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Building an Optimal Investment Portfolio

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Bank investment portfolios are an increasingly important part of balance sheet management. As portfolios have grown by 5.9% over the past year, according to the FDIC, they also produce a larger share of earnings. However, regulatory challenges and the low interest rate environment have pushed some into lopsided positions, such as high concentrations of agency notes and collateralized mortgage obligations (CMOs), with those institutions dealing with what are now sub-optimal portfolio allocations.

These investment portfolios show heightened risk exposures, whether through maturity extension, early call features or declining levels of income – less palatable sources of risk in an industry currently focused on improving earnings. In order to boost long-term performance while mitigating risk, investment officers should keep an eye on the following key areas.

Target Duration

Investment policy statements describe the framework by which the institution manages its portfolio. One goal is to enhance profitability within the overall asset/liability management objectives, while a second aim is to establish a process for implementing specific measures to manage sensitivity to interest rate changes.

Accordingly, management should establish a target level of duration that reflects the institution's asset/liability position, income requirements and risk tolerance. Academic studies consistently show that longer-duration portfolios provide higher levels of income. At the same time, highly-leveraged institutions need liquidity to fund loans, and this may reduce the desired level of price sensitivity, causing the investment officer to "shorten-up."

Maintaining duration, moreover, is an essential factor in preserving margin and maximizing net interest income. As portfolios age, duration can decline unless cash flows are reinvested back out on the curve; this "opportunity cost" limits earnings potential. Similarly, portfolios comprised exclusively of mortgage securities can extend if prepayments lag initial projections, creating unexpected interest rate risk.

Investment officers should closely monitor their portfolios and take steps to ensure target durations are preserved to protect net interest income.

Diversification

Many portfolios become heavily weighted toward certain "comfortable" sectors. The returns fixed-income investors receive are determined by various factors, such as volatility of rates, credit and yield curve slope. An emphasis on callable agencies, for example, implies a reliance on returns from taking extension risk or prepayment risk.

With an expected drop in market rates, this institution will receive unwanted funds which must be reinvested at lower yields. Conversely, calls slow down in a rising-rate environment, providing less cash to put to work at better yields or to fund loans. A diversified portfolio (more call-protected assets, in this case) would keep cash flow fluctuations to a minimum, leading to improved portfolio performance.

Cash Flow

It is recommended that the treasury group prepare cash flow projections in a base case, as well as several alternate scenarios. An institution exposed to mortgage security prepayments, for example, can act in advance to protect against a decline in income in a falling-rate environment by either pre-investing or realigning the portfolio. The cash flow projections provide the information necessary to understand the position and evaluate suitable strategies, with the ultimate goal of establishing an optimal cash flow profile.

Bond Ladder

A laddered portfolio consists of securities that mature in successive years, starting in the short term and extending out to five years or longer. Assembling a stable basket of cash flows avoids locking in all one's funds at "low" yields, while enabling the investor to pick up some additional income.

The benefit of a ladder is that as rates move higher, bonds coming due in the near term can provide funds for reinvestment when the alternatives may be more attractive. Depending on the institution's preference and individual situation, the principal can be put to work at the desired maturity. If current yields are higher than the bonds rolling off, the institution is able to increase overall returns, boosting portfolio performance.

Fixed vs. Floating

Many investment officers wonder about the optimal strategy for deploying assets – whether to put on longer-term fixed-rate investments that pay a higher coupon or add floating-rate instruments that would benefit if rates rise. The investment officer might be considering two options: a five-year fixed-rate note yielding 2.4% or a similar term floating-rate bond priced at 90-Day LIBOR (1.3%) plus 50 basis points, for a current yield of 1.8%.

If the market forecast is correct, then the yield for the floating-rate bond will increase 25 basis points in September 2018 and a similar amount the following year – bringing the yield to 2.3% at September 2019. By contrast, the institution will have received a constant 2.4% for the fixed-rate option. Assuming a $1 million investment, the fixed-rate bond provides interest income of $72,000 over the three-year time horizon, compared with $65,250 for the "floater." Even as the yield curve has flattened, fixed-rate assets may still provide higher levels of current income than floating-rate alternatives in the intermediate term.

Best Execution

In light of recent advances in technology, regulatory agencies such as FINRA have reiterated their commitment to ensuring best execution as a key investor protection requirement. FINRA stated in a November 2015 regulatory notice, for example, that the market for fixed-income securities has evolved significantly and transaction prices for most securities are widely available to market participants.

Broker/dealer transaction costs can vary greatly based on the scope of the transaction and access to the most liquid dealers. For example, the Bid-Ask Spread Index from MarketAxess shows that block trades on actively traded corporate bonds currently have a 3-basis-point bid-ask spread, and "odd lots" trade at 7 basis points. Individual transactions often trade at higher spreads, indicating that investors may be "leaving money on the table." A more diligent approach toward trading efficiencies could help support the bottom line.

Municipal Bonds

Banks have boosted their holdings of municipal bonds steadily over the past decade, according to Federal Reserve statistics. Industry reports generally show that institutions holding larger percentages of municipal bonds tend to be the high performers, and banks holding at least 30% of their investment portfolios in munis are typically found in the first quartile for investment yield.

A primary benefit of municipal bonds is the long period of call protection. Bank treasurers may be relatively certain they'll hold on to the initial yield for seven to ten years, regardless of interest rate movements. With considerable optionality on most bank balance sheets, municipals provide much-needed predictable cash flow. In addition, the municipal curve remains steep, providing some price protection for a rising-rate environment.

The Bottom Line

Taking some of these steps may enable management to build more efficient investment portfolios that generate higher levels of income over time. Building predictable cash flow characteristics provides the flexibility to manage the portfolio effectively within the context of the balance sheet, while also leading to stable returns.

Of course, the institution should consider its asset-liability position when making these decisions. Investment officers should also continue to maintain robust risk management practices, keeping interest rate risk exposure at reasonable levels.

Disclaimer: The views and opinions expressed in this article are those of the author and do not necessarily reflect the official policy or position of the Financial Managers Society.

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