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Playing Under Par

Something that may have gone unnoticed over the last few months is that the book price for the average community financial institution's bond portfolio has dipped below par (100 cents on the dollar). At least according to the 700+ financial institutions that process bond accounting reports with The Baker Group (individual results may vary). More surprisingly, this hasn't been the case since 2009.

As prices on the universe of bonds swung from premiums to discounts when the Fed began raising rates in 2022, portfolio managers admirably continued adding bonds to the portfolio in the face of steep unrealized losses. And today, they're being rewarded for that faith as bond portfolio yields sit at 14-year highs and book prices are below par for the first time in roughly 17 years. Given that we find ourselves in not-recently-charted territory, it's a good time to examine what this means for the bond portfolio and some takeaways we can learn from the game of golf.

Protecting the Scorecard

It's not often that I find myself playing below par in golf, but one key to keeping that streak going for as many holes as possible is playing smart and managing risk. The same goes for the bond portfolio. Just like taking too much risk in golf can turn a bad shot into a bad hole, buying the wrong bond or reaching for yield at the wrong time can wipe out years of progress. As fixed income portfolio managers, we don't have the benefit of uncapped gain potential like stocks do. Our yield can fluctuate based on prepayments, but we have a limit on what our investments can earn. That's why taking too much credit risk is an asymmetrical risk, the maximum upside is capped to the yield we earn, but the maximum downside is total loss of principal. As lenders, you know this game well and have a depth of experience to draw on in evaluating credit risk for individual borrowers. Our philosophy has always been to take credit risk on the loan side

where you can best use that experience in evaluating risk, but you're also better compensated for taking that risk. Reaching for yield in the bond portfolio can often mean taking on unknown risks and in today's world of artificial intelligence, those risks are only potentially growing. As a recent example, consider owning a corporate bond in IBM. IBM is a longstanding titan of Fortune 500 companies with a strong balance sheet, but who could've predicted that a new AI coding tool would send the stock tumbling over fears that it could wipe out a strong revenue generating business line for IBM? I'm certainly not calling for IBM to begin defaulting on its debt but that's an example of how quickly the picture can change and why adding bonds with agency or government guarantees protect the portfolio against credit risk, even if it means a little less yield.

Club Selection Matters

A golfer doesn't win with just one club and neither does a balance sheet manager. As portfolio managers continue to book bonds at discount prices, a couple of benefits happen:

1. In falling rate scenarios, institutions should see the yield on their bond portfolios drift up. This is driven by faster prepayments causing more rapid discount accretion to par as cash flow comes back sooner than was anticipated when the bonds were purchased. This is an excellent hedge against the margin erosion that typically happens in falling rate environments.
2. Total return potential should improve. Generally speaking, a discount bond has more positive convexity than the same bond purchased at a premium. Imagine a callable agency purchased at 100 cents on the dollar. That bond's price appreciation potential is limited to basically 0 because anything above par would be considered in-the-money to be called away. Now imagine the same exact callable agency purchased at 94 cents on the dollar, this bond has 6 points

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of price appreciation potential before getting to a price above par where it can be called away. That slight tweak in strategy could prove significant if rates continue to fall.

Now that I've laid out a couple of reasons to continue adding discounts, it's important to get back to the original point that club selection matters. An area of weakness that discount bonds have is in rising rate scenarios. As rates go up, we get less cash flow than anticipated and the discount accretion slows down causing our yield to drift lower. This is simply something to be aware of in this environment where discounts are plentiful. Few, if any, would have rising rates as their base case scenario, but it's important to acknowledge all scenarios as an effective portfolio manager. Continue to add discounts and focus on structure as you make investment selections, but if you start to notice that your portfolio is full of discounts, don't be afraid to add bonds that have premiums as a way to diversify. The same way that discounts can offer positive yield drift in falling rate scenarios, premiums can offer positive yield drift in rising rate scenarios. Adding both premiums and discounts gives the portfolio a natural yin and yang as rates move in either direction and protects the portfolio from being overly exposed to one scenario.

As I wrap up this article, it's time to come clean and admit that I stole these points of wisdom from a far better golfer than myself. I would give credit, but the name conveniently escapes me as the advice was borrowed without asking. Even still, the takeaway remains the same. It's the first time in a long time that bond portfolios have been positioned with these yields and book prices. Now is not the time to start playing like we need to make up strokes. Continue to focus on building a portfolio with a disciplined strategy and you should continue to reap the rewards.

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