Strategies for a Bear Market

In early June of this year, interest rates for most Treasury securities hit multi-decade lows. Two-year rates were near 1%, five-year rates near 2%, and ten-year rates near 3%. It is unlikely that those levels will be breached in the foreseeable future. And given the length of the rally that brought rates down, it is likely that we will see an upward bias in rates for many years to come. Strategies that served banks well during the long descent in rates need to be reviewed with an eye to modification.

First, the Good News

Because the market underestimated the potential for lower rates, the last two decades have allowed banks to benefit in two important ways. First, any longer term purchase was eventually bailed out by the next cycle in rates. If you bought the ten-year Treasury at the price top (rate bottom) in either 1983 (10.4%), 1987 (7.1%), 1993 (5.3%), or even 1998 (4.5%), you had a profit in your holdings before the half-way point to maturity. And the profit was pretty substantial. Second, a consistent approach to choosing longer maturities and funding short was rewarded. The Federal Funds rate exceeded the yield on purchases at the worst points above for less than 30% of the ensuing time to maturity (to the present in the case of a1998 purchase).

Of course a strategy that was a little luckier in choosing purchase points would have been far more profitable. If you bought the ten-year Treasury at the average rate in any year since 1983 and held it to maturity, funding with Federal Funds, the average spread would have been 2.5%. The high holding period spread was 5.6% (1984) and the low was 0.9% (1998). It turns out that investing in a yield curve arbitrage was about as profitable a strategy as you could have designed over the last two decades.

It is unlikely that the spreads will be as attractive going forward from 2003. With the ten-year Treasury averaging about 4% so far this year, we would need an average Federal Funds rate of only 1.5% over the next decade to hit the average arbitrage profit. If we can't count on easy arbitrage profits, what can we do to generate value-added from the investment portfolio?

Taxes and Death

Most analysts that have tried to explain out-performance of bank investment portfolios have zeroed in on one constant. Top returning bank portfolios tend to have a higher percentage of municipal securities than average. The benefit of holding municipal securities is associated with four key factors. Three dominate, but the fourth can add enough to be worth searching out.

The first and most important advantage of municipal securities in an investment portfolio is the yield advantage the bank receives due to the tax-exempt status of the security. This may look obvious to you, but consider that municipal securities tend to return more than comparably rated corporates for similar maturities. Note the following table which shows comparisons even after a sharp 25 to 50 basis point rally in municipals over the last month:

Term	Industrials (AA)	Financials (AA)	NY Munis (AAA) TE
3 years	2.80%	3.01%	3.00%
5 years	3.70%	3.93%	3.80%
10 years	4.74%	5.17%	5.40%
30 years	5.75%	6.04%	6.75%

The second advantage from a total return investment perspective is that municipal securities are not as volatile as taxable securities of the same maturity. The reason: when interest rates move, the municipal rate only moves about two-thirds as much as the taxable rate. This means that a ten-year municipal acts like a seven-year taxable from a price risk standpoint. Consequently, those investors looking for the highest risk/reward trade-off find municipals pay you more for a given level of risk.

The third advantage of municipal securities is found in the shape of the yield curve. Take another look at the chart above. Note that the yield pick-up from five years to ten years is a bit over 100 basis points for the corporates (it's even less for Treasuries and agencies). The municipal pick-up is over 150 basis points. It pays more to extend maturity in municipals than it does in taxable options. This means a bigger cushion per year of extension versus an increase in interest rates.

The last advantage of municipals comes from the possibility that municipal securities will be refinanced. The rules on municipal refinance force the issuer to escrow proceeds of any new issue to pay off the original issue. This offers the opportunity of a nice upgrade in quality on some municipal holdings. High-coupon, non-insured issues offer the best chance for a windfall.

How does death play a role? Community banks have historically had a buy-and-hold philosophy regarding their investment portfolio. This is a good strategy when you are in a bull market. The returns I cited at the beginning of this article speak to the benefits of holding on during a period of declining interest rates. But a bear market, characterized by rates generally rising, requires a different approach. There will be a time when it makes sense to kill off the portfolio by selling early. In fact, a consistent strategy of riding a steep yield curve and selling when the time to maturity no longer pays you, can be a very effective bear market strategy.

The key to this approach is a view on the market. If you believe that the market is underestimating the rise in interest rates, you sell and shorten maturities. If you believe it is overestimating the rise in rates, you buy longer. The shape of the yield curve itself tells you what the market thinks. For example, if one-year rates are 1.5% and two-year rates are 2%, the market is predicting that one-year rates twelve-months from now will be about 2.5% (adjusting for compounding). If you believe rates will be only 2% one year from now, you should buy the two-year. If you believe they will be 3%, then you stay with a one-year investment. Note that in either case you believe rates will rise (bear market), but the how much determines strategy.

Here's the secret to out-performance with this approach: from overnight rates to about nine months, the market consistently overestimates the rise in rates due to the liquidity premium. This means that a bank looking for out-performance should always invest overnight funds in nine-month investments (as long as you have ready access to liquidity if you need it).

Strategies for a Bear Market

Advanced Math

Bill Gross of PIMCO, the largest fixed income manager in the world, discussed an extremely interesting concept in his November letter to investors. He called the concept “effective yield.” The idea is that all investors have a target maturity in mind. If you have $100 and are trying to target three years, as do most banks, you could achieve the goal by investing in three-year securities. If, however, you decide to choose some ten-year investments because the yield is higher, you will have to invest less than $100 and put enough in Federal Funds so that your overall maturity still comes back to the average of three years. Depending on the shape of the yield curve, you can find the ideal blend of securities to achieve the highest yield while keeping average maturity constant. In today’s market it turns out that the best yield curve trade-off involves buying the three-year Treasury and mixing in enough Federal Funds (either sold or purchased) to bring your target maturity to what you need.

The beauty of this strategy is two-fold. First, the freedom to change the maturity with the best yield/risk trade-off vastly expands your investment options. This freedom will lead to better choices. Note how returns increased when banks reduced their heavy reliance on Treasury securities (from 18% of the portfolio in 1997 to less than 5% recently). The same improvement can occur when previous maturity restrictions are loosened. Second, if you believe rates are destined to rise, buying some five-year investments mixed with Federal Funds offers the opportunity to see returns rise even with a constant duration. The opposite situation obtains if you buy shorter than target investments in larger volume by using Federal Funds Purchased to leverage.

Biblical Wisdom

Ecclesiastes 3:1, “To every thing there is a season.”

I believe that the coming decade will require banks to change from bull market to bear market strategies in the fixed-income arena. All is not lost, however. A more active set of strategies in positioning the portfolio plus a healthy mixture of municipal securities should help to maintain solid value-added for the investment portion of the balance sheet. Whereas a bull market calls for simply not selling at the wrong time, a bear market provides a time to buy and a time to sell; “a time to plant, and a time to pluck up that which is planted.”

Michael Jamesson heads Jamesson Associates, a consulting firm located in Scottsville, N. Y. that specializes in balance sheet management, merger and acquisition analysis, and strategic planning for community banks.