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Can Your Portfolio Play Defense, Too?

Whether we like it or not, there are some immutable truths in this fickle world of ours that simply can't be denied; like water running downhill. Or, the way it always rains the day after you wash the car. When it comes to the bank's investment portfolio, the immutable truth we're all living with these days is the inverse relationship between interest rates and bond prices. When interest rates rise, bond prices fall. Water runs downhill. Nobody likes it, but some are better prepared for it than others.

With the Fed having already instituted a handful of rate hikes and the prospect for a few more almost a certainty, portfolio managers are seeing the value of their holdings decline as, for some, the level of market value depreciation becomes uncomfortably high. For some, perhaps, but not necessarily for all. No one enjoys watching the value of their assets decline, but market risk is, and always has been, an element of portfolio management. Not even the most prudent and savvy of portfolio managers are immune from market risk, and if your bank has a bond portfolio, it has exposure to market risk.

Why is it, then, that declines in valuations are so often accompanied by consternation and hand-wringing? Banks buy securities in order to have earning assets, and whether securities have an unrealized gain or an unrealized loss, they are still assets and they are still earning. Problems seem to arise for those portfolio managers who discover that somewhere along the way, they became speculators and are dismayed when they learn, often the hard way, that they somehow missed the top. Or, maybe they missed the bottom, or whatever it is they "knew" was going to happen. Perhaps blinded by shiny yields, their security selection process failed to identify undesirable characteristics, like cash-flow volatility, that can accelerate price depreciation in the face of rising rates.

How Much Risk Is Too Much?

Other portfolio managers, and boards of directors for that matter, seem a lot less stressed-out by rising rates and falling values. Does that mean they're happy about their bonds being underwater? Probably not, but they also know it's not the end of the world. They know that because, as part of their portfolio management process, they gave some thought to their portfolios' role and along with that, their own appetite for risk. Are they all loaned-up and just need a liquidity buffer or a temporary parking place until loans are funded? Or, is loan demand weak and investments are required to be primary income generators? Does the bank have large volumes of public deposits that require certain types of securities for collateral? How well is the bank capitalized and what other interest rate risk exposure is present? Is asset quality an issue?

The result of such introspection will hopefully help answer a key question: How much risk is the right risk for my bank? The answer is not the same for everyone. With the analytical tools available these days, portfolio managers can estimate with surprising accuracy the price volatility of individual items or an entire portfolio. Having that ability doesn't prevent price depreciation, but it does prevent it from being an unpleasant surprise, and that prevents a lot of hand-wringing.

The Cash Flow Defense

Once it is determined how much market risk can be comfortably tolerated, the security selection process actually becomes simpler. Potential alternatives can now be evaluated in the context of predetermined depreciation parameters. You've identified your pain threshold and can now apply your analytical techniques to measure what kind of exposure your various alternatives might bring with them. Those alternatives, whether they apply to broad

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strategic options or individual security selections, can now be judged on the basis of their contribution to, or mitigation of, depreciation risk.

For those who have taken the steps that allow them to be comfortable in their own risk, downturns in the market do not induce panic. Rather than lament the price depreciation wrought by higher market rates, portfolio managers know their efforts to create and maintain a steady stream of stable cash flow will now be rewarded. This cash flow line-of-defense is beneficial in two ways. Its source represents a diminution, in the case of amortizing securities, of assets with below-market values. These funds now become the transactional ammunition with which to replace lower-yielding "underwater" assets with higher-yielding, current-market bonds. Depreciation is reduced and yield is increased. These are both good things, but they won't happen unless care is taken to identify and acquire, along the way, the kinds of securities that will provide this valuable, defensive cash flow just when it is most needed. Remember what your father told you: defense wins championships.

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