Back to Basics

Bond Swapping

By Tom Slefinger, Senior Vice President, Director of Institutional Fixed Income Sales at Balance Sheet Solutions, LLC. Tom can be reached at tom.slefinger@balancesheetsolutions.org.

A bond swap is when a credit union chooses to sell one bond and subsequently purchase another bond with the proceeds from the sale. Employing a strategy of selling "select" bonds and simultaneously buying other more attractive bonds can help credit unions efficiently adjust and rebalance the portfolio to changing market conditions and risk parameters. A bond swap can include selling and buying one or multiple securities (including cash).

> ***"… cost effective and efficient means of managing risks and enhancing returns in the investment portfolio."***

Advantages to Swapping

Shifts in the market may present opportunities or threats to your investments. Likewise, changes in your balance sheet or ALM risk parameters may require changes to your investment allocations. This is when the versatility of bond swapping provides ample opportunities for credit unions to adjust to the changing environment. Well analyzed and executed bond swaps can be used to alter one or more characteristics of a bond portfolio and can benefit a credit union as a cost effective and efficient means of managing risks and enhancing returns in the investment portfolio.

Benefits of Bond swapping include:

- Take advantage of changing market conditions
- Recognize gains
- Improve quality
- Increase yield/total return
- Boost annual income
- Consolidate small positions – better diversify portfolio
- Shorten or extend maturities
- Enhance liquidity and diversification

Why and When to Swap?

Duration Management

The bond portfolio is the most liquid portion of the balance sheet and has always been the easiest portion of the balance sheet to tweak for asset/liability purposes. As such, if a credit union has an asset/liability profile which shows exposure to falling rates, than an extension swap may be appropriate. Conversely, if a credit union profile indicates risk to rising rates, a duration-shortening swap may be in order. Note: Any swap should be done within a well-defined A/L strategy and risk management process.

Yield Curve Management
From a portfolio perspective, it is possible to construct a portfolio of any particular average weighted duration in many different ways using securities positioned along the yield curve. As a general rule, if the yield curve is expected to steepen, it is advantageous to maintain a bullet portfolio; if the yield curve is expected to flatten or invert, a barbell portfolio may be preferred.

By using rigorous "what-if" scenario analysis, credit unions can proactively quantify how each investment portfolio (bullet, barbell and ladder) will perform under any future interest rate scenario and/or yield curve shift. Yield curve swaps can be executed to achieve the desired portfolio structure.

Sector Security Swaps
Credit unions need to be cognizant of the changing spread relationships with CDs, Treasuries, agencies, corporate bank notes, municipals and mortgage backed securities A widening/narrowing of sector spreads can have the same impact on security/portfolio valuations as does rising/falling interest rates. A credit union can adjust sector weightings to add yield and return or reduce risk. By actively managing the investment portfolio and "rotating" or reallocating investment amongst "rich" or "cheap" sectors, portfolio return can be enhanced and/or risk reduced.

Capturing Gains
In a low interest rate environment, many bonds have appreciated substantially and are currently trading at high premiums. Even if interest rates remain unchanged, this premium will slowly disappear as a bond naturally approaches maturity and is subsequently redeemed at par value. A credit union can sell the bond with a premium, capturing the gain, and then roll the proceeds into another potentially more suitable and attractive issue.

Balance Sheet Solutions "What-If" Bond Swap Analysis

The Balance Sheet Solutions' proprietary "what-if" bond swap program provides a pre-trade comprehensive analysis that helps you eliminate the guesswork when determining when to pursue a bond swap. By utilizing this valuable tool you can invest with confidence knowing what the potential outcomes and risks will be.

1. Bond Transaction Report – provides an overview of the bonds that you are selling and buying.
2. Bond Swap Simulation – will help you determine is a proposed swap will add value.
3. What-If Distribution Analysis – will help you analyze how the portfolio structure will change.
4. What-If Total Rate of Return Analysis – provides an overview of the total portfolio.

For further details and examples of these reports, please see ***Bond Swapping – Adding Value to Your Investment Portfolio*** at www.balancesheetsolutions.org/?page=learn_wrv.

Final Thoughts

First, keep in mind the distinction between Available-for-Sale (AFS) and Held-to-Maturity (HTM) designations. AFS bonds can be readily sold, without your accountant's permission. Sales out of the HTM category could leave a credit union open to criticism, or even "tainting" of the remaining HTM securities.

Second, the portfolio doesn't exist in a vacuum. It is a subset of the balance sheet. So, be sure to analyze the overall impact on credit union balance sheets when considering swaps.

Third, pre/post trade fixed income analytics are key elements of successful bond swaps. When considering a swap make certain that all costs and benefits are known, quantified and documented prior to executing the swap. Be sure to ask questions until you're comfortable, and provide the necessary documentation.

More Information

For more information about credit union investment strategy, portfolio allocation and security selection, please contact the author at *tom.slefinger@balancesheetsolutions.org* *or* (800) 782-2431, ext. 2753.

Tom Slefinger, Senior Vice President, Director of Institutional Fixed Income Sales, and Registered Representative of ISI, has more than 30 years of fixed income portfolio management experience. He has developed and successfully managed various high profile domestic and global fixed income mutual funds. Tom has extensive expertise in trading and managing virtually all types of domestic and foreign fixed income securities, foreign exchange and derivatives in institutional environments.

At Balance Sheet Solutions, Tom is responsible for developing and managing operations associated with institutional fixed income sales. In addition to providing strategic direction, Tom is heavily involved in analyzing portfolios, developing investment portfolio strategies and identifying appropriate sectors and securities with the ultimate goal of optimizing investment portfolio performance at the credit union level.