The Baker Group

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Is Your Investment Portfolio Properly Anchored?

Many financial institutions saw record investment growth in 2020/21 as large stimulus payments bloated balance sheets and far outpaced loan demand. This surge in deposit growth, mixed with the large drop-in interest rates, led to collapsing margins and applied huge stresses on earnings and overall capital levels. As institutions fought to stay afloat and stem the massive tide of liquidity, one of the few ways they could generate additional spread was through the addition of longer duration assets. In fact, when we look at overall industry levels today, we can see that many investment portfolios have more optionality and price volatility than they have had in quite some time.

This is quite important given that 2022 will likely be another year of operating in an extremely volatile rate environment. On one hand, we have inflation fears and the possibility of a Fed rate increase highlighting the potential dangers of a rising rate environment. On the other, we have “recovery fatigue” and the never-ending risk that COVID isn’t quite done with us highlighting the dangers of a prolonged low-rate environment. In fact, several countries in Europe are currently reporting their worst COVID spikes to date, and there is early word of yet another new variant (B.1.1.529) coming out of South Africa.

For many institutions, the additional duration that was added in 2020/21 is just now starting to pop up on their radar as they begin working on their 2022 budgets. More importantly, given the recent jump in yields, year-end ALM results will likely begin to highlight some of the capital at risk measured by examiner favorites like EVE/NEV. We must remember that EVE/NEV results get worse as rates rise, even if the “structure” of our balance sheet does not change. Therefore, we feel it is critically important that management teams begin getting a better handle on their optionality and duration risk now. In an effort to help those discussions, let’s take a quick look at some of the most popular investment sectors offering relative value.

To start us off, one way to offset longer duration assets is to add floating rate products. While this can be a successful strategy for some balance sheets, all too often these products do not offer enough yield to relieve capital and earnings pressures. In addition, if next year’s rate environment leans toward prolonged lower rates, the resets on these floaters will only further complicate our earnings situation. So, while these investments could be part of the solution, we certainly should not solely rely on them.

Mortgage-backed securities are another extremely popular sector that many institutions are currently using to better control their duration. 10yr and higher coupon 15yr/20yr MBS offer fantastic cashflows and liquidity, even in a rising rate environment. However, they lack the ability to truly roll down the curve or stabilize our portfolio’s overall risk position. If rates fall lower, we once again have to worry about prepayment risk while extension risk is a real possibility if rates continue to drift higher. Now please don’t get me wrong, MBS have been and continue to be some of the absolutely best relative value for depository institutions. It is our opinion that we should absolutely continue to purchase this sector. However, we must also understand that there is no one bond type that does it all. The good news is that there are plenty of alternatives that can hedge some of these risks so that we can continue to enjoy the benefits of this sector.

Bullet securities are consistently sought after to help “anchor” portfolio risk levels. When rates go up, callable agencies, MBS, and just about every bond with optionality extends. The opposite is also true; when rates fall, callable agencies, MBS, and high optionality bonds all shorten considerably. While bullet securities

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help fight against these contraction and extension risks, they also typically offer some of the lowest yields available. So, what is a portfolio manager to do? We need bonds that anchor our portfolio shorter when rates go up but also anchor our portfolio longer if rates fall or stay low.

It is our opinion that bullet alternatives are that "anchor." Searching out bonds that perform like bullets but offer yields closer to the MBS and other bonds we typically buy is key right now. While there are several sectors that accomplish this goal, we feel that Agency CMBS currently offer some of the best value. Fannie Mae DUS, Fannie Mae ACES, and Freddie Mac Ks are all specifically structured to provide the exact behavior our portfolios currently need. They protect against prepayment risk in a lower rate environment while their shorter legal final maturities (<10yrs) offer limited extension risk. They also roll down the curve with their final maturities ensuring that with each passing month, their remaining average life and price volatility will decline.

With high volatility likely to continue over the near and moderate term, balance sheet managers can utilize Agency CMBS, along with other bullet alternatives, to better control duration and extension/contraction risk. MBS purchases can then be used to offer the solid yield and near term cashflows we need for future reinvestment and/or loan demand. Written investment strategies will also help keep institutions on track with their preferred risk/reward balance in the portfolio. This proactive management approach will go a long way towards alleviating potential future regulatory issues centered around EVE/NEV results. Our focus for 2022 needs to be on properly measuring and managing our risk position instead of letting fear or the markets drive future performance.

The Baker Group is one of the nation's largest independently owned securities firms specializing in investment portfolio management for community financial institutions.

Since 1979, we've helped our clients improve decision-making, manage interest rate risk, and maximize investment portfolio performance. Our proven approach of total resource integration utilizes software and products developed by Baker's Software Solutions combined with the firm's investment experience and advice. For more information, contact* ***Andy Okolski at The Baker Group: 800.937.2257, www.GoBaker.com, or email: andyo@GoBaker.com.***

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