A New Era for Portfolio Management

Learning to set new standards for a profitable investment portfolio

by Jim Reber
President/CEO

Sponsored by ICBA Securities
The typical community banker has just recently begun to embrace the benefits of technology in day-to-day management. It’s a good thing, because demands on the manager have leapt higher in just the last several months. Recent economic events and trends, as well as stepped-up vigilance from bank regulators and ratings agencies, necessitate a new set of standards for developing and maintaining a safe, sound and, yes, profitable investment portfolio.

This special pull-out guide will review what the market tells us about near-term expectations, and then compare currently available securities. It will then suggest prudent steps which a manager should incorporate into the due diligence process of any investment under consideration.

Market Fundamentals (Updated)

Yield Curve Shape
The vagaries of the slope of the yield curve, which bankers know can be a stiff headwind or a turbocharged boost to net interest margins, are usually correct when predicting future rates, particularly short-term. Where the predictive qualities begin to falter is in the timing of future rates. To illustrate, remember that the curve’s extreme steepness in 2001-2003 finally became prophetic in 2004.

The last quarter of 2007 saw the curve adopt a “normal” slope, defined here as the difference in yield between the 1-year and 10-year Treasuries. Over time, the average slope has been about 120 basis points. As of December 31 the difference was about 100 bps.

Consequently the curve is providing an opportunity to profit from extension swaps, leverages, and bonds with call protection. The last item may seem illogical, if steep curves predict higher rates, but as long as there is some positive slope to the curve the market value of these securities will remain relatively stable even if rates rise.

The curve steepened in late 2007 and early 2008 due primarily to two factors. One is that the Fed’s Federal Open Market Committee decided to not only cut the Fed Funds by 225 basis points, but to “jawbone” for more action in the near future. The second reason is that a seemingly endless string of subprime loan-related write-
downs by mortgage companies, large banks, CDO’s and even GSE’s caused a flight-to-quality action by investors, which pushed down rates on short Treasuries. Joined at the hip with this Treasury rally is the phenomenon of spread widening.

Great Spread, More Convexity

Table 1 below shows how much credit spreads have increased over the last month, six months, year. In the case of bullet agencies, some mortgages and short munis, spreads have more than doubled. This means that investors in this market should be very well treated if the credit markets return to normal (meaning early 2007) spread levels. This does, however, require discipline by insisting on call protection.

Why have spreads widened on U.S. government debt in the first place? Debentures and senior notes have had no suggestion of a downgrade, and earnings have been generally strong (2007 notwithstanding). As much as anything, headline effects on competing products have taken a toll on GSE securities. While it is true both mortgage-related agencies reported multi-billion dollar losses in the fourth quarter of 2007, neither had any problem raising additional capital via Preferred Stock issuance (albeit at very high yields).

Typical examples of securities that have been hammered by the subprime contagion are private label (meaning non-government agency) MBS backed by subprime mortgages, particularly those with “support” or “mezzanine” designations. As we have learned, there was scant margin for error with respect to borrowers’ default rates for these classes to perform as expected.

Although delinquencies are reaching a generational high, the worst is yet to come for many issues. The key rating agencies (mainly Moody’s Investors Service and Standard & Poor’s) have downgraded thousands of classes, and more are under review. Virtually all securities issued by non-agencies that have the slightest whiff of subprime exposure have dropped in value like a proverbial rock.

This brings us back to credit spreads. The sense that any borrower this side of Uncle Sam has some stepped-up credit exposure has forced yields higher, relative to Treasuries. Even FHLB debt, which to date hasn’t endured portfolio write-downs, has seen a spike in spreads. In turn, this gets us to convexity and call protection.

You’ll notice in Table 2 on page A4 that the 60 basis points of head start that the FHLB 4.10% has is quickly erased with even a modest drop in rates. Just as significant is the fact that Treasury rates don’t have to fall at all for this to happen—spreads tightening by a like amount could force this issue. If so, you’ll be getting a phone call from your favorite broker, who will happily inform you that your coveted 4.10% coupon has been called away.

