Tailored to Your Preferences

An investment advisor can build your portfolio to order

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Bankers often are surprised to learn how much money disappears from their pockets because of inattentiveness to the bond portfolio. A community bank portfolio that performs at the median yield level typically has tax-equivalent yields at least 75 basis points below a portfolio in the top quartile. This is not insignificant. For every $10 million invested, this represents $75,000 in pretax income leakage. Every year.

Hundreds of community banks have hired a financial fashion coordinator of sorts. The purpose of this arrangement is to clothe the investment portfolio in whatever attire the banker wishes. The advisor’s responsibility is to ensure that the bond portfolio looks its best in any market environment.

This pull-out guide walks you through the pluses and minuses of having your community bank’s investment portfolio professionally managed by a Registered Investment Advisor (RIA) – a firm registered with and regulated by the Securities and Exchange Commission that has a fiduciary responsibility to act entirely in the best interest of its clients. The discussion highlights factors that any banker should consider in evaluating the possibility of a relationship with an independent advisor and discusses the typical dialog between the client and the tailor as the portfolio becomes dressed for success.

**Does your bank need an advisor?**

Bringing in an investment advisor is not the right direction for every community bank. Ask yourself, your management team and your board the following questions about whether an investment advisor may work for you:

- Is a chief investment officer or dedicated treasury employee already in place? The answer is no for many community banks. Very often a community bank’s CFO or treasurer does the investing – along with A/L forecasting, balance sheet management, earnings modeling and regulatory filings. One or another of these jobs has to become secondary. That job is often investment management – even though investments typically make up a quarter of a community bank’s balance sheet. Too often portfolio management becomes reactive as opposed to proactive. Have you ever tried to buy a tuxedo or the perfect outfit
the afternoon of a big party? Short-term planning does not lead to optimal results.

- If that employee is in place, does he or she have enough time to manage both the portfolio and a sufficient number of brokerage relationships to get a good picture of what investment options are available on an ongoing basis? What about keeping up with regulatory and product developments?

- Are there too many brokerage relationships? That can waste time without providing additional value. Would it be a relief if someone outside of the organization could manage those relationships and cold calls?

- Has the bank made the necessary investment in sophisticated analytic systems? Market volatility has become the norm, not the exception. Products have become increasingly complex. Knowing how individual bonds and the entire investment portfolio will behave in different interest rate scenarios is critical. Keeping abreast of market developments and going beyond simple up/down interest rate shocks are much more important than in the days when the old FMED test was developed. Relying on brokerage firms for that information is certainly a valid option, but are your brokers producing that information often enough and helping you interpret it in a way that is 100 percent aligned with your interests?

- How much experience does treasury staff have with bonds and portfolio management?

Has the bank outgrown these capabilities? Even the most successful community lenders have seen their investment portfolios grow over the last several years, either through acquisitions or because of limited opportunities to develop high-quality new lending relationships. Senior bank managers and the board need to ask whether the current portfolio manager or management team is truly up to managing an increasingly important part of the balance sheet in this new, volatile environment.

All of these questions boil down to two issues: resources and expertise. Successful management of the investment portfolio requires plenty of both. If limited resources would be better deployed in day-to-day operations— and an ever-increasing emphasis on efficiency means fewer employees doing more work— then hiring an investment advisor might be the right decision.

**Give and receive**

The decision to hire an investment manager is not without cost. Perhaps most important, fees add an expense to the income statement, and those are paid whether there is activity in the portfolio or not. In most cases, however, that expense is far less than the implicit cost of management’s time spent on investments or the explicit expense of hiring an in-house specialist to manage the portfolio.

That does not even take into account the necessary investment in systems, which can easily run into the tens and even hundreds of thousands of dollars for an individual bank. For all but the largest community banks, it is likely to make more business sense to leverage an investment in technology made by a provider that can spread costs over many institutions.

Because an RIA handles the bank’s communications with brokerage firms, bank management also gives up direct business interaction with brokers, some of whom have longstanding relationships. That can be a tough decision, but efficiently managing time is difficult also.

Giving the responsibility of fielding unsolicited broker calls to someone outside the bank is a way for management and staff to concentrate on building the bank’s business, and not deal with potential vendors.

One very important right that the bank does not give up is the authority to make decisions regarding the investment portfolio or individual investments. The ultimate authority to invest or sell remains with bank management.

**How do you choose?**

Having decided that hiring an outside investment advisor is the right choice, how should managers and board members choose? A lot of similarities exist among providers at first glance. Every RIA has a fiduciary duty to clients— it must always act in clients’ best interests. Each investment advisor
needs to demonstrate best execution, although not every advisor has the same access to the widest range of product.

