

# CU-ALM REPORT

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## GOOD GRIEF!


**GOOD GRIEF!** Could any of us have imagined the events of the past three months? When I wrote the article in the May 2008 issue of *CU-ALM REPORT* that talked about the forthcoming bailout, I had no idea of the staggering proportions that it would take. In reality, none of us knows the extent of the damage that will be revealed as all of the garbage washes through the income statements of the nation's financial institutions.

Fortunately, it appears that most credit unions were bystanders to the exuberant excesses of the commercial banks, investment banks, and capital markets. Credit unions appear to be safe and well-capitalized. Many appear to be extremely liquid, lacking only qualified and willing borrowers when it comes to making loans.

Although I fully understand that credit unions would much rather make loans to members than invest funds into the capital markets, I believe that for the foreseeable future loan demand will not tax the liquidity of the credit union system. So, one of the most pertinent questions that credit unions must answer today is what to do with the excess liquidity found on many credit union balance sheets.

The easiest thing to do is keep it in a safe and sound, very short-term investment, which, as I write this, offers a near-0% yield. I believe there is an alternative that credit unions should consider: "Laddering" their investment portfolio out a little bit farther and enjoy some of the yields from the intermediate-term part of the yield curve. At the present time, that doesn't offer a whole heck of a lot; but, over time, the difference between short-term and intermediate-term investments can be anywhere from 100 to 300 basis points with all other factors being equal.

Laddering is the fixed-income equivalent of diversification. You don't know what rates are going to do in the future, so you lock in a diversified group of rates with a laddering strategy. To this end, I have asked my friend Larry Miele of Wachovia Securities to share his insight and ideas with regard to investment strategies at this time. Neither Mark H. Smith Inc. nor I as an individual have any relationship with Larry other than mutual respect for each other's skills.

I always hesitate giving investment advice. Nevertheless, some of our clients may profit from a slightly more aggressive investment strategy. In the end, the investment decisions you make will be your own and I wish you success with whatever choices you make. 

## INVESTMENT STRATEGIES TO BUILD INCOME



*The following guest editorial represents the opinions of its author Larry Miele. For additional information regarding the topic of this article, please contact Larry directly. His information is at the end of the article.*



**W**ith so much uncertainty surrounding the next couple of years, if there was ever a time when credit unions should be focused on constructing a solid, well-built investment portfolio it is now. Many of the credit unions I work with have been the beneficiaries of a flight to safety from other types of investments. No surprise, the inflow of credit union deposits has outpaced loan demand across the United States and Canada. So, if you fall within this category, it is essential that you consider the basic principles behind investment portfolio construction. A little history on how we got to this point first.

There is no question, that we are witnessing a once-in-a-century unraveling of the financial system as we have always known it. Throughout history, just about every industry has endured a recalibration of one sort or another, whether it was textiles, steel, or railroads. The metamorphosis of each of those industries resulted in game-changing strategies that reshaped the way their markets operated and which participants were strong enough to survive. In the case of the banking and financial markets, what we were initially seeing was the deleveraging of the United States, but the rest of the world followed. There were many reasons that led to the breakdown of credit markets; but those go beyond the scope of this article. The primary reasons, however, would be cheap and easy credit as well as questionable regulatory oversight.

As I prepare this article, I am pleased to report that the global fixed-income markets which we work within have begun to regain the confidence necessary to operate efficiently. While we are not anywhere near the end of all of this, we are definitely on the right trajectory as measured by credit spreads and liquidity. Make no mistake, whatever we learn coming out of this transformation will reward efficient, well-positioned institutions and, *hopefully*, create constructive oversight to prevent a mess like this from occurring in the future. Thankfully, the Federal Government, whether one likes *(continued on page 2)*

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## INVESTMENT STRATEGIES TO BUILD INCOME *(continued from page 1)*

it or not, has helped restore and maintain a lot of the confidence that is necessary for all of us to perform our roles in the capital markets. Throughout the history of civilization, it is well documented that the success of any society has always hinged upon a strong and successful banking system. Failure to have one in place has resulted in civil unrest and the ultimate failure of an economy. In the United States alone, this has happened on several occasions in our early history as a country. Thus, it is in every citizen's best interest to get as many of the problems fixed as soon as possible, and—I hate to say this—but at whatever the cost.

These are uncharted waters for everyone, including the Federal Reserve and the US Treasury. It is important to realize that the playbook for “repairing” the system and restoring confidence is being rewritten every day. Logic dictates that not every idea that is being invented is going to be effective or even work at all; thus, it may take several attempts.

Since the magnitude of the situation is global in nature and enormous in size, the inventors of all of these new government

programs designed to provide liquidity (i.e., TARP, TALF, commercial paper lending facilities, etc.) will initially have no idea how long it will take for the money being thrown at the problem to prevail. The goal is to inject liquidity into the capital markets and back into the banking system as fast as possible.