**TABLE 1**

<table>
<thead>
<tr>
<th></th>
<th>1 Yr</th>
<th>6 Mo</th>
<th>3 Mo</th>
<th>5 Wks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2/2/07</td>
<td>8/3/07</td>
<td>11/2/07</td>
<td>12/28/07</td>
</tr>
<tr>
<td>Agency Bullets</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 yr</td>
<td>15</td>
<td>28</td>
<td>44</td>
<td>56</td>
</tr>
<tr>
<td>5 yr</td>
<td>24</td>
<td>53</td>
<td>53</td>
<td>52</td>
</tr>
<tr>
<td>Agency Callables</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5/1 yr</td>
<td>75</td>
<td>108</td>
<td>92</td>
<td>115</td>
</tr>
<tr>
<td>10/1 yr</td>
<td>109</td>
<td>143</td>
<td>114</td>
<td>125</td>
</tr>
<tr>
<td>5/2 yr</td>
<td>59</td>
<td>87</td>
<td>72</td>
<td>90</td>
</tr>
<tr>
<td>10/2 yr</td>
<td>96</td>
<td>126</td>
<td>99</td>
<td>105</td>
</tr>
<tr>
<td>CMO PACs</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 yr</td>
<td>42</td>
<td>73</td>
<td>100</td>
<td>130</td>
</tr>
<tr>
<td>5 yr</td>
<td>68</td>
<td>95</td>
<td>110</td>
<td>145</td>
</tr>
<tr>
<td>Muni</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 yr</td>
<td>35</td>
<td>91</td>
<td>86</td>
<td>100</td>
</tr>
<tr>
<td>10 yr</td>
<td>64</td>
<td>90</td>
<td>79</td>
<td>111</td>
</tr>
<tr>
<td>15 yr</td>
<td>87</td>
<td>100</td>
<td>102</td>
<td>139</td>
</tr>
</tbody>
</table>

**Convexity Definition**

A measure of the curvature in the relationship between bond prices and bond yields. The second derivative (after duration) of a security’s price with respect to its yield. A security exhibits positive convexity when its price rises more for a downward move in its yield than its price declines for an equal upward move in its yield.
What this discussion is intended to convey is that investors should look long and hard at call protection when purchasing. The yield penalty which appears to accompany bonds with convexity could more than pay for itself in a few short months. Cheap insurance indeed.

**Risk Assessment in the New Age**

**Municipal Market Synopsis**

A perhaps surprising piece to the community bank portfolio has come under pressure as the subprime issues continue to play out. Municipal bond insurers, who generally go by acronyms like FGIC and MBIA, are being closely reviewed by ratings agencies. Most of them, it turns out, have some exposure to the mortgage market, and in fact Radian Assurance, which was downgraded in September 2007, is the third largest mortgage insurer in the country. Several of these issuers have received capital injections to retain their pristine ratings, and others have been placed on credit watch “negative.” (AMBAC and FGIC actually were cut two steps from AAA to AA by Fitch in January 2008 while XLCA went from AAA to A.) Table 3 on page A5 displays a muni insurer ratings grid.

Bankers have long relied on insurance when buying municipal bonds. Most bank-qualified issues with AAA ratings, which are most of the market, have this guaranty in place to both protect the investor and lower the cost of borrowing to the issuer. Muni buyers have generally paid much more attention to the maturity, yield, and geography than the credit support. That will likely change in the near future.

ICBA Securities recommends that a portfolio manager take the following steps as part of a risk assessment program. First, a running total should be kept of the exposure the bank has to each insurer. It may be difficult to totally disperse the risk over a large range of firms, since there are relatively few who are involved in the BQ market, but it is worthwhile to quantify the exposure. This is a good time to document the underlying rating on each issue as well.

Secondly, at recurring intervals (perhaps annually), ask your broker for an updated DES page from Bloomberg, which will display the current credit ratings, and will also indicate if the issue is being reviewed for a downgrade. Table 4 displays an example of an insured muni that’s under review by S&P. Downgrades of insurers to AA will probably not significantly affect the liquidity of a given issue. However, at any point that you, the investor, have concerns about your tax-free portfolio, consult with your broker regarding latest credit information, and its impact on your market values.
Of course, there is nothing to prevent a purchaser from performing outright due diligence on an offering, which should be done on (at a minimum) non-rated issues anyway. That could entail detailed review of the prospectus, conversations with the financial officers of the issuer, and perhaps even a site inspection.

