Price pullback prospects

Availability of discount bonds causes a rethink of strategies

By Jim Reber, ICBA Securities

I’ve learned a few things about human nature as it relates to bond portfolio management over the years. Some of these notions or biases in the minds of investors are more logical than others. For example, it seems community bankers take some pride in owning a collection of bonds whose price has risen since purchase. An unrealized gain is much preferred over an unrealized loss in the minds of a lot of seasoned portfolio managers, investment committees and boards. This is in spite of the fact that the gain is residue of rates falling since purchase. The natural consequence is that the overall portfolio’s yields are on the way down, and I haven’t met many people who are hoping for lower returns on their bonds.

A great paradox is that many of these same bankers prefer to buy bonds whose prices are less than 100 cents on the dollar, rather than at premiums. In some cases, they’ll opt for discount bonds even if they have lower yields to maturity. I think they get satisfaction out of knowing they’re better off than the poor suckers who originally paid par or more for the same investment.

In that community banking is a cyclical industry, and its earnings have some correlation to market interest rates, there are periods in which certain strategies are in play, and others are not. An environment in which rates are high and rising, such as 2022, will produce bonds whose prices are below par. Like it or not, discounts are the story of the day, so let’s review how discount-priced bonds can be used strategically to improve portfolio performance.

Agency options

The simplest investment sector to analyze is government agencies. These bonds are issued by some of your favorites, such as Fannie Mae, Freddie Mac and the Federal Home Loan Bank. These do not have periodic principal repayments, so your original investment remains intact until maturity date. That is, unless it has a call feature, which is present in about 88% of outstanding issues. For these bonds, the borrower can decide to “call,” or prepay, the debt early, and on designated dates.

If a given bond is purchased in the secondary market at a price below 100, and the issuer later calls the bond early, the investor’s yield to call is higher than yield to maturity. This yield improvement can be dramatic if the callable is owned at a deep discount. Of course, the investor doesn’t expect the call to ever be exercised, so it’s a pleasant surprise to see the yield jump. These discount callables are typically priced to the worst case (i.e., maturity) to yield slightly more than non-callable bonds (i.e., bullets).

Mortgage maneuvers

Mortgage-backed securities (MBS) remain popular as community bank investments. The majority of the dollars in all bank portfolios are in some type of MBS. And it is a deep and liquid (and growing) market, so supplies are plentiful for a given investor to shop around.

The cash flows of an MBS are mostly predicated on how much *pre*payment (not *re*payment) is received each month. There is a direct link between prepayment activity and the borrowers’ rates (in MBS parlance, “Gross WACs”) of a given pool, so investors can (within limits) create a predictable risk/reward profile. And have I mentioned that MBS are currently available at discounts?

Buying below-market coupons means two things in the near term. First, your monthly cash flows will be limited, and that may be fine for your bank’s needs. Secondly, the market price has room to improve, up to and beyond par, if rates begin to fall. For example, a 15-year MBS with a 2.00% coupon is currently priced around 94 cents on the dollar, and was worth around 102 at the start of 2022. Since the borrowers’ rates on these pools will be well below 3%, there is no financial incentive to prepay the loans early, so average lives will be quite long in the near future.

Offset to falling rates

Maybe the biggest benefit to owning bonds at prices less than 100 is that their returns will be inversely related to general market rates. When interest rates fall, the “optionality” comes “in-the-money” and some bonds get called away. To the extent they’re owned at discounts, their yield-to-call is enhanced. This is true for all bonds: agencies, MBS and even munis at discounts.

Further, since most all community banks have interest rate risk profiles that are built for rising rates, investments that out-perform as rates fall can help offset the margin compression that’s likely to occur. Perhaps best of all, discount bonds’ yields will automatically (magically?) increase as interest rates decline, without the need to sell the investments.

All told, owning bonds at prices less than par can help bring stability to the cash flows while lessening exposure to falling rates. It can also feed the needs, however subliminal, to get a bargain price, while improving future chances for unrealized gains. Paradoxical? I’d call it logical.

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