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THE IMPORTANCE OF PORTFOLIO DURATION

By Robert Segal, CEO, Atlantic Capital Strategies, Inc.

Following a recent meeting in Washington, the Federal Reserve lowered the target range for the Fed Funds rate to 2% to 2.25%. The central bank also stopped reducing the size of its balance sheet two months earlier than expected. The FOMC took action in light of the implications of global developments for the economic outlook as well as muted inflation pressures. While the Committee noted a robust labor market and low unemployment rate, it remains concerned about slowing levels of business investment.

In a press conference following the announcement, Chairman Jerome Powell said the move was intended to insure against downside risks from weak global growth and trade policy uncertainty, and to promote a faster return of inflation to the 2% target. Rather than indicating a major turn in policy, Powell referred to the action as a "mid-cycle adjustment." He also suggested that after a period of time, the Fed could go back to hiking rates.

For now, bond market participants see more rate cuts coming. According to fed funds futures, traders are anticipating a 100% chance of a rate reduction at the September 18th FOMC meeting. After that gathering, there are even odds for two more moves by the end of the year, which would bring the range to 1.25% to 1.50%.

Financial institutions have been living with a flat yield curve for some time. As an example, the Treasury yield spread as measured by the difference between two- and ten-year maturities was just 13 basis points on the FOMC's July 31st meeting date. That compares with a slightly-higher 29 basis points on the same date in 2018.

As bond prices have increased, investors continue to chase performance. Money has been pouring into bond funds globally this year, with net buying on pace to reach a record $455 billion in 2019, according to Barron's. Over the past decade, global bond funds received $1.7 trillion of inflows.

At the same time, the funds are getting riskier as managers try to squeeze out better returns in a low-yield world. A recent Morningstar analysis found that even straightforward funds have increased their holdings of lower-rated bonds and emerging-market debt to juice returns. As interest rates keep falling, bond investors are increasingly "reaching for yield."

Treasury officers should remember that a main objective of the investment portfolio is to enhance profitability while balancing the institution's sensitivity to interest rate changes. Accordingly, management should establish a target level of duration that considers the institution's balance sheet, income requirements and risk tolerance.

Maintaining duration is an essential factor in supporting margin and maximizing net interest income. As portfolios age, duration can fall unless cash flows are reinvested back out on the curve; this "opportunity cost" limits earnings potential. When interest rates decline, for example, portfolios comprised of mortgage securities usually shorten as prepayments ramp up. Investment officers should

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closely monitor their portfolio and take steps to ensure target durations are preserved to protect net interest income.

Especially in this environment, caution is advised with regard to investment types that may underperform over a cycle. These include certain CMOs and callable Agency bonds in falling-rate scenarios and low-coupon tax-exempt municipals with rising rates.

CMOs

In a base case scenario, many "plain vanilla" CMOs are projected to have an intermediate-term average life, such as four to five years. However, CMOs are often highly sensitive to movements in interest rates. Changes in the rate at which homeowners sell their properties, refinance or otherwise pre-pay their loans could result in large swings in cash flow. In a falling-rate scenario, the securities could shorten dramatically, causing the investor to reinvest cash flows at appreciably lower yields. Investors in these securities may not only be subject to this prepayment risk, but also to heightened market and liquidity risks.

Callable Agency Bonds

Callable bonds expose investors to the same type of reinvestment risk. Issuers tend to call the bonds when interest rates fall so they can refinance at lower costs. A typical Agency issue carries a first call period of three to twelve months, which may not be enough protection. As bonds are redeemed, the investor receives the original proceeds but is unable to match the original return. Moreover, callable Agency bonds cannot appreciate much above par due to the call feature, and this limits any lift to the institution's capital from unrealized securities gains.

Municipal Bonds

Tax rules describe a price threshold for determining whether a discount bond should be taxed as a capital gain or ordinary income. If a municipal bond is purchased at a large discount, the security's price appreciation can be taxable, which reduces realized investment income. For this reason, many financial institutions prefer to purchase municipal bonds at a premium, since a larger portion of the expected return is comprised of coupon income. Investment officers may want to tread carefully with low-coupon municipal bonds, as these issues could depreciate rapidly in a rising-rate environment.

Of course, every institution should consider its asset-liability position when making investment decisions. With the market at a potential turning point, investment officers need to pay extra attention to performance in multiple rate scenarios to protect the balance sheet from undesired outcomes.

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.

ABOUT THE AUTHOR
Robert Segal is the founder and CEO of Atlantic Capital Strategies, Inc., which provides investment advisory services for financial institutions. He has over 35 years of experience in the banking industry, having worked in several community banks with roles in mortgage banking sales, trading and ALM. Bob is also currently a Director-at-Large on the FMS Board of Directors.

Published by:

1 North LaSalle St., Ste. 2225 | Chicago, IL 60602 | info@FMSinc.org
Contact: mloehrke@FMSinc.org | 312-578-1300
FMSinc.org/IndustryInsights

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