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Here Comes Ms. Banker of the Year!

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Focusing on Investment Process, Regardless of Interest Rates

The current interest-rate environment presents challenges for credit unions. The Fed has continued to raise rates and while industry-wide financial performance has improved, net interest margins remain thin. Appropriately pricing deposits and loans while effectively managing the investment portfolio can be difficult, especially as many credit union CFOs wear multiple hats.

However, if your credit union has a well-thought-out investment philosophy along with a disciplined strategy and framework for making investment decisions, it becomes fairly independent of interest rate levels. This is why ALM First advises credit unions to focus on process, rather than simply considering various bonds and securities to add to their portfolios.

4 Tips for Success

1. Be patient. Long-run institutional investing is sometimes like watching paint dry – a little boring and a little routine.
2. Have a sound, research-oriented and well-defined investment philosophy.
3. Remember, the decision-making methodology we utilize will contribute much more to long-term performance than the individual decisions themselves.
4. Don't make investment decisions solely based on what you are being shown by brokers. Brokers provide a necessary service but, in the end, they simply offer the ingredients to a recipe that has already been developed.

The Investment Process – Creating a Framework for Sound Portfolio Decision-Making

A credit union's investment portfolio serves an important role within the overall balance sheet management process and regardless of the portfolio's objective (liquidity, income, etc.), the ultimate goal should be to maximize return per unit of risk taken. Generating reasonable risk-adjusted returns requires discipline and focus amid an ever-changing market, economic, and regulatory landscape. To that end, a credit union should have a well-defined investment process that involves much more than just looking at bonds.

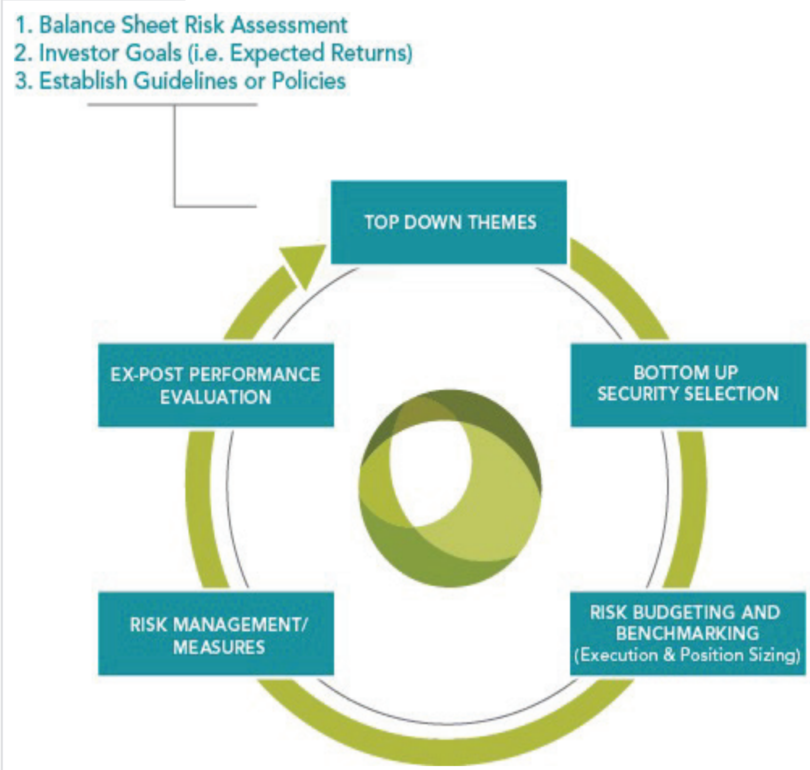
Imagine managing a two- or three-year duration portfolio for 50 years – you're making hundreds and hundreds of fairly routine decisions. This is what makes the decision-making framework or investment process much more important than any individual decision and that is the crux of this article. Institutional fixed-income portfolio management is best thought of as a "rinse and repeat" process, in which portfolio riskiness is increased when compensation for risk is high and vice-versa. For example, if yield spreads and expected returns on corporate bonds or mortgage-backed securities (MBS) are low, portfolio weights and exposure to these assets would also be low.

As spreads widen relative to U.S. Treasuries or interest-rate swap rates, exposure is increased. A data- and research-oriented framework, combined with sound trading-level analytical models, arm today's successful fixed-income managers to address portfolio management in a very controlled manner. Individual security selection can be thought of as the raw materials for portfolio returns. And, as a best practice, consider relative value analysis using robust trading-level analysis in an option and credit-adjusted framework.

Exhibit 1 displays a portfolio management process that begins with an assessment of the overall balance-sheet risk profile. In particular, the securities portfolio should be managed within an ALM framework, which accounts for the balance sheet's existing relationship between the asset and liability risk profiles. Arguably most important is interest-rate risk; managing the duration of the portfolio such that the duration of equity is either mitigated or targeted appropriately is very important. However, other considerations, such as liquidity risk, credit risk and earnings needs, also come into play. Depository investors don't manage their investment portfolios in a vacuum, and the portfolio duration target should be developed in such a framework. Once portfolio objectives are established, it's important to ensure the guidelines/policy allow for successful implementation of the strategy. If they aren't aligned, the depository's portfolio manager is limited in his/her ability to deliver long-term performance goals.

