

Option- Adjusted Spread (OAS) Analysis

Option-adjusted spread is a pricing evaluation method that better captures both the timing and the magnitude of cash flows. Other methods also capture timing and amount of cash flows, but do not address the volatility these flows. OAS pricing gives a more realistic assessment of a bond's return than pricing to a *nominal yield*. *Nominal yield*, like *static (zero) volatility* pricing, does not adjust for embedded options.

Option-adjusted spread measures a bond's incremental return over a benchmark, risk-free yield curve such as the U.S. Treasury curve, evaluating each cash flow separately by applying the appropriate discount rate to the timing of each cash flow. OAS prices a bond based on multiple interest-rate scenarios and their impact on various bond redemption dates by treating every bond as a portfolio of more fundamental securities.

Maturity Strategies

Maturity strategies should also be evaluated during the examination of the bank's investment portfolio. As is the case with all strategies, there is no one correct maturity strategy for all banks. Each bank must establish and alter its own maturity strategy to achieve a distribution of maturities that reflects the bank's characteristics and objectives. Yield, liquidity, and safety must be considered in scheduling investment maturities. This study guide will briefly discuss two of the many possible maturity strategies which are thought of as "traditional" debt portfolio strategies. There are serious flaws with both oversimplified approaches in certain market environments:

In a **laddered** maturity distribution, banks purchase securities such that an equal dollar amount matures in each year over a stated period of years. In general, laddered distributions are more successful when yields are relatively low and the yield curve is upward sloping. Laddered maturities provide a relatively stable average earnings rate. However, if market interest rates rise considerably over the whole range of maturities, the portfolio may show significant depreciation. This risk can be minimized by shortening the acceptable maximum maturity in a laddered distribution to, for example, five years.

In a **barbell** maturity distribution banks hold securities with either very short or very long maturities and very few intermediate maturities. This strategy is used less frequently by banks than the laddered maturity strategy. In this strategy the bank holds only enough short-term maturities to meet liquidity needs and then invests in long-term maturities for their higher yields.