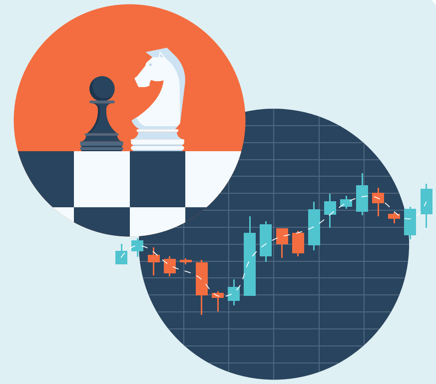
OPPENHEIMER

Immediate Investment Portfolio Strategies

For A Rising Rate Environment: *Part One*



The Problem

In the face of rising interest rates, almost all credit unions will either: ***A. Do nothing*** (caveat: our inaction has consequences); ***B. Do the wrong thing***

How do we recognize and correct this problem –what to do now?

1. Practical and philosophical reasons why CU portolios will underperform – why many CUs will “do nothing” and unintentionally hurt their CU in a rising rate environment.
2. Structural and faulty strategic reasons why credit unions will do the “wrong thing” with their investments during rising rates.
3. What then is “The right approach“ to outstanding portfolio management now that rates are rising?

Section 1 The consequences of “doing nothing”

Practical /philosophical reasons why CU portfolios may underperform during rising rates.

Last month in this space, we issued a warning for 4Q 2018 that CU earnings could be at substantial risk, due to 3-4 potential Fed Fund rate increases this year. We also mentioned a “false sense of security“(relief/euphoria?) that many CUs could express initially in light of higher short term rates.

The reason for this initial reaction to a rate rise is the *temporary* earnings lift that many CUs will experience. As a result, these same CUs will come to the likely conclusion that “we do better (profitability/NIM) in a rising rate environment”. We respectfully submit that this may be correct in the short term, but will be a “false positive”/ mistaken conclusion by 4Q 2018 / 1Q 2019.

Many CUs will “do nothing” and unintentionally hurt their organization –why? There are really 4 main reasons that are practical/philosophical which go to the “traditional” ways that CUs operate:

1. **Credit unions are buy and hold investors** –the investment portfolio is usually not actively managed, e.g. selling a bond out of the portfolio before maturity. ***Downside:*** As rates rise, the CU is locked in at increasingly unattractive yields. This hurts the CU from an income, market value and NEV perspective.
2. **Credit unions only look at their portfolio to provide liquidity** –Typically CUs target maturities/cash flow from investments to fund loan demand and/or deposit outflow. ***Downside:*** During rising rates, as in 2018, the FOMC is reacting to a strong economy. Therefore, CUs have strong loan demand while cash flow from investments is much lower. As a result, the investment portfolio becomes less efficient; illiquid and low-yielding.
3. **CUs Experience Rising Rate “Paralysis” / Indecision + Uncertainty** –Being afraid to do the “wrong thing”, most CUs will do nothing. ***Downside:*** CUs will experience 2 undesired consequences from doing nothing:
   A. Failure to maintain a current level of market income.
   B. Declining market value.
4. **Failure to convert part of the portfolio to variable rate–** Variable rate (see discussion in section 3 of this article on floating vs. adjustable rate) investments increase in yield as short term rates rise. Thus, they are strongly preferred when rates rise. ***Downside:*** Fixed rate investments lose value as rates rise which could be avoided by converting part of the portfolio to variable rate.

Section 2 Why credit unions do the "wrong thing"

Structural and faulty strategic reasons why credit unions will do the "wrong thing" with their investments during rising rates.

There are 3 causes which lead to this - the first 2 are structural and the third is based on faulty strategy.

1. **Most credit unions hold almost exclusively (80%-90%) fixed rate investments as most CUs are familiar with only fixed rate alternatives.** ***Downside:*** The structure/properties of a fixed rate portfolio are not conducive to success in a rising rate environment. Not only would variable rate investments address this problem, but they would act as a hedge to the predominantly fixed rate portfolio as well.
2. **The most common approaches utilized by all CUs in their portfolio approach is either: (1) a maturity ladder; or (2) a "cash flow ladder".** ***Downside:*** *Maturity ladder downside* exists because - while it may be a source of "comfort" - a maturity ladder in a rising rate environment can prove very costly to a CU because the vast majority of the portfolio (typically 70% - 80% beyond 1 year) will lag behind the pace of rising rates. *Cash flow ladder downside* occurs because of the simultaneous rise in rates across the treasury curve resulting in slower prepayments on MBS (mortgage-backed securities) and lower cash flow to reinvest as rates rise.
3. **The "wrong thing" occurs because of faulty strategy due to a lack of knowledge / education on variable rate alternatives.** ***Downside:*** Most CU portfolio managers, and the brokers who sell those bonds, lack experience to develop any strategy but a fixed rate strategy. Even worse, CUs may select the wrong type of variable rate investments - even if they do attempt to respond to rising rates. The 3 biggest mistakes/wrong types of variable rate will be covered in the next section "right approach #3."

