Relative Value Analysis for Investments

A Method to the Madness

Community bank investment officers are given the responsibility of deciding how to manage the bank’s excess liquidity. In order to insure that this responsibility is carried out properly, there needs to be a logical decision-making process. After all, a portfolio manager must make a series of choices about such things as sector allocation, cash-flow profile, liquidity needs, duration, capital at risk, and diversification. There needs to be a method to the madness. Fortunately there are efficient ways to make all of these choices, and methods for determining what makes the most sense for any particular bank.

Perhaps the most critical choice that must be made at the outset of any investment decision has to do with which sector to invest in. This is the choice that involves what we call relative value analysis. When we have funds to allocate in the investment portfolio, we have several alternatives generally. We can purchase treasuries, municipal bonds, agency securities, or mortgage-backed securities among others. In many cases, there are clear-cut reasons for choosing one bond-type over another. For example, a bank’s tax position may dictate that it can use more tax-exempt income. This bank should take a good look at municipals. Another bank might need to smooth out its cash flow ladder over a period of years. A mortgage backed security might be the best vehicle for accomplishing that. There are those times, however, when there is no obvious bond-type for a bank with money to invest. At times like this, how do we decide which of these options makes the most sense?

Spread Analysis: Differences in Rate Relationships

It’s worth remembering that not all interest rates move in the same direction at the same time. Indeed, we have seen very clearly over the last year that short-term and long-term rates have not moved in tandem. But it isn’t just the difference between short-term and long-term rates that we’re talking about. It’s the difference in yield between agencies and mortgage-backed securities, or the rate relationship between treasuries and municipals. The yields of all these different types of bonds move independently of each other. This is what accounts for the constantly changing yield spreads between them, or what we call relative value.

We can track over time the changing relationships between and among bond-types or sectors. The simplest way to compare different sectors is to simply look at the yield spread to treasuries. Using the spread to treasuries as a benchmark, we can see which sectors have wider spreads today than before, and which sectors have seen their spreads tighten. To make the analysis more meaningful, we can determine which bonds have particularly wide spreads relative their average in recent years. Those bonds can be considered relatively cheap. Similarly, we can identify which bonds have seen their spreads tighten in recent years to determine those that are relatively rich.
Looking at the current market environment, we can see how the different sectors have performed on a spread basis over the last five years. Yield spreads these days are historically tight on all of the primary investment options for community banks. In general, agency bullets and MBS are furthest from their five-year average while callable agencies are now slightly above their average. Municipal bonds clearly offer the best relative value relative to their five year history of all the choices.

The relative advantage of bank qualified municipals over other sectors becomes apparent when viewed in comparison. The table below shows the spread over treasuries for the four primary sectors (callable agencies, bullet agencies, MBS, and municipals) at the beginning of each of the last five years and for today. From a trend perspective, it is interesting to note that at the beginning of 2001, the average tax equivalent spread on a municipal was below that of a 5yr/2yr callable agency. That situation reversed dramatically as rates fell in the subsequent three years and callable bonds performed relatively poorly. MBS offered the highest relative tax-equivalent yield spreads in January of ’01, and now they rank just slightly higher than that of callable agencies.

This is the essence of relative value analysis; determining what is relatively rich and what is relatively cheap at a given point in time. It’s important to remember that spread analysis is really telling you two things; how well the existing bonds you own have performed on a relative basis, and which of the choices available to you today make the most sense on a rich/cheap basis. If bonds you purchased three years ago have now seen their spreads tighten substantially, that means that those bonds have performed well. It might also mean that you should look at another (cheaper) sector for funds that are available to invest today.

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