Admittedly, this is a work in progress, one that may take a lot of time. I cannot emphasize enough to you *(con't on pg 3)*

**CU-ALM REPORT** is a publication of Mark H. Smith Inc. that contains opinions, articles, and insight into many facets of credit union operations. At times it offers suggestions in the decision-making process. We are not registered investment advisers and our suggestions tend to be general in nature. While we are happy to share our insights and thoughts with our readers, it is important to understand that the responsibility for implementing the ideas or strategies suggested in these pages rests solely with the credit union's management.

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## INVESTMENT STRATEGIES TO BUILD INCOME *(continued from page 2)*

how many industry professionals tell me on a daily basis that the cash is there in the banking system—the problem is the lack of loan demand as well as the concern for deteriorating credit quality. It is the latter concern that has been criticized by the government; lenders may be willing to lend but are afraid to do so for fear of being criticized by their regulator. This is a crisis of confidence that will eventually correct itself as the economy improves; but since no one I know disputes the fact that we are in the early stages of a lengthy recession, I would venture to say that problem will take a bit of time to work itself out.

In the meantime, many institutions are wondering what they are supposed to do with building cash balances from slow lending and a flight to quality away from the equity market. Based on the number of retirees and the unprecedented level of fear, many analysts are predicting that money may be permanently leaving the equity markets. With that said, as overnight and short-term rates are at their lowest levels in history, keeping excess balances too liquid is *not* a good solution. If the credit union's goal is to retain this potentially stable source of funding and meet its members' expectations of above average returns, then we are faced with a dilemma. This historical situation will necessitate the need to find the higher returns that are suitable for the balance sheets of small- and mid-sized credit unions. If handled properly, this could work out very well for your institution.

At this point in this article, depending upon your institution's level of experience and sophistication, not to mention the permissibility of your investment policy, the advice I can provide could go in several directions. Since the audience of this article is typically smaller credit unions, I will restrict my recommendations to the generic and time-tested strategy of laddering. For those of you who may want to consider a more sophisticated strategy, I would be happy to discuss this with you. My contact information is at the end of this article.

The concept of laddering investment maturities is one of the simplest and easiest to understand methods of investing excess liquidity. There are many varieties to this strategy that will depend on preferences and policy limitations, but in general it can be done with treasuries, US Agency bullets and high-quality, 1x callables, as well as FDIC-insured CDs. A bond or CD ladder works by spreading investment dollars among securities that will mature or are likely to be called (1x calls) at various times between one and as many as thirty years from now. Since the readers of this article are typically smaller, risk-averse credit unions who need liquidity at certain times, we will assume a term maximum of three to four years. If your horizon is longer or shorter, then craft a strategy that coincides with your specific needs.

Since this style of placing investments is called a ladder, think of each individual bond or CD as rungs or steps on your three-

year ladder where each maturity is spaced one month or one quarter apart. As each "rung" in your ladder is retired, your principal is made available for reinvestment into loans or new investments at the then-current interest rates. A ladder is an ongoing work in progress that expands or contracts based on the needs of each credit union.

The value of a ladder of investments is the investment income beyond what one would receive if keeping it in a single maturity or in overnight funds. Since the design of a well-built ladder allows a credit union to capture yields across the term structure of interest rates, reinvestment risk is balanced against the opportunity cost of remaining overly short. Ladders can be customized to suit your needs and investment objectives, such as funding a new branch or seasonal anticipated loan demand by dictating that certain date "rungs" of the ladder are more concentrated than others. For example, on a ladder spread over three years, for a credit union with high auto-loan demands in spring, we would adhere to having more investments coming due at the end of the first quarter than we would in the fourth quarter.

A well-constructed ladder is usually diversified among investment types, as well as issuers. Diversification is always your best friend in any investment strategy. Finally, since an investment ladder enables you to reinvest your assets periodically over time, your portfolio, and consequently your margins, will be less affected by any interest-rate volatility, a concept similar to dollar-cost averaging. If you have individual questions about the mechanics of a basic ladder or any variant we can speak about that one-on-one.

The primary goal of a ladder or any other style of portfolio management is the safe return of principal while generating above-market returns that can be obtained by leaving excess cash balances in short-term funds. By mitigating the potentially large cost of doing the latter, you gain the ability of adding much-needed incremental income to your bottom line at a time when many of your competitors are not. This not only creates a competitive advantage that can translate into the ability to pay higher share rates and lower loan rates, but allows a larger market share during a year that many institutions have written off.

Imagine growing your enterprise while the competition is intentionally shrinking? Try to avoid performing like the masses and be overly concerned about 2009. Make 2009 an opportunity year and exceed the performance of your peer group.

Happy holidays to all.

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