Section 3 "The Right Approach"

What then is "the right approach" to portfolio management now that rates are rising? First of all, to understand what is the "right approach" - we should take a look at what our motivation/underlying purpose should be in responding to rising rates. We certainly can acknowledge that we should be thinking "defensively" and that we are trying to protect the Credit Union.

But what are we trying to protect it from?

ANSWER: As market rates rise, we want to "protect" 2 things:

1. **Our CUs Investment Income** –we want this income to continually reflect current market rates - even if rates steadily rise as they have thus far in 2017 and 2018.
2. **Our CUs Investment Market Value** –How many CU executives have squirmed in their seat trying to explain a sharp decline in their FAS 115 market value position to a Board/ALCO?

FACT: Fixed rate bonds lose value as rates rise, driven primarily by the fixed rate coupon lagging further and further behind new and rising market rates.

Thus, in a rising rate environment, there is an inseparable link between a bond's ability to generate **income** at current market rates and its ability to maintain its current **market value**. Fixed rate bonds, by definition, cannot achieve this. Variable rate bonds, in theory and when selected properly, could be able to help fulfill this objective of "protecting" your credit union!

So what is the right approach?

- Move yourself and your CU out of your comfort zone - discard biases and dated fixed rate thinking.
- Educate yourself/align with a new strategic investment partner who will help you understand the optimal strategy for your CU.
- Above all else, know the difference between variable rate alternatives – specially floating rate (frequent coupon reset) and adjustable rate (periodic / infrequent reset) bonds.

Right Approach 1 Discard Typical Comfort Zone CU Thinking/ Philosophy

- "Rates are rising... So what? We'll be fine."
- "I've always stuck to building my maturity/cash flow ladder; buying variable rate investments won't make a difference."
- "I don't want to recommend anything (investments) that my CEO / Board / ALCO is not familiar with."
- "I would have to change my investment policy."
- "I don't have time, my CU is focused on lending."
- "I'm not sure we know how to account for floating rate investments - my GL would be affected and my coupon would keep changing and going up." (Note: That's a *good* thing, right?)
- And my personal favorite, "We've run our ALM reports with an upward shock and ***we actually do better*** in a rising rate environment."

Right Approach 2 Education First

Strongly consider a change in outside investment advice and align with a strategic partner who will help you understand:

- Which floating rate alternatives are permissible under §703.
- How you can realign/re-allocate your portfolio to move a % from fixed to floating rate.
- The potentially positive effects of floating rate investments on:
  - Your ALM position.
  - Addressing your NEV on the new NCUA NEV test.
  - Your future market value and FAS 115 calculation.
  - Your regulator's reaction / view of what you have strategically devised.
  - *Your end result:* The rare opportunity to possibly decrease risk AND potentially increase income.

Right Approach 3 Above all else...

...know the difference between variable rate alternatives - specifically, floating rate (frequent coupon resets) and adjustable rate (periodic / infrequent resets) bonds.

This aspect of the right approach will be the full subject of our next article - Part Two of "Immediate Investment Portfolio Strategies for a Rising Rate Environment."

However, we need a starting point as we leave this discussion until part two of the series. Our starting point is to look at the structure of what we currently hold and/or what our outside investment advice (Broker) is recommending to us now. CUs need to understand what coupons adjust frequently (floaters) versus periodically (adjustable). It was mentioned earlier that there are three distinct "culprits" in the world of variable rate investments which underscore this difference and are being purchased by many CUs in the attempt to "protect" their CU from rising rates. As mentioned earlier, these 3 reset periodically (one year or greater) and don't respond rapidly enough:

- ARM's (Agency adjustable rate mortgage securities)
- Agency fixed to float bonds
- Agency step up callable bonds

Conclusion *What to do now?*

Adjustable rate bonds with only *periodic reset* properties do not have coupons which react quickly enough in a consistently rising rate environment. Especially where the FOMC has indicated the strong likelihood of 3 to 4 fed funds rate increases in 2018. This problem is compounded by the 10 year Treasury reaching 3.00% in late April 2018 – its highest peak since December 31, 2013.

What we can do now is to identify:

1. Our allocation of fixed rate versus variable rate in the portfolio and what our broker is recommending.
2. Distinguish between those investments which reset one year or greater versus those which reset less than one year. Again, we should review those bonds we currently hold and those which our broker may be recommending.

We will look at and compare specific variable rate investment alternatives in part two of this series. Those responsible for the construction and oversight of their CU's investment portfolio should re-open their thinking as to what is best for their CU.

And we always remember, we must be good stewards of **all** the members' money, not just the portion we are able to lend out. Thus, the investment portfolio is an important and significant portion of our overall asset structure and Earnings/Risk Management picture.

Credit Union Investment Strategy Group of Oppenheimer & Co. Inc.

Request your complimentary Portfolio Evaluation today.
Call (844) 616-4431 or email us at regina.wickard@opco.com