**MBS Risk Analysis**

To the extent a portfolio includes private-label mortgage-backed securities, a number of steps should be performed both pre- and post-purchase to ensure that the investor’s secure position isn’t being compromised. To start, the DES page will display the credit ratings of the issue or tranche. This is a fundamental part of the documentation that should accompany all purchases.

For a new issue, or one with relatively little seasoning, the Collateral Composition screens (found using the acronym “CLC”) will display details on a host of collateral topics, such as Loan-to-Values, FICO scores, and geographic distribution.

As an issue gets months or years down the road, the Collateral Performance (“CLP”) page will display delinquency, foreclosure and prepayment speed information on a monthly basis. This is a great way to keep abreast of how the borrowers are behaving. Related to the CLP screen is the Credit Support (“MTCS”) page. This screen calculates how much over-collateralization exists for each class of an issue, based on current delinquency status and priorities to cash flows.

Much like any non-agency issue, this should be updated at normal intervals. If you as an investor detect some deterioration in your credit support, consult with your broker regarding live bids and borrower performance expectations. It is reasonable to expect your broker to be attuned to these matters as well.
The Changing Product Mix

Mortgage Securities
Hybrid ARMs can no longer be considered new, but they still have misconceptions surrounding them. While it’s true that most subprime loans (about 75 percent) are of the hybrid variety, only those of the highest quality are used in FNMA/FHLMC pools. GNMA will purchase and pool FHA/VA loans, but its full faith and credit backing removes any credit risk. So, unless you own private-label MBS, you can rest assured that all your principal and interest will ultimately find its way to your cash account.

Hybrids continue to gain popularity as the depth of the market grows and more historical data on prepayments are gathered. Also, an investor has a wide range of product to choose from: Fixed rates for anywhere from three years up to ten, amortizing or interest-only, LIBOR or CMT-based. The differing initial fixed rate periods make hybrids ideal asset/liability tools.

Tried-and-true products from the recent past which no longer have much supply include balloon MBS and one-year ARMs. Borrowers have opted for hybrids to leave themselves less vulnerable to rising rates (vis-à-vis one-year ARMs) and not subject to a forced refinancing on balloon date (vis-à-vis balloons). It has also been assumed that most hybrid borrowers will be paying off their borrowings early, at some point near the initial roll date. That too may be changing.

With the slowdown in home price appreciation (or even house price depreciation a real possibility), coupled with a tightening in credit standards and an increase in credit risk premia, it will be more difficult for all borrowers to refinance existing loans. Unless two or more of the above variables revert to 2005-era levels and interest rates fall, there are expected to be substantially less prepayments of MBS in the next few years. This theory implies that premium-priced mortgage securities, and/or those that have built-in extension protection (e.g., PAC CMOs), should out-perform bonds with low coupons or those with extension risk.

Municipals
In addition to the procedures recommended under “Municipal Market Synopsis” above, several new assumptions about tax-free securities can be made that likely affect this sector. Callability of munis is one that deserves some thought.

It is understood that there are at any time many hundreds of outstanding issues that are economically in-the-money to be called; that is, the municipality could potentially save interest cost by calling some of its debt, and reissuing it at then-current rates. The call option for munis is much less efficient than for U.S. agencies, due mainly to scale. Bank-qualified issues can be no more than $10 million in size, so even the largest BQ deals can have a hard time overcoming fixed issuance costs. Also, a muni issue can be pre-refunded only once, so the municipality can’t go back to the well a third time to lower its borrowing costs.

As you can see by the Spread Snapshot on page A5 that spreads on all munis are much wider than they were a year ago. In fact, tax-free yields are now close to 100 percent of taxable yields on the longer part of the curve. This means that any cost savings from newly-issued bonds is lessened, and until credit spreads return to more normal levels, we can assume that a number of bonds that are callable will in fact not be called. What does this mean to a portfolio manager?

