Community Bank Views: Proactively Managing the Bond Portfolio July 31, 2019

There are three important elements to achieving long-term excellence in the performance of the fixed income investment portfolio. The first is attention to detail. The second is to craft then follow a strategic plan that fits the overall goals of the institution. The third simply requires management to be proactive rather than reactive. While the first two are certainly important, this article will primarily focus on the third element – proactively managing the bond portfolio. Successful community bank investment officers understand that when it comes to proactively managing the portfolio, best practices generally follow one of two basic themes: What to do and What NOT to do. Although CMG is not a portfolio manager nor an investment advisor, select best practices are listed below:

Consider the following best practices:

- Manage the bond portfolio in the context of overall balance sheet risk. Remember, investment portfolio cash flow and duration should not be viewed in isolation. The portfolio is meant to help offset total balance sheet risk. As the balance sheet risk profile changes, so should the bond portfolio.
- Understand how optionality embedded in select fixed income investments may impact their performance. Metrics such as effective duration and convexity are essential tools used to best manage risk associated with changes in interest rates.
- Take advantage of how various securities trade. Certain security sectors often trade rich to other security sectors. Management should actively pursue these market inefficiencies for the investment portfolio's benefit.
- With the recent changes in tax law, re-evaluate the role of tax-exempts in the overall investment portfolio. Depending on the institution's tax rates and duration bogey, taxables may now be a better choice.
- If earnings are significantly higher than budget and/or prior year, consider taking security losses to reduce earnings to desired levels. If done properly, restructuring the bond portfolio should provide additional income in future years.
- If earnings are significantly down, consider taking security losses. If earnings are down, they are down no matter what the percentage. Use this as an opportunity to off-load or "clean up" under-performing securities. Like the previous bullet point, proper restructuring should enhance future earnings. Capital restraints may prevent an institution from employing this strategy.
- If/when exploring the idea of running a "wholesale" bank, management must first consider the potential impact on capital ratios before executing leveraged transactions (borrowing wholesale to buy bonds). While a leveraged transaction can be very effective in increasing earnings, analyze the optionality on both sides of the transaction. Determine what happens to leverage performance as rates change. Question whether the level of risk is typical for the institution. And finally, document key aspects associated with the leverage as your notes will help explain management's thought process. The steepness of the yield curve combined with wide spreads often drives management's appetite to leverage excess capital.

Avoid the following potential dangers:

- Avoid significant levels of credit risk in the investment portfolio. While elevated levels of credit risk may increase current income, a credit problem will incrementally impact earnings more than the initial increase in income. Furthermore, the increase of on-going analysis with heightened levels of regulatory reporting and due diligence often adds to management's heartburn. Significant credit risk should reside in the loan portfolio, not the investment portfolio.
- Prepayments on mortgage-related collateral are complicated - never think you have them figured out. Betting on mortgage prepayment speeds have tripped up even the most seasoned mortgage professional. Run prepayments on a

worst-case basis. Meaning, when analyzing the potential performance of any mortgage-related bond, include stupid-fast and stupid-slow prepayment speed assumptions. Additionally, vector all CMOs.

- Avoid diversifying into more risk by staying away from complicated securities. The potential impact of structured securities is probably not worth the additional yield. Simple rule: If you don't understand it well enough to explain it, don't buy it!
- Never bet big on the direction of interest rates; rather, know the investment risks associated with changes in rates. Use analytics (shocks, non-parallel shifts, ramps) to better understand how your investment portfolio may perform. Make informed decisions to mitigate risks.
- Leave running a trading account to the investment banks! While the idea that an institution can achieve continued success with a long-term trading account may sound reasonable to some, its execution challenges even the most-skilled community bank investment officer. Active portfolio management does not necessarily mean trading. Management may occasionally take gains/losses depending on balance sheet needs & market conditions, but this is not the purpose of the transaction. The purpose is to increase balance sheet/portfolio performance – not gains trading.
- Extremely high-yielding securities typically contain an unacceptable level of risk. Buyer beware; make informed and well-researched decisions. The risk is there - it's your job as the investment officer to find it! If you do decide to pull the trigger, document-document-document…
- Steer clear of the following:
    - Interest-only (IO) or principal-only (PO) mortgage-backed securities. While philosophically these securities could be used to hedge an institution's position, reality would show that they are complicated and have extremely volatile characteristics. They are also red flags for regulators.
    - Residual tranche, the Z-tranche or other volatile tranches of CMOs. Those are the most volatile components of a CMO and like the IO and PO securities above, residuals are considered an unsuitable investment practice by regulators.
    - Inverse-floating securities. Similar to the IO/PO guidance, these securities could be used to hedge an institution's balance sheet, yet the increased price volatility and regulatory scrutiny could offset any positive impact to the financial institution.

Loan officers often attest that every loan made was good when it was first originated. Similarly, investment officers believe that every investment decision was sound at the time of execution. But, things change. As such, following the above-described best practices while avoiding the potential dangers should help management achieve a higher level of investment portfolio performance.

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