Seller's Market?

A guide to finding liquidity among your holdings

By Jim Reber

Quick: What're the most saleable assets on your community bank's balance sheet? If you get this wrong, you need to be running a "not-for-profit depository financial institution."

Bonds, of course. Most people I talk to consider the liquidity feature a close second (to safety) in importance when contemplating a purchase. That feature has come into play for thousands of community banks in the last several years, as loan demand has outstripped deposit growth. Between December 2013 and December 2018, investments as a percent of assets dropped from 23% to 18% for the community bank industry as a whole. While most of the decline was simply maturing bond proceeds being reallocated into loans, some portion was outright securities sales to fund new credits.

Assist: Federal Reserve

You may also have noticed that your bonds' prices have risen in 2019. Since rates peaked last November, there has been a strong market rally across the entire yield curve, particularly beyond two years. For example, if you had purchased the new five-year Treasury note last November, you would now have a nearly five-point gain in that bond. Yields in that sector are down around 125 basis points in about seven months.

That has essentially wiped out unrealized losses in community banks' bond portfolios. As of the end of June, the average portfolio was worth slightly more than the collective book prices of the bonds. What that means in practice is that you probably own some bonds at higher prices than they're currently worth, and others at lower prices. And this is exactly what you should hope for.

If a community bank owns some winners and some losers, and it decides it needs to sell, it can manage the impact on current year earnings very easily. As 2019 progresses, it's clear that industry earnings will be quite good, so it is entirely possible that a bank may choose to realize some losses on sales of bonds now, and push that income (and tax liability) into future years.

Priced to sell

Assuming for the moment that a community bank is ambivalent about booking any gains or losses, and is instead more focused on the creation of a liquidity pad, there is a basic rule of portfolio management that needs to be applied to achieve maximum benefit. This is the concept of the "take-out yield." Take-out yield has several other nicknames like market yield or give-up yield, and what it quantifies is the yield that a purchaser of your bond would get, if you were to sell that bond today.

The lower the take-out yield, the more efficiently you have sold your bond. Economically, the seller will have to re-employ the proceeds at a return higher than the take-out yield for the sale/reinvestment to make sense. So a wise portfolio manager will resist the temptation to cash in gains, unless the sale item results in a low take-out yield. Your broker should readily identify the take-out yield on any security that you're thinking about selling at the same time you receive a bid.

Keep these in mind
There are a couple of other variables that could impact if, or what, your community bank might sell. One is that you likely can't sell a bond that was designated Held to Maturity on purchase date. That alone is a good reason to classify 100% of your bonds as Available for Sale.

Another widely under-reported fact of the bond market is that liquidity will dry up as we approach a quarter- or year-end. How much this affects prices is difficult to quantify, but I would recommend not bidding anything within two weeks of the end of a reporting period.

Also, you likely have other liquid assets on your balance sheet, besides your investments. There is a robust secondary market for most performing loans, beyond conforming residential mortgages. Government-guaranteed sectors such as SBA 7(a) and USDA loans can be efficiently sold. And even non-guaranteed loans can fetch attractive prices, especially in the current yield environment.

A final thought: usually, yield spreads widen as interest rates fall. They have not yet widened out noticeably from the peak in rates late last year, at least on many sectors that are popular with community banks. This includes callable agencies, munis and straight pass-through mortgage-backed securities. All of which makes the mid-2019 bond market an attractive time to consider targeted sales.

Bid thee well!

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[Sidebar]
Interactive portfolio site
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