Some helpful questions to ask prospective advisors:

• “Will the advisor make it a priority to know the whole balance sheet, or will it focus almost entirely on the investment portfolio?” The investment portfolio should serve three purposes for a community bank, in this order of importance: First, it should provide a source of liquidity. Second, it should serve as a balance sheet management tool; investments are typically the most efficient way to change or maintain a desired asset/liability position. Third, investments should serve as an earnings driver.

• Too much emphasis on maximizing yield, or trying to replace income from the loan portfolio when borrower demand is low and loan pricing is competitive, tends to lead to poor investment decisions. Structuring the portfolio by analyzing the bank’s liability structure, the loan portfolio, the tax and earnings situation, and management’s overall business plan is critical to a successful long-term relationship.

• “Will the advisor share our market approach?” One-size-fits-all generally does not mean a very good fit, and that is just as true with money management. A manager who begins by listening to management and the board can craft an approach that fits with your bank’s overall goals.

• “Does the investment advisor provide recognized intellectual leadership?” Getting caught up in the day-to-day management of investments is easy to do. One reason that it may make sense to hire an outside investment manager is to handle transactions, but a good manager should also invest the time to lay out and communicate a complete framework for thinking about community banking, the bond market and how the two interact through the investment portfolio.

• “Does the investment advisor have the market expertise and investment in sophisticated analytical systems that come with a strong, well-capitalized parent?” Every investment advisor can offer your bank their time and advice, but that advice needs to be backed up by sophisticated analytics. A firm that can invest in the systems and resources to fully support decision making is a firm that has the capability to add long-term value. Seat-of-the-pants judgments are a thing of the past.

• “Does the advisor—and, just as importantly, its staff—enjoy a good reputation in community banking circles?” Advisors who primarily manage money for other types of clients such as insurance companies, larger banks, and mutual funds may have long track records, but those may not be relevant to a community bank. Even the most sophisticated analysis is useless without a deep understanding of your bank’s business.

• “What kind of commitment to ongoing involvement and communication will the advisor make?” If occasional board meetings and management updates are all that a manager will commit to, maybe employing a manager to whom your bank is an important client rather than an afterthought makes more sense.
Sharing your goals
Franchise value at the community bank level is ultimately created on the right hand side of the balance sheet. A stable, strong core deposit base is the foundation of any successful community bank. An advisor’s job is to help manage and preserve that value. Many investment professionals, whether advisors, brokers, or in-house portfolio managers, tend to measure the success or failure of portfolio management decisions solely through how much yield the portfolio generates in comparison to peers’. Peer group analysis can be an important tool, but the problem with relying purely on that approach is that it typically ignores credit and price risk and the differences between banks’ footprints, balance sheets, overall profitability and the strength of loan pipelines. Bank portfolios should be managed not just in the context of the market or in relation to what the herd is doing but in the context of the individual institution’s business.

The investment management process should be transparent. Some advisors use a “black box” approach that determines buy and sell recommendations. Community banks should be suspicious about a process that is difficult to understand or explain; the banking sector is littered with stories of institutions that got into serious, even life-threatening, trouble when they invested in products they did not fully understand or correctly analyze. The promise of consistently buying “cheap” bonds over time is a hollow one – the bond market is too big and too deep to not be efficient. Attempting to call market tops and bottoms trying to realize gains through trading is extremely difficult to do consistently and in most cases is inappropriate.

What hiring an advisor means
Hiring an advisor means bringing in additional expertise to the bank, and all levels of the bank should benefit.

At the board level, an advisor should provide regular updates not only of portfolio performance and the broader economic environment but of business trends experienced by its other clients. Board communications should be regular – at least quarterly – and should be strategic and high-level as opposed to tactical in nature. The advisor should have experience in presenting financial ideas to nonfinancial professionals. The board should expect insight regarding the direction of the industry, advice on balance sheet positioning and broad sector recommendations.

Management and staff will have a different type of relationship with the advisor. The RIA will discuss broad strategy with managers during regular calls and presentations to ALCO. It will also discuss how to implement those strategies and, in the case of individual transactions, their execution. The advisor’s job is to present ideas and execute them, but only after management gives its approval for each and every transaction. The bank gives up absolutely no authority to transact business; the relationship with an investment advisor is nondiscretionary, and the advisor cannot trade on the bank’s behalf without permission.

Ideally, this relationship has the benefit of saving significant time for management while distilling the most important macroeconomic, balance sheet and business issues that management needs to address. Supervisor access to unbiased research and education is just as important as the advice the advisor gives; management will always make the ultimate decision.

How the advisory process should work
A department store might have sweaters on sale, but that doesn’t help someone who is looking for a suit. The advisory process should never start with an individual trade recommendation. Rather, a top-down approach should ensure that whatever happens in the portfolio is consistent with the bank’s broader goals.