It should mean that cushion bonds have value. These are securities that are priced above par the day they are purchased, and the investor is told to expect that they will be called at the earliest opportunity. If they’re not, your yield improves, sometimes dramatically, once your book value becomes par. Since we are contending that even fewer than normal call options may be exercised in the near future, this translates into opportunity to add upside yield potential and minimum price volatility to the long end of your tax-free portfolio.

Corporates and Agency Preferred Stock
These items have seen perhaps that most dramatic widening of spreads in the entire debt security universe. Thousands of heretofore high quality securities have seen downgrades, with more to come. Previously unthinkable events such as
Countrywide being acquired by Bank of America for about 20 percent of what its market value had been just six months earlier illustrate the problems non-government issuers have encountered.

Even Fannie Mae and Freddie Mac were forced to recapitalize themselves via Preferred Stock, and at expensive rates. Late 2007 saw both raise billions of dollars at tax-equivalent rates well into double digits. The combination of supply and uncertainty related to all things housing will likely keep prices on seasoned FNMA/FHLMC Preferred Stock issues significantly depressed for the foreseeable future. It is expected that auditors will seek to apply Other Than Temporarily Impaired (OTTI) treatment to many of the pre-2007 issues. See Environmental Changes below for a more complete discussion.

The operative word for investing in corporate debt is “caution.” There are still solid credits available, many of which are totally unrelated to housing, whose spreads have widened in sympathy to the rest of the market. It is prudent to periodically review the ratings on these issues as well.

Environmental Changes
This subtitle doesn’t imply climate change, but there has in fact been a series of events that has long-reaching day-to-day effects. Not the least of these are recent Statements of Financial Accounting Standards (FAS).

FAS 133, effective in the year 2000, clarified the concept of Other Than Temporarily Impaired (OTTI) assets. In reality, there was very little added to already-existing generally accepted accounting principles (GAAP). It does, however, step up the requirements of portfolio managers to be aware of the trends of individual bonds’ market values, and also to assess the ability and intent of management regarding future ownership of those bonds.

For example, if a bank has a history of selling bonds at a loss early in the year, it should recognize those losses not when sold, but when the decision is made to do so. Just as fundamental are management’s expectations relative to future market values. A bond that has been under water for a long period could escape OTTI treatment if management can make a compelling case that it expects the market value to recover in a reasonable amount of time.

FAS 159, which gives investors the option to value certain financial assets at fair value, became GAAP for most banks at the start of 2008. This document is seen by many as one more step in the march toward full fair value accounting. It, like its FAS 133 brethren, puts the onus on the banker to know the market value of the assets affected, because the adoption creates income statement impact. This in turn can cause overall bank earnings to whipsaw in volatile rate environments.

As mentioned in the Market Fundamentals section above, late 2007 saw a string of financial events and announcements that literally shook the core of the credit markets world-wide. The underpinnings were historically high mortgage delinquencies and defaults by U. S. homeowners. The fallout, which is far from being fully quantified, will affect portfolio management for many periods into the future. The good news is that for most community bank portfolios, this upheaval represents opportunity (read: profits).

In Summary
The confluence of a number of factors, economic and otherwise, has created a new landscape for bank portfolio management. Yield curves will continue to steepen and flatten, spreads will widen and narrow, and supply of new products will ebb and flow. Yet auditors, examiners, directors and shareholders are asking questions that are of a different ilk than before.

Now and in the future, stepped-up vigilance of credit quality and market values can be expected by regulators. Increased attention to cash flows and mortgage prepayments by portfolio managers would seem logical. And above all, a clear understanding of a security’s structure, and attendant risks, will be an absolute necessity to sound community bank portfolio management.

Jim Reber is President/CEO of ICBA Securities and may be reached at jreber@icbasecurities.com.
Don’t Miss the Action!

ICBA FIXED INCOME FORUM 2008
MEMPHIS, TENNESSEE • JUNE 8-11, 2008

C O - S P O N S O R E D B Y

ICBA
INDEPENDENT COMMUNITY BANKERS OF AMERICA

ICBA SECURITIES

IN CONJUNCTION WITH

STANFORD ST. JUDE CHAMPIONSHIP
Memphis, Tennessee
Final Round: June 8, 2008
Watch some of the best golfers in the world. Then play a round on the same course.

Please visit www.icbasecurities.com or call (800) 422-6442 for more information.