From here, top-down market themes lead the way through the investment process. Top-down themes communicate the current assessment of various market metrics and risk factors, which drive sector allocation decisions. Security selection, risk budgeting, and risk measurement bring us to the finish, with ex-post performance evaluation.

Exhibit 1



Actively managed fixed-income portfolios are at some stage of this feedback loop at all times. For example, we might see monthly top-down themes, combined with daily security selection, weekly risk analysis and monthly performance reporting. Duration-targeting and interest-rate risk management take the guesswork off the table.

Notice there's no discussion here on the direction of rates or when the Fed is going to move. Interest-rate forecasts, rate bets, and trades that are explicitly positioned for a specific interest-rate change have no place in this process and often can cause portfolio managers to rue the day. Instead, portfolio performance comes from good, old-fashioned risk measurement and management, as well as sector and security selection.

Analytical Models and Why We Need Them

It's vital for credit unions to have analytical models to identify and measure risks and potential returns.

In today's dynamic fixed-income markets, the need for robust models increases with the complexity of the assets or asset classes being evaluated.

Exhibit 2 shows this graphically. The line in the sand is clearly drawn between option and credit embedded assets and their other, simpler, cousins.

It's best to evaluate callable bonds using a lattice approach while, given the path-dependent nature of the prepayment option, MBS are better evaluated using Monte-Carlo simulations. Interest-rate and option models should price observe market instruments accurately and be arbitrage free, and prepayment models should exhibit a "best data fit" approach. Without these tools, investors are unable to properly evaluate market pricing of such assets. Of course, we can't forget the popular phrases "model users beware" and "use models at own risk." There are plenty of historical examples of financial models leading investors to their early demise. Models are only as good as the assumptions that go into them, requiring an investment in the human capital needed to properly manage robust analytical systems. So, proceed cautiously; understand the inputs and assumptions; and absolutely, positively be critical of outputs. That's why feedback loops are such an important component of the overall investment process. Models can help us make decisions, but they are not the end-all, be-all.

To help navigate today's financial environment, a growing number of credit unions are turning to experienced external advisors, both for expert guidance and to outsource specialized functions like investment and balance-sheet advisory. An institutional asset manager can provide the tools and resources (both systems and human capital) needed to build and maintain high-performing bond portfolios at a fraction of what it may cost to attain those resources internally. When seeking outside counsel on investing, credit unions must understand how that advisor is compensated (e.g., fee-based or commission), and performance must be measured relative to the stated portfolio objectives. That said, a thoughtful and disciplined investment process should lead to more consistent and predictable earnings from the fixed-income portfolio.

Robert Perry is a Principal at ALM First Financial Advisors, joining the firm in 2010. Mr. Perry leads ALM First's ALM and Investment Strategy Groups and is responsible for the development of asset liability and investment portfolio themes for the firm. He also provides strategic focus for financial institution client portfolios that are primarily invested in the high credit quality sectors, and is instrumental in balance sheet hedging strategy development.

Mr. Perry has more than 27 years of experience in the banking and bank-consulting businesses. Mr. Perry has shared his in-depth knowledge and financial management background at many conferences, training and educational events in the areas of ALM and investment strategy, profitability and portfolio strategies, as well as hedging and derivatives use. Mr. Perry has been quoted and published in various publications including WIB CFO Digest, WIB Directors Digest, Credit Union Business, and many more.

Before joining ALM First, Mr. Perry previously served as Managing Director of the ALM and Investment Strategy division of DataTech Management in Los Angeles, California, and Chief Investment Officer for First Coastal Bank in Manhattan Beach. Previously, Mr. Perry was a Principal and Product Portfolio Manager at Smith Breeden Associates, Inc., where he managed Smith Breeden's Enhanced Cash and Enhanced Equity Strategies. He also managed Smith Breeden's bank consulting group, which included the non-discretionary asset management and risk-reporting businesses. Prior to joining Smith Breeden in 1991, he worked as an analyst in the risk management area of Centura Bank in North Carolina.

Jason Haley is the Managing Director at ALM First Financial Advisors, joining the firm in 2008. Mr. Haley is head of ALM First's Investment Management Group and is responsible for leading the investment process and investment theme development for the firm, including management of the ALM First's model portfolio strategies. He oversees all capital markets activities, including security selection & trading, market research & commentary, and execution of hedging and funding strategies for the firm's depository clients. He regularly monitors the financial markets for cross-sector relative value opportunities within clients' stated objectives.

Mr. Haley provides daily and monthly market commentaries and presents regularly-scheduled webinars on those topics for ALM First and its clients. Drawing from a strong financial background,