Vining Sparks Asset Management is a wholly-owned subsidiary of Vining Sparks IBG, ICBA Securities’ clearing broker. VSAM, a Registered Investment Advisor, provides a full-service asset management program for community bank investment portfolios. For a consultation regarding the benefits of an RIA, contact either author or your ICBA Securities sales rep.
The first step involves the combination of a macroeconomic analysis of the industry and the markets along with an analysis of your institution. That should produce a set of strategic priorities for your institution and help refine existing goals.

The second step formulates a balance sheet and risk management strategy consistent with management’s business objectives and determines which goals can be addressed through the investment portfolio.

The third step should result in the correct portfolio structure to carry out that strategy. Only then should the advisor present and discuss specific sectors with management. This is where an advisor’s relative value analysis and specific recommendations come into play. Talking about the right tools for the job – individual bonds – is premature without knowing exactly what that job is.

Once the advisor has identified specific buy and sell recommendations, management needs to understand, agree with, and approve each potential transaction. At this point the advisor goes out into the market and executes, always with an obligation to provide the best available bids and offers to the bank. It is fair to ask whether an advisor has strong relationships with brokerage firms that can provide the most competitive bids and offers. Trade documentation includes the bank’s broad strategy, the individual trade that fits into the strategy, and evidence of best execution on behalf of the bank. The back-office mechanics of executing transactions effectively remain unchanged.

A guide for community banks to rebuild and strengthen their business

With Community Banking Strategies, author Vincent Boberski, a financial professional who has spent years working with senior management and the boards of directors at local banks, skillfully reveals how community banks can compete against bigger institutions in the wake of the most significant financial crisis since the 1930s.

Chapter by chapter, he offers practical advice on many of the most important issues in this area, including portfolio management, balance sheet management, and dealing with interest rate and credit cycles. Along the way, Boberski also offers in-depth insights on establishing and encouraging the lasting client relationships that produce the most essential piece of the banking business: focusing on increasing core deposits, which is at the heart of any good local bank.

- Details the strategies, products, and tactics that will enable community banks to create opportunities out of market dislocations and effectively manage risk
- Reveals how to capture consistently profitable growth at the expense of regional and national competitors
- Discusses what it takes to transform newfound market dynamics into customer relationships that touch both sides of the balance sheet

Community Banking Strategies will be available in the ICBA Bookstore at the 2011 ICBA National Convention.
An ongoing relationship should mean continuous monitoring of the individual trade, the broader strategy it fits into, and economic and market conditions. A material change in any one of those factors should prompt a review outside of the regular monthly or quarterly management and board updates. Benchmarking performance versus peers can be part of those regular reviews, although meeting the bank’s predetermined goals in terms of earnings and risk management is the primary definition of a strategy’s success.

**A perfect fit**

Most community banks possess sufficient in-house resources to manage their investment portfolios adequately. Increasing complexity in bank-suitable investments and ever-growing regulator demands notwithstanding, banks have generally been able to step up their stewardship of the bond portfolio to meet their strategic objectives.

Technology advances have had a lot to do with this achievement. For example, ICBA Securities and its clearing broker, Vining Sparks, have consistently increased the online availability of bond data for all ICBA members. Historical and projected loss severities on many private-label CMOs are displayed on the member’s own portal on www.icbasecurities.com. Current cash flows and price volatilities for the entire portfolio are likewise available. Other full-service brokers have similar offerings.

Investment education has improved as well. Not only are research archives more readily accessible, but online directories of current and past webinars make it very convenient for portfolio managers to stay up to date on investment products and strategies.

However – there is always a however – most community banks do not dress their investment portfolios for maximum effect. Utilizing professional services as we’ve described can create a wardrobe of advantages.

An outside advisor working with your bank as an RIA can help management arrive at a suitable investment strategy. From there, the advisor should be able to improve execution of individual trades by canvassing broker/dealers in the marketplace. In plain terms, this means minimizing commissions paid by the investor.

Ultimately, the decision to hire an outside advisor to manage the investment portfolio is a question of fit. Most bank managers are content with their current in-house management because of the relative lack of activity in the portfolio, the belief that they have adequate experience and capabilities on staff, or productive relationships with existing brokers. But for hundreds of other community banks, the best choice for an investment alteration is to hire a reputable advisor to tailor-make the portfolio for maximum and lasting benefits.

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The ICBA Community Bank Investment Institute is designed to provide community bankers with the knowledge needed to plan and manage effective community bank portfolios and to meet bank objectives. Institute topics will progress from the basics to more advanced topics during the session. You will learn something new, regardless of your level of experience.

Visit www.icbasecurities.com for more information or to register for either conference or call us at 800-422-6442.