently mentioned that average bond portfolios have healthy unrealized gains, which means your overall portfolio yields are probably on the way down. Still, as long as your portfolio is matching or beating its longer-term trends, I would conclude it’s making a positive contribution to the franchise. Like the friendly, unassuming cousin-in-law Mike, security portfolios are glad to be there.

**Education on Tap**

**2020 webinar series**

ICBA Securities and its exclusive broker Vining Sparks will again offer a multipart webinar series, Community Banking Matters, next year. A variety of topics that address balance sheet strategies and risk management will be offered. We will again offer CPE to the participants. Be sure to read future columns or visit ***icbasecurities.com*** for more info.

**ICBA Securities signs extension with Vining Sparks**

ICBA Securities recently reached an agreement to continue its longstanding relationship with its exclusive broker, Vining Sparks. The contract will run through October 2021 and extends the arrangement that has existed since 1989.

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